

ECONOMIC PAPERS

COMMISSION OF THE EUROPEAN COMMUNITIES
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Number 100

March 1993

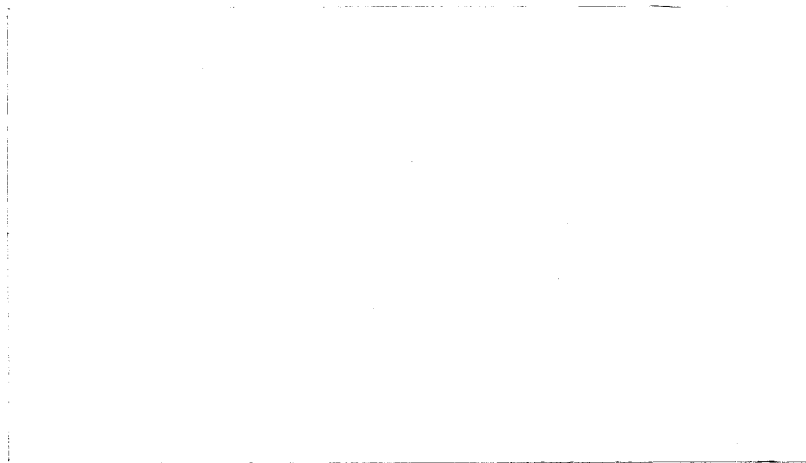
EC Enlargement and the EFTA Countries *

Christopher Sardelis **



"Economic Papers" are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and to seek comments and suggestions for further analyses. They may not be quoted without authorisation. Views expressed represent exclusively the positions of the author and do not necessarily correspond with those of the Commission of the European Communities. Comments and enquiries should be addressed to:

The Directorate-General for Economic and Financial Affairs,
Commission of the European Communities,
200, rue de la Loi
1049 Brussels, Belgium



ECONOMIC PAPERS

Number 100

March 1993

EC Enlargement and the EFTA Countries *

Christopher Sardelis **

* The study covers developments up to the end of 1992.

** Sveriges Riksbank and European Commission, DGII-D.

Useful comments from H. Matthes, J-F Pons, L. Andersson, A-B Christensen and T. Belessiotis, all from Directorate-General for Economic and Financial Affairs are gratefully acknowledged. Valuable comments have also been received from M. Hetemäki, from the Finnish Ministry of Finance.

Contents:

1 INTRODUCTION	1
2 ECONOMIC LINKS BETWEEN THE EFTA(4) AND THE EC	4
2.1 Trade Relations	4
2.2 Cyclical Synchronization between the EFTA(4) and the Community	7
3 NOMINAL CONVERGENCE IN THE SHORT- AND MEDIUM- TERM	9
3.1 Monetary policies	10
3.2 Fiscal policies	13
3.3 Financial Crisis in the Nordic Countries	17
4 STRUCTURAL POLICIES	20
4.1 Public sector and taxation	20
4.2 Labour markets	20
4.3 Subsidies	21
4.4 Malfunctioning internal markets	22
4.4.1 The Institutional Set-up	24
4.4.2 Radical reforms are coming	24
5 A FINAL COMMENT	25

Tables:

PANEL 1: Basic Data about the EFTA(4) Countries	2
Table 1: The Size and the Structure of the External Sector	5
Table 2: Cyclical Covariability between the EFTA(4) and the EC	7
Table 3: Convergence Requirements	9
Table 4: Financial Crisis in the Nordic Countries; Selected Statistics	18
Table 5: Selected Labour Market Statistics	21
Table 6: Size and Subsidization of the Agricultural Sector, 1990	22

Graphs:

Graph 1: Main Destinations of Exports, 1990	5
Graph 2: Main Origins of Imports, 1990	5
Graph 3: The Slope of the Yield Curves: (3-m)-(5-y) Interest Rates 1986-1992	10
Graph 4: Long-term Interest Rate Differentials <i>vis-à-vis</i> the Deutsche Mark	11
Graph 5: 3-months' Interest Rate Differentials <i>vis-à-vis</i> the ECU	12
Graph 6: Fiscal Balances in the EFTA(4) Countries 1980-1993	14
Graph 7: Inflation and Unemployment in the EFTA(4) Countries 1980-1993	15

1 INTRODUCTION

The creation of the European Economic Area (EEA), i.e. the free trade area between the EFTA- and the EC-countries might be considered as a first step towards closer relations between the countries of the two blocks. Before the negotiations came to an end, Austria, Sweden, Finland and Switzerland¹ had already applied for membership to the EC. Norway joined the other in November 1992. Responding to these initiatives the European Council decided in the Edinburgh summit "that enlargement negotiations will start with Austria, Sweden and Finland at the beginning of 1993". Moreover, the European Council invited the Council of Ministers to "take decisions on the opening of negotiations on the same basis with Norway as soon as the Commission's opinion on its application is available".

Following the indications of the European Council the present study confines Austria and the three Nordic countries (EFTA(4) for short). It purports to give a short presentation of these economies, emphasising more the aspects that have a bearing on the costs, the benefits and the risks of the prospective integration of these economies with the existing EC. The review is also marked by another statement of the European Council at the Edinburgh summit, namely that "the conditions of admission will be based on the acceptance in full of the Treaty on European Union". It means that the Maastricht treaty forms the guide-line for the enlargement assessments.

Basic data about these countries in panel 1 suggest that the EFTA(4) countries belong to the group of the most prosperous and privileged countries in the industrial world. Using conventional criteria, one can easily anticipate that inclusion of these countries to the EC will invigorate the industrial basis of the Community and enhance its economic importance. This is not the central issue however, because the mutual benefits of an enlarged free trade region or a customs union are already ensured by the EEA treaty. What makes this particular enlargement unique is that it will occur during the ongoing transformation of the Community to an economic and monetary union, the EMU. One consequence of the delicate nature of this evolution, is that candidates will have to meet requirements that go far beyond those for participation in the internal market alone.

The declared ambition of the governments of the EFTA(4) countries is to join the EC in the middle of the 1990's. Assuming that the time schedule holds, the enlargement will occur at the critical stage II of the EMU, a stage at which economic convergence has proceeded to a degree that ensures irrevocable fixing of exchange rates without any credibility problems. This imperative may entail several restrictions on policy priorities in the short and medium term, in the sense that intermediate targets which are not conducive to the principal objective of reducing the importance of exchange rates as a policy instrument have to be subordinated to this. Otherwise, there is a risk of inconsistency between short-

¹ The EEA-treaty was rejected by the Swiss people in a referendum in early December 1992.

PANEL 1: Basic Data about the EFTA(4) Countries

	<u><i>Austria</i></u>	<u><i>Finland</i></u>	<u><i>Norway</i></u>	<u><i>Sweden</i></u>
Area (1000 sq.km)	84	338	324	450
Population (1000)	7 718	4 997	4 249	8 591
Currency	<i>Schilling</i>	<i>Markka</i>	<i>Krone</i>	<i>Krona</i>
GDP/capita; US \$ (1989)	16 603	23 270	21 341	22 360
Exchange rate regime	<i>Linked to Deutche Mark</i>	<i>Floating since 9/9-92</i>	<i>Floating since 10/12-92</i>	<i>Floating since 19/11-92</i>
<u>Industrial origin of GDP, 1990 (per cent)</u>				
Agriculture	3	7,5	2,9	3,7
Industry	27	24,8	21,8	29
Construction	7	9,1	5,6	9,9
Services	63	58,6	55,3	57,4
Oil			14,4	
Gross fixed Capital Formation in 1990, per cent of GDP	24,7	26,9	19,3	20,7
<u>Government (1989)</u>				
Public Consumption (per cent of GDP)	18,2	21	21	27,2
General Government Outlays (per cent of GDP) ¹⁾	48,6 (38,2)*	38,2 (30,5)*	54,6 (41,4)*	59,9 (43,3)*
General Government Revenues (per cent of GDP) ²⁾	45,8 (39,4)*	39,8 (34,1)*	54,9 (43,3)*	64,2 (46,6)*
<u>Taxation (1991)</u>				
Tax brackets for personal income (lowest - highest)	10 - 50	17 - 55	30-48,8	30 - 50
Capital income	30	25	28	30
Corporate taxes	30	25	28	30
V.A.T. ³⁾	20	22	20	25

1) EC average was 47,8 in 1989 and 36,9 in 1970.

2) EC average was 44,1 in 1989 and 36,5 in 1970.

* the numbers in brackets refer to the corresponding shares in 1970.

3) EC average was 15 per cent in 1991.

Sources: OECD Economic Surveys: Austria 1991/1992; Finland 1990/1991; Sweden 1991/1992; Switzerland 1990/1991. Some figures have been revised by national authorities.

and long-term priorities, if countries try to overcome current difficulties by using instruments that have to be removed in the future. This aspect has become particularly important for the Nordic countries, especially after their commitments to keep fixed exchange rates *vis-à-vis* the ECU succumbed to market pressure in late 1992.

Consequently, the following brief review of the EFTA(4) countries highlights economic and policy aspects from this particular angle. A minimum set of criteria concerning nominal convergence are specified in the Maastricht treaty, which gives them the status of necessary conditions for participation in the EMU. The medium-term possibilities for the EFTA(4) countries to meet these requirements are examined in the third section. The economic links between the EFTA(4) and the Community constitute another relevant aspect, and are reviewed in the next section. Extensive trade relations, especially on inter-industry basis and with well-diversified products, reduce the probability of so called asymmetric shocks to occur, which in turn makes it easier to formulate a common monetary policy in stage III of the EMU. Finally, microeconomic performance and the overall functioning of domestic markets are discussed (fourth section). These aspects are crucial for nominal flexibility and relative competitiveness in the long-run, the most essential determinants of the real costs of participation in a monetary union.

The basic conclusions from this review can be summarised the following way: The performance of the Austrian and Norwegian economies suggest that these two countries easily can achieve nominal convergence by 1995. Finland and Sweden however, suffer from obvious difficulties to cope with their fiscal imbalances. Moreover, weak intra-industry trade linkages between the Community and Finland and Norway suggest also that these economies are more exposed to risks for asymmetric shocks than the other two countries. The prolonged crises in these two economies, precipitated by the sharp fall in oil prices in 1986 (in the case of Norway) and the collapse of the trade with the former USSR (in the case of Finland) verify to some extent this supposition. At last, malfunctioning and heavily regulated domestic markets hint at grave nominal rigidities in all the EFTA(4) countries. Thus, even if the EFTA(4) countries have a good reputation as well performing economies fostering prosperity and welfare, several problems have to find their solution before the move to join the EMU can be made at low real costs.

