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1994 ANNUAL ECONOMIC REPORT

(presented by the Commission)

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CONTENTS

Part A: Community-wide trends

PART B: Economic situation and policy issues in the individual Member States

22-03-94

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PART A

COMMUNITY-WIDE TRENDS

22-03-94

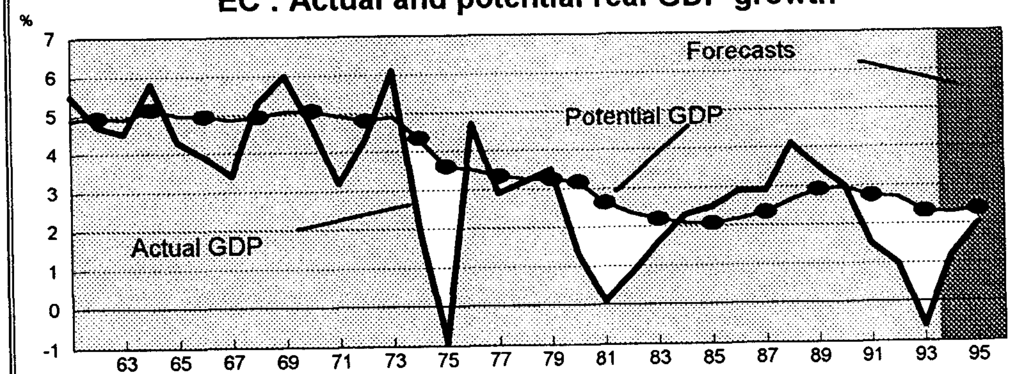
Section 1: The Community economy in 1993

1.1 Main economic trends

In 1993, the period of slow growth or near stagnation, which had started in 1991, turned into an outright recession. Last year, Community output declined by about a quarter of a percentage point in real terms; only the second time in the 35 year history of the European Community that a real decline in GDP was registered. In 1975, in the wake of the first oil shock, the GDP drop had been stronger (almost one per cent), but - in a more pronounced cyclical pattern - the contraction had been preceded and followed by periods of strong growth. The current period of economic difficulties follows a long period of steady and satisfactory growth, but, if the forecasts for 1994 prove correct, the overall loss of output could be larger than that experienced during the 1974-75 and 1980-83 episodes. Employment fell by a record amount - 2.4 million jobs lost in the course of the year - and unemployment increased at a fast pace reaching a level of 10.6 per cent of the civilian labour force.

Chart 1

EC : Actual and potential real GDP growth



The recession had also a strong effect on the Community's convergence performance. Real convergence stalled and nominal convergence presented a mixed result: inflationary pressures abated but budgetary positions deteriorated substantially.

1.1.1. Growth performance of the Community and its main trading partners

1993 was a year of recession...

After a period of strong growth leading to a clear-cut case of overheating in the second half of the 1980s, the Community's economy lost steam in the course of 1990. Under the impact of the policy tightening, essentially through monetary policy, which had taken place in the Community following the appearance of the first serious macroeconomic imbalances and under the impact of the recession which hit the United States in 1991 and other important industrialised countries, the Community's rate of growth fell substantially below potential from the end of 1990 to the first half of 1992. The decline would have certainly been more pronounced had it not been for strong growth in Germany. In the second half of 1992, however, the combination of an absence of signs of recovery, rising unemployment, continued tight economic policies, exchange rate instability and negative political factors provoked a marked deterioration in the expectations of economic agents and turned the period of slow growth into stagnation and, from the beginning of 1993, recession.

Table 1: The Community economy : Use and supply of goods and services and main economic indicators

(annual real percentage change)	1988	1989	1990	1991	1992	1993
Private consumption	4.3	3.2	3.1	1.9	1.8	-0.1
Government consumption	1.9	1.4	2.0	1.5	2.0	0.5
Gross fixed capital formation	8.7	6.9	3.8	-0.3	0.0	-4.6
Domestic demand (incl. stocks)	5.1	3.7	2.9	1.1	1.4	-1.3
Exports of goods and services a)	2.5	5.0	5.7	6.6	3.4	3.6
Imports of goods and services a)	10.5	7.2	4.3	2.5	4.6	-3.1
GROSS DOMESTIC PRODUCT	**4.2**	**3.5**	**3.0**	**1.4**	**1.1**	**- 0.3**
Inflation (deflator private consumption)	3.8	5.0	4.5	5.4	4.6	3.8
Employment	1.5	1.5	1.7	0.2	-1.2	-1.7
Unemployment (% of active pop.)	9.8	8.9	8.3	8.7	9.7	10.9
Public deficits (% of GDP) b)	-3.4	-2.7	-4.0	-4.6	- 5.0	- 6.0
Current account bal. (% of GDP)	0.1	-0.2	-0.4	-1.2	-1.1	-0.6

NB: The figures for the public deficit and the current account balance include the five new German Länder from 1991 onwards. The figures for GDP and its components, inflation and employment/unemployment include the new Länder from 1992 onwards.
a) Extra-Community trade only b) General government net borrowing

... but the economy may have reached the trough

However, there are now some encouraging signs which suggest that the decline in activity may have levelled off since the summer of 1993. The latest survey results also indicate that the Community economy may have reached the trough of the current recession. In the last few months, the main economic sentiment indicators have moved out of the low levels which had been reached and some of them, especially the industrial and construction confidence indicators, are again on a slightly rising trend (see chart 15). In summary, Community GDP increased by 1.4 per cent in 1991, by 1.1 per cent in 1992 and declined by 0.3 per cent in 1993.

Cyclical downturn in majority of Member countries

Notwithstanding the strength of the recessionary forces in 1992, a decline of output was registered only in the United Kingdom, where the economy had already entered into a recession in 1990-91. In 1993, however, most Member countries registered a stagnating or falling GDP with the exception of the United Kingdom, which started to emerge from a very severe recession, plus Ireland, Luxembourg and the Netherlands. The most marked declines occurred in the western part of Germany (- 1,9 per cent) and in Belgium (-1,3 per cent). Substantial declines in output - about one per cent - were registered also in France and Spain, while in Greece, Italy and Portugal the contraction was about a quarter to a half a percentage point. Positive rates of growth of about 2 per cent were recorded in the United Kingdom, where the recovery took hold firmly, and in Ireland. The eastern part of Germany, sustained by large financing flows coming from the rest of the country, again registered a substantial rate of growth (7.1 per cent). As a result, the recorded decline in German GDP was reduced to -1.2 per cent.

Table 2:
Economic growth in the European Community

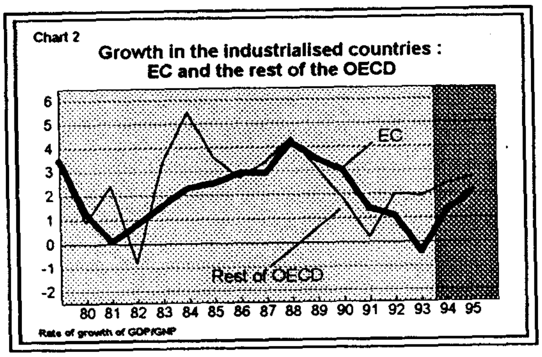
	1988	1989	1990	1991	1992	1993
B	5.0	3.6	3.2	1.8	1.4	* -1.3
DK	1.2	0.6	2.0	1.2	1.2	0.0
WD	3.7	3.6	5.7	4.5	1.6	* -1.9
D	—	—	—	—	2.1	* -1.2
GR	4.1	3.5	-0.1	1.8	1.3	-0.2
E	5.2	4.7	3.6	2.2	0.8	-0.9
F	4.5	4.3	2.5	0.7	1.4	* -0.7
IRL	4.2	6.2	9.0	2.6	4.8	2.0
I	4.1	2.9	2.1	1.3	0.9	-0.3
L	5.7	6.7	3.2	3.1	1.9	0.7
NL	2.6	4.7	4.1	2.1	1.4	* 0.3
P	3.9	5.2	4.4	2.1	1.1	-0.5
UK	5.0	2.2	0.4	-2.3	-0.5	* 2.1
EC(1)	4.2	3.5	3.0	1.4	1.0	* -0.4
EC	—	—	—	—	1.1	* -0.3

(1) Excluding the five new German Länder
European Commission estimates of November 1993 except for the figures marked with an asterix where more recent information has been included

Community output developments opposite to those of the rest of the World

In 1993, the recession in the Community contrasted with an improving performance in the world economy. After having practically stagnated in 1991, output in the rest of the world picked up slowly and expanded in 1993 by 2.2 per cent. The differing European and world performances are essentially due to the recovery in the USA and to the substantial growth registered in the non-OECD countries, especially those of south-east Asia and of Latin America. Japan and most of the other OECD countries, on the other hand, registered unsatisfactory growth figures. The divergence in the GDP performances is mirrored in the trade figures. The combined imports of the rest of the world increased by more than 8 per cent in real terms, while EC imports from the rest of the world declined by about 3 per cent.

The recovery of the US economy, which had entered into recession before Europe and Japan, was slower than in the past: a drop in GDP of just above one per cent in 1991 was followed in 1992 and 1993 by rates of growth of 2.6 and 3 per cent respectively. The recovery of employment was also weaker, but in 1993 employment still expanded by 1.5 per cent, a figure which compares favourably with the performance of many other industrialised countries. The main factors supporting growth were historically low interest rates, which supported the restoration of financial equilibrium in the private sector, and a continued relatively weak US-dollar which led to a substantial increase in exports. In addition, strong growth impulses came from the wide-ranging structural adjustment efforts of the business sector, especially industry, which were associated with high levels of investment.



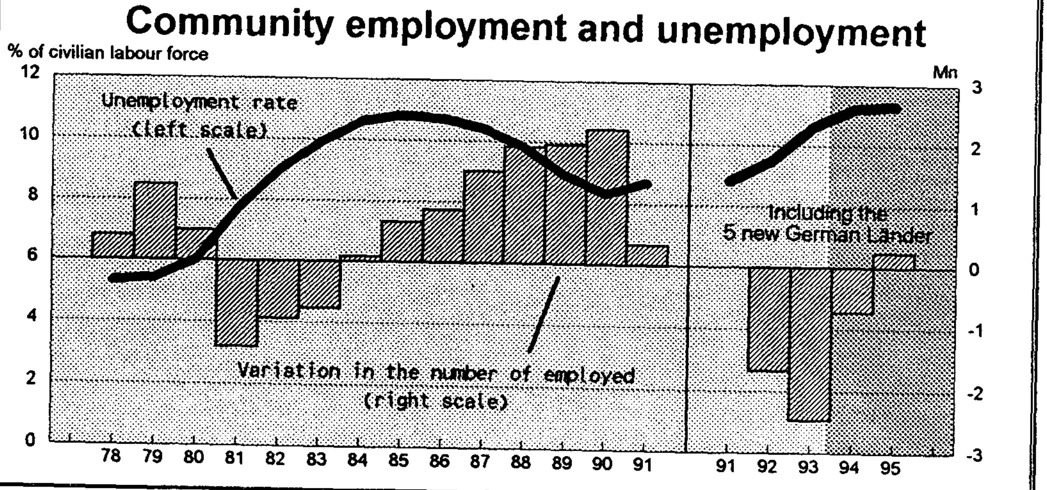
The Japanese economy, on the contrary, is experiencing a period of very weak growth. In 1993, output stagnated for the first time since 1974. One important factor behind the slowdown was the need for firms and households to adjust their spending behaviour following the large variations in asset prices which had taken place. As in Europe, there are as yet no clear signs of recovery. A small positive contribution could come from the monetary and fiscal easing which has taken place, but the appreciation of the yen will be an important negative force.

In Europe, the EFTA countries experienced their third consecutive year of output fall in 1993 (-1.1 per cent). This was the result of both the weakness of the domestic economy and of the decline in their European Community export markets. The economies of Central and Eastern Europe continued to be affected by a number of factors, including the adjustment programmes undertaken to move to a market economy, the collapse of CMEA trade and a severe drought. After a large contraction - about 10 per cent in real terms - in 1991, output continued to decline in most countries in both 1992 and 1993, though in all of them the decline was smaller in 1993 than in 1992. A positive rate of growth was registered, however, in Poland.

1.1.2. *Recession causes further fall in employment...*

The 1992/93 recession has led to a sharp fall in employment and a marked increase in unemployment. This is due both to the severity of the decline in economic activity and to the fact that employment trends have become more responsive to the economic cycle (see chart 4). In the second half of the 1980s, satisfactory, but historically not exceptional, rates of economic growth led to record rates of increase in employment (between 1.2 and 1.7 per cent a year). In 1993, the recession resulted in a decline in employment of almost 2 percent (-1.7 per cent), another, unwelcome, record in the

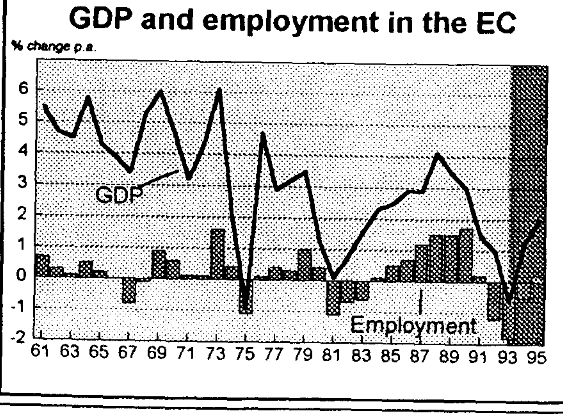
Chart 3



Community's economic history. Even excluding the eastern part of Germany, where the employment losses are essentially due to the wide-ranging adjustment taking place, the current recession has cost, until now, around three million jobs.

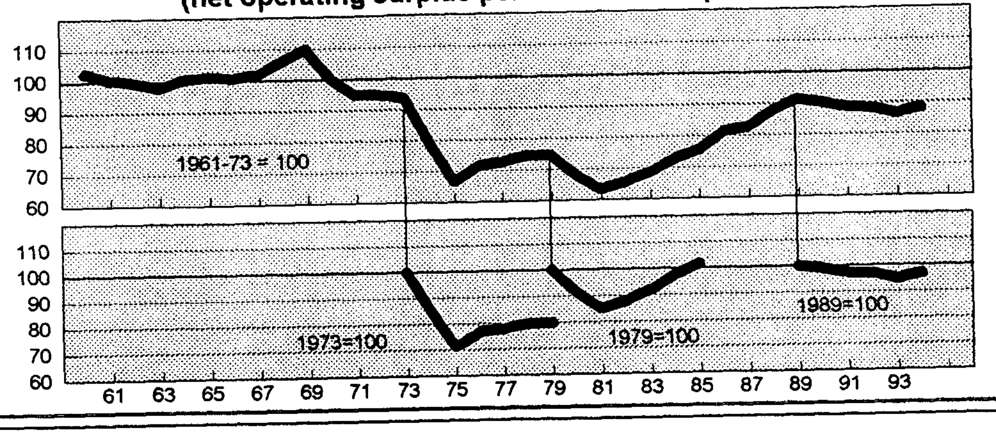
Taking into account the expected drop by a further half a point in the current year, the employment loss incurred during the present period of economic difficulties is larger than those of the two previous economic crises. The total contraction in employment over the period 1992-1994 is likely to reach 2.7 per cent excluding the eastern part of Germany or 3.4 per cent if this area is included. By contrast, employment declined by 2.4 percent over the period 1981-1983 and by only 1.1 per cent in 1975.

Chart 4



The greater cyclical responsiveness of employment to economic trends,

Chart 5 **Investment profitability in the EC**
(net operating surplus per unit of net capital stock)



however, prevented a repeat of the strong deteriorations in investment profitability which were experienced during previous recessions which means that, all other things being equal, the recovery could be faster and more durable.

Table 3

	Employment (1) (annual percentage change)						Unemployment (2) (as percentage of the civilian labour force)						
	1988	1989	1990	1991	1992	1993	1988	1989	1990	1991	1992	1993	
B	1.5	1.6	1.4	0.1	-0.4	*-1.4	10.2	8.6	7.6	7.5	8.2	9.4	B
DK	-0.6	-0.6	-0.5	-0.9	-0.1	-1.0	6.4	7.7	8.1	8.9	9.5	10.4	DK
D (1)	0.8	1.5	3.0	2.6	0.9	*-1.7	6.3	5.6	4.8	4.2	4.5	5.6	D (1)
D	--	--	--	--	-1.7	*-2.0	--	--	--	5.8	6.8	8.1	D
GR	1.6	0.3	1.2	1.3	2.1	0	7.7	7.5	7.0	7.2	7.5	7.6	GR
E	2.8	3.4	3.2	0.5	-1.9	-4.3	19.3	17.1	16.2	16.4	18.2	21.5	E
F	0.9	1.3	1.0	0	-0.5	-1.4	9.9	9.4	9.0	9.5	10.0	10.8	F
IRL	* 0.0	* 0.9	* 2.9	* 0.3	* 0.5	* 0.7	17.3	15.7	14.5	16.2	17.8	18.4	IRL
I	0.9	0.1	0.8	0.8	-0.9	-1.5	10.9	10.9	10.0	10.1	10.3	11.2	I
L	3.1	3.7	4.3	4.3	1.9	1.1	2.0	1.8	1.7	1.6	1.9	2.6	L
NL	1.6	1.9	2.3	1.5	0.8	-0.8	9.3	8.4	7.5	7.1	7.2	8.8	NL
P	0.1	1.0	0.9	0.9	-0.6	-1.9	5.7	5.0	4.6	4.0	3.9	5.0	P
UK	3.2	2.5	1.1	-3.1	-2.2	-1.3	8.5	7.1	7.0	8.9	10.2	10.5	UK
EC(3)	1.5	1.5	1.7	0.2	-0.6	*-1.7	9.8	8.9	8.3	8.7	9.4	10.5	EC(3)
EC	--	--	--	--	-1.2	*-1.7	--	--	--	8.9	9.7	10.9	EC

(1) European Commission estimates of November 1993 except for the figures marked with an asterix where more recent information has been included. (2) Harmonised Eurostat definitions (3) Excluding the five new German Länder

Given these employment trends, unemployment continued to increase rapidly. Notwithstanding a slowing down in the average rate of increase in the labour force, unemployment in the European Community increased by 0.4 percentage points in 1991, by 0.7 points in 1992 and by more than a full point (1.1) in 1993.

The average rate of unemployment for the Community stood in 1993 at 10.6 per cent and was therefore practically back to the previous record level reached in 1985. The wide differences in the individual performances of the Member States persisted and actually increased. In Spain unemployment rose to over 21 per cent and in Ireland to over 18 per cent. In Germany the corresponding rate was less than 6 per cent for the western part of the country and about eight per cent for the country as a whole.

1.1.3. Convergence situation in the Community

The current economic difficulties have also had a profound effect on:

- ***real convergence***, the long term process of narrowing the differences in standards of living, and
- ***nominal convergence***, the improvement in the individual performances in terms of inflation and public finance positions which is necessary for the transition to Economic and Monetary Union.

Real convergence: catching-up process stalled

Of the four poorest Community countries only Ireland was able to achieve a positive growth rate of economic activity in 1993 and thus improve its relative position. In the other three countries output contracted: in Greece slightly less than the Community average, in Portugal close to, and in Spain somewhat more than, the average. As a result, no significant changes could be registered for these countries in their relative positions in terms of GDP per head (the indicator usually used to approximate real standards of living). Unemployment, on the other hand, increased in all these countries including Ireland (see table 3). The deterioration in this respect was very strong in Spain where unemployment increased by more than 3 percentage points whereas in the

Table 4:
GDP per head * (PPP, Community = 100)

	1985	1990	1992	1993
B	104.7	104.1	107.0	106.2
DK	114.2	106.2	104.9	105.8
WD	118.9	117.3	120.3	117.4
D	---	---	104.9	104.0
GR	51.3	47.2	48.9	49.0
E	70.5	75.0	75.7	75.7
F	112.0	110.7	109.7	109.2
IRL	64.8	71.3	75.4	77.4
I	102.6	102.3	102.9	103.6
L	120.3	126.6	128.9	130.1
NL	104.4	101.9	100.2	100.2
P	51.4	55.9	60.7	61.1
UK	100.9	101.4	96.2	98.9
EC(1)	100.0	100.0	100.0	100.0
EC	----	----	97.3	97.7

* GDP figures may over/underestimate a country's command over its income.
(1) Excluding the five new German Länder

other three countries the increase was smaller than that registered in the Community as a whole.

Progress in nominal convergence mixed

The recession had mixed effects on the nominal convergence performance of the Community: on the one hand, it provoked a new deterioration in the average budgetary position but, on the other, it contributed to the reduction of inflation.

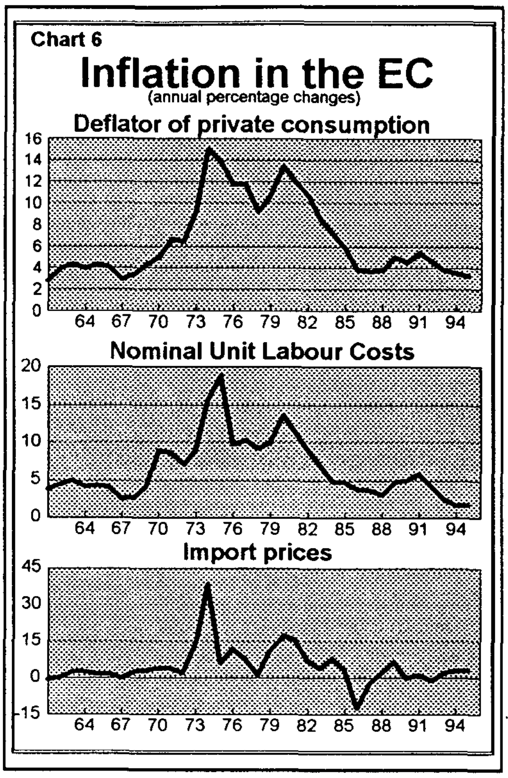
While past budgetary trends are reviewed in greater detail in the next section, some of the main features can be underlined here. Between 1991 and 1992 five Member countries were able to reduce their budget deficits as a percentage of GDP notwithstanding the economic slowdown. In 1993, however, general government net borrowing expressed as a percentage of GDP increased in many Member States. The public debt/GDP ratios also increased throughout the Community.

Significant progress was achieved on inflation. After its peak of 5.4 per cent in 1991 the private consumption deflator fell to 4.6 per cent in 1992 and to 3.8 per cent in 1993 despite the modest acceleration in import prices in 1993 and the impact of various indirect tax increases. Lower energy prices made a significant contribution. A better result was only achieved in 1987 (because of the fall in the price of oil) and during two years in the 1960s. The average of the three best performing countries also declined from 2.4 per cent in 1991 (IRL, B, DK) to 2.1 per cent in 1992 (DK, B, F) and to 1.8 per cent in 1993 (DK, IRL, NL). The trend of the deflator of GDP was very similar (5.3 per cent, 4.6 per cent and 3.6 per cent respectively during the three years 1991 to 1993). Impressive as these comparisons are, they should not lead to complacency given that the decline in inflation has been achieved

Table 5

	Inflation (Deflator of private consumption)			**Budget deficit** (General government net borrowing)		
	1991	**1992**	**1993**	**1991**	**1992**	**1993**
B	2.5	2.1	2.8	* -6.8	* -7.1	* -7.0
DK	2.5	1.9	1.4	-2.2	-2.6	-4.4
WD	3.8	4.0	3.4	-3.5	-2.3	* -2.8
D		4,8	4.0	-3.2	-2.6	* -3.3
GR	18.4	14.9	13.7	-16.3	-13.2	-15.5
E	6.3	6.4	4.7	-5.2	-4.6	-7.2
F	3.0	2.4	2.3	-2.1	*-3.8	* -5.5
IRL	2.3	2.6	* 2.0	-2.0	* -2.3	* -2.3
I	6.9	5.4	4.4	-10.2	-9.5	* -9.4
L	2.9	2.8	3.6	-1.0	-2.5	-2.5
NL	3.4	3.0	2.1	-2.5	-3.5	-4.0
P	11.1	9.7	6.7	* -6.6	* -3.3	* -7.1
UK	7.4	4.8	3.4	-2.7	* -6.3	-7.6
EC	5.4	4.6	3.8	-4.6	-5.0	* -6.0

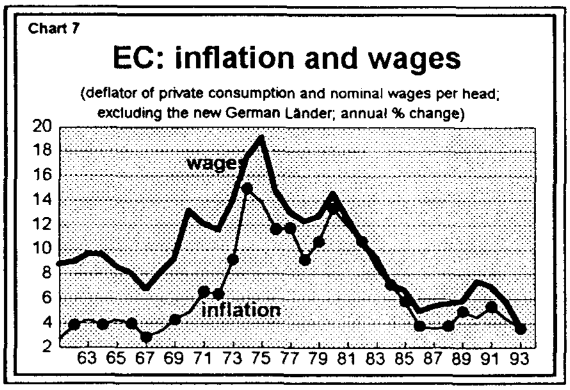
European Commission estimates of November 1993 except for the figures marked with an asterix where more recent information has been included



after a very long period of below potential growth.

Some encouragement can be drawn from the fact that wage trends, especially towards the end of 1993 and at the beginning of 1994, are moderating (see chart 11). In 1993, nominal compensation per employee is estimated to have increased by 4.1 per cent for the Community as a whole. This figure is much lower than those recorded in the 1970s and in the 1980s when inflation was higher, but it is also substantially lower than those recorded in the 1960s. The comparison with this last period, however, has lost much of its relevance since the high nominal wage increases of those years were made possible by high rates of increase in productivity.

