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1996 ANNUAL ECONOMIC REPORT

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PART A

COMMUNITY-WIDE TRENDS

Summary and conclusions

In presenting the Commission's views on the current economic situation and main policy issues in the Community, the 1996 Annual Economic Report is intended to initiate a debate on the policy options to be considered in the forthcoming 1996 Broad Guidelines exercise. Job creation is the principal social, economic and political objective of the Union and its pursuit requires a whole variety of measures. This report concentrates on macroeconomic policies and also deals with structural policies, in particularly those initiated and agreed at the Community level. These policies have been set out in detail in a number of reports, including in particular the joint employment report approved by the December 1995 Madrid European Council.

The Community needs to stay on course

Creating jobs and reducing unemployment is the single greatest challenge facing the Community at the present time. Policy-makers in the Community are faced with a situation in which decisions taken in the short term will fundamentally affect the evolution of the Community's growth, employment and convergence performance in the coming years. However, the juxtaposition of cyclical difficulties and slow progress with structural reforms has raised uncertainties about the short-term economic prospects and pointed to the need for affirmation about the effectiveness and soundness of the policies followed by Community governments. In this situation, there is a clear need to articulate policy intentions more effectively in order to stabilise expectations and to mobilise political support for stated objectives. This is all the more essential in order to avoid a weakening in the determination to implement the appropriate policy framework in the face of the current, less than ideal, economic conditions.

This situation has certain parallels to the conditions prevailing in the first half of the 1980s but decisive and concerted action provided the key to a turnaround in economic sentiment and performance. The challenge facing policy makers is therefore:

- to revive the recovery by introducing national and Community co-ordinated measures aimed at restoring confidence; and
- to achieve the latter whilst simultaneously supporting the medium-term orientation of Community policy aimed at transforming the upswing into a strong and sustained growth process supported by capacity and employment-creating investment coupled with the necessary progress towards nominal convergence.

The maintenance of this medium-term orientation is crucial to the realisation of the two complementary objectives of Community policy, namely:

- a substantial reduction in the level of unemployment; and
- successful transition to Economic and Monetary Union on 1 January 1999.

Disappointing growth trend during 1995 ...

The Community economy is experiencing a marked slowdown. Contrary to expectations prevailing at the beginning of 1995 of output growth of around 3 percent per year in 1995 and 1996, the economic expansion lost considerable steam throughout 1995 and came to a virtual standstill in the closing months of the year. Overall, the performance was disappointing not just in terms of the average growth rate achieved (available evidence suggests GDP growth of the order of 2½ per cent) but especially because the momentum was insufficient to prevent unemployment from rising in some Member States at the end of last year and since progress with fiscal consolidation was modest. Better results on these two fronts are crucial to the credibility of the Community's medium-term ambitions.

The slowdown was initially induced by "inherent cyclical forces", including an end to the early-cycle boost from stockbuilding. These forces were exacerbated by the rise in long-term interest rates during 1994, the currency turmoil in the spring of 1995 and the ensuing decline in private sector confidence. The abrupt and sizeable movements in exchange rates -- reflecting a combination of dollar weakness and doubts in the financial markets concerning the credibility of fiscal and structural policies in a number of countries -- heightened financial uncertainties and created perceptions of risks to the proper functioning of the internal market. These developments in combination with inadequate progress in combatting unemployment have contributed to a decline in confidence and a scaling back of spending and hiring decisions.

... threatens confidence in the Community

Consequently, the Community enters 1996 in a less confident mood. Although the balance of probability is still pointing towards a renewed strengthening in activity, the ongoing deterioration in business and consumer sentiment suggests that confidence-enhancing action remains essential to prevent a prolongation of the current pause in economic activity. Increasing levels of uncertainty among economic agents stem from a variety of sources. Externally, the global technological revolution, increasing competition from low cost producers and an accelerated pace of structural change in all areas of the economy are having an impact. Internally, insufficient reduction of high unemployment and uncertainty surrounding the implementation of measures needed to realise key economic and political objectives are negatively affecting the medium-term expectations of investors and consumers alike.

Such pessimism is exaggerated given favourable economic fundamentals...

While the fears generated by global and Community-wide phenomena may be understandable, much of the anxiety should prove short-term in nature. The Community is presently enjoying quite favourable underlying economic conditions. Extra-Community import demand continues to expand at a healthy pace, the profitability of investment is improving and, in overall terms, is noticeably higher than during the second half of the 1980s, inflation is at a historical low, interest rates have been substantially reduced and a partial reversal of previous exchange rate overshooting has taken place. Furthermore, progress is being made towards greater nominal convergence. The Community finds itself, therefore, in a paradoxical situation. The prevailing sentiment of caution and indecision is at odds with the fundamentals and with the broad degree of convergence amongst governments regarding their objectives and the means for achieving them.

... but confidence building measures are necessary.

Consequently, within the overall economic policy framework established in the Commission's 1993 White Paper on Growth, Competitiveness and Employment and embodied in successive Broad Economic Policy Guidelines adopted by the Council since 1993, confidence building measures are called for to overcome the current short-term fears and anxieties. Measures which can be organised at the national and/or Community level should help provide the reassurance necessary to re-ignite the recovery process and thereby exploit the favourable underlying conditions. This is the essential rationale underlying the Commission President's recent proposal for a European confidence pact for employment. In this context, the Commission has suggested making supplementary resources available for the successful realisation of the trans-European networks (TEN's) as well as for research and development efforts. In addition, following the conclusions of the Madrid European Council, the Commission is proposing an action plan in favour of SMEs. Display of common action in these fields will foster confidence in the ability of the Member States and the Community to achieve shared objectives. Furthermore, cooperation between the social partners, in concertation with governments, on a comprehensive programme for stability and employment could spur confidence and improve the investment climate. Such pacts should be examined not only in the light of short-term considerations but also as a part of an overall medium-term package of measures. To ensure the chances of overall success, such policy packages must be credible, provide clear signs regarding the policy course, be compatible with the agreed macroeconomic strategy, contain detailed initiatives on ways to pursue structural reform and aim to receive broad acceptance among different strands of opinion in society.

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Realising the desired "détente" of the macroeconomic policy mix...

The objective of policy must be to re-ignite the recovery process whilst at the same time maintaining the credibility of the stability-oriented medium-term policy framework. With respect to budgetary policy, there appears to be virtually no room for manoeuvre in the vast majority of Member States in the current situation. Given the risk of adverse reactions on forward-looking financial and foreign exchange markets, any slippage in fiscal consolidation efforts would be counterproductive. On the contrary, the most important contribution that macroeconomic policies can make at the present time is to bring about a continued "détente" in the policy mix. The primary objective of monetary policy is to achieve and maintain low inflation. But, if budgetary consolidation efforts are pursued resolutely and wage developments remain adequate, the conditions will be created for realising a further, durable, easing in monetary conditions. The attached report highlights the fact that such a "détente" was hampered last year by the incomplete application of policy intentions in some Member States. Consequently, the key to avoiding a more prolonged economic slowdown is linked essentially to the enthusiasm and commitment of *all* Member States to put their *overall* policy framework on a credible footing.

...will depend on a credible budgetary consolidation process...

Despite the generally promising trends towards more fiscal rectitude in recent years, excessive budget deficits continue to exert downward pressures on current and prospective living standards in the Community. In a number of Member States, high budgetary imbalances fuel inflationary expectations and contribute to high interest rate premiums. More generally, high budget deficits depress national saving, lead to higher expected tax rates, impair additional actions to combat unemployment, hamper efforts to raise production and employment potential, and reduce the ability of budgetary policy to respond to economic downturns. The urgency of fiscal consolidation efforts in the Community is recognised by all Member States.

Despite the positive medium-term effects, governments may be reluctant at present to continue budgetary reforms due to concern about their short-term impact. However, depending on the particular circumstances that a country finds itself in, this impact may well be limited, or indeed positive in countries with high interest rate premia and insufficient fiscal credibility. The right fundamentals are in place to induce a significant crowding-in of private sector demand. The impact also depends on the overall package of measures decided and the manner in which implementation is achieved. The most critical requirement is that budgetary consolidation must form part of an overall economic approach which is credible.

.... and on continuing appropriate wage developments.

Within the macroeconomic framework, the Social Partners carry a vital responsibility in maintaining appropriate wage trends. The Broad Economic Policy Guidelines emphasise the necessity of nominal wage increases which are compatible with the inflation objective of the monetary authorities. Furthermore, real wage developments should ensure a continuing recovery in investment profitability, whilst also providing for increases in standards of living.

From a macroeconomic point of view, recent and prospective aggregate wage developments do not constitute a serious constraint on growth in most Member States. In some, however, wage trends have not been fully compatible with the stability objective of the monetary authorities and/or with the need to improve and safeguard the economy's growth potential. On the micro side, labour cost levels are often not in line with productivity levels. Consequently, a greater degree of skill-related, regional and sectoral wage cost differentiation will be necessary in order to ensure a more employment-generating growth process.

Macroeconomic policies must be accompanied by structural reforms.

Re-igniting the recovery process should go hand-in-hand with progress towards the realisation of the Community's key medium-term objectives in terms of unemployment and the move to a single currency. In order to achieve these objectives, macroeconomic policies must be accompanied by action on the structural side with essentially three aims: (i) to ensure a tension-free macroeconomic growth process by measures aimed at a better functioning of goods and services markets allied to a greater flexibility of the labour market; (ii) to enhance the endogenous growth forces by actions geared towards promoting innovation, competition and improving human capital and (iii) to increase the employment-intensity of growth through a widening of the wage cost scale, especially by reducing indirect labour costs at the lower end, and reorganising working conditions.

Structural policies are largely the responsibility of national authorities, but in order to increase their potency and effectiveness, national actions should be co-ordinated and complemented by specific actions at the Community level when appropriate. At present, Community actions comprise a series of competitiveness and labour market initiatives with particular attention being devoted to the internal market, the trans-European networks (TENs) and the monitoring of the implementation of the Community's employment strategy adopted at the Madrid European Council in December of last year. This strategy is focused on action in the five key areas defined by the European Council in Essen: (i) improving

employment opportunities for the labour force by promoting investment in vocational training; (ii) increasing the employment intensity of growth (flexible work organisation, appropriate wage agreements, environmental and social services activities); (iii) reducing non-wage labour costs extensively enough to ensure a noticeable effect on decisions concerning the hiring of employees and in particular of less qualified workers; (iv) improving the effectiveness of labour-market policy by avoiding practices which are detrimental to the readiness to work and by moving from a passive to an active labour market policy; and (v) improving measures to help groups which are particularly hard hit by unemployment.

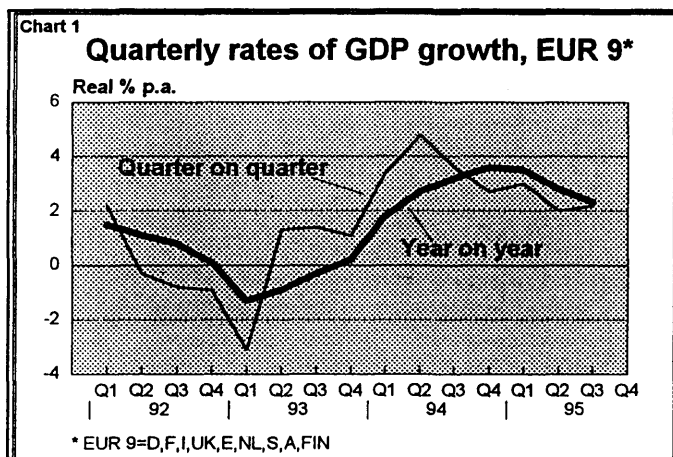
A complete application of the Broad Economic Policy Guidelines is the key

In overall terms, therefore, the key to solving the Community's present short-run difficulties and achieving its medium-term ambitions lies in the credible application of the Broad Economic Policy Guidelines framework and the employment strategy agreed by the European Council in Essen and subsequent European Councils. These respective frameworks embrace macroeconomic, labour market and structural elements which will produce mutually reinforcing effects crucial to the simultaneous promotion of growth and employment creation and to the realisation of EMU on 1 January 1999.

Chapter 1: Recovery looking for a second breath

1.1. Marked growth slowdown during 1995

1.1.1. Main trends



The surprisingly strong recovery of the Community economy in 1994 gave way to a marked slowing of the rate of expansion during 1995. Output growth progressively decelerated from a pace of 3½ to 4 per cent (annualized rate) throughout most of 1994 to around 2 per cent in the second and third quarters of 1995

(chart 1). On the basis of the latest available indicators, the Community economy may have seen virtual stagnation in the final quarter of the year. Output may even have contracted slightly in some countries, notably Germany and France. If these expectations are borne out, output growth in the Community for 1995 as a whole would turn out to be slightly below the 2.7 per cent anticipated in the Commission's November 1995 Economic Forecasts, but likely remain of the order of 2½ per cent.

	1986-90	1991-92	1993	1994	1995 a)
Private consumption	3.7	1.8	-0.3	1.6	1.9
Government consumption	2.0	1.9	1.1	1.0	1.0
Gross fixed capital formation	5.7	-1.3	-6.6	2.5	4.5
- of which: equipment	7.1	-2.3	-10.7	2.6	8.0
- of which: construction	4.8	-0.5	-3.3	2.4	1.9
Stocks (contribution % GDP)	0.1	-0.2	-0.7	0.9	0.1
Domestic demand (incl. stocks)	3.9	1.0	-2.0	2.5	2.3
Exports of goods and services b)	1½	3½	8	10	8½
Imports of goods and services b)	6	4	-3	4½	5½
Gross domestic product	3.3	1.2	-0.6	2.8	2.7

a) November 1995 Forecasts. Growth rates are likely to be revised down.
b) Extra-Community trade only (estimates)

While economic activity in 1995 continued to be supported by healthy extra-EC exports, domestic demand within Community countries slowed down. In the first half of the year, there was a sharp reduction in the contribution from stockbuilding and construction investment slowed unexpectedly. Investment in equipment kept expanding solidly while private consumption continued growing at a modest pace. In

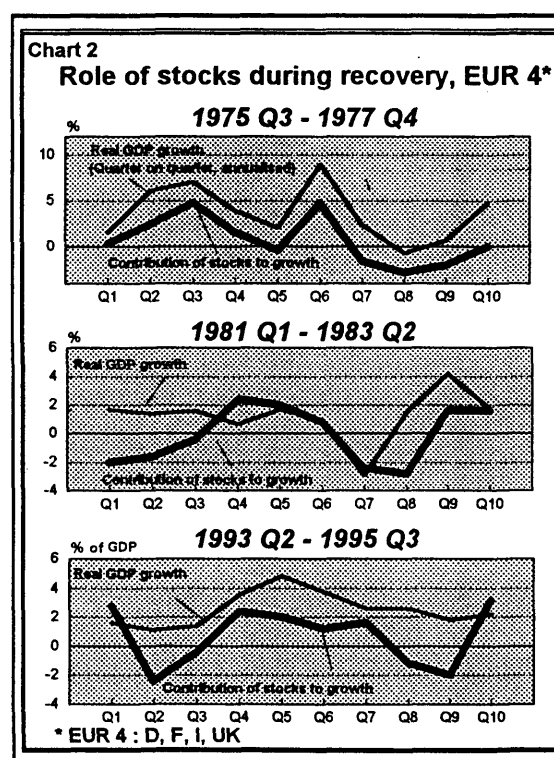
the latter half of the year both investment and private consumption slowed down markedly. The loss of growth dynamism was particularly marked in countries whose currencies appreciated significantly in the spring of 1995, but the pace of expansion moderated in virtually all Member countries. In the former group of countries, exports generally levelled off and investment grew less rapidly than previously expected. While private consumption initially held up well, the worsening labour market prospects led to a moderation in consumer expenditures in the second half of the year. In countries whose currencies depreciated markedly, the boost to export market shares was to some extent off-set by slowing growth on their export markets, and domestic demand was restrained by high real interest rates and adverse terms-of-trade effects.

1.1.2. Factors behind the slowdown

The faltering of the recovery process essentially appears to have been caused by two types of forces. First, the initial moderation of output growth was induced by what may be termed "inherent cyclical forces", comprising an end to the early-cycle boost from stock-building and a gradual switch in the forces driving the recovery. Such factors have also caused a short-lived pause during previous upturns. Secondly, this cyclical pause has been exacerbated by a number of interrelated forces: the lagged effects of the rise in long-term interest rates during 1994, the currency turmoil in the spring of 1995 and, partly as a result of these factors, a steady decline in private sector confidence.

Growth pause not in itself unusual

The importance of the "inherent cyclical forces" is highlighted by a comparison of the growth profile as well as the role of stocks in the recent recovery with previous experiences. During 1994, the swing in stockbuilding gave a powerful boost to the recovery in activity, accounting for almost a full percentage point of the 2.7 per cent GDP growth rate, but the 1994 recovery did not rely more heavily on stock-building than previous upswings. Also in the two previous cyclical upturns there was subsequently a temporary negative contribution from stocks which led to a short-lived growth pause (chart 2). Thus, such an "inherent cyclical



pause" principally related to the stock cycle is not unusual, and therefore not necessarily worrying. However, the present slowdown may prove to be more intense and more protracted than previous growth pauses as a result of adverse developments in financial markets.

Long-term interest rates increased markedly during 1994

First came the marked increase in long-term interest rates on world and Community financial markets during 1994. Between December 1993 and December 1994, long-term bond yields increased by some 225 basis points in the Community on average while inflation in general remained on a declining trend. This increase was partly related to a "contagion effect" from a similar rise in US yields,

	Dec. 1993	Dec. 1994	April 1995	Jan. 1996
D	5.5	7.3	6.8	5.3
E	8.1	11.1	11.8	9.1
F	5.8	8.3	7.7	6.3
I	9.2	11.8	12.8	10.0
S	7.6	10.9	11.4	8.3
UK	6.3	8.6	8.4	7.8
EUR	6.8	9.0	8.8	7.4

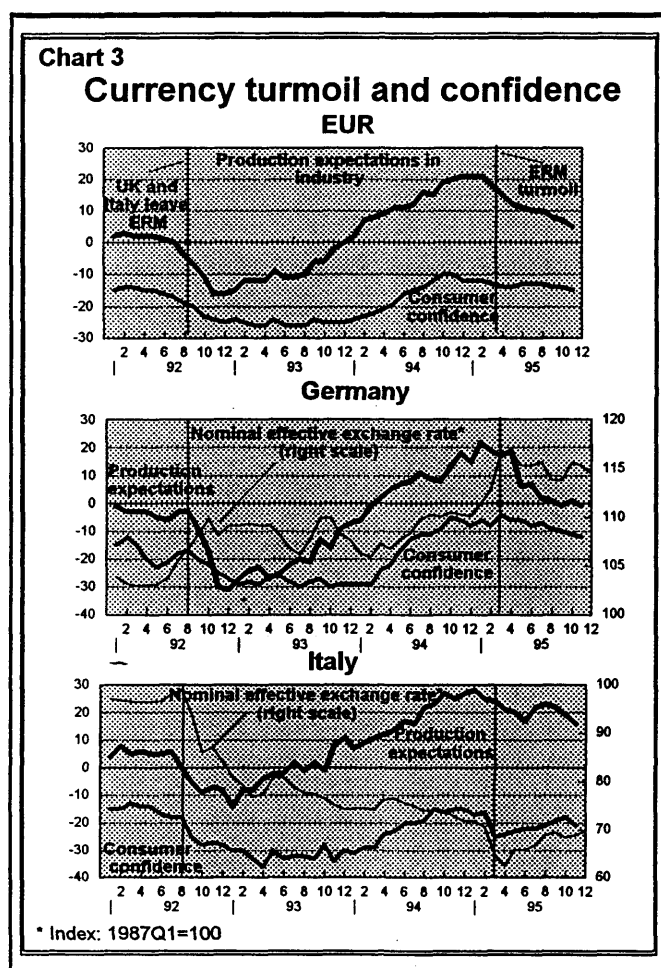
and partly reflected the surprising strength of the European economic upturn which seemed to raise the prospects either of early monetary tightening or an eventual build-up of inflationary pressures. However, the rise in yields varied considerably across EC Member States, reflecting *inter alia* their economic performance, policy stance and credibility. In particular, long-term interest rates rose significantly more in countries where uncertainty about future fiscal policies was rife and whose public finances were not yet perceived by the markets as having been put on a clearly sustainable path.

The rise in long-term interest rates was expected to hold back economic activity in 1995 through its demand-dampening effects, particularly on investment in construction, but within the context of an ongoing recovery the impact was thought to be modest. However, it appears in retrospect that the higher long-term interest rates in conjunction with other factors may have placed a stronger-than-anticipated brake on companies' and households' spending decisions in 1995.

Exchange rate turmoil and faltering confidence

Chief among these additional factors was the exchange rate turmoil which erupted in spring 1995. The abrupt and sizeable shifts in exchange rates heightened financial uncertainties and undermined confidence in the perspectives for an orderly recovery. The currency turmoil appears to have been caused essentially by two developments. First, the US-dollar weakened significantly in the wake of the Mexican peso crisis and shifting market sentiment about the relative strength of the major international currencies. Secondly, the pressure already exerted on intra-European exchange rates by the weak dollar was reinforced by

uncertainties concerning the future course of budgetary consolidation in some Member States and/or perceived risks of renewed inflationary tensions. The resulting currency movements, which in many cases came on top of previous shifts, were bound to have a significant impact on the economies of appreciating as well as depreciating countries and played a key role in the slowdown of the Community economy as a whole (see box 1).



While industrial confidence had declined slightly before March 1995, the exchange rate turmoil set in train a sustained decline in production expectations in industry and caused a weakening in consumer confidence (chart 3). The drop in industrial confidence was generally more pronounced in appreciating countries (exemplified in the chart by Germany) reflecting anxiety about the loss in competitiveness, while consumer confidence tended to decline in depreciating countries (particularly Italy) where consumers anticipated an erosion of their purchasing power while having to face higher interest rates. Much the same pattern was discernible during the exchange rate crisis of September 1992 when the British pound and the

Italian lira left the ERM. Also then, economic sentiment had started deteriorating before the currency crisis, but the latter greatly accelerated the erosion of confidence, particularly for businesses in appreciating countries and for consumers in depreciating countries.

Developments in early 1995, including in Germany inappropriate wage agreements together with the appreciation of the DM, undermined the competitiveness and profitability of industry. They also caused companies to scale back their expectations of future sales, to revise down their desired stock levels and to postpone spending decisions. This initial drop in purchases led to a further weakening of business confidence which again had repercussions on spending and hiring decisions. The decline in business confidence

continued throughout the year, but seems to have come to a halt more recently. As confidence in the continuation of economic recovery was slipping and as the improvement in the labour market faltered, consumer confidence declined gradually during the second half of the year.

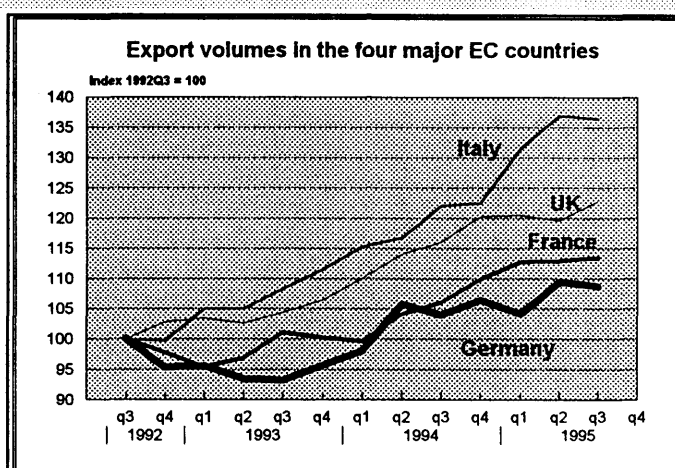
In sum, the progressive weakening of economic activity during the year owes much to a "vicious circle" of declining confidence and increased caution in spending and hiring decisions. This was in large part a result of financial turmoil, while the underlying economic forces had in fact not deteriorated to an extent which would necessitate or justify such a marked slowdown in the Community. This points to the need both for increased policy credibility within the EC and for increased efforts at the international level to prevent large and sudden movements in the major international currencies.

Box 1: The growth impact of the 1995 exchange rate turmoil

Between December 1994 and April 1995, the US dollar fell by 12 per cent vis-à-vis the Deutsche Mark, adding to a 10 per cent slide during 1994. The fall of the dollar, combined with uncertainties surrounding budgetary/inflation prospects in some Member States, triggered significant intra-European currency movements. Between December 1994 and April 1995 the Italian lira fell by around 13 per cent in nominal effective terms, and the pound sterling and the Swedish krona weakened considerably. Within the ERM, the central rates of the Spanish peseta and the Portuguese escudo were devalued in March. The Deutsche Mark and the currencies which are closely tied to the DM strengthened significantly in trade-weighted terms, by up to 6 per cent between December and April.

	Dec. 1993	Dec. 1994	April 1995	Jan. 1996
B	99.9	103.3	107.9	105.9
D	100.8	103.1	109.3	106.7
F	100.9	102.4	106.3	106.7
I	75.1	72.7	63.2	71.7
Esp	78.4	78.2	77.1	80.6
Sw	74.6	77.5	73.0	83.2
UK	88.7	87.1	83.1	82.1

The large shifts in exchange rates led to substantial changes in relative price and cost competitiveness. As was also the case following the exchange rate movements in September 1992, this had a marked, if not unequivocal, impact on the relative export performances of the Member States. Following September 1992, the exports of Italy and the UK improved relative to those of Germany and France by almost 10 per cent within two to three quarters



(see chart). Export growth was then broadly similar until late 1994, when the stronger DM caused German exports to grow at a slower pace and the weaker lira helped Italian exports leap forward. The less pronounced changes in the nominal effective exchange rates of France and the UK

meant that currency movements had a less dominant, but still visible, influence on export growth in those countries.

Exchange rate movements in early 1995 affected macroeconomic developments in the Community in a number of ways. Firstly, on average the European currencies appreciated relative to the Community's international competitors, implying a loss of price competitiveness on world markets. Secondly, in countries whose currencies depreciated significantly, the short-term boost to export market shares was to some extent off-set by lower growth on export markets, and by rising interest rates and the erosion of consumer purchasing power from higher inflation on the home market. Thirdly, in countries whose currencies appreciated significantly, the negative impact on exports and squeezed profit margins had knock-on effects on investment which expanded by less than it might otherwise have done. Fourthly, for all these reasons, the exchange rate turbulence had a negative impact on industrial as well as consumer confidence, which precipitated a decline in the willingness to spend.

A quantitative assessment of the overall impact on economic activity is possible only under specific assumptions. An indication of the magnitude may be given by simulations using the Commission services' Quest model. These simulations assume unchanged real interest rates (disregarding any tightening of monetary policy in depreciating countries over and above the increase in inflation) and do not take into account any autonomous blow to confidence which the

turbulence may have caused. Table B1.2 shows the simulated impact on growth in 1995 and 1996 of, first, the exchange rate changes between December 1994 and April 1995, and second, the partial reversal between April and December 1995. The simulated impact on growth in Germany of the initial appreciation (and in general in countries whose currencies closely followed the DM) is of the order of 1 percentage point in the first year and about half as much in the second year. Conversely, Italian output would be boosted by about ½ per cent with most of it taking place in the first year.

	Spring currency turmoil (Dec. 94 - April 95)		Subsequent partial reversal (April - Dec.95)	
	1995	1996	1995	1996
D	-1.1	-0.4	0.1	0.3
F	-0.3	-0.1	0.0	0.1
I	0.4	0.2	-0.1	-0.3
UK	0.1	0.0	0.0	0.0
EUR	-0.4	-0.2	0.0	0.2

For the EC as a whole, the model simulations indicate that the currency turmoil may have led to a reduction in output by almost ½ percentage points in 1995. However, it is likely that the knock-on effects which the turmoil had on confidence and on interest rate differentials relative to the DM did in fact lead to a larger negative impact on growth. The partial reversal of the exchange rate overshooting which took place during the remainder of 1995 is likely to have positive effects on growth in 1996 in appreciating countries as well as for the Community as a whole, thus off-setting the second-year effects of the spring turmoil. Again, through confidence effects and reduced interest rate premia, the positive impact is likely to be larger than indicated by the model simulation.

1.2. Rebound in activity expected during 1996

Due to the deterioration in economic conditions since the finalisation of the Commission services' November 1995 forecasts, the growth outlook for 1996 has become less favourable than previously anticipated. Whereas output in the Community as a whole had been forecast to expand by 2.6 per cent in 1996, it now seems likely that growth will be below 2 per cent. This downward adjustment of expectations essentially reflects the impact of the weaker starting point and the anticipated continuation of weakness in activity into the first months of 1996.

In qualitative terms, however, the reasoning behind the November 1995 forecasts remains valid. Provided that the credibility of economic policies is not weakened, the main forces determining the growth outlook for the European economy are favourable to a renewed pick-up in the rate of expansion in economic activity during the year. In these circumstances, output growth is likely to accelerate from a subdued pace in the beginning of the year to an annualized rate of around 3 per cent in the latter half of the year. Although the average figure for the year is likely to be lower than that of 1995, the underlying tendency would, in contrast, be positive.

The expansion of economic activity would likely be led by rising investment in equipment, underpinned by sustained growth in Community exports and a gradual revival in consumption, enhanced by positive, albeit moderate increases in real wages and employment. Residential and non-residential construction should see a renewed pick-up, and the drag from destocking will come to an end as inventory overhangs are brought down, after which the stock cycle might again provide a boost to growth.

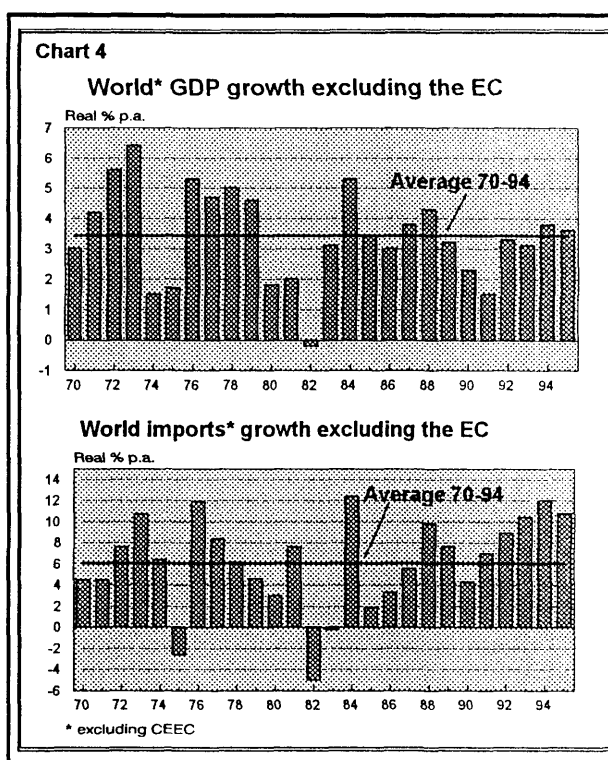
1.2.1. Underlying economic fundamentals are favourable

The main positive growth forces include:

- i. The world economy outside the EC is set to continue to expand at a healthy pace;
- ii. The fundamentals of the European economy in terms of low inflation, moderate wage pressures and sound investment profitability are favourable;
- iii. Monetary policies have been eased, long-term interest rates have fallen back, and the spring 1995 exchange rate misalignment has been partially reversed.

World economy continues to expand at a healthy pace

Economic activity outside the Community has expanded at a strong pace since 1992 and world trade has been growing at a rate well above the average of the last two decades (chart 4). The growth in non-EC countries' imports in 1993-95 was even faster than might have been expected on the basis of the observed output growth. This is partly explained by the composition of world demand growth in recent years, not least in the US, which has been skewed towards investment and stocks both of which typically have a large import content. In addition, the renewed dynamism of world trade owes to the rapid integration of emerging markets in Asia and Central and Eastern Europe into the world economy, as well as to the trade-liberalising measures agreed in the GATT Uruguay round.



	1993	1994	1995	1996
Real GDP				
World excl. EC	3.0	3.8	3.6	4.4
USA	3.4	4.1	2.1	2.3
Japan	-0.2	0.5	0.4	2.3
DAE ^{a)}	6.8	7.9	7.9	7.4
CEEC and FSU ^{b)}	-8.4	-7.4	-4.3	4.0
Imports				
World excl. EC	10.1	11.4	10.8	9.2
USA	11.9	15.0	12.3	7.7
Japan	7.0	13.3	11.4	10.5
DAE ^{a)}	13.4	15.8	14.4	12.4
CEEC and FSU ^{b)}	4.6	7.0	7.3	9.0
Extra-EC markets	6.8	10.2	9.2	8.5
Extra-EC exports	9½	10¼	9	6½

^{a)} Dynamic Asian Economies.
^{b)} Central and Eastern Europe and former Soviet Union
Source: Commission services estimates and forecasts

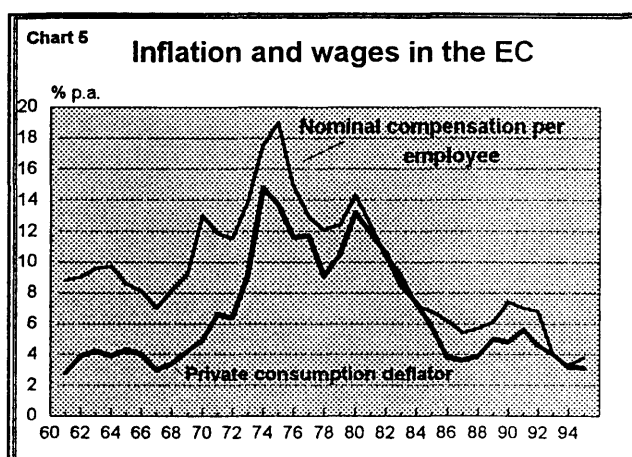
In addition to strong export market growth, the Community has benefitted from a large improvement in its competitive position between 1992 and 1994 due to subdued unit labour cost increases and a substantial fall in the EC's trade-weighted exchange rate. As a consequence of these factors, extra-EC exports expanded strongly in 1993-95 at an average annual rate of 9½ percent (table 3). Community exports grew rapidly on most major markets, including the US, Japan, South-East Asia and countries in Central and Eastern Europe.

The rapid pace of export market growth appears to have slowed down somewhat and the gain in export market shares is likely to have

come to an end following the strengthening of the Community's currencies on a trade-weighted basis during 1995. Nevertheless, the outlook for the external environment remains relatively favourable. The expansion of economic activity in the United States moderated to less than 3 per cent during 1995. In the absence of inflationary tensions, output is expected to expand at close to its potential rate in 1996 (table 3). In Japan, the depreciation of the yen in combination with substantial monetary and fiscal policy stimulus is expected to produce the long-awaited recovery during this year. The rate of expansion in *non-OECD countries* is also expected to firm slightly in 1996-97 as continued high output growth in Asia, Latin America and Eastern Europe combines with an end to recent years' severe output drop in the former Soviet Union. Notwithstanding the firming of economic activity outside the Community, world import growth is assumed to moderate slightly in 1996 as recent years' high import elasticity is not expected to continue unabated. The growth of extra-EC export markets (i.e. the weighted import growth of the Community's trading partners) is expected to remain high by historical standards in 1996. Therefore, although Community exporters have on average lost price competitiveness as a result of exchange rate changes, Community exports to third countries are expected to continue expanding at a rather healthy pace.

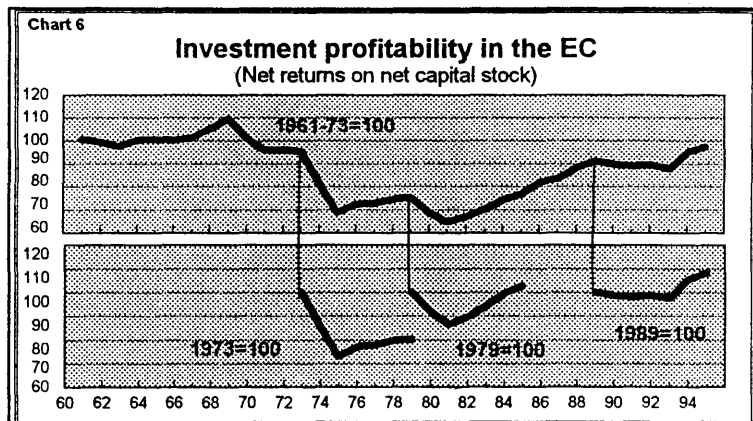
Healthy supply-side fundamentals

Favourable conditions on the supply-side of the Community economy, in terms of subdued inflation, available resources and strong and increasing profitability levels, are in place to accommodate a sustained renewed strengthening of demand. **Inflation** in the Community, as measured by the private consumption deflator, subsided further to a level of around 3 per cent in 1995. Currently, inflation



is either below 3 per cent or on a downward trend in all Member States. Overall, the Community's inflation performance matches even the best results of the 1960's (chart 5). Furthermore, although wage settlements in some countries were concluded at disappointingly high levels in early 1995, recent developments indicate that wage increases will remain relatively moderate in the near future. It thus seems that the price stability gains in the Community are being safeguarded and continue to provide a positive background for the conduct of monetary policies.

Capital profitability in the Community remains strong on average and is almost back at the level prevailing in the 1960's, after having suffered a severe and prolonged deterioration during the 1970's and the early 1980's. If profitability in the 1961-73 period is set to an index of



100, investment profitability now stands at an index of 96 (for EUR15 in 1995) after having touched a minimum of index 65 in 1981. Return on capital is higher today than during the strong economic upturn in 1986-90, when investment in equipment expanded at rates about twice as high as the rate of GDP growth. The sound profitability levels are likely to sustain increased investment, not only by raising expected returns on capital but also by exerting a beneficial impact on the balance sheet position and thus the financing means of companies.

Improved monetary and financial conditions

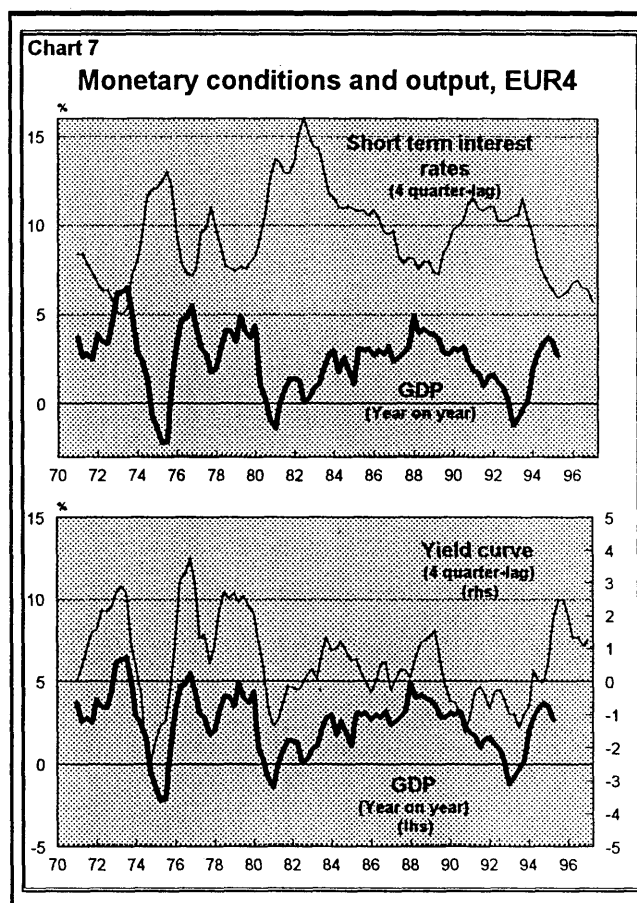
Following the exchange rate turmoil in spring 1995, many governments have taken steps to sustain and in some cases reinforce the pace of fiscal consolidation in 1996. This has carried with it important benefits.