2 ECONOMIC LINKS BETWEEN THE EFTA(4) AND THE EC

2.1 Trade Relations

As shown in table 1, the EFTA(4) economies have developed strong commercial links with the EC. This can be partly explained by the 20-years old free-trade agreement between EFTA and EC, but also by a purposeful participation in the international division of labour. Finland's slightly lower degree of integration with the EC-market reflects the extensive trade this country developed with the former USSR, based on special political relations and preferential treatment.

The most important message of table 1 is that the trade with the Community by far constitutes the largest external source of income, consumption and investment for each one of the EFTA(4) countries. On average, around three quarters of these countries' external trade takes place within the *enlarged* EC area, and this share is expected to increase as a result of the new EFTA-EC treaty, which goes further than the previous one especially in the liberalization of the trade in services. Moreover, Austria and Sweden have not only become more open during the two last decades, but also exhibit a high degree of intra-industry integration. This feature makes these economies less vulnerable to asymmetric shocks, as branch shocks will afflict the entire Community symmetrically and can therefore be met by common policies. This is of great importance for economies participating in a monetary union. In this respect, conditions in Finland and Norway are less favourable (see table 1).

Finland

The degree of openness of Finland is notably lower than the others' and has been trending downwards (table 1). The latter indicates that the relatively rapid growth of the Finnish economy (table 2) was based on a strong domestic demand. Moreover, a closer look on the export side reveals two important characteristics: First, there is a dominating sector, as the very special wood, pulp and paper industry stands for more than one third of total Finnish exports. Second, one of the most important export markets up to 1990 was the former Soviet Union. Around 15 per cent of total exports were directed to USSR under a quite special barter regime, with the Finnish government acting as an intermediary.

The former Soviet Union was an important market for many Finnish industries. About a quarter of textiles and engineering and over a third of the food industries were exported to USSR (up to 1990). Supported by a comprehensive system of state guarantees and with oil products to balance the trade account, Finnish exporters enjoyed quite favourable trade conditions. There is evidence that the price of exports were around ten per cent above world market prices and the markets were secured by quotas. Moreover, this trade shielded the Finnish economy from the oil-price shocks in the 1970s and early 1980s.

Table 1: The size and the structure of the external sector

	<i>Exports as a percentage of GDP</i>		<i>Imports as a percentage of GDP</i>		<i>Share of intra-industry trade with the EC^{a)}</i>
	1970	1990	1970	1990	
Austria	31,2	46,1	30,1	39,9	0,68
Finland	27,4	22,6	28,8	24,1	0,39
Norway	41,9	44,4	43,2	36,7	0,36
Sweden	24,4	29,9	24,9	30,3	0,70

a) The degree of inter-industry trade is measured by the Grubel-Lloyd coefficient. This is

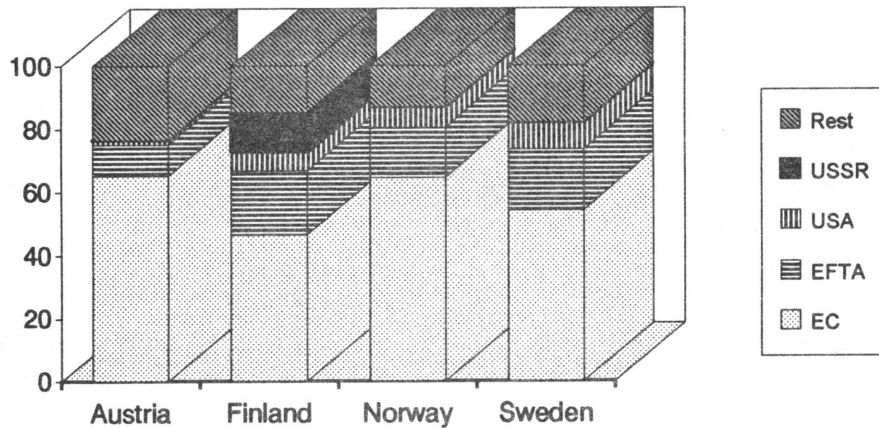
$$1 - \frac{\sum_k |x_k^i - m_k^i|}{\sum_k (x_k^i + m_k^i)},$$

where x_k^i and m_k^i denote the exports and imports of good k by country i, respectively.

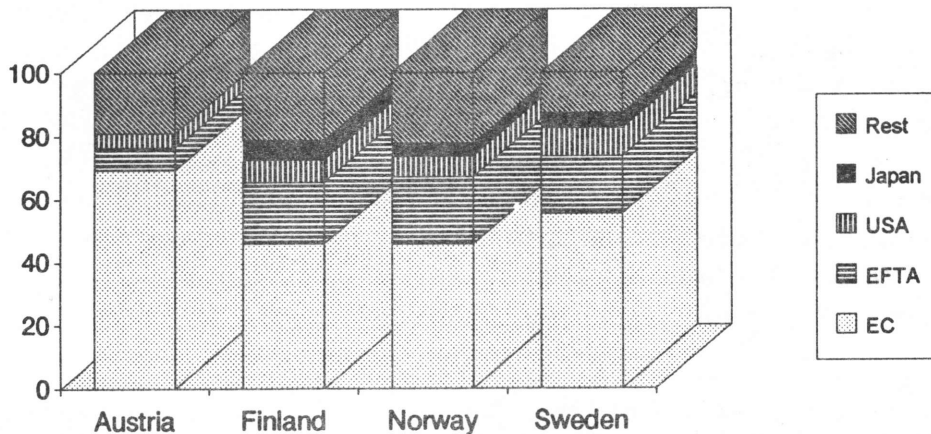
The closer this coefficient is to 1, the greater is the share of intra-industry trade.

Sources: OECD Economic Outlook 51, June 1992; and "Effects of 1992 on the Manufacturing Industries of the EFTA Countries", EFTA, Occasional paper no 38.

Graph 1: Main Destinations of Exports 1990



Graph 2: Main Origins of Imports 1990



On the other hand, such a concentration of exports on an economically fragile market implied substantial risks. This became clear in the beginning of 1991 when this trade collapsed, imparting a tremendous shock to the Finnish economy. Over two thirds of these exports disappeared in 1991 which, together with the cyclical weakness in other export markets, yielded a fall in the value of total exports of 8,6 per cent. The shrinkage of the exports had of course rapid repercussions to the entire economy, as investment fell by 17 per cent, output by 6,1 per cent and the unemployment rate doubled, to reach the level of 7,6 per cent in 1991. After this shock, an important question is whether the capital stock used for that trade is modern enough to allow a sustainable diversion of exports to other, more competitive markets. The two recent devaluations of the markka² have nevertheless given a push to Finnish exports during 1992, but this policy also entails the risk that the provided relief weakens the incentives for necessary structural changes, to the extent such changes are necessary.

The heavy reliance on wood, pulp and paper constitutes another source of concern. This industry is concentrated to few countries (Sweden, Finland and Canada are among the big producers), and it uses extremely capital-intensive technology. The high proportion of fixed capital makes the sector extremely inflexible, as the supply side cannot respond to fluctuations in world demand. Thus, cyclical fluctuations in demand give rise to sharp fluctuations in prices, which in turn are transmitted to the terms of trade. On top of this, there is an additional factor which usually tends to magnify the demand-price effect, namely the dollar effect³. Generally, the dollar becomes weak during recessions, because of the monetary loosening in U.S.A., and recovers during the economic upturns. Thus, there are two mutually reinforcing factors that affect the profitability of this important sector during a business cycle, making the Finnish economy more exposed to cyclical variations in world trade than European economies on average⁴. This is, of course, a structural weakness of the Finnish economy, explaining also the frequent use of the exchange rate as a policy instrument.

Norway

The composition of exports, with oil and gas amounting to 42 percent of total in 1990, makes even Norway a special case. The rapid expansion of the oil sector since late 1960s secured a substantial annual income, but has also contributed to a gradual displacement of other industrial activities, as a strong real wage development made traditional branches less profitable. This feature explains the poor intra-industry integration with the EC, shown in table 1.

The dominance of oil exports entails exchange rate problems similar to the above mentioned in the case of Finland. Contrary to the economies of the Community, oil price increases favour the total Norwegian economy and fluctuations in the dollar exert a strong impact on the terms of trade. Moreover, profitability in the oil

² By 12 per cent in November 1991 and by another 11 per cent in September 1992, the latter in connection with the floating of the markka (graph 4).

³ Dollar is the vehicle currency for the world trade in these products.

⁴ This is true even for Sweden to some extent, where the value of wood, pulp and paper exports amounts to around 18 per cent of the total.

sector goes in the opposite direction with the rest of the economy, the so called mainland economy, for several reasons. First, when the world trade suffers from increases in oil prices the export industry loses export possibilities. Second, by keeping factor demand and factor prices high even when the export industry is weak. Third, by allowing more expansionary policies, since extra oil-income compensates for higher imports. All these effects imply that high oil prices contribute to shifting resources from the exposed mainland sector to the oil and the sheltered mainland sectors.

2.2 Cyclical Synchronization between the EFTA(4) and the Community

It is self-evident that common monetary policy is easier to agree upon if income developments in the participating countries are in phase during the business cycles. In case they are not, monetary loosening can stimulate real activity in some of them while boosting inflation in others. Similarly, monetary tightening designed to restrain inflationary tendencies in some countries can lead to deep recession in others. Strong economic links improve the synchronization of output and income moves, but this is not sufficient as deviating economic policies can distort an otherwise good underlying synchronization.

Table 2, provides a simple measure of cyclical covariability. The table contains both the existing EC and the OECD-Europe, the latter as a proxy for the enlarged Community. As it can easily be seen, with exception of Austria, the cyclical synchronization of the three Nordic countries and the Community with respect to *real income* is rather weak. However, this impression disappears if we look at the interrelation between *nominal incomes*. Apparently, a problem of interpretation emerges⁵.

Table 2: Cyclical Covariability between the EFTA(4) and the Community

	Real GDP Correlations		Nominal GDP Correlations	
	OECD-Europe	EC	OECD-Europe	EC
Austria	0,72	0,72	0,68	0,67
Finland	0,47	0,41	0,72	0,68
Norway	0,24	0,21	0,77	0,74
Sweden	0,34	0,29	0,65	0,66

Calculations of correlation indices based on OECD data for the period 1972-1991. The correlation indices measure the degree of synchronization in cyclical income moves. A high covariability index (close to 1) indicates that income developments are in phase, i.e. they follow closely each other during a business cycle.