In 1993, the rate of inflation increased only in Luxembourg and Belgium and this was due to a large extent to the consequences of indirect tax increases. Particularly successful in reducing the rate of inflation were Portugal, the United Kingdom, Italy and Spain, countries where the rate of inflation was above the Community average in 1992. Five Member States recorded encouraging rates of inflation of between two and three and a half per cent while Denmark experienced a rate of 1.4 per cent (see table 5). Germany, which is still suffering from the inflationary consequences of unification, plus Spain and Italy recorded rates of inflation of between 4 and 4.7 per cent. The rate of inflation remained well above the Community average in Portugal and especially in Greece. Although Greece has made considerable progress in reducing its inflation during the past three years, the divergence of its price trends from the Community average continues to be pronounced.



1.2 The policies

During the course of 1993, policy makers were confronted with very difficult choices. On the one hand, the worsening of the recession and the concomitant increase in unemployment were calling for a substantial stimulus to activity. On the other, the worrying budgetary situations in most countries and the resilience of inflationary pressures in some were suggesting the need for caution. The widening of the ERM margins in August added a new dimension to the debate through the effective removal of the exchange rate constraint.

The discussions in the European Council meetings in Edinburgh, Copenhagen and Brussels and the initiatives that were decided on these occasions show that employment and growth again became the priorities for concern in the Community. This was reflected in the conduct of macroeconomic policy especially with regard to the budgetary decisions taken by Member States. As a result of the decisions of governments and central banks, the overall stance of macroeconomic policy in the Community eased significantly. However, the heavy inheritance of the previous years prevented economic policy from becoming as supportive to demand as the depth of the recession would have called for.

At the same time, the severity of the situation increased the awareness of the need to improve the functioning of the Community's economy through determined action in the area of structural policies. Substantial progress in this respect took place, especially in countries where resistance to change had previously been strong. At the Community level, such concern led to the elaboration by the Commission, with contributions from all the Member States, of the White Paper on "Growth, Competitiveness and Employment" which was endorsed by the Brussels European Council and transformed into an action plan to revitalise the economy.

1.2.1 The inheritance from the recent past

The stance of economic policy in the course of 1993 was largely shaped by the very unbalanced situation existing at the end of the previous year. In turn, this was the result of past policy decisions to such an extent that it is useful to retrace the events that led to the situation existing at the end of 1992.

i) ***1987 to mid-1988***. Between 1987 and 1988, the overall stance of economic policy in the Community became expansive. Monetary policy was loosened in the course of 1987 in response to the abating of inflationary pressures, the relative weakness of economic activity and in application of the Louvre accord aiming to prevent further falls in the value of the dollar vis-à-vis the European currencies. An additional substantial loosening took place towards the end of 1987 as the authorities attempted to prevent the sharp fall in share values from negatively affecting consumption and investment.

Table 6: Interest rates in the European Community *

	1987	Dec. 1987	May 1988	Dec. 1988	Oct. 1989	Dec. 1989	1990	1991	May 1992	Dec. 1992
Short-term interest rates	8.4	8.0	7.5	9.5	11.3	11.7	11.4	10.8	10.7	11.0
Long-term interest rates	9.0	9.4	9.0	9.1	9.8	10.2	10.9	10.2	9.6	9.6
long-term _minus_ short-term	+0.6	+1.4	+1.5	-0.4	-1.5	-1.6	-0.5	-0.6	-1.1	-1.8
real short-term rates	5.0	4.7	4.2	5.0	5.8	6.1	5.4	5.5	5.6	7.1
real long-term rates	5.5	6.0	5.6	4.6	4.4	4.7	4.9	4.9	4.6	5.8

* Weighted averages for the Community. Real interest rates are computed using the consumer price index.

Budgetary policy also supported economic activity. Between 1987 and 1988, the cyclically adjusted budget deficit for the Community as a whole deteriorated by about half a point (see table 7)[1]. This average figure is the result of a discretionary loosening of budgetary policy in a majority of countries. In most cases, the discretionary loosening took the form of cuts in fiscal receipts and was largely the result of medium-term considerations.

This overall economic policy stance can be explained by the widespread fear that the stock exchange crash might halt the hesitant recovery which had been under way for some time. Indeed, the forecasts for 1988 produced at the turn of the year by many private and public organisations were quite gloomy. In the case of the European Community, the forecasts were suggesting growth of no more than one and half per cent (the outturn was 4.2 per cent).

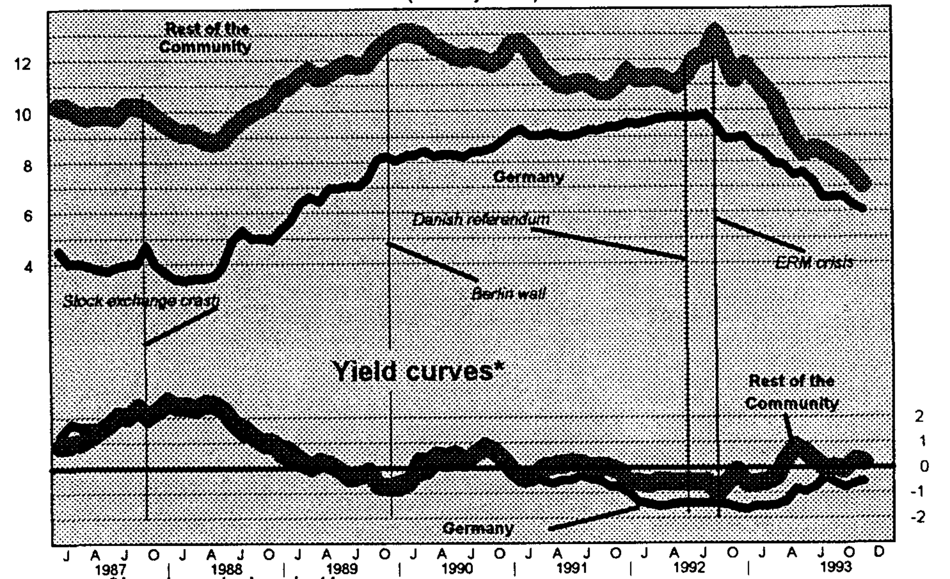
ii) ***Mid-1988 to end of 1989***. The authorities' policy reaction was probably very effective in preventing the stock exchange crash from affecting confidence.

[1] In view of the difficulties to account correctly for the influence of the economic cycle on revenue and expenditure, these figures are to be treated with caution. However uncertain the absolute figures may be, the direction of the change remains significant.

Chart 8

Short-term interest rates and Yield curves in the Community and in Germany since 1987

(monthly rates)



* Long term rates less short term

However, it also stimulated an economy which was in a better state than the economic evidence available at the end of 1987 suggested. Thanks also to factors such as the internal market programme, better investment profitability, financial liberalisation and the delayed effects of the reduction in oil prices, the pace of economic activity accelerated significantly. The recorded rate of growth in the Community in 1988, 4.2 per cent, was the strongest since 1976, and is estimated to have overshot potential output growth by about one and a half percentage points (see chart 1 and table 8).

In response to the unexpected dynamism of the economy and to counter the risk of renewed inflationary pressures, monetary policy was tightened throughout the Community from mid-1988 onwards. Budgetary policy, on the other hand, was only moderately tightened as many countries continued to implement previously announced tax cuts. Notwithstanding the monetary tightening, the economy continued to grow at a pace higher than potential growth. Capacity utilisation reached a record level and inflationary pressures started to increase. Fuelled also by a strong increase in import prices, inflation recorded a significant acceleration: 5 per cent in 1989 against 3.8 per cent in 1988.

iii) In *1990*, budgetary policy became very expansionary with the estimated cyclically adjusted budget deficit deteriorating by 1.7 points of GDP and the actual deficit deteriorating by 1.3 points. This deterioration was due not only to developments in Germany, where the unification-induced surge in spending came on top of the tax reductions resulting from the last portion of the tax reform decided in 1988, but also to the attempts of the governments of many other Member States to counter the first signs of the incipient economic slowdown. Wage trends, which had remained relatively under control up until the previous year, reacted to the acceleration in inflation and as a result wage increases per head accelerated strongly (7.4 per cent against 5.8 per in 1989; see table 9).

Table 7: Main budgetary trends in the European Community (% of GDP)

	1987	1988	1989	1990	1991	1992	1993
Budget deficit	- 4.0	- 3.4	- 2.7	- 4.0	- 4.6	- 5.0	- 6.0
Cyclically adjusted budget deficit	- 3.6	- 4.1	- 3.9	- 5.6	- 5.7	- 5.7	* - 5.9
Cyclically adjusted receipts	44.7	43.4	43.1	42.6	43.7	44.5	* 45.8
Cyclically adjusted total expenditure	48.2	47.4	47.0	48.2	49.5	50.1	* 51.7

Including the new German Länder from 1992 onwards * European Commission estimates of November 1993

Table 8: Indicators of output and labour market tensions (EC)

	1987	1988	1989	1990	1991	(2) 1992	1993
Actual less potential rate of growth (1)	0.5	1.5	0.6	0.0	-1.4	-1.6	-2.6
Capacity utilisation	82.6	84.0	85.6	85.0	82.1	80.4	77.6
Unemployment rate	10.4	9.8	8.9	8.3	8.8	9.7	10.9
Inflation (GDP deflator)	4.0	4.3	4.9	5.2	5.3	4.6	3.6

(1) Potential rate of growth approximated by the rate of growth of the capital stock (2) Including the new German Länder from 1992 onwards

iv) ***1991-1992.*** In the light of these developments monetary policy became even more restrictive in 1991-92 notwithstanding the emerging weakness of activity, in part reflecting the world-wide recession of 1991. This resulted largely from the fact that i) financial integration and the quest for exchange rate stability had led to a situation where monetary conditions in the Community were strongly influenced by conditions in Germany and ii) the latter was the country where the gap between actual trends and the monetary authorities' objectives was the largest.

However, the cyclical positions of Member countries diverged. In West Germany economic activity remained buoyant and the needs of unification induced a new, strong, discretionary deterioration of the budget deficit in 1991. In the rest of the Community, however, activity was weakening while budgetary policy was becoming moderately restrictive as some governments tried to rein in runaway expenditure. Under these circumstances, authorities in the rest of the Community lowered short term interest rates. The credibility that policy coordination, the EMS parity grid and EMU prospects had acquired allowed these divergent trends to continue for many months.

By mid-1992, however, doubts about the credibility of the existing ERM parity grid became visible. With the political difficulties surrounding the ratification of the Treaty on European Union acting as a catalyst, this situation led to the ERM crisis of September 1992. At the same time, the Community economy plunged into recession.

Table 9: Inflation, wage and profitability trends (European Community)

	1987	1988	1989	1990	1991	1992	1993
Inflation (Deflator of private consumption)	3.6	3.8	5.0	4.5	5.4	4.6	3.8
Nominal wages per head	5.4	5.6	5.8	7.4	7.0	7.0	4.1
Real wages per head (deflator of private consumption)	1.7	1.8	0.7	2.7	1.5	2.3	0.3
Nominal Unit Labour Costs	3.6	2.8	3.8	6.0	5.7	4.6	2.7
Real Unit Labour Costs (deflator of GDP)	- 0.4	-1.4	-1.0	0.7	0.4	0.0	-0.9
Profitability (1961-73=100)	82.7	87.7	91.2	90.0	88.5	88.2	86.3
Including the new German Länder from 1992 onwards							

v) At the ***end of 1992***, policy makers were forced to face the recession starting from a very unbalanced policy situation whose main features were:

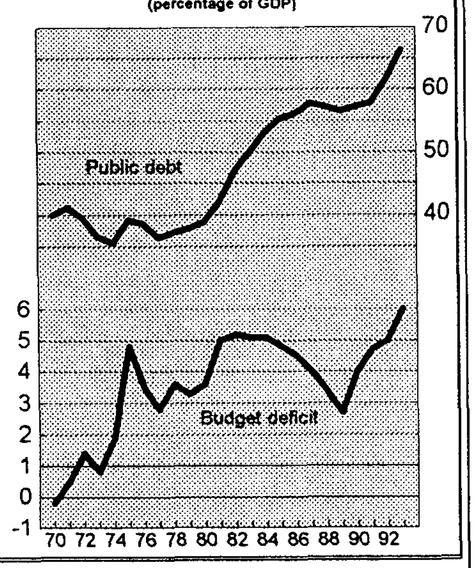
- Very worrying ***budgetary positions*** with budget deficits increasing in most countries and debt/GDP ratios increasing in all.
- ***Wage trends*** were beginning to adjust to the changed economic conditions but wages per head were still increasing at a rate clearly incompatible with the authorities' stability objectives.
- Finally, ***monetary policy***, notwithstanding a cautious start towards an easing process, remained very tight: interest rates were high, especially in real terms (see table 6), and the yield curve was inverted and strongly negative.

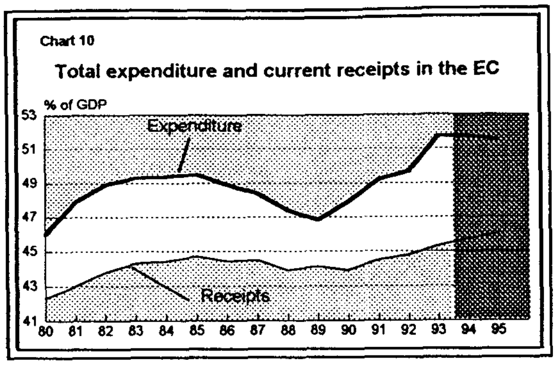
1.2.2 Budgetary policy in 1993

Due to the widespread recession, no Member State could reduce its budget deficit (general government net borrowing, national accounts definition which includes central government, regional and local authorities and social security) as a percentage of GDP in 1993. Seven countries, namely Denmark, Germany, Greece, Spain, France, Portugal and the United Kingdom registered considerable increases in their deficits (see table 10). Particularly large were the deteriorations recorded in Portugal, Spain and the United Kingdom. In Italy the deficit was contained by rigorous fiscal measures. A number of Member States chose to acknoledge the seriousness of the economic downturn and allowed the "automatic stabilisers" to operate, resulting in some deterioration in their budgetary positions. Some countries, for instance France, the United Kingdom and Denmark even took discretionary action to support demand, although the room for manoeuvre was very limited. In addition, all countries proceeded to review their spending programmes with the aim of switching expenditure towards those programmes which had the strongest effects on growth and employment; public investment being the obvious example. In this respect, it is worth noting that public investment increased from 2.6 points of GDP in 1988 to 3 points in 1993 notwithstanding the pressure on public expenditure exerted by the recession.

Chart 9

Outstanding gross public debt and general government net borrowing in the EC
(percentage of GDP)





Budgetary slippage led to sharply rising debt/GDP ratios in most of the Member countries. On average, the debt ratio increased by almost 10 percentage points from 56,5 per cent in 1989 to 65.9 per cent in 1993. This automatically created a growing interest burden for national budgets. This type of expenditure already represents more than 11 per cent of total public expenditure and around 5½ per cent of GDP. However, in 1993 the gradual reduction in interest rates helped to mitigate this. While interest payments had increased by almost 14 per cent in 1992, the increase was only 4 per cent in 1993.

Table 10

	General government primary balance (excluding interest payments)			**General government net borrowing**		
	percentages of GDP					
	1991	**1992**	**1993**	**1991**	**1992**	**1993**
B	3.9	4.3	3.7	* -6.8	* -7.1	* -7.0
DK	5.1	4.2	3.1	-2.2	-2.6	-4.4
D	-0.5	0.7	0.1	-3.2	-2.6	* -3.3
GR	-3.5	0.4	-0.5	-16.3	-13.2	-15.5
E	-1.2	-0.4	-2.2	-5.2	-4.6	-7.2
F	1.0	-0.5	-2.2	-2.1	* -3.8	* -5.5
IRL	5.6	4.9	4.2	-2.0	* -2.3	* -2.3
I	0.0	1.9	2.0	-10.2	-9.5	* -9.4
L	-0.4	-1.9	-1.7	-1.0	-2.5	-2.5
NL	3.6	2.7	2.3	-2.5	-3.5	-4.0
P	1.7	4.3	-0.4	* -6.6	* -3.3	* -7.1
UK	0.3	-3.0	-4.5	-2.7	* -6.3	* -7.6
EC	0.4	0.4	-0.9	-4.6	-5.0	* -6.0
European Commission estimates of November 1993 except for the figures marked with an asterix where more recent information has been included						

During 1993 it became clear, in Member States, that the scope for a budgetary stimulation of the economy had been exploited and that any action in this direction would have seriously affected policy credibility and would have had more negative than positive effects on the economy as a whole.

Table 11

	Gross public debt (1)			Interest payments		
	percentages of GDP					
	1991	1992	1993	1991	1992	1993
B	(2) 129.5	(2) 131.9	(2) 138.4	10.6	11.2	10.7
DK	(3) 64.2	(3) 68.4	(3) 80.6	7.3	6.8	7.5
D	42.1	44.8	48.9	2.8	3.3	3.5
GR	(4) 103.9	(4) 110.2	(4) 121.2	12.8	13.6	15.0
E	45.2	48.2	55.9	4.0	4.2	5.0
F	35.5	39.5	44.1	3.1	3.4	3.7
IRL	97.0	94.5	99.0	7.7	7.1	7.3
I	101.4	108.0	118.1	10.2	11.4	12.0
L	(5) 6.2	(5) 7.3	(5) 10.0	0.6	0.6	0.8
NL	79.0	79.7	81.4	6.2	6.2	6.3
P	69.4	61.7	66.4	8.3	7.6	6.7
UK	35.8	41.8	(6) 48.8	3.0	2.9	3.1
EC	57.0	60.9	65.9	5.0	5.4	5.6

European Commission estimates. (1) General government consolidated gross debt at nominal value; (2) Social security debt not included; (3) Government deposits with the central bank, government holdings of non-government bonds and public enterprises related debt amounted to 17.8% of GDP in 1991, 20.1% in 1992 and 27.3% in 1993; (4) Military debt not included. Various balances outstanding with the banking sector not included for 1993 (5) Not consolidated. Social security debt not included (6) End of financial year (31 March 1994)

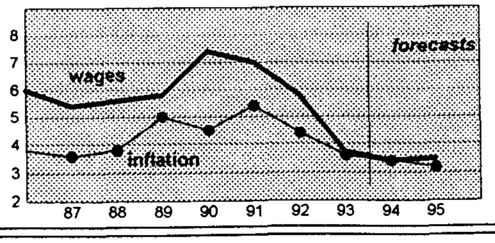
1.2.3 Wage trends

Wage trends moderated substantially during the course of 1993. The average increase in nominal wages per head for the year as a whole was 4.1 per cent against 7 per cent in 1992 (see table 9). Given that productivity continued to increase, even if at the cost of employment reductions being larger than the fall in output, this implied a substantial deceleration in unit labour costs which are estimated to have increased in 1993 by 2.7 per cent against more than four per cent in 1992. Thus, average Community trends improved substantially on the performance of the two/three previous years, yet they still did not quite reach what was required for the achievement of the authorities' stability objective. In addition, if compared to the developments in the Community's main competitor countries, wage increases in the EC were still relatively high.

Chart 11

EC: inflation and wages

(deflator of private consumption and nominal wages per head; excluding the new German Länder; annual % change)



In some Member States, however, wage developments were less satisfactory. In Greece, the rate of increase in nominal wages per head remained at the same high level of 1992 (above 11 per cent); however, in inflation-adjusted terms wages fell. In Spain and Portugal, wage increases slowed down compared with 1992 but were still well above the Community average and clearly incompatible with rising unemployment. On the other hand, Denmark, France and Italy recorded average wage increases significantly below the Community average.

Notwithstanding the recession, real wage costs per head increased, even if only slightly (+0.5 per cent in real terms). Since their increase fell short of productivity increases by about a percentage point, their trend contributed to improving investment profitability. Indeed, the average outcome for 1993 was in line with the rule of thumb suggested both in the White Paper and the Economic Policy Guidelines (real wage cost increases per head one percentage point below productivity increases).

Towards the end of the year, signs appeared which suggested that wage increases were moderating further and that the conflict between wage trends and price stability, which had been a distinctive feature of the policy mix of the 1990-92 period, could be disappearing.

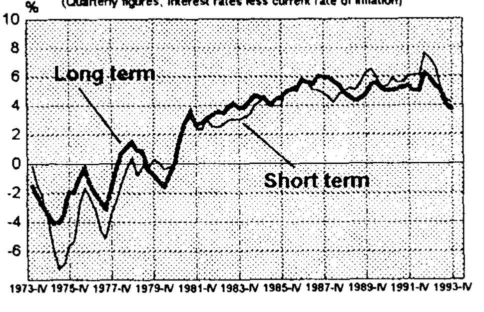
1.2.4 Monetary policy

For the Community as a whole, monetary conditions eased significantly during 1993 both before and after the new ERM crisis of July. Short-term interest rates also fell in most countries and, even though inflation was declining, real short term rates fell (a reduction of more than four points in nominal short term rates and about three and a half points in real short term rates; December 1993 over December 1992, Community average, see table 16). Long term yields also continued to decline in nominal terms but yield curves became much less inverted than had been the case at the beginning of the year.

Chart 12

EC: Real short and long term interest rates

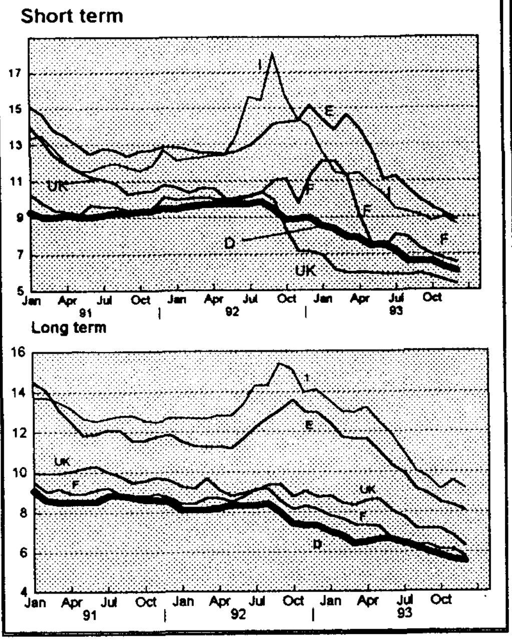
(Quarterly figures; interest rates less current rate of inflation)



These trends were not continuous during the course of the year. Indeed, for several countries there was considerable volatility both in interest rates and in exchange rates as periods of turbulence continued to afflict the ERM. The year began with very heavy pressure on the French Franc which eased after a repeat of the previous

Chart 13

Interest rates in some Member States



September's joint declaration of support for the parity by the French and German governments and central banks. But French short-term interest rate differentials remained high throughout the first quarter of 1993. At the end of January, after a period of intense market pressure, the bilateral central rates of the Irish pound were reduced by 10 per cent. Immediately afterwards, the Danish krone came under very heavy pressure. However, concerted intervention and a reduction in Bundesbank interest rates calmed the foreign exchange markets.

In the Spring, after the French general elections were over and the new government had reaffirmed the "franc fort" policy, pressures on the French Franc eased rapidly, allowing differentials vis-à-vis the DM to fall and, by late June, to become negative. Indeed, short rates were below German levels in all other narrow-band countries except Denmark (whose remaining positive differential was very small). In the wide band, however, the Spanish Peseta and the Portuguese Escudo were again devalued in May, the former currency by 8 per cent and the latter by 6.5 per cent. During July, generalised tension developed linked to market perceptions of weak or declining activity, rising unemployment and/or worsening public finance situations in a number of the countries whose monetary policies were tied to those of Germany. In such circumstances, markets believed that the countries concerned would have had difficulty in conducting a prolonged defence of the narrow bands via increased interest rates.

At the beginning of August, the decision was taken by the authorities to widen the ERM bands to +/- 15% for all participating currencies[2] without changing the central rates. The widening of the bands had the effect of re-introducing an effective two-way risk into the system. Markets had to assess the sustainability of the monetary policy stance in each country on the grounds of fundamentals, undisturbed by a need for exceptionally high interest-rate differentials. Initially, several currencies depreciated

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2 The Dutch and German authorities announced a bilateral agreement, outside the ERM framework, to maintain their currencies within bilateral bands of +/- 2¼%.

significantly against the DM. Subsequently, reductions in German interest rates allowed reductions in other ERM countries.

Table 12: Nominal effective exchange rates (quarterly figures; 1992-I= 100)

	1992-III	1992-IV	1993-I	1993-II	1993-III	1993-IV
B	102.14	104.18	104.27	103.61	101.04	100.54
DK	103.59	106.07	107.34	106.47	101.52	103.07
D	103.42	105.53	105.68	104.60	104.43	105.13
GR	95.68	92.76	90.35	88.46	85.76	84.07
E	99.90	92.33	92.38	87.20	81.15	80.81
F	103.72	106.05	106.35	106.02	102.70	103.52
IRL	102.57	105.19	99.73	96.23	93.07	94.32
I	100.06	88.58	81.62	82.30	80.57	77.83
NL	102.12	104.49	104.88	104.29	104.35	105.17
P	102.41	101.65	100.10	96.39	90.42	89.29
UK	100.78	88.39	86.79	88.76	89.79	89.85
EC	105.79	98.59	95.03	93.87	90.13	89.93

Relative to their 20 (9 for the EC as a whole) most important trading partners

Cyclical conditions in some of these countries showed signs of relative improvement vis-à-vis Germany, differentials declined and most former narrow-band currencies returned, by the end of 1993, to within their former bands. This development, i.e. the fact that the authorities concerned did not feel it appropriate to use the additional room for manoeuvre opened up by the August decision, has positive implications for economic and monetary cooperation.