First, helped by a moderate recovery of the US-dollar, there has been a *partial reversal of the exchange rate overshooting* which occurred in spring 1995. The D-Mark and currencies closely linked to the DM have receded somewhat in trade-weighted terms and the currencies of several countries which achieved an improvement in the credibility of their budgetary policies, notably Italy and Sweden, strengthened significantly relative to their most undervalued levels in April 1995. Second, *long-term interest rates in the Community have fallen back* considerably during 1995, assisted by a coincident decrease in US long-term yields. Just as higher long-term interest rates during 1994 played a significant role in restraining economic activity in the Community in 1995, the subsequent fall in rates should be an important stimulus to economic activity in 1996.

In addition to these factors, the conduct of *monetary policy in the Community in the second half of 1995 is likely to have a positive influence* on economic activity in 1996. As described in detail in chapter 2, short-term interest rates were reduced in Germany and

countries whose currencies are closely linked to the DM (in France, this only took place following the introduction of consolidation measures in November 1995) as well as in countries which had been forced to raise interest rates during the spring currency turmoil to defend their exchange rate and to head off inflationary consequences of currency depreciations.

Although monetary policy is far from the only factor affecting economic activity, there has been a close relationship between short-term interest rates and subsequent growth in output (over the following 4 quarters) in the Community over the last two decades (chart 7, top half). The level of nominal interest rates is only one indicator of the stance of monetary policies. In a detailed assessment, other indicators such as real short-term interest rates, the term structure, the growth of money supply and credits etc. should also be taken into account (see chapter 2). The lower half of chart 7 illustrates the relationship between the yield slope (the difference between long-term and short-term interest rates) for the



Community and subsequent output growth. The yield slope is partly a reflection of the current monetary stance and partly of the financial markets' expectations concerning growth, inflation and the future stance of economic policies.

In view of recent interest rate reductions, the current monetary policy stance seems geared towards a renewed, but moderate strengthening of growth for the Community as a whole in 1996. In addition, provided that the credibility of the overall policy framework is reinforced, subdued inflationary pressures and intensified fiscal consolidation efforts in a number of countries imply that the conditions are increasingly in place under which central banks are likely to find themselves in a position to be able to lower interest rates further and/or keep them low without jeopardizing the stability objective.

Box 2: Current outlook in a historical perspective

This box reviews three episodes which have specific features in common with the current situation and which may help to shed light on the forecast of renewed strengthening in 1996.

Recovery in early 1980's -- A comparison of the current situation with the recovery in the early 1980's reveals a number of similarities as well as important differences. Also then there was, a clear pause in the recovery when the initial stock-building effect faded. Output growth even turned temporarily negative in the third quarter of 1982. Furthermore, the recovery in the early 1980's also took place against a background of high budget deficits and fiscal policy was tightened almost to the same degree as now, as measured by the annual reductions in the cyclically-adjusted budget deficit. Nevertheless, there are three fundamental differences which bode well for the present economic outlook. First, while world trade growth was very subdued in 1980-83, the external environment has been favourable in 1993-95 and is expected to continue to be so in 1996. Second, investment profitability suffered less during the recent recession and starts improving from a relatively high level. Third, inflation is running at a much slower pace now (3 per cent) than it did in the early 1980's (still above 10 per cent in 1982). This provides a much more favourable background for the setting of monetary and financial conditions.

US-dollar fall in 1985-86 -- The plunge of the dollar from its severely overvalued level of 3.3 DM in February 1985 initially had little impact on industrial confidence in the Community since it was not wholly unexpected and the dollar level remained relatively favourable. But the continued decline of the dollar into 1986 led to a noticeable drop in industrial confidence in the first half of that year and had an immediate and significant adverse impact on investment. However, the impact of this deterioration on the real economy was short-lived, and recovery in investment was rapid thanks partly to an easing of monetary conditions. At the time, the economy also benefitted importantly from the sharp fall in oil prices and stronger consumer confidence. Nevertheless, most of the factors making for a rapid revival then would appear also to be in place in the current situation.

Stock market crash in 1987 -- Stock prices tumbled on world financial markets by roughly one third within the span of a few days in September 1987, and business confidence suffered a severe blow. Partly due to the initial caution of economic operators, output growth in the Community faltered in late 1987. However, the monetary authorities took fast and significant action in reducing interest rates in the wake of the stock market crash. This easing of monetary policy was instrumental in overcoming the shock of the financial turbulence and to turn around the economy one or two quarters later. With hindsight, however, the combination of this monetary easing with an excessively lax fiscal stance proved too expansionary. As growth rebounded quickly and strongly, output in the Community expanded by 4.2 per cent in 1988 after 2.9 per cent per year in 1986-87. The subsequent overheating of the Community economy, exacerbated by the effects of German unification, led to a build-up of inflationary pressures which in turn forced a prolonged and painful economic downturn to re-establish price stability.

1.2.2. Important short-term risks and uncertainties

While expectations centre on a renewed strengthening of activity no later than the second half of 1996, the worsening economic climate over the latest months has raised the risks of a more extended period of subdued growth.

The most pertinent risk in the period immediately ahead is that the self-reinforcing downward spiral in confidence and spending intensifies. In the near future, output is likely to grow at a slower rate than final demand (until the inventory adjustment has come to an end) raising the risk that job creation will come to a virtual halt or, in certain countries or industries, even be reversed. Particularly in an environment where companies are faced with fierce global competition as well as rapid technological and structural changes, they are likely to want to see more solid demand prospects before they again become willing to hire additional labour. Consumers have to gauge uncertain employment and income prospects in the short run as well as the effects of necessary social and pension reforms in some countries in the longer run. This might prompt households to raise their saving ratio out of precautionary motives, thus leading to a further moderation in the pace of consumer spending. If this risk materializes, the slowdown could -- in spite of improved monetary and financial conditions -- be more severe and possibly more protracted than currently anticipated.

The growth slowdown has cast doubts among some observers as to whether a sufficient number of Member States would be ready to participate in EMU at the starting date of 1 January 1999 laid down in the Maastricht Treaty given that weaker economic activity hampers the necessary progress towards sounder budgetary positions. An extended period of subdued growth would likely intensify these uncertainties. This might in turn lead to renewed instability on financial markets, dimming further the growth prospects in the Community.

A different but related set of risks applies to the conduct of economic policies. Impatience with the pace of recovery along with fears of social unrest might weaken or even paralyze governments' efforts to carry out the necessary budgetary and structural reforms. However, any hoped-for short-term benefits of reduced fiscal rigour would most likely prove illusory. If uncertainties were to arise about the resolve and ability of governments to implement fiscal consolidation plans, this would be reflected in higher long-term interest rate risk premia in the countries concerned, and would presumably force central banks to raise short-term interest rates in order to underpin the currency on foreign exchange markets, and in an attempt to preserve overall policy credibility. Indeed, a relaxation of the

fiscal consolidation efforts within the Community would risk leading to renewed and possibly wide-spread tensions in foreign exchange markets. The combined impact of such unfavourable interest and exchange rate developments would have severe, detrimental effects on private sector confidence and thus on the chances of renewed and sustained recovery.

It is equally important to maintain the current policy consensus within the Community concerning the desirability of moderate wage developments. Any attempt to stimulate consumer demand by encouraging higher wages would most likely backfire. Such a policy would serve only to add to Europe's long-standing problems of insufficient international competitiveness, underinvestment and excessive labour costs relative to the costs of other production factors. Even in the short run, the negative effects of these factors would assert themselves. Reduced competitiveness, diminished attractiveness as a production location and lower capital profitability would have a negative impact on exports and investment. For consumers, higher wage income per worker would be partly off-set by higher prices, by companies' reduced ability to profitably employ labour, by reduced income for self-employed and by reduced capital income. Perhaps most importantly, if wages were increased at a rate incompatible with the stability objectives of the monetary authorities, the ensuing tightening of monetary and financial conditions would ensure a negative overall impact on demand and employment.

However, some of the uncertainties surrounding the outlook may also point in a positive direction. As the Community is enjoying the most favourable underlying economic conditions since the 1960s, the revival in economic activity could surprise in a positive manner once confidence is restored. This requires *inter alia* that governments take all possible steps to persuade economic agents of their determination to realise their stated objectives.

1.3. Continued progress towards nominal convergence

Further progress towards meeting the convergence criteria was achieved in 1995, although not in all cases at a sufficient pace. Convergence on the inflation and interest rate fronts made largely satisfactory advances; progress was also made in relation to the consolidation of public budgets although the fiscal outcome was less than satisfactory in several Member

states; and the situation on the foreign exchange markets stabilised after being marred by marked fluctuations in the spring of the year¹.

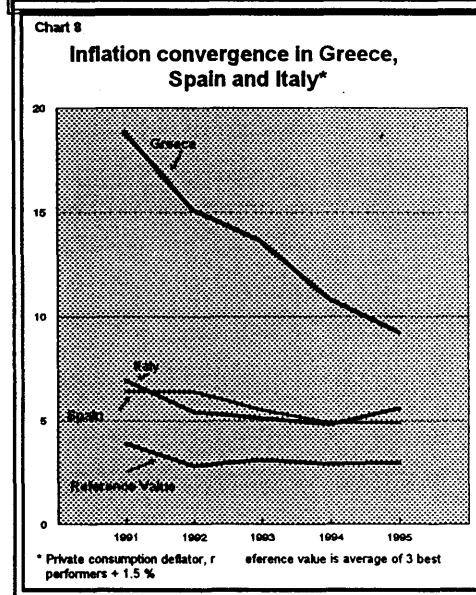
1.3.1. Historically low and converging price increases

In 1995, the average rate of inflation in the Community, as measured by the private consumption deflator, eased marginally to 3.1 percent. Price convergence strengthened and eleven Member countries had rates of inflation at or below the reference value for compliance with the Maastricht inflation criterion. Inflation convergence was maintained among the Member States which have long participated in the ERM and were in the narrow band prior to the widening of the fluctuation margins in August 1993 (Belgium, Denmark, Germany, France, Ireland and the Netherlands). In addition, the United Kingdom and the three new Member States (Austria, Finland and Sweden) all had inflation rates below the reference value. Austria has long maintained a stable exchange rate vis-à-vis the German mark, and in the UK, Sweden and Finland, central bank policy is conducted with respect to an inflation target. Of the remaining countries, Italy witnessed an acceleration in its inflation rate to 5 ½ percent, mainly as a result of the depreciation of the lira. Spanish inflation remained at around 5 percent, Portugal showed a strong deceleration to 4 ¼ percent and Greece experienced a significant deceleration of over 1 ½ percentage points, although the rate of inflation remained above the Community average.

Table 4
Inflation developments
(percentage change, private consumption deflator)

	1992	1993	1994	1995
B	2.0	3.1	3.0	1.5
DK	1.8	1.0	1.0	2.0
D	4.8	3.9	2.7	2.0 ^a
GR	15.1	13.6	10.8	9.2
E	6.4	5.5	4.9	4.9
F	2.4	2.2	1.8	1.9
IRL	2.5	1.7	2.7	2.5
I	5.4	5.1	4.8	5.6
L	0.1	4.4	2.6	1.9
NL	3.1	2.3	2.4	1.6
A	3.9	3.4	3.0	2.4
P	11.1	7.1	5.5	4.1 ^a
FIN	4.1	4.2	1.3	1.1 ^a
S	2.2	5.8	3.0	2.8
UK	4.7	3.5	2.4	3.0
EUR15	4.6	4.0	3.2	3.1
Reference Value	2.8	3.1	2.9	3.0

Source: Commission's November 1995 forecasts
"Reference value" is calculated as the average of the 3 best performers plus 1½ percentage point.
a) Taking into account latest information.



¹ For a detailed analysis, see the European Commission's "Report on Convergence in the European Union in 1995", November 1995. The present report only reviews convergence with respect to price stability and sound public finances.

The generally favourable inflation performance had its origins in a number of factors:

- the establishment of central bank independence in several countries has raised the credibility of price stability objectives, and low inflation is increasingly built into expectations;
- central bank actions, particularly in countries whose currencies had depreciated significantly or where wage settlements had been concluded at relatively high levels, reinforced the firmness and credibility of the anti-inflationary stance;
- moderating GDP growth meant that output remained below its full capacity level;
- notwithstanding higher-than-expected wage settlements in some countries at the beginning of the year, nominal compensation per employee increased by a relatively moderate 3 ¾ percent last year in the Community as a whole; together with productivity growth of 2 percent this led to a relatively modest 1 ¾ percent increase in nominal unit labour costs;
- raw material prices decelerated in the first half of 1995 and remained subdued thereafter.

Given the expected continuation of these factors, and in particular the strengthened credibility of the anti-inflation objective throughout the Community, the outlook for price convergence in 1996 is relatively benign. The recent strengthening of the currencies of some of the countries with comparatively high inflation rates should further help this process. Nevertheless, continuing vigilance will have to be exercised if inflationary pressures should reemerge. This is particularly the case for countries which have experienced significant currency depreciations in the not-too-distant past because of the variable lags which exist in the pass-through from such currency movements to domestic inflation.

1.3.2. Insufficient progress in reducing budget deficits

The budgetary position of the Member States in general improved in 1995. Government deficits were reduced in the large majority of Member States, but there were important exceptions to this rule. Government debt continued to increase as a share of GDP in a majority of Member states, but with few exceptions the deterioration occurred at a significantly slower pace than in previous years.

The latest available Commission services estimates of budgetary developments in the Community date from the economic forecasts of Autumn 1995 (table 5). The unexpectedly

sharp cyclical slowdown in some countries towards the end of 1995, in conjunction with budgetary slippages in at least a couple of Member States, imply that the budget deficits in several countries are likely to be somewhat higher than indicated in these forecasts. It is particularly disappointing that the government deficit turned out to be significantly higher than anticipated in Germany (3.6 per cent of GDP against a forecast of 2.9 per cent) thus overshooting the Maastricht reference value.

	1992	1993	1994	1995
B	-7.1	-6.7	-5.3	-4.5
DK	-2.9	-4.5	-3.8	-2.0
D	-2.8	-3.5	-2.6	-3.6 ^b
GR	-11.7	-12.1	-11.4	-9.3
E	-4.2	-7.5	-6.6	-5.9
F	-4.0	-6.1	-6.0	-5.0
IRL	-2.4	-2.4	-2.1	-2.5 ^a
I	-9.5	-9.6	-9.0	-7.2 ^b
L	0.8	1.8	2.2	0.4
NL	-3.9	-3.2	-3.2	-3.1
A	-2.1	-4.3	-4.4	-5.5
P	-3.3	-7.1	-5.7 ^b	-5.2 ^b
FIN	-5.9	-8.0	-5.8	-5.6 ^b
S	-7.8	-13.4	-10.4	-7.0
UK	-6.3	-7.8	-6.8	-5.1
EUR	-5.2	-6.3	-5.5	-4.7

Source: Commission's Nov. 1995 forecasts
a) This figure includes the payment of arrears of social welfare payments due under the Equal Treatment Directive and incorporates the more recent information presented in the Irish budget.
b) Taking into account most recent information.

Consequently, the general government deficit in the Community as a whole in 1995 will almost certainly turn out to be above the 4.7 percent of GDP estimated in the latest forecasts, but most likely remain at about 5 per cent of GDP. Compared to 1993, when the recession had strongly deteriorated the public finance positions of most countries, the overall public deficit has nevertheless been cut by around 1 ½ percentage points of GDP. Discretionary policy actions contributed to more than half of this improvement with the remainder owing to the positive effects of recovery in 1994 and early 1995.

Notwithstanding the worse-than-expected budgetary outcome in some countries, most Member States succeeded in reducing their budget deficit in 1995. The strongest improvement is

expected in Sweden (more than 3 percent of GDP) while Denmark, Greece, France, Italy and the United Kingdom are expected to reduce their deficits by 1-2 percentage points. Other countries see declines of less than 1 percent of GDP. However, in Germany, Ireland and Austria, the deficit-to-GDP ratio has deteriorated, partly as a result of lower-than-expected economic growth (Germany and Austria), and partly due to a relaxation of budgetary stringency.

The average debt-to-GDP ratio for the Community increased in 1995 by about three percentage points to 71 percent. This was largely due to the unification-related debt assumptions by the German federal government (especially the Treuhandanstalt) but even in the absence of this factor the debt ratio would have increased. In fact, the debt-to-GDP ratio deteriorated in 11 of the Member States. On a more positive note, the fall in the ratio in the other Member States ranged from a ½ of a percentage point in the case of Italy to

Table 6 General government gross debt (percent of GDP)					
	Level			Change	
	1993	1994	1995	95/94	95/93
B	137.5	136.0 ^a	133.8 ^a	-2.2 ^a	-3.7 ^a
DK ¹	80.3	75.6	73.6	-2.0	-6.7
D	48.2	50.2	58.8	8.6	10.6
GR	114.5	113.0	114.4	1.4	-0.1
E	60.4	63.0	64.8	1.8	4.4
F	45.3	48.4	51.5	3.1	6.2
IRL	97.4	91.1	85.9	-5.2	-11.5
I	119.4	125.4	124.9	-0.5	5.5
L	6.3	5.9	6.3	0.4	0.0
NL	81.3	78.0	78.4	0.4	-2.9
A	62.8	65.2	68.0	2.8	5.2
P	67.2	69.4	70.5	1.1	3.3
FIN	57.3	59.8	60.3 ^a	0.5 ^a	3.0 ^a
S	76.2	79.3	81.4	2.1	5.2
UK	48.5	50.3	52.5	2.2	4.0
EUR	66.2	68.1	71.1	3.0	4.9

Source: Commission's November 1995 forecasts

1) Government deposits with the central bank, government holdings of non-governmental bonds and public enterprises related debt amounted to 20 % of GDP in 1995.

a) Taking into account latest information.

over 5 percentage points in Ireland. The continued increase in the debt ratios in a majority of the Member States during the recovery demonstrates the urgent need for fiscal retrenchment in many countries.

With regard to the short-term outlook, the less favourable output growth in 1996 will, in itself, render more difficult progress towards lower budget deficits. On the other hand, a number of governments have recently taken significant, and sometimes courageous, steps to place public finances on a more sound footing. Irrespective of the current slowdown, the progress which is being made in reducing structural deficits will remain intact and thus reinforce the basis for meeting EMU objectives independent of cyclical conditions.

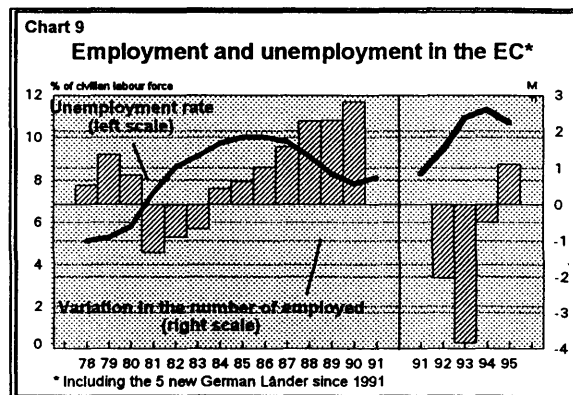
It is essential that governments do not allow cyclical weakness to become an excuse for relaxing structural fiscal consolidation efforts. Only a strict fiscal discipline can provide the restoration of confidence and the lower interest rates which are necessary for a renewed strengthening of economic activity. While it is evident that a number of countries have yet to achieve considerable reductions in their deficits in order to respect EMU commitments, the degree of progress to be achieved is not so great as to be regarded as unrealistic. Several Member States are expected to introduce additional retrenchment measures between now and 1997, which would further improve convergence in the budgetary field.

1.4. Faltering improvement in labour market conditions

1.4.1. Recent developments

Employment

The initial strength of the current recovery led to some improvement in labour market conditions and employment started rising gently during 1994, for the first time since 1991. During the first three quarters of 1995, total employment increased slightly further but under the impact of slowing economic activity the positive trend was reversed in the latter part of the year.



Consequently, employment is likely to have risen by considerably less than the $\frac{3}{4}$ per cent anticipated in the November 1995 forecasts and, correspondingly, net job creation did not attain the 1.1 million jobs hoped for earlier.

Notwithstanding fast productivity gains, employment growth for 1995 as a whole was strongest in Ireland (previously forecast at $3\frac{1}{2}$ per cent), driven by a buoyant expansion of economic activity of around 7 per cent. The growth of employment was strong also in Denmark, Luxembourg, Sweden and Finland (in the likely range of $1\frac{1}{2}$ to 3 per cent) due to above-average economic growth as well as a catching-up of hiring following the increase in the number of hours worked per person during the economic upturn in 1994. In Spain, measures aiming at a more flexible organisation of work may have helped to lower the employment threshold of growth. The number of employed people increased by $2\frac{1}{2}$ per cent against a background of output growth of around 3 per cent.

In contrast, employment continued falling or, at best, remained stagnant in 1995 in Belgium, Germany, Italy, Austria and Portugal. In several of these countries the most recent trends have continued to point downward. In the remaining Member States, the rate of improvement slowed down towards the end of the year.

	1992	1993	1994	1995
B	-0.4	-1.4	-0.7	0.4 ^a
DK	0.1	-2.3	-0.2	2.1
D	-1.9	-1.8	-0.7	-0.2 ^a
GR	1.5	0.9	1.9	1.0
E	-2.1	-4.4	-0.9	2.7 ^a
F	-0.7	-1.0	0.1	1.1
IRL	0.4	0.6	2.6	3.5
I	-0.6	-6.8	-1.6	0.1
L	2.5	1.8	1.3	2.5
NL	2.0	-0.1	0.1	1.2
A	1.8	0.6	0.3	0.2
P	-1.8	-1.9	-0.2	-0.6
FIN	-7.1	-6.1	-1.3	2.2 ^a
S	-4.3	-5.5	-1.0	1.7
UK	-2.0	-1.5	0.7	0.8
EUR	-1.3	-2.5	-0.4	0.7

a) Taking into account latest information.
Source: Commission's November 1995 forecasts

Unemployment

The resumption in job creation in 1994 originally led to a fall in the unemployment rate from its peak of 11.3 percent of the labour force in the spring of that year to 10.6 per cent in September 1995. But due to the slowing of employment growth in the course of 1995, the improvement subsequently reversed course and the unemployment rate rose to 10.9 per cent in December 1995. The rate of joblessness continued falling in Denmark, Spain, Finland and the United Kingdom. In Ireland and Greece significant employment gains were not translated into substantial progress in reducing the jobless rate due to high labour force growth. In the closing months of 1995, the unemployment rate edged up in Germany, France, Italy and Sweden.

	1992	1993	1994	1995
B	7.3	8.9	10.0	10.2
DK	9.2	10.1	8.2	6.9
D	6.6	7.9	8.4	8.3
GR	7.9	8.6	8.9	8.9
E	18.5	22.8	24.1	22.5
F	10.4	11.7	12.3	11.5
IRL	15.4	15.7	15.1	14.9
I	9.0	10.3	11.4	11.7
L	2.1	2.7	3.5	3.8
NL	5.6	6.6	7.0	6.7
A	3.6	4.2	4.4	4.5
P	4.2	5.7	7.0	7.2
FIN	13.1	17.9	18.4	17.2
S	5.8	9.5	9.8	9.1
UK	10.1	10.4	9.6	8.5
EUR	9.3	10.9	11.3	10.7

Source: Commission's November 1995 forecasts

If the latest assessment of weaker economic activity in early 1996 is borne out, the short-term outlook for the labour market is less favourable than previously expected. With practically no further gains in employment for the Community as a whole, unemployment would rise further over the very short term. However, provided that the economy picks up again, unemployment should resume its downward trends in the latter part of the year.

1.4.2. Longer-term trends in employment creation in the Community

The Community suffered large job losses during the economic downturn of the early 1980's. However, the subsequent strengthening of economic growth to an average rate of 2.8 per cent per year during the period 1984-91 led to the net creation of 10½ million jobs in the Community. Whereas private sector employment

	1976-1980	1981-1983	1984-1991	1992-1994	1995
Total economy, EUR15-	2,9	-3.0	10.4	-4.4	1.1 ^{b)}
Total economy, EUR13- ^{a)}	2,8	-3,1	10,0	-4.4	1.1 ^{b)}
- of which: private	0,0	-4,1	7.4	-3.4	1.2 ^{b)}
- of which: public	2,8	1,0	2.6	-1.0	-0.1 ^{b)}

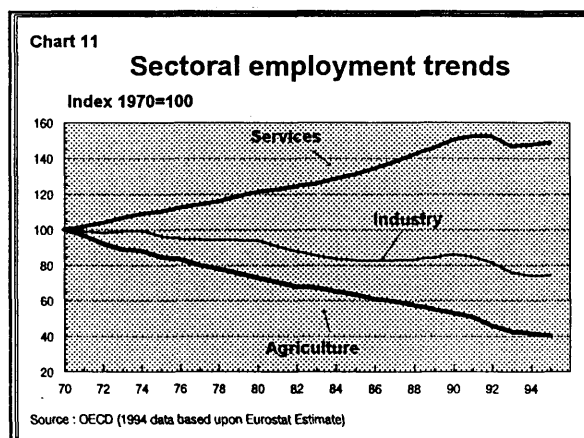
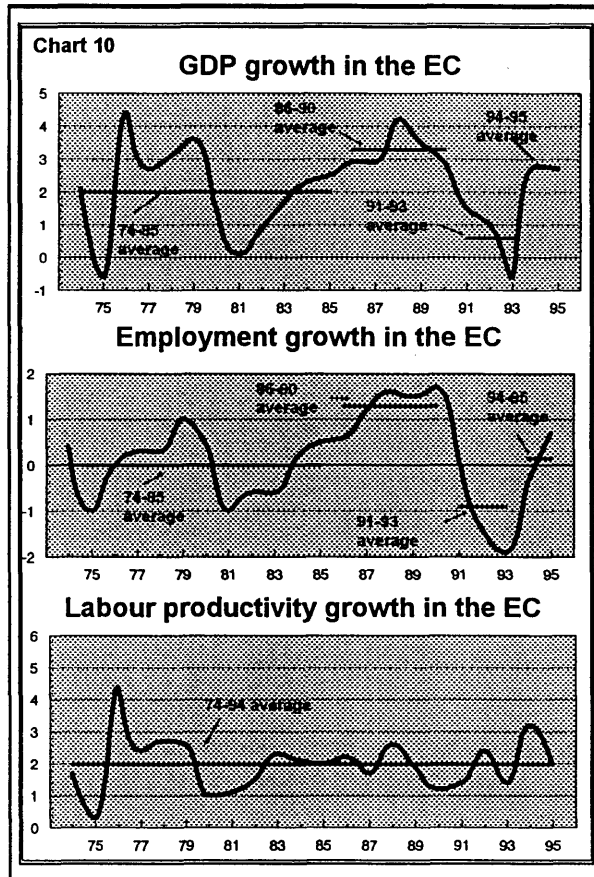
^{a)} EUR15 except Portugal and Greece.
^{b)} November 1995 forecasts; including the new German Länder.
Source: National accounts and Commission services estimates.

had stagnated and then declined markedly during the period 1975-83, coinciding with rising employment in the public sector, the net creation of jobs in the 1984-91 period took place predominantly in the private sector. In this regard, the contribution of SMEs was

significant. In 1988-90, employment in SMEs grew by 2½ per cent per year whereas employment in larger companies grew by ¾ per cent per year. The 1984-91 period clearly demonstrated the capacity of the European economy to create new employment as long as robust, non-inflationary growth could be maintained. However, during the subsequent economic downturn 4½ million jobs were lost in 1992-94². While the downturn affected both SMEs and large enterprises, the employment decline was less pronounced in SMEs.

The performance of employment in the current recovery does not appear to confirm often-stated fears of "jobless growth". Despite the intensely competitive environment in the industrial sector and consequent efforts to cut costs, the EC economy was able to sustain a positive net creation of jobs in the first three quarters of 1995, and the employment threshold of growth -- i.e. the level of output growth above which total employment will expand -- was the same as the average over the last two decades for the Community as a whole. However, the employment threshold has tended to vary between Member States as well as fluctuate over time in individual countries.

Slow job creation or even job losses in certain sectors with fast productivity growth may indirectly help generate employment in other sectors of the economy via a reduction in the relative price of the products of the former, which helps raising the purchasing power of all consumers and boosting the overall demand for products and services, including those produced in employment-



² In addition, around 1 million jobs were lost in the new German Länder as a result of restructuring.

intensive sectors with low productivity growth. SMEs, which tend to make a relatively greater contribution to employment in less capital-intensive sectors, play a key role in generating employment opportunities. Over the last 25 years, employment has been on a downward trend in the sectors of the economy with high productivity growth, namely agriculture and manufacturing industries (chart 11). However, in the manufacturing sector, where cyclical movements of employment are more pronounced, there have been periods of strong employment creation, notably during the high-growth period in the late 1980's. The long-term downward trend in manufacturing and agriculture, however, is a structural phenomenon which has been compensated by increased employment in the services sector of the economy. This upward trend was temporarily interrupted during the latest recession, when employment in the service sector began to shrink, partly under the impact of a more competitive environment, for instance in financial services, and due to the vulnerability of many small and medium sized service enterprises which had been founded during the preceding period of high growth.

The Community's record during the 1980s and again the improvement in employment from mid-1994 to mid-1995 suggest that the failure to reduce unemployment significantly has not primarily been due to an incapacity to create jobs under the right conditions, but rather to an inability to sustain job-creating growth for sufficiently long without encountering macroeconomic hindrances or structural barriers on the labour market.

1.4.3. Incidence of unemployment in the EC

The gravity of the structural unemployment problems in Europe is underlined by the extent to which unemployment affects certain groups of labour, in particular low-skilled and inexperienced workers, and often turns into long-term unemployment.

With respect to skills, the rapid transformation which the European economy is undergoing under the impact of technological developments, new organisational structures, increased competition and globalisation, have tended to reduce the demand for unskilled labour in Europe. However, these rapid changes on the demand side have not been met with equally rapid progress on the supply side of the labour market in terms of new skills, competences and occupational and geographical mobility.

In addition, low-skilled and inexperienced labour is often priced out of the market since the productivity of such labour is not considered to correspond to the total labour costs including taxes. Non-wage labour costs represent, in many European countries, a substantial share of total wage costs, and generally weigh most heavily on the lower paid.

Furthermore, the degree of protection provided through income support schemes in some cases generate very small differences in net disposable incomes between being in and out of work. In this way, the functioning of the social benefits system may, despite its overall merits, put a floor under the wages for unskilled and inexperienced labour which contributes to pricing such labour out of work.

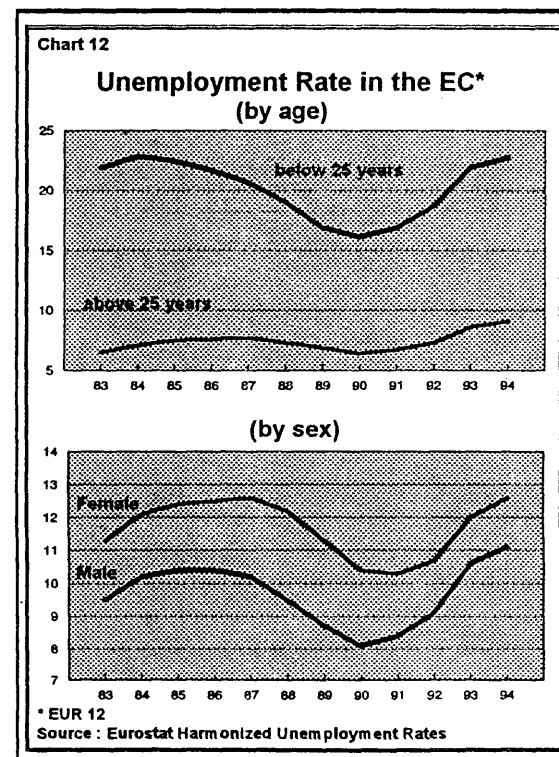
These mechanisms reinforce the difficulties which young, inexperienced people and long-term unemployed whose skill levels have deteriorated, have in finding and retaining a foothold on the active labour market.

Young people continue to be particularly affected by joblessness, and they appear to have borne a disproportionately large part of the increased unemployment risk during the recent economic downturn. Furthermore, unemployment remains significantly higher among women than among men, even if the incidence of unemployment has become less imbalanced in recent years. During the economic downturn, the rate of unemployment increased more among men than among women, in part reflecting the larger share of the male working force employed in cyclically sensitive sectors.

Table 10
Unemployment features, 1994

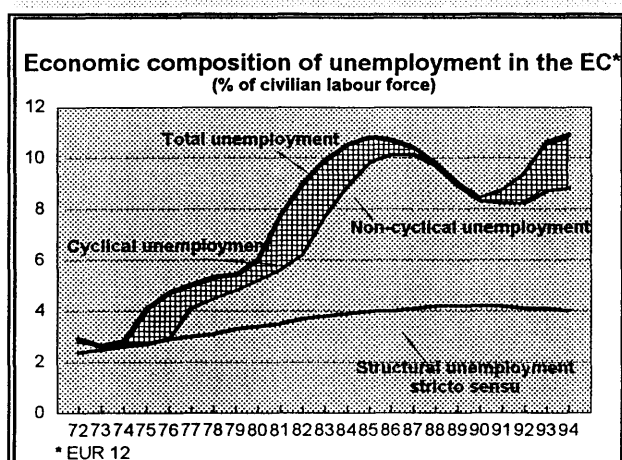
	Unem- plov- ment rate	Youth unem- plov- ment rate	Long-term unem- plov- ed ²⁾	Low- skilled unem- plov- ed ³⁾
	Per cent		Share of total unemployment	
B	10.0	24.1	58	52
DK	8.2	10.7	32	31
D	8.4	8.6	44	22
GR	8.9	27.7	51	40
E	24.3	45.3	53	68
F	12.3	29.1	38	46
IRL	14.7	23.3	59 ¹⁾	64
I	11.4	32.3	62	59
L	3.5	7.7	30	63
NL	7.0	10.7	49	32
P	7.0	15.1	43	79
UK	9.6	17.0	45	58
A	:	:	:	:
S	9.8	22.6	10 ¹⁾	:
FIN	18.4	33.6	21	:
EUR	11.2	21.8	48	50

1) 1993 2) Unemployed for more than 12 months 3) Edu-
cational level lower than upper secondary; share calculated
for the persons aged 15 to 59 years.
Source : EUROSTAT Labour Force Survey 1994 and
National Statistical Institutes for S, FIN



Box 3: The economic composition of unemployment

From an economic perspective, unemployment may be disaggregated into a cyclical and a non-cyclical component³. The **cyclical** component results from a lack of total demand relative to the available productive capacity. Since a part of the unemployed labour force is directly "employable", cyclical unemployment can be absorbed by an increase in demand during the first stages of a recovery corresponding to the return to normal use of the existing capacity. However, since the cyclical component of unemployment has been estimated to represent little more than 2 percent of the labour force in 1994, eliminating it will not be enough to bring unemployment down to acceptable levels.



The **non-cyclical** component is linked in the first instance to the lack of employment posts at given real labour costs, i.e. ultimately to a lack of capacity which can be profitably employed at given wage and price levels. In such circumstances, higher demand would lead to inflation rather than a durable expansion of employment. Part of the non-cyclical unemployment can be absorbed by a strong, investment-based growth process involving an expansion of the productive capacity facilitated by an increase in investment profitability. The working posts thus made available could be filled by those who continue to be in the

turnover on the labour market and who are quickly "employable" with limited retraining.

However, part of the non-cyclical unemployment corresponds to a part of the labour force which is not easily able to fill the kind of jobs that will become available through the growth process. This overlap represents **structural unemployment stricto sensu**. The size of this overlap is difficult to assess but according to estimates of the Commission services, it amounts to at least 4 per cent of the labour force³. The proportion of long term unemployment (about 5½ per cent of the active population) may also be used as a rough indicator. This structural unemployment *stricto sensu* must be reduced by active labour market policies especially geared to problem groups and long-term unemployed. Such policies have an important social objective and contribute to reduce social exclusion. But without the creation of adequate working posts, the full return of these policies would not be reaped and such measures would risk becoming a source of disillusion for the intended beneficiaries if, as before, they were unable to find a job.

In a different perspective, tensions in the labour market may appear even before the level of structural unemployment *stricto sensu* is reached. A marked rise in employment might be constrained by the appearance of a NAIRU (Non Accelerating Inflation Rate of Unemployment) limit in the form of an acceleration of wage inflation before unemployment has been sufficiently brought down. When unemployment falls, the increasing bargaining power of "insiders" or regional and occupational bottlenecks in combination with rigid wage structures may lead to an acceleration of wages. However, the empirical estimation of the NAIRU is fragile, partly because the NAIRU is not a universal constant but a structural, endogenous parameter of the economic and the wage formation system. One recent estimate³ put the NAIRU in the EC as a whole at just above 6 per cent in 1994, but the uncertainty is very considerable. The risk of renewed wage inflation putting a brake on employment creation can be reduced by carrying out structural reforms of the labour market as proposed in the priorities of the European Councils in Essen and Madrid.

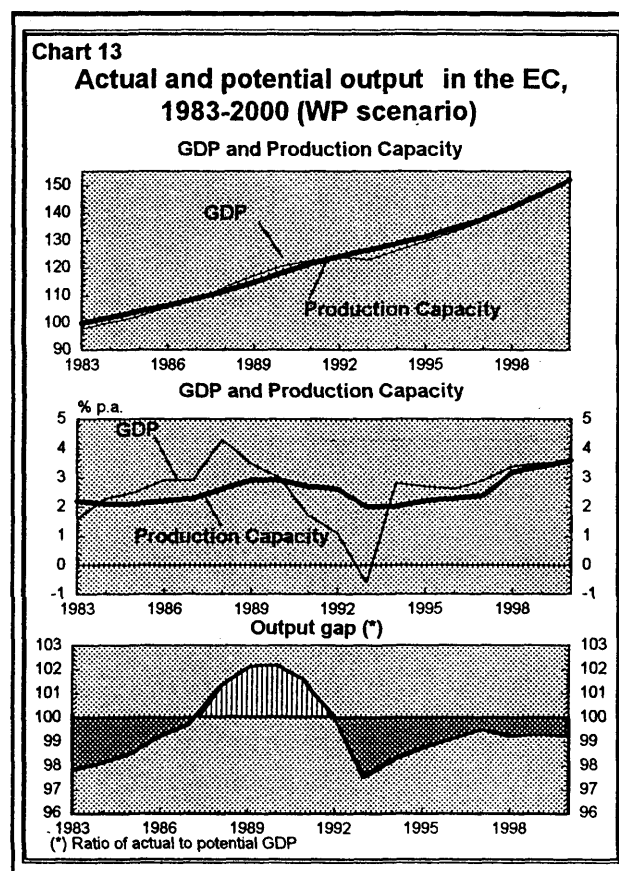
³ "The composition of unemployment from an economic perspective" European economy no. 59, 1995.