Bad correspondence in real incomes with parallel moves in nominal incomes suggests that even the difference between them, the inflation rate, has followed different time paths. It also means that the Nordic countries have followed stabilization

⁵ Changes in the chosen period affect the measures quantitatively without affecting the message.

policies which have been at variance with the average policy stance of the Community, and this is probably the main explanation of the observed paradox.

It is well-known that the Nordic countries have been very reluctant to accept strong fluctuations in unemployment, without showing a similar aversion against inflation (graph 7). Economic policies have therefore been based on the ambition to smoothen nominal income. One problem with systematic smoothening of nominal income is that economic policy becomes predictable, which generally has a negative feed-back effect on the behaviour of the private sector. This can happen because easily anticipated accommodating measures, like devaluations or income injections through increased public spending, make the private sector less responsive to external impulses. For example, when trade with the EC weakens, private firms in the considered countries may not respond by cutting production or releasing labour to the extent it is motivated by the economic conjuncture, because they expect stimulative measures. This behaviour has been observed in the Nordic countries.

Moreover, the public sector has been used as a cushion against cyclical unemployment, at least Sweden and Norway, creating this way severe structural problems. Public sector expansions during recessions were not followed by commensurate contractions during booms. Instead, taxes were increased in order to finance the enhanced public activities. The accumulative effect of this kind of policies led to continuous augmentation of the public sectors (see panel 1) and, as it is expected, the total economy has become more subjected to political decisions than to external conditions.

To the extent the observed peculiarity in table 2 can be explained by deviating trade patterns and odd economic policies, there are several indications that things can improve in the immediate future. First, a structural shift in the underlying preferences with respect to inflation and unemployment seems to be under way, indicated in graph 7 (b-d). Second, plans for scaling down the public sectors have been announced. Third, ongoing efforts to direct more of the Finnish trade towards the European economies looks promising, so far. Fourth, economic policies in Norway are currently not based on total, but on the mainland economy. Finally, the new treaty between EFTA and the Community improves the conditions for enhanced trade relations comparing with the old one, e.g in the area of services. Besides, the technologically advanced industrial basis of these countries provides sufficient flexibility and adaptability to new policy environments.

3 NOMINAL CONVERGENCE IN THE SHORT- AND MEDIUM- TERM

Moving to the nominal convergence criteria set out in the Maastricht treaty, we can see from table 3 that inflation is currently a minor problem for all the EFTA(4) countries. The subsiding inflation had reached quite low levels in 1992, which can be explained mostly by price stability oriented economic policies than by the recession. The recent depreciations of the currencies of the Nordic countries gave

Table 3: Convergence requirements (1991-1993)

	Inflation			Gen. Gov. Balance in % of GDP			Public Debt in % of GDP			Long-term interest rates		
	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
Austria	3,3	4,0	3,5	-2,3	-1,9	-2,1	56,7	55,4	55,2	8,6	8,4	7,9
Finland	5,4	3,5	3,5	-6,0	-8,9	-7,7	21,4	37,1	47,1	12,2	12,8	11,0
Norway	3,7	2,4	5,2	-0,5	-3,0	-3,2	39,9	45,1	50,1	9,9	9,8	9,3
Sweden	10,2	2,8	5,3	-1,5	-9,0	-12,0	55,0	65,8	75,0	10,9	10,2	9,5
<i>EMU-crit.</i>	<i>4,4</i>	<i>4,0</i>	<i>3,8</i>	<i>3,0</i>	<i>3,0</i>	<i>3,0</i>	<i>60,0</i>	<i>60,0</i>	<i>60,0</i>	<i>11,9</i>	<i>12,5</i>	<i>11,9</i>

Memorandum items

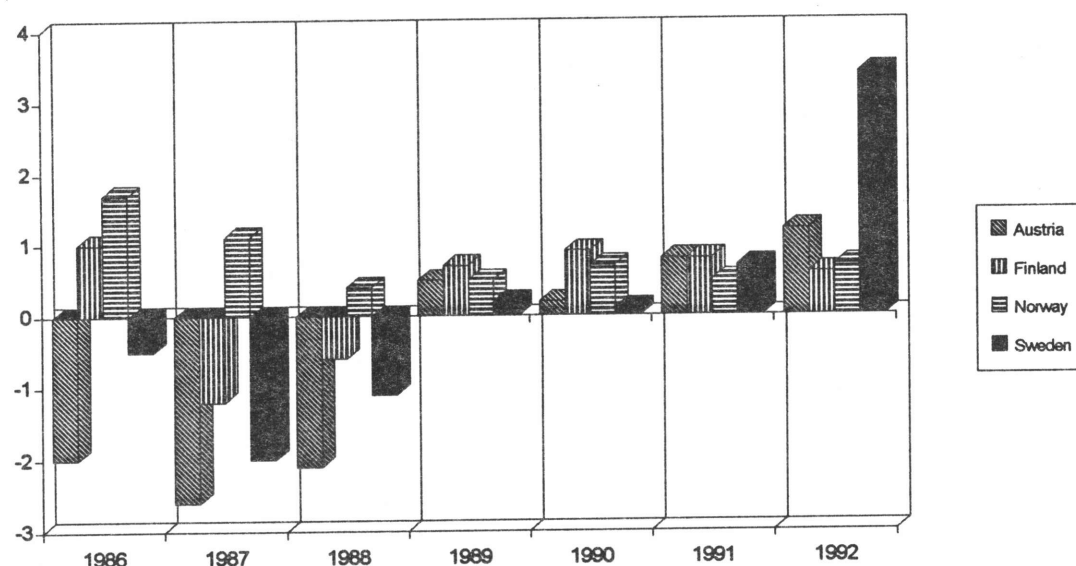
	Real GDP growth			Unemployment rates			Current Account balances (% of GDP)		
	1980- 1991	1992	1993	1980- 1991	1992	1993	1980- 1991	1992	1993
Austria	2,3	2,0	2,0	3,2	3,8	4,3	-0,2	0,4	0,1
Finland	2,5	-2,0	2,0	5,0	12,8	13,2	-2,5	-4,1	-1,8
Norway	2,6	2,6	1,0	3,2	5,9	6,1	1,2	2,7	2,8
Sweden	1,6	-1,6	-1,6	2,1	4,8	6,2	-2,9	-1,5	0,1
<i>EC-average</i>	<i>2,1</i>	<i>1,0</i>	<i>0,7</i>	<i>9,4</i>	<i>9,6</i>	<i>10,6</i>	<i>-0,02</i>	<i>-0,8</i>	<i>-0,7</i>

Source: OECD Economic Outlook 51 revised by national authorities; National budgets; Commission Services.

a temporary inflationary impulse, expected to abate during 1993 due to weak demand and continuing antiinflationary policies. As shown in graph 7, a change in priorities has taken place, especially distinct in the Nordic countries. Graph 3 gives some information about market expectations⁶. Looking at the difference between three-months- and five-years-bonds, it can be seen that money markets advanced disinflation in 1989, a year when realised inflation still was accelerating. Norway is an exception, because the disinflation process started in 1987, after the collapse in oil prices. The 1992 numbers are of special interest, since unemployment has peaked without changing markets' expectations. What happens in the years ahead, depends of course on current policies.

⁶ If short-term interest rates are higher than long-term rates, the usual interpretation according to the so called expectation hypothesis is that markets expect the short-term rates to fall, reflecting falling expected inflation. Accordingly, if the relation between short- and long-term rates is the opposite, markets expect rising inflation.

Graph 3: The slope of the yield curves: 3-months' minus 5-years Interest Rates 1986-1992



Source: OECD Economic Outlook 52 revised by national authorities.

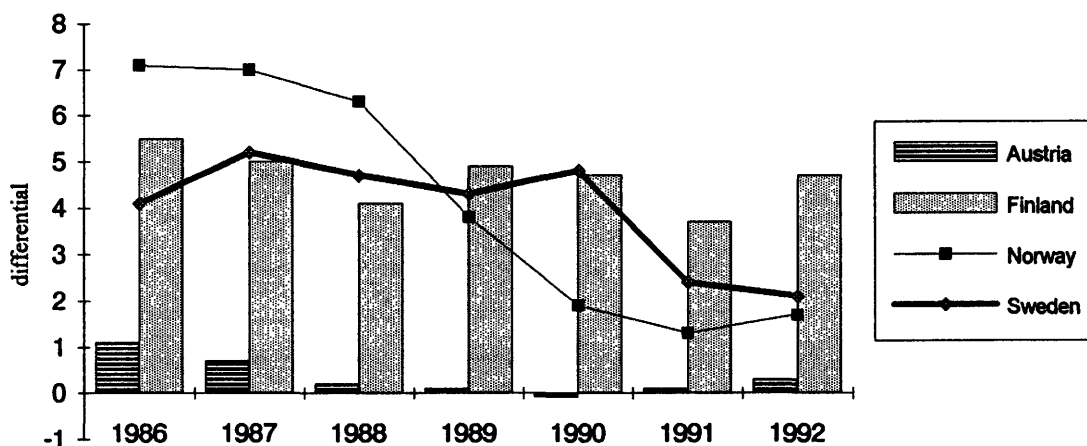
3.1 Monetary policies

Austria has been pegging to the German Mark since the late 1970s, and the unequivocal commitment to that target has never been questioned by the market; hence the good record of inflation, and the elimination of risk premia, shown in graph 4. As there are no intentions to change monetary policies, and the German monetary policy is projected to remain tight, any inflationary impulses stemming from monetary policy must be discounted.

Mastering inflation has been the main concern for the Central Banks even in the Nordic countries. Struggling with a high and stubborn inflation (graph 7), a credible exchange rate commitment would serve as a vehicle for breaking the inflationary expectations. Before the peg to the ECU⁷, the Central Banks used trade weighted indices. However, having a long record of devaluations and accommodating policies, the task of overcoming markets' doubts about such a commitment has proved very difficult. Recurring waves of capital outflows demonstrated lack of credibility and pegging to the ECU proved a successful move, at least in the beginning (graph 4). Weak fundamentals worked however against them, as the interest rate differentials *vis-à-vis* the Ecu-rates (graph 4) suggest. Among other things, markets demanded more determined fiscal policies than the weak governments could come up with. The situation was not helped by the economic conjuncture either, especially in Finland and Sweden, as both countries experience the deepest post-war recession.