Outside the ERM, the pound sterling reached a trough in late January following a reduction in interest rates to 6 per cent but subsequently recovered fairly steadily throughout the rest of the year. A further cut in UK interest rates took place in November in a context of declining interest rates elsewhere in Europe. The Italian Lira experienced sharp fluctuations during the course of the year, mainly limited to market perceptions of the impact of political events.

Table 13 :
Monetary and credit targets in 1993

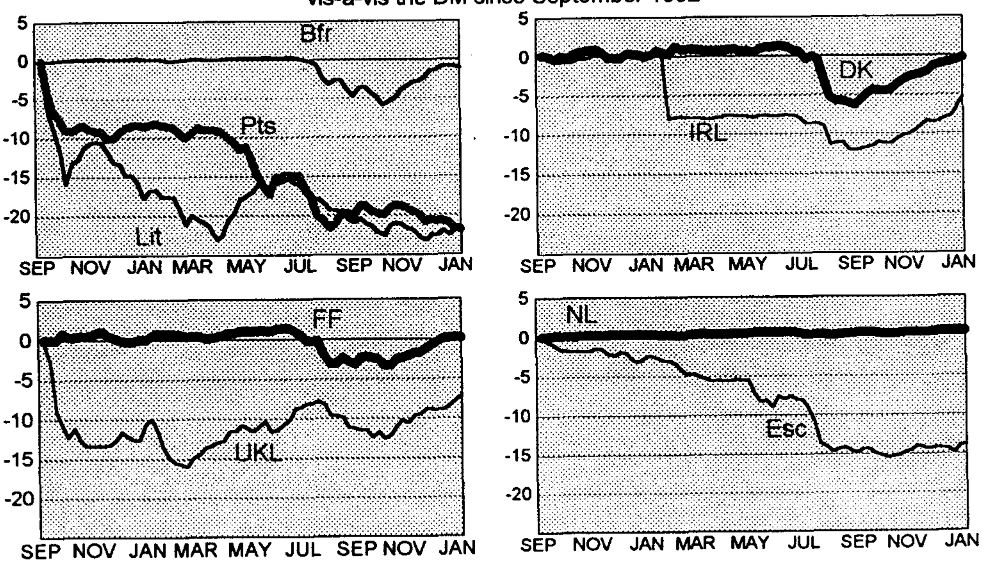
		Target	Outcome (annual rate)
D	M3	4.5 - 6.5	8.1 (Dec)
F	M2		0.0 (93-IV)
	M3 (new)	4 - 6.5	-1.5 (93-IV)
E	M3	4 - 7	8.1 (Dec)
	ALP + CP		7.5 (Dec)
	ALP	4.5 - 7.5	8.6 (Dec)
I	PSCE (1)		
	M2	5 - 7	7.9 (Dec)
UK	M4	3 - 9	4.9 (Nov)
	M0	0 - 4	5.8 (Dec)

(1) Domestic credit to the private sector

The turbulence in the ERM was one factor contributing to contrasting developments in monetary aggregates. Of the Community countries that set targets for the aggregates, there was overshooting in Germany, Spain and (outside the ERM) Italy, while there was a very substantial undershooting in the case of France. In the overshooting countries, the link between the aggregates and final variables (underlying inflation slowed in all three countries while activity was flat or falling) appeared to be less strong than in the past; but in France the undershoot (after allowing for special factors) appears to have been also related to a weakness in the growth of nominal income that probably continued into the final quarter of the year.

Chart 14 **Exchange rates in the Community**

Percentage change in the value of Community currencies vis-à-vis the DM since September 1992



1.2.5 Structural adjustment policies

Member States have recently taken important measures in the field of structural policy. In particular, various countries started or continued privatisation programmes (Italy, France, Spain, Belgium, Ireland, Portugal), reduced or re-orientated subsidies (Germany and Ireland) or lifted administrative and legal barriers to market entry (Greece).

Various countries have undertaken bold steps to improve training programmes and to target them more towards school-leavers and the unemployed (United Kingdom, France). Almost all countries have taken measures to help small businesses. These measures range from fiscal incentives, to start-up help and to the simplification of administrative procedures. Italy has taken important measures aimed at improving the functioning of its public administration.

Measures related to the labour market and labour costs have also been taken. In Spain, structural reform, especially of the labour market (for instance the legalisation of private employment agencies), is an important element in government policy considerations. In Italy, the abolition of the indexation of wages ("scala mobile") in 1992 was followed in July 1993 by an agreement that future wage developments must be consistent with agreed inflation targets as well as a number of measures to increase the flexibility of the labour market. In Belgium, the "Global Plan" has introduced a new index for the adaptation of wages (the "health index" which excludes tobacco, alcohol and petrol prices) as well as a real wage freeze for 1995-96. In Germany, the social partners have agreed to an extended timetable for the equalisation of wages between the eastern and western part of the country for some key industrial sectors.

In order to improve labour supply, some relevant aspects of the social security system were tackled. More stringent eligibility requirements for payment of pensions (increase of retirement age and/or qualifying period) were introduced in France, Italy, Portugal and the United Kingdom and stricter rules regarding payment of unemployment benefits were enforced in Belgium and Spain. In order to reduce the high level of social security contributions, employer's charges for certain categories were cut in Belgium, France, Ireland and Spain. The United Kingdom has launched a scheme designed to encourage employers to invest in developing their training strategies so that the skills of the workforce are improved.

Although some of these measures will bear fruit only in the medium term and although structural measures are especially unpopular in times of recession, Member States have to continue these structural adjustment efforts in order to allow for a smooth development of the economy and the labour market in the years to come. The decision of the Brussels European Council to establish an action plan based on the White Paper will contribute to a more effective implementation of structural reform both at the national and the European levels.

1.2.6 The Edinburgh and Copenhagen Growth Initiative

The Edinburgh Growth Initiative was launched by the European Council in December 1992 as a reaction to the slowdown in economic activity in the early 1990s. It was created as an instrument to promote economic recovery and employment via investment, for instance in physical infrastructure in the areas of transport, energy, communications and environment, with the priority being given to the development of Trans-European Networks (TENs). It was geared to exploit all possible margins for manoeuvre in national public budgets and to boost the confidence of economic agents without departing from the objective of medium-term budgetary consolidation.

Progress in relation to the Growth Initiative has been closely followed by the EcoFin Council and the Copenhagen and Brussels European Councils of June and December 1993. These reviews have confirmed the broad strategy to be followed. Firstly, the measures taken in relation to the Growth Initiative must be consistent with the medium-term requirements of the Treaty on European Union. Secondly, they must strike a balance between providing a short-term stimulus to economic activity without jeopardising longer term growth prospects and finally, they must include a combination of measures at the Community and national levels.

In 1993, loans of almost ECU 3,4 billion were granted to 59 projects under the temporary lending facility of ECU 8 billion (including the additional ECU 3 billion agreed by the Copenhagen Council) established by the European Investment Bank. The total investment involved in these projects is estimated at ECU 29,1 billion. Progress towards the establishment of a European Investment Fund has been slower than expected, but substantial progress has been achieved in accelerating investment under the new Cohesion Fund's financial instrument. Following the submission of eligible projects by the four countries concerned by the Cohesion Fund, the

Commission approved total appropriations of over ECU 1500 million in respect of more than 230 projects.

With the establishment of the new generation of "Community Support Framework", ECU 8 billion will be available for investment in 1994 from the Union's structural funds. The need for increased resources for SMEs has been addressed through the adoption by the Council of a new multi-annual action programme involving overall expenditure of ECU 112,2 million of which ECU 85 million represents new support decided in the framework of the growth initiative. Furthermore, the Copenhagen European Council provided for additional loans of ECU 1 billion under the EIB temporary lending facility for measures to improve the job creation potential of SMEs, with an interest rate subsidy linked to employment creation. Unfortunately, the implementation of this measure has encountered some obstacles which have delayed its effects.

Section 2: The outlook for 1994 and beyond

At the beginning of 1994 there are signs that the sharp deterioration in confidence and in other survey indicators, which occurred in the first half of last year, has been arrested and in some cases has even shown some improvement. While some of the evidence is conflicting, the overall impression is that the Community may well have reached the trough of the recession. The latest indicators, however, provide little evidence of a rapid upturn. At the end of last year, the Commission services had forecast Community GDP to grow by a modest 1 ¼ per cent in 1994 and about 2 per cent in 1995. Despite the considerable risks characterising the outlook, the evidence which has become available in the interim does not suggest any need to modify this projection.

On the basis of the above Commission projections, the jobless total will continue to grow in both forecast years reaching 11¼ per cent in 1995, the highest recorded rate in Community history, before starting to decline. Inflation is expected to be reduced further, while progress towards reducing budgetary deficits will be slowed down by the slow pace of the recovery.

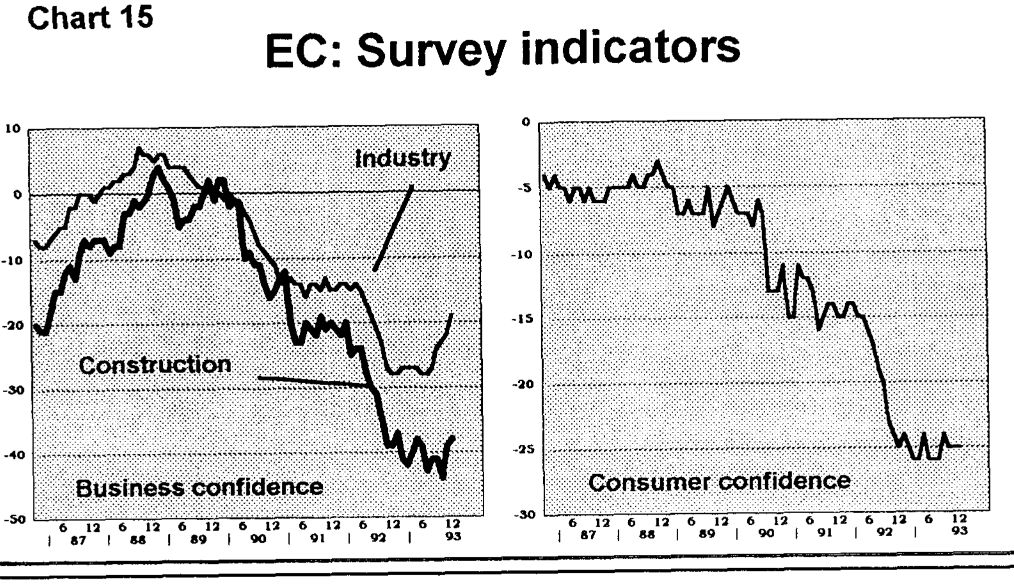
Table 14: The Community economy : Use and supply of goods and services

(annual real percentage change)	1993	1994 a)	1995 a)
Private consumption	-0.1	0.3	1.3
Government consumption	0.5	0.5	0.4
Gross fixed capital formation	-4.6	2.0	4.5
Domestic demand (incl. stocks)	-1.3	1.0	1.9
Exports of goods and services b)	3.6	5.7	5.8
Imports of goods and services b)	-3.1	2.6	3.9
GROSS DOMESTIC PRODUCT	**- 0.3**	**1.3**	**2.1**

a) Forecasts b) Extra-Community trade only

The figures presented in table 14 reflect the mid-point of a wide range of possible outcomes. The uncertainties attached to these forecasts are particularly high on this occasion given that the Community's economy is apparently close to a turning point and therefore that consumer confidence, notoriously difficult to predict, will play a major role. Small changes in the saving behaviour of households can produce significant variations in the rate of growth of private consumption, which is by far the largest component of total demand. A worse than expected outcome could emerge if

Chart 15



investor confidence does not begin to appear in a form more convincing than it does at present. On the other hand, a stronger recovery could materialise if the Community's export performance improved substantially and/or the present tentative signs of upturn were to prove sufficient to rekindle consumer confidence. In both cases, investment, which is expected to pick up somewhat because of cyclical factors and because of lower borrowing costs, could be stimulated further. The subsequent paragraphs will assess the relative strengths of the growth depressing and promoting factors which are inherent in the Community's short term outlook and will stress the high degree of risk in terms of accurately predicting the likely course of events in the Community over the next two years.

Growth depressing factors

A pessimistic viewpoint could be justified by the continuing influence, although admittedly diminishing, of some of the main recessionary forces of the last two years: tight monetary conditions, the difficulty of EC firms to profit from a relatively benign international economic environment and the continuation of low levels of confidence amongst economic agents, especially consumers.

Despite the reductions which have taken place in the course of 1993, short term interest rates remain high given the cyclical position of the Community's economy. A continued cautious monetary easing in 1994 appears to be largely discounted by both consumers and investors so that a process of accelerated cuts in borrowing costs may be required in order to provide the basis for an upswing in economic sentiment and activity. Such an acceleration could take place if the current trend towards a reduction in inflationary pressures were to be confirmed over the coming months.

Furthermore, while the outlook is for a gradual strengthening in world output and trade growth in 1994 and 1995, and while the Community's external competitiveness in both cost and non-cost terms remains relatively weak, Community exporters might not be able to fully benefit from this strengthening. Continuing low levels of business and consumer confidence could also be a constraining factor on growth in 1994 due to the ongoing uncertainty generated both by high and rising rates of unemployment and the credibility damage inflicted by currency upheavals to the prospects for EMU.

In addition to the ongoing influence of a number of the growth-constraining factors of previous years, one additional specific factor could take on an increasingly important role in 1994 and 1995. Given the alarming pace of deterioration in the budgetary situation in some Member States, a number of Member States have either announced or started to implement ambitious budget consolidation programmes in the closing months of last year. These programmes are essential to put countries' budgetary positions on a more sustainable and firm footing following the sharp deteriorations which have occurred over recent years and are a vital precondition for the re-establishment of a robust medium-term growth path in the economies concerned. While the longer-term benefits are not in doubt, it is not clear the extent to which the demand-dampening impact of such fiscal retrenchment strategies in the short-run can be offset by any potential crowding-in effects resulting from lower interest rates and increased levels of confidence. To the extent that these programmes can convince economic agents that the authorities have it within their power to reduce budget deficits, the crowding in effects will be stronger.

Growth promoting factors

A more optimistic viewpoint could be justified by a more sanguine assessment of the behaviour of consumers, based, for instance, on the progress made in reducing the indebtedness of households. Their savings ratio could drop by more than expected and private consumption could recover more strongly thus creating a virtuous consumption/investment circle. Even in the absence of such a development, investment could improve faster than predicted. Following a decline of over 4½ percentage points last year, fixed capital formation is currently forecast to grow by 2 per cent in 1994 with a further strengthening to 4½ per cent forecast for 1995. A large number of factors could combine to produce a stronger investment-driven upturn in the Community:

- following some years of contraction, a revival in investment levels is likely for purely cyclical reasons;
- moderation in both employee compensation rates and in nominal unit labour costs has made a substantial contribution to investment profitability, which is now higher than at the same point of previous cycles (see chart 5);
- the coming on stream of projects resulting from specific incentive schemes to switch public expenditure towards infrastructure investment and other growth promoting capital investments;
- a stronger than expected improvement in Community competitiveness as a result of a lower increase in unit labour costs and/or a lower than expected effective exchange rate of the Community's currencies;
- expectations of a more benign domestic demand environment as a result of more favourable trends in the areas just mentioned combined with moderate and decreasing energy prices;
- improved external demand prospects as a result of the dynamism of some important economies and of the completion of the GATT agreement.

An acceleration of the present trend towards lower borrowing costs would combine favourably with these factors and could lead to a faster than expected recovery.

With regard to the improved external demand prospects mentioned above, it is important to examine the overall trends in relation to world output and trade as well as examining the performance of individual countries or groups of countries. Firstly, it should be underlined that the outlook for world output growth in 1994 and 1995 has become a little more favourable in recent months. This increased optimism emanates essentially from the more dynamic than expected performance which has become evident in the case of the United States and Canada. In overall terms, output growth for the world, excluding the EC, is expected to

Table 15: World Growth

GDP /GNP (annual real % change)					
	1991	**1992**	**1993**	**1994**	**1995**
EC	1.4	1.1	-0.3	1.3	2.1
USA	-0.8	2.6	3.0	3.5	2.6
JAPAN	4.4	1.3	-0.1	0.8	2.8
EFTA	-0.5	-0.3	-0.4	1.7	2.9
WORLD	0.8	1.7	1.6	2.6	3.1
IMPORTS (annual real % change)					
OECD	1.5	3.6	1.0	5.0	5.2
DAE a)	14.1	10.3	13.8	12.3	12.2
LDC b)	10.0	14.6	12.2	8.8	8.9
World exc. EC	1.8	6.2	8.4	8.5	8.0
WORLD	3.0	5.0	3.4	6.4	6.5

European Commission forecasts
a) DAE: Dynamic Asian Economies
b) Less Developed Countries (excluding DAEs, OPEC and the countries of Central and Eastern Europe)

be about a quarter of a percentage point higher for both 1994 and 1995 than expected at the time of the Autumn 1993 forecasts, with three percent now being forecast for the present year and three and a half percent envisaged for 1995. With regard to world trade the present view is also more optimistic than that which prevailed in October/November of 1993 and again as with GDP growth the main explanatory factor is the performance of the United States. Not only is the growth performance of the United States expected to be higher than in 1994 and 1995 than previously thought, its import propensity is also expected to increase. In overall terms, world trade excluding the EC, measured by import volumes, is assumed to increase by eight to eight and a half percent over the forecasting period which is roughly one percentage point higher than the assumption underlying the Autumn 1993 forecast. It is important for Community exporters to more actively exploit these additional external opportunities which are evidently emerging.

Medium-term projections point to a wide range of outcomes

The available medium to long-term projections for the Community show that a wide range of outcomes is possible. If economic trends in 1994 and 1995 develop as in the central scenario of the Commission's economic forecasts, there will be a good probability that the rate of growth could reach 3 per cent by 1996 and that unemployment could start falling. This outcome is conditional on the expected gradual strengthening of exports, investment and consumer confidence, but even more so on the avoidance of some pitfalls. The first is that the conflict between price stability objectives and wage behaviour, which has now almost entirely disappeared, does not arise again. The second is that the authorities' ability to take control, over the medium term, of the budgetary situation becomes and remains credible. This is important in order not to overburden monetary policy, to maintain a balanced policy-mix with low interest rates, to maintain confidence and to get under way the necessary process of increasing national savings.

But even if these errors are avoided and the Community's economy returned to a growth path of around three per cent, this will be difficult to maintain and the expected reduction in unemployment will be small unless the potential rate of growth is also increased. To achieve the objective of reducing substantially the rate of unemployment, the White Paper underlined the need to act decisively to strengthen the dynamism of the Community's economy, to increase its potential rate of growth and to make growth more employment intensive.

The dynamism of the Community's economy will be strengthened by the full exploitation of the possibilities offered by its internal market, by the maintenance of an open trading system, additional efforts to improve training systems and research efforts and by the rapid completion of the planned infrastructure networks (TENs). In addition, there is a continued need to reform the legal and institutional framework in which the productive process takes place with a view to adapt it to market needs, to the new international and technological environment and to the need of making growth environmentally sustainable.

Increasing the potential rate of growth of the Community depends on creating the conditions which will bring about an increase in the rate of growth of the capital stock and, by necessity, an increase in the share of investment in GDP. As the White Paper has stressed, this depends on many factors, some of which cannot be controlled directly by policy makers, but requires in any case a further increase in investment profitability and an increase in national savings. These two trends depend in turn on real wages continuing to increase less than average productivity and on the public sector returning to positive rates of saving which implies substantially lower budget deficits.

A more employment intensive growth pattern will require action in a large number of areas which have been indicated in the White Paper. In particular, efforts will have to be continued to improve the efficiency of labour markets, to give them greater flexibility, to adapt working time to the needs of employers and employees, to review the effects on employment of the arrangements to finance social security and to reduce as far as possible non-wage costs on the lowest wages and on those of young workers.

Section 3 The policies for more growth and employment

The White Paper on "Growth, Competitiveness and Employment" clearly indicated that to substantially reduce unemployment the Community needed to return to sustained rates of growth and to strengthen the capacity of the European Economy to create jobs. In so far as the latter area is concerned, the framework defined in the White Paper will serve as a reference for Member States' policies and the Commission will be monitoring the progress made.

To achieve a stronger rate of growth, the Economic Policy Guidelines adopted last December by the Community have confirmed the macro-economic part of the strategy presented in the White Paper which was aimed at:

i) sustaining the recovery without putting at risk the prospects for sustained growth in the medium term;
ii) increasing the dynamism of the economy and its potential rate of growth so as to be able to reach and sustain stronger rates of growth.

3.1 Sustaining the recovery

The current economic situation of the Community calls for very difficult policy choices. As noted in section 1, the Community's economy taken as a whole, appears to have reached the trough of the recession but the recovery is, and indeed is expected to be, hesitant and slow. Supply conditions are better than at the same point of previous cycles but demand expectations remain very subdued. Exports towards the rest of the world appear to be picking up but their small relative weight (about 10 per cent of GDP) makes it unlikely that very strong growth impulses can be expected from this direction. Investment is showing some signs of improvement but it is unlikely to pick up strongly until overall demand prospects clearly improve.

Across the Community, the general consensus view among the relevant authorities is that the room for manoeuvre is limited. The unsatisfactory budgetary situation is largely due to the fact that fiscal policy has not only been used to counter the effects of the recession but has started from a position of structural imbalance. The conclusion in the jointly agreed Economic Policy Guidelines is that further slippage in the present situation could only produce very short term benefits, which in all likelihood would be more than offset by the adverse reaction in financial markets and a further weakening of confidence.

Wage increases have slowed down considerably and this has contributed to lower inflation and improved competitiveness and profitability. Despite possible downward pressure on aggregate demand, the general view in Member States is that the risk of some future wage and price inflation cannot be entirely ruled out. Inflation in the Community at 3 ½ per cent (deflator of private consumption) in 1994 represents a considerable improvement on the recent past but more is needed to achieve the Guidelines' target and the aim of squeezing inflation out of the system remains a priority. Again success on this point will improve expectations and serve to boost confidence.

At the same time, there is a strong commitment to measures aimed at improving market functioning to increase the dynamism of the economy and to offset any disincentives to increase productivity which might result from a policy of wage restraint.

Under these conditions, the White Paper had reached the conclusion, implicitly confirmed by the Guidelines, that the most significant contribution economic policy could make to sustaining the recovery was to continue to make progress towards eliminating the conflict between the stability objective and wage and budgetary behaviour. This would allow short term interest rates to fall even more than presently expected and would have substantial positive effects on the behaviour of both consumers and business. This is particularly important since the easing of monetary conditions in the Community has not yet proceeded to the point at which the stance is consistent with a strong recovery in activity in the Community, especially in the light of the budgetary retrenchment in prospect for 1994 and beyond in many Member States. The following paragraphs will discuss the present stance of monetary policy and the progress achieved in creating the conditions for lower interest rates.

3.1.1 The current monetary policy stance

Short-term rates of interest, as noted in section 1 above, fell significantly in late 1992 and into 1993. Indeed, in a period of just over a year (September 1992 to October 1993), short rates in Germany, the ERM anchor country, fell by around 375 basis points while on average in the Community they fell by more than 500 basis points between September 1992 and January 1994. These are large and rapid reductions in historical terms, yet short term interest rates are still too high given the cyclical position of the Community's economy. The reduction in short rates have been made possible in Germany by clear evidence of a substantial downward trend in underlying inflation (evident for some time in producer prices and now increasingly translated into moderate wage settlements and decelerating consumer price movements) and, elsewhere in Europe, by inflation rates that in several countries are already consistent with a medium-term price stability standard and continue to trend downwards.

Table 16: Recent interest-rate developments in the Community

	Dec 92	Feb 93	Apr 93	Jun 93	Aug 93	Oct 93	Dec 93	Jan 94
Short term interest rates	11.0	10.2	9.2	8.1	7.9	7.5	6.9	6.7
Long term interest rates	9.6	8.8	8.7	8.1	7.4	7.0	6.6	6.5
long-term *minus* short-term	-1.4	-1.4	-1.2	0.0	-0.5	-0.5	-0.3	-0.2
Real short -term rates	7.1	6.4	5.6	4.7	4.2	4.1	3.6	3.2
Real long term	5.8	5.1	5.1	4.7	3.8	3.6	3.3	3.0

Weighted averages for the Community, short term: 3 months rates; Long-term: 10 years ; real rates deflated using the consumer price index

Monetary policy should continue the course that was followed with a considerable degree of success in 1993. One indicator of that success was the much-reduced degree of inversion of the yield curve while long rates were falling. The main effect on the yield curve of a continuation of 1993 monetary policy trends would probably be a further pivoting effect, with short rates continuing to fall and with long rates little changed.

Against this background, the strength of economic growth in the United States and the consequent probable tendency of US short rates to move upwards might go together with a further upward movement in the value of the dollar. Given the rapid US growth rate and the sluggishness - as yet - of the European economy such a development would not be inappropriate for either party.