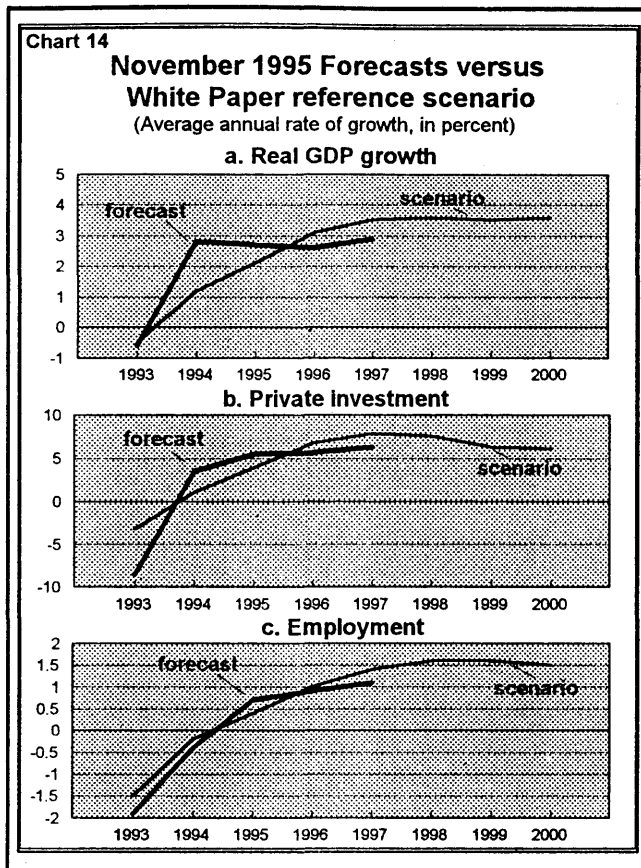
1.5. White Paper medium-term objectives put at risk

Since the publication of the Commission's 1993 White Paper on growth, competitiveness and employment, there has been widespread consensus in the Community on the need for solid medium-term growth as a prerequisite for a significant reduction in the level of unemployment. The current economic slowdown has raised doubts about the possibility of achieving such strong growth and employment creation in the Community in the coming four to five years and, in particular, about the feasibility of cutting unemployment by half between 1994 and the year 2000.

The White Paper was accompanied by medium-term projections for a number of scenarios for the period 1994-2000. The "reference scenario" illustrated the possible outcome if the Member States maintained, as soon as their economies had recovered, budgetary policies in line with the desired convergence path and if wage trends would be kept appropriate. These conditions would allow monetary policies to be less restrictive than otherwise, and exchange rate stability would be restored.

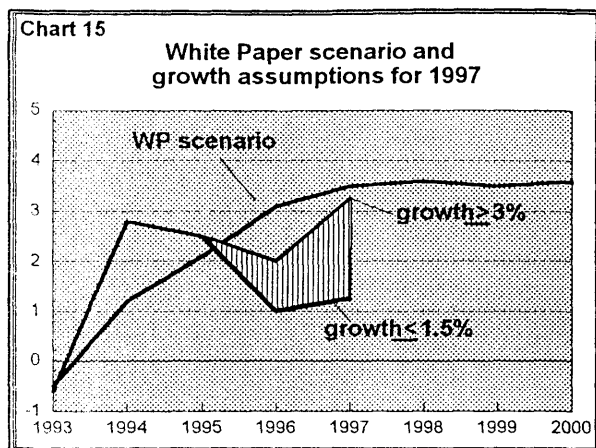
The growth profile in this scenario implied a rather slow recovery in 1994-95 followed by a further acceleration in 1996-97 and a stabilisation of the average growth rate in the Community at around 3½ per cent per year in the following years. The average growth rate in the years 1994-2000 would be 2.9 per cent, just below the 3 per cent per year observed in 1984-1990. In this scenario, the expansion would be led by a strong expansion of investment thanks to a satisfactory evolution of final demand combined with high and rising levels of profitability. Thus, the expansion of productive capacity would keep in step with output, and the scenario would not imply a repetition of the overheating problems of the 1988-90 period (chart 13).





In actual fact, however, the recovery was much stronger in 1994 and, despite the intensifying slowdown during the year, also better than expected for 1995 on average (chart 14). Thus, at the time of elaboration of the Commission's November 1995 forecasts, the achievement of the White Paper growth scenario still appeared feasible. However, the subsequent deterioration in the outlook for 1996 will render the achievement of the White Paper scenario more difficult, even if it is not yet excluded.

If, and only if, confidence is restored quickly there may be a strong rebound in the Community as a whole on the basis of healthy growth fundamentals. Indeed, growth in the second half of 1996 and in 1997 could well be as strong as 3 per cent or more. This would provide the basis for a strong, investment-led and sustainable growth pattern in 1998-2000. However, too buoyant growth from 1997 onwards would imply a renewed risk of tensions on the use of productive capacities. Policy-makers would have to remain vigilant in order to avoid a repetition of the overheating phenomenon which occurred in not so dissimilar circumstances in 1988/89.



If growth were to revive strongly by 1997, a return to the White Paper growth scenario would become possible (chart 15) and this could lead to a substantial reduction of unemployment. A stronger growth path would hardly appear feasible without tensions arising. But a return to the White Paper growth scenario, combined with structural policies aimed at securing a tension-free growth process,

increasing the employability of the labour force and making economic growth more employment-creating, are necessary in order to make progress towards the White Paper ambition in terms of unemployment.

The Report of the Commission to the Madrid European Council on the mutually reinforcing effects of increased co-ordination of macroeconomic and structural policies concluded that: *“no process of strong growth and no substantial reduction in unemployment is possible in the European Union unless the Broad Economic Policy Guidelines are applied in a determined and properly co-ordinated fashion. The most important risk - which was felt through the monetary turbulence of Spring 1995 - is a lack of credibility in the application of the common strategy by a number of Member States, which has negative consequences for everybody. In that case, the result would be sub-optimal for all. This is why the Broad Economic Policy Guidelines should be implemented with determination by policy makers and social partners in all countries”*. This should be done along the lines set out in the remainder of this report.

Chapter 2: Economic policies for growth and employment

2.1. Desired policy mix

The macroeconomic policy-mix is largely determined by a triangle of forces -- namely monetary policy, budgetary policy and wage trends --, responsibility for which is assumed by three different groups of actors. The conduct of monetary policy is exercised by increasingly independent central banks whose primary objective is to achieve and maintain price stability. The responsibility for budgetary policy resides with sovereign governments and parliaments, but whose freedom of action is constrained by Treaty provisions and by the pressing need for fiscal consolidation. The conduct of wage negotiations is generally under the responsibility of the social partners with the wage formation process varying importantly across Member States. Wage developments should respect the conditions for price stability and contribute to the required profitability of employment-creating investment. Efficient co-ordination between the various policy actors is essential to ensure the avoidance of policy conflicts of the type seen during the late 1980s/early 1990s which was one of the key factors behind the 1992/93 recession.

The most important contribution that this triangle of forces can make to relaunch the recovery process, to achieve a high degree of sustainable convergence and to significantly and durably reduce an alarming unemployment total consists in bringing about a further *détente* in the macroeconomic policy mix. In the Community there exists a potential for a further easing of monetary conditions. A healthy and efficient use of this potential requires, however, that the other two forces are consistent with the objective of price stability. Indeed, more decisive and credible fiscal adjustments efforts in a number of Member States and continuing adequate wage developments will enable further, soundly-based reductions in short and long-term interest rates.

In order to overcome the current growth pause and to place the Community's economy on a strong, non-inflationary and employment-creating medium-term growth path, a rebalancing of the macroeconomic policy, thus generated, must be reinforced and co-ordinated by a broad range of structural policies. The latter contribute to the overall strategy through essentially three channels : (i) to ensure a tension-free macroeconomic growth process by measures aimed at a better functioning of goods and services markets and a greater, positive flexibility of the labour market; (ii) to enhance the endogenous growth factors by actions geared towards promoting innovation, competition and

improving human capital and (iii) to increase the employment-intensity of growth through a widening of the wage cost scale, especially by reducing indirect labour costs at the lower end, reorganising working conditions, etc.

2.2. Monetary policy

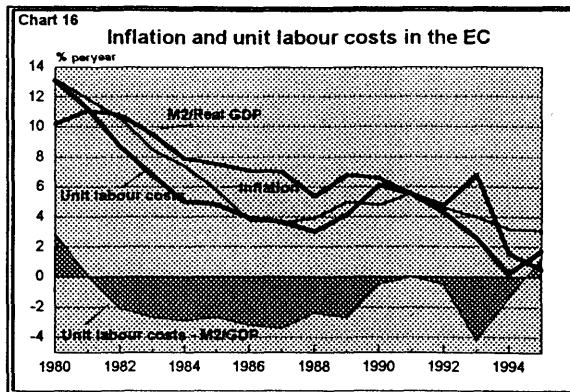
2.2.1. Inflation and monetary policies in the medium term

Since the early 1980s monetary policy in the Community has been increasingly geared towards the objective of price stability. This strategic reorientation of monetary policies was driven by disappointment with the macro-economic performance of the Community in the 1970s which made it clear that low unemployment could not simply be achieved at the cost of accepting higher inflation and that, in fact, there was no lasting trade-off between low unemployment and low inflation. In addition, governments and economic operators were becoming more and more convinced of the drawbacks of high inflation and adapted their behaviour accordingly.

High inflation is typically accompanied by a greater degree of price uncertainty. This tends to be reflected in higher real long-term interest rates than otherwise (through the incorporation of a risk premium) and makes long-term investment and savings decisions more uncertain since the real value of income and wealth is more difficult to maintain when the future price level is uncertain. These factors lead to a sub-optimal level of investment and savings and thus to a lower production potential than otherwise. High and variable inflation also distorts price signals and may contribute to a misallocation of resources. Moreover, high inflation has negative distributional effects since households in the lower income brackets have less access to durable consumption goods or financial investments with good real value characteristics. Finally, unanticipated inflation represents a shift in resources from creditors to debtors. In the 1970s, the government sector became an important borrower, spending too often on present consumption rather than on investment. An easy monetary policy facilitated this channelling of funds to the government. In the 1980s, disinflation and high real interest rates added to the governments' debt burden which increased drastically as a share of GDP.

The realisation that a sustainable growth path is better served with price stability led to the formulation, with increasing success, of monetary policy in terms of that objective. The rate of inflation in the Member States decelerated markedly during the first half of the 1980s and since then have remained markedly lower than during the 1970s. The average

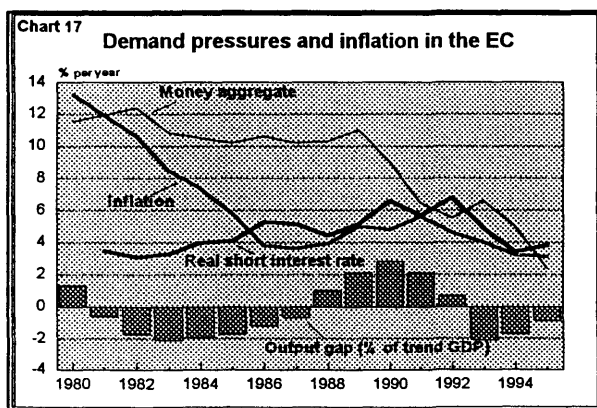
inflation in the Community (based on the consumption price deflator) declined from over 12 per cent in the early eighties to 3.6 per cent in 1987 (chart 16). While the endeavour to improve price stability in the wake of the second oil price shock in conjunction with the recession among the Community's trading partners was a main factor behind the economic downturn in the



early 1980's, the further reduction in inflation from 1983-87 was achieved alongside renewed employment-creation and accelerating economic growth. The credibility of the ERM based on a stable nominal anchor contributed strongly to this favourable evolution.

The disinflation process was temporarily interrupted in the late 1980s when a too expansionary monetary-fiscal policy mix engendered an overheating of the Community economy. The accompanying acceleration in inflation and inflationary expectations was compounded by German unification and the hike in oil prices resulting from the Gulf war. Monetary policy returned to a firm anti-inflationary stance in late 1990 and inflation, after having peaked at over 5½ per cent in 1991, fell gradually back to just over 3 per cent in 1995. Meanwhile, the severe tightening of monetary policy in Germany and the rest of the Community in the aftermath of German unification contributed to the exchange rate turbulence in the ERM because in a number of Member States the deterioration of the economic situation called, in the opinion of markets, for a differentiated policy response. The recession in 1993, when real GDP in the Community declined by 0.6 per cent, was then also particularly severe.

The considerable progress towards price stability can be attributed to a combination of factors.



First, as the monetary authorities became increasingly conscious of the importance of low inflation they took action accordingly. While nominal short-term interest rates declined regularly throughout the 1980's on average in the Community, compatible with the trend decline in the Community-wide money supply growth, real short rates followed

an upward course until 1986-87. In late 1987, interest rates were lowered in the wake of the world-wide drastic fall in stock market prices, which created fears of an impending slowdown. Instead, the economy overheated and from 1989 to 1992, interest rates were increased considerably. Both nominal and real rates peaked in August/September 1992 at 12.4 per cent and around $7\frac{3}{4}$ per cent, respectively. Already by 1989, money supply growth was decelerating more rapidly and, by 1991, also inflation. In a number of Member States, however, money supply targets in the early nineties were overshoot, so it was only from 1993 onwards, in the context of subdued economic growth, that central banks were able to ease monetary conditions significantly. In late 1995, the average nominal short rate in the Community, at 6.4 per cent, was lower than at any time in the 1980's and the real rate, at $3\frac{1}{2}$ per cent, was down to levels last prevailing in 1983. Despite the lowering of interest rates, money supply growth plunged in 1994-95 and targets were undershot (table 11), suggesting that monetary policy could have eased earlier without jeopardising price stability. The overshooting of money supply targets in some Member States and exchange rate unrest in others prevented this from happening.

Secondly, and related to the first factor, the rate of wage increases declined markedly. Unit labour costs -- which are a prime determinant of inflation together with profit margins, import prices and indirect taxes -- decelerated strongly in the first half of the 1980's and rose at a rate generally below inflation. Following a sharp upturn in 1989-90, unit labour costs decelerated again between 1991 and 1994 (chart 16). The evolution of unit labour costs can be compared with the evolution of the ratio of M2 over real GDP. This ratio -- with an appropriate assumption on the velocity of money -- gives an indication of the increase in the money supply in excess of what is needed to finance real transactions. The decline in the M2/real GDP-ratio over the 1980's reflects the lower availability of liquidity to finance nominal developments. A widening in the difference between the change in the M2/real GDP ratio and the change in unit labour costs suggests that monetary policy accommodates wages pressures, while a narrowing suggests that monetary policy is relatively tight as in the late eighties/beginning of the nineties. The difference narrowed again in 1994-95. This may suggest either an increase in the velocity of money or that monetary policy was relatively strict in 1995 with respect to the moderate wage pressures.

Finally, from the mid-1980's onwards, the creation of the single market (including the liberalisation of capital movements) in combination with a generalised move towards market deregulation, led to a strengthening of competition and an improvement in the allocation of resources. These effects contributed to the moderation of price rises.

Whilst all Member States pursue the objective of price stability, the monetary policy frameworks in individual Member States target different variables. These frameworks have become more diverse in the Community over recent years (table 11) in an attempt to formulate the most appropriate and credible response to the changing economic and financial circumstances. Inside the ERM

Table 11					
Money, credit and inflation targets and outcomes					
(per cent per year)					
		1994		1995	
Target variable ^a		Target (medium term)	Outcome	Target (medium term)	Outcome
Germany	M3	4 - 6	4.9	4 - 6	2.5 (Dec)
France	M3	(around 5)	1.1	(around 5)	3.9 (Nov)
	EIT ^a		4.2		4.8 (Oct)
Spain	M3	-	8.2		10.7 (Nov)
	ALP+CP	-	7.6		9.2 (Nov)
	ALP	4.5 - 7.5	8.2		9.7 (Nov)
	CPI ^b		4.7	(<3)	4.3 (Dec)
Italy	M2	5 - 7	1.6	5	2.2 (Dec)
UK	M4	3 - 9	4.5		9.3 (Dec)
	M0	0 - 4	6.7		5.6 (Dec)
	RPIX ^b	1 - 4	2.4	1 - 4	3.0 (Dec)
				(≤ 2.5)	
Finland	CPIY ^b	-	1.3	2	-0.6 (Nov)
				(2)	
Sweden	CPI ^b	-(2)	2.4	2 ± 1	2.6 (Dec)
				(2 ± 1)	

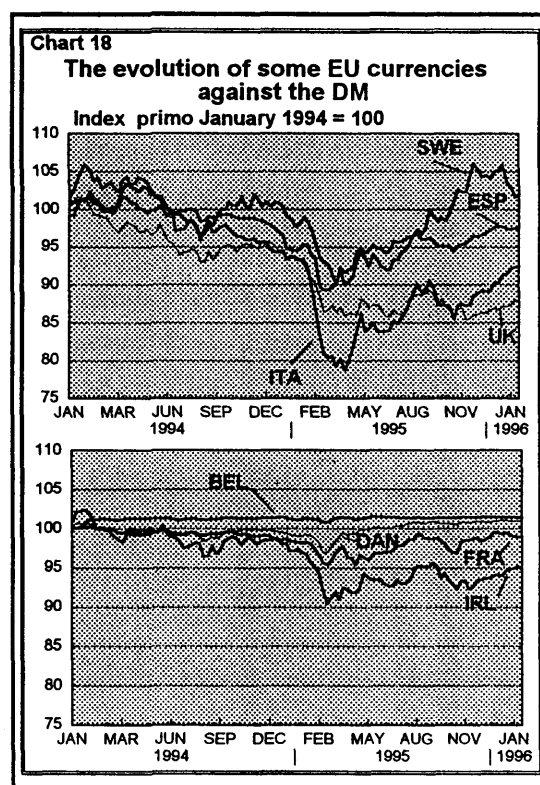
^a Money supply targets: M0, M2, M3, M4; ALP; credit targets: EIT
^b Inflation targets: CPI, CPIY (CPI minus indirect taxes, subsidies and capital expenditure on housing, RPIX (retail price index minus mortgage interest payments)

the focus is on the exchange rate, but to a variable degree. Hitherto, the exchange rate target has been most narrowly binding in Belgium, the Netherlands and Austria while, on the other hand, in Spain and Portugal, exchange rate fixity has been less pronounced. Furthermore, in Spain and France the exchange rate target is complemented by an inflation and money supply target, respectively. Germany is the only country which continues to give considerable weight to the control of the money supply. Outside the ERM, an inflation target represents the focus of attention of the policy makers in Finland, Sweden and the United Kingdom.

2.2.2. Monetary stability affected by internal and external factors in 1995

After the exchange rate turbulence of 1992 and 1993, exchange rates in the EU countries went through a period of calm that lasted until the end of 1994. Subsequently, the currencies of the Member States once more displayed pronounced volatility, particularly in March and April 1995. Despite interruptions, calm had returned to the markets by the end of 1995 (chart 18). Similarly, short- and long-term interest rates displayed considerable volatility in 1995 with diverging trends (chart 19) reflecting, to some extent, the tensions in the exchange markets but also responding to developments and prospects for inflation and economic activity. Internal and external factors prevented monetary policy from being more balanced at the beginning of 1995 and delayed the necessary easing of monetary conditions.

Exchange rate tensions at the international level, related to the financial crisis in Mexico affecting especially the dollar exchange markets, were at the origin of pressures on several European currencies at the beginning of the year (see box 4). The Italian lira suffered most during the currency turbulence, losing over 16 % of its DM value between the end of 1994 and April 1995. Political uncertainty and doubts about the commitment to budgetary consolidation played a major role in the currency's weakness. Similar problems affected the Swedish krona, and inside the ERM, the Spanish peseta, which devalued on 6 March by 7 % and with it the Portuguese escudo by 3.5 %. The strong appreciation of some Community currencies

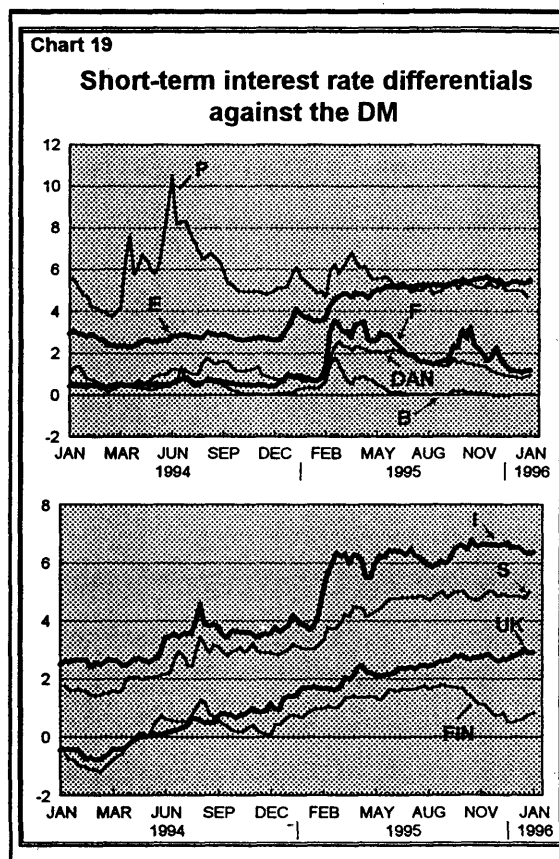


and the simultaneous increase in interest rates in countries whose currencies had come under pressure amounted to a significant tightening of the monetary stance in Europe.

Slow money supply growth in Germany and better inflation prospects led the Bundesbank to reduce official rates at the end of March; two more cuts were to follow (in August and December). This provided the other Member States with the necessary room to ease monetary policy as well. This was done in a differentiated way and at a different pace, determined by recent inflationary developments and the situation in the exchange markets,

reflecting *inter alia* the credibility of governments to stick to a stability oriented economic policy.

Almost all ERM participants were in a position to lower rates substantially. Dutch and Austrian money market rates followed closely developments in Germany, although the short-term differential in the latter widened. In Belgium, the differential with DM rates widened temporarily to close to 2 % in March, but it subsequently disappeared and Belgian rates were able to track short-term interest rate developments in Germany. In Denmark, France and Ireland; considerable progress was likewise made in the second half of the year when exchange rate tensions subsided. There was a brief interruption for France in the Autumn, but following the introduction of credible fiscal consolidation efforts, the differential narrowed significantly. However, short differentials with Germany remained higher compared to the beginning of the year in France and Ireland. Spain was



not in a position to lower rates substantially because of doubts in the markets on the political stability and the budgetary situation, while in Portugal interest rates continue to be more than 5 % higher than in Germany.

Outside the ERM, where central bank action is geared more directly to developments in domestic inflation, monetary policy was progressively tightened in Sweden and Italy because the inflation outlook deteriorated. Money market rates remained relatively stable in the United Kingdom, fluctuating between 6.50 per cent and 6.75 per cent. In Greece better inflation prospects allowed interest rates to be reduced considerably, while in Finland, after an initial hike in March, interest rates were cut in several steps from the Autumn onwards and short-term differentials narrowed again to 70 basis points.

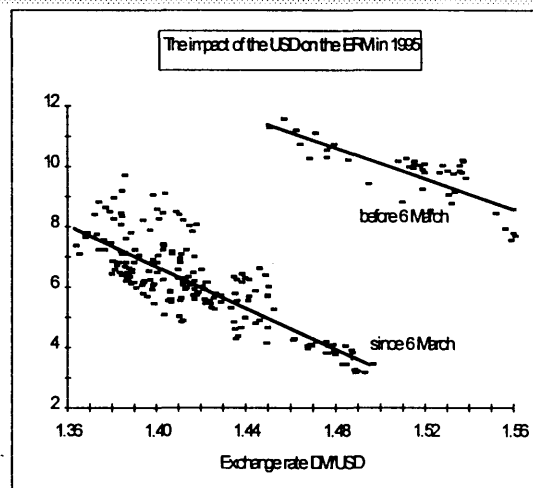
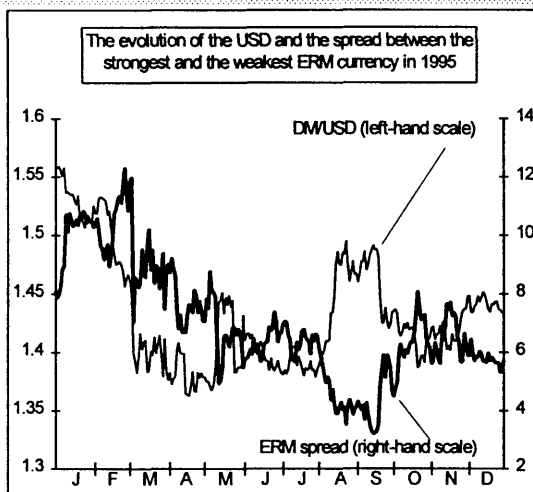
At the end of 1995 the monetary situation compares favourably to the Broad Economic Policy Guidelines. Exchange rate stability was returning (chart 18) and 11 Member States realised the objective of an inflation rate between 2 and 3 per cent as a step towards

stability. These developments are encouraging for keeping the inflation rate low in a durable way. Progress was strongest in the Member States already experiencing a low degree of inflation as well as in Greece and Portugal. In Italy, the rate of inflation accelerated by 2 percentage points to 6.0 per cent while in Spain inflation remained broadly unchanged. Monetary policy made an important contribution to the overall positive developments, but occasionally led to tensions when there was a perceived lack of fiscal discipline or when inflationary expectations were fuelled by excessive wage claims.

Box 4: The dollar and the ERM

Although domestic reasons, related to political uncertainty or to the commitment to budgetary consolidation, explain part of the exchange rate volatility in the ERM, external factors had an important influence. The sensitivity of the ERM to external developments is illustrated in the graph below, showing the influence of the USD/DM exchange rate on tensions in the ERM, represented by the spread between the strongest and weakest currency in the grid. One observes that an appreciation of the German mark vis-à-vis the dollar tends to widen the spread. A clear shift in the relation after the realignment on 6 March is also visible.

The transmission mechanism explaining this phenomenon is as follows. When the US dollar weakens, capital flows into the German mark more than into other European currencies because the markets think that certain countries have relatively more difficulties to accept a higher dollar. This puts upward pressure on the German mark in the ERM and the spread widens. This sort of intra-European volatility will naturally vanish among members of EMU. While the US dollar appears to be an important trigger at certain moments for ERM turbulence, it can not be considered as its only cause; in fact, for several other currencies, the bilateral exchange rate spread does not widen after a dollar fall against the DM.



2.2.3. Room for further easing of monetary conditions

In early 1995, Member States in the ERM took a cautious approach to the easing of monetary conditions in order to preserve stability. This policy was successful in terms of the chosen objective (low inflation, low growth of money supply or stable exchange rate) but against the background of the more restrictive fiscal stance and the low level of the dollar it appears to have been relatively tight in the first half of 1995. Later in the year, when it became clear that the economy was hit by a marked slowdown, Member States were, to varying degrees, able to relax monetary policy. This led to a more balanced policy mix. After the sharp rise of long rates in 1994 -- because of better growth prospects, international arbitrage flows and a less certain inflation outlook, but also because monetary policy was prevented to be sufficiently loose due to the budgetary situation -- long rates almost completely reversed the evolution in 1995. As long-term interest rates declined more rapidly during the year than short-term interest rates, the term structure of interest rates became flatter (chart 20). While the difference between the 3-month interest rate and the 10-year bond yield was 2.5 per cent in January for the Community average, it decreased to 1.2 per cent in December 1995. As the slope of the yield curve partly reflects market expectations about future inflationary pressures, this flattening suggests that inflationary expectations were abating. It also implies that the official interest rate reductions have, on average, been credible. However, these cuts in interest rates have yet not been fully transmitted to the economy as bank lending rates remain high (chart 20), suggesting that credit institutions did not fully pass the advantage to their customers but also increased their profit margins. This is of particular importance for small and medium-sized enterprises which have less easily access to capital and money markets -- where interest rates declined markedly -- but rely more on bank credit. The same applies to the household sector and this may restrain consumer spending. A smooth and competitive transmission mechanism forms an essential element in reaping the full benefits of lower interest rates.

Outside the ERM monetary policy generally remained tight, on the whole, in response to emerging inflationary pressures. In Italy, short rates rose by about 1.5 per cent in the first quarter of 1995 and stayed high. Measured by the reaction of the exchange rate, this policy enjoyed particularly high credibility in Sweden and Finland. In the latter country short-term differentials against the DM could already be reduced substantially (chart 19).

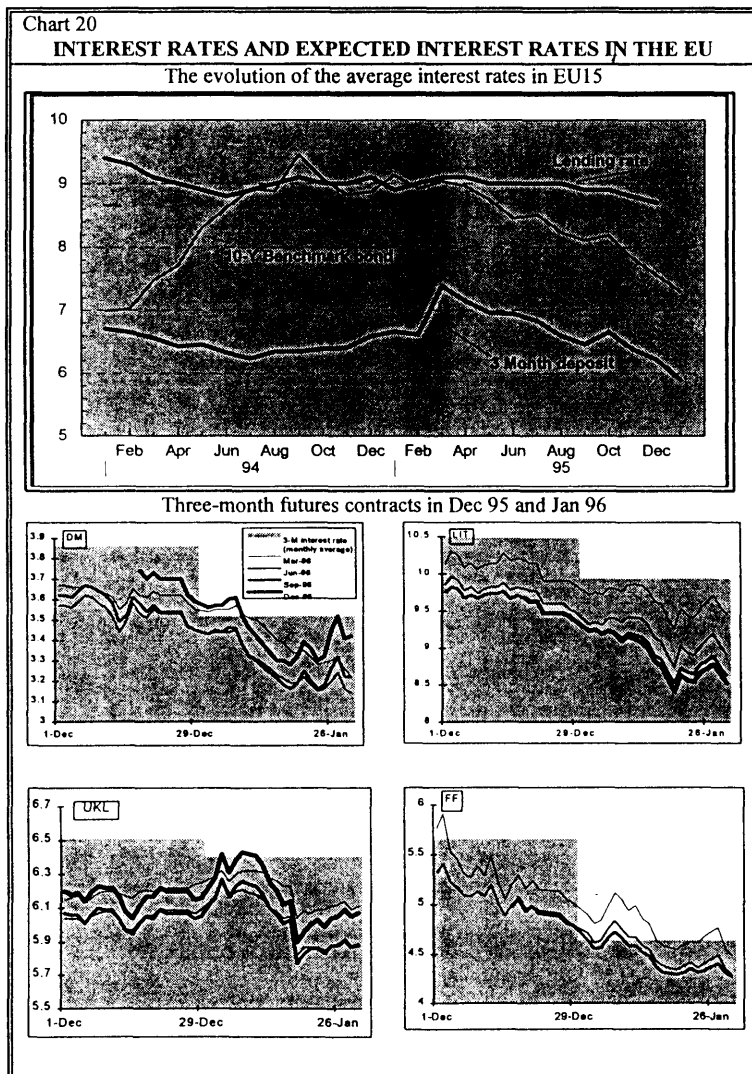
Inflation seems to be currently firmly under control in the majority of the Member States while the appropriate action was taken where this was less the case, mainly in countries with a weaker exchange rate. The risks for an interruption of the favourable trend also appear small. Such risks could be linked to the future emergence of a positive output gap

and/or a stronger growth of unit labour costs. Long-term interest rates adjusted for (current) inflation remained substantial in 1995. This could reflect a general increase of real rates of return on investment which would be a positive development. The liberalisation of capital movements and financial deregulation from administered interest rates towards market behaviour contributed to the emergence of higher real interest rates already during the 1980s. On the other hand, the current high real long rates may to some extent also reflect a risk premium for a higher level, and/or higher volatility, of inflation in the future. This kind of price uncertainty appears to stem more from occasional doubts in the markets on the commitment for budgetary consolidation and, linked to that, the commitment to meeting the EMU objectives, rather than to excessive wage demands. These risks make the monetary stance more restrictive than it would otherwise need to be to preserve stability.

In this context market analysts often refer to the existence of a risk premium on German long-term bonds because they presume that monetary policy in EMU would be less

rigorous than current German monetary policy. This is an interpretation based on the steep slope of the yield curve compared to the relatively flat slope in the USA and a higher long-term interest rate in Germany than in the US. However, another interpretation is equally valid. Indeed, the present constellation of interest rates is consistent with an expectation of a strengthening of the US dollar against the German mark relative to its currently low level.

Given the current growth outlook, and in the light of the successful easing of monetary policy and the gradual reversal of exchange rate misalignments since March 1995, the objective



of low inflation would appear to be compatible with an additional easing of monetary conditions. This presupposes that wage pressures and exchange rate tensions can be avoided and budgetary consolidation remains credible. The potential for easing remains intact even though short-term interest rates in Germany and some other countries are approaching low levels. Even lower interest rates have been observed in the past. In Germany, the level of the discount rate was lower in 1959 and at the end of 1987/beginning of 1988, the period following the October 1987 stock exchange crash (2.75 per cent and 2.50 per cent respectively). Futures contracts provide an indicator of the general orientation of market expectations about future interest rates (chart 20). Interest rate expectations have been adjusted downward as illustrated by the decline in the interest rates implied by futures contracts, suggesting that market expectations are consistent with a further easing of monetary policy. In France and Italy the expected drop in short-term interest rates is larger than in Germany, so that the short-term interest rate differentials could narrow, which is an indication of stability in the exchange markets. In Germany and the UK the implied interest rate by the December-96 contract is higher than on some previous contracts, suggesting that short-term interest rates could be bottoming-out in the course of 1996. The expected interest rate at the end of 1996 remains, however, lower than the one observed on average in January.

Continued wage moderation and enhanced credibility for fiscal consolidation should create the conditions for a durable relaxation of monetary policy in Europe.

2.3. Budgetary policy

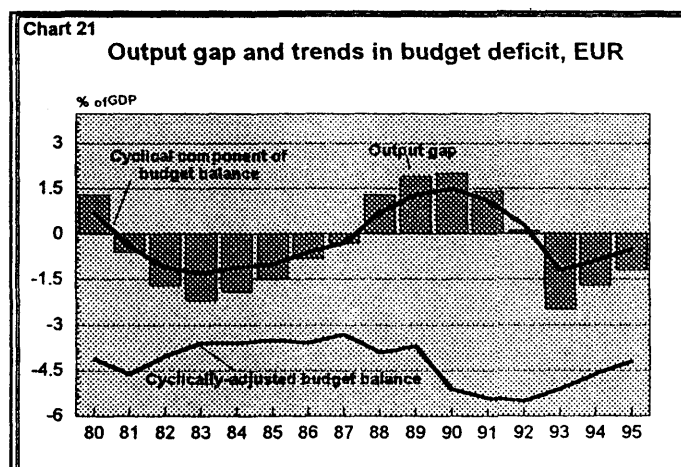
2.3.1. Recent developments and short-term prospects

Recent origins of budgetary imbalances

In general terms, the worrying budgetary positions confronting the Community as a whole and the majority of member countries result from the combined influence of three main factors: first, the failure of Member States in general to exploit the strong economic expansion of the second half of the 1980s to curb existing large structural imbalances; second, the exacerbation of these imbalances in the early 1990s by underlying deteriorations in Germany (related to unification) and also in a large number of the other Member States; and finally, the sharp cyclical deterioration linked to the recession of 1992/93.

At the trough of the downturn in the early 1980s, the Community's overall budget deficit widened to a hitherto unseen high of around 5 per cent of GDP. Despite a growing consensus among policy-makers that budgetary policies needed to be oriented towards the objective of medium-term consolidation, efforts made to reduce structural imbalances in the course of the 1980s proved insufficient. The Community's overall budget deficit declined to a low of 2½ per cent of GDP at the end of the decade but the improvement was mainly due to better cyclical conditions. Indeed, the structural deficit remained unchanged at the high level of some 3½ per cent of GDP during the prolonged and healthy economic expansion of the 1980s (chart 21).

The early 1990s witnessed a substantial and rapid deterioration in the budgetary performance due to both discretionary policies and cyclical factors. In the space of only 4 years, the Community's budget deficit increased by nearly 4 percentage points to a record high of 6.3 per cent of GDP in 1993. Initially, there was a strong deterioration in the cyclically-



adjusted budget deficit for the Community as a whole. This stemmed to a large extent from the impact of unification on German public finances. But it also reflected a move towards an expansionary fiscal stance in some Member States (table 12), in part reflecting

endeavours to offset the growth impact of the coinciding tightening of monetary conditions.

Following the onset of recession in the second half of 1992, the further sharp deterioration in the Community's overall budgetary position entirely reflected the consequences of the cyclical downturn. This was partly offset by a small, but in the circumstances necessary, attempt at redressing the structural imbalances.

Countries reacted very differently to the deepening downturn. In Germany, the process of correcting the unification-induced build-up in imbalances firmly commenced in 1992-93. Likewise, budgetary policy was tightened significantly in Belgium, Ireland, Italy and the Netherlands, broadly off-setting the negative budgetary impact of the recession. All of these countries were confronted with high budgetary imbalances at the beginning of the 1990s. In contrast, several countries (Denmark, France, Finland, Sweden and the UK) attempted to alleviate the economic slowdown through a fiscal stimulus. In these countries, structural deficits widened by at least 1 percentage point during 1992/93.

In retrospect, the attempt to use budgetary policy to counteract monetary tightening proved neither viable nor successful in most Member States. In addition, as the Community had failed to cure its fiscal imbalances during the previous boom period, it had lost control over a potentially important policy instrument during the recession in 1992-93.

Insufficient consolidation efforts in 1994-95

Consequently, most Member States committed themselves to ambitious medium-term fiscal consolidation plans once the recovery took hold. In overall terms, the net borrowing of the general government was estimated in the November 1995 forecasts to have fallen to 4.7 per cent of GDP in 1995 from its peak of 6.3 per cent of GDP in 1993, as a result of better cyclical conditions as well as retrenchment efforts. Despite this improvement, the government debt/GDP ratio in the Community as a whole posted a marked rise of nearly

	1985	1989	1991	1993	1995 ^a
B	-7.6	-7.2	-8.2	-5.9	-4.0
DK	-3.4	-0.5	-1.4	-2.4	-2.2
D	-0.3	0.5	-5.2	-3.3	-3.2
GR	-13.7	-15.5	-12.0	-11.7	-8.9
E	-4.8	-4.9	-7.3	-6.4	-4.9
F	-1.8	-2.4	-3.1	-5.0	-4.5
IRL	-10.3	-1.4	-2.3	-1.1	-3.3
I	-11.9	-10.9	-10.9	-8.3	-6.8
L	7.7	:	:	2.8	0.6
NL	-2.4	-5.2	-4.5	-2.7	-3.0
A	-1.9	-2.9	-3.4	-3.6	-5.4
P	-4.8	-3.6	-8.3	-6.7	-4.6
FIN	2.9	1.2	-0.7	-2.4	-3.5
S	-3.7	2.2	-2.4	-9.3	-5.4
UK	-1.7	-3.3	-2.6	-5.8	-4.5
EUR	-3.5	-3.7	-5.4	-5.1	-4.2

a) November 1995 Forecasts; EUR including five new German Länder from 1991 onwards
 Note: Commission services' estimates. The methodology is explained in *European Economy*, n° 60, 1995, p. 35-90.

five percentage points in the years 1994-95. Although partly due to exceptional factors, this development underscores the insufficient adjustment in the primary balance.

The estimated discretionary tightening in the Community over the two years 1994-95 amounts to just below 1 percent of GDP. During the last two years, considerable consolidation measures -- leading to reductions in structural deficits of one percentage point of GDP or more -- were undertaken in about half of the Member States, including those where budgetary situations were most preoccupying. Nevertheless, the structural deficits in the vast majority of Member States are still in excess of 3 per cent of GDP going into 1996.

Two countries (Ireland and Austria) are estimated to have shown a noticeable structural deterioration over the period under review. In Ireland, the budgetary relaxation (over 2 percentage points of GDP during 1994-95⁴), albeit from a low level, give some cause for concern. With regard to Austria, the underlying budgetary position worsened markedly (1¾ percentage points), with the additional costs of EU membership in 1995 accounting for only a limited part of this deterioration.

Evidently, many countries did not exploit to the full the possibilities of implementing fiscal consolidation measures in the context of the relatively good economic conditions pertaining in 1994 and early 1995. Consequently, the differentiated increase in long-term interest rates during 1994, the currency turmoil in the early part of 1995 and the associated tightening of monetary conditions in several countries, were in part related to a belief in financial markets that consolidation efforts had been smaller, and less rapid, than hoped for. In this way, insufficient credibility of fiscal policies played a significant catalysing role in the slowdown of the Community economy in the course of 1995.