⁷ The Norwegian krone pegged to the ECU in October 1990, the Swedish krona in May 1991 and the Finnish markka in June 1991.

Graph 4: Long-term interest rate differentials *vis-à-vis* the Deutsche Mark



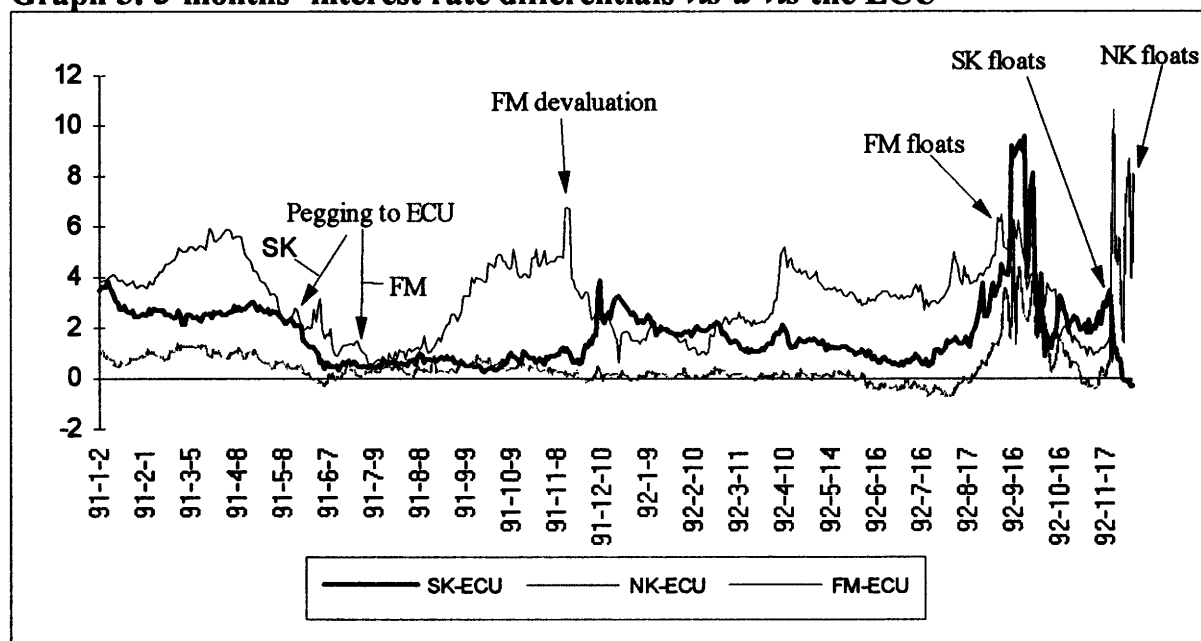
Source: Commission Services

Thus, lack of credibility and the financial turmoil in the European markets during the second half of 1992 exposed the Central Banks of the Nordic countries to several endurance tests whose outcome was that first Finland (8-9/1992), then Sweden (19-11/1992) and eventually Norway (10-12/1992) abandoned their exchange rate commitments, initiating a period of free float. The three Central Banks have also declared that they have no intentions to relink their currencies to the ECU in the foreseeable future.

A comparison of the interest rate differentials against the ECU (graph 5) suggests that markets were more unwilling to take positions in the Finnish markka than in the other two currencies. The market pressure on the markka was always stronger, reflecting not only the weak fundamentals, related to the above mentioned collapse of exports and the adverse development in terms of trade due to the weak dollar, but foremost the equivocal political support for the hard currency policy. This was a fundamental difference between Finland and the other two Nordic countries, where the exchange rate commitment enjoyed unanimous political support.

Another interesting feature in graph 5 is that it shows how events in the Finnish market always had repercussions to the Swedish market. The repeated episodes of capital outflows in the two markets have been strongly correlated, with the Finnish one usually leading the Swedish. It has been asserted that international investors have pooled the Scandinavian markets, so as events in one country induce changes in their overall "Scandinavian position". To the extent this is true, it can explain the quick transmission of financial crises between Finland and Sweden. Yet, even if much of the pressure on the Swedish krona could be explained by external factors, one cannot ignore the fact that the interest rate differential *vis-à-vis* the Ecu shown in graph 4 had some of its roots in the domestic scene. Uncertainty about the government's ability to cope with the soaring fiscal deficit was one reason. Pressure stemming from the labour market situation was another.

Graph 5: 3-months' interest rate differentials vis-à-vis the ECU



Source: Sveriges Riksbank

Apparently, the Norwegian krone was efficiently sheltered by means of the much stronger fundamentals, but also because of market thinness. The connection became although quite clear when the problems in the EMS-currencies had appeared.

However, the Central Banks of Sweden and Norway provided quite spectacular proofs of adherence to their exchange rate commitments. They raised market rates to historical highs in order to reverse the capital flows. In response to the Finnish decoupling from the Ecu, the Swedish marginal overnight rate, the lending rate to the banking system, rose to the unprecedented level of 75 per cent. When the almost simultaneous turmoil in the European financial markets showed that this was not sufficient, the Riksbank raised it to 500 per cent. Norges Bank acted in a similar way after the Swedish floating, sending the marginal overnight rate to 1000 per cent. The unavoidable floating decisions in all three cases came when the Central Banks were depleted of exchange reserves.

Against this background it is not difficult to foresee the stance of monetary policies in the Nordic countries, even if the Central Banks refrained from defining explicit intermediate targets. A price stability norm, interpreted as two to three per cent annual growth of the CPI, seems to be the ultimate target for their policies, presumably pursued by recourse to the interest rate instrument. A combination of the usual monetary indicators such as broad money, the slope of the yield curve, domestic credit expansion and the time path of the exchange rates are going to serve as a vehicle for the formulation of the monetary policies.

The inflationary impulses coming from the currency depreciations and in some cases from higher income taxes are considered to be of minor importance for the underlying inflation, as high rates of unemployment are expected to provide labour market discipline. Finland for example, has already embarked on a medium term income policy package giving zero nominal wage increase for 1993.

In conclusion, monetary policies based on flexible exchange rates is a new and challenging experience for the Nordic Central Banks. The fixed exchange rate regime provided an widely understood norm for the antiinflationary policies, the problem that haunted these economies for over two decades. However, setting explicit targets for price stability could prove risky in times of extremely high unemployment. Inflationary objectives might be subjected to bargaining in the formulation of the policy mix. This risk might be especially high in the Nordic countries, which have strong corporatistic traditions. Besides, until recently policies were based on the notion that there is a trade off between inflation and unemployment.

3.2 Fiscal policies

Fiscal deficits and public indebtedness in Austria and Norway fluctuate at levels not allowing any misgivings about their manageability. However, the soaring deficits in Finland and Sweden (table 3 and graph 6) have already reached very high levels and these two countries run an obvious risk to fail to meet the Maastricht criteria. Current deficits are in both cases not in line with historical trends and this is especially true for Finland, which systematically avoided fiscal deficits (graph 6). Apart from country-specific factors, the deteriorating fiscal position during the 1991-1993 period can partly be attributed to cyclical factors and partly to the disinflation process which affects revenues and expenditure asymmetrically.

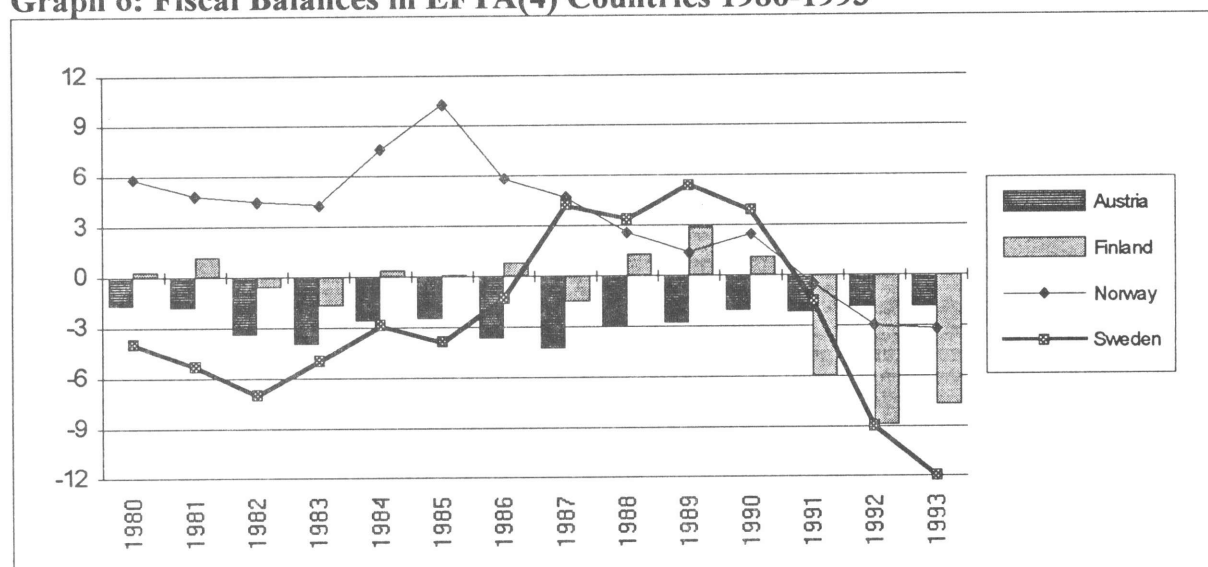
Fiscal developments in Austria are expected to follow recent trends, and it is unlikely that the fiscal deficit will deviate significantly from its current level. A reasonable projection therefore is that Austria will meet the Maastricht criterion (three per cent) by 1995.

The Norwegian public sector also shows a strong financial position (graph 6). Nevertheless, even if there should be no reason to cast any doubts about Norway's capacity to meet the Maastricht criteria, some comments related to the stance of its fiscal policy are justified.

Given the strongly dualistic nature of the Norwegian economy, with the important oil and the gas sector on one side and the rest of the economy on the other, economic trends can be better judged if the erratic influence of the former is excluded. Excluding the oil sector from both the GDP and the public finance aggregates, the central government deficit would be 10,5 per cent of mainland GDP for 1991, rising to 11,5 per cent in 1992 and 12,5 per cent in 1993. Fiscal policies are therefore strongly stimulative with respect to the mainland economy. Moreover, excluding a calculated permanent income from the oil, amounting to around 7 per cent of the mainland GDP, the financial position of the public sector could be considered as unsustainable. As a matter of fact, the collapse in oil prices 1986 initiated a period of deteriorating public finances (graph 6), which, after a short period (1986-1989) of fiscal austerity, ended up as an outright deficit.