However, it should be recalled that the significant reductions in short-term interest rates in Europe in 1993 depended not only on progress in disinflation but also on some progress towards the establishment of better prospects for medium-term budgetary consolidation. That requirement still remains, while a continuation of the declining trend in interest rates and, thereby, an improvement in growth prospects will help the process of reducing budget deficits (in several countries, these had risen in 1992/93 not only as a result of the automatic impact of recession, but also because attempts were made to provide budgetary support to activity). However, the countries in which budgetary problems may represent an independent barrier to a further easing of monetary conditions are often those in which there is a need for further progress in disinflation.

3.1.2 Progress in creating the conditions for lower interest rates

Favourable developments have appeared in the trends for costs and prices over recent months. ***Wage trends*** appear to have moderated substantially and the outcome for 1994 might even be lower than was suggested by the forecasts completed at the end of last year. These forecasts pointed to a reduction in the rate of increase in compensation of employees per head from 7.0 per cent in 1992 to 4.1 percent in 1993 and to about 3 ½ per cent this year. Given an expected increase in labour productivity of about 1 ½ percent this year, partly due to labour shedding, the average increase of unit labour costs in the Community should decelerate to below 2 percent, the lowest rate in the Community since 1960 and broadly consistent with the Community's inflation targets. In addition, the evidence which has become available after the completion of the forecasts suggest that the outcome might even be slightly better. If confirmed, these indications suggest that a considerable step towards consistency with the stability objective of the monetary authorities is being made.

However, as with all average outturns, individual country performances differ markedly. According to the available forecasts, nearly half of the Member States are expected to register increases of less than 3 to 3 ½ per cent, a trend which must be maintained and improved in 1995 and beyond. A number of countries, however, continue to show rates of increase clearly inappropriate to a situation of rising unemployment and incompatible with the price stability target of the Community (no more than 2 to 3 per cent by 1996). In Spain, compensation of employees per head is forecast to increase by 5½ percent this year despite the severe fall in economic activity and the sharp rise in unemployment. In Portugal, wage increases were forecast to grow by 6 ½ percent in 1994 which is less than half the rate in 1992, but still close to twice the Community average. The most recent information suggests that the deceleration could be even more pronounced. Overall Spain and Portugal are

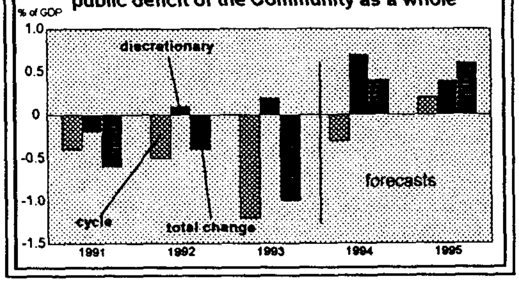


Chart 16
Estimates of the origin of the changes in the public deficit of the Community as a whole

expected to register declines in their rates of wage increase of between 1 1/2-2 percentage points. Greece, on the other hand, is forecast to have a rate of increase of close to four times the Community average. However, it should be pointed out that recently announced 1994 wage increases in Greece for central government staff are below the rate of predicted inflation as opposed to the assumption of real increases embodied in the Autumn 1993 forecasts. If the government can hold the line on public sector pay, and on the assumption that the recently negotiated agreements in the private sector will be effectively implemented, rates of increase in compensation of employees per head could be 1½-2 percentage points lower in 1994 than previously thought.

Encouraging signals have also come from Germany where important pay agreements pointing in the right direction have been reached. If the trend is continued in the forthcoming agreements, the outcome for 1994 could even be significantly better than the forecasted 3 per cent. A global agreement both for the public and the private sector has been reached in Ireland: wages should increase by about 2 ½ per cent a year in the period 1994-96. Several pay deals of between 2 and 3 per cent for 1994 have also been concluded in some important sectors in the United Kingdom and average pay increases are quite low.

Price trends are also rather satisfactory. The forecasts point to a new deceleration in the rate of increase in the deflator of private consumption to 3.5 per cent this year against 3.8 per cent in 1993 and 4.6 in 1992. For 1995 a new deceleration to a rate of 3.2 per cent is forecast. This suggests that the Community and most Member States are on course towards meeting the target agreed in the Economic Policy Guidelines of achieving a rate of inflation of no more than 2 to 3 per cent by 1996. Indeed, also in this case, the most recent figures suggest that the outcome could be even better than this forecast. The appreciation of the dollar, if sustained, might add a few decimals to the rate of inflation, but this is likely to be more than offset by the probable better wage outcome and weak energy prices. Very positive signals are also coming from producer prices in many countries.

Most countries are expected to record rates of inflation consistent with the guidelines' target or very close to it. The pace of price increases remains unsatisfactory, however, in Greece (where the rate of inflation is declining, but at a slow speed) and to a much lesser extent in Portugal. Additional efforts might be desirable in Spain and Italy. The measures that some of these countries have taken to reduce costs and which were presented in the above paragraphs should also produce positive effects on the rates of inflation.

The ***budgetary*** picture is more difficult to assess. The first recommendation concerning budgetary policy of the Economic Policy Guidelines was to prevent any further deterioration in the budget deficits in 1994 and to carry forward the process of deficit reduction. All countries, except Denmark and Ireland, are attempting a discretionary tightening of policy and are aiming to reduce deficits in 1994. Success in reducing total deficits in 1994, in accordance with government plans, will depend not only on the scale and effectiveness of the discretionary adjustment measures being introduced, but also on whether the recovery in economic activity proceeds as expected and on the savings on interest payments to be achieved from lower interest rates. The depth of the recession and the slow pace of the recovery will limit the improvement in the deficits of several countries. Indeed, cyclically adjusted estimates suggest that practically all countries will be reducing their structural deficits this year. For the Community as a whole this reduction is expected to amount to about three quarters of a per cent of GDP, but more than half of this improvement is likely to be offset by the direct effects of the enduring weakness in economic activity. Most countries appear to have taken significant steps to check the increase in current expenditure. Public sector pay, in particular, is increasing substantially less than the rate of inflation.

Looking more closely at the budgetary situations of the individual Member States in relation to the guidelines, the prospects for 1994 are generally more encouraging than in 1993 but the adjustment efforts will have to be pursued in most cases over several years. The guidelines stressed that an immediate strong pursuit of the consolidation process was especially necessary for Member States with very high and rising public debt ratios. In this respect, in both Belgium and Italy the appreciable discretionary tightening already carried out in 1993 is being pursued further in 1994 with positive results, even though growth is likely to remain relatively weak. But given the seriousness of their debt positions these efforts may need to be reinforced by additional measures if there is any slippage from targets. In Greece, by contrast, the measures so far announced do not appear sufficient to achieve a significant correction and without a substantial additional adjustment there is a danger that interest payments will put upward pressure on the already very high deficit.

The guidelines also recommended that the consolidation process should intensify in those Member States with high budget deficits and which are expected to face a relatively favourable economic situation in 1994. With the recovery clearly established in the United Kingdom (in advance of the continental European economies), the British government presented two budgets in 1993 (in March and in November) which introduced a significant fiscal tightening based on strict public expenditure control and substantial tax increases (being phased in over two years). In Denmark, the government has introduced a tax-cutting fiscal stimulus which will lead to a deterioration in the budget deficit this year, but it has followed this policy in the context of a medium-term strategy for budgetary consolidation and has already announced tax increases for 1995 and beyond. Ireland is likely to be the fastest-growing Community economy in 1994, and its budget deficit is already low and its debt ratio over the last number of years has been on a declining trend, thus allowing room this year for a modest budgetary relaxation (tax cuts for the lower paid). Luxembourg is in an even more favourable budgetary position and is not faced by the consolidation needs confronting most of its Community partners.

Most of the other Member States are looking for some improvement in their deficits in 1994 through tight budgetary control, as recommended in the guidelines, but they are not seeking a major correction in budgetary imbalances in the current year because of the continuing weak state of their economies and concerns about the possible short-term impact on demand and the recovery of an over-abrupt fiscal tightening. In such circumstances, as stressed in the guidelines, it is especially necessary to establish credible medium-term strategies for deficit reduction over the next few years. France, Germany, Portugal and Denmark have recently presented new or updated convergence programmes, and other countries, especially those whose earlier budgetary strategies have been knocked off-track by the recession, also need to restate their objectives and how they intend to achieve them. As suggested in the guidelines, credibility can be enhanced by announcing measures now which will take effect in future years as the recovery strengthens; measures of this kind have already been announced on the tax side by, for example, Germany, the United Kingdom and Denmark, and several other countries have announced reforms likely to have a strong impact on various categories of social spending over future years.

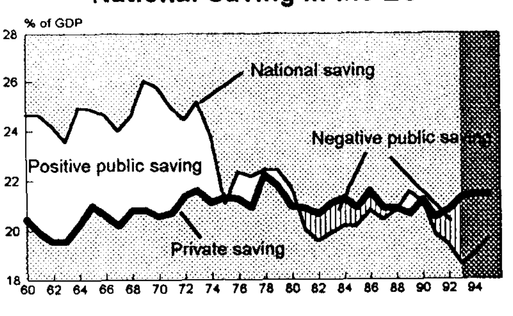
The expected better growth performance next year warrants a bolder step towards the necessary medium-term budgetary consolidation. It is urgent that all countries revise their convergence programmes to take into account the most recent changes in the economic environment and thus establish a credible perspective for the return to sounder public finance positions. The Economic Policy Guidelines indicate that in 1995 budgetary policy should aim towards making public finance situations sustainable again. They also indicate that this means action towards reducing budget deficits to the reference value indicated in the Treaty on European Union (three per cent of GDP). Most Member States are still far from this target. The situation in this area will be reviewed under the "excessive deficit procedure" (art. 104c), which will be applied for the first time this year, and will need to be addressed in the 1994 Economic Policy Guidelines.

3.2 Underpinning Medium Term Growth and Employment Creation

Over the medium-term, the task for policy makers in all Member States must be to act prudently in order to ensure that the conditions are created which will permit the achievement of strong, employment-creating, growth over the medium to longer-term. These conditions involve, above all, the maintenance of a stable macro-economic framework which reduces the uncertainties affecting the decisions of economic agents and helps to reduce real long term interest rates.

The outlook presented earlier suggests that there appears to be a reasonable chance of achieving a rate of growth of about three per cent by 1996. This rate will be slightly above the Community's potential rate of growth, but this need not give cause for concern since a substantial degree of slack has opened up during the current recession. But from the following year onwards, notwithstanding the possibility of using some of the slack created during the current recession, the Community's rate of growth will be constrained by the pace of growth of its productive potential. Economic policy must therefore, as indicated in the White Paper and in the Guidelines, aim to improve it.

Chart 17
National Saving in the EC



Recent wage trends are also encouraging in this respect. Since real wages are likely to stagnate in 1994 while productivity is expected to pick up somewhat (an increase of about one and a half per cent) real unit labour cost reductions will provide a positive contribution to investment profitability. Eleven of the 12 Member States are forecast to show declines or stagnation with regard to real unit labour costs with Greece forecast to be the exception by showing an increase of 3/4 of a percentage point. According to the latest available forecast, these trends are expected to continue in 1995 and to result in a trend close to the rule of thumb suggested in the White Paper (real wage increases per head equal to productivity increases minus one point).

The main contribution budgetary policy can make to an improvement in medium term prospects consists in the return to positive rates of public saving as a way of increasing national saving. Again this objective figures prominently in the Economic Policy Guidelines. Trends in this area cannot be assessed yet, as the effects of budgetary consolidation will show clearly in the actual budget figures only when the recovery is fully under way. However, as already noted in the previous section, the information available suggests that not enough is being done in the direction of setting in place credible medium-term consolidation strategies.

Progress towards a more competitive Community economy is also taking place. As noted in section one significant steps are being taken by the Member States and important developments are under way at the Community level. In the light of the White Paper proposals presented by the Commission, the Brussels European Council of December 1993 adopted a short- and medium-term action plan consisting of :

- a framework for Member States' actions;
- accompanying measures at Community level; and
- a monitoring procedure.

The plan calls for action at the level of the Community, the Member states and the individual enterprises. To monitor the implementation of the plan, the European Community, each year beginning in December 1994, will take stock of the results of the action plan and will take any measures deemed necessary to put the plan back on track. The Commission will present an interim report to the European Council at Corfu in June 1994. An intensive work programme for the follow-up of the action plan and the White Paper during the first half of 1994 has been established and similar arrangements will be necessary during the next presidencies.

Conclusions

The conflict between the stability objective, on the one hand, and budgetary and wage behaviour, on the other, which has been a feature of recent years appears to be becoming less acute. The unbalanced policy mix which has resulted from this conflict bears a large responsibility for the slow growth of 1991-92 and for the recession of 1993. Significant progress has been made in the course of 1993 and in the first months of 1994 in bringing about wage trends compatible both with price stability and with a situation of rising unemployment. Inflationary pressures also appear to be abating. Progress towards reducing budget deficits, however, is less clear cut with practically all Member States taking active steps to consolidate budgetary positions, but with actual progress being hampered by the weakness of economic activity.

The progress which has been made in the course of 1993 and in the first few months of 1994 has allowed a substantial rebalancing of the policy mix with interest rates declining substantially. Notwithstanding the reductions which have taken place, however, short term interest rates remain too high for a period of recession.

The most recent available information suggests that a modest recovery could take hold soon. In all likelihood it will be led by a modest pick up in exports to the rest of the world, where economic conditions are significantly better than in the Community, and by a revival of investment. It would help if European exporters directed their attention increasingly towards the emerging dynamic economies where additional export opportunities clearly exist. Private consumption is expected to recover at a later stage once growth will be strong enough to halt the rise in unemployment. The pattern of the expected recovery (investment growing faster than consumption), disappointing as it may be in terms of the rapidity of the turn around, will help the sustainability of growth and bodes well for the return of the Community's economy to rates of growth of more than 2 per cent next year and more than 3 per cent in 1996.

Current trends raise the hope that the recovery will go hand in hand with a resumption of the nominal convergence process. Barring unforeseen circumstances, the target of a rate of inflation between 2 and 3 per cent by 1996 appears realistic for the Community as a whole and for a majority of Member States. Achieving the objective of bringing budget deficits towards the 3 per cent mark by 1996/97, on the other hand, appears to require additional efforts which will have to be implemented in line with the return to more robust rates of growth. These efforts are necessary to ensure a balanced policy mix and to open the way to a prolonged period of growth thus reducing unemployment from 1996 onwards.

Past experience suggests that the return to higher rates of growth will imply a resumption of the process of real convergence. In the past, the catching up countries have almost always benefited more than proportionally from general improvements in economic conditions throughout the Community. Furthermore, in the years ahead the efforts of these countries will be supplemented by interventions by the Community's structural funds much larger, in nominal and real terms, than at any time in the past.

A substantial reduction in unemployment requires that growth remains both strong and employment creating for many years. This calls for determined structural adjustment efforts and a careful macroeconomic management.

Structural adjustment must aim at making the labour market more effective and at modifying various aspects of the "employment systems" so as to make growth more employment creating. Again the White Paper constitutes a very useful basis for actions in this area. In particular, active labour market policies are necessary to make sure that the current cyclical increase in unemployment does not consolidate into structural unemployment. Improved training possibilities must maintain, and possibly increase, the skills of those who are either losing their jobs or run the risk of being in this situation.

Structural policies must also aim at making the Community economy more competitive and more dynamic. The White Paper "Growth, Competitiveness and Employment" has indicated a series of actions necessary to achieve this goal.

- Member States, who are competent for most of the necessary actions, should act without hesitation. In particular they should pay attention not to reduce their efforts once growth becomes strong again. Good economic periods may make structural reform appear less urgent, but they are also the periods when reform is easiest to implement and is likely to bear fruit in the shortest time. Action while economic conditions remain difficult and unemployment continues to increase is more difficult, but in certain cases it can contribute significantly to improving economic agents expectations and may therefore be necessary. In any case, it is important to impress on economic agents that action will be taken, even if only when growth will be stronger.

- The Community must implement rapidly the actions defined in the Action Plan agreed at the European Council meeting of December 1993. The Trans-European Networks assume a particular importance in this respect.

The actions which aim at making the Community economy more dynamic and more competitive will tend to accelerate the rate of increase in the productivity of those in work. This makes it all the more urgent to take actions to bring into the labour market those who are now excluded, encourage job creation in the sectors which offer the greatest employment potential (local services, leisure, culture, environment, etc.) and to ensure that the rate of growth of the economy remains strong.

Macroeconomic policy will have to aim at making sure that:

i) strong investment activity leads to an increase in the stock of capital and thus contributes to increasing the Community's potential rate of growth; this calls for an additional improvement in investment profitability to be obtained, to a large extent, through real wage increases falling short of productivity increases.

ii) national saving rises at least in line with the increase in the share of investment in GDP; this requires substantial improvements in public saving which should lead to budget deficits being reduced, in the long term, to less than one per cent of GDP.

iii) in the medium term, actual output growth does not significantly exceed the potential rate of growth, which would make growth unsustainable (the errors of 1988-89 should not be repeated); the weight of any stabilisation that may become necessary must be borne by budgetary policy.

iv) the policy mix becomes, and remains, balanced with monetary policy oriented towards the maintenance of price stability while the other instruments support growth without being incompatible with the former.

Continued implementation of the policies put forward in the White Paper and recommended in the Broad Economic Policy Guidelines will open up the perspective not only of achieving the Community's objectives for growth, employment and unemployment reduction, but also of achieving in most countries a convergence performance which will allow their transition to stage III of EMU before the end of the decade.

1994 ANNUAL ECONOMIC REPORT

PART B

ECONOMIC SITUATION AND POLICY ISSUES IN THE INDIVIDUAL MEMBER STATES

PART B: ECONOMIC SITUATION AND POLICY ISSUES IN THE INDIVIDUAL MEMBER STATES

BELGIUM

Economic activity stabilised in the second half of 1993

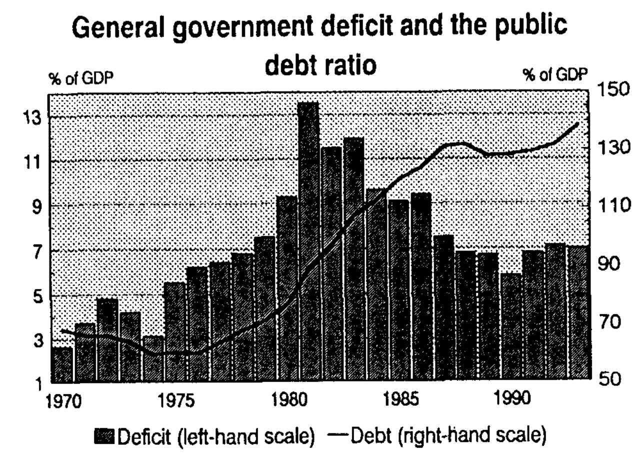
After the good economic performance in the late 1980s, economic activity in Belgium slowed down in the early 1990s, and has weakened considerably further since the second half of 1992. All major components of domestic private demand and exports fell in the first half of 1993 and then stabilised in the rest of the year at a low level; as a result real GDP is expected to have contracted by about 1½% in 1993. Although the unemployment rate in Belgium remained below the Community average, it has risen uninterruptedly from 7.5% of the civilian labour force in 1991 to about 9.5% in 1993.

Private consumption, which had been the most dynamic component of demand in both 1991 and 1992, contracted in 1993, particularly the demand for consumer durables, reflecting to a large extent sagging confidence as households' saving rate peaked at a historically high level. The continuous deterioration in the labour market situation in the past two years also had a negative impact on confidence. Enterprise investment declined in 1993 for the third consecutive year, reflecting slack capacity and unfavourable economic prospects, together with the completion of major industrial projects in previous years. Residential construction, which had performed well in 1992 when it benefited from lower mortgage rates, also contracted in 1993.

The information available suggests that export volumes of merchandise goods decreased in 1993. The accumulated deterioration in price-competitiveness registered since 1990, due both to the effective nominal appreciation of the Belgian franc and to lack of wage moderation, are the main causes behind the loss in market shares in 1992 and 1993. Available data on the balance of current transactions of the Belgian and Luxembourg Economic Union (BLEU) in 1993, on a payments basis, point to an increase in the current surplus, mainly reflecting the rise in the balance on interest income due to Luxembourg investment funds, and the improvement in the balance on merchandise trade as imports of goods seem to have declined more sharply than exports.

Inflation in Belgium - measured by the CPI - is still below the Community average, although it edged up somewhat in 1993, from 2.4% in 1992 to 2.8%, due mainly to increases in indirect taxes together with the tapering off of the favourable impact of energy import prices in 1992. Nominal wages in the private sector are estimated to have increased by about 4% in 1993, reflecting real wage increases of around 1%, which were mainly awarded at sector and enterprise levels. However, real wage increases in the public sector in 1993 are put at around 4.5%, which has not helped the process of fiscal consolidation.

Chart 1 - Belgium



Source: Commission services

Worsening economic conditions and insufficient control over social security spending were the main factors responsible for the unsatisfactory budgetary outcome in 1993. The general government deficit remained at about the same level (7% of GDP) as in 1992, thereby overshooting the (revised) convergence programme target for 1993 of 5.8% of GDP ([1]). Although some progress was achieved during the year in curbing excessive spending in several areas of social security, namely on unemployment benefits and health care, the deviation from the programme targets was essentially caused by the widening deficit in the social security system.

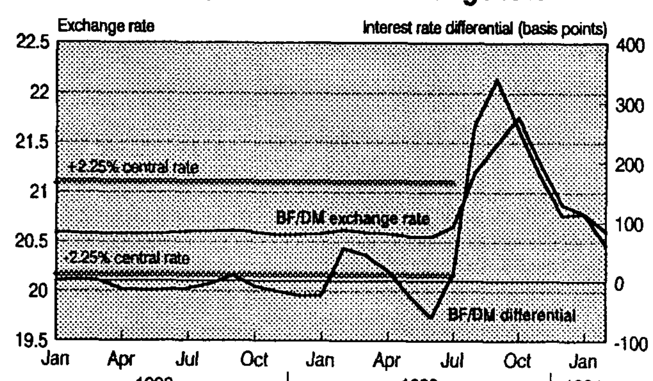
Until the widening of the ERM intervention margins in August 1993, the hard currency policy was highly successful in reducing interest rate differentials with the DM across the maturity spectrum. Only briefly in February/March 1993, when markets were worried about budgetary developments, did the negative short-term interest rate differential with the DM turn positive. However, in the period last year between August and mid-November (roughly coinciding with the preparation of the Global Plan), and despite the unwavering commitment of the monetary authorities in support of the BFR

1 During the budgetary control exercise of March/April 1993, the target annual path for the reduction of the general government deficit was slightly revised, although compliance with the EMU deficit criterion of 3% of GDP by 1996 remains the ultimate goal. The revised convergence programme deficit targets for 1994 and 1995 are 4.7% and 3.6% of GDP, respectively.

parity (2), the currency remained under severe strain, (its depreciation vis-à-vis its central parity against the DM at one point reached 6.6%). Since the presentation of the Global Plan, the BFR has strengthened, re-entering the former narrow margin of 2.25%, while short-term rates have declined by about 3 percentage points between September of last year and the beginning of 1994.

Chart 2 - Belgium

Short-term interest rate differential and the BF/DM bilateral exchange rate



Source: Commission services

The trough of the economic cycle was attained in the first quarter of 1993. Since the Spring of 1993, economic activity recovered at a slow pace, with economic indicators improving considerably at the end of 1993. The main factors which are expected to foster economic recovery in 1994 are the anticipated upswing in the European economy and the continuing easing of monetary policy in Europe. Inflation is expected to rise slightly in 1994, reflecting further increases in indirect taxes at the beginning of the year. However, and in the framework of the Global Plan, the impact on wages of higher indirect taxes through the indexation mechanism will be partially neutralised from 1994 onwards by the introduction of a new reference index (the "Health index", which excludes from the CPI a number of products, e.g. tobacco, alcohol products, petrol and diesel).

Fiscal consolidation is paramount for the credibility of overall economic policy

In the framework of the convergence programme approved in June 1992, Belgium faces in coming years the major challenge of successfully pursuing the process of fiscal consolidation initiated in the 1980s. Given the recession and the prospect of a slow recovery, the task of redressing the Belgian public finance situation requires a thorough re-evaluation of policies, in particular in areas such as social security in order to curb

2 Between August and October, the short-term interest rate differential with the DM (monthly averages) was wider by between 260 and 340 basis points than before the crisis.

excessive growth in spending. The action called for in the broad economic policy guidelines to reduce budget deficits and put the public debt ratio on a sustainable downward path is especially urgent in the case of Belgium.

On 17 November 1993, the Federal Government introduced a series of important measures, in a document entitled: "Plan global pour l'emploi, la compétitivité et la sécurité sociale", to pursue and strengthen the fiscal consolidation process. In particular, the plan proposes measures to balance the social security accounts in the medium term, thereby seeking to restore full credibility to the process of fiscal consolidation and hence to the hard currency policy.

The saving measures included in the Global Plan - aiming to balance the social security accounts - amount to approximately 1% of GDP in 1994 (about BFR 70 billion), rising to 1.3-1.4% of GDP in 1996 (BFR 110 billion) ([3]). The bulk of the fiscal consolidation effort falls on the expenditure side, namely the pledge to cap at 1.5% per year the growth in real health-care spending between 1994 and 1996. This is a very ambitious goal as health-care spending grew by about 6% per year between 1989 and 1992. The increase in real wages (and pensions) in the public sector might continue to be excessive in 1994 despite the reduction in public employment.

Another major concern of the Global Plan is the improvement of the competitive position of enterprises which has deteriorated in recent years. This is to be achieved through the introduction of a modified CPI - the "Health index" - for the wage indexation mechanism and the freezing of real wages in the 1995-96 period ([4]).

