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Growth, employment and convergence
on the road to EMU

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1997 Annual Economic Report

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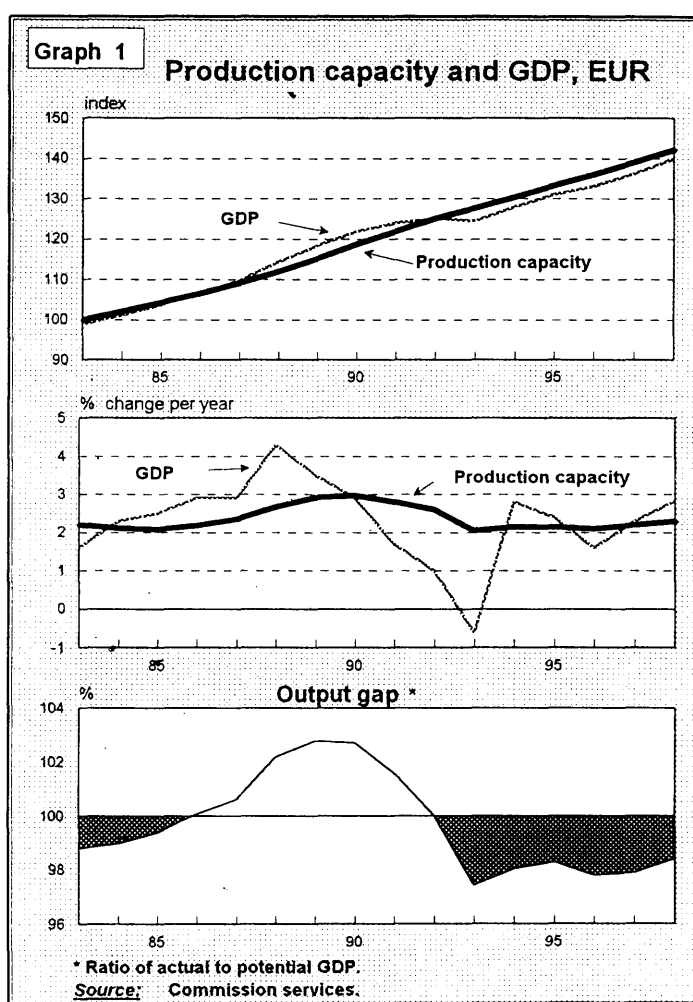
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This performance is clearly worse than that of the Community's main international partners. The US economy, helped by higher growth and a more responsive labour market, has created jobs at an average rate of 1.2 per cent per year over the first half of the 1990s. And although Japan experienced a severe recession and average growth over the period was only slightly higher than in the Community, the Japanese economy managed to create jobs at a rate of 0.7 per cent per year.

The comparatively poor performance of the Community over the 1990s reflects the fact that the Community economy has repeatedly come up against important macroeconomic constraints on growth.

1.1.1 1990-93: Overheating and recession

In 1988-90, the macroeconomic policy-mix in the Community on average became too expansionary relative to available production potential. Insufficient efforts were being made to reduce budgetary imbalances while average monetary conditions had been eased in the wake of the October 1987 stock market crash. With business expectations buoyed also by the prospects for the implementation of the Internal Market, output growth accelerated to around 4 per cent per year on average in 1988-89. This was considerably faster than the potential growth rate of the Community and with no spare capacity available it led to an overheating in the economy. The debt-financing of massive unification-related expenditure led to a high budget deficit and rising inflationary pressures in Germany. For the Community as a whole, the current account balance turned from a



Part A : Community-wide trends

SUMMARY AND CONCLUSIONS

The Community is on course towards a successful transition to EMU...

Since the adoption of last year's Annual Economic Report, substantial progress in institutional preparations for EMU and a reinforced commitment to budgetary adjustment in many Member States has brought important benefits. Both short- and long-term interest rates have converged towards lower levels and exchange rate stability has improved. Thus, progress towards EMU is helping Member States to overcome some of the most important obstacles to sustained growth and job creation in recent years, namely high real interest rates and monetary turbulence. Against the background of a widespread easing of monetary conditions and the increased credibility of budgetary consolidation in many Member States, the prospects for a sustained pick-up in economic activity and employment in the Community have improved considerably.

...helped also by progress in institutional preparations.

On the institutional front, the Community has achieved substantial progress with preparations for stage three of EMU. This concerns the technical preparations for the introduction of the euro and arrangements guiding currency relations between the euro and the currencies of Member States that may not be in a position to participate in the single currency from 1 January 1999. Equally importantly, agreement has been reached on the framework for ensuring budgetary discipline and co-ordination in the third phase of EMU (the Stability and Growth Pact). Prospects for exchange rate stability have also been enhanced by the entry of the Finnish markka and the Italian lira into the exchange rate mechanism of the EMS.

This institutional progress has played an important role in underpinning confidence in EMU. It is essential that the Community continues to work determinedly to ensure that all the conditions for a successful transition to the third stage of EMU on 1 January 1999 are put in place in a timely fashion.