Calculations based on reasonable assumptions about oil prices and economic growth suggest however that the overall fiscal position will recover as the economy shows signs of upturn, after an extended period of stagnation. Moreover, the impact of the disinflation process on public revenues has abated.

Graph 6: Fiscal Balances in EFTA(4) Countries 1980-1993



Source: Commission Services and National Authorities

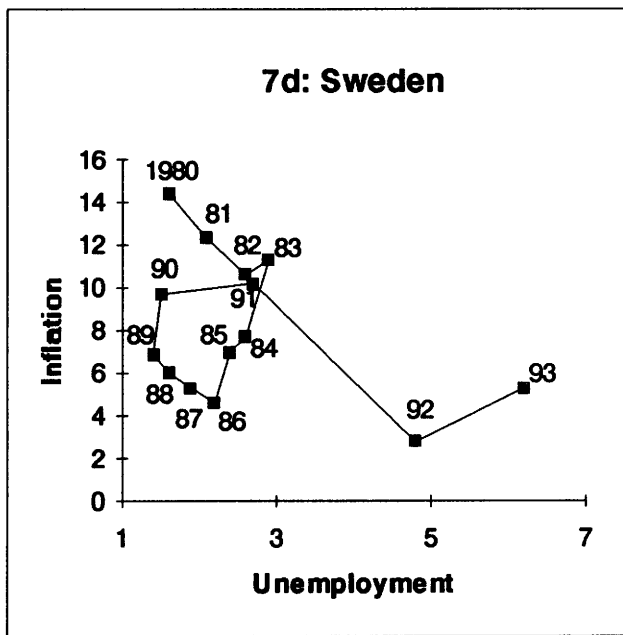
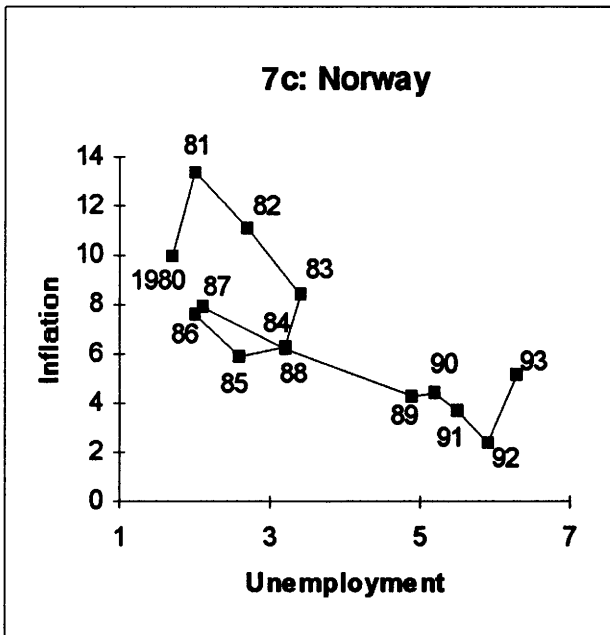
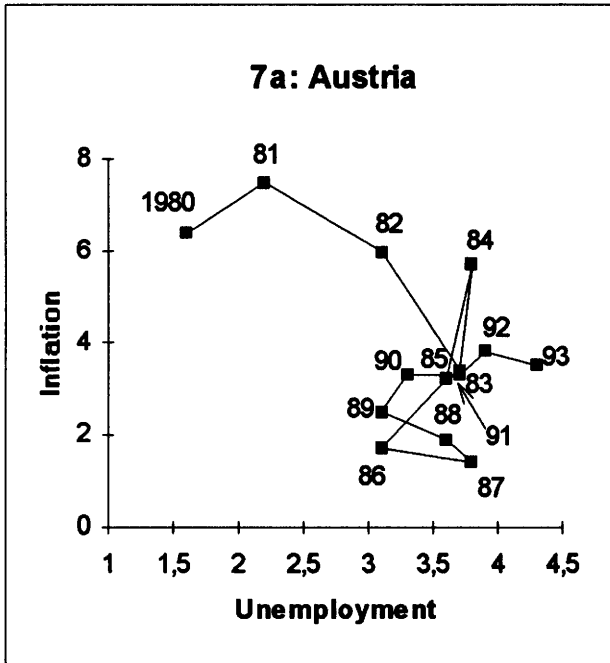
Finland

The comfortable tradition of balanced budgets in Finland turned to acute deficits after 1991. Behind this development is the above mentioned trade shock, which initiated the sharp drop in economic activity. The unusual slippages in the 1991 budget suggest that the events surprised the Finnish government, as revenues were strongly overestimated and expenditure strongly underestimated⁸. Besides, the initial reaction of the Finnish government was based on the false perception that the crisis was of transitory nature, and the first bundle of measures aimed at just relieving the effects of a pure demand shock. Thus, public expenditure increased in order to stimulate the economic activity, and the cyclically adjusted deficit, initially projected at -0,4 per cent of GDP, became -2,8. The stimulative effect did not come off, however, due to a sharp increase in private savings as households and corporations sought to consolidate their financial positions. This was indicative of the declining public confidence, but also a result of the disinflation process which boosted real interest rates.

With greater recognition of the structural problems of the economy, and under strong pressure on the markka, the Finnish government formulated a medium term financial program whose spirit is to secure sustainable recovery through low interest rates and moderate cost developments. Fiscal consolidation has therefore regained its traditionally strong position among the policy targets, and the overriding restriction in the medium-term budget is that public expenditure in 1995 will not exceed the level of 1991, in real terms. Consequently, taking into account the increase in spending stemming from the mounting public debt, real non-interest spending must fall by two to three per cent annually. In line with these medium-term targets, the government announced measures for 1993 implying cuts in public consumption and transfers of the order of two per cent of GDP.

⁸ Revenues were overestimated by 13 per cent and expenditure underestimated by 20 per cent.

Graph 7: Inflation and Unemployment in the EFTA(4) Countries 1980-1993



Source: OECD Economic Outlook 52.

It is also clear that the decision to float the markka did not entail any relaxation in these efforts, as changes in the pension system and further increases in employers' collateral in the social security and unemployment insurance have been notified. Finally, an agreement on unchanged nominal wages for 1993 demonstrates a consensus about the stance of the economic policy.

Sweden

A long period of sluggish growth (table 1) combined with more or less automatic increases in the major spending systems⁹, ambitious reforms and increasing difficulties to raise the already high tax burden (panel 1), provide the major explanations of the fiscal imbalances in Sweden. According to official statements, almost half of the current deficit (12 per cent of GDP in 1993) has its origin to non-cyclical factors. Moreover, the part of public spending attributed to structural factors, such as demography, is expected to enhance its share to total spending in the years to come. As an example, during 1985-1990, one of the best periods in macroeconomic terms since the beginning of 1970s, transfers to households increased by 54 per cent in fixed prices, whereas real GDP grew by 12,9 per cent. Indicative of the inherent difficulties to control public spending are also the findings that in spite of the fact that the labour market was overheated during this period, fiscal policy was stimulative, a fact that tends to be concealed behind the fiscal surpluses (graph 6).

The fast rising transfers have drawn the interest of both the former socialist government and its center-right successor for several reasons. First, most of the public insurance systems are inefficiently funded, with the national supplementary pension system being the most threatening example in the long-run. Second, there is a strong redistributive leaning in their construction, which makes the linkage between individual participation and individual benefits very weak. For example, the deficiently funded unemployment insurance is believed to have undermined labour market discipline, while the strongly redistributive pension system has probably contributed to the traditionally extremely low rate of the Swedish household saving. Generally, the inadequate correspondence between productive efforts and individual standard of living, stemming from the generous welfare system, has been blamed as one of the major reasons for the sluggish growth during the two latest decades.

A major tax reform was implemented in 1990, with the intention to improve the supply side of the economy without diminishing the tax revenues¹⁰. The general notion however seems to be that the reform was insufficiently funded. Since the reform came into effect at the beginning of the economic downturn it is difficult to separate the cyclical from the structural factors of the subsequent revenue losses. The sharp rise in household savings provides the most striking example in this respect. But whatever the exact explanation behind the rapid deterioration of the

⁹ According to official sources, e.g. the latest budget proposal, 85 per cent of central government spending is beyond the discretionary power of the government.

¹⁰ Among other things it reduced the marginal rates of the direct taxes, especially on the highest income levels (from over 80 per cent to 50 per cent in the course of three years). The revenue losses would be counterbalanced by higher rates and broadened bases of indirect taxes.

fiscal position might be, the alarming development made a total reconsideration of the public sector activities unavoidable.

Several packages of corrective measures have seen the light since early 1991, some of them aiming to prevent the anticipated deterioration in public finances and some of them as a desperate effort to restore confidence to the failed exchange rate norm. The basic approach has been to curb public spending in a way that strengthens the supply side of the economy. Thus, less generous unemployment and health insurance, increased fees for public services and reduced transfers and subsidies have been decided, along with reductions in some "growth impeding" taxes such as the turnover tax on securities and capital income.

The rapid cyclical weakness of the economy however, imposed severe constraints on policy priorities, and some of the tax decreases have been suspended or deferred. So, previously announced reductions in e.g. the general V.A.T. rate from 25 to 22 per cent and the capital income from the current 30 per cent rate to 25 per cent have been cancelled. Cross-party agreements aiming at improving the competitiveness of the economy, e.g. substantial cuts in the employees' contributions to social security funds, also have been financed by increases in both direct and indirect (mostly environmental) taxes. As the decision to float the krona radically changed the conditions on which decisions have been based on, one expects that the coming budget proposal (January 1993) will demark a return to measures that have sustainable long-run effects, and the exact status of the previous agreements is not clear.

Current forecasts hint at negative growth and continuing deterioration of the fiscal position in 1993, as economic recovery is not foreseen before 1994. So, the medium term situation remains gloomy, unless the strong improvement in the competitive position leads to a rate of growth that clearly exceeds previous forecasts. Current official scenarios foreshadow a fiscal deficit of the order of 6 per cent of GDP in 1997 and the soaring public debt moves quickly towards the level of 90 per cent of GDP during the same period. Clearly, the ambition to meet the EMU-criteria calls for more radical measures.

3.3 Financial Crisis in the Nordic Countries

An additional problem currently haunting the Nordic countries is the financial distress of the banking sector, showed in table 4. Substantial credit losses emerged already in 1987 in Norway and surfaced in Finland and Sweden in 1990. Despite the chronological difference, the origin and the extent of the problem seems to be quite similar. The major explanations can be found behind an unfortunate combination of credit and exchange market deregulations along with radical tax reforms.