In order to redress the "balance of incentives" towards employment creation, the Global Plan includes a series of important measures consistent with the approach recommended in the broad economic policy guidelines in this area. A number of programmes are introduced which decrease employers' contributions conditional on creating jobs or implementing work-sharing schemes, the latter in the framework of a "Plan

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3 In April 1993, an important package of fiscal saving measures had already been adopted, the impact of which was estimated at about 1.5% of GDP (BFR 114 billion) in a full year.

4 As regards 1994, the Government only recommends to the social partners that the real wage increases agreed for that year should instead be used to promote employment. Real wage increases in the private sector in 1994 are estimated at around 1%.

d'entreprise" ([5]). The reduction in employers' social security contributions is being particularly targeted on low paid jobs, the hiring of young unemployed people, and the first wholly unemployed worker engaged by an independent. In order to guarantee the budgetary neutrality of these measures, indirect taxes are raised by an estimated BFR 30 billion (about 0.4% of GDP).

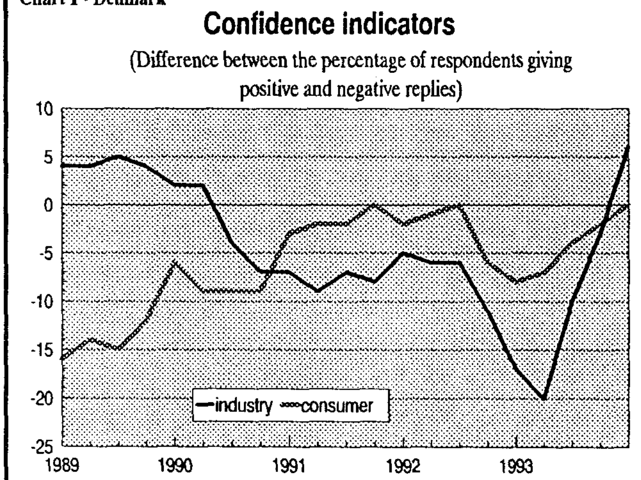
5 The "Plan d'entreprise" reduces employers' social security contributions by BRF 100 000 per year for each new (part-time) employment "created" through work-sharing.

DENMARK

Economic slowdown but stable nominal developments

In 1993, the Danish economy witnessed a disappointing rate of economic growth. While GDP stagnated, unemployment continued rising, reaching a record level at the end of the year. In contrast, nominal macroeconomic variables performed well. The inflation rate is among the lowest in the Community (1,5% in December 1993), the current account balance is recording a solid surplus (approximately 3,5% of GDP) and the public sector deficit, although widening, has not yet reached the levels experienced in other Community countries. After the temporary weakening in the aftermath of the exchange market turmoil in July 1993, the exchange rate is now back to the former ERM narrow band and the short-term interest rate differential vis-à-vis the DM declined to 130 basis points at the end of the year.

Chart 1 - Denmark



Source: Commission services

The main factor explaining the unsatisfactory growth performance has been weak domestic demand with, in particular, protracted weakness of consumer spending and a significant decline in private investment. Moreover, the growth performance was affected by the external environment. The currency depreciations of important trading partners and the recession in many European countries led to a contraction of exports (-5% in 1993). However, the recorded fall in imports was even sharper (-9%) and so the external side offset part of the impact of the fall in domestic demand on output.

Unemployment continued rising at an accelerating pace. The unemployment rate, at 12½% (national definition; 10,4% at the end of 1993 on the harmonized Eurostat definition), is the highest since the 1930s, and is the biggest challenge facing the Danish economy. An important cyclical component adds to high structural unemployment - the

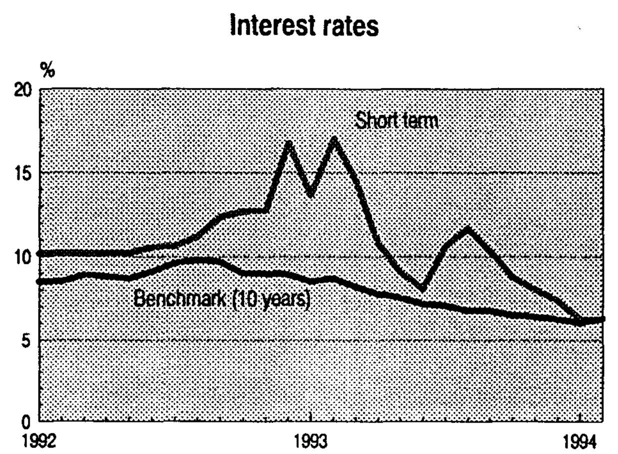
NAIRU is estimated to be around 8-9%. The remarkable disinflation process made further progress in 1993. Actual inflation is flat and unit labour costs are rising moderately. However, the gradual improvement in competitiveness which was experienced in the early 1990s was interrupted by the first EMS turmoil in September 1992 when important Community partner countries (and Sweden) devalued their currencies.

Preserving stability and responding to economic downturn

The conduct of economic policies has been determined by the twofold aim of, firstly, preserving and strengthening the nominal stability achievements of the past years and, secondly, of mitigating the effects of the recession on the real economy and on the labour market.

Monetary policy successfully defended the exchange rate during the exchange market turmoil in September 1992 by increasing short-term interest rates and thus accepting a sizeable interest rate differential vis-à-vis the DM. Continued uncertainties on exchange markets during the first half of 1993 determined the conduct of monetary policy with the effect that interest rates in Denmark remained undesirably high during a period of economic recession. The widening of the ERM fluctuation bands loosened the formal constraint on monetary policy. The authorities allowed a temporary deviation of the krone from its central rate, but made clear that they would continue their "hard currency" policy strategy. The krone is now back within the former narrow ERM band. During the process of kroner strengthening, the Danish authorities cautiously lowered short-term interest rates, and the short-term differential with the DM narrowed substantially. It has now reached pre-crisis levels. Long-term average bond yields have steadily declined last year and the differential of the 10-year benchmark bond yield with the DM has narrowed significantly. More recently, however, bond yields have started to increase and the long-term interest rate differential with the DM has widened again.

Chart 2 - Denmark



Source: Commission services

Fiscal policy responded more actively to the economic downturn. First, automatic stabilizers, which react strongly in Denmark, were allowed to work fully and, second, a fiscal package was introduced in 1993 containing both discretionary fiscal measures and structural measures mainly designed to improve labour market behaviour. The adopted programme was a reflection and in full accordance with the Edinburgh growth initiative. The discretionary measures are equivalent to 1½% of GDP in 1994. They include cuts in marginal tax rates, advancing of public investment, measures to stimulate the housing market and measures to expand education and retraining programmes. The temporary loss of revenue from tax cuts is planned to be recouped through increases in taxes and social contributions in the period 1995-98. Therefore, the fiscal stimulus provided in 1994 will fall in subsequent years, thus allowing the progressive reduction of the budget deficit.

The success of this policy will depend upon the behaviour of the private sector. A strengthening of private sector confidence in response to programme would indeed lead to the desired revival of both investment and consumption. For the time being, confidence indicators and short-term prospects indicate some revival in private sector activity and economic growth prospects have improved for this year. A recovery in major trading partner seems equally important to sustain a favourable growth pattern as the fiscal stimulus can only mitigate the short-fall in demand temporarily.

The main elements of the structural part of the programme concern labour market measures intended to reduce structural unemployment. Passive and active labour market measures will seek to ensure that people receive an early job offer in order to prevent them from being trapped in long-term unemployment, and in cases where no permanent job has been found the unemployed will have to join public schemes work in order to receive unemployment benefits.

Active labour market measures will be restructured and improved. The educational efforts for employed and unemployed will be strengthened. Furthermore, increased access to leave of absence (of up to one year), for the purpose of further education on personal reasons will be provided. Additionally, financial incentives for unemployed persons to become entrepreneurs and more room in the educational system will be created. All in all these measures should improve labour market flexibility.

The Danish government presented its first convergence programme in February 1994. The convergence programme describes medium-term growth prospects and the efforts being made to achieve convergence. The programme is based on the broad guidelines and the main element is the fiscal package introduced in May 1993. The main goals of the programme are fiscal consolidation and the reduction of unemployment; in particular the Danish authorities underline their commitment to meeting the convergence criteria.

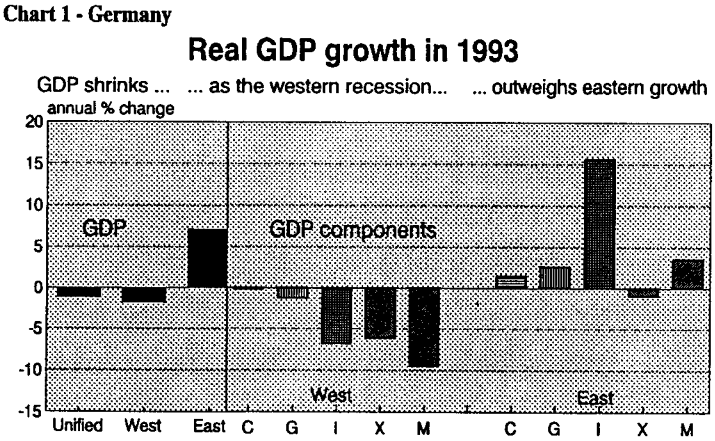
Given the seriousness of the economic recession in Europe, Danish economic performance has been relatively favourable. Priority has been given to maintain nominal stability, while during 1993 the importance of labour market problems have been recognised and started to be adressed through structural reform. The policy choice of using fiscal policy as the short term stabilizing instrument is not without risk and success will depend largely upon a recovery in the rest of the Community.

FEDERAL REPUBLIC OF GERMANY

The German economy adjusting to unification

In 1993, GDP in the whole of Germany fell by 1,2% (in West Germany the decline was 1,9%). In 1994 growth will probably be in a range of 0,5% to 1%. At present expansion in eastern Germany is constrained by the difficult economic situation in the western part of the country and in the short run there remain uncertainties about the likelihood of a major self-sustained recovery. Growth performance in the whole of Germany will be affected by the short-term effects of fiscal consolidation and depressed disposable income of households, possibly well into 1995. However, further monetary easing will provide support to the resumption of growth.

Chart 1 - Germany



C = Private consumption, G = Govt. consumption, I = Investment, X = Exports, M =Imports

Source: Statistisches Bundesamt

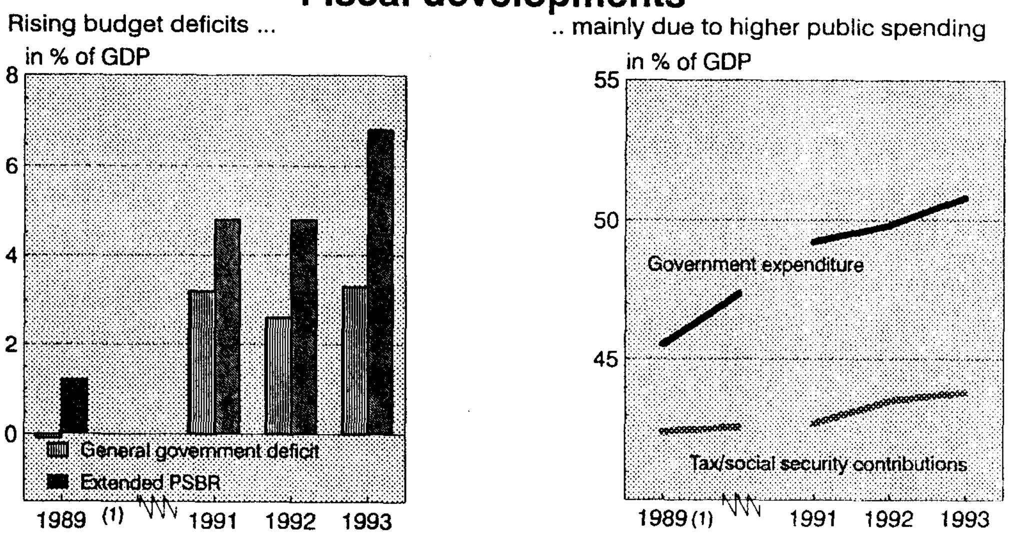
In addition, export performance, which has already recovered during 1993, should progressively improve together with competitiveness and so should overall growth dynamism. The major problem in the meantime will be unemployment, already at 4 million in the whole of Germany (more than 10% of the labour force according to the national definition; 8% on the harmonized Eurostat definition).

Due to the substantial public transfers to East Germany - currently at some 5% of GDP per year - a small surplus in the general government balance before unification (1989: 0,1% of GDP) has turned into a sizeable deficit (2,6% of GDP in 1992, 3,3% in 1993). This figure, however, was approximately half of total borrowing by the public sector in the broad sense (including the Treuhand and railways). The government reckons that, in 1995, when all these earlier borrowings will have been taken over by the government, the public debt/GDP ratio according to the Treaty on European Union will be around the 60% benchmark.

Savings measures seem, nevertheless, to be gaining credibility and public borrowing could be on a declining trend. This improvement of the outlook for government borrowing and the expected reduced pressure on prices have allowed the Bundesbank to gradually, albeit cautiously, ease its monetary policy.

Chart 2 - Germany

Fiscal developments



(1) 1989 West Germany only

Sources: Commission services, Statistisches Bundesamt (general government)
Deutsche Bundesbank (extended public sector borrowing requirement)

The trade surplus, which declined by some DM 100 billion (to DM 50 billion in 1993) after unification, will remain substantial in 1993 and 1994, but partly because of weak imports. The positive trade balance does not make up for the traditional deficit in invisible trade, however, in particular so because the surplus on factor incomes is expected to dwindle, especially due to net payments of capital income abroad following large inflows of capital in the last few years.

Slow recovery in West Germany after deep recession

In 1993, the West German economy seems to have reached the trough of the recession. Total output fell 2,5% below the peak reached in early 1992. From the spring of 1993 onwards output and orders began picking up and the second and third quarters saw modest GDP growth. The improvement was slow, however, and some indicators pointed to stabilisation at a low level rather than a genuine recovery. In the course of 1993 business confidence improved but later in the year GDP and industrial production contracted again. GDP for the whole of 1993 fell by 1,9%.

The strongest reduction was in investment; equipment investment fell by as much as 15%. Total domestic demand was 2,6% lower than in 1992. Net exports provided some positive contribution to growth, but only because imports fell even more than exports (by 9,5% and 6,1% respectively) ([6]). The performance of private consumption was the surprise as it stabilised at the level of the previous year in spite of a considerable erosion of households' real disposable incomes (because of job losses, wage moderation and higher social security contributions and taxes). This relative stability of consumption was to a large extent supported by a dip in the household saving ratio to 12,3%, below the level of previous recessions.

The labour market situation has been worsening very rapidly in 1993. Employment has been falling since it peaked at 29,4 million in September 1992, after several years of strong growth. At the end of 1993 the unemployment rate (national definition) stood at 8,1% (Eurostat: 6,0%). Industrial employment was particularly hard hit. Relatively slow productivity improvements and high wage rises had caused unit labour costs to rise steeply relative to competitor countries. Large scale rationalisation is now taking place in order to restore the competitive position of German industry. More than 500 thousand jobs (net) in manufacturing disappeared in 1993; unemployment will be one of the major problem areas of the next couple of years.

In early 1994, the German economy faces considerable uncertainty. Some further output contraction in particular at the beginning of the year cannot be excluded while the outlook for the rest of 1994 may be more promising. Domestic demand will remain depressed, especially in the area of private consumption as real disposable household incomes will deteriorate again although this could possibly be cushioned by a further fall in the saving ratio. Government consumption is also expected to remain flat (in real terms) as a result of fiscal consolidation. The downward trend in total capacity utilisation could bottom out, but investment growth will be modest. The domestic demand component which should provide a positive contribution to growth seems to be residential construction, benefiting from the low level of long-term interest rates (and possibly also from the continuous rise in rents). The possibilities for a recovery driven by exports seem to have improved in view of a returning to a sounder footing in important partner countries; export orders rose visibly during 1993, especially towards

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[6] These trade data should be regarded with caution. The introduction of the new recording system for intra-EC flows at the beginning of 1993 may have caused both exports and imports to be underrecorded, but imports to a greater extent (see box).

the end of the year. Therefore West German GDP could expand again in the course of 1994.

Notwithstanding this improving background employment will fall further and unemployment could rise to more than 9% (or more than 7% on the Eurostat definition) of the labour force in the current cycle. Inflation - now mostly driven by services, rents and fiscal and administrative charges - is easing. Import prices, which were on a downward trend throughout 1993, are no longer declining. Although this might involve some inflationary risk, the dampening effect of domestic factors seems much more important in the current circumstances (e.g. low capacity utilisation and wage claims). Wages actually reacted to the change in economic climate and wage rises can be expected to slow further. Moreover, the one-off tax increases should not permanently affect inflation.

Economic upswing in East Germany driven by public transfers

East Germany's present steady growth performance is still strongly supported by transfers from the western part of the country. Meanwhile, locally produced output has sharply declined since unification. Employment has decreased from 9,5 million to 6 million and is expected to fall a little further up to 1995. Unemployment is the result of the restructuring that is required and reflects generally low productivity and an overall lack of competitiveness. Although output is now growing again and productivity performance is improving, output per person employed is still only some 45% of the West German level. At the same time wage costs are already more than two thirds of those in West Germany, causing unit labour costs to be approximately 50% higher. Employment in the public sector (roughly half the number of those in public employment in western Germany compared with less than a quarter of the number of inhabitants) will have to decrease considerably in the years to come. Future job losses will, more than in the past, result in open unemployment which is projected to rise up to 1995, albeit at a much lower pace than in the past.

Output is growing in a number of manufacturing sectors, but employment continues falling in all sectors except construction. A promising sign is the high rate of investment. For the most part investment is taking place in infrastructure (railways, telecommunications etc.) and construction, but business investment, especially in the services sector, is now also strongly picking up, admittedly from a low level. This should gradually allow for self-sustained overall growth.

Inflation in East Germany, close to 9% in 1993, has been mostly driven by price increases of services and rents, largely resulting from the gradual deregulation of administered prices (rents, transportation, energy). Producer prices rose by a little less than 1% in 1993 and are not expected to accelerate in 1994. Inflation is expected to converge gradually to the West German rate.

Economic policy focuses on fiscal consolidation and structural reform

In early 1994, the German economy seems at a cross-roads and policy makers are facing serious dilemmas. Fiscal consolidation is imperative for regaining confidence and long-term credibility, as emphasised in the broad economic policy guidelines. Measures to this end are now being implemented, but their inevitable contractionary effect in the short term comes at an unfortunate time in the cycle. As to monetary policy, a further reduction of short-term interest rates seems desirable for domestic purposes and feasible in the light of the reduced risk of inflation. The rise in consumer prices, in early 1994 a little more than 3%, is coming down and the "underlying" rate of inflation is by any measure already very close to the Bundesbank's 0-2% objective. The downward pressure on inflation is further illustrated by producer prices which have remained practically unchanged for more than a year. Against this background, the renewed acceleration of M3 growth at the end of 1993 and early in 1994, seems surprising. It was, however, strongly influenced by special factors.

In November 1993 the German authorities presented their updated convergence programme, setting out government measures for enhancing the German convergence effort and improving medium-term growth prospects. Most of these measures form part of two major fiscal packages introduced in 1993: the Federal Consolidation Programme and the Programme for Savings, Consolidation and Growth.

The Federal Consolidation Programme was adopted in Spring 1993. It settles, first, the allocation of the debt related to unification which has so far been dealt with off-budget. In 1995, all unification-related items will entirely be accounted for in the budget and the re-introduction of the "solidarity" tax surcharge (worth some 1% of GDP) is envisaged. The second major issue settled in the Federal Consolidation Programme concerns the incorporation of the new Länder into the regular fiscal framework of the Federal Republic from 1995. The reshaped revenue sharing system will provide for additional funds to flow from the western Länder and the Bund to the East German states.

The Savings, Consolidation and Growth Programme was adopted in late 1993. It marked a shift in government policies in that it emphasised spending cuts, rather than revenue rises, in order to help to achieve the fiscal targets for 1994 and beyond. Envisaged savings amount to some DM 25 billion in 1994, rising to more than DM 30 billion in 1995. They concern mainly unemployment benefits, but also salaries in the public sector, subsidies, social benefits and family allowances.

Despite unsatisfactory developments in M3, a continuation of the Bundesbank's policy of cautious cuts in interest rates is expected by markets, in the context of subsiding inflationary pressures and the prospects of further declining inflation rates. The timing of monetary policy moves might depend on the performance of the DM on exchange markets. However, some downward correction in the DM's effective nominal external value should be seen as a return to normal rather than as a matter of concern.

With respect to structural issues the German authorities have put much stress on the need for greater flexibility on the supply side and the improvement of economic structures. In September 1993 they presented their views and policies in a policy report on Germany's future attractiveness as a business location ([7]). Among the points dealt with figured greater flexibility in the labour market and of working-hour regulations, an opening up of the liberal professions and improved functioning of product markets (e.g. energy). In order to improve the international competitiveness of German banks the Bundesbank reduced the minimum reserve requirements substantially (becoming effective in March of 1993 and 1994).

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7 Bundesminister für Wirtschaft, Bericht der Bundesregierung zur Zukunftssicherung des Standortes Deutschland, September 1993

GREECE

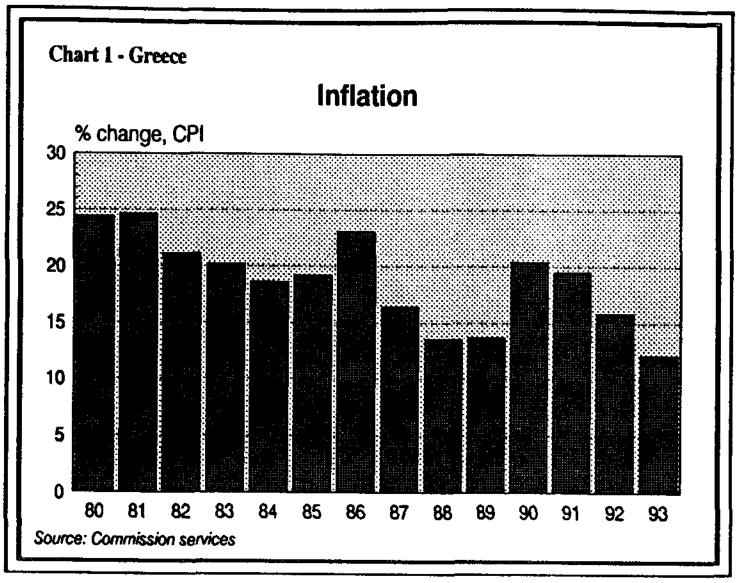
Stabilization efforts and weak demand improve inflation and external position

Greece experienced a slowdown in economic activity in 1993, with output estimated to have remained approximately flat. Official estimates suggest that the level of domestic demand was broadly unchanged in 1993 compared to the previous year. A rise in private consumption was offset by a fall in investment particularly in public investment as a result of a DR 230 billion cut in the public investment budget. The weak economy has had adverse consequences for budgetary consolidation and, as a result, prospects for nominal convergence have been set back. However, inflation and the external accounts showed improvement.

The labour market has gradually deteriorated. Employment remained flat, although employment in manufacturing has declined. Wage growth decelerated further in 1993. Incomes in the whole economy have risen by 12.1%, the combined result of the public sector incomes policy and the private sector wage agreement negotiated in May. However, real disposable income declined by 0.4%.

Greece's external accounts improved slightly in 1993, with the current account deficit representing 3.5% of GDP compared to 4.4% of GDP in 1992. This improvement is due partly to the decline in domestic demand which led to a fall in imports and partly to higher Community transfers. The trade deficit stabilised in absolute terms and the external sector made a positive contribution to GDP in 1993.

Greece made progress in bringing the inflation rate down from 19.5% on average in 1991 and 15.9% in 1992 to 14.4% in 1993, according to CPI data. The gains made on inflation are mainly due to the slowdown of the economy and to the decline in real incomes, especially in the public sector, which have affected demand. However, the decline in inflation has been modest, due to the continuing depreciation of the drachma, to the overshooting of the targets of the monetary programme which has increased liquidity above planned growth, and to apparent inflation expectations associated with continuing fiscal imbalances.



The nominal effective depreciation of the drachma in 1993 was 9.6% against 20 industrial countries' currencies and 6.9% against other Community currencies, compared to 7.7% and 8.4% respectively in 1992. There was a serious overshooting of monetary targets in 1993: M3 grew at a rate above 15% compared with the target band of 9-12%[8].

Public finances severely hit by economic slowdown

The most important development in 1993 was the overrun in the fiscal deficit. The central government net borrowing requirement (excluding capitalised interest) rose to 14,2% of GDP, about 6% of GDP above the planned deficit. This overrun was principally due to a large shortfall in budget revenues and to a small overrun in expenditure.

Factors underlying the fiscal imbalances in 1993 were the decline in economic activity, the reform of the personal and corporate tax code (Law 2065/92) which failed to realise the projected rise in tax declarations and the widening of the tax base, continuing tax evasion (especially in VAT following the abolition of customs controls), and increased primary expenditures in the approach to the October elections.

The financial position of the wider public sector also deteriorated in 1993. The deterioration was particularly pronounced in the area of public enterprises, while the net borrowing target for public entities (social security organisations) has been respected.