1996: Reinforced fiscal consolidation efforts

Several Member States have taken substantial, and sometimes courageous, efforts to reduce budget deficits in 1996. According to the Commission services' estimates of cyclically-adjusted deficits, the discretionary consolidation measures to be implemented in the Community in 1996 will result in a reduction in the overall structural deficit from 4.2 per cent of GDP in 1995 to 3.4 per cent in 1996. The size of this discretionary tightening is roughly twice as large as the efforts undertaken in 1995. All fifteen Member States are

⁴ Around ½ percentage point of GDP is due to exceptional factors (see note to table 5 in chapter 1).

expected to reduce their structural deficits this year. Particularly important efforts are being taken in countries with currently high deficits or debt problems.

Whilst the improvement in structural budget balances will *in se* not be affected by the worsening growth outlook in 1996, actual budget deficits risk widening under the influence of adverse cyclical conditions. However, it would be unwise to allow slippage from announced targets. Any market doubts about the resolve of governments to stick to fiscal adjustment programmes would risk resulting in an instant reversal of the favourable trends in short- and long-term interest rates currently being experienced in many Member States. Furthermore, in these countries the negative effects on budgetary positions emanating from a lower-than-expected level of economic activity in 1996 will be compensated by diminishing debt service costs resulting from lower interest rates. This impact depends *inter alia* on the size of the outstanding debt and its maturity structure. For instance in Belgium and Italy, countries with a high public debt, the effect is important: a 1 percentage point decrease in the interest rate is estimated to lower the budget deficit by 0.3 to 0.4 per cent of GDP in the first year and by 0.5 and 0.8 per cent of GDP (cumulative), respectively, in the second year.

Encouragingly, there is a general recognition in the Community of the need to prevent any slippage from the announced consolidation paths. While continuing fiscal consolidation efforts are clearly needed, the stated targets remain within reach, provided that there is a relatively strong growth revival in the course of 1996, strengthening into 1997.

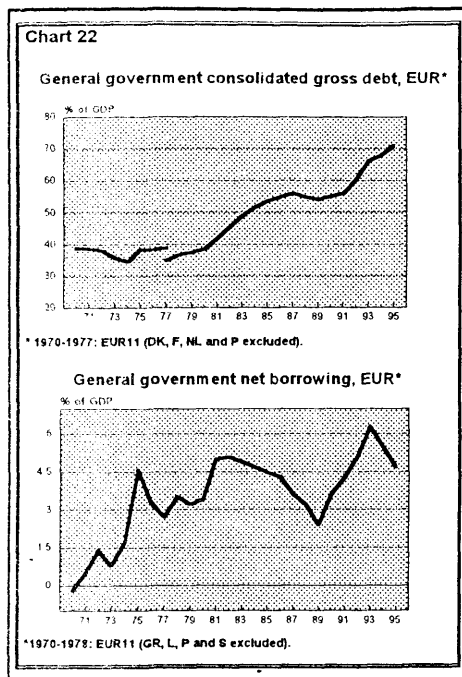
2.3.2. Medium-term benefits of continuing and enhanced consolidation

Bringing order to the Community's public finances can be expected to yield a high medium and long-term dividend. Indeed, in most Member States credible fiscal consolidation efforts are a prerequisite:

- i. to place public finances on a sustainable footing, increase economic efficiency and contribute to the achievement of a sustained medium-term growth process;
- ii. to unburden monetary policy and restore the potential for counter-cyclical fiscal action;
- iii. to participate in EMU.

Placing public finances on a sound footing

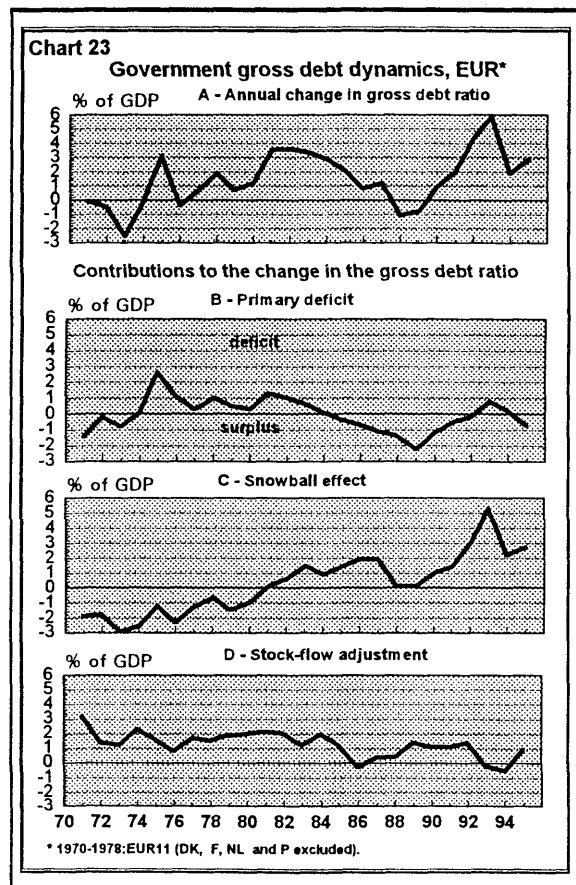
The persistence of sizeable budget deficits (exceeding 3 per cent of GDP for most of the period since the first oil shock) has resulted in a steep upward trend in the government debt



to GDP ratio, reaching over 70 percent of GDP in 1995 in the Community (chart 22). The steady ascent in the government debt ratio has been accompanied by a sharp increase in the debt servicing cost, with interest payments on the existing debt climbing from 1.8 per cent of GDP in 1973 to a daunting 5½ percent of GDP now. This evolution carries the risk of keeping the government finances on an unsustainable track and leads to the crowding-out of more productive government expenditure.

While a secular rise in public debt is a common feature in most Member countries, the increase was particularly spectacular in Belgium (in the 1980s), in Greece, Spain and Italy (in the 1980s and 1990s) and Finland and Sweden (in the 1990s). These developments have been accompanied by a rapid rise in interest payments on debt, approximating or exceeding 10 per cent of GDP in the three most indebted member countries (Belgium, Greece and Italy).

The primary deficit is the key policy-variable determining the change in the debt ratio. The improvement in the primary balance over the period 1982 to 1989 (from a deficit of 1.3 per cent of GDP to a surplus of 2.2 per cent of GDP) was too slow to halt the increase in the debt ratio because real interest rates in excess of real output growth added to an adverse "snowball effect" (chart 23). In the early 1990s, a sharp increase in the debt ratio (the ratio grew from 55 percent of GDP in 1990 to 68 percent in 1994) occurred essentially because of a relaxation of budgetary stringency which led to a deterioration in the primary balance. Given that a primary surplus of ¾ per cent of GDP in 1995 was insufficient to stabilise the debt ratio in the



Community on average, there is an urgent need to pursue with determination the achievement of larger surpluses on primary balances.

Increasing economic efficiency

The development of budgetary imbalances has generally taken place in conjunction with an increase in the governments' share in overall GDP. General government receipts and expenditure, which represented 34 per cent of Community GDP in 1961, rose to 46 per cent and 51 per cent of GDP, respectively, in 1995. Asymmetric policy behaviour over the course of the business cycle is at the root of the trend increase in the ratio of government spending to GDP. Whereas expenditures climbed markedly in every economic downturn, only limited corrections took place in subsequent periods of recovery. The revenue ratio typically adjusted to the new expenditure situation albeit partially and with a certain time lag.

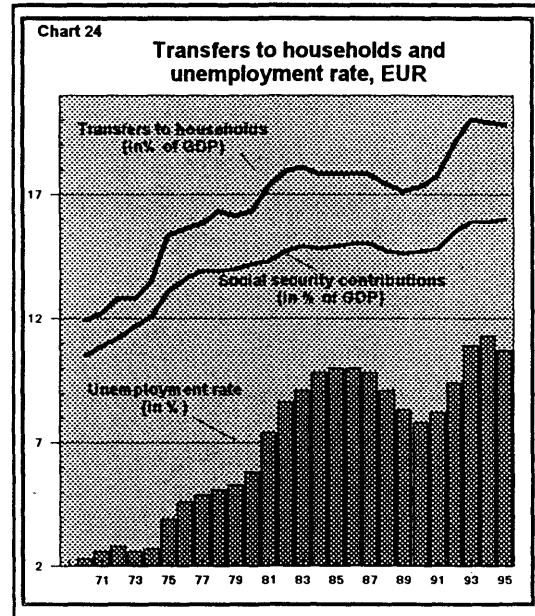
	Levels						Changes				
	1961	1973	1985	1989	1993	1995	1961-73	1973-85	1985-89	1989-93	1993-95
Current receipts	34.3	37.6	45.2	44.8	46.2	46.2	3.3	7.6	-0.4	1.4	0.0
of which											
1. Indirect taxes	13.9	12.7	13.5	13.4	13.6	13.9	-1.2	0.8	-0.1	0.2	0.3
2. Direct taxes	8.7	10.2	12.9	13.3	12.9	12.8	1.5	2.7	0.4	-0.4	-0.1
3. Social security contributions	10.2	12.0	14.9	14.6	15.9	16.0	1.8	2.9	-0.3	1.3	0.1
4. Other current receipts	1.5	2.7	4.1	3.4	3.7	3.4	1.2	1.4	-0.7	0.3	-0.3
Total expenditure	33.6	38.5	49.4	46.8	52.5	50.9	4.9	10.9	-2.6	5.7	-1.6
of which											
5. Current transfers	11.5	16.1	21.8	20.7	23.7	23.4	4.6	5.7	-1.1	3.0	-0.3
5bis. of which to households		13.1	17.9	17.1	20.0	19.8		4.8	-0.8	2.9	-0.2
6. Actual interest payments	3.1	1.8	5.0	4.6	5.5	5.4	-1.3	3.2	-0.4	0.9	-0.1
7. Public consumption	13.7	16.1	19.2	18.2	19.5	18.9	2.4	3.1	-1.0	1.3	-0.6
8. Net capital transfers	0.8	0.9	1.0	0.9	1.0	0.6	0.1	0.1	-0.1	0.1	-0.4
9. Gross capital formation	4.5	3.6	2.9	2.8	2.8	2.6	-0.9	-0.7	-0.1	0.0	-0.2
Pro memory											
10. Gross saving	6.0	3.7	-0.6	1.2	-2.5	-1.6	-2.3	-4.3	1.8	-3.7	0.9
11. Net lending(+) / borrowing(-)	0.7	-0.9	-4.5	-2.4	-6.3	-4.7	-1.6	-3.6	2.1	-3.9	1.6
12. Gross public debt ^b	65.2	36.8	53.9	54.1	66.2	71.0	-28.4	17.1	0.2	12.1	4.8

^a 1961 and 1973 : EUR 15 excluding Greece, Portugal, Austria, Sweden and Finland.
^b 1961 and 1973 : EUR 15 excluding France, Netherlands, Greece, Portugal, Austria, Sweden and Finland

On the expenditure side the main contribution to the progression in the government's share of GDP has stemmed from rising transfers to households, which has risen from 12 percent of GDP in 1973 to 20 percent in 1995, linked essentially to growing rates of unemployment and increased old age pension provisions, and greater levels of interest payments on government debt (3½ percentage points increase). The strong growth in transfers to households was only partly matched by an increase in social security contributions, implying that a growing proportion of these transfers (about 3 per cent of GDP at present) has to be financed through fiscal resources. Whilst the share of indirect taxes remained

broadly unchanged over the last two decades, the direct tax pressure increased by 4 percentage points in the Community on average.

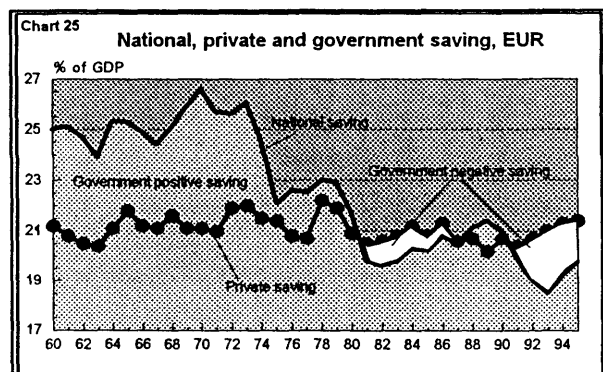
There are growing signs that the present share and structure of government revenues and expenditures is impairing the efficiency and flexibility of the Community economy in terms of crowding-out of private sector activities, higher tax burdens, an increasing wedge between labour costs and take-home pay, and reduced labour market flexibility. Greater awareness of these detrimental effects has contributed to make a downsizing of the government's share in the economy an important goal for budgetary policy in the Community.



Contributing to the achievement of a sustained, strong medium-term growth path

In the context of the need to move to a sustainable, healthy medium-term growth path, action towards sounder public finances is crucial to excite a rise in national saving, a reduction in real interest rates and a crowding-in of private investment. Although a high investment level may be realised by drawing upon foreign savings, such a situation is not sustainable over a longer period of time, and would be inappropriate for the Community as a whole given its size in the world economy and its degree of economic development. Recent empirical analyses concur that persistent fiscal imbalances and declining national saving (in the Community and elsewhere) have contributed importantly to the high level of real long-term interest rates experienced in the Community and world-wide since the 1980s and to the declining trend in investment.

A high level of national savings must therefore go hand in hand with the Community's ambitions to generate the higher investment levels which are vital to underpin a satisfactory medium-term growth performance. Given the observed long-term stability in private savings, there is widespread agreement that the



most direct and desirable way to increase national savings is through an increase in government saving. Restoration of positive government savings must consequently form an integral part of the budgetary strategy.

Unburdening monetary policy

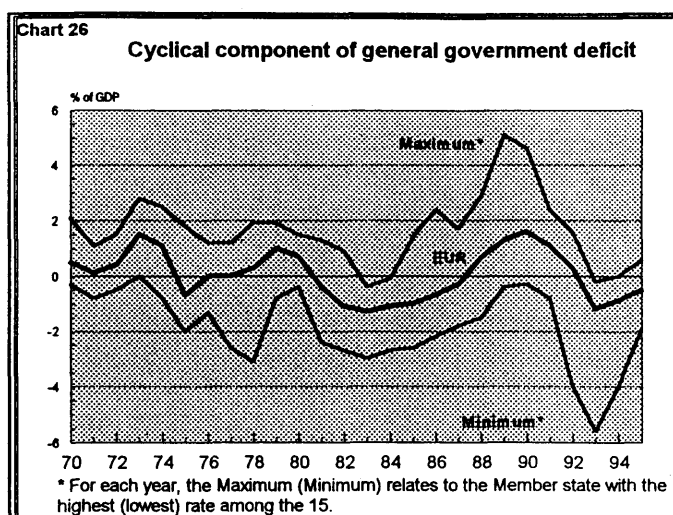
By fostering low and stable inflationary expectations, a low budget deficit and government debt facilitate the primary task of monetary policy to achieve and maintain nominal stability. Especially in countries where short-term interest rates are to a large extent determined by exchange rate considerations, the credibility of fiscal policy plays a decisive role in the degree of restrictiveness of a stability-oriented monetary policy. This was amply demonstrated by recurrent currency turbulences during recent years. Financial market concern about the firmness of the commitment of some governments to achieve a sustained reduction of budget deficits led to pressures on currencies, forcing bouts of interest rate tightening in the countries concerned. In addition, risk premiums on long-term interest rates are substantial in several countries, despite marked progress towards low inflation and relatively large margins of slack. Whilst to some degree this reflects perceived risks to stability associated with the considerable depreciation of these currencies in recent years, large fiscal imbalances also appear to have affected expectations about future inflation in some member countries. Finally, sound public finances will also reduce the likelihood of, or the economic costs of, a possible market testing of the anti-inflationary credibility of the newly independent central banks.

As a consequence, the combination of sound fiscal policy with less restrictive monetary policy is likely to result in a composition of growth which provides stronger investment and thus a faster and sustained expansion of potential output, than a combination of lax fiscal policies with higher real interest rates.

Restoring the margin of manoeuvre for counter-cyclical fiscal action

Large budgetary imbalances reduce the scope for counter-cyclical fiscal action. When the underlying budgetary position is sound, the free play of the automatic stabilisers tends to cushion cyclical variations in economic activity and the potential availability of fiscal action may be an important insurance in case of severe adverse shocks. In the case of severely unbalanced budgetary positions, however, the counter-cyclical use of budgetary policy may well de-stabilise rather than stabilise the economy if financial markets fear sustainability problems, leading to a rise in long-term interest rates or currency instability. Consequently, the stabilisation function cannot be considered in isolation.

In the Community, the size of the cyclical component of the budget deficit is quite important but it varies in a substantial manner over time and across Member States. The adverse impact of the automatic stabilisers was equal to or exceeded 2 per cent of GDP in at least one Member States during about half of the time over the last two decades (chart 26).



Furthermore, there appears to be a quite clear relationship between the magnitude of the cyclical component and the size of the country: small, open economies, which are relatively more vulnerable to external developments and usually less diversified, tend to need more room for manoeuvre. Other factors which influence the size of the automatic stabilisers are the overall size of the government sector, the progressivity of the tax system, the generosity of unemployment benefit schemes and the sensitivity of unemployment to fluctuations in output.

In the Community on average, the cyclical component of the budget deficit fluctuated within a margin of slightly less than ± 2 per cent of GDP during the last two decades. Consequently, in order to keep the actual budget deficit below 3 per cent of GDP in the Community as a whole during economic downturns, it is essential to bring the structural deficit down to close to balance (compared to an estimated level of above 4 per cent of GDP in 1995).

Participating in EMU

The budgetary convergence criteria of the Maastricht Treaty provide an effective support framework for Member State efforts by exerting a useful disciplinary role in terms of the correction of existing excessive deficit and debt ratios. The correction of these imbalances will ensure the necessary degree of fiscal discipline in Stage 3 and support the anti-inflationary commitment of the future European Central Bank which is essential for ensuring an optimal policy mix in the third stage.

The Community's budgetary policies must therefore encompass the convergence requirements of the Maastricht Treaty within the overall medium-term budgetary goal of close to balance, as stated in the Broad Policy Guidelines approved by the Council in July

1995. The appropriate reference benchmark in this perspective should be broad equilibrium in the "structural" budget balance while at the same time allowing the actual balance to fluctuate around this value in accordance with the economic cycle. Thus, budgetary policy would be in a position to play a symmetric stabilisation role in periods of economic expansion and downturn, without endangering the restored sustainability. This shock-absorbing role for budgetary policy will be particularly important once the single currency is in place in terms of its role in helping to accommodate country-specific economic disturbances.

2.3.3. Fiscal consolidation and short-term growth prospects

Governments acknowledge that the medium-term benefits of fiscal consolidation efforts are potentially large. That is why all Member States are committed to the objective of sound public finances. Nevertheless, governments often hesitate to implement planned retrenchment measures because of the perception that in the *short run* these will restrict economic activity and worsen the labour market situation. Clearly, the *direct* impact of fiscal consolidation tends to restrain demand and growth via a reduction in government purchases or in private sector disposable incomes. It is thus understandable, given the present pause in the growth process, that some Member States may be anxious about any negative growth impact from adhering to their existing consolidation plans.

However, this demand-restraining impact may be offset by a number of *indirect* effects. Budget deficit reductions are likely to make it easier for a stability-oriented monetary policy to contribute to a better policy mix. Furthermore, fiscal consolidation may limit the adverse demand impact via a reduction in long-term interest rates. In an environment of forward-looking financial markets which increasingly focus on the sustainability of budgetary policies, high and rising public debt ratios are contributing to high risk premiums on interest rates. Provided that the announced adjustment measures are judged credible by financial markets -- i. e. they dispel fears of future monetisation of the public debt and, thus, rising inflation --, fiscal consolidation, especially in highly indebted countries saddled with high risk premiums, may entail a sizeable fall in long-term interest rates, which in turn stimulate investment and alleviate the debt service burden. Less restrictive monetary conditions and lower long-term interest rates will have a beneficial impact on investment and attenuate the impact on private consumption. This may well offset the direct impact of withdrawing the fiscal stimulus, even in the short run.

The "crowding-in" of investment is more likely to be encouraged, as is the case at present, by high levels of profitability and a progressive return to positive public savings contributes soundly to its financing. A rapid and substantial crowding-in of investment is essential not only in terms of expanding future productive capacities but also in terms of anchoring non-inflationary expectations.

Furthermore, through expectational effects, credible fiscal restraint may also exert a favourable impact on consumer behaviour. There is ample theoretical and empirical evidence that if budget retrenchment signals a permanent cut in government spending and taxes over the medium term, consumers tend to respond rapidly by decreasing their savings.

In broad terms therefore a credible package of consolidation measures may not have significant adverse short-term effects provided a number of factors are adequately taken into consideration. The consolidation process must be correctly timed, be non-piecemeal in its implementation with the order of priorities firmly oriented towards the expenditure side. In addition to these basic requirements, it is important that budgetary consolidation is perceived to constitute an element in an overall economic approach which is balanced and consistent. Under these circumstances the application of the overall economic approach would represent a type of "regime" change (see box 5).

2.3.4. Priority areas for consolidation

It is clear that trenchant medium-term fiscal consolidation efforts will require fundamental budgetary reforms which may provoke adverse political reactions. It is therefore crucial that the distribution of the necessary efforts is even-handed to ensure the required degree of social acceptability which is vital to the success of the overall adjustment exercise.

Although specific measures to be taken need to be tailored to situations in individual member countries, the primary task in virtually all member countries is, as stated in the 1995 Broad Economic Policy Guidelines, to promote fiscal consolidation by reducing structural deficits. Whilst in terms of actual budget deficits, the less favourable economic environment may hide the extent of the fiscal adjustment being undertaken, significant consolidation results should become apparent over the medium term as cyclical conditions improve.

It is widely recognised that controlling the growth of government expenditure is the preferred approach. The overall tax burden in the Community is already high, especially relative to its major partner countries, and tax increases would imply raising their distortionary effects. Furthermore, there is widespread and strong political resistance to higher taxation. Conversely, actions aimed at containing the increase in government expenditure, and also at restructuring the latter, could be accompanied by increased efficiency of the public sector. In a medium-term perspective, they would open the door for new and more productive initiatives, such as additional expenditure to combat long-term unemployment, to improve education or to reverse the downward trend in public investment. It will also increase the degree of preparedness to meet longer-term challenges linked to the ageing of the population which will inevitably put additional strains on an already stretched social spending budget. Finally, curtailing the share of government expenditure would create scope for a reduction in the overall tax burden once budget deficits are on a firmly declining path and close to balance.

Following several years of attempts at controlling government spending, but whose impact was offset by continuing 'snowball effects' and high and rising unemployment, little if any scope exists for easy and painless actions in most Member States. These countries face the more daunting task of fundamental reform of basic government expenditure programmes. Among the issues which need to be addressed are the need to place pension provisions on a sustainable footing, to curb the rise in health care costs, to reduce distortionary and costly subsidies, to increase the effectiveness of social transfers and to improve the functioning and efficiency of public services.

Finally, in countries with high budgetary imbalances, a drastic reduction in budget deficits without a certain rise in the tax burden appears unachievable. In this context, increasing indirect taxes may be preferable to direct taxes, as the distortionary effects are likely to be lower. Furthermore, member countries would also stand to gain from a broadening of the tax base, a reduction of excessively high marginal tax rates, modification of tax structures in ways which are likely to be conducive to growth and employment and introduction of measures designed to improve tax administration. Member countries should give particular attention to a reduction in employers' social contributions at the lower end of the wage scale and provide for alternative financing means or increased expenditure restraint in order not to endanger the overall goal of greater budgetary discipline.

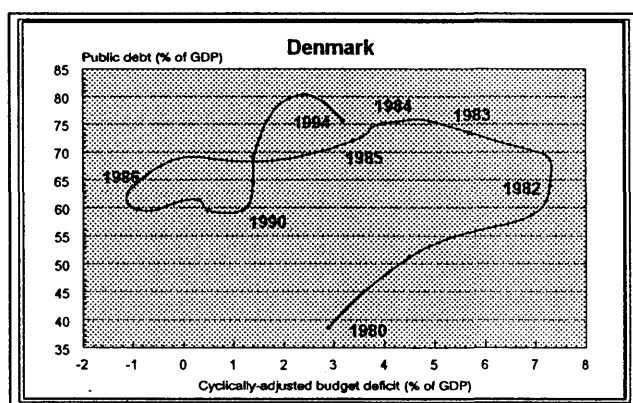
Box 5: Examples of successful fiscal consolidation efforts

There is broad consensus within the Community on the need for fiscal consolidation and all governments have committed themselves to policies of medium-term fiscal consolidation. While subscribing to the unambiguously positive, medium-term macroeconomic effects of credible efforts to reduce excessive budget deficits, many policy-makers fear that far-reaching fiscal retrenchment efforts will, in the short run, adversely impact on aggregate demand and thus jeopardise output growth and add to unemployment.

Recent economic analysis and historical evidence shows that this concern is not always justified, especially not in countries with excessively high budget deficits. Indeed, experience in a number of Member Countries during the 1980s suggests that major fiscal contraction can go hand in hand with high growth and strong job creation. The 1983 Danish fiscal adjustment program and the 1987 Irish deficit reduction program are two illustrative cases. Against a backdrop of poor economic performance, both countries implemented very demanding measures which proved to be very successful in reversing a steady trend of rapidly worsening budgetary positions while enjoying a substantial improvement in economic performance in the short run.

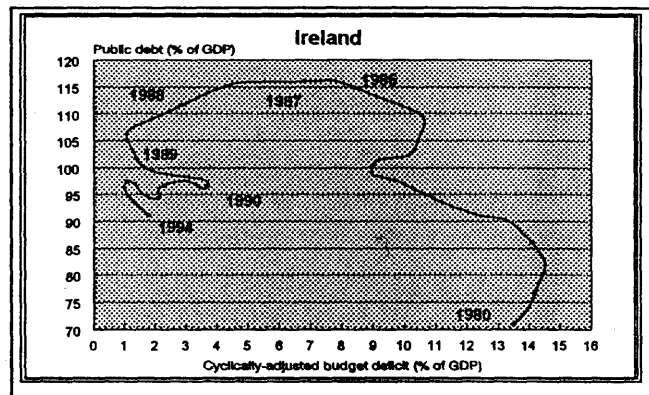
Over the period 1982-1986 Denmark transformed a deficit of 9.1 per cent of GDP into a surplus of 3.4 per cent of GDP, i.e. an improvement of 12.5 per cent of GDP. The credibility of the policy shift was reflected in a halving of the level of long-term interest rates and a marked fall in inflation. Rather than plunging the economy into recession, the fiscal adjustment was accompanied by a strong economic expansion, despite an unfavourable international environment in the initial phase. Over the period, real GDP growth averaged 3½ per cent, almost double the Community average. Growth was predominantly driven by the crowding-in of private spending; private consumption and, especially, investment expanded vigorously. As a result of buoyant economic activity, the rate of unemployment fell from 8.9 per cent in 1982 to 5.4 per cent in 1986. This prosperous episode came to a sudden end in the second half of the 1980s. Overheating and high pay rises, reflecting strained labour market conditions, led to a tightening of monetary policy and a relapse of expectations. This, in turn, resulted in a prolonged period of subdued growth, deteriorating public finances and rising unemployment.

Denmark					
	1982	1983	1984	1985	1986
Budget balance (% GDP)	-9.1	-7.2	-4.1	-2.0	3.4
Primary balance (% of GDP)	-3.1	0.9	5.5	7.8	12.2
Government debt (% of GDP)	63.9	73.4	75.1	72.0	63.7
GDP (real % p.a.)	3.0	2.5	4.4	4.3	3.6
Domestic demand (real % p.a.)	3.5	1.4	5.1	5.4	6.1
-of which investment (% p.a.)	7.1	1.9	12.9	12.6	17.1
Long term interest rate (%)	20.5	14.4	14.0	11.6	10.6
Inflation (% p.a.)	10.2	6.8	6.4	4.3	2.9
Employment (% p.a.)	0.2	0.7	2.9	2.6	4.3
Unemployment (%)	8.9	9.0	8.5	7.1	5.4



In Ireland, the 1987 budgetary adjustment plan led to a marked reduction in general government net borrowing from 10½ per cent of GDP in 1987 to 1.8 per cent of GDP in 1989, reflected in a 15 points large drop in the public debt-to-GDP ratio over the same period. The fiscal consolidation did not hamper high economic growth, as real GDP growth accelerated from virtual stagnation in 1986 to growth of 6 per cent in 1989. While improved competitiveness and positive external developments proved instrumental in spurring the marked turnaround both in terms of output and budgetary performance, the domestic economy also responded favourably to the policy shift with the preceding phase of deeply depressed domestic demand giving way to a substantial pick-up in investment and consumption. Furthermore, unemployment fell, albeit less significantly, from 16.6 per cent in 1987 to 14.7 per cent in 1989. A key feature of the Irish approach was that fiscal consolidation was assisted by an agreement with the social partners on a comprehensive adjustment plan in which the adherence to moderate wage increases was a crucial element. In contrast to the Danish experience, output growth remained buoyant in the subsequent period and the public debt ratio declined steadily, despite slowing fiscal consolidation efforts.

Ireland					
	1986	1987	1988	1989	1990
Budget balance (% GDP)	-10.6	-8.5	-4.4	-1.8	-2.3
Primary balance (% of GDP)	-1.4	0.8	4.2	6.0	5.5
Government debt (% of GDP)	114.9	116.0	111.6	101.7	96.5
GDP (real % p.a.)	0.3	4.7	4.3	6.1	7.8
Domestic demand (real % p.a.)	2.1	0.3	1.3	7.6	5.7
-of which investment (% p.a.)	0.0	-2.3	-1.6	13.8	11.1
Long term interest rate (%)	11.1	11.3	9.4	8.9	10.1
Inflation (% p.a.)	3.7	2.4	4.0	4.0	2.0
Employment (% p.a.)	0.2	0.8	0.0	-0.2	4.2
Unemployment (%)	16.8	16.6	16.1	14.7	13.4



However, success of fiscal consolidation efforts in Denmark and Ireland contrast with the experience of many other countries. Important features of both the Danish and Irish experiences, differentiating them from less successful ones, are:

- In both countries, fiscal retrenchment was part of a credible change in the economic policy regime. The regime change implied a renewed commitment to stable exchange rates and low inflation supported by budget consolidation and appropriate wage behaviour. Other factors were also at work (improved competitiveness position; liberalisation of capital movements) but undoubtedly the positive expectations effect of the policy shift enabled the economy to reap the benefits of these developments.
- Although the direct impact of slower public expenditure growth was clearly negative, important indirect effects, linked to the improvement in expectations, were evident in the substantial falls in long-term interest rates and a surge in private sector confidence.
- The distinction between the Danish and Irish experiences and other less successful retrenchment efforts is not simply the scale of adjustment undertaken but also the positive effects on private sector expectations attributable to a credible commitment to sustaining the budgetary adjustment into the medium-term. While there was some rise in the tax burden, the bulk of the adjustment was on controlling growth of public expending, which yielded positive expectations about a permanent decline in the share of government in the economy.

2.4. Wage developments

2.4.1. The appropriate wage trends

Whereas monetary policy is conducted by increasingly independent central banks and budgetary policy is determined by sovereign governments, the development of wages generally represents the outcome of negotiations between social partners. Nevertheless, wage trends are a key ingredient of macroeconomic and structural policies. The macroeconomic wage bill (including all social security contributions) is equivalent to about 50 per cent of Community GDP, broadly equalling the share of total government spending in the economy. Consequently, the evolution of aggregate wages and wage differentials has substantial implications for inflation, growth, employment and the employment-content of growth. In view of their economic importance, it is warranted that policy-makers, whilst fully respecting the autonomy of the social partners in this area, closely monitor wage developments and set the stage by concluding appropriate wage agreements in the public sector.

To help assess the appropriateness of wage developments, some broad signposts have been developed at the Community level in the framework of the surveillance of economic performance and policy. At the macroeconomic level, two issues are of particular concern. Firstly, it is of crucial importance that the perception of the expected rate of inflation which is embodied in wage settlements is, as much as possible, compatible with the price-stability objective of the central bank. If this is the case, wage developments *de facto* do not place an undue burden on the conduct of monetary policy. Conversely, if wages increase in a manner which is inconsistent with achieving and/or maintaining low inflation, a stability conflict arises of the type experienced during the early 1990s.

Secondly, as regards real wages, it is important that their evolution at the macroeconomic level takes into account the need for safeguarding, and if necessary improving, the profitability of investment. In this respect, the Commission, in its 1993 White Paper, put forward a rule of thumb: over the next few years, real wages should increase by about one percentage point less than overall labour productivity. The validity of such a rule is now widely accepted. It was embodied in the Council's Broad Guidelines of 1994 and the conclusions of the Essen European Council. This rule is based on both past experience and the realisation of the significance of enhanced investment profitability to the Community's medium-term conditions to foster a strong expansion of productive capacity and employment-creating growth. During the period 1982-89, which saw a steady restoration

in investment profitability, real wages increased on average by 1 percentage point per year less than productivity growth. This marked improvement in profitability contributed to the brisk expansion of investment, especially in equipment, and to the acceleration of actual and potential rates of growth during the second half of the 1980s.

Respecting this rule, in combination with employment growth, also allows for a sufficient increase in consumption and overall demand which is necessary for investment and to favour an appropriate balance between capital-widening and capital-deepening investment. Furthermore, adequate wage trends will contribute to the external cost competitiveness of the economy and positively affect entrepreneurial location decisions.

In this context, it is noteworthy that in the Community on average, the profit share already exceeds the level registered in the 1960s. However, this is necessary in order to compensate for the comparatively higher capital/output ratio. In the next few years, profitability may approximate the level reached during the quasi-full-employment period. But in view of huge capital needs and to offset the relatively higher level of real interest rates (compared to the levels prevailing during the 1960s), a further improvement in profitability is called for. Since average labour productivity is enhanced by the employment of a larger capital stock, the standard of living of workers will be positively affected over the medium term.

Obviously, for the development of employment, an adequate degree of wage differentiation is also highly relevant. However, policies should aim at lowering total wage costs at the lower end of the scale without reducing the *disposable* income of low-wage earners. In the pursuit of a higher level of employment, the results of wage settlements should provide for an appropriate differentiation across qualifications as well as geographical areas and sectors and firms. Market forces are pushing into this direction. But the interaction between tax and social benefit systems in many countries create an 'implicit wage floor', preventing a substantial downward adjustment of wages relative to productivity. A widening of the distribution at the lower end of the wage scale would increase the employment-content of growth but the scope for such action is limited by the social/political exigency to preserve the foundations of the European social model. The closer the link between wage and productivity levels of the particular working post, the more activities with below-average productivity could be (re-)introduced in the production process. It would make low-productivity activities profitable that were formerly either priced out of the official market or "transferred" to foreign low-wage producers. Similarly, it would help limit the process of substitution of parts of the workforce by capital investment.

Such a downward widening can be obtained in two manners. Market forces can be allowed to substantially lower the wages of low-skilled workers as has happened in the US. Taken to extremes, this option entails serious economic and social consequences ("working poor syndrome"). There are, however, possibilities for some widening in keeping with a reform of the European social model. Gross labour costs can be reduced by lowering employers' social contributions or by simultaneously lowering wages and taxes on low incomes without affecting net income. The first approach is currently being pursued in several Member Countries (including France, Belgium, Netherlands, Ireland and the UK). While some positive results are emerging at the national level, their size appears yet to be insufficient to perceive a noticeable macroeconomic influence at the Community level. To neutralize the impact on budget deficits and to avoid adverse economic side-effects, it is essential to carefully design such measures and to target them at the low end of the wage scale.

The requirement for an appropriate degree of wage flexibility has also significant **regional** aspects. In the Community, intense intra-regional trade links have been accompanied by a narrowing of regional divergences in wage and productivity *levels*. Nevertheless, wide discrepancies remain between Member States and regions in the levels of overall compensation per employee and disparities of broadly identical magnitudes exist in the levels of overall labour productivity. As a result, the levels of unit labour costs are similar across Member States. For the less-favoured regions in the Community to exploit fully their competitive advantage in terms of wages and non-wage labour costs, it is essential that increases in real wages relative to changes in productivity remain adequate. This should enable these regions to post a relatively more dynamic growth, productivity and employment path and would eventually enable relatively stronger increases in real wages, thereby advancing the catching-up process.

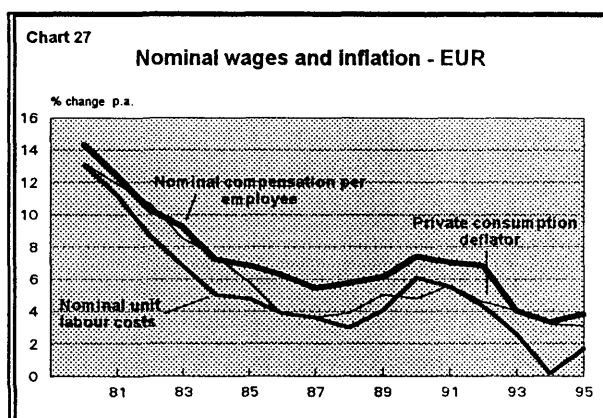
In the wage-profitability-investment-employment nexus, there is also a role for wages having a larger flexible and profit-related component. Such a flexibility is especially desirable at the **sector/firm** level in order to respond adequately to sectoral/firm specific changes in economic conditions. In this context, experience has indicated that in the absence of such flexibility, the adjustment to adverse shocks occurs through disproportionate losses in working posts.

These considerations stressing the need for appropriate wage behaviour are all the more pertinent in view of the ongoing deepening of European economic integration. Following

the full liberalisation of capital movements, investments are taking place in those geographical areas where the expected rate of return is highest. Although the latter is determined by several structural and microeconomic factors, wage developments are an important element. In EMU, with single monetary and exchange rate policies and overall reduced freedom in budgetary policy, the role of wages in response to changed economic situations will gain prominence. As a result, it will be essential that the social partners exhibit the necessary degree of flexibility in wage negotiations. All these issues constitute important topics for the dialogue between the social partners.

2.4.2. Wage adjustment in the EC since 1980

Over the past 15 years, the evolution of nominal wages in the Community has generally not only accompanied but also facilitated the remarkable disinflation process. As shown in chart 27, significant wage adjustments contributed quite strongly to the noticeable fall in inflation achieved during the protracted expansion phase of the 1980s. The rate of increase in nominal unit labour costs

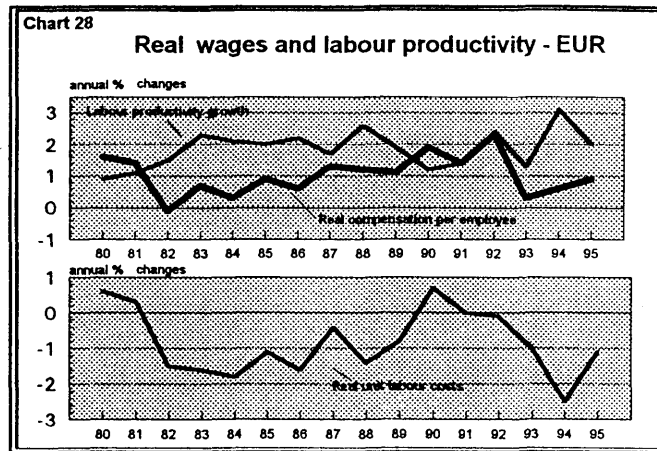


decelerated strongly from the beginning of the decade and was actually faster than the rate of inflation. The success in adjusting wage trends during the period 1980-89 was all the more spectacular in the initial years as it occurred against an unfavourable background of strongly rising import prices.