Credit market deregulations came during the first half of the 1980s, a time of strong growth and solid income prospects. Consequently, they led to a very strong credit expansion as the supply side immediately responded to the strong demand.

Moreover, the demand side was propelled by extremely low (negative up to 1987) *after tax* real interest rates, owing to both high tax deductibility of interest expenditure (the tax reforms came in late 1980s) and low nominal interest rates due to exchange controls (also abolished in late 1980s). Surprisingly, neither of these reforms seems to have been discounted in the behaviour of either side of the credit market, even if they were quite predictable.

Table 4: Financial Crisis in the Nordic Countries; Selected Statistics

		1987	1988	1989	1990	1991	1992
Credit growth	Finland	20,0	30,6	16,6	10,5	1,1	-4,0*
	Norway	15,7	9,3	7,4	4,1	4,1	-2,4*
	Sweden	15,9	31,5	25,7	16,6	-1,5	-6,9*
Credit losses	Finland			0,7	0,8	1,6	3,0***
	Norway			2,1	2,5	3,9	2,5**
	Sweden			0,2	0,7	2,9	4,4**
Savings ratio	Finland	3,5	0,4	2,1	3,6	6,0	n.a.
	Norway	-6,1	-2,6	1,2	2,0	5,0	8,0
	Sweden	-3,4	-5,1	-4,6	-1,0	1,9	3,1
Household indebtness ratio	Finland	62,0	82,7	83,8	81,9	78,5	
	Norway	147,0	151,3	154,0	147,5	142,4	
	Sweden	120,2	134,5	134,2	125,9	116,7	

* 12 months average in July 1992; ** First eight months 1992; *** Estimate for 1992 provided by the Bank of Finland.

Source: National Authorities and Commission Services.

The problems appeared first in Norway in 1988, after the fall in oil prices 1986 and the tax reform of 1987. The former weakened dramatically the income prospects of the private sector, whereas the latter curtailed significantly the tax deductibility of interest expenditure. As a consequence, the relative prices between borrowing and saving changed dramatically. Similar events took place in Finland and Sweden about three years later. First, the tax reforms of the beginning of 1990s considerably reduced tax deductibility of interest expenditure and this came at the same time as a significant drop in the income prospects of the private sector occurred. Second, the almost simultaneous dismantling of exchange controls led to higher nominal interest rates at the same time as the governments embarked on disinflationary policies. These two changes together boosted real interest rates and triggered a considerable drop in credit demand, with a commensurate increase in the savings ratios. Asset prices, especially for real estate, plunged to levels that made much of the previous rather speculative and highly leveraged investment in real assets unprofitable. The subsequent credit losses made several banks in the three countries not only unprofitable in the short run, but also insolvent.

The policy response, starting from a case to case treatment, has gradually become more systematic. Comprehensive guarantees aiming at restoring depositors' and other asset holders' confidence have been issued by the governments and quite elaborate restructuring plans have emerged as well. Outright financial support also has reached non-negligible levels which, besides from adding to the already high borrowing requirements for the three governments also raised the crucial question of public ownership of the banking sector. In Norway for example, where the support hitherto amounts to 3,6 per cent of GDP, the state has become a major owner of the banking system. The Finnish government tries to avoid direct ownership due to the attendant moral hazard problems, by issuing loans involving only an option for the government to swap loans with shares in the future. The Swedish government, which has been trying to privatize the plagued state-owned Nordbanken¹¹, has declared that financial support is granted on purely commercial principles.

Whatever the remedies to the financial crisis might be, there is an obvious risk that the Nordic economies have come to a very disadvantageous situation. The currently tight credit market may, besides from contributing to a deepening of the current recession, also prove unable to financially support an economic recovery, when improved international conditions boost the demand for credit.

¹¹ Nordbanken is one of the major Swedish banks.

4 STRUCTURAL POLICIES

Inflation in the long-run depends not only on macroeconomic policies, but also on the overall functioning of domestic markets. Competitive pressure and incentives to exploit or create profitable opportunities are of crucial importance for productivity growth. On the other hand, rigidities stemming from regulations, the wage formation system, taxation and the size of the public sector undermine an economy's flexibility, strength and competitiveness in the long-run. The brief review of these aspects in this section suggests that several reforms are necessary, if the EFTA(4) countries want to reduce the costs of participation in the EMU.

4.1 Public sector and taxation

Most of the public services are not distributed through markets and the production costs are financed by taxes. Lack of a price mechanism means that one of the basic tools for judging efficiency is absent, while heavy taxation and subsidies are distortive *per se*. According to traditional measures of public sector size shown in panel 1, one can suspect that the Swedish economy must suffer from severe structural problems, as the use of 60 per cent of its GDP is subjected to decisions within the public sector. As a matter of fact, the Swedish public sector is the highest in the OECD area.

Recognising the negative influence of the huge public sector on efficiency and growth, Swedish governments have been trying several ways to remove the most negative elements from the system. Traditional remedies like privatisation, contracting out of complementary services such as cleaning, and enhanced possibilities for private competition in the provision of services have been in the agenda for a long time, but weak asset markets retard the privatisation process. An interesting and popular trend is currently the decoupling of production from distribution. Trying to promote *efficiency in production* without diminishing the availability of certain public services, it has been suggested that production of e.g. health, education, transports could be carried out by competing private and public entities. Political control will still be exercised on the distribution of the resulting output however, meaning that the public will still have free (or almost free) access to these services, implying that production costs will be financed by taxes. Thus, the new system does not solve the problems of the heavy taxation, and this can be especially problematic in the future as the extent the ongoing economic integration increases tax-base mobility, setting this way effective upper limits to tax rates.

Recent tax reforms in all the EFTA(4) countries have made their tax systems less distortive, and have brought them more in line with EC practices. The guidelines in these parallel reforms have been similar: Lower marginal rates on direct taxes and more reliance on VAT.

4.2 Labour markets

The traditional way of correcting competitiveness by exchange rate changes will be closed after participation in the EMU. Moreover, the possibilities for the public

sectors to absorb unemployment will be severely curtailed. Therefore, much of the impressive unemployment numbers or the high real wage flexibility estimates shown in table 5 are not quite relevant for a situation in when exchange rate adjustments are not possible. It is not unlikely that the recent rise in unemployment in the Nordic countries can be related to the new orientation in economic policies, at least prior to the recent depreciation. If so, the shifts shown in graph 7 are of structural nature, suggesting that average future unemployment will probably exceed its historical levels. It also means that flexibility in nominal wages will be more compelling in the new environment.

Assuming low and stable inflation under the EMU, nominal wage flexibility is of key importance for the competitive position of the participating countries and for the Community as a whole. Since such flexibility cannot be provided overnight, it must be a part of the program of real convergence. From this point of view, the recent depreciations of the Nordic currencies can be considered as time-inconsistent policies, to the extent the temporary relief induces a more relaxed attitude towards the imperative of nominal flexibility.

Table 5: Selected Labour Market statistics, 1991

	<u>Austria</u>	<u>Finland</u>	<u>Norway</u>	<u>Sweden</u>
Participation rate	67,7	76,9	79,8	83,9
-Female	55,4	72,9	72,6	80,1
NAIRU ¹⁾	n.a.	4,0	3,5	2,2
Long-term unemployment	15,8	19,0	17,0	8,0
Long run real wage flexibility ²⁾	-0,8	-0,5	n.a.	-1,4
Wage formation system	<i>Centralised</i>	<i>Centralised</i>	<i>Centralised</i>	<i>Centralised</i>

1) Non Accelerating inflation rate of Unemployment; 2) Semi-elasticity of real wages changes with respect to the rate of unemployment.

Source: OECD, Country Studies.

4.3 Subsidies

While subsidies in general is a minor problem, subsidies in the agricultural sector are quite problematic for two reasons. First, the degree of subsidization, on average, has been much higher in these countries than in the EC. Second, the EEA treaty exempted this particular sector from harmonization to the regulations of the EC. Only the fact that the governments of the EFTA countries wanted to maintain their discretionary power in this area indicates that important national goals are

hidden behind their agricultural policies. In effect, a mixture of environmental, social, regional and defence objectives, along with assumed positive externalities to other sectors such as tourism, is encountered in different proportions in each country, and the result is shown in table 6.

Table 6: Size and subsidization of the agricultural sector, 1990

	<u>Austria</u>	<u>Finland</u>	<u>Norway</u>	<u>Sweden</u>	<u>EC</u>
PSE ^{a)}	46%	73%	78%	59%	47%
CSE ^{b)}	-49%	-71%	-65%	-65%	-41%
Employment	8,0%	8,9%	6,9%	3,6%	

a) Producer Subsidy Equivalence; OECD measure of the share of subsidies or subsidy equivalents to the value of sector output.

b) Consumer Subsidy Equivalent; The total value of transfers as a percentage of total value of consumption.

Source: OECD, Agricultural policies, markets and trade, Paris 1992.

Even if EC's common agricultural policy does not constitute the best point of departure for economic reasoning, simple alignment with the more transparent system prevailing in the Community might be an improvement. The single objective of attaining a stable development of sectoral income, basically by means of price support and external protection, is less extensive and probably less distortive than the existing national systems.

Sweden has taken a first step in reforming its agricultural policies in 1991, by deciding to reduce the subsidies and relax the protection from import. It seems that these measures are part of a more comprehensive package, because the Swedish government announced plans to dismantle most of the regulations in the medium term. Similar reforms have not been notified by the other governments.

4.4 Malfunctioning internal markets

According to the EEA treaty, all the EFTA countries have to align their competition policies to EC rules after a period of three years. More exact, EC regulations will replace national legislation at the beginning of 1996. This is indeed an area of much-needed changes in the EFTA(4) countries, because a substantial amount of (mostly anecdotal) evidence suggests that the market mechanism has been severely squeezed. Imprecise legal and institutional arrangements are responsible to some extent, but it looks like that most of the violations against the market mechanism have their origin to an extremely tolerant stance against practices that effectively utilize the borderland between what is lawful and illegal. Idiosyncratic views about market efficiency seems to underpin this attitude, with further support from long traditions of corporatistic ruling.

Deviations from market efficiency are difficult to substantiate quantitatively, but the single observation that consumer prices for both tradable and non-tradable goods are notably higher in these countries than in equally developed EC-countries can be taken as indirect evidence. Consumer goods were for example around 40 per cent higher than EC-average in 1985 in the EFTA(4) countries, with small differences between them. Even if a small portion of this difference can be explained by market segmentation due to topographical and geographical idiosyncrasies, the major part must be attributed to lack of competition.