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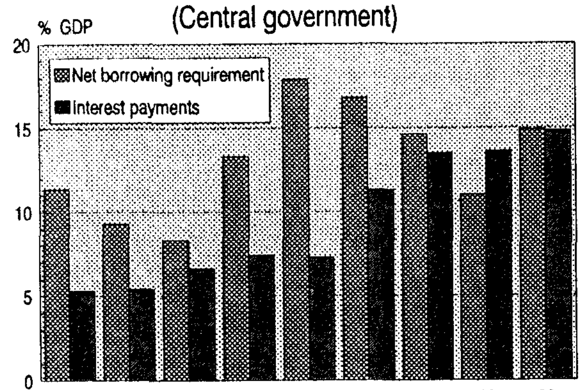
[8] Credit to the public sector is expected to have increased by some 12% as compared with the target range of 5% to 7%.

The debt of the central government at the end of 1993 is estimated at DR 23 278 billion or 138.8% of GDP[9]. Because of the very large public debt financing needs marginal interest rates on government borrowing remained high throughout the year: interest rates on one-year Treasury bills passed from 22.5% in December 1992 to 20.5% in December 1993. Deflated by the CPI inflation rate, real interest rates for the 12-month Treasury bill have stayed relatively high, at 8.4% in December 1993. Interest payments in the ordinary budget amounted to 13.6% of GDP in 1993, up from 10.5% of GDP in 1992.

Chart 2 - Greece

Net Borrowing Requirement and Interest Payments(*)

(Central government)



Source: Budget Statement, various issues

(*)Includes postponed interest.

The prospects for 1994 are not bright. In the real economy, domestic and foreign demand could contribute to modest output growth in 1994, the former through an increase in infrastructure construction activity, and the latter through the recovery of international and of the European economy. Private consumption could also slightly increase. The increasing borrowing needs of the public sector will inhibit the decline in interest rates, thus slowing a recovery in private investment. Incomes policy announced early this year projects an increase in the wages in the central government of 7.8% over the year, at a lower level than the expected inflation rate; however, it is not yet clear whether nominal wage arrangements in the private sector will be in line with inflation perspectives. On the other hand, social security contributions increased by 2.75% in January. Consequently, real wages and real disposable incomes are expected to decrease, in the public sector, continuing the trend observed since 1991.

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9 This estimate includes debt owed to the Bank of Greece which has not previously been included in official Greek debt figures and is not yet included in the general government debt figures in Part A of this report.

Fiscal adjustment: a necessary but not sufficient condition towards convergence

The macroeconomic outlook for 1994 and beyond is dominated by fiscal prospects. In order to establish the conditions for output recovery and real incomes growth, real interest rates must decline from the persistently high levels of the past three years. In turn, the key condition for this is the decline in the risk premium on government borrowing which is associated with the continuing fiscal imbalances. Furthermore, a determined fiscal correction would not only foster expectations that future budgetary imbalances will be contained, thus dispelling prospects for high levels of future taxation and encouraging private investment, but also, the portfolio crowding out observed during recent quarters would be reduced, making room for an increased level of private investment to be financed by domestic saving.

In the framework of the broad economic policy guidelines adopted by the Council in December 1993, all the efforts of macroeconomic policy will have to concentrate on the correction of fiscal imbalances. The challenge for Greece's economic policy, starting in 1994, will be to prevent further deterioration and resume the process of public deficit reduction. Given the size of current fiscal problems, the efforts will have to be pursued over several years in order to put Greece's public debt position in a sustainable position. A determined budget deficit and public debt reduction is the necessary condition for substantial interest rates reduction, price stabiliy and exchange rate stabilisation, and thus, for real and nominal convergence as provided by the Union Treaty.

However, if fiscal adjustment is necessary for Greece to start moving towards convergence, it is not a sufficient condition. Policies aimed at reforming the institutional setting and the restructuring of the economy will be necessary if the full potential of the Greek economy is to be realised. Among the changes required will be the improvement of the quality of services offered to business and households by the wider public sector, through increased competitition and privatisation, and the reform of business factor costs to improve the competitiveness of the economy and the trade balance through increased export activity and substitution of domestically produced goods for imports.

SPAIN

Economic activity bottomed out in mid 1993 but prospects are for a slow recovery

In the past two years Spain was hit by its deepest recession of the last few decades. GDP declined for four quarters in a row between the third quarter of 1992 and the second quarter of 1993. According to provisional data, GDP reached a trough in the second quarter of 1993, but it rose (quarter-on-quarter) at only a very mild pace in the third quarter.

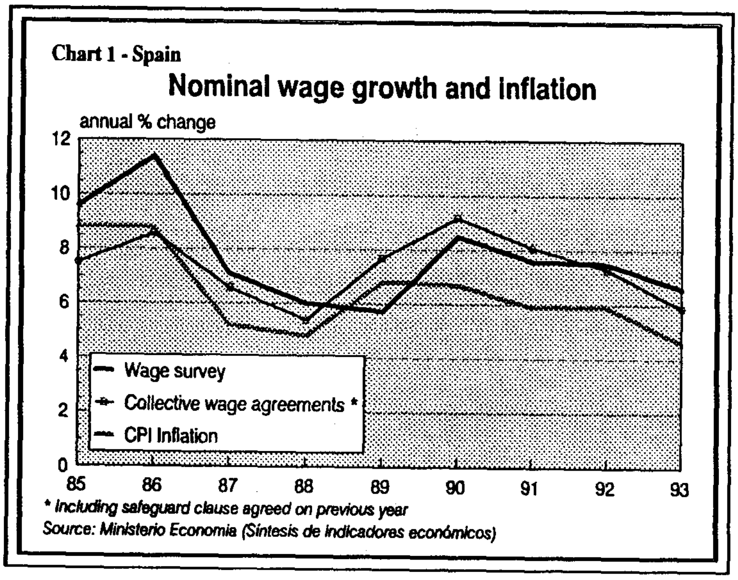
The 1992-93 recession in Spain and the current low level of economic activity are similar to those in most other European countries. Investment, which slumped from a growth rate of 6.9% in 1990 to a sharply negative figure in 1993, has accounted for most of the weaker trend in domestic demand and GDP. Private consumption has been weakening very markedly since the second half of 1992 and also recorded a negative figure in 1993, an unusual feature in Spain. The peseta depreciation and the very depressed domestic demand led to a substantial improvement in the external accounts in 1993.

Short-term prospects are for a gradual shift from external demand to domestic demand growth. Domestic demand has probably begun to rise early in 1994, while the positive contribution from the external sector is expected to weaken, particularly due to the rise in imports stemming from the recovery in domestic demand.

In 1993, the peseta depreciated approximately 13% against the DM. The 8% devaluation of the currency in May and the widening of ERM bands in August, by relaxing the exchange rate constraint, provided greater leeway for a reduction in official interest rates. Following the devaluation, the Bank of Spain lowered its key intervention rate in a series of steps from 13% to 9% on 3 December, the lowest level since 1977. This drop, which was mirrored in both short-term and long-term nominal rates, was the main factor behind the considerable drop in inflation-adjusted short-and long-term rates during the same period. By the end of the year, the latter recorded values of 3.8% and 2.9%, respectively. The continued reduction in interest rates after the widening of ERM bands in August has, however, been compatible with a stable peseta exchange rate.

Wage increases compounded recessionary trends and partly offset the impact of the peseta devaluations

The three devaluations of the peseta between September 1992 and May 1993 allowed for significant gains in competitiveness in 1993, making room for a positive contribution of the external sector to GDP growth which softened significantly the extent of the recession. The poor working of the labour market has however hindered the possibility to take full advantage of these competitive gains. Despite the severe fall in economic activity and the sharp rise in unemployment, wages have not adjusted to the situation on the labour market and continued to grow in real terms.



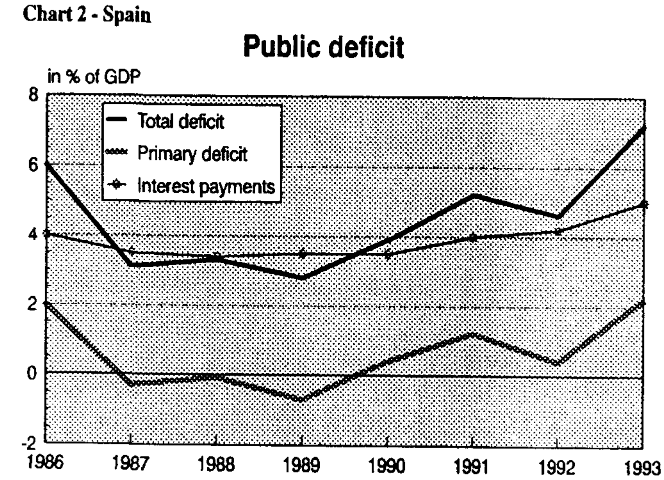
As a consequence of the poor working of the labour market and of rigid wage behaviour, companies have reacted to lower demand through strong cuts in employment. This aggravated the already high level of unemployment. The rise in unemployment has in turn contributed to job insecurity among a large share of the work force and has played a role in the general loss of confidence among consumers. This partly explains the deepness of the recession and has contributed to delaying a recovery in private consumption and, indirectly, in investment.

Moderate progress on inflation, sharp deterioration in public accounts

The cyclical downturn has had a dampening impact on inflation. Despite the increases in indirect taxation, the depreciation of the peseta and continued stickiness in services prices, inflation decelerated significantly in the second half of 1992 and in early 1993. However since then, while price increases for non-tradeables have slowed down significantly, less progress in tradeable goods and sharp increases in non-processed food in particular interrupted the disinflation process, leading to an average CPI inflation rate of 4.6% in 1993. Progress in inflation cannot be taken for granted to continue in 1994. The delayed impact of the peseta depreciation on domestic prices together with the expected recovery in demand can push prices up further. Moreover, if insufficient wage moderation persists, price expectations would worsen.

The figures for the budget deficit show a sharp overrun in 1993. After a general government deficit of 5.0% of GDP in 1991, 4.6% in 1992 and a target of 3.6% for 1993, as included in the budget law, the official estimate for 1993 is now put at 7.2% of GDP (chart 2). Three major factors explain the very pronounced deficit overrun of 1993. First, the downswing in economic activity was sharper than expected (the cumulated GDP outturn for 1992 and 1993 is -0.1% against an expected growth of 4.3% in the two budget laws). Second, there were some revenue lags and losses related to the removal of customs on 1 January 1993. Third, a less important factor was a regularisation of non-recognised debts originated in the preceding years which also had some impact on the 1993 deficit.

Chart 2 - Spain



Source: Commission services

These deficits have sharply pushed up public debt which reached 55.6% of GDP at the end of 1993. Stabilisation of the debt ratio has become more difficult as this now requires a positive primary balance, whereas the latter has become increasingly negative in recent years

Tackling unemployment through structural reform

Spain has continuously experienced, for more than a decade, the highest unemployment rates among the Community countries largely as a consequence of a malfunctioning labour market. To deal with the problem, the Spanish government approved last December a wide ranging package of structural reforms, in line with the convergence programme and with the recent broad guidelines for economic policy.

The package comprises two draft laws and a decree-law. The first draft law reforms the workers' statutes (Estatuto de los trabajadores). It intends to ease regulations on working hours, firing requirements and job mobility (geographical and functional). The second draft law authorizes temporary placement agencies. Finally, the decree-law on urgent measures to foster employment legalizes private job agencies, sets new hiring procedures with new contracts for apprentices, part-time and temporary replacement work, and extends the time-span of temporary contracts coming to its term next year. These reforms can be seen as entailing sweeping changes which aim at reducing rigidities in the labour market and fostering the responsiveness of real wages to the economic situation. In the short term, this higher flexibility may have a perverse effect on unemployment, with a related budgetary cost. However, in the medium term, it is expected to improve competitiveness, encourage investment and foster employment creation.

Budgetary redress hinges upon economic recovery and fiscal discipline

In the very unfavourable context described above, the targets of the convergence programme presented in April 1992 had to be set aside, especially those regarding fiscal consolidation (deficit of 1% of GDP by 1996). The Spanish authorities are currently revising the medium-term path of fiscal consolidation to make it more realistic.

The 1994 target for the general government deficit has been set at 6.4% of GDP (0.8 points lower than in 1993) while the draft budget for 1994 aims at reducing the central government deficit to 5.7% of GDP, i.e., 0.5 percentage points below the 1993 estimated outturn. The reduction in the central government deficit is to come mainly from expenditure cuts, both on public consumption and social transfers. In particular, the wage bill has been frozen, unemployment benefits have been reduced and pensions are to be increased at the rate of expected inflation, instead of being based on past price increases. The deficit target could, however, turn out to be optimistic unless a significant recovery in economic activity occurs. In dealing with the budget deficit, there is a need for greater control in public expenditure.

Another fundamental problem concerns the medium-term development of the deficit. Two aspects call for special attention. One relates to the extent of the welfare system. Though Spain still lacks the degree of social protection of other developed countries, social expenditure has grown very substantially since the early 1980s. As a consequence, the tax burden has also risen markedly. Trimming the budget deficit may require a re-evaluation of social expenditure in the light of the country's financing capacity and of a more selective access to social benefits.

A second important issue relates to the relationships between the different layers of general government. The decentralisation process has implied some overlapping of activities between the central government and the regional and local authorities. Moreover, the central government can only influence budgetary developments at the lower levels of public administration indirectly. After several years of budget overruns, a sounder stance now appears to be prevailing at the level of the Autonomous Communities, but in contrast the local authorities seem to face new difficulties. Further improvements in the co-ordination between the different layers of public administration would contribute to better control and efficiency of public finance.

FRANCE

Slowly coming out of the recession

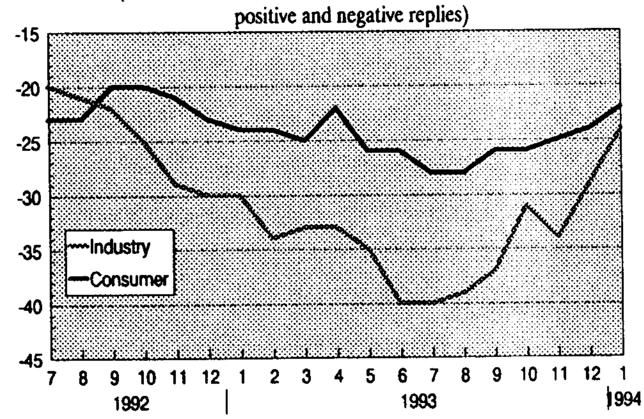
For the first time since 1975 French GDP declined in 1993 (by 0.7%). After a sharp fall at the end of 1992, French output shrunk further in the first quarter of 1993, dragged down by the weakness of domestic demand. Since then, some signs of slight improvement are appearing. The French economy has been reacting more sensitively to the cyclical downturn in the Community than during previous recessions.

A marked fall in foreign demand affected exports. While in 1992 exports still contributed significantly to economic growth, they fell in 1993. Some loss in competitiveness at the end of 1992 relative to some European main partner countries were compensated only in the second half of 1993 by the improvement of competitiveness vis-a-vis non-European countries. Even a decline in export prices in manufacturing industry, reducing profit margins on export markets, did not prevent this unsatisfactory performance. More generally, the consequences of the depreciation of some important trading partners from September 1992 interrupted momentarily the period of improving competitiveness through a low rate of inflation which resulted in large market share gains in 1992.

Chart 1 - France

Confidence indicators

(Difference between the percentage of respondents giving positive and negative replies)



Source: Commission services

The external performance did not fail to have its effects on the domestic economy. After the September 1992 exchange market turmoil confidence indicators dropped sharply and the threat of a severe recession became apparent. Moreover, still high interest rates further subdued domestic economic activity, discouraging borrowing and therefore private consumption and investment. The easing of monetary policy in Europe in the course of 1993 and the retreat of speculative pressures in the EMS after the substantial widening of the ERM fluctuation bands in August, contributed to some improvement of the French economic environment in the second half of the year.

Investment was particularly hard hit, following the strong increase in corporate investment in the second half of the 1980s. Its decline, some 30% in industry over the period 1991-1993, could reduce the growth rate of potential output in manufacturing.

As a consequence of the drop in confidence and a deteriorating labour market performance, consumers reduced their spending in particular on consumer durables. The saving ratio increased sharply at the end of 1992 and declined only moderately during 1993 as confidence improved slightly. The growth in disposable income was restrained by wage moderation in the private sector. However, large social transfers and rising wages in the public sector prevented real disposable income from falling. Without the positive contribution of public expenditure, households' consumption would have been even weaker.

Weak economic growth had its impact on the labour market. The labour market situation has continuously worsened since early 1991. Unemployment was at a record level at the end of 1993 (3.3 million people, or a rate of 11,2% on the harmonized Eurostat definition) and continues to rise. The recession mainly explains this trend, but structural factors have contributed to the unsatisfactory development. For example, the youth unemployment rate amounted to about 23%. Given modest growth prospects a reduction in unemployment cannot be expected during 1994.

The inflation performance improved again in 1993. Inflation has been kept under control by moderate wage development and particularly by imported stability as a result of the French exchange rate policy. Consumer prices increased by about 2% and the rise would have been even smaller in the absence of the increase in indirect taxation. However, in manufacturing industry, unit labour costs continued rising because of a marked slowdown in productivity growth. With increased price competition on domestic and foreign markets profit margins in French manufacturing industry were reduced substantially as a result of the fall in production and export prices.

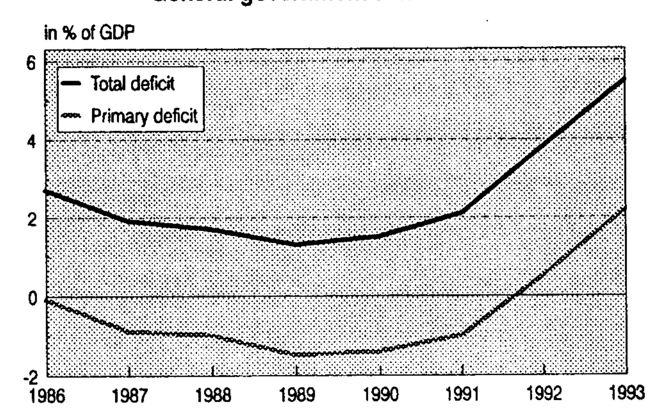
The trade balance recorded a surplus in 1993 (about FF 90 billion), mainly resulting from declining imports and an improvement in the terms of trade. It is doubtful if the recorded surplus in the trade balance can be maintained once the domestic recovery gains momentum and imports start to rise again. However, while exports declined in

1993, competitiveness of French industry remains quite good and exports should benefit from a general recovery in foreign markets.

Endogenous growth prospects remain uncertain in the short term. Given the slow growth profile likely in some important partner countries, e.g. Germany, a strong export-led upswing cannot be expected. Capacity utilisation remains low and the profit situation is not supporting capital-widening investment. Rising unemployment might prevent a strong fall in the saving ratio even if monetary policy continues along its path of cautious easing. In addition, fiscal policy is now aiming at medium-term consolidation and might have less supporting effects on demand in the short term. Domestic demand is therefore likely to remain subdued in the first part of this year, but may recover gradually in the second half.

Chart 2 - France

General government deficit



Source: Commission services

The slowdown in French economic activity has led to a major deterioration of the State budget deficit from 1,9% of GDP in 1991 to 4,4% in 1993, with a primary deficit exceeding 1% of GDP. The loss in fiscal receipts and also increasing public expenditures aiming at supporting economic activity have widened borrowing needs. The rising public debt resulted in a very sharp increase in interest charges (by 12%). The budget deficit would have been even larger if privatisation proceeds had not been allocated to finance budgetary expenditures, particularly current outlays. Financial receipts collected during the previous privatisation programme (1986-1988) were mainly devoted (two-thirds) to debt consolidation.

The financial equilibrium of the French social security system (régime général) deteriorated in 1993 as a result of cyclical and structural factors. The latter have their origin especially in the progressive ageing of the French population which is affecting pension expenditure, and also health expenditure. A set of short-term (health insurance) and long-term (pension scheme) measures were adopted in order to consolidate expenditure. Moreover, larger fiscal resources were allocated to limit the social security deficit: the CSG (contribution sociale genéralisée) was increased from 1,1% to 2,4%, corresponding to about FF 25 billion in 1993 and tax on fuels was raised too. As a result of these measures, the social security deficit which amounted to FF 57 billion in 1993 will probably decline to close to FF 40 billion in 1994. Taking into account unemployment insurance and local authorities' financial imbalances, the French general government net borrowing was about 5½% of GDP in 1993 according to the most recent official estimate. Therefore, together with the measures that have already been taken, a clear upward swing in economic activity will be necessary to start to restore sound French public finances. This is the aim of the French convergence programme adopted in November 1993, which provides a medium-term strategy for achieving budgetary consolidation in France during the second stage of EMU.

French economic policy has been primarily concerned with maintaining a large degree of nominal stability while attempting to mitigate the economic slowdown. Monetary policy has been devoted to preserving the DM-FF exchange rate. After temporary tensions on the exchange markets during which French short-term interest rates were increased markedly, the widening of the ERM bands in August 1993 enlarged the room for manoeuvre of monetary policy. As confidence in the FF strengthened, nominal interest rates were lowered sharply. Nevertheless real interest rates are still high in view of the sluggishness of the economy, indicating a cautious approach towards monetary easing. Against the background of these cautious interest rate reductions, in late 1993 the FF was back within the former narrow band.

Given the priority of the exchange rate objective, the Banque de France's monetary target (an increase of 4-6% in M3) was considerably undershot in 1993: by the end of the year, the aggregate was in effect showing no increase. Part of the undershooting can be attributed to "technical factors" such as the issue of the Balladur bond and portfolio shifts in general but it must also be related to the weakness of nominal GDP in France and to interest rates relatively high given that weakness. For 1994, the Banque de France has only slightly modified its targeting procedures: the importance of M3 has in practice been somewhat downgraded (medium-term target of 5% a year instead of an annual target range) and total domestic credit has been introduced as a "privileged indicator". The government retains the authority to decide on the exchange-rate régime and the franc-DM link will continue to be of major importance for monetary policy decisions.

Adoption of a medium-term strategy of fiscal consolidation

Fiscal policy has been used as the cyclical stabilizing instrument during the recession. The automatic stabilizers were allowed to work to the full extent and discretionary measures were also taken to stimulate the economy. The effects of previously adopted cuts in taxation and weak domestic demand squeezed tax revenues. Given the significant deterioration of the public sector deficit, there now exists little scope for continuing this process.

In order to strengthen fiscal credibility, the French authorities have adopted a medium-term strategy of fiscal consolidation which is embodied in the convergence programme. The planned restoration of healthy public finances in France is in line with the European Council's broad economic policy guidelines for 1994, aiming at improving conditions for growth. The convergence programme aims at a reduction of the general government deficit to below 3% of GDP in 1997 mainly through expenditure restraint and a reform of the social security sector. Budgetary expenditure should not increase in real terms implying that the consolidation target (a reduction by a half percentage point of GDP in each of the coming years) might prove a quite ambitious challenge.

The success of this consolidation strategy will crucially depend upon a revival of private sector-led growth as fiscal policy will change from a supportive to a restrictive stance. A favourable external demand environment and a significant improvement in private sector confidence seem to be the main preconditions for a favourable growth scenario. The contribution of monetary policy would consist in a continuation and perhaps acceleration of easing in order to compensate for the shift in fiscal policy.

Wage developments will have to continue to contribute to both re-establishing external competitiveness and improving profit margins. However, in order to influence private sector expectations positively wage moderation should be accompanied by greater flexibility in particular as regards the possibilities to employ low productivity workers.

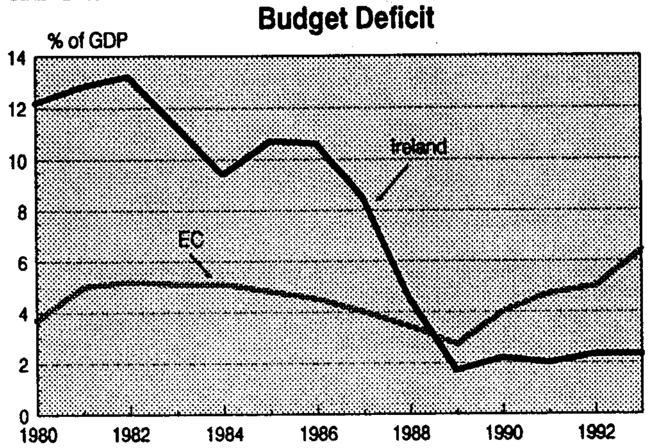
As suggested in the broad guidelines' recommendations on the reduction of indirect labour costs and on policies in favour of employment, structural policies in 1993 were principally devoted to removing rigidities in the labour market and corporate sector. Cuts in social security charges on low-skilled workers and other measures increasing flexibility of working time were adopted. Employment is hampered by the still high level of labour costs in the case of unskilled workers resulting from the existing rules on minimum wage (SMIC). The French government has opted for progressively reducing employers' social security contributions on low wages. This measure is part of a recently adopted medium term law in favour of employment. Other rigidities will be removed by improving vocational training (particularly apprenticeships) and flexibility in the organisation of work. In this perspective, settlements on working time on a yearly basis will be encouraged. A recovery of employment is all the more necessary also with respect to consolidation of public expenditure. In 1993 large amounts of budgetary resources have been allocated to support the labour market, particularly in the form of subsidised part-time jobs in the public sector, at a budgetary cost of FF 15 billion. Moreover, structural reform has been enhanced by the start of a large programme of privatisation which has been well received by financial markets which see scope for an improvement in the efficiency of the enterprises to be privatised.