It is only towards the end of the 1980s that the promising trend of moderating wage increases came to a halt and wage behaviour became clearly incompatible with the monetary authorities' stability objective in the period 1990-92. The policy-induced overheating of the Community economy in 1988-89 led to a marked pick-up in inflation and inflation expectations. Wage trends reacted to the accelerating rate of inflation, albeit with a certain lag: nominal wages per head accelerated to 7.4 per cent in 1990 against 5.4 per cent in 1987. In the light of these developments, monetary policy was tightened as from late 1988 and became very tight in 1991-92. The stability conflict was exacerbated by the post-unification boom in West Germany which generated bottlenecks in the labour market and entailed steep wage increases. The period since 1993 has generally seen a substantial improvement in wage behaviour. Nominal wage increases decelerated

considerably and assisted the resumption of the trend towards price stability in the Community.

The long-term macroeconomic evolution of real wages in relation to labour productivity and investment profitability shows a similar pattern as the nominal indicators. During the 1980s, increases in real wages, while remaining positive, fell clearly short of labour productivity growth, resulting in a substantial decline in real unit labour costs. This



conspicuous wage development was a key factor behind the boost in investment profitability which rose steadily from the low point reached in 1980 of about 65 per cent of the average over the period 1961-73 to close to 90 per cent in 1989 (see chart 6 in chapter 1). This improvement was interrupted during the slowdown of the early 1990s as real wages reacted with a certain time-lag to the cyclical deceleration in labour productivity growth. Nevertheless, due to the greater responsiveness of employment to economic trends, the deterioration was markedly smaller than in previous recessions. Noteworthy in this respect were developments in 1992 when growth in labour productivity exceeded its long-term trend because of strong labour shedding. Productivity gains thus obtained should not be distributed to those who keep their employment. Over the last two years, wage trends were again generally in line with the Council's recommendation in the Broad Economic Policy Guidelines. The rapid expansion of output and the impact of restructuring measures have resulted in labour productivity growth in excess of real wages, albeit also accelerating. This laid the grounds for a renewed recovery in investment profitability from 1994 onwards.

With respect to an increased flexibility of the labour market in relation to unemployment, empirical evidence seems to suggest that in the first half of the 1980s wage flexibility in the Community deteriorated, but stabilised thereafter. In terms of the differentiation of wages, there is no clear picture for the Community. While in France and the UK there is a clear trend towards an increased earnings dispersion in the 1980s, the latter stayed almost unchanged in Italy and decreased somewhat in Germany⁵.

⁵ Based on figures published in "The OECD jobs study, Implementing the strategy", 1995, p. 14

2.4.3. Expected wage developments

Following a slight acceleration last year from the low rate registered in 1994, nominal wages are assumed, according to the Commission's November 1995 forecast, to increase by about 3¾ per cent this year and next in the Community on average. Real wages might pick up to 1 per cent following two years of virtual stagnation whereas labour productivity growth is expected to return to its long-term trend of around 2 per cent. These recent and prospective developments suggest that from a macroeconomic perspective wage behaviour in the Community on average is appropriate and set to contribute positively to the achievement and maintenance of price stability, to the generation of a high, employment-creating growth path and to the improvement in the Community's external competitive position. Given a long-term trend in annual productivity growth of 2 per cent in the Community on average, the Broad Guidelines in effect suggest that growth in nominal compensation of employees per head of the order of 3½ per cent in the Community on average may be considered compatible with the intermediate price inflation target of 2-3 per cent, as a step towards stability, with the need for a continuing improvement in investment profitability and with the necessity to ensure an adequate expansion of domestic demand.

Although in most Member Countries wage developments are in keeping with the objectives of price stability and a further restoration of investment profitability, some important, country-specific, trends are discernible. In some countries where inflation is already low, relatively subdued demand and, more importantly, the competitiveness losses associated with currency appreciation, have limited the extent to which wage and unit labour costs can be passed on to prices. This is particularly the case in Germany where the relatively high pay settlements at the beginning of last year and the strong effective appreciation of the DM led to a significant squeeze of profit margins in export sectors. Obviously, wage trends cannot adjust instantaneously to movements in exchange rates and in case of a clear overshooting, a market-induced correction of exchange rates is certainly the most desirable option. Still, in order to safeguard the country's competitive position and its attractiveness for private sector investment decisions, it is essential in Germany, but also in some other countries, to contain pay settlements whilst at the same time implementing measures to enhance productivity and employment. Proposals of this type are currently being discussed in some countries by the social partners, sometimes in concertation with the government.

Conversely, in some depreciating countries, like Spain and Italy, the actual rate of inflation turned out to be higher than the targeted rate of inflation incorporated in the pay

settlements last year. This resulted in a fall in real wages for the second consecutive year. According to the forecasts, nominal wage increases might accelerate somewhat to the 4½ to 5 per cent range. In both countries, it is essential that workers do not seek to catch up on previous years' losses in purchasing power through higher pay claims as this would risk fuelling a price/wage spiral. Instead, continuing adequate wage behaviour in combination with credible fiscal rectitude should engender an appreciation of these currencies, thereby lessening (imported) inflationary pressures. Such an evolution seems to take place in Spain and Italy and such a policy mix was successfully implemented in Sweden last year. In the latter country, however, forecasted wage settlements for this year seem to embody a marked acceleration in the rate of increase of nominal wages which risks being in conflict with the stability objective and which allied with the considerable appreciation of the Krona may threaten its external competitive position. Finally, in a few other Member Countries, for instance Greece, the disinflation process is far from being completed.

2.5. Structural policies

2.5.1. Vital complement to macroeconomic policy-mix

The objective of setting in place the desired macroeconomic policy mix, described in previous sections, is essentially twofold: firstly, to overcome the present pause in the recovery and secondly to firmly re-establish the Community's economy on a robust medium-term growth path. With regard to the latter objective, macroeconomic policies provide the essential framework within which such a strong traditional growth process underpinned by capacity and employment-creating investment can develop. This is needed to ensure a significant increase in both the effective and potential rates of growth in the Community. Assuming the maintenance of trend productivity growth of the order of 2 per cent, this would allow for strong employment creation. However, for such a growth process to be sustained and thus to allow for strong employment creation, macroeconomic policies must be accompanied and supported by structural measures in both the goods and services markets and in the area of labour market reform.

Structural policies are crucial to the success of the Community's growth and employment strategy for essentially three reasons. Firstly, structural policies create the conditions necessary for a higher rate of economic expansion without the early appearance of adverse inflationary pressures. Secondly, they help to increase the endogenous growth forces by ameliorating the efficiency and overall competitiveness of the economy. Thirdly, they play a crucial role in improving the employment content of growth and reducing structural

unemployment. Furthermore, structural policies must also take into account the need to preserve a healthy environment.

- (i) *To ensure a tension-free macroeconomic growth process* -- Well functioning product and service markets contribute to achieving higher growth and employment by allowing relative prices to adjust swiftly to changing economic conditions. Furthermore, the economic merit of actions geared towards increasing the flexibility of labour markets is related to their contribution to avoiding labour market bottlenecks and a resumption of wage inflation as unemployment comes down. As such, they are crucial to help reduce the NAIRU. Indeed, measures aimed at improving the transparency of labour markets, at enhancing flexibility in the areas of professional and geographical mobility or at retraining target groups hit by exclusion or industrial restructuring facilitate the re-absorption of unemployed workers when the demand for labour resumes. Some measures have already been introduced in these areas at the national level, backed up by Community programmes in the context of the Structural Funds. Such measures, however, do not in themselves engender new jobs.
- (ii) *To reinforce the Community's endogenous growth forces* -- Specific measures directed towards enhancing competitiveness and innovation will underpin strong advancements in terms of productivity and consequently real standards of living and wealth. Indeed, policies aimed at fully exploiting the potential of the internal market, reinforcing competition, fostering investment in new technologies, accelerating the realisation of trans-European infrastructure networks, stimulating SMEs, raising the quality of human capital, and furthering investment in weaker regions, all have in common the objective of reinforcing the endogenous growth forces of the Community's economy via increases in overall productivity. Taken as a whole, these policies could, according to the new growth theories, lead to an acceleration in the Community's rate of growth through an enhancement of the overall productivity of its economic structure.

The *net* employment effects of these policies will ultimately depend on the smoothness of the inter-sectoral redistribution of productivity gains and developments in terms of labour demand (see box 6). For this process to operate effectively, relative price movements must be permitted to operate flexibly, the sectoral changes implied by this process must command a large degree of economic and social acceptability and finally growth must be sufficiently high as to ensure a positive net balance in terms of job creation across the sectors. Therefore, to bear fruit in terms of *net* employment, the

Box 6: Productivity and employment growth

As stressed in the White Paper on "Growth, competitiveness and employment" and by the Social Partners, there is no contradiction between initiatives to enhance productivity growth and *net* employment creation provided that the wealth created by the sectors with high-productivity increases is adequately redistributed within the economy, enabling sectors with low productivity growth to create new jobs. One important channel of redistribution of productivity gains is decreasing relative prices in sectors with high productivity growth, increasing the purchasing power for all consumers, and thus demand for products and services in general, and especially in employment-intensive sectors with low productivity growth and increasing relative prices. As is shown in the table below, such a mechanism has worked well during the 1960s and in 1986-90 in the Community.

Employment, productivity and relative prices in main sectors (EUR5, in % per year) ^a						
Indicator	Period	Total	Agriculture	Industry	Market services	Non-market services
Value added	1961-73	4.9	1.8	5.5	5.6	3.7
	1974-85	2.1	1.7	1.0	3.5	2.3
	1986-90	3.1	1.7	2.4	4.0	1.4
Employment	1961-73	0.3	-4.6	0.5	1.6	2.2
	1974-85	0.2	-2.9	-1.4	1.7	2.0
	1986-90	1.0	-3.1	0.3	2.4	1.0
Productivity	1961-73	4.6	6.5	5.0	4.0	1.5
	1974-85	1.9	4.7	2.4	1.5	0.3
	1986-90	2.1	4.9	2.1	1.6	0.4
Relative price	1961-73	--	-0.4	-1.0	0.7	3.4
	1974-85	--	-2.5	-0.4	0.5	3.5
	1986-90	--	-2.0	-0.4	0.4	2.9

a) Comparable data over the whole period are only available for B, D, F, I and NL.
Source: Eurostat and Commission services.

For such a process to work effectively, three essential conditions must be met simultaneously:

- *relative product prices* between sector must be allowed to change in the right direction without artificial rigidities. The full working of the internal market and the achievement of convergence together with the pressure of international competition in a more open world economy are ensuring that the required flexibility of markets is maintained and strengthened throughout the Union. There is statistical evidence that this process has been and continues to be at work;
- *sectoral changes* need to be economically justified and socially acceptable. Also concerning the process of sectoral change there is clear evidence that it is going on strongly. Progress in the five key areas identified by the Essen European Council, especially the re-direction of labour market policies from passive income support to more active measures, such as reforms and strengthening of education and training systems, are underway and will be instrumental in supporting such processes of change, while cushioning the possible adverse social costs;
- and, above all, the *rate of growth* must be high enough to maintain a positive balance between job creation and job destruction across sectors. If this is the case, this process will give an important contribution to the achievement of the employment targets of the Union. At present the growth condition is not fulfilled, underlining the need for a firm and credible implementation of the policies agreed upon in the Broad Economic Policy Guidelines.

newly created competitive and productivity potential must be exploited by effective high rates of growth. If the latter is not the case, efforts targeted at the labour market will lead to frustration amongst the higher skilled groups while human capital continues to be destroyed by long-term unemployment.

- (iii) *To increase the employment-content of growth* -- The achievement of a higher labour content of growth essentially means that more jobs will be created for a given growth rate of GDP. Such an outcome implies, in statistical terms, that the growth of the overall apparent productivity of labour will become slower. It is self-evident, of course, that this outcome should not be achieved by negatively influencing productivity at the firm or sector level. Theoretically, the employment-content of growth may be increased by a macroeconomic evolution of *relative factor prices* which favours the use of labour with respect to capital. Such a development of relative factor prices stimulates in the first place, via increased profitability, the traditional growth process driven by capacity-enhancing and employment-creating investment. Yet, this is likely to take a considerable time to have a noticeable impact on the employment-content of growth.

Apart from this macroeconomic substitution process, increasing the employment-content of growth rests essentially on a widening of the wage scale and changes in the field of working time and work organisation. In the European social model the first option can only be realised to a limited extent by reducing net wage income at the lower end of the wage scale (see above). A more promising way is by lowering non-wage labour costs for this category. The second approach of a higher flexibility in working time arrangements -- which can be combined in some cases with a reduction in working time -- if tailored to the specific needs of enterprises and individuals, will achieve a better utilisation of fixed capital and stimulate both new jobs and higher participation in the labour market. In addition to these two approaches, the promotion of local and regional initiatives, for example in the fields of social services could contribute considerably to an increase in the labour-content of growth. This also applies to environmental protection industries and services, where job creation has been much higher than in the rest of the economy.

There are thus ways to achieve a higher labour content of growth without calling into question fundamental social values. In implementing these measures, caution must be exercised to ensure that they are neutral in terms of costs and government budgets. Under these assumptions, it is clear that the introduction of these measures has substantial employment potential. They are used to varying degrees in the Member States. However, the scale of the measures currently taken is still too small to ensure significant results at the Community level.

Box 7 : The Community in the world economy

The world economy is becoming increasingly "globalised". Trade integration among industrialised countries continues to rise and emerging economies in Asia and in Central and Eastern Europe are becoming increasingly important trading partners. In addition, international capital flows have become more mobile and both financial and foreign direct investment flows have risen markedly (although gross flows have risen strongly, this does not in general apply to *net* capital flows, as mirrored in current account balances). The globalisation of markets has been driven by progress in transportation and communication technology, liberalisation of trade and investment, and by changes in enterprise organization and strategy⁶.

	1970-79	1980-89	1990-95
World Trade ^{a)}	7	4½	6
World GDP	4	3½	2½
EC GDP	3.4	2.2	1.7

a) Average of exports and imports of goods

These developments play an important role for the Community economy. Currently, extra-EC exports of goods and services account for about 10 per cent of Community output (EUR15). The share in GDP has increased only modestly over the last two decades, but since prices on internationally traded products have risen slower than the overall price level, this

masks the fact that international trade has expanded at a considerably higher pace in volume terms than overall output growth.

The Community is a major participant in world trade. Table B7.2 shows that the Community's share in world merchandise exports (excluding intra-EC trade) remains high at 23 per cent, but since the early 1970s, this share has declined somewhat. This fall is to some extent explained by a comparatively low share of Community exports in strong-

	1972-74	1982-84	1992-94
EUR12	25.3	23.2	23.5
US	19.0	17.6	18.4
Japan	10.6	12.5	14.2
DAE ^{b)}	5.6	10.9	15.1
World	100.0	100.0	100.0

a) Exports; world and EC trade excludes intra-EC trade
b) Dynamic Asian Economies

demand, high-technology sectors relative to the US and Japan (26 per cent of total exports in the EC versus 30 per cent in the US and 35 per cent in Japan⁷). In addition, the Community has a comparatively low share of exports directed towards markets which have been growing fast, partly due to geographical

factors. For example, exports to Japan, the NICs and China, where import growth rates would appear to be particularly promising over the medium term, represent only 14 per cent of extra-EC exports, against 23 per cent in the US and 27 per cent in Japan⁷. However, the Community is well placed to benefit from the expected strong growth of trade with Central and Eastern European countries (CEEC) in coming years. In 1994, around 9 per cent of extra-EC exports (EUR12) were directed towards CEEC and the former Soviet Union, and such exports expanded by around 15 to 20 per cent per year in 1994-95 (in value terms).

⁶ It is worth recalling that internationalisation of the economies, as measured by the share of trade in overall GDP, for many countries is no greater today than before 1914 during the period of liberal trade and fixed exchange rates under the gold standard. In a similar vein, capital mobility, in terms of net flows, do not appear to be higher today than it was at that time.

⁷ "European Competitiveness in the Triad", Note for the attention of the EPC, Commission services 1995.

Table B6.3 Foreign direct investment flows, EUR12 (billion ECU)			
	1984	1989	1993
Inward FDI	6.2	27.9	21.0
- from OECD	5.0	23.0	16.0
- from US	3.0	9.8	9.0
- from Japan	0.4	4.4	1.7
Outward FDI	17.4	33.3	21.9
- to OECD	13.0	26.8	13.4
- to US	11.5	24.1	10.2
- to Japan	0.3	0.7	-1.2
- to rest of Asia	n.a.	n.a.	1.8
- to CEEC	n.a.	n.a.	2.4
Net inflow	-11.2	-5.4	-0.8

Source: Eurostat. FDI excluding reinvested earnings.

Increased trade has been paralleled by increased foreign direct investment. In the second half of the 1980's there was a marked rise in both inward and outgoing FDI for the Community. Foreign investment in the EC rose vigorously as foreign investors sought to prepare for the internal market, and the Community's net outflow of FDI was substantially reduced. From 1989 to 1993, the latest year for which data are available, both inward and outgoing FDI flows fell back somewhat under the impact of the economic slowdown, but the level remained relatively high in a historical perspective. FDI flows were largely in balance for the Community (EUR12) as a whole in 1993.

At least until recently, most outward investment flows have been directed towards other industrialised countries with a secondary role played by investment in low-wage countries. In most sectors outward FDI takes place mainly to gain access to local markets for goods and services. Services sectors -- in many of which firms are required to have a physical presence in the local market -- account for a share of outward FDI almost as large as the manufacturing sector. Outward FDI in low-wage countries represent only a marginal, though growing fraction of domestic investment in the EC.

While there is broad agreement that the Community economy, as well as its partners, stand to gain in overall terms from increased international integration, there remains a concern that particular groups within the Community may lose out (unless they are, in one way or another being compensated). In particular, the downward pressure on low-skilled wages and/or the rising unemployment among low-skilled labour in most European countries has been attributed to the increased competition from low-wage countries. However, it is very difficult to separate the effects of increased international trade from the effects of technological changes which also appears to have reduced demand for unskilled labour. Recent studies have not been able to offer conclusive evidence on the magnitude of these effects. One recent review of the available evidence has concluded that competition from low-wage economies has had a negative impact on EC employment in some sectors, but that it is not particularly large. It may well be off-set by rising employment in other sectors. Trade with developed economies has in general had larger positive and/or negative effects. In the EU, with the exception of the UK, rising import penetration from low-wage competitors has resulted in falling employment among low-skilled labour, whereas in the US and the UK, it has resulted in lower wages for manual labour.

For the Community, active participation in the globalisation process is an essential means of achieving a continued improvement in living standards as well as better overall job opportunities. However, in order to reap the full benefits of such international integration, rigorous and extensive action is called for in the Community to facilitate structural adjustments as well as retraining efforts.

(iv) *To generate environmentally sustainable economic growth* -- It is, by now, increasingly recognized that there is no simple linear relationship between economic growth and pressures on the environment. Although an increase in the production of goods and services would *a priori* lead to an increase in resource use and pollution, countervailing forces - like technical progress, structural change and increasing preferences for a clean environment - frequently tend to compensate for this increase. One can therefore say, provided that an appropriate policy framework is put in place, that there is no inherent conflict between economic development and the environment. In fact, in the long run, economic prosperity is likely to depend on a healthy environment.

One of the main conditions for a harmonious development of economic activity and the environment is, in line with the polluter pays principle, that market participants receive the right price signals. Only if market prices reflect not only private but also environmental costs will it be possible to reach a path of environmentally sustainable economic growth.

Although it has to be stressed that environmental policies should be pursued in their own right, environmental policies can make a positive contribution to employment creation. The main channel for employment gains to occur from environmental policies involves the use of revenues from taxes, which are introduced for environmental purposes, to compensate for reductions in social charges levied on essentially low-paid labour. Caution has to be applied both with respect to the size of these potential employment gains from such tax reform and with respect to the specific conditions that have to be fulfilled for reaping any such benefits. Overall, most of the available evidence suggests that well devised environmental policies could have positive employment effects, but that these are likely to be very moderate and will certainly not offer a complete solution to the present European unemployment problem. The energy sector can also assist economic growth and employment by becoming more competitive. The achievement of a single energy market through the integration of the gas and electricity sectors is the primary requirement in this respect.

Active labour market and education policies can improve the efficiency of the labour market by matching demand with supply of labour. In addition, by concentrating efforts in terms of enhancing the employability of workers, in particular for those groups trapped in the hard core of structural unemployment, structural reforms act to address some of the key factors contributing to social exclusion. These policies have therefore an important social dimension as they contribute to maintaining and reinforcing cohesion and social consensus in the Union.

An unprecedented pace of technological change, the emergence of new producers of traditional products and an acceleration in the process of globalisation are leading to fiercer competition in world-wide as well as domestic markets. This is, in turn, provoking fundamental sectoral, enterprise and skills-based changes in economies. The latter are moving swiftly towards a diversified, knowledge-based, pattern of production of goods and services with companies being organised in a less hierarchical and more decentralised manner leading to the generation of increasing opportunities for high-skilled jobs linked to the greater complexity of operations. While new opportunities are undoubtedly flowing from this process of structural change, the side-effect is that it also demands deep-seated changes not only in the work organisation but also in the skill levels needed.

This process of globalisation should not, however, be seen as a negative phenomenon since it ultimately generates a more efficient, world-wide, allocation of resources. It should also be stressed that the increased competition that globalisation inevitably brings should not be met by inappropriate calls for protectionist measures or for drastic cuts in wage levels. It should however be confronted by policies aimed at enhancing the Community's natural comparative advantages particularly in terms of having a highly skilled, highly educated, workforce. There is a clear link extending from multilateral trade liberalisation and increased market access for Community producers in third countries to better growth and employment opportunities in the Community. The Commission has recently set out a strategy for ensuring improved market access⁸, using to the full the WTO trade disciplines and rights while pursuing additional liberalisation efforts.

In conclusion therefore, it is clear that macroeconomic and structural policies should be applied in parallel in a climate of enhanced confidence and increased social consensus. This view is shared by the European Social Partners⁹. Without growth, structural policies are more difficult to implement and may even have undesired effects. Thus the policies designed to improve the operation of the markets in goods and services could result in increases in overall productivity without net job creation. Similarly, labour market policies can, for the most part, reach their objectives only if growth ensures that a sufficient number of actual jobs is created and provides the necessary financing capacity. At the same time, improvements in competitiveness and in the operation of the labour market are necessary to

⁸"The Global Challenge of International Trade: A Market Access Strategy for the European Union", Communication from the Commission 1996, COM(96) 53.

⁹"The Social Partners guidelines for turning recovery into a sustained and job-creating growth process". Joint Opinion elaborated by the Macroeconomic Group of the Social Dialogue, 16 May 1995.

maintain sustained growth in the medium term by limiting the risks of inflationary strains in producer prices and wages.

2.5.2. Initiatives taken in 1995 to improve the functioning of product markets

Implementing reforms aimed at strengthening the forces contributing to endogenous growth and at enhancing the dynamism and competitiveness of the Community economies has been reiterated with good reason in Community documents over the years. In this regard, the importance of *fully exploiting the opportunities provided by the internal market* has been particularly stressed. The Madrid European Council of December 1995, reaffirmed the importance it attaches to the completion of this, already highly successful, initiative by highlighting the need to introduce greater competition in many sectors in order to improve competitiveness with a view to job creation. With regard to Member States' implementation of Internal Market directives in this area, the global rate of transposition of such directives, as of 21 November 1995, was 93.2 percent with national performances ranging from rates of transposition of 87.8 percent to 99.1 percent. Problems in relation to transposition (i.e. delays in transposition, partial transposition, non-conformity) are being experienced in the following sectors: public procurement, insurance, free movement of people, new technologies and services/audio-visual, and intellectual and industrial property rights.

Efforts to ensure better conditions for the effective operation and *competitiveness of European enterprises* continued in 1995. In July 1995 the *independent expert group on legislative and administrative simplification* submitted its final report and the Commission agreed to present concrete measures to ensure that such a simplification process occurs. In this regard, the Madrid European Council referred to the Commission report on the independent experts group study and called upon the Commission to table its new proposals for the consolidation of Community law and asked the Council to act as soon as possible in this area. The Commission's action programme for industrial competitiveness was given Council support and the Commission nominated the *Competitiveness Advisory Group*, presided over by Mr. Ciampi, and consisting of high-level experts and industrialists. This latter group presented its report on competitiveness to the Madrid European Council with the latter instructing the Council to examine its recommendations.

As regards the *Information Society*, the Commission presented important initiatives in the area of telecommunications in 1995. The objective of these initiatives, which essentially

concerned infrastructures and the provision of universal services, was to ensure a greater liberalisation of the regulatory framework.

In relation to the key area of *SMEs*, the Madrid European Council took note of the Commission report on the role played by the latter as a source of jobs, growth and competitiveness. The Commission report stressed the need to simplify the administrative formalities impacting on SMEs, to remove obstacles affecting their operation in the internal market, to improve their financial environment and to ensure better access for SMEs to information, training and research. The European Council urged the Commission to act on their report as quickly as possible in order to put into practice its recommendations. In response to this request, the Commission expects to approve a new multi-annual programme for SMEs in March and submit it to the Council. Also the next integrated programme for SMEs is under preparation.

With regard to the *Trans-European networks (TENs)* some progress was made in 1995. In all areas -- transport, telecommunications and energy -- examination of the various proposals progressed. As regards the energy sector, a common position on the guidelines was adopted by the Council in June. The aim was twofold: to advance the development of the networks in general and to facilitate the realisation of the priority projects identified by the Essen European Council in December 1994. In the autumn, the Council formally adopted the Financial Regulation in relation to the financing of the TENs and under its provisions the Commission was able to decide, in December, on the co-financing of a number of feasibility studies in the area of energy. The Madrid European Council confirmed the essential role of TENs in enhancing competitiveness, job creation and the cohesion of the Union. It welcomed the progress recently achieved in this area and called upon the Council and the Parliament to complete the legislative framework rapidly. It urged Member States to give top priority to the effective implementation of projects and especially those identified as being of special importance. Lastly, the European Council requested the EcoFin Council to adopt, on a proposal from the Commission, the necessary decisions to complement the financial resources currently available for these networks. This proposal is expected to be submitted to the Council soon.

The *Structural and Cohesion Funds* continued to make an important contribution to the balanced development of the EU. In fact, ECU 22 billion was spent in the weaker regions under the *Structural Funds*, which concentrated on investment in productive capacity, physical infrastructure and human capital. Over ECU 2 billion was spent in the poorer

countries under the *Cohesion Funds*, divided between transport and environmental measures.

Finally, on the subject of the *environment*, the clear and decisive role which the Community is playing on the international stage in terms of environmental protection was welcomed by the Madrid European Council. With a view to putting economically efficient measures in place to help the Community fulfil its international commitments to stabilise emissions of greenhouse gases, the Commission presented a revised CO₂/energy tax draft Directive in May 1995. This draft Directive contained guidelines that will enable Member States to introduce CO₂/energy taxes at the national level which are compatible with Community legislation. Fair and efficient pricing approaches, also in other areas, are necessary to bring the Community on a sustainable development path. In December 1995, the Commission published a Green Paper aimed at launching a broad discussion on policy options for internalising the external costs of transport. In addition, financial incentives for demonstration projects promoting sustainable production techniques, land use development and other measures will be made available once the Council Regulation for LIFE II is adopted. Furthermore, the Commission announced in 1995 a pilot project on "Growth and Environment" to offer financial support, in the form of loan guarantees, to small firms carrying out investments that either contribute to energy savings or otherwise bring environmental improvements. Finally, the Commission issued, in December 1995, a White Paper on an *Energy Policy for the European Union*, highlighting market integration as the central, determining factor in the Community energy policy. The contribution that the energy sector can make towards enhancing the competitiveness of the European economy is to seek greater efficiency in the organisation of energy systems and more effective delivery of energy services. The White Paper proposes the building up of a cooperative approach by establishing a framework which supports dialogue, transparency and shared analysis of energy policy issues leading to the identification of common energy policy objectives.

2.5.3. Labour market reforms: More needs to be done

The creation of jobs and the fight against unemployment constitutes the primary economic and social goal of the European Community. In this regard, it is encouraging that, for the first time, the Community has a common employment strategy, based on a combination of a stability oriented macroeconomic policy, aimed at engendering higher rates of economic growth, and structural adjustment. Structural adjustment initiatives involve both continuing improvements in the functioning of product and service markets, along the lines

covered in 2.5.2., and labour market policies aimed at improving skills and competencies as well as promoting a higher degree of overall flexibility which is crucial for strengthening the economy's growth capacity.

While ascertaining the nature of the problem and outlining the correct policy approach to be adopted is an important element in terms of the overall solution, the greatest challenge is at the implementation phase. Following the broad employment strategy agreed by the *European Council in Essen* in December 1994, Member States have started to renew and enhance their existing employment policies along the lines of the five broad objectives agreed at the latter summit and fleshed out at Cannes in June 1995.

Since the launching of the Essen strategy a wide range of measures aimed at upgrading the skills of low-skilled workers, at reducing the overall costs of labour, at improving the efficiency of active labour market policies and at facilitating higher labour mobility have been introduced, to varying degrees, in a large number of Member States. A first assessment of the efforts undertaken was made by the Commission, the EcoFin Council, the Labour and Social Affairs Council and the Social Partners in preparation for the Madrid European Council in December 1995. These various reports highlighted that efforts made so far needed to be commended and recognised. Nevertheless, they stressed that labour market reforms would have to be pushed forward if a decisive improvement in the Community's employment situation was to be realised. With this in mind a number of areas for reform were singled out as needing to be pursued or strengthened at national level.

These recommendations were taken on board in the joint report submitted by the Council (EcoFin and Labour and Social Affairs) and the Commission to the *Madrid European Council* which approved the report and reaffirmed its determination to give the objective of job creation maximum priority in the European Union in the coming years. It expressed its pleasure with the way in which the Essen-strategy, based on close co-operation between all the interested parties, had been implemented in practice in 1995 and emphasised that this strategy would continue to provide the framework for Member States' multiannual programmes and for the development of their employment policy. Concretely, Member States were urged to prioritise the following areas of action in their multiannual employment programmes, applying the latter particularly to certain disadvantaged categories such as first time job-seekers, the long-term unemployed and unemployed women:

- additional training programmes, especially for the unemployed;

- making business strategies more flexible in areas such as the organisation of work and of working time;
- ensuring a pattern of non-wage labour costs which are appropriate to unemployment-reducing objectives;
- continuing the current wage restraint by linking it to productivity, as an essential element in promoting the intensive use of the factor of production labour;
- obtaining the maximum level of efficiency in social protection systems so that, while maintaining where possible the level attained, they never act as a disincentive to seeking work;
- pressing for adaptation of passive labour market policies, which act to protect the unemployed, into active job-creation measures;
- substantially improving the machinery for information-sharing between those providing and those seeking employment;
- promoting local employment initiatives.

Finally, the Madrid Council, requested the Council (EcoFin and Labour and Social Affairs) and the Commission to continuously monitor and assess Member States' progress in relation to the application of their multiannual employment programmes and to submit a second joint annual report for its December 1996 meeting. In this way the European Council reaffirmed its determination to ensure the continued success of its job creation strategy centred on the need to ensure a more employment-creating growth pattern backed up by structural reforms aimed at eliminating existing rigidities and achieving a more efficient operation of national and Community labour markets.

PART B

**ECONOMIC SITUATION AND POLICY ISSUES
IN THE INDIVIDUAL MEMBER STATES**

BELGIUM

Weak consumer expenditure slows down growth

In 1995, economic growth in Belgium is estimated at 1.9%, approximately $\frac{1}{4}$ of a percentage point lower than in 1994. After strong growth in economic activity in the last quarter of 1994 and the first of 1995, the level of economic activity decreased in the second and third quarters of 1995. The unemployment rate (Eurostat definition) rose in the whole year of 1995, from 10.0% in 1994 to 10.2%. In 1995, Belgium made significant progress towards nominal convergence: (i) inflation fell to 1½%, remaining amongst the lowest in the Union, and; (ii) the general government budget deficit declined from 5.3% of GDP in 1994 to an estimated 4½%.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.0	0.8	2.2	1.9 *
Total domestic demand (% change)	3.8	0.8	1.4	1.5 *
Employment (% change)	1.1	-0.6	-0.7	0.4 *
Unemployment rate (%)	8.7	7.6	10.0	10.2
Inflation (% change)	2.3	2.5	3.0	1.5
Balance of current account (% of GDP)	1.4	2.6	4.3	5.0

For definitions, see Table 2

Source: Commission's November 1995 forecasts

* Taking into account latest information

In 1995 real GDP decelerated from 2.2% in 1994 to 1.9%. Key factors in this have been the weakness in private consumption, which grew by just 1.4% in real terms in 1995 (virtually the same rate as in the previous year), and an estimated neutral contribution of stocks to economic growth (in 1994 changes in stocks had given a positive net contribution of 0.3%). Although the household saving rate fell in both 1994 and

1995, it remains at about 19% of disposable income, which is a relatively high level by European standards. The lack of dynamism of private consumption mainly reflects three factors: (i) slow growth in disposable income; (ii) unfavourable prospects for the labour market, and; (iii) the uncertainty surrounding additional fiscal tightening measures, together with the impact of the planned reform of the Social Security system.

Investment expenditure, particularly in the manufacturing sector, played a significant role in fostering economic growth in 1995. Investment of enterprises grew by about 5% in 1995, reflecting high capacity utilisation rates in the manufacturing industry since 1994, together with improved profitability. Residential construction is estimated to have increased by about 1% in 1995. The growth rate of exports in 1995 remained at around

the same level as in the previous year, notwithstanding the slowdown in foreign demand and the effective real appreciation of the Belgian franc. Wage moderation resulting from the real wage freeze in the private sector and the adoption of the so-called "health index" to adjust wages¹ should improve competitiveness.

Nominal convergence is progressing

The excellent monetary stability record of Belgium in recent years continued in 1995. The inflation rate (measured by the CPI) declined from 2.4% in 1994 to about 1½% in 1995, which is amongst the lowest rates in the Union. In 1996, inflation is projected to remain at a low level.

Table 2 Belgium: Economic policy indicators				
	1986-90	1991-93	1994	1995
Money growth (% change)		9.1	-4.8	
Government budget balance (% of GDP)	-7.2	-6.8	-5.3	-4.5
Gross government debt (% of GDP)	131.4	133.0	136.0*	133.8*
Nominal wages per head (% change)	3.8	5.7	4.9	2.7
Real wages per head (% change)	1.5	3.1	1.8	1.1

Source: Commission's November 1995 forecasts

* Taking into account latest information

Definitions

Unemployment rate: harmonized Eurostat definition, excluding Austria, for which OECD data is used.

Inflation rate: private consumption deflator.

Money growth: broad money (M2/M3).

Government budget balance: net lending/borrowing of general government.

Nominal wages: compensation of employees per head.

Real wages: nominal wages per head deflated by private consumption prices.

In 1995, significant progress was registered in reducing fiscal imbalances. The budget deficit fell from 5.3% of GDP in 1994 to an estimated 4½%, mainly reflecting the reduction in real primary spending of around ¼%, together with lower interest charges due both to lower interest rates and improved debt management techniques. The general government gross debt ratio declined for a second consecutive year, attaining 133.8% of GDP in 1995 (137.9% in 1993).

¹ These two measures were adopted in the framework of the "Global Plan" in November 1993. The "health-index" is the official CPI excluding tobacco, and alcohol products, petrol and diesel. Effectively, the "health-index" excludes from the CPI those products which are more directly affected by (increases in) excise taxation, thereby in practice partly severing the link between price increases and automatic wage indexation.

Since the introduction of the convergence programme in 1992, the government has adopted several fiscal packages. The 1996 Federal budget is the most recent set of measures, aiming to reduce the public deficit to 3% of GDP in 1996, with total savings amounting to BFR 118 billion (or 1.4% of GDP), of which about a third are non-recurrent measures. The general government deficit is projected to decrease from 4.5% in 1995 to nearly 3% in 1996.

Since the end of 1993, the Belgian franc has been amongst the strongest currencies of the EMS. In the course of 1995, the short-term interest rate differential against the DM has been progressively reduced and disappeared since the end of 1995. The long-term interest rate differential against the DM has also narrowed substantially. Interest rate developments reflect to a large extent an improved assessment of Belgium's economic fundamentals, and the enhanced credibility attached to the process of fiscal consolidation.

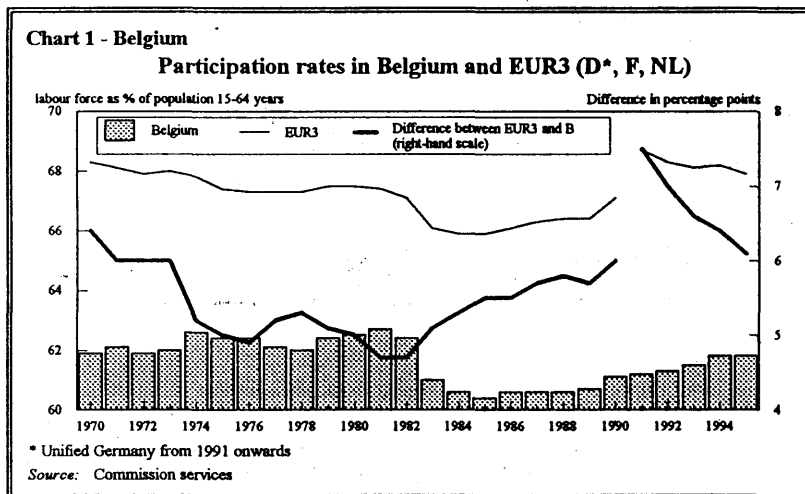
Labour market imbalances remain

Since 1993, Belgium has registered a significant surplus on the current account of the balance payments of over 4% of GDP. However, Belgium has lost price-competitiveness since 1990; between 1990 and 1995, relative unit labour costs expressed in a common currency deteriorated by nearly 13% against a group of 19 competitor countries. Given the appreciation trend of the nominal effective exchange rate associated with the "franc fort" policy, Belgium needs to keep the rise in its production costs below the average of its trading partners. This can be achieved either: (i) by having relatively lower increases in labour costs expressed in local currency, and/or, (ii) by achieving higher productivity gains.

Given the insufficient degree of wage moderation in the first half of the 1990s, Belgian enterprises are forced to increase labour productivity in order to remain competitive, adopting capital intensive techniques of production which are not conducive to job creation.

Between 1985 and 1995, output increased by about 25%, whereas employment rose by just 3½%. There is a window of opportunity to reassess labour market policies in 1996, given that the current real wage freeze comes to an end at the beginning of 1997, and

there seems to exist a wide social and political consensus on the need to revise the law on the "safeguard of competitiveness"².



Labour market participation is relatively low in Belgium, and the average duration of unemployment spells high. This suggests that there might be a correlation between the relatively generous eligibility rules

governing the various unemployment and career interruption schemes and the low degree of labour market participation. Measures aiming to reduce the attractiveness of non-participation could pay out a substantial reward in the medium to long term, reducing the imbalances in the labour market and easing the financing of Social Security.

The 1996 budget included a number of measures to stimulate employment creation, namely measures favouring work-sharing, temporary reductions in Social Security contributions for low-paid jobs, and measures targeted to some problem groups (e.g. young unemployed, long-term unemployed, etc.).

Belgium has achieved significant progress in recent years as regards nominal convergence. However, over the same period, important labour market imbalances have been building up, which require additional corrective measures to improve the functioning of the labour market and allow for a substantial reduction of unemployment in the medium-term.

² The law to "safeguard competitiveness" (31.1.1989) established a number of objective criteria to assess competitiveness developments and take appropriate corrective measures.