Numerous official reports reveal that cartelization, market dominance, and direct regulations of markets are frequently encountered in these countries. The well documented existence of price lists, usually issued by branch organisations, market share agreements either in form of carving the market into distinct areas or by fixing quantities produced or sold, exclusive sales agreements of specific trademarks, non-entrance agreements of previous owners in case of takeovers and even joint tendering in procurement, provide sufficient evidence that cartels hold domestic markets under tight control.

The effects of cartels are well known. Prices tend to be higher than necessary and more rigid, as the convenient market position allows both higher mark-ups and price smoothing. Another effect is that foreign suppliers find it easy to apply price discrimination in cartelized markets. For example, import prices for identical goods are more than seven per cent higher in Austria than in Germany, and the difference becomes ten per cent if we compare with Netherlands.

Vertical integration based either on ownership or on well controlled distribution networks is also widespread in all the EFTA(4) countries. Three to five major wholesalers or distribution chains control 80 to 90 per cent of sectoral sales, depending on which country or which sector one chooses to look at. Construction, food processing and consumer goods are found among the most vertically integrated sectors. The pulp and paper industry holds a distinct position in the Scandinavian countries, as it is integrated both with forestry and construction material industries.

Comprehensive systems of price regulations give also the impression that the price mechanism has been one of the major tools to achieve social goals. Items exposed to price regulations of one kind or another constitute a basket whose weight stands for over one third of the CPI basket. Price regulations are most frequent in transports and communications, housing rents, energy, culture, food, tobacco and beverages¹². Since price regulations are in most cases encountered in sectors of "particular importance", they usually are only a component of an intervention package, other parts being subsidies and entry controls.

Unusual difficulties for market entry is another interesting feature. A quite inflexible system of licensing and franchising has provided effective protection to existing suppliers, whilst extensive use of needs-testing, especially at the local level, has in essence given discretionary power to authorities to prevent "unnecessary"

¹² Among interesting peculiarities one can mention that excessive rebates (over 3%) and pricing below the cost are still prohibited in Austria. Comparative advertising with respect to prices was also banned until recently.

competition. Thus, one can easily find local monopolies in areas like energy¹³ and transportation. Rigid use of town plans has also contributed to restricted competition, as localities for shops are limited and shopping centers are usually controlled by construction companies, distribution chains and wholesalers, often interconnected by cross-ownership. Needless to say that access to markets where public monopolies prevail, such as energy production, postal services, air traffic and telecommunications has, until recently, been very restricted.

Constraints on foreign ownership of various types of assets have been working in the same direction. Upper limits on the share of foreign participation in industry, prohibitions for ownership of land and/or real estate, the right allotted to firms to issue shares with limited voting power have hindered foreign direct investment and sheltered managers from hostile take-overs.

4.4.1 The Institutional Set-up

At heart of the problem seems have been the strong corporatist element in the EFTA countries' political life, and the attendant idiosyncratic ways of viewing the market mechanism and conducting economic policies. Thus, the institutional set-up in most areas has a strong corporatist leaning which, whilst it served as a plank to underpin major reform programs and good macroeconomic performance in the past, also favoured an institutional framework in which the social parties keep tight reins on market forces. So, instead of invigorating competition as a means to achieve good market performance, one tried to defend a vaguely defined public interest by banning only abuse of market power. This concept has been pivotal of the legislation in all the EFTA(4) countries, and had the adverse effect to promote cartellization, tacit collusions, market dominance etc, because they have not been prohibited *per se*. So, the burden of proving what is detrimental to public interest has been reverse to economic thinking, which also hampered the work of the supervising authorities.

4.4.2 Radical reforms are coming

The growing interest to revitalise the supply side of their economies and the recent EFTA-EC agreement have imparted a new impetus to the competition policies in the EFTA(4) countries. So, a strong wave of deregulations and rapid harmonization to EC rules, combined with markedly strengthened supervisory authorities are to emerge in the next two years.

Sweden has already started this process and the Parliament adopted a new Competition Act in November 1992. The new Act is in every relevant respect identical to EC rules and will take effect on 1 July 1993. Promotion of competition *per se* rather than abuse of market position is the new overriding objective, prohibiting thereby all forms of collusive behaviour. Agreements or mergers can be allowed only if they pass a "competition test", implying that special cases can be tolerated only if it shows that competition will not suffer.

¹³ Norway has recently deregulated the energy sector.

Similar signals come even from the other countries. The new Competition Law in Finland, which took effect in September 1992, prohibits horizontal cartels but maintains its philosophical bias towards the old "abuse principle". The government has also announced the preparation of a bill, expected to be submitted to the Parliament during 1993, aiming at removing restrictions on foreign ownership. The Austrian Cartel Law is currently subjected to a comprehensive overhaul, with a view to increasing the possibilities of initiating infringement procedures and to introduce merger controls. However, a strengthening in the enforcement of existing rules by the Cartel Commission has been reported. Yet, another deviation from previous practices in all these countries is the shift from moral suasion to considerable legal and economic sanctions in case of infringement.

5 A FINAL COMMENT

The expected costs and benefits of joining the EMU are probably different for each one of the EFTA(4) countries. Relinquishing the exchange rate requires an adjustment period for the three Nordic countries while Austria has already gained a credible fixed exchange rate regime *vis-à-vis* the Deutsche Mark. Unfortunately, the costs of achieving low inflation and nominal flexibility occur in a period of deep recession, at least in Finland and Sweden, with the additional constraint of fiscal consolidation. Moreover, the time schedule for the EMU does not allow any short-term deviations from the adjustment process. However, the macroeconomic policies adopted by the governments in recent past suggest that, in spite of the adverse economic conditions, a shift in priorities has taken place.

Undoubtedly, the timing of the adjustment undermines the popularity of the idea to join the EMU. Even if such tendencies have come to the surface in many EC countries, the risk that public sentiment will be more affected by the restrictive convergence policies than by the underlying EMU ideas must be higher in these countries. This is because the provisions of the treaty are completely external to them, in the sense that they had no participation and, of course, no influence on the preparation of it. It is to be hoped that, in spite of these considerations, the outcome of the referenda which are due in the course of 1994 will be positive.

Economic Papers

The following papers have been issued. Copies may be obtained by applying to the address mentioned on the inside front cover.

- No. 1 EEC-DG II inflationary expectations. Survey based inflationary expectations for the EEC countries, by F. Papadia and V. Basano (May 1981).
- No. 3 A review of the informal economy in the European Community, by Adrian Smith (July 1981).
- No. 4 Problems of interdependence in a multipolar world, by Tommaso Padoa-Schioppa (August 1981).
- No. 5 European Dimensions in the Adjustment Problems, by Michael Emerson (August 1981).
- No. 6 The bilateral trade linkages of the Eurolink Model : An analysis of foreign trade and competitiveness, by P. Ranuzzi (January 1982).
- No. 7 United Kingdom, Medium term economic trends and problems, by D. Adams, S. Gillespie, M. Green and H. Wortmann (February 1982).
- No. 8 Où en est la théorie macroéconomique, par E. Malinvaud (juin 1982).
- No. 9 Marginal Employment Subsidies : An Effective Policy to Generate Employment, by Carl Chiarella and Alfred Steinherr (November 1982).
- No. 10 The Great Depression : A Repeat in the 1980s ?, by Alfred Steinherr (November 1982).
- No. 11 Evolution et problèmes structurels de l'économie néerlandaise, par D.C. Breedveld, C. Depoortere, A. Finetti, Dr. J.M.G. Pieters et C. Vanbelle (mars 1983).
- No. 12 Macroeconomic prospects and policies for the European Community, by Giorgio Basevi, Olivier Blanchard, Willem Buiter, Rudiger Dornbusch, and Richard Layard (April 1983).
- No. 13 The supply of output equations in the EC-countries and the use of the survey-based inflationary expectations, by Paul De Grauwe and Mustapha Nabli (May 1983).
- No. 14 Structural trends of financial systems and capital accumulation : France, Germany, Italy, by G. Nardozzi (May 1983).
- No. 15 Monetary assets and inflation induced distortions of the national accounts - conceptual issues and correction of sectoral income flows in 5 EEC countries, by Alex Cukierman and Jorgen Mortensen (May 1983).
- No. 16 Federal Republic of Germany. Medium-term economic trends and problems, by F. Allgayer, S. Gillespie, M. Green and H. Wortmann (June 1983).
- No. 17 The employment miracle in the US and stagnation employment in the EC, by M. Wegner (July 1983).
- No. 18 Productive Performance in West German Manufacturing Industry 1970-1980; A Farrell Frontier Characterisation, by D. Todd (August 1983).
- No. 19 Central-Bank Policy and the Financing of Government Budget Deficits : A Cross-Country Comparison, by G. Demopoulos, G. Katsimbris and S. Miller (September 1983).
- No. 20 Monetary assets and inflation induced distortions of the national accounts. The case of Belgium, by Ken Lennan (October 1983).
- No. 21 Actifs financiers et distortions des flux sectoriels dues à l'inflation : le cas de la France, par J.-P. Baché (octobre 1983).
- No. 22 Approche pragmatique pour une politique de plein emploi : les subventions à la création d'emplois, par A. Steinherr et B. Van Haepere (octobre 1983).
- No. 23 Income Distribution and Employment in the European Communities 1960-1982, by A. Steinherr (December 1983).
- No. 24 U.S. Deficits, the dollar and Europe, by O. Blanchard and R. Dornbusch (December 1983).
- No. 25 Monetary Assets and inflation induced distortions of the national accounts. The case of the Federal Republic of Germany, by H. Wittelsberger (January 1984).