IRELAND

The January devaluation required a cautious macroeconomic policy stance

Chart 1 - Ireland

Budget Deficit



General government net borrowing as a % of GDP
Source: Commission services

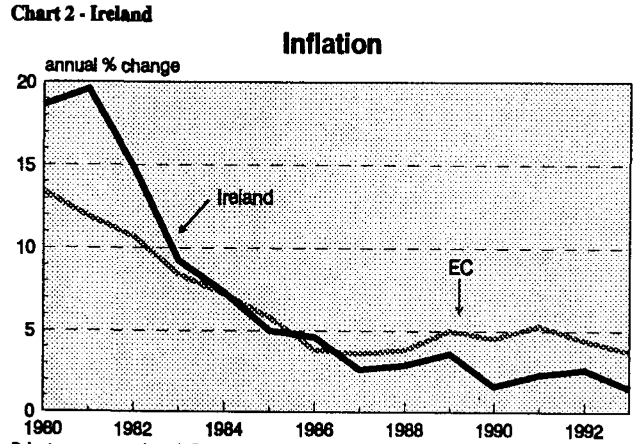
A firm macroeconomic policy stance was needed in Ireland in 1993 to strengthen credibility in the wake of the devaluation of the pound in January. Hence, fiscal policy remained firmly focused on maintaining control over the budget deficit. While the January 1993 budget did project a mild deterioration in the deficit to about 3½% of GDP, this implied a fiscal tightening given the impact of the slowing economy on the public finances. Monetary policy remained similarly oriented towards stability with cuts in the Central Bank's short-term facility (STF) being determined by falls in market interest rates and the stability of the pound within the ERM.

This policy stance - complemented by the strengthening of sterling - successfully re-assured financial markets of the continued stability orientation of economic policy. Following the 10% devaluation of the currency's ERM central rate on 30 January the pound stabilised quickly within its new ERM bands. The Central Bank of Ireland reintroduced the short-term facility (STF) rate at 13.75% which subsequently was reduced in a series of steps to 7%, the lowest level since the introduction of the facility in 1979. From September the Irish pound appreciated steadily (mirroring sterling) and by end year was the strongest currency in the ERM grid. Furthermore, the eventual outturn for the budget deficit, at just over 2% of GDP, was substantially lower than market expectations and the official forecast.

Moderate output growth, low inflation but continued very high unemployment

Given the constraints presented by the policy stance outlined above, growth in output continued at a respectable pace in 1993, particularly compared with the falls in output in most Member States. Nonetheless, the estimated outturn of around 2% represents a sharp slowdown on the corresponding figure of almost 5% achieved in 1992. This slowdown was largely due to the sharp deceleration in the growth in the volume of exports. The other components of demand failed to fully offset this slowdown. Private consumption remained relatively weak despite continued strong growth in real disposable income owing to fears of unemployment and the carry-over of high interest rates from 1992. Private investment was similarly affected by interest rates and only a major boost to the public capital programme prevented a sharp fall in total investment. Finally, public consumption was constrained by the need to keep the budget deficit in check.

Chart 2 - Ireland



Private consumption deflator
Source: Commission services

The expected acceleration in inflation following the January devaluation failed to materialise - a trend seen in several other Member States whose currencies also devalued. The private consumption deflator is now expected to have risen by only about 2% compared to a forecast range of 3% to 4%. Several factors underlie this better than expected performance. Firstly, Ireland's effective exchange rate did not depreciate signficantly relative to its pre-ERM crisis level, owing to even more substantial devaluations in several other Member States. Secondly, substantial stocks had been accumulated when the pound was strong which combined with strong retail competition restrained price increases. Thirdly, pay rises for 1993 had already been decided under the existing agreement on incomes policy. Fourthly, exchange rate (post-devaluation) and commodity price developments were favourable. Finally, and perhaps most importantly, the firm stance of macroeconomic policy and the slowdown in growth restrained inflationary pressures.

Superficially, labour developments suggest that some progress was achieved in 1993. The average annual level of unemployment in 1993, as measured by the live register, emerged at about 294 000 compared to a budget estimate of 309 000. However, while data is still scarce, this lower than anticipated level is probably attributable to an upsurge in emigration, changes in eligibility conditions for unemployment benefits and an increase in training programmes rather than strong employment growth. Moreover, at around 18% of the civilian labour force this still represents an unacceptable level of unemployment and emphasises the enormity of the challenge facing policy makers in the years ahead when labour force growth can be expected to continue at about 2% annually.

Impressive nominal stability needs to be complemented by accelerated structural reform

The challenge facing the Irish authorities in 1994 is to build on the strengths and room for manoeuvre created by the success on the nominal front and to turn the focus of policy more strongly towards unemployment. A number of policy considerations will crucially determine their success or failure in meeting this challenge.

There are clearly deep structural rigidities underlying both the current level of unemployment in Ireland and the failure of the strong output growth of recent years to be translated into sufficiently increased employment. The government-commissioned "Culliton Report" performed a valuable service in identifying these rigidities and highlighting the need for their urgent reform. The government are continuing the necessary programme of reforms. It is essential that this programme is speedily and effectively implemented. The commitment to follow the "general guidelines" on Community economic policy agreed by the EcoFin Council in December should assist this process.

Reform of the taxation system has a crucial role to play in tackling the structural rigidities currently preventing a better employment performance. The continuing fiscal consolidation of recent years has been achieved partly at the cost of a rise in the burden of direct taxes. This burden impacts heavily on lower paid workers and is widely credited with having major disincentive effects on labour supply. The improved fiscal position in Ireland now presents an opportunity to intensify the necessary tax reforms. The recent budget has made some further progress in this respect and the commitment to further reforms in future budgets is welcome.

Ireland has followed a centralised pay bargaining system over the past six years which has made a valuable contribution towards consolidating economic and social stability. However, future wage developments should afford a higher priority to employment and competitiveness. Real wage growth in Ireland over the period of the two previous agreements has been substantially above the Community average. The economy's job creation needs would be better served by more moderate pay developments, particularly in the public sector where wage growth has been strongest. In this respect there has also been recent encouraging progress with the government and social partners agreeing to moderate pay rises for the period from 1994 to 1996.

Investment growth in Ireland has been relatively stagnant in recent years. Encouraging a higher level of private investment is a priority. Consideration also needs to be given to the scope for switching public spending towards increased public investment which has borne the brunt of spending cuts over the past decade. The investment opportunities presented by the substantially increased structural and cohesion funds must also be efficiently exploited.

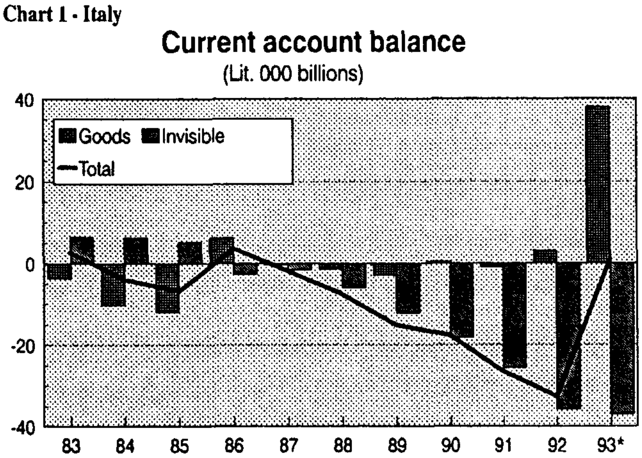
ITALY

Recession continued in 1993 despite large contribution of real net exports to GDP growth

The recession starting in mid-1992 continued throughout most of 1993 and at the end of the year no definite signs of cyclical upturn had yet appeared. After the prolonged slowdown in growth from 4.1% in 1988 to 0.9% in 1992, real GDP declined in 1993 by around 0.5% according to latest estimates. The recession would have been much deeper but for the contribution of real net exports, which partially offset the persisting fall in domestic demand. While economic activity may have bottomed out by the end of 1993, expectations are for only a slow recovery in 1994 (1.6% GDP growth, according to official figures), with momentum gaining in the second half of the year.

The fall in domestic demand, initially resulting from an unusually sharp decline in fixed investment, deepened because of a significant reduction in private consumption (-1.8% on average in 1993), a behaviour never recorded in previous post-war recessions. Consumers' expenditure has been heavily affected by the decline of disposable income, which was due to the fall in total employment, the reduction in real per capita compensation and the increase in the tax burden. At the same time, the contraction in total investment that preceded the recession at the beginning of 1992 intensified in the first part of 1993. Fixed investment is estimated to have fallen by more than 8% in real terms on average in 1993.

Chart 1 - Italy



*Estimates of Commission Services
Source: Bank of Italy

The response of the Italian trade balance to the devaluation of the lira after the departure from the ERM in September 1992 has been extremely rapid and positive. Since then, the depreciation of the lira significantly exceeded the losses in competitiveness recorded in the previous three years. In nominal effective terms the average depreciation of the Italian currency in 1993 was around 20% in comparison with the pre-crisis level. Notwithstanding the deterioration in terms of trade, the nominal trade balance did not show any perverse J-curve effect, whereby a real depreciation of the exchange rate worsens a balance-of-trade deficit initially, only to improve it over time. By contrast, the trade balance moved into positive figures in the first months of 1993 and strongly improved in the remainder of the year. Preliminary estimates on volumes indicate that in 1993 average imports fell by between 8 and 10%, while exports increased by the same rate.

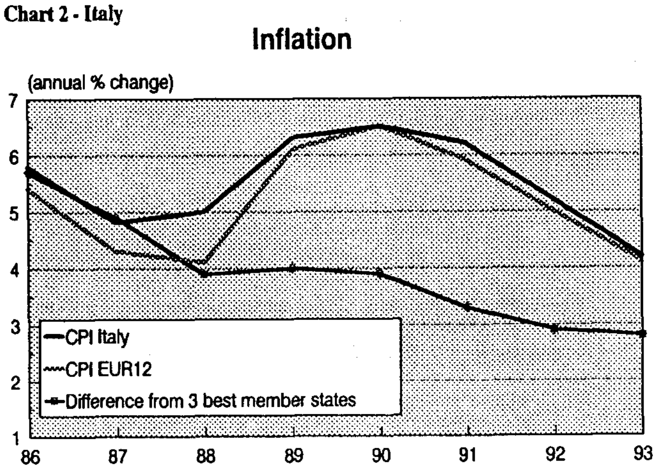
Cyclical impact on labour demand compounded by severe restructuring in manufacturing and services sectors

While employment in Italy was traditionally characterized by low responsiveness to output fluctuations, the current recession has heavily affected labour market conditions. A number of institutional reforms introduced in the last ten years substantially reduced private labour market rigidities, but also fiscal constraints have recently prevented the public sector from playing a role of employment stabilizer. The cyclical impact on labour demand has been compounded by severe restructuring involving first the manufacturing sector and then the private services sector. In 1993, employment losses are estimated to have been over 600 000, of which almost a half were in services and a third in manufacturing. The unemployment rate, according to the national definition, rose from 9.4% to 11.3% between January and October 1993 and reflected, once again, substantial differences in the regional distribution of unemployment, with a rate of 18.9% in the South, 9.8% in the Centre and 6.9% in the North.

Inflationary impact of devaluation dampened by falling demand and wage moderation

The large depreciation of the lira has only slackened, but not halted the progress in disinflation. In 1993 the average rise in consumer prices was 4.2%, which is below the official target for inflation (4.5%) and represents the lowest rate in twenty-five years. Falling domestic demand and structural factors contributed to contain domestic inflationary pressures. However, behind these results has also been wage moderation, essentially due to the institutional changes introduced between 1992 and 1993 in the wage formation mechanism, which substantially removed the risk of a wage-price spiral. The reform of the wage setting mechanism started in 1991 and completed in July 1993 has greatly changed industrial relations and reinforced incomes policy as a decisive instrument to curb inflation. The rules for wage settlements have been completely reshaped: the economic effects of the contracts bargained at national level have to be consistent with the target inflation rate; firm-level wage increases will be rigorously linked to productivity gains and improvements in competitiveness. The new regime constrains the wage evolution to the disinflation path set in the goverment targets, and replaces the previous indexation mechanism. Since mid-1992, the rate of growth of per capita wages has been outpaced by the inflation rate. The rebound in measured productivity, obtained through reduction in employment, helped to reduce unit labour costs, which fell by 0.5 percentage points in the first three quarters of 1993.

Chart 2 - Italy

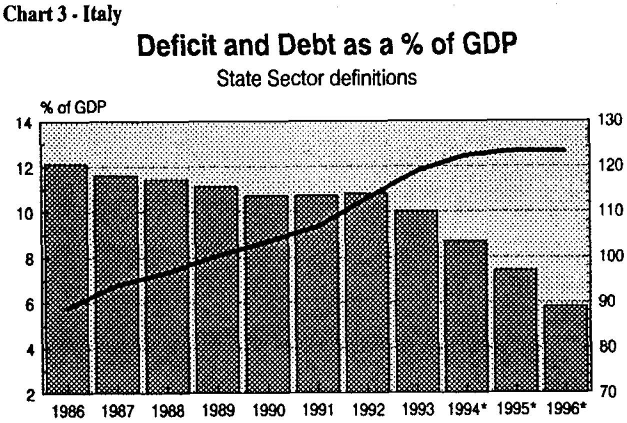


Source: Eurostat

Progress in fiscal consolidation in spite of the recession

There has been a very significant adjustment effort in the public finances in the last two years. The budget for 1993 was a landmark, both in the size of the planned correction relative to underlying trends (close to an estimated 6% of GDP) and in the willingness to tackle structural fiscal problems. Reforms were introduced in the fields of public employment, pensions, health care and local authority finances. These efforts were to some extent

Chart 3 - Italy



Note: New State Sector definition applies as of 1992.
Source: Treasury, official targets (September, 1993) for 1994 to 1996

overshadowed by the recession which hampered the pursuit of fiscal adjustment and increased its cost. Nevertheless, an improvement of the order of 1% of GDP was achieved in the primary budget surplus in the state sector account in relation to 1992. At the same time, the exchange rate regime followed since the departure of the lira from the ERM allowed a steep fall in interest rates (from a peak of 15% in September 1992 to below 7.5% at the end of 1993 for the net yield on 3-month Treasury bills) and thus helped contain the total deficit relatively close to its targets. Although interest rates are expected to remain low, the persistence of a risk premium vis-à-vis other EU countries points to the need to hasten deficit reduction and to the danger that significant slippages from the deficit targets might reverse the declining trend of interest rates. The progress achieved so far in fiscal consolidation must therefore be continued in 1994 and beyond. Last year also marked a turning point in privatization; the long-awaited process of dismantling the large state involvement in the economy has started to achieve some concrete results. The strategy pursued privileges the objective of swift and irreversible privatizations rather than maximization of proceeds from the sales. Total revenues from the sale of public enterprises are estimated at some 5% of GDP, but a significant proportion will be needed for restructuring operations, thus the direct impact on public debt is going to be very small.

Prospects for convergence reinforced by structural reforms

Economic policy in the last two years correctly adressed the major structural problems of the Italian economy. The implementation of these reforms will allow the convergence process of the Italian economy to rest on a more solid foundation. Fiscal consolidation should be continued vigorously, as recommended in the broad policy guidelines, so that the stabilization and subsequent decline in the debt to GDP ratio is achieved soon. The inflation differential from the three best-performing Member States, currently at 2.5 percentage points, must be narrowed. Although the large output gap along with wage moderation has helped contain the inflationary pressures arising from the currency depreciation, the hoped-for recovery will require the anti-inflationary commitment to be built in a context of exchange rate stability. A scenario of healthy recovery in economic growth and employment, along with steady progress towards convergence, includes income and monetary policies to control inflation and a budgetary policy to achieve fiscal consolidation. This policy mix will help to ensure exchange rate stability.

LUXEMBOURG

Growth supported by internal demand

Over the last decade, Luxembourg has consistently accomplished a better economic performance than most other European countries. The estimated growth for 1993 of around 3/4% continues to compare favourably with the other Member States. The improving external environment should permit GDP to increase by approximately 2% in real terms in 1994, still considerably less than the average growth rate of around 4% in the period 1983-92.

The relative resistance of the Luxembourg economy to the European recession in 1993 is a consequence of the strength of domestic demand. An increase in private investment of 5.5% represented the principal contribution to growth in 1993. This figure is mainly the result of a big state-supported renovation program in the steel sector and the launching of a new Astra telecommunications satellite; public gross capital formation receded. Private consumption rose by about 1% and was sustained by wage increases higher than in the neighbouring countries, driven by close-to-full employment in the labour market. Because the expansion of employment in the services sector more than compensated for the continued decrease in the traditional steel sector, total employment continued to rise, albeit at a slower pace than in the previous years. Since the number of foreign workers is increasing faster than the creation of additional employment, domestic unemployment has risen a little to around 2.5% (Eurostat definition), although it still remains by far the lowest in the Community.

In contrast to most other Member States, inflation is not declining in Luxembourg, but remains lower than the European average. The relatively high real wage growth, combined with higher excise duties and increases in costs for medical care and other administered prices are responsible for this evolution.

As a result of the strong internal demand combined with weak external demand, the merchandise trade deficit widened in 1993. As usual, this was compensated by a surplus on the services balance and by a net inflow of factor income, creating a healthy surplus on the current account.

If the improvement of the economic situation in the neighbouring countries is confirmed in 1994, the negative growth contribution from external trade could be eliminated. The level of domestic demand will be sustained by the increase of private consumption, due to a relatively high real wage growth, and of public consumption; investment is likely to fall back a little, because of the completion of some major investment projects. As a result gross domestic product could grow by 2% in real terms. Without major indirect tax increases in 1994, inflation might fall back to just over 3.2%.

Public finance situation remains healthy

After the reform of the tax system in 1991, which included a reduction of direct taxes only partly compensated by higher indirect taxes, the government accounts are no longer in surplus. The rapid increases of public expenditures, especially on health and pensions, further weakened the public finance position. Still, Luxembourg continues to comply with the EMU convergence criteria on public debt and deficit.

To prevent a further deterioration of the public deficit, the government has reduced the budget norm from 3.5% to 1.5%. This norm gives the admissible real increase in central government expenditures (social security excluded), based on medium-term growth prospects. In combination with the expected increase in wages, as generated by the automatic wage indexation system, this results in the allowed nominal increase of central government expenditures. The application of this norm still results in an expected growth of nominal expenditures of the central government (social security included) of 6.8%, which implies a real increase of more than 3%. The reduction of this growth rate is proving to be very difficult since the major part of spending is rigid and regulated (wages, previous engagements of the central government in the social security system). Still, the government should try to revise some of these automatic expenditure mechanisms to prevent a worsening of the still healthy public finance situation.

Central government revenue is estimated to increase by 6.8% in 1994, with similar contributions from direct and indirect taxation. A major part of the higher indirect tax receipts is explained by the increased proportion of the common receipts of the economic union between Belgium and Luxembourg. The part for Luxembourg is to be increased from 12.8% to 15.7%.

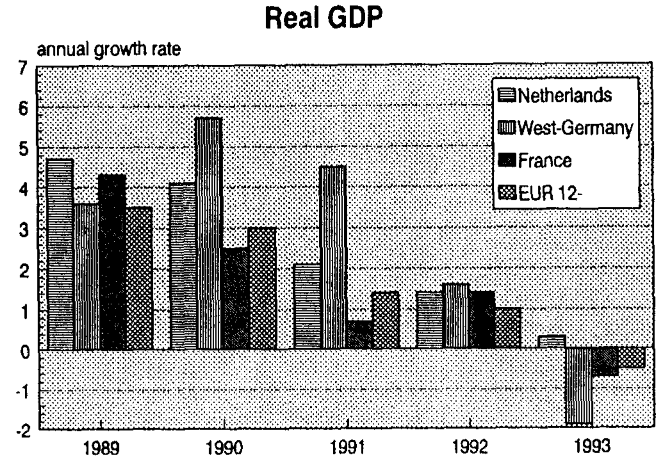
In the social security sector, the further implementation of the reform of the health insurance system, which was initiated in 1992, limits the state's contribution to 39% of total revenues of the system. This was necessary to prevent a further fiscalisation of the system. As a consequence of this reform, it might be necessary to increase private social security contributions. Health expenditures will be limited by negotiating a fixed budget for each hospital. Together with the improving economic environment, which generates higher tax receipts, these measures could lead to a small reduction of government borrowing in 1994.

NETHERLANDS

Deep recession avoided but recovery will be slow

In contrast to most other countries in continental Europe, the Netherlands were able to avoid a marked recession in 1993 and real gross domestic product probably remained about equal to the year before. This apparent resistance of the Dutch economy to the deep recession in Germany is remarkable, considering the openness of the country and the close economic and monetary integration with Germany.

Chart 1 - Netherlands



Source: Commission services

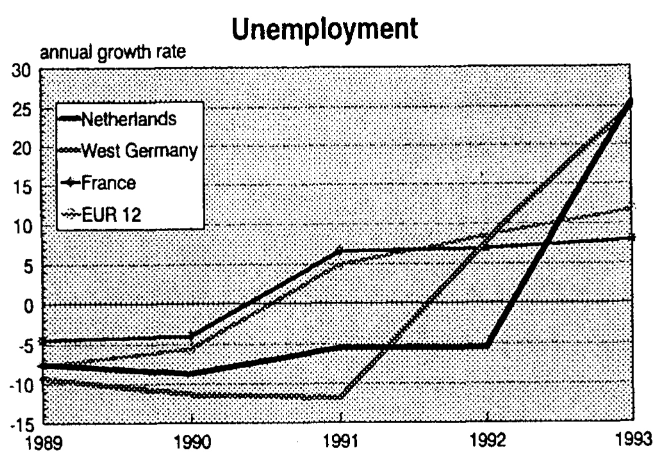
Private consumption has been the main contributor to growth in 1993. After a small dip in the first quarter, caused by anticipatory purchases of durable goods in the last quarter of 1992 in advance of higher indirect taxes, consumption recovered promptly and grew by approximately 1% over the year. This can partly be explained by higher than expected real wages because inflation was over-estimated when the long-term wage contracts were negotiated. However, the strong consumer spending mainly originated from lower saving, possibly caused by low long-term interest rates.

For the first time in 10 years, real gross capital formation was lower (by some 3.5%) than in the previous year, as a result of lower capacity utilisation and weak order positions. While government investment, non-subsidised residential construction and investment in equipment were stable or still showed some progress, non-residential construction and investment in transport equipment (especially trucks) receded sharply.

The small share of the hard-hit manufacturing sector in Dutch GDP (only 17.8% of value added in 1992) also helped to shelter the Dutch economy from a deeper recession. The automotive sector, which was probably most affected in the current recession, is almost absent in the Netherlands. The Dutch specialisation in agricultural products and their derivatives, which are less sensitive to cyclical variations, further helped to isolate the Netherlands from the recession in its neighbouring countries.

This specialisation pattern also allowed Dutch exports to remain relatively unaffected by the fall in demand from the major trading partners. This was realised at the cost of a strong decline in profitability in the exporting sector. Import volumes were about 1% lower than the year before ([10]) reflecting the decline of investment. The combination of steady exports and falling imports led to a current account surplus of around 2% of GDP.

Chart 2 - Netherlands



Source: Commission services

Unemployment, which had been constantly abating since 1984, rose sharply from 6.8% in 1992 to 8.2% in 1993 (Eurostat definition). Compared to other countries such as France and Germany, it took a long time in the Netherlands before unemployment started rising in response to the lower growth. A first explanation for this phenomenon is that the economic downturn in the Netherlands started later and was more moderate than in most other countries. The sudden increase in unemployment also points to earlier labour hoarding, caused by the institutional framework in the Netherlands. Indeed, the costs of the rigorous legal procedures that have to be followed to lay off employees postpone necessary labour market corrections. Finally, because of the recent changes to the disability scheme, which were aimed at reducing the number of hidden unemployed in this scheme, more people registered as unemployed than before.

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10 As in other EC countries, there are considerable uncertainties about the development of intra-EC trade during 1993 following the abolition of internal customs frontiers and the introduction of the new INTRASTAT recording system. See box on "Reliability of intra-EC trade statistics in 1993".

The activity slowdown, combined with the strength of the Dutch guilder, has brought down inflation from a peak of 4.4% at the beginning of 1992 to an average of 2.1% in 1993. A cut in the highest VAT rate by one percentage point to 17.5% at the end of 1992 and the recent wage moderation also contributed to lower inflation.

The credibility of the peg of the Dutch guilder to the German mark never came seriously under pressure despite the economic downturn and the turmoil in the ERM. Under a bilateral agreement with Germany, the Netherlands even maintained the pre-August 1993 fluctuation margin of 2.25%, while the other currencies moved to a 15% band. The continued strength of the Dutch guilder, leading towards the end of 1993 to an appreciation of 0.6% above its DM parity, permitted the monetary authorities to regularly cut interest rates independently of the Bundesbank. This produced a negative short-term interest rate differential with the DM for most of the year under review, reaching a maximum of -100 basis points on 3-month euro-deposits in June; after the August events in the exchange markets the differential widened again to -60 basis points in December.

Despite the relatively good performance in 1993, the recovery in 1994 will be slow and growth will probably be below 1%. Both consumers' and producers' confidence indicators have bottomed out in the second half of 1993, but remain at low levels and no clear upswing is in sight. Domestic components of GDP will remain very subdued while the specialisation pattern of Dutch exports will not allow full advantage to be taken of a possible economic recovery in the rest of Europe.