DENMARK

Strong growth, supported by a balanced economic policy

The recovery in Denmark started already in 1993, somewhat ahead of the other continental Member States, and strengthened in the following year in which output recorded a strong 4.4% rate of growth. 1995 was altogether again a year of good growth and continued decline of unemployment. During the year, however, the cyclical pattern became more similar to other European countries: growth was strong in the first months of 1995, but has weakened since then.

As in the majority of the other Member States, Danish fundamentals are sound and there is reason to believe that the current growth slowdown is a temporary one. Profitability is good, long and short-term interest rates are low and consumer confidence remains at a high level, all of which would point to renewed growth momentum.

Private consumption remained subdued in the second half of 1995. However, this should be seen on the background of very strong growth in 1994, and of relatively high real long-term interest rates which have stimulated savings.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	1.4	1.2	4.4	3.4
Total domestic demand (% change)	0.4	0.0	5.2	4.5
Employment (% change)	0.9	-1.1	-0.2	2.1
Unemployment rate (%)	6.4	9.2	8.2	6.7
Inflation (% change)	3.7	1.8	1.0	2.0
Balance of current account (% of GDP)	-2.1	2.2	2.0	1.5

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

Investment in equipment picked up strongly in 1995, mainly due to the high degree of capacity utilisation in industry and the good profitability in manufacturing. Construction, on the other hand, increased only modestly, given the high level of interest rates earlier in the year. Indicators for construction in late 1995 suggest a moderate pick-up. As previous investment has increased production capacity, and as incoming orders appear to have been stagnating, new investment in equipment may not have increased further in the second half of 1995.

	1986-90	1991-93	1994	1995
Money growth (% change)	6.3	6.8	-5.6	3.9
Government budget balance (% of GDP)	0.9	-3.2	-3.8	-2.0
Gross government debt ¹ (% of GDP)	60.7	71.3	75.6	73.6
Nominal wages per head (% change)	5.1	3.4	3.2	3.3
Real wages per head (% change)	1.4	1.6	2.2	1.3

For definitions, see Table 2 for Belgium

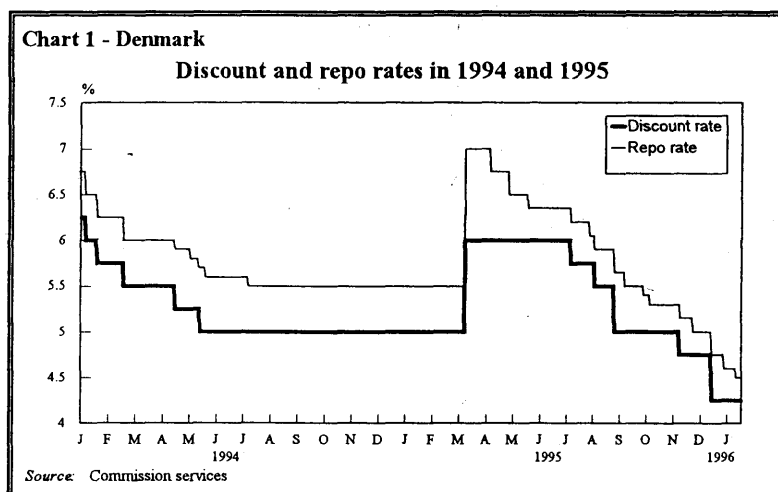
Source: Commission's November 1995 forecasts

¹ Government deposits with the central bank, government holdings of non-government bonds and public enterprise related debt amounted to some 23% of GDP in 1994

The weakened growth in major export markets has influenced Danish exports negatively and the Danish krone appreciation in the first half of 1995 may have depressed exports further. Imports moderated, compared with the double digit growth rate of 1994, and the current account surplus remained solid. Reduced interest payments on foreign debt due to declining foreign debt and lower interest rates contributed to this. The prospects for Danish exports

next year could be positively influenced by greater exchange rate stability while on the other hand growth prospects for export markets have worsened recently.

Despite strong growth and a sharp decrease in registered unemployment Danish inflation remains subdued. For 1995, consumer prices increased by 2%. The favourable inflation



performance may in part be explained by the appreciation of the Danish krone. Also, it seems that Danish wage settlements are adjusting to low Danish consumer price increases, thus reducing the risks of unfavourable wage/price developments.

While fiscal policy is being tightened, short and long-term interest rates have been decreasing, in line with those of most other countries (Chart 1). Key interest rates were increased in the Spring of 1995, as the Danish krone came under pressure. Since then, the krone along with the other core currencies has been appreciating against most other currencies and the monetary authorities, following international developments, decreased

the discount rate and other key interest rates. Long-term rates have also been decreasing in 1995.

Registered unemployment in Denmark had been increasing from 1987 onwards. The situation changed in 1994, when unemployment started decreasing. The favourable development in unemployment continued in 1995, as employment increased faster than the labour force and as active labour market measures (leave schemes, early retirement schemes and special job training or education) brought down registered unemployment further. The improved employment situation has not led to any sharp wage increases although the registered unemployment rate is now approaching the level which could lead to some inflationary pressures.

Continued fiscal tightening and structural reform

After having fought the 1992/93 recession with a temporary fiscal expansion, the Danish government has been tightening fiscal policy since 1995. This followed i.a. from the 1993 tax reform which is implemented over the period 1994-98, personal income taxes being to some extent replaced by environmental taxes. Discretionary budgetary measures together with strong automatic stabilisers have markedly improved public finances. In 1995, general government net borrowing of about 2% of GDP is estimated and the gross public debt ratio is likely to have continued its downward trend. The near-term outlook is for a continued reduction of the deficit and debt.

Structural policies, not least in view of the persisting high unemployment, remain very important. Throughout 1995, increased efforts were made to improve education and increase labour mobility in order to prevent labour market tensions. Further structural improvements are laid down in the 1996 budget, aiming at preventing youth unemployment, tightening unemployment benefit eligibility rules, improving state supported jobs and vocational training and creating jobs for elderly or handicapped persons. Also, the maximum period for which unemployment benefits can be received is reduced from 7 to 5 years. These highly needed structural measures will have full effect in the coming years.

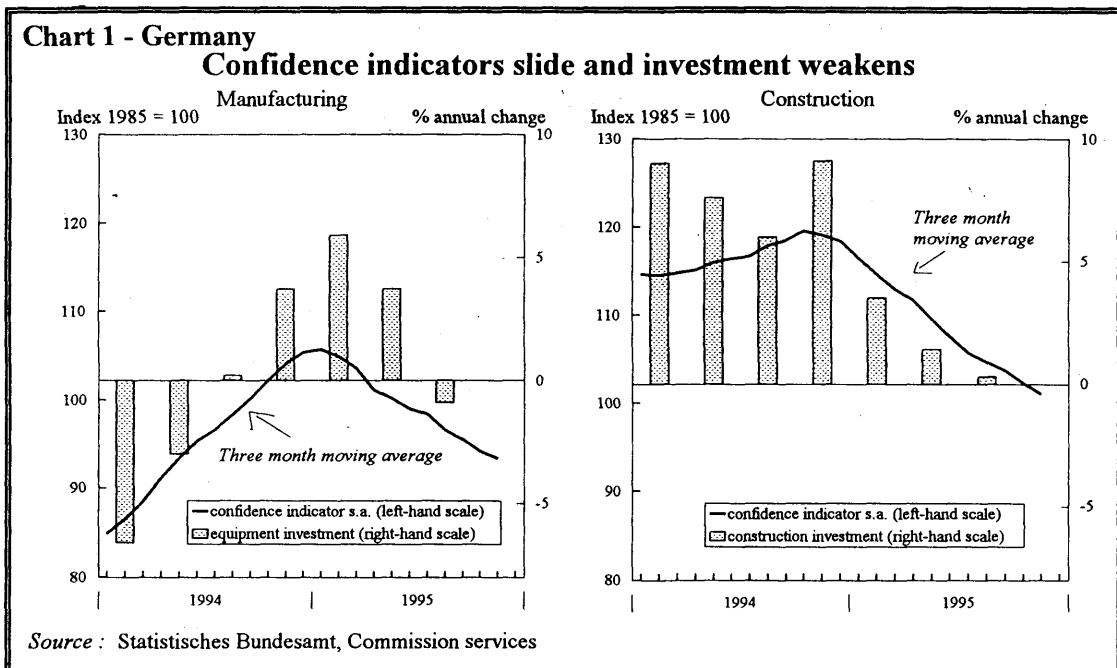
The fiscal tightening and the continued structural reforms constitute important policy measures which go in the right direction. However, an increased effort is needed to ensure a positive macroeconomic development over the medium term, particularly through increased labour market flexibility and education.

GERMANY

Slow-down in the pace of the recovery during 1995

In 1994, Germany came out of recession with a fairly strong recovery: GDP increased by 2.9%. The upswing was led mainly by buoyant growth in exports and investment, particularly in construction. The pace of the recovery slowed somewhat in the second half of 1994 and in a more pronounced way in 1995, so that economic growth reached about 2% in the latter year, significantly below initial expectations.

One of the main factors behind the deceleration was a gradual loss of drive in investment: while in the last quarter of 1994 fixed capital formation was still growing by almost 7% on the year, by the third quarter of 1995 it had fallen below the previous year's levels. Not only construction, but also equipment investment slowed, despite relatively high capacity utilisation. Exports, too, gradually decelerated, partly because of a weaker growth in export markets than had been the case in 1994. By contrast, domestic consumption, while not particularly dynamic, was on a slow upward path, after having been rather weak throughout 1994.



The cooling down of investment was preceded, at the beginning of the year, by a worsening of economic sentiment. Confidence in industry, which had reached high levels

in the preceding recovery, fell off dramatically after January 1995. In the construction sector, a slowdown had been widely anticipated, mainly owing to the phasing out of fiscal incentives (Chart 1).

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	:	:	2.9	1.9 *
Total domestic demand (% change)	:	:	2.8	1.8 *
Employment (% change)	:	:	-0.7	-0.2 *
Unemployment rate (%)	:	6.7	8.4	8.3
Inflation (% change)	:	:	2.7	2.0 *
Balance of current account (% of GDP)	:	-1.0	-1.3	-0.8 *

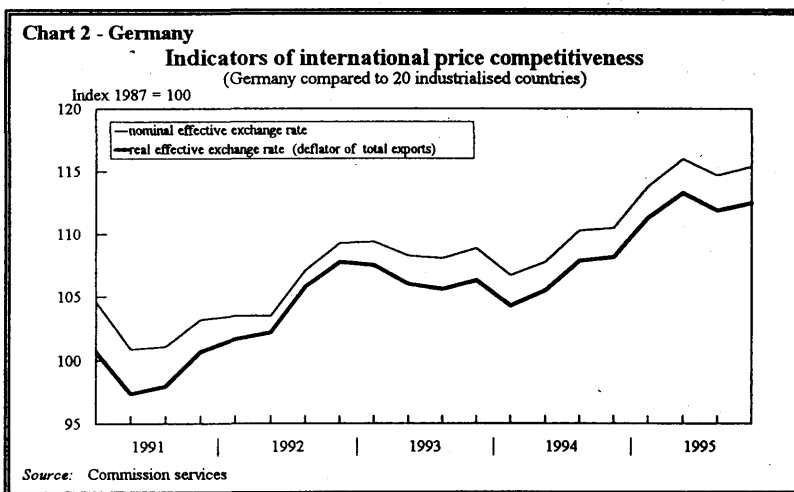
For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

The loss of confidence went together with renewed concern over German industrial competitiveness, already negatively affected by the preceding combination of a strong DM and high wage increases (Chart 2). Tough cost control, restructuring, extensive payroll cuts and wage moderation were starting to redress the trend in

1994; but then a revaluation of the DM in the summer of that year, relatively high wage increases at the beginning of 1995, and finally a further considerable DM appreciation in March 1995 significantly worsened the situation. By then, the DM's nominal effective exchange rate had risen 8.3% in twelve months³. On the domestic side, tax increases negatively affected sales prospects.



The deteriorating mood induced enterprises to be very cautious in hiring personnel. In west Germany, employment continued to slide longer after the beginning of the upswing than in the previous recovery. Overall, employment in

the year 1995 did not show any improvement over 1994: job creation in East Germany, due to rapid economic convergence, could not fully compensate for the losses in the

³ Effective rate vis-à-vis 18 industrial countries.

West. Unemployment gradually increased during the year. Despite weakening consumer confidence, the saving rate remained more or less unchanged.

By the end of the year, there were few signs of improvement, even if some sectors did show some indications of a more positive trend in the offing. Nevertheless, the deceleration observed during 1995 need not continue in the course of 1996. Several negative factors are set to fall away, or to diminish in importance, so that growth prospects should gradually improve during the year.

In particular, the strong decline in interest rates which occurred in the course of 1995

	1986-90	1991-93	1994	1995
Money growth (% change)	:	8.3	1.6	2.3
Government budget balance ¹ (% of GDP)	:	-3.2	-2.6	-3.6 *
Gross government debt (% of GDP)	:	44.6	50.2	58.8
Nominal wages per head (% change)	:	:	3.2	3.7 *
Real wages per head (% change)	:	:	0.5	1.7 *

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

¹ Unification related debt assumptions by the federal government in 1995 (Treuhand and eastern housing companies), equal to DM 235 bn (6.75% of GDP), are not included.

will stimulate the economy, just as the increase during 1994 was a factor behind the slow-down. Nominal short-term interest rates fell by more than 200 basis points during 1995 and real short-term rates are currently just above 2%. There are chances for a further easing in short-term rates. The appreciation of the DM seems to have come to an end, so that pressure from foreign competitors should also subside somewhat.

The Federal Government has acknowledged the current growth pause in its annual economic report and has reduced its growth expectations for 1996 to 1½%. The outlook assumes that activity will regain momentum in the course of 1996. Nevertheless, since the weak start to the year renders a higher annual growth performance unlikely, the government expects total employment to continue to fall and unemployment to rise further in 1996, to about 10% of the German workforce or almost 4 million.

The labour market situation has prompted the social partners, including the Federal government, to agree on a pact for employment. The ambitious goal to halve registered unemployment by the end of the decade was commonly agreed upon. To achieve this goal, decisive action is necessary to improve the supply-side conditions of the German

economy in the medium term and in its annual economic report the government presented a 50 point programme for this purpose.

East Germany: convergence advances, but deep-rooted problems persist

After having grown markedly in the years before, east German GDP advanced again strongly by 6% in 1995. Manufacturing output continued to rise even faster, as new or modernised plants began production, while the boom in construction, where activity had increased by 21% in 1994, petered out. In 1995, employment increased for the second consecutive year and unemployment fell again. Yet the latter has been edging higher since last summer, reflecting decelerating growth and less relief from labour market policy.

With eastern (nominal) unit labour costs still exceeding the west German level by about one third, little progress was achieved in 1995 with respect to cost competitiveness. Wage increases slowed, but productivity gains decelerated also. Factories are more diverse than elsewhere: some are technologically very advanced, able to cope with western wage rates, many are less productive, and have difficulties surviving even with lower eastern wages. One way to tackle this would be relatively low collectively agreed wages, leaving room for wage differentiation by means of a positive wage drift where circumstances permit.

The very weak eastern competitive position is still evident in various aspects. Although there is a rising number of modern plants, and east German exports to the EU increased by some 30% in 1995, eastern exports still account for only 2% of the German total, compared with a share of 11% of GDP. With the current average level of profitability it will take considerable time to converge to western patterns of distribution. Profits are still low and enterprises vulnerable to shocks. The region will continue to rely heavily on western transfers, which currently represent some 4½% of German GDP.

Public finances: no further consolidation in 1995

The general government net borrowing requirement amounted to 3.5% of GDP in 1993 and fell to 2.6% in 1994. In early 1995, the deficit was expected to decline further. Since

then, however, the deficit perspectives have deteriorated and the preliminary official borrowing figure for 1995 was 3.6%⁴.

This reversal was mainly due to disappointing revenues. Over and above the consequences of slower than expected growth in 1995, there were larger than previously estimated shortfalls in direct taxation linked to several special, mainly temporary factors, e.g. the impact of the 1993 recession on final tax bills settled last year. Nonetheless, the total tax to GDP ratio remained at an all time high of 43¾% of GDP, reflecting the re-introduction of the 7.5% solidarity surcharge on income taxes.

General government spending accelerated, particularly in social security. Health expenditures turned out more dynamic than expected and a new long-term care insurance was introduced. Yet outlays by territorial authorities fell short of initial plans. At the outset, the execution of the federal budget was delayed, owing to the October 1994 elections, and later, when revenue shortfalls became obvious, spending was handled restrictively on an ad hoc basis at all government levels. Given quickly rising interest charges due to debt assumptions, primary non social security spending barely rose in real terms.

Government debt rose to some 59% of GDP by the end of 1995. The assumption of Treuhand and eastern housing companies debts alone accounted for a 6¾ percentage points jump in the debt ratio. By now, unification-related liabilities which have partly been accruing off budget have by and large already been taken over by the federal government. They have contributed heavily to the rise in the debt ratio from just 41.5% back in 1991.

⁴ Figure released early in 1996 by the German authorities. It excludes debt assumptions from Treuhand and eastern housing companies amounting to 6.75% of GDP.

GREECE

Progress in macroeconomic adjustment in 1995

Macroeconomic trends in 1995 were marked by two key developments: progress in disinflation and, continued efforts to redress the fiscal imbalances. At the same time, real interest rates, while continuing to remain high, have shown some easing tendency and actual exchange-rate depreciation has been broadly consistent with the monetary policy objective of the Bank of Greece. In 1996, economic growth is expected to accelerate underpinned principally by strengthening domestic demand.

Economic activity in Greece started to recover in 1994, reflecting principally the contribution of an improving external economic environment, while domestic demand remained weak. Growth accelerated further in 1995. Domestic demand, and particularly gross fixed investment, began to strengthen, while private consumption remained flat. Public investment performed quite well, largely supported by Community Structural Funds. The recovery of domestic activity has also been accompanied by a modest widening of the deficit in the external accounts.

Table 1				
Greece - Macroeconomic performance				
	1986-90	1991-93	1994	1995
GDP growth rate (% change)	1.7	1.0	1.5	1.7
Total domestic demand (% change)	2.4	1.5	1.3	2.2
Employment (% change)	0.7	0.0	1.9	1.0
Unemployment rate (%)	6.6	7.8	8.9	8.9
Inflation (% change)	17.0	15.8	10.8	9.2
Balance of current account (% of GDP)	-4.8	-4.5	-2.6	-2.7

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

factors in this development have been the implementation of the 1994 tax bills, which led to a rise in direct tax revenues, and the decline in interest rates, which limited the growth of non-labour income. However, private consumption was supported by a fall in the saving rate, from 18.9% of gross disposable income in 1994 to 17.9% in 1995. This fall in the saving rate likely reflects the combined impact of the reduction in real interest rates and the partial resolution of tax uncertainty. Moreover, the situation in the labour market

Growth of private consumption spending, at 1.4% in volume terms in 1995, continued to remain weak, reflecting principally the modest growth in real incomes. Real wages grew by 0.5% in 1995, after growing at 1.3% in 1994. However, real disposable income remained virtually stagnant in 1995. Important

has started to improve; unemployment, which peaked during the recession, has stabilised at 9.5% of the labour force.

Greece's relatively high inflation has been on a downward trend since mid-1993, and for the first time in over twenty-two years the rate of consumer price inflation was in single digits through most of 1995. On the basis of the private consumption deflator, inflation averaged 9.2% in 1995, compared with an average of close to 16% in the first three years of the 1990s. The improving inflation performance has been supported by several factors: first, fiscal policy over the past two years has become gradually more restrictive than in previous years; secondly, the stance of monetary and exchange rate policy has been restrictive since 1991; consequently, imported inflation has been limited through successive reductions in the rate of depreciation of the drachma and the under-indexing of the inflation differential against Greece's Community partners has led to an appreciation of the real exchange rate; as a result, while this has contributed to shifting relative prices in favour of imports, it has also contributed to anchoring inflation expectations and, together with the progress in budgetary consolidation, it has imparted a disciplining effect on domestic price-setting behaviour; and, finally, the success in reducing actual inflation has likely restrained inflation expectations in the product and labour markets (in recent years, nominal wage agreements now extend over a two-year horizon and, together with clauses protecting against surprise inflation, have generally contributed to easing cost-push pressures on prices).

Table 2 Greece: Economic policy indicators				
	1986-90	1991-93	1994	1995
Money growth (% change)	21.1	13.9	8.9	10.4
Government budget balance (% of GDP)	-13.0	-11.7	-11.4	-9.3
Gross government debt (% of GDP)	66.6	97.1	113.0	114.4
Nominal wages per head (% change)	16.7	10.7	12.8	9.8
Real wages per head (% change)	-0.3	-4.4	1.8	0.6

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

With a disinflation strategy largely based on fiscal adjustment and on underindexing the depreciation of the drachma exchange rate to Greece's inflation differential vis-à-vis the ECU, the exchange rate objective has been supported by a positive sentiment about stabilisation and depreciation prospects. Following the successful response to averting an exchange rate crisis in mid-1994, which

was unleashed by the liberalisation of the remaining capital account restrictions, Greece's foreign currency reserves have risen to unprecedentedly high levels and large net autonomous capital inflows are supporting the external value of the drachma. At the end

of September 1995 Greece's reserves stood at USD 16.1 billion. The capital inflows have been largely sterilised to prevent the swelling of domestic liquidity above the objectives set by the Bank of Greece's monetary programme for 1995.

Real interest rates, which have displayed some easing tendency in 1995, continue to remain high. The continuing high level of inflation, as well as uncertainty about the durability of both the gains made on inflation and those made in budgetary consolidation, continue to underpin risk premia in interest rate determination.

Policies to address imbalances and promote convergence

Greece's budgetary imbalances have started to improve since 1994 when the central government budget targets were broadly realised. In 1995, the progress in reducing fiscal imbalances and in containing the growth of indebtedness continued. The deficit of the general government has been reduced from the peak so far this decade of 12.1% of GDP, recorded in 1993, to 9.3% of GDP in 1995⁵. Correspondingly, the primary balance has recorded surpluses since 1992; the deficit is expected to decline further in 1996, and the primary surplus to increase, compared to last year. However, budgetary policy continues to be circumscribed by large interest payments which in 1995 amounted to 13.4% of GDP and constituted almost 35% of total receipts of the general government.

The size of the interest bill reflects Greece's heavy indebtedness and the persistence of high interest rate on government debt. In spite of stubbornly high inflation, the debt ratio reached 114.4% of 1995 GDP, up from 82.6% in 1990. This large increase reflects principally the takeover of debt outside the general government into its accounts. It is clear that the primary surpluses recorded in recent years are not yet adequate to stabilise the debt ratio but only to contribute to a slowdown in the growth of the debt ratio.

Budgetary adjustment has relied on raising revenues through combating tax evasion, widening the tax base, and improving the efficiency of the tax mechanism, and also on restraining the growth of primary expenditure. Total current revenues of the general government have risen from 32% of GDP in 1990 to 36.4% of GDP in 1995, and much of this progress has taken place following the implementation of the April 1994 tax bills.

⁵ In the summer of 1995, the Greek authorities included the general government accounts items previously omitted or not fully accounted for; the revised data, which are used presently, have resulted in a lowering of the general government deficit dating back to 1992. The revision has not affected the pace of fiscal adjustment between 1993 and 1995 measured by the change in the deficit ratio, even though the level of the ratio is now lower by more than one percentage points in terms of GDP in 1993.

There has been less progress in restraining primary expenditure growth; primary spending represented almost 31% of GDP in 1995, up from 29.4% in 1992.

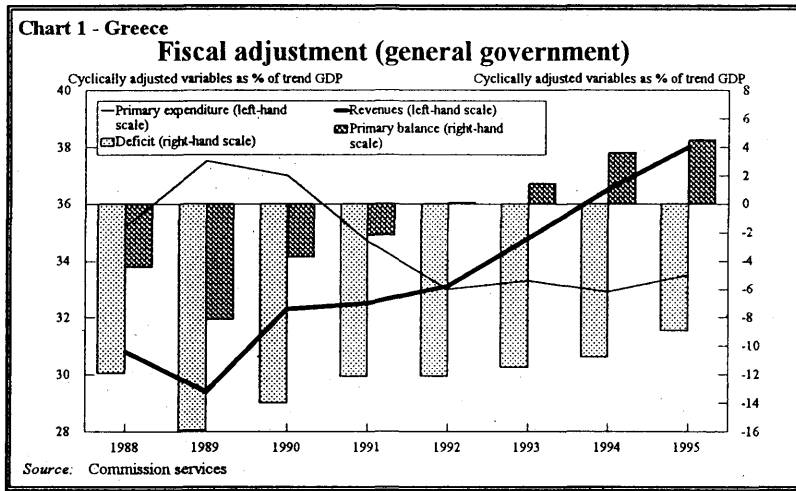


Chart 1 presents the composition of fiscal adjustment since the end of the past decade by comparing data on revenues and primary spending adjusted for cyclical fluctuations and reported as ratios of trend GDP; thus, the data may be

thought of as representing discretionary policy. The reduction in the primary deficit has been taking place since 1992 and it has been achieved principally through discretionary increases in the ratio of revenues to GDP which has risen from 32.3% of trend GDP in 1990 to 38.0% in 1995; on the other hand, cyclically adjusted primary spending has remained broadly stable at close to 34% of GDP.

The key policy issue is to secure and further the gains on inflation and on budgetary consolidation; these are key conditions for reductions in real interest rates and for fostering and sustaining economic growth. While progress has been made in relation to the Treaty convergence criteria in the past two years, the distance that needs to be covered requires that the adjustment policies must be pursued without fail.

SPAIN

Healthier economic recovery but surrounded by a number of uncertainties

Despite the deceleration in economic activity since the Spring, Spanish GDP rose in 1995 by 3%. Employment rose sharply in 1995 (2.7%) as a result of the economic growth, wage moderation and a more flexible labour market. Nevertheless, the unemployment rate fell only moderately because of an increase in the participation rate. Inflation resumed its downward trend in May 1995 whereas the general government deficit was in line with the convergence programme target in 1995. Although imports resumed faster growth than exports in 1995 the external accounts remained close to balance, partly as a result of the improvement in the terms of trade.

Economic activity in Spain, which has been growing continuously since mid-1993 began to decelerate in the second quarter of 1995. Despite this, after having risen 2% in 1994, GDP is estimated to have grown by 3.0% in 1995.

After two years of growth led by net exports, partly due to the peseta depreciation, in 1995 the engine of growth was domestic demand, whereas the external sector contributed negatively to GDP growth. The marked recovery in domestic demand in 1995 was based on a strong growth of investment, both in construction and equipment, while private consumption remained sluggish.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	4.5	0.6	2.1	3.0
Total domestic demand (% change)	6.6	-0.2	1.1	3.3
Employment (% change)	3.2	-2.1	-0.9	2.7 *
Unemployment rate (%)	18.9	19.2	24.3	22.7
Inflation (% change)	6.6	6.1	4.9	4.9
Balance of current account (% of GDP)	-1.3	-2.7	-1.2	-1.3

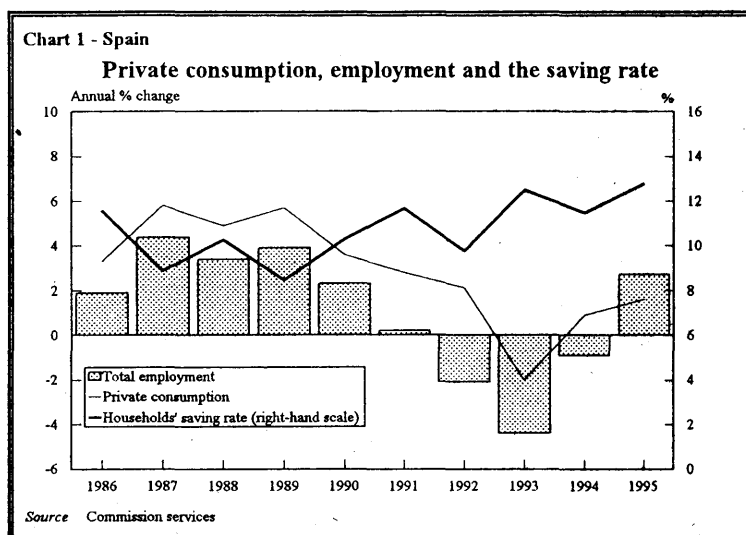
For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

After a cumulative fall of 14% in 1992 and 1993, investment began to recover in 1994 as a result of the pick-up in final demand, led at first by strong export growth, the improvement in business profitability, lower indebtedness of the non-financial enterprise sector and a higher capacity utilisation rate. However, given subdued private consumption and some deceleration in external demand

growth, investment began to decelerate in mid-1995.



Private consumption is assessed to have grown by 1.6% in 1995, a relatively low rate taking into account the sharp rise in employment (Chart 1) and in real gross disposable income (3.1%). The household saving ratio is estimated to have picked up to 12.8% in 1995, as a result of growing

uncertainty as to future income developments. This could be explained by lower job security, as a result of the 1994 labour market reform, memories of the sharp 1992-93 recession, tougher conditions for access to unemployment benefits and uncertainty as to the future of the pension system, also reflected in a boost of private pension systems. Hence, a major question mark as to the development of economic activity in Spain, as in other Member States, is associated with households' readiness to spend.

Exports and imports have been slowing down after the very sharp rises recorded in 1994. However exports have been decelerating more markedly than imports as a result of the

fading effects of the earlier peseta depreciation and the recovery in domestic demand.

	1986-90	1991-93	1994	1995
Money growth (% change)	14.5	7.5	7.6	8.8
Government budget balance (% of GDP)	-3.8	-5.5	-6.6	-5.9
Gross government debt (% of GDP)	44.1	51.5	63.0	64.8
Nominal wages per head (% change)	7.7	8.2	3.1	3.9
Real wages per head (% change)	1.0	2.0	-1.7	-0.9

For definitions, see Table 2 for Belgium.

Source: Commission's November 1995 forecasts

The Spanish external accounts improved significantly in the last few years as a consequence of the peseta depreciation in 1992-94 and the deeper recession in Spain than in the EU as a whole. The balance of goods and services shifted from a deficit of 3.2% of GDP in 1991 into balance in 1994. Although in

1995 real import growth once again outpaced the growth of real exports, an

improvement in the terms of trade allowed the balance of goods and services to remain in balance.

Employment rose substantially in 1995, as a consequence of the steady economic growth, wage moderation and a more flexible labour market, the two last factors having led to a lowering in the threshold of employment creation and the apparent productivity growth. However, the unemployment rate has fallen relatively moderately and has remained clearly above 20% in 1995 given the continuous rise in the activity rate, linked to a steady increase in women's participation in the labour market.

The general government deficit-to-GDP ratio is estimated to have been cut further to 5.9% in 1995 after 6.6% in 1994 and 7.5% in 1993. However, despite this reduction, the general government debt ratio still increased, though at a decelerating pace, to some 64% of GDP by the end of 1995.

There has been a deceleration in the CPI inflation rate (year-on-year) since May 1995. However, on average the inflation rate remained flat in 1995 as compared to 1994, mainly as a result of the impact of the January 1995 indirect tax rises which pushed up inflation in the first months of 1995. The downward trend in inflation is supported by moderate wage increases, a stable currency, a slowdown in import price growth and the anti-inflationary stance of the Bank of Spain.

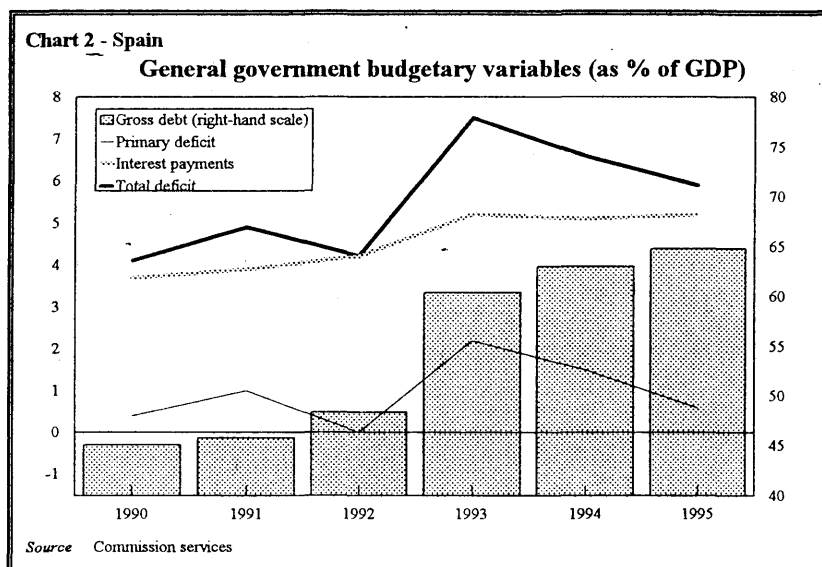
At the end of 1994, the Bank of Spain adopted a new monetary policy strategy incorporating a basic medium-term objective set in terms of the inflation rate, with exchange rate stability viewed as having especial relevance for the attainment of this objective. Indications of strong inflationary pressure led the Bank of Spain to raise interest rates by a total of 190 basis points during the first half of 1995. Improved inflation prospects in the second half of the year, together with the strength of the peseta, paved the way for a 25-basis-point reduction in interest rates in December. Long-term interest rate differentials with Germany narrowed somewhat during the year but remained at 390 basis points in December. Currency turbulence early in 1995 led to a sharp depreciation of the peseta culminating in a 7% devaluation of the peseta's ERM central parity on 6 March. The currency subsequently recovered against the DM, appreciating quickly towards its new central parity. In the last quarter of the year, the peseta strengthened further, moving progressively upwards in the ERM grid to finish the year as the second strongest currency in the grid.

The economic fundamentals now appear to provide a sounder base for steadier economic growth in Spain than in previous upturns, in particular that of the late 1980s. The recovery has been led by exports and investment and some room exists for stronger private consumption without major tensions showing up in the external accounts. A more flexible labour market which has also contributed to wage moderation has laid a better ground for more balanced economic growth.

The main uncertainties as to the strength of the recovery now have to do with the developments in external markets and the behaviour of consumers as reflected through the household saving ratio.

High public deficit and unemployment still the two main challenges

Economic policy in Spain has been guided by the 1994 revised convergence programme which aimed at complying with the EMU criteria through structural reform and a more balanced policy mix. Of key importance is the process of fiscal adjustment which should lead to a 3% general government deficit-to-GDP ratio in 1997.



The Spanish authorities have gained credibility by meeting their convergence programme/budget deficit targets in 1994 and in 1995. This has been mainly achieved through a cut in the primary deficit (which excludes interest

payments) as shown in Chart 2. Reversing the previous trend, current expenditure excluding interest payments was reduced from 39.1% of GDP in 1993 to 37.2% in 1995, more than compensating the fall in current receipts from 41.8% of GDP in 1993 to 40.7% in 1995.

However, fiscal adjustment was largely back-loaded to 1996 and 1997 along with the convergence programme. The draft budget law for 1996 targeted the deficit ratio included in the convergence programme: 4.4% of GDP, but it was voted against by Parliament. Hence, the 1995 budget law has been carried forward into 1996 with some fiscal adjustments, which should have a similar impact on the deficit as the draft budget law. In 1996 the budgetary savings are expected to lead to a primary surplus for the first time this decade. A strict compliance with the budgetary targets is essential to make it easier for interest rates to come down further and so, while boosting the economy, to curb the growing weight of interest payments, which already account for more than 5% of GDP.

Employment has been evolving very favourably since early 1994. Although its growth decelerated in 1995-Q4, total employment still rose in that quarter by 3.2% (year-on-year) and by 2.7% on average in the whole year. This has allowed an increase in the traditionally very low activity and employment rates. However, despite the improvements, the unemployment rate was still 22.8% in 1995-Q4 and the share of temporary jobs in total employment was 34.5%. In order to redress the large Spanish labour market imbalances, further reforms in product and services markets are called for, especially in sectors sheltered from competition, which can help reduce inflation and improve efficiency, output and employment.

FRANCE

Economic growth slows as domestic demand weakens

The French economy began to slow down early in 1995 before decelerating sharply, with GDP growth (year-on-year) falling from more than 4% in the first quarter to less than 1% in the last quarter. The very significant contribution of stocks to economic growth in 1994 had somewhat masked the lack of dynamism in the other components of domestic demand, which failed sufficiently to take up the running in 1995.

Table 1 France: Macroeconomic performance				
	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.2	0.2	2.7	2.8
Total domestic demand (% change)	3.8	-0.5	2.9	2.4
Employment (% change)	1.1	-0.5	0.1	1.2
Unemployment rate (%)	9.8	10.5	12.3	11.5
Inflation (% change) -	2.9	2.6	1.8	1.9
Balance of current account (% of GDP)	-0.3	0.2	1.1	1.4

For definitions, see Table 2 for Belgium
Source: Commission's November 1995 forecasts

Consumption has not regained momentum and the support measures taken in 1994 have been prolonged in 1995. The distinct increase in the purchasing power of personal disposable income, resulting from higher employment and the more favourable trend of wages per head, gave rise to a modest upturn in consumption in 1995 since the savings ratio

rose significantly. Households' expectations regarding unemployment and incomes fell after the summer, which has adversely affected consumption and overall economic activity.

The revival of productive investment, which started in the spring of 1994, is likely to continue beyond 1995. Although the capacity utilization rate has decreased since mid-1995 and the outlook for demand is less rosy, the low level of investment in previous years means there is a hefty investment backlog. Profitability has also risen over the last two years. Substantial financing capacity have been generated during the last years and the constraint of high real interest rates has been partly removed at the beginning of 1996.

Exports were exceptionally buoyant and made a major contribution to growth in 1994 and the first quarter of 1995, but a lull has been discernible since the spring. Although firms have benefited from lower unit labour costs, an increase in the effective exchange

rate has been detrimental to price competitiveness and forced them to cut margins. France now has a healthy current account position; following a deficit equivalent to 0.5% of GDP in 1991, a surplus of 0.6% of GDP was recorded in 1994 and a surplus of some 1.0% of GDP is expected in 1995.

Inflation firmly under control but labour market situation worrying

The rise in consumer prices remained below 2% in 1995. In spite of the hike of two

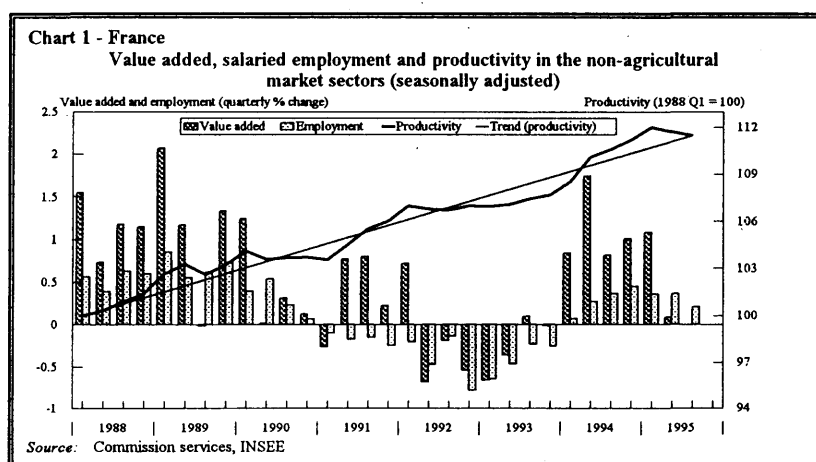
	1986-90	1991-93	1994	1995
Money growth (% change)	8.9	1.4	1.9	
Government budget balance (% of GDP)	-1.8	-4.1	-6.0	-5.0
Gross government debt (% of GDP)	33.7	40.2	48.4	51.5
Nominal wages per head (% change)	4.2	3.6	2.1	3.0
Real wages per head (% change)	1.3	0.9	0.3	1.1

For definitions, see Table 2 for Belgium
Source: Commission's November 1995 forecasts

percentage points in the standard VAT rate on 1 August 1995, retail prices rose in 1995 at the same pace as in 1994. Sales prices in manufacturing have decelerated since the beginning of 1995 and consumer caution is likely to keep retailers' margins under pressure.