- No. 26 Actifs financiers et distorsions des flux sectoriels dues à l'inflation : le cas de l'Italie, par A. Reati (janvier 1984).
- No. 27 Evolution et problèmes structurels de l'économie italienne, par Q. Ciardelli, F. Colasanti et X. Lannes (janvier 1984).
- No. 28 International Co-operation in Macro-economic Policies, by J.E. Meade (February 1984).
- No. 29 The Growth of Public Expenditure in the EEC Countries 1960-1981 : Some Reflections, by Douglas Todd (December 1983).
- No. 30 The integration of EEC qualitative consumer survey results in econometric modelling : an application to the consumption function, by Peter Praet (February 1984).
- No. 31 Report of the CEPS Macroeconomic Policy Group. EUROPE : The case for unsustainable growth, by R. Layard, G. Basevi, O. Blanchard, W. Buiter and R. Dornbusch (April 1984).
- No. 32 Total Factor Productivity Growth and the Productivity Slowdown in the West German Industrial Sector, 1970-1981, by Douglas Todd (April 1984).
- No. 33 An analytical Formulation and Evaluation of the Existing Structure of Legal Reserve Requirements of the Greek Economy : An Uncommon Case, by G. Demopoulos (June 1984).
- No. 34 Factor Productivity Growth in Four EEC Countries, 1960-1981, by Douglas Todd (October 1984).
- No. 35 Rate of profit, business cycles and capital accumulation in U.K. industry, 1959-1981, by Angelo Reati (November 1984).
- No. 36 Report of the CEPS Macroeconomic Policy Group. Employment and Growth in Europe : A Two-Handed Approach by P. Blanchard, R. Dornbusch, J. Drèze, H. Giersch, R. Layard and M. Monti (June 1985).
- No. 37 Schemas for the construction of an "auxiliary econometric model" for the social security system, by A. Coppini and G. Laina (June 1985).
- No. 38 Seasonal and Cyclical Variations in Relationship among Expectations, Plans and Realizations in Business Test Surveys, by H. König and M. Nerlove (July 1985).
- No. 39 Analysis of the stabilisation mechanisms of macroeconomic models : a comparison of the Eurolink models by A. Bucher and V. Rossi (July 1985).
- No. 40 Rate of profit, business cycles and capital accumulation in West German industry, 1960-1981, by A. Reati (July 1985).
- No. 41 Inflation induced redistributions via monetary assets in five European countries : 1974-1982, by A. Cukierman, K. Lennan and F. Papadia (September 1985).
- No. 42 Work Sharing : Why ? How ? How not ..., by Jacques H. Drèze (December 1985).
- No. 43 Toward Understanding Major Fluctuations of the Dollar by P. Armington (January 1986).
- No. 44 Predictive value of firms' manpower expectations and policy implications, by G. Nerb (March 1986).
- No. 45 Le taux de profit et ses composantes dans l'industrie française de 1959 à 1981, par Angelo Reati (Mars 1986).
- No. 46 Forecasting aggregate demand components with opinions surveys in the four main EC-Countries - Experience with the BUSY model, by M. Biart and P. Praet (May 1986).
- No. 47 Report of CEPS Macroeconomic Policy Group : Reducing Unemployment in Europe : The Role of Capital Formation, by F. Modigliani, M. Monti, J. Drèze, H. Giersch and R. Layard (July 1986).
- No. 48 Evolution et problèmes structurels de l'économie française, par X. Lannes, B. Philippe et P. Lenain (août 1986).
- No. 49 Long run implications of the increase in taxation and public debt for employment and economic growth in Europe by G. Tullio (August 1986).
- No. 50 Consumers Expectations and Aggregate Personal Savings by Daniel Weiserbs and Peter Simmons (November 1986).
- No. 51 Do after tax interest affect private consumption and savings ? Empirical evidence for 8 industrial countries : 1970-1983 by G. Tullio and Fr. Contesso (December 1986).
- No. 52 Validity and limits of applied exchange rate models : a brief survey of some recent contributions by G. Tullio (December 1986).

- No. 53 **Monetary and Exchange Rate Policies for International Financial Stability : a Proposal** by Ronald I. McKinnon (November 1986).
- No. 54 **Internal and External Liberalisation for Faster Growth** by Herbert Giersch (February 1987).
- No. 55 **Regulation or Deregulation of the Labour Market : Policy Regimes for the Recruitment and Dismissal of Employees in the Industrialised Countries** by Michael Emerson (June 1987).
- No. 56 **Causes of the development of the private ECU and the behaviour of its interest rates : October 1982 - September 1985** by G. Tullio and Fr. Contesso (July 1987).
- No. 57 **Capital/Labour substitution and its impact on employment** by Fabienne Ilzkovitz (September 1987).
- No. 58 **The Determinants of the German Official Discount Rate and of Liquidity Ratios during the classical goldstandard : 1876-1913** by Andrea Sommariva and Giuseppe Tullio (September 1987).
- No. 59 **Profitability, real interest rates and fiscal crowding out in the OECD area 1960-1985 (An examination of the crowding out hypothesis within a portfolio model)** by Jorgen Mortensen (October 1987).
- No. 60 **The two-handed growth strategy for Europe : Autonomy through flexible cooperation** by J. Drèze, Ch. Wyplosz, Ch. Bean, Fr. Giavazzi and H. Giersch (October 1987).
- No. 61 **Collusive Behaviour, R & D, and European Policy** by Alexis Jacquemin (November 1987).
- No. 62 **Inflation adjusted government budget deficits and their impact on the business cycle : empirical evidence for 8 industrial countries** by G. Tullio (November 1987).
- No. 63 **Monetary Policy Coordination Within the EMS : Is There a Rule ?** by M. Russo and G. Tullio (April 1988).
- No. 64 **Le Découplage de la Finance et de l'Economie - Contribution à l'Evaluation des Enjeux Européens dans la Révolution du Système Financier International** par J.-Y. Haberer (Mai 1988).
- No. 65 **The completion of the internal market : results of macroeconomic model simulations** by M. Catinat, E. Donni and A. Italianer (September 1988).
- No. 66 **Europe after the crash : economic policy in an era of adjustment** by Charles Bean (September 1988).
- No. 67 **A Survey of the Economies of Scale** by Cliff Pratten (October 1988).
- No. 68 **Economies of Scale and Intra-Community trade** by Joachim Schwalbach (October 1988).
- No. 69 **Economies of Scale and the Integration of the European Economy : the Case of Italy** by Rodolfo Helg and Pippo Ranci (October 1988).
- No. 70 **The Costs of Non-Europe - An assessment based on a formal Model of Imperfect Competition and Economies of Scale** by A. Smith and A. Venables (October 1988).
- No. 71 **Competition and Innovation** by P.A. Geroski (October 1988).
- No. 72 **Commerce Intra-Branche - Performances des firmes et analyse des échanges commerciaux dans la Communauté européenne** par le Centre d'Etudes Prospectives et d'Informations Internationales de Paris (octobre 1988).
- No. 73 **Partial Equilibrium Calculations of the Impact of Internal Market Barriers in the European Community** by Richard Cawley and Michael Davenport (October 1988).
- No. 74 **The exchange-rate question in Europe** by Francesco Giavazzi (January 1989).
- No. 75 **The QUEST model (Version 1988)** by Peter Bekx, Anne Bucher, Alexander Italianer, Matthias Mors (March 1989).
- No. 76 **Europe's Prospects for the 1990s** by Herbert Giersch (May 1989).
- No. 77 **1992, Hype or Hope : A review** by Alexander Italianer (February 1990).
- No. 78 **European labour markets : a long run view (CEPS Macroeconomic Policy Group 1989 Annual Report)** by J.-P. Danthine, Ch. Bean, P. Bernholz and E. Malinvaud (February 1990).
- No. 79 **Country Studies - The United Kingdom** by Tassos Belessiotis and Ralph Wilkinson (July 1990).
- No. 80 See "Länderstudien" No. 1
- No. 81 **Country Studies - The Netherlands** by Filip Keereman, Françoise Moreau and Cyriel Vanbelle (July 1990).

- No. 82 Country Studies - Belgium** by Johan Baras, Filip Keereman and Françoise Moreau (July 1990).
- No. 83 Completion of the internal market : An application of Public Choice Theory** by Manfred Teutemann (August 1990).
- No. 84 Monetary and Fiscal Rules for Public Debt Sustainability** by Marco Buti (September 1990).
- No. 85 Are we at the beginning of a new long term expansion induced by technological change?**, by Angelo Reati (August 1991).
- No. 86 Labour Mobility, Fiscal Solidarity and the Exchange Rate Regime: a Parable of European Union and Cohesion**, by Jorge Braga de Macedo (October 1991).
- No. 87 The Economics of Policies to Stabilize or Reduce Greenhouse Gas Emissions: the Case of CO₂**, by Mathias Mors (October 1991).
- No. 88 The Adequacy and Allocation of World Savings**, by Javier Santillán (December 1991).
- No. 89 Microeconomics of Saving**, by Barbara Kauffmann (December 1991).
- No. 90 Exchange Rate Policy for Eastern Europe and a Peg to the ECU**, by Michael Davenport (March 1992).
- No. 91 The German Economy after Unification: Domestic and European Aspects**, by Jürgen Kröger and Manfred Teutemann (April 1992).
- No. 92 Lessons from Stabilisation Programmes of Central and Eastern European Countries, 1989-91**, by Domenico Mario Nuti (May 1992).
- No. 93 Post-Soviet Issues: Stabilisation, Trade and Money**, by D. Mario Nuti and Jean Pisani-Ferry (May 1992).
- No. 94 Regional Integration in Europe**, by André Sapir (September 1992).
- No. 95 Hungary : Towards a Market Economy** (October 1992).
- No. 96 Budgeting Procedures and Fiscal Performance in the European Communities**, by Jürgen von Hagen (October 1992).
- No. 97 L'ECU en poche? Quelques réflexions sur la méthode et le coût du remplacement des monnaies nationales par des pièces et des billets en ECU**, par Ephraïm Marquer (octobre 1992).
- No. 98 The Role of the Banking Sector in the Process of Privatisation**, by Domenico Mario Nuti (November 1992).
- No. 99 Towards budget discipline: an economic assessment of the possibilities for reducing national deficits in the run-up to EMU**, by Dr. J. de Haan, Dr. C.G.M. Sterks and Prof. Dr. C.A. de Kam (December 1992).
- No. 100 EC Enlargement and the EFTA Countries**, by Christopher Sardelis (March 1993).

Country Studies*

See also Economic Papers No.79 (The United Kingdom), No.81 (The Netherlands) and No.82 (Belgium).

No. 1 The Federal Republic of Germany (September 1990)

No. 2 Portugal (February 1991)

No. 3 United Kingdom (March 1991)

No. 4 Denmark (April 1991)

No. 5 France (août 1991)

No. 6 Ireland (September 1991)

No. 7 Spain (March 1992)

No. 8 Netherlands (June 1992)

No. 9 Greece (July 1992)

* Country studies are the result of internal analysis of the economic situation of the respective member country; they are made on the responsibility of the Directorate-General for Economic and Financial Affairs of the Commission of the European Communities.