Growth expected for 1994 will be insufficient to create additional employment, so the unemployment rate will continue to rise to more than 9%. This will put additional pressure on social partners to limit wage increases in their negotiations. Inflation will benefit from lower wage settlements, but higher excise duties and government-regulated gas prices will broadly offset this.

Fiscal consolidation continued in 1993, but some easing in 1994

Despite the lower than expected economic growth in 1993, the central government deficit has been reduced to 3.6% of Net National Income([11]), slightly below the target set in the coalition agreement of October 1989. This was achieved because additional measures were taken in Spring 1993 and was also due to higher than expected revenues amounting to 0.7% of GDP which occurred in the final part of the year.

In the original budget for 1994, the government decided not to compensate for expected lower tax receipts, caused by the adverse economic environment, to avoid possible deflationary effects of further budget cuts or tax increases. The budget objective was relaxed from 3.25% of NNI to 3.9% of NNI. Nevertheless, to arrive at this result, real expenditures have to be reduced, excise duties raised and part of the expected proceeds of the privatisation of the state-owned telecommunications company will be used. The most important structural expenditure cut comes from freezing the level of government salaries and social security benefits. When it became clear that revenues in 1993 were considerably higher than expected, the government decided in February 1994 to use these budgetary opportunities to improve employment through a reduction of the collective burden of taxes and social premium payments, starting from July 1994 and getting to its full extent in 1995 when the package will amount to approximately 1% of GDP. Part of the additional revenues is used to reduce the central government deficit to 3.75% of NNI in 1994, but no further improvement is envisaged before 1997.

While the original target for 1994 in the convergence programme of March 1992 was set at 2.4% of GDP, the government now expects a deficit of 3.6% of GDP. Although the difficult economic circumstances explain part of this loosening of the target and it still remains one of the lowest deficits in the Community, the effort to reach the 3.0% EMU objective before 1997 should be continued; this is especially important for the evolution of government debt, which continues to increase slowly from its present level of 81% of GDP.

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11. The official Dutch deficit objective is the deficit including financial transactions, based on cash receipts, expressed as a percentage of Net National Income (NNI). This deficit was 4.3% in 1992, compared to a deficit of 3.5% of GDP using the EMU deficit concept.

Government takes measures to promote employment

In its 1994 budget, the government proposes a three-pronged offensive to create jobs and strengthen the economy, in line with the recommendations of the broad economic policy guidelines. Firstly, a new infrastructure improvement programme up till 1998 was announced. These additional public investments will be financed by part of the privatisation proceeds and windfall gas revenues. Secondly, the government is urging the social partners to moderate wages. A freeze of nominal wages for 1994 is already accepted by the trade unions in the public sector; employers and trade unions in the private sector agreed to limit wage increases, after a government threat to impose a global nominal wage freeze. The government also intends to give the possibility to employers to hire people at wages below the minimum agreed for the sector, but still above the national minimum. Finally, the government announced a number of measures to promote job creation. A fiscal incentive for research and development expenditures will be introduced and the wealth tax on enterprises will be reduced. Furthermore, the basic income tax deduction for job-related expenses will be raised. This increase of the income gap between employed and unemployed should provide a greater incentive for people on social benefits to return to the job market. The additional fiscal package of February 1994 also lowered non-wage labour costs for employers and reduced taxes for small and medium sized enterprises.

Although these measures will have some beneficial effects on employment, they will not be sufficient to stop the rise in unemployment in the short term. Additional structural measures in the social security system will be necessary, to create an appropriate incentive structure to increase labour market participation. Some far-reaching reform proposals have been made by a parliamentary commission last year, and measures along these lines should be part of the agenda for the next government after the upcoming national elections.

Reliability of intra-EC trade statistics in 1993

Because of teething problems of the new INTRASTAT system, which records trade data within the European Community, current figures are still preliminary and probably not very reliable. After the realisation of the Single Market in January 1993, customs-based data were no longer available. As a consequence, a new system was introduced relying on data from both importers and exporters. There is no doubt, that the introduction of this new system has entailed distortion in the time series; intra trade flows are underestimated in both directions. The distortion occurred in a period of recession and subdued trade; it is difficult to isolate reasonably the statistical effect of the change of the statistical system from the slow-down of the underlying trends in trade.

It seems that in most Member States the distorting problems observed are of a more transitional nature. INTRASTAT figures for the months following the first quarter of 1993 are showing a certain return to normal. Nevertheless one may not exclude that, for the time being, there are still factors which tend to lower the level of statistical results. Eurostat and Member States have started detailed analyses in order to assess the quality of INTRASTAT data and to cope better with possible distortions due to the new statistical system.

Intra-Community trade, values, Q1/1992-Q2/1993 (billion ECU)

	Q1/92	**Q2/92**	**Q3/92**	**Q4/92**	**Q1/93**	**Q2/93**
Arrivals	185.1	183.0	166.5	182.0	159.9	161.2
Dispatches	181.4	178.2	161.9	176.0	166.7	166.1
Difference	3.7	4.9	4.6	6.0	-6.8	-4.9

Q1-2-3-4/92 have not been adjusted for re-exports.
Source: EUROSTAT, provisional, based on data provided by Member States, for some Member States, estimates have been made. Arrivals are CIF, dispatches FOB.

The problem can be illustrated by comparing Dutch and German bilateral trade data. Following the most recent Dutch data (until July 1993), Dutch export value to Germany remained flat compared with the previous year. However, German official sources show that in the first six months German imports from the Netherlands were 25% lower than the year before.

Contrary to INTRASTAT, the Community figures referring to the period before 1993 dot not cover, for example, re-exports to other Member States of goods imported from third countries and released for free circulation in the Member States of re-export. Such flows are of great importance especially in the case of the Netherlands, Belgium and Germany. This distortion in the "customs figures" has been overcome in the new system; thus a meaningful comparison of INTRASTAT data with data of previous years requires adjustments.

The above could imply that provisional estimates for net exports, and therefore GDP growth in 1993, as presented in this report, are too favourable.

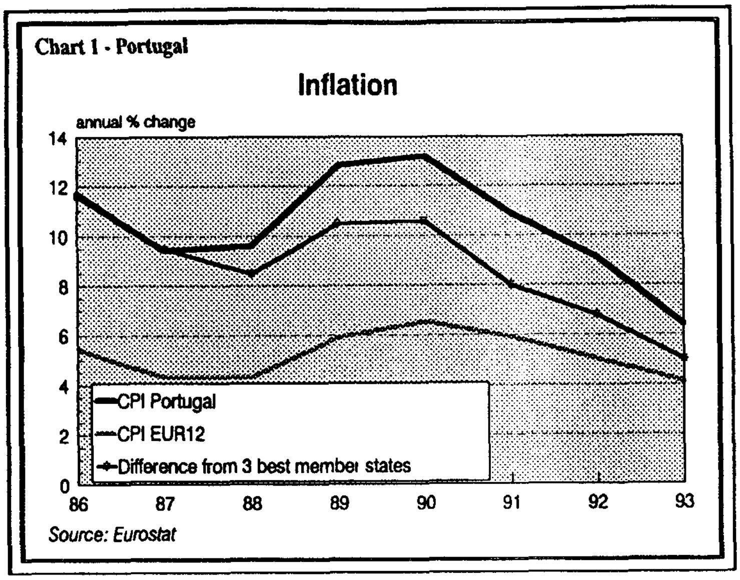
PORTUGAL

Sharp deceleration of economic activity in 1993 accompanied by progress with disinflation

In line with developments elsewhere in the European Community, economic activity in Portugal was characterized in 1993 by a contraction in GDP, led by a substantial deceleration of internal demand. Continuing the prolonged slowdown of economic growth since 1990 (4.4% in 1990, 2.1% in 1991 and 1.1% in 1992) real GDP is estimated to have declined by around 0.5% last year. As a result of the cyclical position of the economy and some difficulties in the process of tax collection, the general government deficit recorded a sharp increase in 1993, well above the budget forecast. Inflation declined further, a development to which the weakness of the economy has also contributed. Furthermore the situation in the labour market eased considerably and nominal wages recorded a large deceleration.

The evolution of GDP in 1993 was marked by developments on domestic demand. In particular private consumption by residents recorded a sharp slowdown to a rate of 1.5% as gains in real wages were much smaller than in the previous years and unemployment increased. The weakness of economic activity, compounded with the decline in profit margins and the level of real interest rates, contributed to a decrease in total gross fixed capital formation and, particularly, of investment by private sector enterprises.

Since 1992 the employment situation (close to full employment in the previous years) has been deteriorating, a trend that was reinforced last year, due to not only cyclical factors but also the ample process of industrial restructuring which is taking place in both the private and the public sectors. With some delay to the marked easing in labour market conditions, wages in 1993 have displayed an impressive deceleration in both nominal (from around 15% to 8%) and real terms (from 4½% to 1½%). To a large extent these developments suggest that the Portuguese economy continues to enjoy a substantial degree of real wage flexibility, which should prove to be an important advantage in efforts to achieve simultaneously real and nominal convergence.



In 1993 inflation was significantly reduced. The rate of increase of consumer prices fell from 9.5% in 1992 to 6.8% last year, mainly as a result of the weakness of economic activity and the pronounced slowdown of internal demand. The deceleration of wages certainly also played a role. These factors seem to have more than offset so far the impact on inflation of the depreciation of the escudo following the upheavals in the EMS since the summer of 1992. The escudo has lost about 12% vis-à-vis the ECU, but the real depreciation of the escudo vis-à-vis the other Member States has remained limited to about one half of the nominal depreciation, allowing an improvement in Portugal's competitive position.

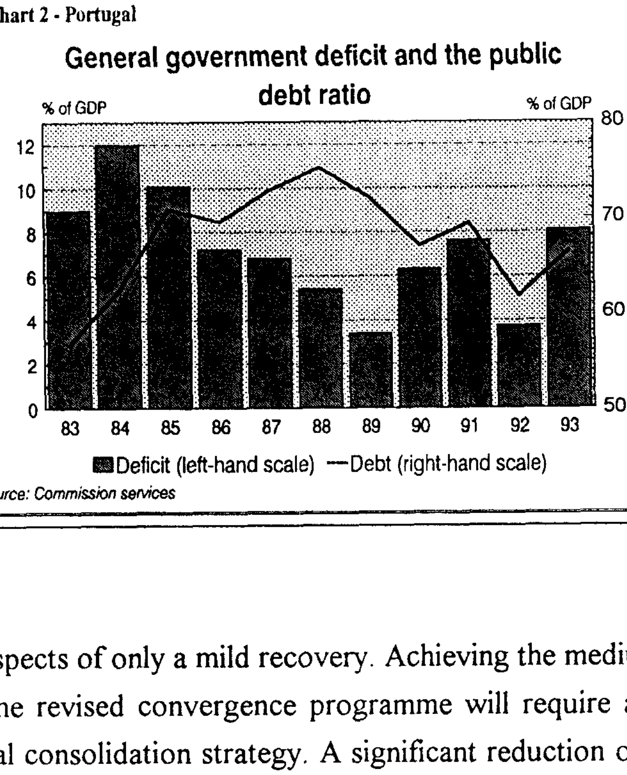
Public finances were severely hit in 1993. In the presence of much weaker than expected economic activity the authorities allowed the automatic stabilizers to work instead of adhering to the targeted budget deficit (4.2% of GDP, down from 5.2% in 1992). In addition, the revenue shortfall problem seems to have been compounded by an increase in VAT avoidance following the abolition of customs controls on imports from other Community countries, together with the surfacing of structural problems in the overall tax collection process. As a result of all these factors, and despite some success in controlling non-social security expenditure the budget deficit turned out to be around 8% of GDP.

The gradual recovery from recession of the European economies which now seems likely will certainly have an important impact on a small open economy like Portugal. The marked increase in public (and also private) investment co-financed by the Community Structural Funds will also play a positive role. Furthermore and assuming a non-accommodating exchange rate policy, continuation of disinflation is likely although at a gentler pace than in recent years. On the domestic side the main doubt regarding economic recovery in the current year seems to concern the behaviour of private consumption, in a context of increasing unemployment and sluggish wage growth.

The need to consolidate the public finances and the revised convergence programme

Achieving further progress in convergence remains the main challenge for Portugal. This means continuing to pursue stability while securing a growth rate above Community partners, in line with the broad economic policy guidelines. However, convergence is taking place in the context of a process of deep structural adjustment.

Chart 2 - Portugal



Source: Commission services

The envisaged path towards convergence is displayed in the revised Portuguese convergence programme (1994-1997). Public finances are to be brought back to the convergence track with the budget deficit declining steadily from 1995 onwards; for 1994 an accommodative fiscal stance will be followed (the budget deficit is targeted at about 7%) given the prospects of only a mild recovery. Achieving the medium-term public finance targets set in the revised convergence programme will require a rigorous implementation of the fiscal consolidation strategy. A significant reduction of public finance imbalances is not only necessary for the purpose of allowing Portugal to respect the criteria set for participation in EMU. It is also decisive to achieve, in a sustained way, both real and nominal convergence.

Disinflation is to be based on a non-accommodating exchange rate policy aiming at a stable escudo vis-à-vis the main ERM countries. Domestic wage developments should support this approach, which is in line with the Community broad guidelines for wage moderation. In this vein, nominal wage increases in the public sector in 1994 are expected to be in the 0-3% range while in the private sector a similar development will most likely occur.

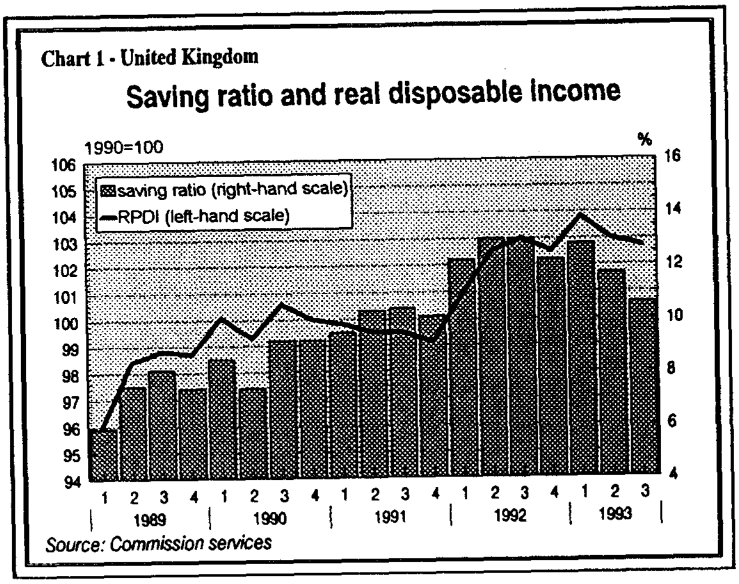
The Portuguese economy has been subject to ample structural changes in particular since accession to the Community in 1986. This process is leading to a reduction in the size of the agricultural sector, a restructuring of industry both in the public and private sectors, the liberalization and modernization of the financial system and the contraction of the importance of the public sector in the economy. Notable changes are taking place in industry. The latter has benefited from the emergence and development of new sectors (e.g. transport equipment, electrical goods), led by foreign direct investment and whith a dynamism which contrasts with the rest of industry. The traditional export activities, based on labour-intensive technologies, have been losing importance and should continue to face difficult challenges in the future. As for the remaining economic sectors, industry is adjusting in Portugal to an economic environment in which exchange rate stability is the prevailing rule.

The inflow of Structural funds foreseen for the 1994-99 period will be a major support to the ongoing process of structural adjustment. The Community support framework will be used primarily to improve the long-run global competitiveness of the economy through investment in physical (including infrastructures) and human capital. Upgrading the qualifications of the labour force, through professional training and education, would allow a smoother adjustment process. Further reform of the labour market, namely the promotion of a higher degree of regional labour mobility, which requires the development of an effective housing market in Portugal, would certainly prove beneficial.

UNITED KINGDOM

A developing upswing

By the end of 1993 the recovery in the United Kingdom was well established, following a recession that had been sharper and earlier than in the rest of the Community. Beginning in mid 1992 the upturn, particularly for non oil GDP, was at first slow and uncertain but during the course of 1993 there were some signs that the pace of growth was accelerating; the year-on-year growth rate rose from 1.4% in the first quarter of 1993 to 2.6% in the 4th quarter. Non-oil GDP growth has been somewhat weaker than overall growth through the year but it too accelerated towards the end of the year. At the same time inflation remained subdued, so that the economy entered 1994 with a growth rate close to its trend rate with inflationary pressures seeming dormant.



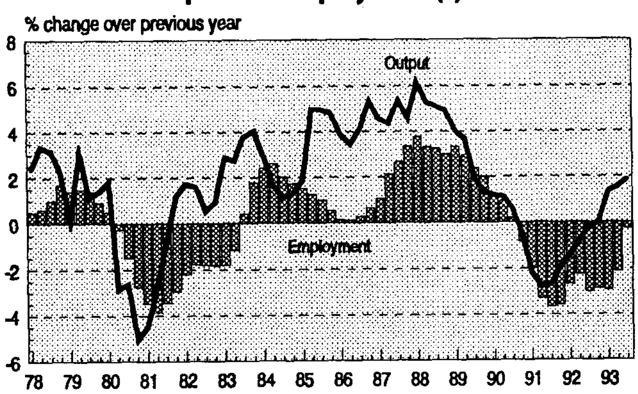
The upswing has been led by domestic demand and in particular by private consumption which by the 4th quarter of 1993 was growing at an annual rate of over 3%. Consumption growth largely resulted from a fall in the saving ratio. Having declined to historically low levels during the preceding boom in 1988-90, the household saving ratio was restored during the recession and reached an above average level of 13% by mid-1992. From early 1993 the saving ratio began to fall and by the 3rd quarter was 2½% points down from its peak. Consumption growth was also helped by a somewhat better employment performance than expected although rather less so by developments in real personal disposable income which has remained broadly unchanged since end 1992. Gross fixed capital formation has yet to make a significant contribution to the growth of domestic demand.

Exports have also been contributing to the upswing. Trade data in 1993 have been erratic and uncertainties have increased with the changed recording system resulting from the implementation of the single market from 1 January 1993 (see box). The overall picture would appear to be one of modest export and import growth. From the 3rd quarter of 1992 to the 3rd quarter of 1993 exports grew by around 3% in volume while import growth was just over 2%. Sharp recorded differences in trade developments with the Community and non-Community areas reflect partly the recession in Europe, in contrast to growth elsewhere, and partly statistical disturbances caused by the changed recording system.

Inflation remains more subdued than expected particularly in the light of the devaluation of sterling subsequent to its exit from the ERM. The headline index for consumer prices fell to an annual rate of 1,2% in June 1993, the lowest level since 1964. Subsequently it rose to 2,5% in January 1994. The underlying rate, i.e. excluding the impact of interest rate changes on mortgage payments, remains under 3% representing the best UK inflation performance in two decades. Behind this good inflation performance lies a continued fall in the growth rate of average earnings and wage settlements leading to falling unit labour costs, intense competition at the retail sales level as well as the cautious relaxation of monetary policy. As a result of the fall in unit labour costs and the lower level of sterling, compared to the previous year, the competitiveness of the UK improved sharply.

Chart 2 - United Kingdom

Output and employment (*)



(*): non-oil GDP compared with workforce in employment (s.a.)
Source: Commission services

A feature of the UK economy in 1993 was a turnaround in unemployment which was both earlier and sharper than expected. From its peak in January 1993 unemployment had fallen by over 200 000 by the end of the year with the unemployment rate down from 10.6% to 9.9% (10.3% on the harmonized Eurostat definition). Employment rose marginally in the second quarter and more strongly in the third quarter.

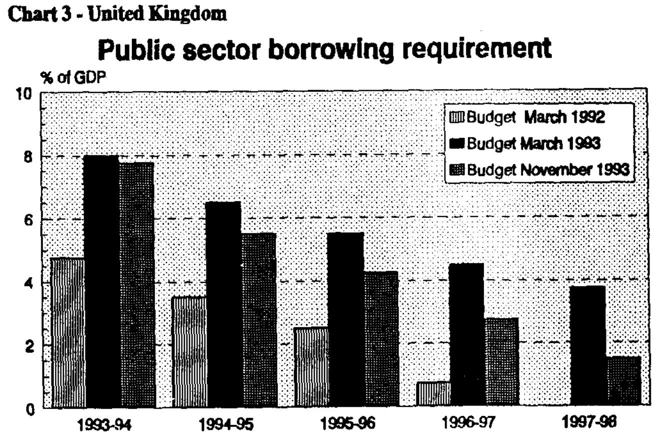
The UK enters 1994 with better short-term prospects than most of the other Member States; continued growth in output is expected with inflation remaining under control. On the other hand the UK also faces uncertainty concerning the sources of future growth. The recovery in 1993 has been substantially based on domestic, and in particular, consumer demand which has expanded largely through a reduction in the household saving rate. This has occurred despite the overhang of financial imbalances associated with the previous inflationary upswing. While the personal sector debt problems have been significantly reduced on a flow basis (i.e. the interest costs of debt have fallen very substantially) the stock of debt remains close to its historically high levels. This increases the sensitivity of the personal sector to monetary policy - though this will be modified by the recent shift towards fixed rate mortgages - but it could also be expected to have some impact on saving behaviour. Hence the question is whether the continuing large stock of debt, assuming house price increases remain modest, will not put a floor on the fall in the savings rate. This combined with the weight of tax increases and possibly a fall in real personal disposable income would suggest that the outlook for consumption growth would be subdued and that sustaining the recovery in the UK may well require that exports and investment contribute increasingly to growth.

The prospects for export growth are enhanced by the expected turnaround in the European economy and by continued growth in America and Asia (Japan excepted). However, the rather full pass through of price rises (in domestic currency terms) on exports following the devaluation of sterling and the subsequent, partial, reversal of the depreciation could be moderating influences. The fall in investment has flattened out in 1993 largely due, however, to a significant rise in public sector investment; private sector investment continued to fall through to the second quarter of 1993. While investment continues to be a lagging variable, the prospects for future growth in private investment will depend on a continuation of the expansion of internal and external demand. Overall the UK should continue to grow faster than the other large Member State economies in 1994.

Measures taken to improve the fiscal outlook

As the recession deepened and remained prolonged the UK fiscal position deteriorated. Measurement of the impact of the cycle on deficits can only be approximate but it is clear that prolonged and sizeable deficits, whatever their initial source, eventually become increasingly structural in nature and increasingly difficult to reverse. In the case of the UK four years of increasing deficits had brought a degree of intractability to the UK fiscal position (as was illustrated in the UK convergence programme, presented to the Eco/Fin Council in July 1993, which foresaw general government deficits remaining above 3% of GDP to beyond 1997/8 unless a rapid growth rate of 3½% was achieved). In the event the two budgets of 1993 (March and November) between them improved considerably the medium-term fiscal outlook, with the general government deficit now expected to reach the Maastricht 3% reference value by the financial year 1996/7.

Chart 3 - United Kingdom



Source: H M Treasury, Financial Statement and Budget Report

The two budgets were notable for tax increases pre-announced to apply in later years, thus not directly impinging on the fragility of the recovery, particularly in the early part of 1993. The overall impact of the discretionary changes in the budgets was expected to reduce the deficit by 2.4% GDP in 1995/6. This represents a substantial medium-term adjustment in line with the Community's broad economic policy guidelines. While most of this adjustment will consist of increases in tax revenues, there are also substantial cuts in planned expenditure implying a reversal of the upward trend in public expenditures in recent years and a very tight control which may be difficult to sustain.

Although risks remain for the future

The size of fiscal adjustment due in 1994/5 and subsequent years does raise the issue of the appropriate stance of policy and the impact on the economy. While the pre-announcement of tax increases and other changes was designed to avoid dampening down the rather slow recovery in 1993, the question of the impact in 1994 remains. Tax increases taking place from April 1994 amount to UKL 8.4 billion (1.2% GDP) and it is not clear how much of a risk there is to the upswing. Hence careful judgement is required concerning the appropriate stance of policy overall in the face of the fiscal tightening.

Monetary policy has been set in the context of maintaining inflation on a downward course. To this end the authorities have adopted a direct inflation target with regular monitoring by the monetary authorities. The direct targeting of inflation implies careful policy judgement about the future course of inflation and during 1993, even in the face of a somewhat unexpectedly good inflation performance, the UK authorities took a cautious approach to monetary policy. No doubt the authorities were influenced by a recognition of the lagged impact of the sharp falls in interest rates which occured since the UK left the ERM in September 1992. Indicators of longer-term inflation expectations and inflation performances suggest that the credibility of the monetary policy framework grew steadily during the course of 1993.

While the current inflation performance in the UK is among the best in the Community, at least in headline terms, nevertheless there is a need to take account of the risks which could be realized through the course of the upturn. One uncertainty in UK policy concerns the extent of the gap between potential and actual output, i.e. in judging the risks which the developing upturn could lead to in terms of inflationary pressure. There might also be some concern about possible restoration of margins; with producer output prices having risen more strongly than retail prices and evidence of severe price competition at the retail level. However the squeeze on profit margins will have been moderated (or even offset) by the good productivity performance. Nevertheless the indications of a rise in employment and the normal cyclical effects on productivity could lead to a greater pass through of cost and price pressures as the upswing develops. There is also some uncertainty about wage behaviour, although on the basis of previous cyclical behaviour, wage pressures are unlikely to be a factor in the course of 1994. All of these factors, in the context of a monetary policy which targets the inflation variable directly would argue in favour of a degree of caution in monetary policy decisions.

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