Unit labour costs are estimated to have increased by about 1% in 1995 as a result of lower growth in productivity and

rising wages. Bringing these costs under control has formed a key part in combatting inflation. Expressed in national currency, unit labour costs fell by some 10% in relation to the other industrialized countries between 1987 and 1995, whereas for the Community, as a whole they increased by about 5%.



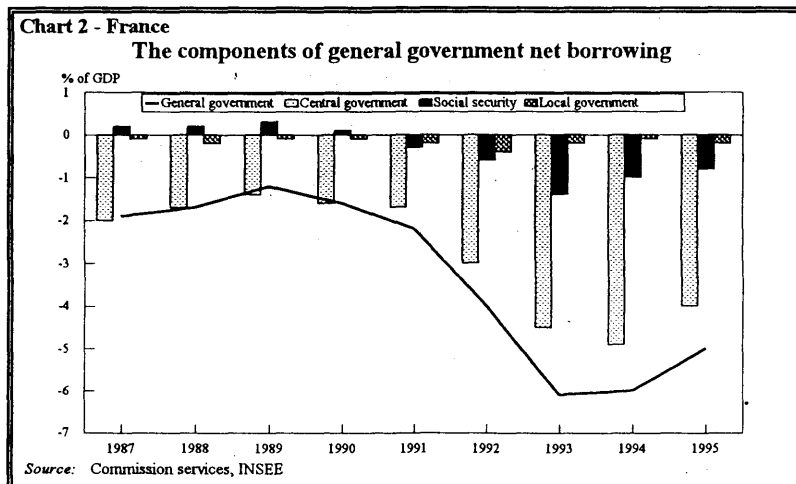
Changes in employment have been consistent with the standard productivity cycle. Growth in employment, which was limited in the early part of the recovery and thus led to a sharp increase in productivity

in the first half of 1994, subsequently grew at a quarterly rate of 0.4% in the non-agricultural market sectors. New jobs were created largely in the business service sector, which includes the activities of temporary employment agencies, and in the household service sector. Employment continued to expand up to the middle of 1995, whereas GDP stagnated, producing a dip in productivity. However, after falling steadily since the summer of 1994, unemployment began to rise again as from the autumn of 1995. In 1996, as in 1995, productivity gains could be slightly below their trend rate since the employment support policy should result in a disproportionately large increase in jobs relative to growth.

Cutting public deficits, a priority for jobs and growth

Fiscal consolidation is a necessary condition for a stable macroeconomic environment conducive to growth and employment. It should enable an easing of monetary policy, compatible with the monetary stability objective, which should offset the adverse effect on economic activity of budgetary restraint. The Government has also launched structural initiatives to make the labour market function more effectively.

General government net borrowing rose sharply after 1991, reaching 6% of GDP in 1994. The public deficit will probably amount to 5% of GDP in 1995 and will therefore be in line with the Government's objective. Moves to bring public finances under control in 1995 focused largely on the central government deficit, which was to be trimmed from 4.9% to 4.2% of GDP. Tax increases and spending cuts contained in the supplementary Finance Law of August 1995 enabled new spending on employment to be funded while adhering to the deficit target specified in the initial Finance Law. However, additional measures were taken at the year-end to offset the shortfall in taxation.



The consolidation of central government finances will continue in 1996 and efforts will be made to remedy the recurrent social security deficit, which constitutes a major obstacle to compliance with the

convergence criteria. The ongoing reform of the social security system aims at reducing the deficit from 0.8% of GDP in 1995 to 0.2% in 1996 and to achieve a surplus in 1997. The consolidation will stem from health spending control and increases in taxes and social security contributions.

The Government's objective is to reduce net borrowing by 1% of GDP each year so as to bring it down to, or below, the 3% mark by 1997. However, if growth would not increase again, additional measures could be necessary in order to achieve the Government's fiscal policy objectives.

The twin objectives of monetary policy are to ensure domestic price stability and maintain the franc's parity within the EMS. They were achieved in 1995. Nevertheless, interest rates and the differential with Germany were still high in France in the course of 1995. The large public deficits and high unemployment are two of the factors undermining the franc's credibility, with the result that interest rates still carry a risk premium. Whereas long-term rates were headed downwards throughout the year, short-term rates rose sharply in March as the German mark gained ground against the other European currencies. After June, as political and budgetary uncertainties were gradually dispelled, the Bank of France was able to ease monetary policy.

Structural measures are necessary to improve the functioning of the labour market. This year, for instance, France adopted a multiannual employment plan in response to the request of the Essen European Council. Measures have recently been taken in the priority areas identified by the Council. Policy in 1995 focused on reducing the cost of unskilled labour and placing young people and the long-term unemployed in employment. The Government decided to intensify moves - begun in July 1993 - to reduce security contributions for the low-paid. Overall, budget efforts to reduce the cost of unskilled labour should amount to 0.6% of GDP in 1996 and account for 9% of the total cost of wages below 1.3 times the minimum wage level (SMIC).

A rebound in growth in the course of 1996 could be fostered by renewed household confidence, due to a reduction in uncertainties concerning budgetary policy. Moreover fiscal consolidation and the lack of inflationary pressures should constitute an environment favourable to a further reduction in interest rates.

IRELAND

Continuation of broad-based growth in 1995

The current dynamism of the Irish economy is based on a variety of factors which encourage both stability and growth. Consumer and business confidence remain high, having recovered from the setback of temporarily higher interest rates in the first quarter of 1995. The subsequent decline in nominal interest rates to relatively low levels and the generally buoyant domestic demand provide a favourable climate for investment. The background of nominal stability has also been encouraged by continued strict budgetary policy and the corresponding decline in the debt burden. Price stability is also helped by the continued adherence to the wage agreement between the social partners which allows for cumulative pay increases in line with expected inflation, but lower than the expected growth in productivity. The resulting improvements in competitiveness combined with the favourable development of outlook for international trade have seen a continued positive contribution of net exports to overall GDP growth.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	4.6	3.1	6.7	6.7
Total domestic demand (% change)	3.3	-0.2	4.2	5.9
Employment (% change)	1.0	0.4	2.6	3.5
Unemployment rate (%)	15.5	15.3	14.7	14.4
Inflation (% change)	3.2	2.4	2.7	2.5
Balance of current account (% of GDP)	-1.2	3.4	5.1	6.0

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

The Irish economy grew strongly in 1995, continuing the broad-based growth that emerged in 1994. As in 1994, GDP is expected to increase by over 6% in 1995, but unlike the trend of earlier years, when growth was fuelled mainly by net exports, domestic demand is expected to make the most important contribution to growth. The buoyancy of

domestic demand has had a beneficial impact on the more labour-intensive indigenous sectors of the economy, resulting in strong employment growth of 49 000 in the year to mid-April 1995 (+4.1%). However, this strong rise in employment has not been matched by the decline in unemployment. The rising trend in labour force participation from a relatively low level, particularly the substantial rise in female participation, is the main explanation for this difference. With the expectation that this trend will continue into the medium term combined with the projected increase in the population of working age, the implication is that, in the absence of increased emigration, employment growth needs to

be sustained at a high level for a number of years if unemployment is to show a more significant decline. Nevertheless, the rising numbers in employment, along with continued moderate increases in real wages, contributed to the growth in private consumption. In addition, unanticipated post-budgetary contingency payments in the latter half of 1995 raised household incomes, while a confidence-induced decline in household saving is thought to have further boosted private consumption with growth expected to have been over 4% in 1995. The low level of interest rates, the continuing confidence of the industrial sector, rising output, and a healthy saving ratio allowed investment growth to improve on the recovery which began in 1994, when it rose by 7.3%. The recovery in investment is expected to have reached about 8% in 1995, driven partly by increased private sector activity but also reflecting some upturn in public investment. The recovery in public investment reflects some catching up from the relatively low level of 1994 when delays in disbursements from the Structural Funds constrained the capital programme. The steadily improving competitiveness of the Irish economy helped export volumes rise by about 10% in 1995, thereby continuing to make a significant contribution to growth, albeit lower than in previous years. The state of the public finances remains healthy and although there was some upward pressure in 1995 the deficit is expected to remain comfortably within 3% of GDP. The recovery has thus far not been accompanied by any significant increase in price pressures, with the consumer price index showing only a 2.4% increase in the final quarter of 1995 compared with the previous year.

Foreign exchange market developments during the first quarter of 1995 were dominated by a weakening US dollar, a strengthening DM and a re-emergence of tensions in the ERM. Amid these tensions, the Irish pound depreciated sharply early in the year. The Irish central bank responded to exchange market tensions by engaging in forex intervention to stabilize the currency. A 1 percentage point rise in the official short-term facility rate in early March, also helped to support the currency. In March, the Minister of Finance expressed a preference for the Irish unit to move higher in the ERM even if it meant trading above par with sterling. The IRL promptly broke through par, moving quickly to a range of UKL 1.02-1.03. Against the DM, the Irish unit also entered an appreciating trend from April onwards, although it has been subject to short-term reversals during periods of sterling weakness. In the second half of the year, with inflation pressures remaining under control, the Irish Central Bank followed Bundesbank official rate cuts in August and December, reducing Irish official interest rates by a total of 75 basis points. By the end of the year, the Irish unit had strengthened further against sterling, as well as reducing its gap against the strongest in the ERM grid.

	1986-90	1991-93	1994	1995
Money growth (% change)	7.3	11.8	9.7	14.0
Government budget balance ¹ (% of GDP)	-5.5	-2.3	-2.1	-2.5 *
Gross government debt (% of GDP)	108.1	96.2	91.1	85.9
Nominal wages per head (% change)	6.0	5.2	3.2	2.7
Real wages per head (% change)	2.7	2.8	0.4	0.2

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

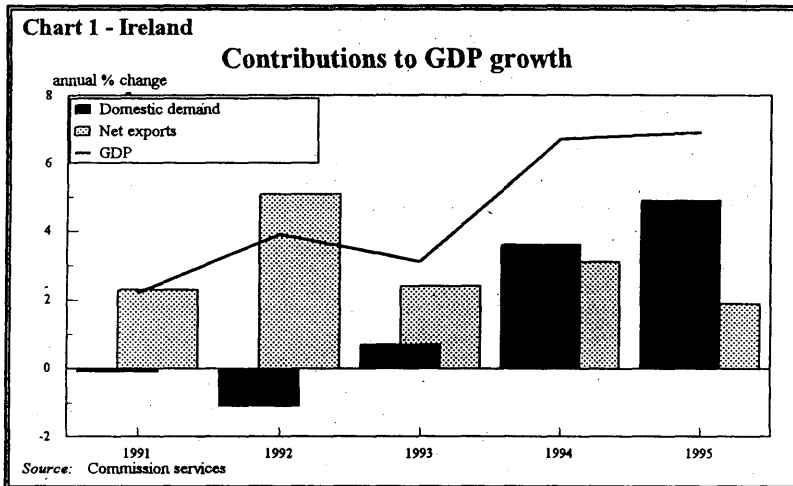
* Taking into account latest information

¹ The 1995 figure includes the payment of arrears of social welfare payments due under the Equal Treatment Directive and incorporates the more recent information presented in the Irish Budget.

Favourable prospects over the medium term

The prospects for continued non-inflationary growth remain favourable, although some moderation from the very high rates of 1994 and 1995 is expected. The general outlook is one of growth slowing toward its trend rate following the rapid surge of 1994 and 1995. The growth in consumption in particular should moderate, following the exceptionally strong growth in 1995. This is anticipated partly

because of the absence of the substantial budgetary transfers that occurred in 1995 and also due to the expected attenuation of employment growth. Investment has particularly benefited from the emergence of more balanced growth in the economy and the generally



favourable business climate suggests that investment will remain buoyant. However, investment growth is expected to fall from its 1995 rate to about 6% to 7% in the following two years. Public consumption is expected to show the

lowest growth of the components of domestic demand as the authorities seek to restrain the growth in public expenditure. On the external side, further improvements in competitiveness should see export volumes continue the strong growth of 1995 resulting in continued substantial trade surpluses.

The favourable outlook for growth and interest rates should, along with stricter control of general government expenditure, see a renewed decline in the general government deficit. The favourable cyclical conditions and the need to further reduce the debt ratio warrant greater efforts to reduce the budget deficit. The continued absence of inflationary pressure is encouraging, especially considering the shift from export-led growth (where prices tend to be moderated by international factors), towards internally driven growth. The success of the social partners in moderating wage increases and the stability of the exchange rate provide the cornerstones of the anti-inflation policy. Continued adherence to these policies should see the private consumption deflator remaining at about 2½%.

ITALY

An economic recovery with poor employment content and high inflation

After the depreciation of the Lira, Italy enjoyed an export-led economic recovery earlier than other countries. The economic upswing continued to gather momentum in 1995 despite the strains in financial and exchange rate markets and the unsettled political

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.0	0.2	2.2	3.2
Total domestic demand (% change)	3.6	-1.1	1.4	1.9
Employment (% change)	0.6	-2.3	-1.7	0.1
Unemployment rate (%)	9.6	9.4	11.4	11.9
Inflation (% change)	5.9	5.8	4.8	5.6
Balance of current account (% of GDP)	-0.6	-1.0	1.8	1.9 *

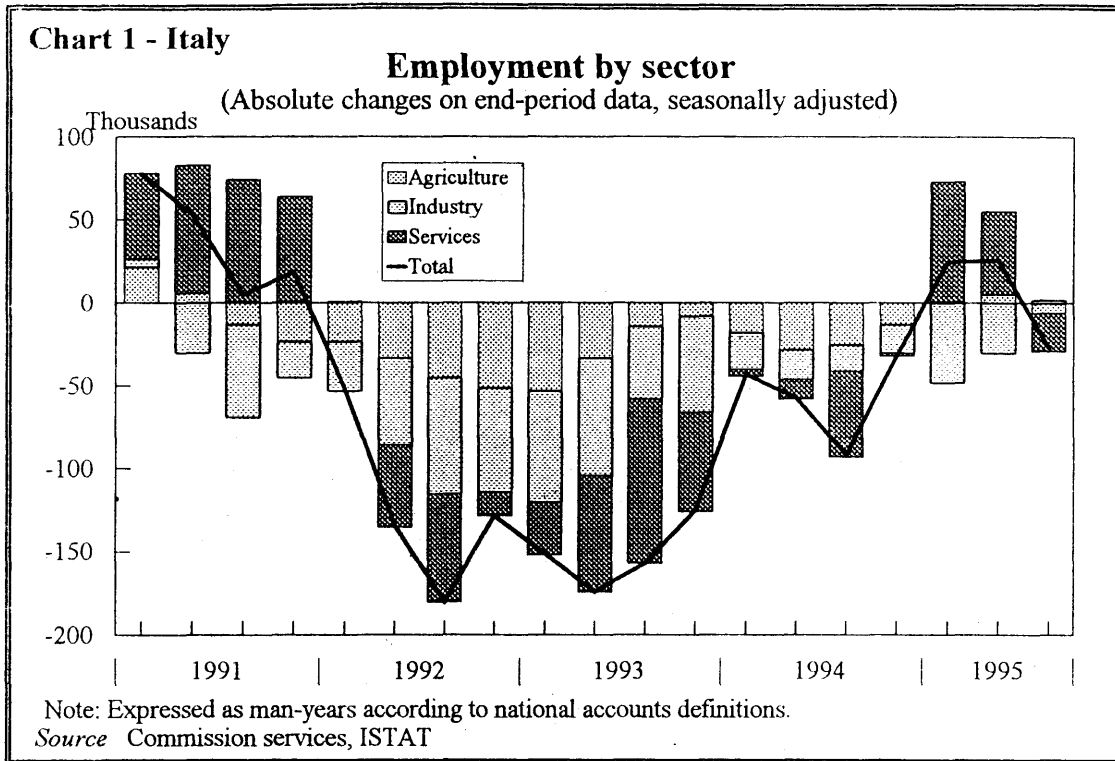
For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

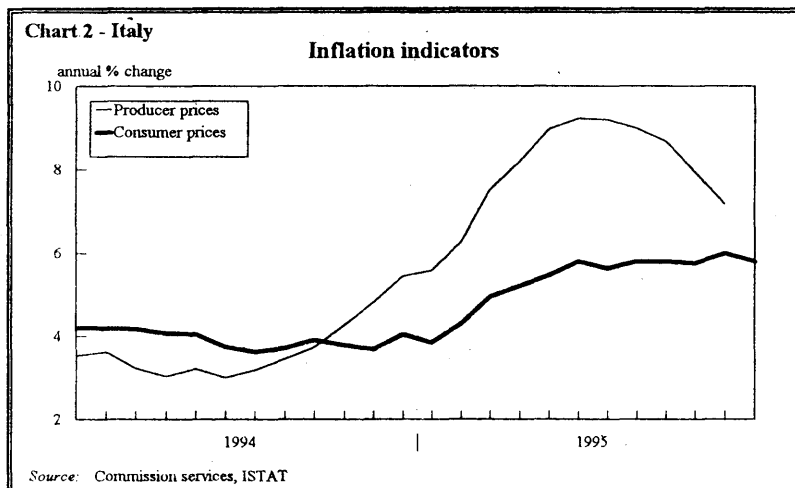
situation. Inflation accelerated during the year but peaked in November 1995, whereas employment creation was lagging. Italy's economic cycle, however, might have reached its peak in 1995.

The path of the economic recovery initiated in the last months of 1993 has been, until now, the traditional one with the initial impulse coming from a

buoyant export performance followed by a steady increase of investment in equipment. The latter surged in 1995 fuelled by a still robust external demand, strong profits and capacity utilisation rates approaching historically high levels, while investment in construction remained weak reflecting both the uncertainties affecting public works and the high level of interest rates. Private consumption, unlike in previous recoveries, experienced a continuous deceleration on a year-on-year basis. Tight fiscal conditions and moderation in wages induced some squeeze on household real gross disposable income. Moreover, throughout most of 1995 the consumer confidence indicator deteriorated in spite of some positive signs in employment creation. Uncertainties over the pace of the budgetary consolidation process, the reform of public pensions' schemes and the lack of security of the new jobs appear to have made households more cautious. Net foreign trade made a positive contribution to the growth of GDP and the surpluses of both the trade and the current accounts widened compared to 1994. A specific characteristic of the current cyclical phase as compared to previous consumption-led upturns was that, late in 1995, private consumption was not taking the lead and emerging as the main contributor to growth at a time when exports were running out of steam and investment in equipment was probably approaching its peak.



Employment creation in 1995 was disappointing (Chart 1) and had little impact on the reduction in the unemployment rate which reached a peak of 12.2% in January 1995. Without the significant reduction in the labour force due to the discouragement effect this figure would have been even higher.



In 1995, the net increase in employment was very marginal (81 000 units) and only the labour force surveys of April and July showed positive employment creation figures. On average, employment fell by 0.5% compared to the

average employment level prevailing in 1994. In October, the labour force survey showed a trend reversal for the first time since October 1993 and total employment increased by 0.4% year-on-year (confirming the positive signals already emerged in the

previous surveys of April and July). Most of this increase took place among independent workers. Employment in the services sectors, in particular, increased by 2% year-on-year, whereas in the agriculture and industry sectors it declined by 5.4% and 1.1%, respectively. In the early stages of the recovery Italian companies made a more intensive use of labour before recruiting new employees as they preferred to re-engage workers who were previously laid off and put temporarily aside in the Wage Supplementary Fund and to increase overtime working. However, as the scope for more intensive use of labour progressively narrowed, firms started to hire new workers. The effects of the economic upswing on employment were smaller than in previous expansionary phases. Moreover, the poor impact of the current economic recovery on employment and the correspondingly high level of unemployment could be an indication of the need to continue with the removal of the still existing structural constraints on the labour market.

Inflation, as measured by the CPI, increased substantially in 1995 (5.4%) as compared to the previous year (3.9%). A number of factors contributed to an upsurge in consumer prices (Chart 2) since February 1995. Apart from the mechanical increase in the price level induced by the February mini-budget, the weakness of the lira during most of the year allowed for a widening in profit margins and fuelled import and producer output prices. Moreover, the capacity utilisation rate in the manufacturing industry was increasing at a rapid pace and business and consumer expectations on prices worsened. Inflation, however, might have reached its peak in November 1995: producer and wholesale prices peaked in June, the impact of the February 1995 increase in indirect taxes is over and the currency appreciated by the year end. In addition, wage

	1986-90	1991-93	1994	1995
Money growth (% change)	8.7	7.3	1.9	2.1
Government budget balance (% of GDP)	-10.8	-9.8	-9.0	-7.2 *
Gross government debt (% of GDP)	92.6	109.7	125.4	124.9
Nominal wages per head (% change)	8.8	5.9	3.4	4.7
Real wages per head (% change)	2.7	0.1	-1.3	-0.9

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

developments are not putting a pressure on inflation, given that wage setting did not seem to be affected by the upwards trend during 1995.

Monetary policy is playing a major role in combatting inflation. The central bank has placed a tight rein on monetary and credit aggregates. Official rates were hiked twice in the first part of 1995 and the Bank

of Italy did not follow the Europe-wide cut in official rates that occurred later in the year. Real short-term interest rates remained at very high levels (above 5%) for most of 1995. The lira, which had fallen to a low of LIT 1 275 per DM in March, recovered substantially from May onwards. After a brief emergence of tensions in October, it remained on a clear upward trend in the last part of 1995, closing the year just above LIT 1 100 per DM. The recent reappreciation of the lira bodes well for combating inflation.

Budgetary consolidation made significant progress but still represents the main challenge ahead.

In 1995 the state sector borrowing requirement declined to 7.4% of GDP from 9.5% in the previous year. The primary balance reached a surplus of 3.5% of GDP, considerably higher than the 1.1% surplus recorded in 1994. The public debt is likely to have fallen, albeit marginally, in terms of GDP for the first time since 1980.

The budgetary consolidation effort was carried out in two steps. The Budget Law for 1995 enacted a fiscal package with measures amounting to 2.7% of GDP. This package, however, became insufficient to achieve the intended objectives due to the unfavourable evolution of interest rates. Therefore, the authorities decided to adopt, in March 1995, an additional package of measures, worth 1.2% of GDP, mainly consisting of an increase in indirect taxes. The additional measures did contribute to the rise in prices, but had the advantage of having an immediate and certain impact on the budget. The deficit - also owing to the strong nominal GDP growth - was finally reduced below its original target.

The economic policy objectives for 1995 also included the reform of the pension system and the advancing of the privatisation of the state-owned companies. A comprehensive pension reform was approved in August modifying the former earnings-based system into a contribution-based one. The new system has gained in transparency and equity although its financial equilibrium might still not be secured. The new rules, however, should facilitate a solution to the issue in the future. The privatisation process has made significant progress: the legal framework for the sell-off of the public utilities was established and the first phase in the privatisation of ENI, the energy conglomerate, has begun with the quotation on the stock market and the placement of 15% of its shares. In 1995, LIT 8.3 trillion revenues from privatisation accrued to the Treasury, an outcome not too far from the declared LIT 10 trillion target.

As for the future, in July 1995 the Italian Parliament approved a three year economic and financial plan aiming at a general government deficit of 5.9% of GDP in 1996, 4.4% in

1997 and 2.6% in 1998. In order to meet these objectives, the Budget Law for 1996 introduces a budgetary package (1.7% of GDP) quantitatively lower than those enacted in the last four years.

The budgetary measures introduced in the past few years have reduced the room for manoeuvre for further intervention with respect to increases in tax rates or cuts in the spending of public institutions. Nevertheless, transfers, subsidies and tax breaks granted to private enterprises and institutions should be scaled down in the present phase of economic recovery. More important, a reform effort should be aimed at increasing the efficiency of the public administration, at abating tax evasion and at enhancing the budgetary discipline of local authorities. The measures defined by this year's Budget Law appear to target these issues. They involve structural changes and often depend on modifying the behaviour of public administrators and/or tax-payers, which makes it difficult to either predict their degree of success or to quantify their effect on the budget.

LUXEMBOURG

Luxembourg economy still enjoying sustained growth

The Luxembourg economy was largely unaffected by the 1992-93 recession and has recovered from the world steel crisis which marked that same period. From 1994 onwards it benefited from the recovery in neighbouring countries, recording real GDP growth of some 3% in 1995. Economic activity in 1995 was stimulated by both domestic demand and exports. Private consumption, underpinned by fairly substantial wage rises, grew by more than 2%. Investments recovered after dipping in 1994. Exports made a positive contribution to growth in spite of an increase in the effective exchange rate. The upward trend in employment continued, climbing by more than 2.5% in 1995, while the downturn in manufacturing was more than offset by growth in the service sector.

Table 1 Luxembourg: Macroeconomic performance				
	1986-90	1991-93	1994	1995
GDP growth rate (% change)	4.6	1.6	3.3	3.1
Total domestic demand (% change)	5.5	2.7	2.3	2.5
Employment (% change)	3.1	2.8	2.5	2.5
Unemployment rate (%)	2.1	2.2	3.5	3.9
Inflation (% change)	3.5	3.7	2.4	1.9
Balance of current account (% of GDP)	28.1	21.6	15.9	29.6

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

After a short-lived inflationary burst in 1993 which saw price rises of 3.6%, largely as a result of the mechanical effects of the rise in excise duties, the increase in consumer prices fell back to 2.2% in 1994 and will probably remain more or less unchanged in 1995.

This favourable trend is set to continue in 1996 even if the buoyancy of exports is curbed

by the appreciation of the Luxembourg franc and by the cyclical downturn in Luxembourg's main trading partners, because growth should still be buoyed up by domestic demand, particularly private consumption and investment. Employment should therefore continue to rise steadily.

General government as a whole recorded a surplus equivalent to some 0.4% of GDP in 1995; the small central and local government deficit was more than offset by the social security surplus. Gross public debt, running at around 6.3% of GDP, has increased slightly in recent years, whereas net public debt has fallen as social security has built up

substantial financial assets. In view of the favourable outlook for growth, the public finance situation is unlikely to worsen in the foreseeable future.

	1986-90	1991-93	1994	1995
Money growth (% change)	:	:	:	:
Government budget balance (% of GDP)	:	1.5	2.2	0.4
Gross government debt (% of GDP)	8.8	5.2	5.9	6.3
Nominal wages per head (% change)	5.2	5.7	3.4	3.7
Real wages per head (% change)	1.7	1.9	1.0	1.7

For definitions, see Table 2 for Belgium

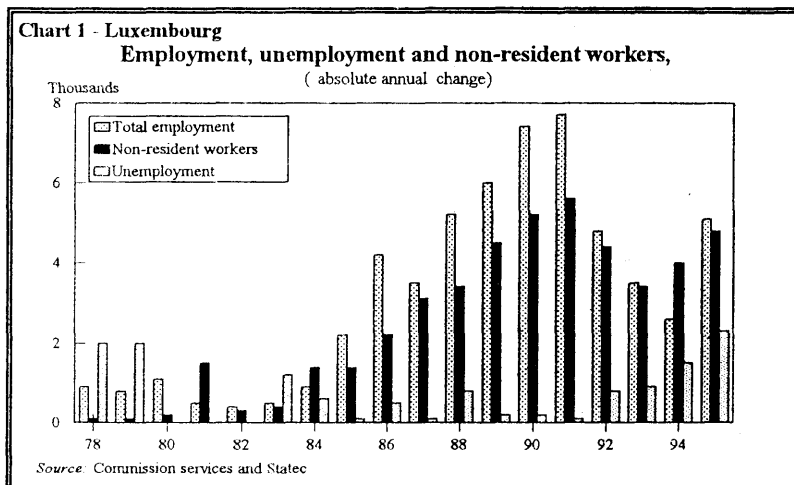
Source: Commission's November 1995 forecasts

However, this overall positive trend conceals marked differences between sectors. Whereas the growth in financial activity continued, confirming its role as the motor of the Luxembourg economy, the steel industry had to undergo further restructuring. Employing almost 18 000 people, the financial sector now accounts for about 10% of domestic

employment, but a period of consolidation is now anticipated following the very rapid expansion of recent years.

Unemployment, although the lowest in the European Union, has risen sharply since 1990.

The expansion in domestic employment was very rapid between 1980 and 1994, averaging 1.8% a year as against 0.2% for the European Union as a whole. The bulk of this expansion was essentially met by an increase in the number of foreign workers,



whether resident in the country or, as was primarily the case, frontier workers. In 1994 resident foreign workers and frontier workers accounted for 28% and 25% respectively of total domestic employment, with Luxembourg citizens accounting for

only about 47%. The most spectacular increase was in the number of frontier workers, which rose more than threefold between 1985 and 1994 in response to the high wages paid in Luxembourg.

In spite of this very favourable labour market trend, unemployment has increased sharply in recent years, from 1.7% in 1990 to 3.8% in 1995 (as defined by Eurostat). Although this figure is the lowest for the European Union and would be considered very satisfactory in most Member States, it is historically high for the Grand Duchy. Since this albeit limited rise in unemployment can scarcely be attributed to unduly sluggish growth or to an insufficient increase in the number of jobs available, it would seem to suggest that the available pool of labour is no longer adapted to the quite specific structure of the Luxembourg economy.

THE NETHERLANDS

Steady growth maintained in 1995

Following a relatively mild recession in which gross domestic product never fell in volume terms from one year to the next, the upturn began sooner than expected, i.e. at the end of 1993. Growth was relatively strong in 1994, at approximately 2.5%, and was slightly below 3% in 1995.

The upturn in activity was initially driven mainly by exports; in 1995 export growth accelerated, while domestic investment, especially by firms, showed renewed buoyancy. Domestic demand was also bolstered by the increase in private consumption which continued to grow at the moderate pace recorded in 1994, i.e. approximately 2%. A slightly more marked increase in real disposable income and the improvement in the labour market situation underpinned spending by households and improved their expectations. With domestic demand expanding, a high rate of import growth was maintained. In 1996 activity is likely to slacken in particular as a result of the cyclical slowdown in the Netherlands' main trading partners.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.1	1.5	2.7	3.0
Total domestic demand (% change)	3.0	0.7	3.3	3.0
Employment (% change)	2.3	1.5	0.1	1.2
Unemployment rate (%)	7.4	6.0	7.0	6.7
Inflation (% change)	0.9	2.9	2.4	1.6
Balance of current account (% of GDP)	3.0	3.7	4.4	4.8

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

Employment, which had practically marked time in 1993 and 1994, showed a fairly sharp upturn in 1995; total employment increased by 1.2%, paving the way for a reduction in the unemployment rate - measured as a proportion of the labour force - from 7% in 1994 to 6.7% in 1995.

restraint and the strengthening of the exchange rate; consumer prices rose by no more than approximately 1.9% in 1995. The external trade and current account surpluses again increased, with the latter reaching 4.8% of GDP in 1995, as compared with 4.4% in 1994.

Inflation remained low as a result of continuing wage

The main target of monetary policy is to maintain a stable parity between the guilder and the German Mark due to the strength of the guilder in the exchange rate mechanism of the EMS, the Dutch central Bank has been able to reduce secured loans rate to 2.75% at

the end of 1995. Long-term rates have closely followed the German rates while short term rates have been consistently lower than in Germany, with the differential reaching - 0.25% at the end of 1995.

The priority economic-policy objectives: public finances and employment

The two main problems currently facing the Dutch economy, which constitute the principal priorities of the last convergence programme adopted in December 1994 and of the current government's programme, are the fight against unemployment and the public finance situation.

Table 2 Netherlands: Economic policy indicators				
	1986-90	1991-93	1994	1995
Money growth (% change)	8.1	6.4	-0.5	0
Government budget balance (% of GDP)	-5.1	-3.3	-3.2	-3.1
Gross government debt (% of GDP)	77.3	79.9	78.0	78.4
Nominal wages per head (% change)	1.7	4.1	2.3	3.2
Real wages per head (% change)	0.8	1.2	0.0	1.5

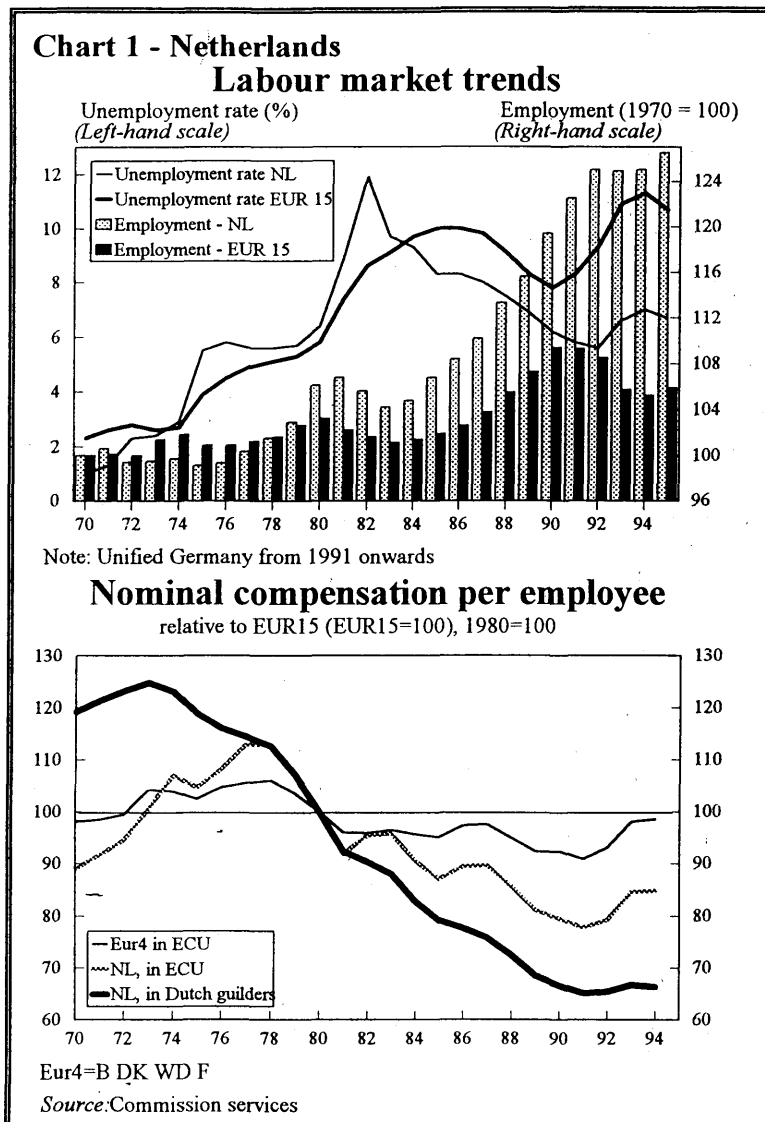
For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

Unlike most other Member States, the Netherlands was successful, during the recession of the early 1990s, in limiting the growth in the general government deficit, which reached a maximum of 3.9% of GDP in 1992. However, the deficit decreased only slowly, since it is still at 3.1% in 1995 and should be reduced to 2.8% in 1996, below the 3% reference value in the Treaty.

Taking into account the improvement of the economic situation since the beginning of 1994, this means that the structural deficit has only marginally decreased. The reduction of the public deficit has not been sufficient to bring about a significant decrease of the ratio of gross government debt to GDP, which has fluctuated around 80% since 1988 and still stood at 78.4% in 1995. The current fiscal policy in the Netherlands aims simultaneously to reduce the ratio of government debt and deficit to GDP and to support growth and employment by reducing taxes and social security contributions, aiming especially at cutting non-wage labour costs.

Since the second oil shock, the Netherlands has succeeded in reducing unemployment more rapidly and more sharply than most other Member States despite an increase in the labour force of almost twice the Community average. Similarly, unemployment increased only fairly moderately during the last recession and remained far below the level recorded in the early 80s, whereas it reached record levels in many other Member States. This good performance by the Netherlands is due in part to the very low participation rate,



which is a consequence of the systematic recourse to an early retirement system and of an exceptionally high number of persons deemed unable to work for medical reasons. However, the favourable evolution in Dutch unemployment is also due to the strong growth in employment since the second oil shock, which resulted in particular in a substantial increase in part-time working, especially with women working in the service sector. This growth in employment reflects the fact that, for almost 15 years, wage growth in the Netherlands has been less than in the Community as a whole and the main trading partners in particular, either in

nominal or in real terms or in national or in common currency.

The economic performance of the Netherlands in recent years and its successful emergence from recession, compares favourably with other countries, clearly placing it among the Member States achieving the most satisfactory degree of nominal convergence. However, further efforts need to be made in order to bring a fundamental solution both to the problems of employment and of public finance.

AUSTRIA

Although decelerating, growth was solid in 1995

As a small, open economy Austria is strongly affected by international developments. Nevertheless, with the help of a specific policy mix it has managed in the past to partly compensate negative external effects. Among others, a combination of a hard-currency exchange rate policy and a productivity oriented incomes policy helped to keep both inflation and unemployment low, while in general GDP growth rates were above the EU-average.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.0	1.7	3.0	2.4
Total domestic demand (% change)	3.4	1.6	4.5	2.7
Employment (% change)	1.1	1.5	0.3	0.2
Unemployment rate (%)	3.4	3.8	4.4	4.5
Inflation (% change)	2.1	3.6	3.0	2.2 *
Balance of current account (% of GDP)	0.2	-0.1	-0.9	-1.8

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

In recent years, the Austrian economy benefited from significant productivity gains and its exports to the European car industry. Tourism is another traditional field of Austrian specialisation. That sector's surplus has offset the large merchandise trade deficits, especially with Germany. The opening of Eastern Europe increased competition, but also brought new opportunities: Austria's eastern neighbours

showed a strong interest in Austrian consumer and investment goods and the process of structural adjustment in Austria was to some extent speeded up by transferring labour-intensive processes to neighbouring countries with considerably lower wage costs.

In 1995, real GDP may have grown by about 2½%, somewhat less than in the previous year (3%). The slowdown mainly resulted from adverse effects of the Schilling's appreciation and a predominantly cyclical decline in construction demand. Nevertheless, a favourable export performance and a strong demand for investment equipment supported a solid real GDP growth. Private consumption developed well in 1995, stimulated especially by the real disposable income but also by facilitated possibilities of shopping abroad. Investment in equipment grew strongly, mainly reflecting the increased

need to restructure and improve productivity in order to maintain competitiveness within the European Union. Public consumption increased only moderately. At the same time, investment in construction decreased, mainly due to the normal pattern of the construction business cycle. Unlike in recent years, the budgetary strains limit the public sector's possibilities for additional investment in infrastructure.

The external balance worsened significantly, mainly due to a sharp decrease of the traditional surplus in tourism for the second year in a row. Despite the effective appreciation of the Austrian Schilling, commodity exports performed very well, partly as a result of improved market access due to EU-membership, but also benefitting from the strong international demand for equipment investment, not just in the European Union but also in Central and Eastern Europe. Exports outperformed imports, thus contributing to a slight improvement in the trade balance. But the Schilling's appreciation stimulated imports too, not least through travelling and shopping abroad. Low air-fares contributed to this trend. At the same time, Austria's tourism exports were confronted with decreasing demand. Especially tourists from Germany, which account for about 60% of Austria's foreign guests, shifted towards other destinations. While the relatively price inelastic winter tourism developed well, summer tourism experienced lower revenues as a result of exchange rate related losses in price competitiveness and occasional deficiencies in the quality supply. Tourism in Austria is not only highly specialised on visitors from Germany and the Netherlands, but it is also confronted with significant overcapacities, while low capital reserves increase the vulnerability with respect to demand fluctuations. The stagnation in tourism revenues underlines the need for structural adjustment.

These developments led to a marked deterioration of the current account. In addition, for the first time Austria contributed to the EU-budget, which further weakened the current account balance by some 0.7% of GDP. However, despite the breakdown of the coalition government during the set up of the 1996 budget, the credibility of the exchange-rate peg to the DM was not affected.

Price inflation moderated significantly in 1995. Agricultural producer prices dropped due to the shift to the CAP; the Schilling's appreciation further relieved import costs. Nevertheless, despite higher competitive pressure it took some time for prices and cost advantages to be passed on to consumers. The effect of EU-membership is estimated to have lowered consumer prices by $\frac{3}{4}$ percentage points by the end of 1995.

Labour market performance worsens and the budget deficit widens

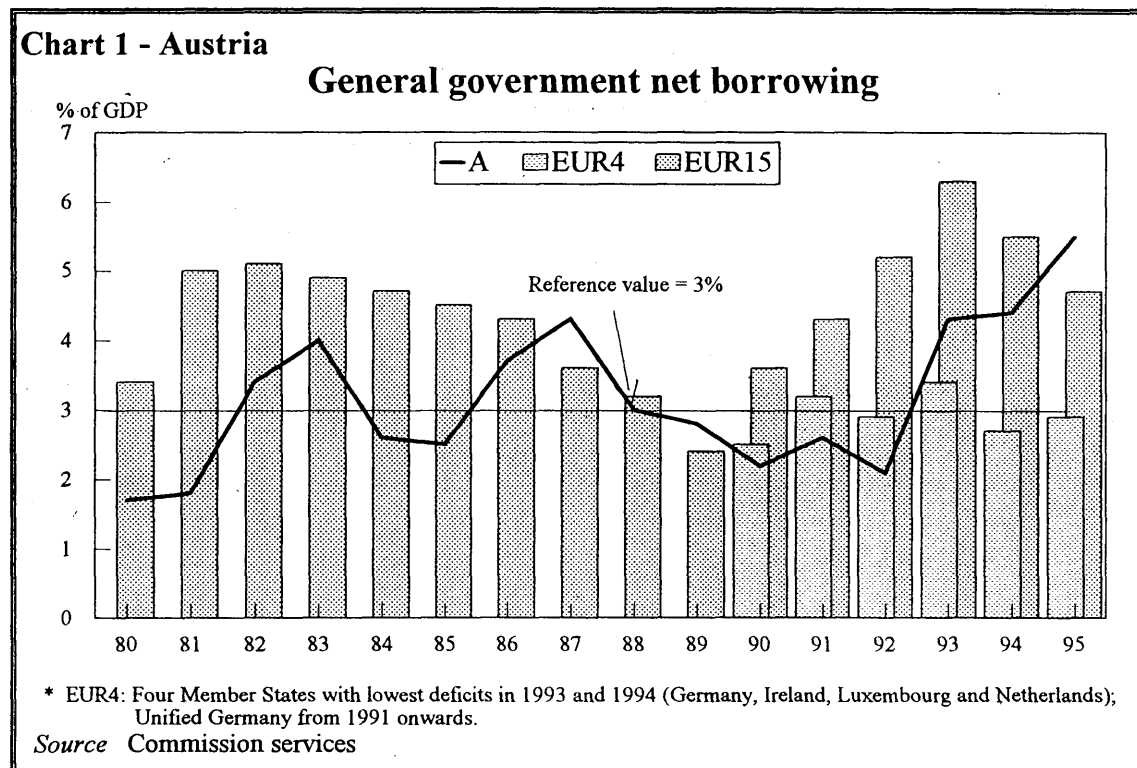
Table 2 Austria: Economic policy indicators				
	1986-90	1991-93	1994	1995
Money growth (% change)	7.2	5.4	5.3	:
Government budget balance (% of GDP)	-3.2	-3.0	-4.4	-5.5
Gross government debt (% of GDP)	58.1	59.9	65.2	68.0
Noninal wages per head (% change)	4.4	5.6	3.1	4.0
Real wages per head (% change)	2.3	2.0	0.1	1.5

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

Recent output growth has not sufficiently translated into employment growth. On the contrary, especially in manufacturing increased investment in equipment reduced the need to hire additional labour in order to meet increased output. In contrast with past experience, reduced job opportunities in manufacturing are not being compensated by new employment in the service

sector. The tourism industry itself faces a crisis, while the construction sector suffers from decreasing demand, especially with respect to infrastructural investment. This development is partly compensated by a stronger outflow from the labour force, especially into early retirement, which, however, aggravates the financial problems due to the strong increase in the number of pensioners and the decreasing labour force participation rate of the Austrian pension system.



After having been for a long time among those EU-countries with the lowest public deficits, Austria's public finances deteriorated quickly from 1993 onwards, leading to a more than doubling of general government net borrowing from 2.1% of GDP in 1992 to 4.4% in 1994. This was partly caused by the effects of automatic stabilisers and the second stage of a tax reform, both cushioning the negative effects of the 1993 recession. Another important factor was a systematic underestimation of social policy related expenditures. In 1995, Austria's EU accession increased total public spending by a further 2% of GDP. About half of those costs were internal payments to mitigate transition costs for the agricultural and other hard hit sectors. These transition supporting payments will fade out within the next four years, reducing the burden to the budget to less than 1½% of GDP. In order to bring public deficits back to a manageable, pre-1993 level, decisive consolidation steps will have to be taken.

PORTUGAL

Domestic demand continued to strengthen in the first part of the year

The upturn of economic activity in Portugal, which had started in 1994 primarily driven by exports, was furthered in 1995 by the dynamism of investment and the recovery of private consumption. Still subdued in the beginning of the year, private consumption has gradually gained strength, as real income and consumer confidence improved. The late recovery of private consumption reflected the consecutive fall of household real disposable income in the two previous years as well as prolonged pessimism in consumer confidence. In 1995, lower inflation and slower deceleration of nominal wages than in the previous years allowed real income to increase, providing room for the recovery of private consumption. Investment accelerated in the year, significantly induced by public projects partly financed by the EU funds, but private investment has also picked up as business confidence and economic activity improved. By the second half of the year, however, this component of demand lost steam in line with the deterioration of the external environment. Construction and machinery equipment were the most dynamic components of investment in 1995, while transport equipment fell markedly, after the exceptional increase in the latter part of 1994.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	5.1	0.7	1.1	2.5 *
Total domestic demand (% change)	7.6	2.6	1.7	3.3
Employment (% change)	1.8	-0.3	-0.2	-0.6
Unemployment rate (%)	6.1	4.6	7.0	7.2
Inflation (% change)	11.7	10.2	5.5	4.1 *
Balance of current account (% of GDP)	-0.5	-2.0	-1.4	-1.4

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

Exports continued to lead the economic upswing in 1995, and market share gains are likely to have occurred in some external markets. The trend of both export prices and estimated production costs suggests that exporters' profit margins increased as well. However, exports started to decelerate in the second half of the year but the completion of a large automobile factory project helped total exports to maintain

a significant growth rate in the year as a whole. Imports also grew at a marked pace, in line with the expansion of total demand; as a consequence, the trade balance deteriorated considerably in 1995.

Table 2 Portugal: Economic policy indicators				
	1986-90	1991-93	1994	1995
Money growth (% change)	17.0	12.5	9.4	:
Government budget balance (% of GDP)	-4.7	-5.6	-5.7 *	-5.2 *
Gross government debt (% of GDP)	64.4	66.6	69.4	70.5
Nominal wages per head (% change)	16.4	11.0	4.8	6.0
Real wages per head (% change)	4.2	0.7	-0.7	1.7

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

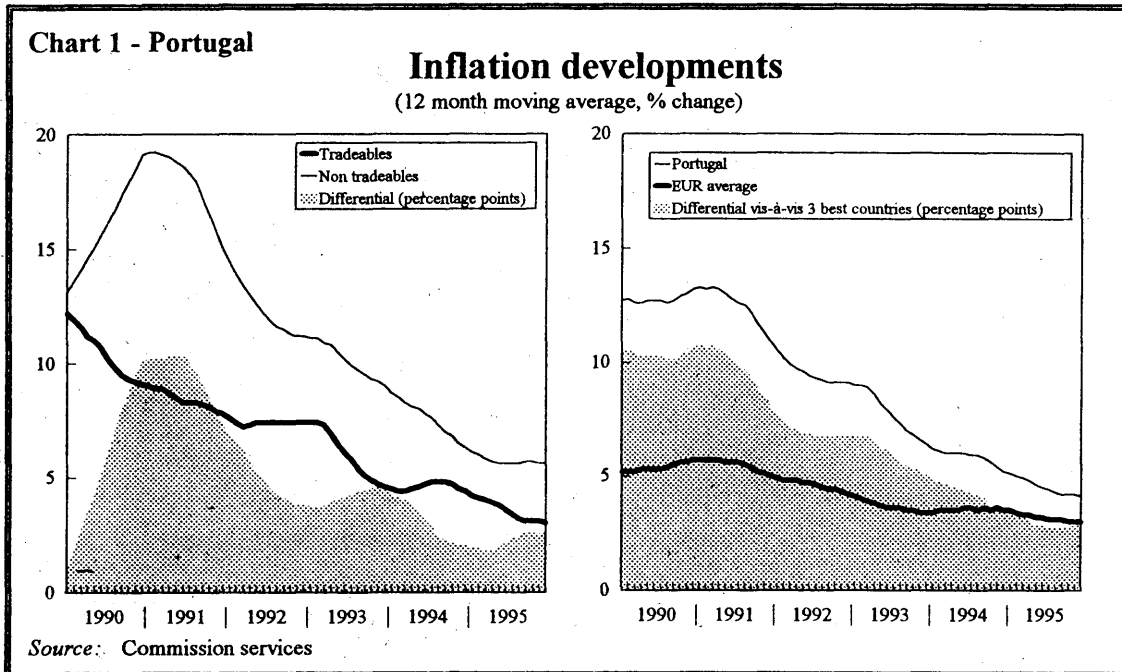
Due to the delay in the recovery of domestic demand, the labour market situation continued to deteriorate in 1995. Total employment fell by 0.6% on average, more than in the year before. However, this is due to a slower expansion of the number of self-employed. In fact, self-employment, which represented about 30% of total employment in 1995, increased only marginally (by 0.3%), after having grown by more

than 5% in the previous year. The significant expansion partly reflects a growing preference on the part of enterprises to switch from permanent employment contracts to "out-sourcing", with a view to reducing payroll costs. The number of wage-earners, in turn, decreased by 1%, in 1995, after a 2% fall in the year before (-2.8% in 1993). Total hours worked declined less, by 0.3% (in 1994 and 1993, they had fallen by, respectively, 0.4% and 2.2%). The unemployment rate (which has followed the economic cycle with a lag of one year) rose to 7.2% on average, after 6.8% in 1994 and 5.5% in 1993; nevertheless, it remained clearly below most EU countries, reflecting the more flexible labour market in Portugal. But long-term unemployment increased significantly, amounting to roughly 40% of total unemployment (34.2% in 1994); youth unemployment grew faster than the total as well; both these facts suggest an increase in structural unemployment. In line with labour market developments and helped by the declining path of inflation, nominal wage growth continued slowing in 1995, albeit less than in the years before. Excluding general government, wages implicit in collective agreements increased by 4.8% in 1995, after 5.1% and 7.3% respectively in 1994 and 1993.

Inflation continued decelerating

Foreign exchange stability, wage moderation and the sluggish recovery of consumer demand allowed inflation to continue on a downward trend in 1995. This trend has been

steadily maintained since the end of 1990, when exchange rate policy was geared towards escudo stability. In 1995, the consumer price index (excluding rents) rose by 4.1% on average, down from 5.2% in the previous year, and the differential vis-à-vis the three best performing EU economies narrowed, to 2.7 percentage points from 3.6 percentage point in 1994. The VAT rate increase in January 1995 from 16% to 17% affected price performance in the first quarter of the year; but the 0.75% reduction in employers' Social Security contributions, declining labour costs, and some narrowing of



profit margins in retailing may have partly offset the impact of that measure on inflation. However, the pattern has not been the same as regards inflation for tradeables and non-tradeables: the first remained on a downward course over the year, assisted by the relative stability of the escudo and the moderate increase of import prices; the latter, which had particularly contributed to the deceleration of overall inflation in 1993 and 1994, showed a more moderate improvement, reflecting slower progress in wage moderation and the revival in consumer demand.

The Spring 1995 exchange rate turmoil affected particularly the volatility of the Spanish peseta and, to a lesser extent, the Portuguese escudo. Strong market strains led the Spanish peseta to be realigned within the ERM, on 6 March 1995; the escudo followed and its central parity was devalued by 3.5%. Nevertheless, in effective terms, the escudo appreciated by about 2%, on average, in the year. Despite the relative stability of the escudo after the currency turmoil and steady progress in nominal convergence, the interest rate differentials vis-à-vis the German mark remained wide.

Government deficit below the budget target but faster progress is required

The general government deficit was reduced in 1995 to 5.2% of GDP⁶, after 5.7% in the previous year. This development was mainly due to the growth of direct tax revenues, reflecting further progress in efficiency in tax collection. The primary balance improved slightly and just moved into surplus; but, after having fallen since 1992, interest payments increased albeit at a lower rate than the other current expenditures. Public investment grew significantly, by 20%, in line with the allocation of the EU structural funds. The government debt ratio increased marginally, to 70.5% of GDP from 69.4% of GDP in 1994.

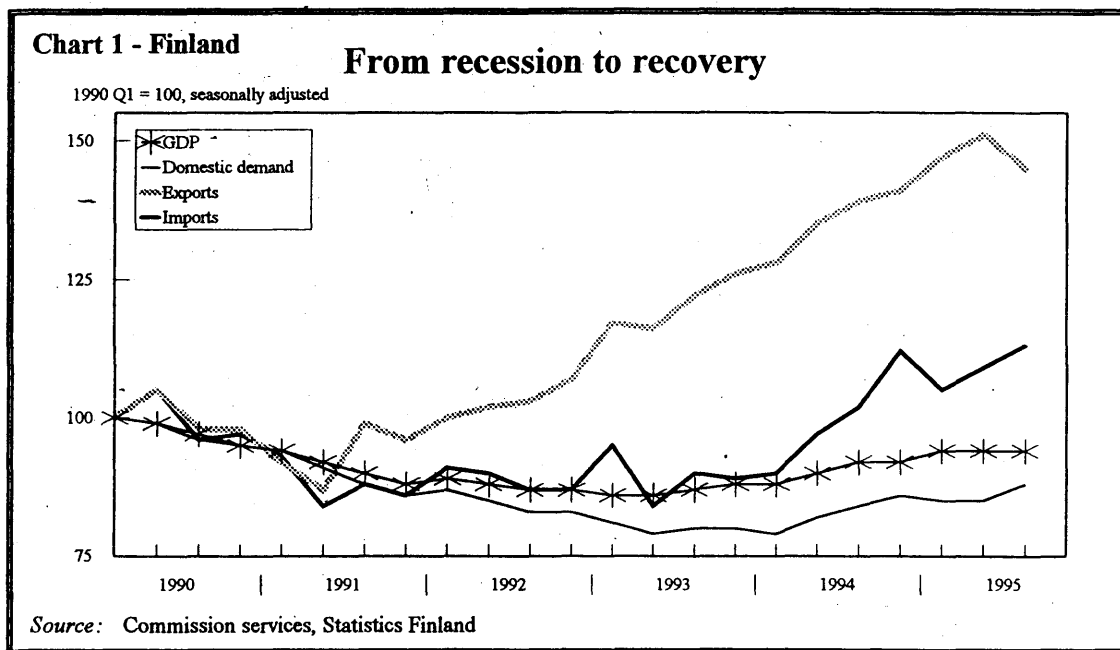
The general government deficit needs to be further reduced in line with the objectives of the convergence programme. A strict budgetary policy must be followed, namely because investment expenditures should be allowed to grow, in line with the availability of EU structural funds. A rigorous budgetary policy should contribute to consolidate the credibility of the policy pursued by the authorities, therefore allowing domestic interest rates to come down and so reducing the still wide differentials vis-à-vis the best performing EU economies.

⁶ This figure corresponds to the latest estimate of the Portuguese authorities included in the proposal of the 1996 budget, submitted to the Parliament in February 1996. At the time of the Autumn forecasts, the official estimate for the general government deficit in 1995 was 5.4% of GDP.

FINLAND

From deep recession to well-founded recovery

Finland has been recovering from the very deep recession of the early 1990's, but the high unemployment and public sector indebtedness will take time to be tackled. In the second half of the 1980's, financial liberalisation and favourable terms-of-trade developments led to a rapid credit expansion which, in turn, resulted in an unsustainable soaring of asset prices, an overheated investment activity and an excessive rise in the indebtedness of the private sector in the late 1980's. The subsequent weakening of domestic demand owed much to a sharp reversal of asset prices and the ensuing debt problems. The severity of the recession was magnified by the falling apart of the Eastern export markets and terms-of-trade losses, which all together led to high interest rates in the wake of weakening confidence on the markka.



Despite some deceleration of growth, Finland's GDP growth reached an estimated 4.4% in 1995. The recovery was initially driven by rapidly expanding exports since the second half of 1991; the turnaround in domestic demand, however, came later and has been much weaker (Chart 1). Export growth decelerated in the second half of 1995 and, due to increasing imports, the contribution of net exports to GDP growth is turning negative. However, due to a marked improvement in the terms of trade, the current account showed a record surplus in 1995.

Private consumption picked up in the second half of 1993 as households reduced their saving, but the recovery remained modest until mid-1994, when the pent-up demand for consumer durables, accumulated during the recession years, started to turn into effective demand. Private confidence has recovered in line with rising employment and increasing real incomes, and households indebtedness is already back to the pre credit-boom level, though households still remain cautious as to their borrowing decisions. In 1995, private consumption increased by a figure close to 5%.

Investment provided the main impetus to economic growth in 1995. Investment in equipment, which declined by more than 60% during the recession, picked up in the course of 1994 and grew strongly during 1995. Export industry investments expanded particularly fast: they had started from a low level, capacity utilisation rates were high,

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.4	-4.0	4.4	4.4 *
Total domestic demand (% change)	4.0	-7.3	3.6	4.9 *
Employment (% change)	0.2	-6.0	-1.1	2.2 *
Unemployment rate (%)	4.7	12.9	18.4	17.2
Inflation (% change)	4.5	4.6	1.3	1.1 *
Balance of current account (% of GDP)	-3.2	-3.8	1.3	3.5 *

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

companies' profitability was good and their balance sheets were relatively sound. By contrast, construction activity remained subdued throughout 1995: public investment continued to decline and private building activity was depressed by an over-supply of old business premises and dwellings.

Employment fell strongly during 1991-94 (by 19%) and started to pick up only in the second half of 1994, accelerating to a 3% annualised growth in the first half of 1995, despite further job losses in some home market services. This job increase did not, however, translate into an equivalent fall in unemployment, because of a rebound of the activity rate from its recession-induced low levels. Finland's traditionally low unemployment rate rose sharply in the early nineties, having reached 19% in early 1994 before dropping to 17.2% in 1995.

In the past, Finland had in general healthier public finances than most EU countries, with general government balances showing surpluses. The level of public gross debt was low and, due to large surpluses in the pension funds, there was even a strong net asset

position. The recession, however, led to a sharp rise in the general government deficit,

	1986-90	1991-93	1994	1995
Money growth (% change)	13.5	3.5	6.1	:
Government budget balance (% of GDP)	4.0	-5.1	-6.3 *	-5.6 *
Gross government debt (% of GDP)	16.5	40.6	59.8	60.3 *
Nominal wages per head (% change)	8.8	2.8	2.5	5.3 *
Real wages per head (% change)	4.1	-1.7	1.2	4.2 *

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

which was attributable to state finances, as local government and social security funds showed surpluses. The recovery has already contributed to put the deficit onto a declining trend, although in 1995 a number of temporary and exceptional factors affecting both revenues and expenditures (e.g. timing of tax refunds, and transitory effects of the change from sales tax to value added tax as well as of joining the EU)

masked this trend; however, the central government deficit remained large in 1995 (10% of GDP).

So far the upswing has shown no signs of emerging inflationary pressures. In 1995, consumer prices rose only by 1.1%; in December 1995, the increase in the CPI from the previous year was only 0.3%. Import prices remained stable throughout 1995 due to the strengthening of the markka, and food prices declined by a tenth as a result of Finland's accession to the EU. The centralized two-year wage agreement signed in September 1995 has further contributed to moderate inflation expectations. The agreement will constrain wage increases to about 2 % in both years.

Monetary policy remains targeted at low inflation. The development of monetary aggregates has been very moderate. In response to inflationary pressures, the Bank of Finland one month tender rate was first raised in February and then in June 1995, when it reached 6%. After September 1995, however, the tender rate was cut four times altogether by 1¾ percentage point to 4¼% by the end of 1995. Low inflation, favourable inflation outlook and, later, lower economic growth motivated these interest rate cuts. By the end of 1995, interest rate differentials with Germany had narrowed to one percentage point in the long end and half a percentage point in the short end.

High unemployment and central government indebtedness are the main challenges

Whereas the economic recovery seems to be on sound ground, high unemployment and heavy central government indebtedness remain the main challenges ahead for economic policy. Fiscal policy up to 1999 is due to be conducted in the framework of the convergence programme of September 1995 and the multi-annual employment programme of October 1995. Hence, the two main priorities will be the reduction of the government net borrowing and the increase in the flexibility of the economy.

The stated goal of economic policy is to meet in time all the convergence criteria of the Economic and Monetary Union. The government is committed to maintaining permanently the former temporary austerity measures, amounting to approximately 6.5% of GDP, and to new expenditure cuts amounting to 3.5% of GDP, most of which are to be implemented by 1997. The austerity measures concern grants from central government to local government, subsidies to industry and agriculture, child benefits, student grants, national pensions and other social assistance grants.

Government finances will be consolidated without raising the overall tax burden, but the structure of taxation will be reformed to encourage working and employment. The taxation of earned income will be eased, while the tax rate on capital income and the corporate tax rate have been raised from 25 to 28%. Also environmental taxes and indirect taxes will be increased.

Unemployment remains the biggest problem for the Finnish economy. The multi-annual employment programme aims at the very ambitious target of bringing the unemployment rate down to 8-9% by 1999. However, structural problems, as reflected in the increasing share of long-term unemployed, make it hard to achieve such a target. Even if the labour market is to be made somewhat more flexible, the fiscal consolidation process limits the scope for tax incentives such as those leading to significant tax wedge reductions.

SWEDEN

Improved economic situation

After the severest recession since the 1930s, during which GDP fell by about 5% of GDP, the Swedish economy is recovering. GDP grew by 2.6% in 1994 and in the first half of 1995 the growth rate accelerated further. The recovery is led by exports which have induced a strong increase in manufacturing production and investment. This has resulted in a relative increase of the industrial sector in the Swedish economy offsetting a trend relative decline in recent decades. In 1995 it is expected that GDP growth averaged 3.7%.

Table 1 Sweden: Macroeconomic performance				
	1986-90	1991-93	1994	1995
GDP growth rate (% change)	2.3	-1.6	2.6	3.7
Total domestic demand (% change)	2.9	-2.9	1.8	1.5
Employment (% change)	0.8	-3.9	-0.9	1.7
Unemployment rate (%)	2.1	6.2	9.8	9.2
Inflation (% change)	6.6	6.1	3.1	2.8
Balance of current account (% of GDP)	-0.9	-2.6	0.3	1.6

For definitions, see Table 2 for Belgium

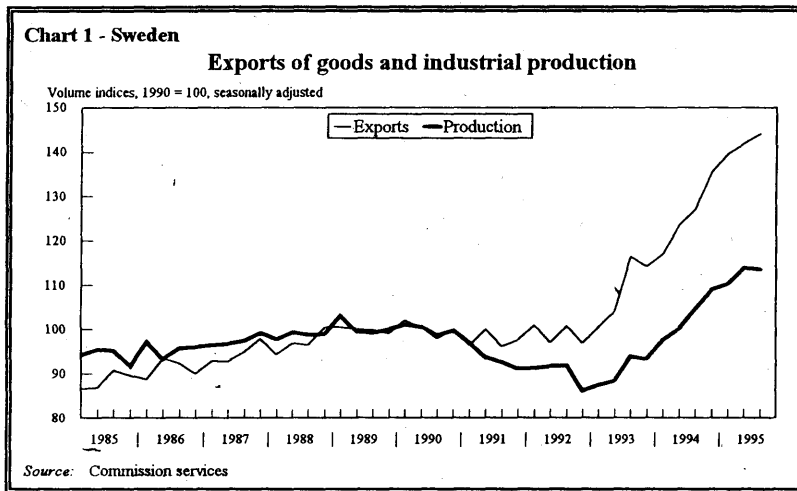
Source: Commission's November 1995 forecasts

During 1995, the situation of the public finances was the focal point of Swedish economic policy. In the beginning of the year, despite announced measures to reduce the fiscal deficit, lack of confidence resulted in a further depreciation of the krona and an increase in the interest rate differential against Germany.

A supplementary budget bill with some further measures was presented in April 1995, but this could not prevent the krona falling to an all time low against the DM and the long-term interest rate differential against Germany increased to around 4.5 percentage points. Since then, however, the strong growth, a marked improvement in public finances and falling inflation expectations has increased the credibility for the Swedish economy and economic policy. The krona has gradually strengthened and interest rates have fallen. From its low point in April, the krona had appreciated by more than 15% against the DM by the end of 1995 and the long-term interest rate differential against Germany had diminished to some 2.5 percentage points.

The economic recovery has been led by exports induced by the strong competitive position of industry. In volume, exports of goods increased nearly 16% in 1994 and are expected to expand by a further 13% in 1995. At the same time, world market prices for

important Swedish export products, such as paper and pulp, increased sharply during 1995 implying strong gains in the terms of trade. As a result net exports have given a major boost to GDP growth both in 1994 and 1995. The strong growth in exports has led to a rapid increase in industrial production. This resulted in a sharp increase in capacity utilisation early in the upturn, that raised fears of an upsurge in inflation. A strong increase in investment particularly in manufacturing has, however, led to a rapid expansion of production capacity and despite a continued increase in industrial production during 1995, the rate of capacity utilisation remained broadly unchanged through the year.



During the latter part of 1995, a slowdown in export growth and industrial production was registered due to recent economic indicators. This may partly stem from the weaker demand in other European countries. It may also

be partly due to the appreciation of the krona which to some extent has eroded the previously extremely strong competitive position.

Table 2
Sweden: Economic policy indicators

	1986-90	1991-93	1994	1995
Money growth (% change)	7.4	6.1	4.5	:
Government budget balance (% of GDP)	3.2	-7.1	-10.8	-7.0
Gross government debt (% of GDP)	51.8	65.4	79.3	81.4
Nominal wages per head (% change)	8.3	4.3	3.3	3.2 *
Real wages per head (% change)	1.6	-1.2	0.2	0.4 *

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

* Taking into account latest information

In 1995, household disposable incomes have been affected by the tight stance of fiscal policy. The result of various fiscal consolidation measures in 1995 is a reduction in disposable income of more than 5 percentage points. Together with rather modest wage increases in 1995 and employment growth, this resulted in a decrease in disposable income of 1.5%.

Nevertheless private consumption increased modestly and the household saving ratio decreased somewhat compared to 1994.

In 1996, growth is expected to slow. Domestic demand is expected to remain rather subdued partly because of a continuously strict stance of fiscal policy in coming years that will restrict the growth of household disposable income. In such a situation, a strong growth in exports is needed to keep up the growth rate in the economy. In this respect, the tendency toward a slowdown of external demand during the second half of 1995 may be cause for concern.

Producer prices increased at a rapid pace in the beginning of 1995 partly as a consequence of the weak krona. Another factor was price increases for pulp and paper. These price increases raised fears of a pick-up in inflation which has been the case in previous episodes of depreciation induced recoveries in Sweden. There was also an acceleration in the consumer price index in the beginning of 1995 and the year-on-year increase exceeded the upper tolerance margin of the Swedish central bank's inflation target. This upturn was, however, only temporary and in line with the appreciation of the krona the rate of inflation has since gradually dampened and was at the end of 1995 again well inside the tolerance band.

Major challenges for economic policies in coming years

To bring down the rate of unemployment is one of the major challenges facing the Swedish authorities at present. Despite some employment gains during 1995, unemployment has remained at an historically very high level. In this respect, the outcome of the wage agreements in 1995, which will result in wage increases above competitor countries in coming years, is not an encouraging sign. This is particularly worrying given the fact that wage increases in the sheltered part of the economy exceeded those in industry. This indicates a need to increase the efforts to improve the functioning of the labour market. Otherwise there is a risk that the result will be an erosion in competitiveness and an upsurge of inflation, which would be damaging for employment prospects.

Another major challenge is to put the public finances on a sound footing after the severe deterioration during the recession in the beginning of the 1990s. In this respect, economic policies have so far been successful and public finances have improved considerably since the budget deficit peaked at 13.4% of GDP in 1993. The deficit is

expected to amount to some 7% of GDP in 1995 and is forecast to continue to improve in coming years. At the same time, the rapid build-up of the public sector debt has almost come to an end. This would be in advance of the path laid down in the convergence programme presented in June, which forecast a considerably higher budget deficit in 1995 and also a stabilisation in the consolidated public debt at a later date than now foreseen.

The improvement in public finances stems from the government's consolidation programme of 118 billion kronor corresponding to some 7.5% of GDP, which is the cornerstone in the convergence programme. The stronger economic activity has also played an important role in the improvement. As a result of the high level of public sector revenues and expenditures the Swedish budget is very sensitive to cyclical swings. The improvement is due both to increased revenues and lower expenditures in roughly equal parts. A marked slowdown in the economy in the coming years might therefore raise fears concerning prospects for employment and public finances.

As regard monetary policy, the explicit inflation target that was announced after the krona was left to float is for an annual increase in the consumer price index of 2% with a tolerance limit of 1 percentage point on either side. From August 1994, monetary policy was gradually tightened in response to indications of higher inflation expectations and pressure. The main inflationary impulse came from the weak krona, although the appreciation of the krona that took place in the latter part of 1995 and subdued domestic demand helped to keep inflation within the tolerance band. Inflation expectations also fell gradually in the course of 1995. In January 1996 the official repo rate was reduced twice with in total 0.46 percentage points.

UNITED KINGDOM

The recovery continues though growth slows down

The recovery is now well into its fourth year and is of longer duration than that in the rest of the EU where recovery started later. The expectation for 1995 was that growth would slow down to more sustainable rates than the 3.9% of 1994 but, in the event, growth was less than generally expected. While GDP in 1995 as a whole rose by 2.6%, growth in the second, third and fourth quarters of the year averaged just under 2% at an annual rate.

	1986-90	1991-93	1994	1995
GDP growth rate (% change)	3.3	-0.1	3.8	2.6
Total domestic demand (% change)	4.0	-0.3	3.3	2.0
Employment (% change)	1.9	-2.3	0.0	0.8
Unemployment rate (%)	9.0	9.8	9.6	8.8
Inflation (% change)	5.0	5.2	2.5	3.0
Balance of current account (% of GDP)	-3.8	-2.6	-2.1	-2.1

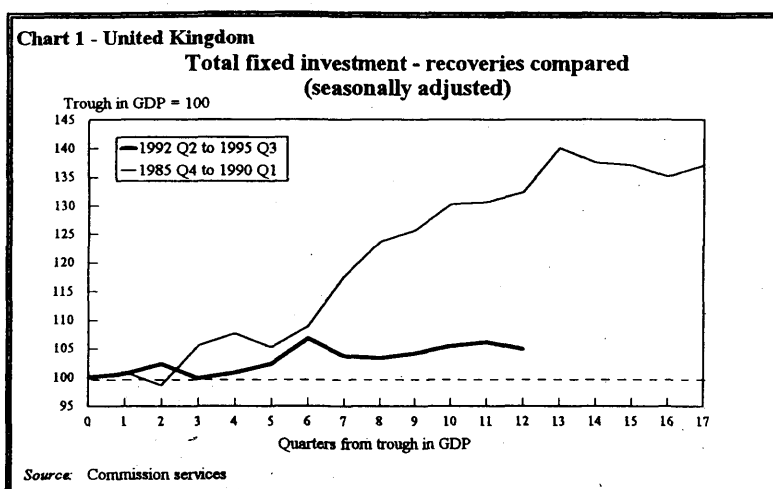
For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

In 1994, the output of production industries grew by 5.1%, partly as a result of an upsurge in oil production as output from newly developed fields came onstream. Manufacturing and construction output also grew strongly - by 4.3% and 4.0% respectively. Service output rose by 3.6%. However, in 1995 industrial production

was subdued as oil production peaked; in addition manufacturing output was broadly flat throughout the year and construction output fell. The service sector provided most of the rise in GDP throughout 1995.

The reasons for these production trends seem to be associated with changes in the pattern of growth of final demand. Net exports contributed significantly less to growth in 1995 than in 1994. However, private consumption, despite weak retail sales, grew by 2½% in 1995 as a result of growth in spending on services. Real disposable income was depressed in these quarters due to subdued wages growth and the introduction of some personal tax rises: consequently, growth in consumption was associated with a fall in the saving ratio. While the economy is well into the fourth year of recovery, fixed investment has yet to enjoy the growth normally observed at this stage of the cycle and in 1995 it rose by only 1¼%. Chart 1 contrasts the current investment performance with that of the previous recovery. The performance has not, however, been uniformly disappointing.



Though investment in buildings and works remained depressed, manufacturing investment in the first three quarters of the year grew by 14% at an annual rate. Stockbuilding continued to increase during most of 1995 and may be partly involuntary in the face of subdued final demand.

Growth of exports of goods was 10% in 1994 and contributed considerably to the strength of GDP. However, in 1995 growth of exports slowed down - partly as a result of subdued oil exports and partly as a result of the pause in growth in other EU member states which account for 59% of exports of UK goods. Even netting out oil, exports rose by only an annualised 2½% between the final quarter of 1994 and the third quarter of 1995 despite the improvement in competitiveness associated with sterling's depreciation in 1995.

Table 2
United Kingdom: Economic policy indicators

	1986-90	1991-93	1994	1995
Money growth (% change)	16.3	4.6	3.5	10.1
Government budget balance (% of GDP)	-1.1	-5.6	-6.8	-5.1
Gross government debt (% of GDP)	43.5	42.0	50.3	52.5
Nominal wages per head (% change)	8.3	6.0	3.5	3.2
Real wages per head (% change)	3.2	0.8	1.0	0.2

For definitions, see Table 2 for Belgium

Source: Commission's November 1995 forecasts

The latest indicators of the economy are mixed though they do not suggest that growth in activity is much different, currently, from that throughout most of 1995. Retail sales grew strongly, by ¾%, in the fourth quarter of 1995 having been flat for most of 1995. Export volumes rose by 1% in the three months to November while imports fell by ½%. In contrast,

manufacturing output remained stagnant and shorter and longer leading indicators of the economy continued to fall suggesting, and confirming, a slowdown. However, forward

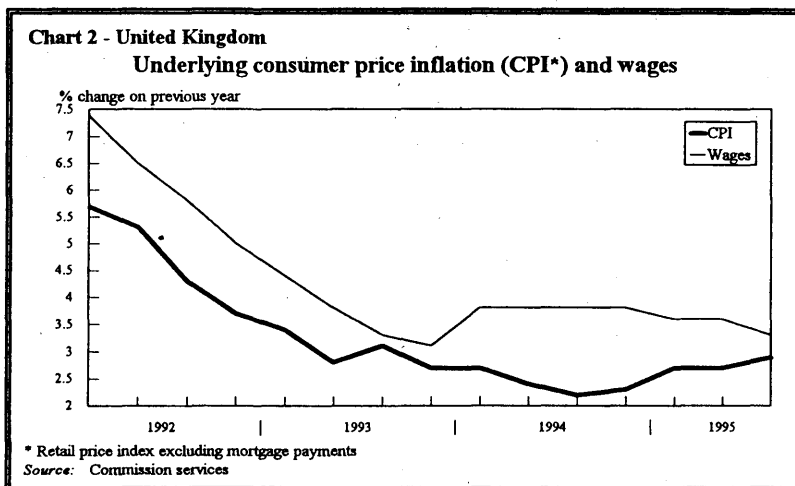
looking survey indicators for manufacturing suggest a pick-up in output and increased orders in the first quarter of 1996.

Underlying inflation, measured by the rise in retail prices excluding mortgage interest payments, crept up very gradually throughout the year to average 2.9% in the final quarter of 1995, though this is comfortably within the Government's target range of 1-4%. This acceleration was associated with a rise, over this period, in annual producer price inflation. In turn, this followed the earlier strong increases in input prices resulting from rises in world commodity prices. Annual input price inflation declined significantly in the latter months of 1995. In addition, wage inflation remained low despite a tightening of the labour market: underlying earnings growth was no more than 3¼% in the third quarter of 1995 - the lowest for two years. These trends are shown in Chart 2.

Monetary policy is set to achieve a target of underlying inflation of 1-4% with an aim of securing it in the 1-2½% range by the end of this parliament (May 1997 at the latest) and beyond. Successive rises in base rates from 5¼% to 6¾% from September 1994 to February 1995 ensured that inflation remained comfortably within the wider target band despite sterling's depreciation of some 7% in 1995. However, as described above, economic activity remained sluggish throughout 1995 and was accompanied by subdued inflationary pressures. Base rates were reduced to 6½% on 13 December 1995 and to 6¼% on 18 January of this year. The challenge facing the Government is to bring underlying inflation within the narrower range in the short term specified and to hold it there but, at the same time, to deliver adequate economic growth.

Though economic growth slowed down, employment continued to grow in 1995 albeit modestly.

The employer-based survey showed annual growth of 0.9% in the first three quarters of 1995 whereas the household-based Labour Force survey suggested employment growth was more rapid. The possibility remains that the former



is not picking up new jobs in newly created businesses adequately or rising employment in parts of the construction sector. Unemployment continued to fall and at the end of 1995 was just over 8% of the labour force: more than 2 percentage points below the EU average. However, falls in the second half of 1995 were generally lower than those earlier in the year as growth has slowed down markedly.

Employment growth, in association with recent GDP growth, resulted in a productivity increase of 2.5% in the first three quarters of 1995 at an annual rate - rather slower than the 3.3% of 1994. Wage inflation, as noted above, was subdued and unit wage costs in the first three quarters of 1995 rose by only an annualised 2.1%. However the picture is rather different for manufacturing where growth has recently been flat and underlying earnings inflation in the third quarter of 1995 was 4¼% - well above the whole economy average of 3¼%. Accordingly, productivity in manufacturing in the third quarter of 1995 was only 0.7% up on a year earlier whereas unit wage costs were some 3.7% higher.

Growth to continue at sustainable rates

The outlook is for growth to continue at sustainable rates. Certainly the economy would seem capable of growing around productive potential of 2½% in the near future - a little above current growth rates - as there is little indication of capital or labour shortages and inflationary pressures remain subdued.

One factor expected to contribute to growth is a long-awaited recovery in fixed investment though this will be moderated by falls in that of general government.

The prospects are for subdued inflation. The current moderate nature of growth is expected to restrain wage inflation in the short term and expected growth is unlikely to lead to a major resurgence in wage inflation over the next two years.

The UK government presented an update of the convergence programme in March 1995 based on measures introduced in the November 1994 budget. In particular, reductions in cash expenditure on previous plans were introduced that were permitted by a better than projected inflation outturn. A more rapid improvement in government finances was therefore expected. In the event sluggish economic growth and, even allowing for this, an unexpected weakness in revenues in 1995 slowed down the fiscal consolidation. This arithmetic was acknowledged in the budget for 1996-97 presented in November 1995 which was broadly neutral in its impact on public finances.

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