A gradually strengthening upturn in economic activity is underway

Following the set-back to economic growth in the second half of 1995 and in early 1996, the Community economy now appears to be back on a more favourable track. Activity has recovered in virtually all Member States and for the Community as a whole the pace of expansion is expected to pick up to around trend rate in 1997 and above-trend in 1998. This will contribute to some improvement in the employment situation. However, the labour force will also increase and, while unemployment is likely to decline gradually during 1997 and somewhat faster in 1998, overall levels will remain high. Recent inflation trends are encouraging in most Member States and the outlook is for continued convergence of inflation rates at a low level.

A good basis has been laid for achieving strong investment-supported economic growth and sustained job creation over the medium term. Supply-side fundamentals -- in terms of reinforced prospects for moderate wage increases and sound investment profitability -- are better than during the period of high growth and job creation in the second half of the 1980s, and better also than during the recovery in 1994 and early 1995. The forecast pick-up in investment will ensure a sufficiently rapid expansion of productive capacity to keep pace with growing demand. And the stance of economic policies has become more conducive to a soundly-based and sustained expansion of output, investment and employment.

Sound rebalancing of the macroeconomic policy-mix has taken place

In 1996 and in their budgets for 1997, a large majority of Member States have taken significant measures to reduce their budget deficits to 3 per cent of GDP or below as a step towards moving close to budget balance or achieving a surplus over the medium term. While some countries have relied to some extent on one-off measures which will need to be complemented by lasting budgetary improvements, the overall scale and composition of the consolidation efforts underlines the strong resolve of Member States to place their public finances on a sound footing. Budgetary positions would already have improved more by now had it not been for the slowdown in economic growth in 1995/96.

Budgetary consolidation is necessary and desirable in its own right. The need to make headway in fulfilling the conditions for the introduction of the single currency has provided a unique opportunity to achieve large gains in the credibility of these adjustment efforts. During 1996, this led to a very significant reduction in interest rate premia in a number of Member States. The most striking examples are Spain, Italy, Sweden and Portugal where long-term interest rate differentials relative to the lowest-yielding currencies have fallen substantially. In addition to strengthening the growth prospects of the economy and stimulating investment, lower interest rates provide a significant boost to deficit reduction by lowering the government debt service burden.

Budgetary consolidation forms an integral part of the overall rebalancing of the economic policy mix in the Community. Reduced inflationary pressures and the prospects for moderate wage increases have paved the way for a significant easing of monetary conditions. Against the background of healthy supply-side fundamentals and a favourable international setting, the net growth impact of budgetary consolidation and lower interest rates in the Community is consistent with healthy economic growth in 1997-98. Even if economic activity should fail to pick up to the extent foreseen, there should be no let-up in budgetary consolidation efforts. Slippages from budgetary targets would put at risk the favourable trends in interest and exchange rates and therefore undermine the prospects for stronger economic growth.

Avoiding macroeconomic obstacles to growth ...

The poor growth and employment performance of the Community over the first half of the 1990s has often been incorrectly blamed on factors such as globalisation or the introduction of new technologies. In fact, it was mainly the result of macroeconomic obstacles to growth within the Community:

- (i) *Insufficient expansion of productive capacity:* In the late 1980s/early 1990s inflationary pressures built up in the Community as demand expanded too fast relative to productive capacity;
- (ii) *Distorted economic policy-mix:* A distorted policy-mix led to an overburdening of monetary policy. Indeed, too lax budgetary policies (since 1988) and wage developments (since 1990) inconsistent with the objective of price stability caused a rise in interest rates which resulted in a slowdown in growth and job creation and the 1992/93 recession;
- (iii) *Monetary turbulence:* currency crises, which to a considerable extent reflected insufficient credibility of economic policies in several countries and a lack of policy co-ordination in the Community, have had a disruptive influence on economic growth both in countries whose currencies appreciated and in countries whose currencies depreciated. The most recent

example was the currency turmoil of spring 1995 which, together with the rise in long-term interest rates and the depreciation of the US dollar, aborted the otherwise sound recovery which had started in mid-1993.

If the Community is to achieve a sustained period of healthy economic growth capable of ensuring a significant and lasting reduction in unemployment, it has to find lasting solutions to these macroeconomic obstacles to growth.

... means enhancing the Community's growth potential...

Strong medium-term economic growth must be supported by investment to ensure that productive capacity increases in line with rising demand. In the short run, economic growth can and should exceed potential output growth in order to take up idle productive capacity and to absorb the, generally small, cyclical component of unemployment. However, over the medium term economic growth cannot exceed the potential growth of the economy without creating capacity tensions and therefore resulting in rising inflation. With the current investment rate, the Community economy would, in the longer run, barely be able to grow at more than 2¼ per cent per year. On the basis of historical trends, this would result in a slow increase in employment. In view of the high level of unemployment in the Community and the huge potential for an increase in labour force participation, considerably faster and durable economic growth and job creation is required. High growth in fixed investment, as much as better quality of investment, is needed in order to achieve potential output growth in the 3 to 3½ per cent range over the medium term.

Investment conditions are now favourable from a macroeconomic point of view but they must be assisted by a balanced and credible policy mix over the medium term. On this account, the strengthening of the policy framework inherent in the process leading to EMU is a major positive factor.

...ensuring a balanced and credible policy-mix over the medium term...

The objective of achieving a government financial position close to balance over the medium term has been adopted by the Community in successive Broad Economic Policy Guidelines since 1993. This objective has been given increased credibility and importance within the framework of the "Stability and Growth Pact" agreed by the Dublin European Council in December 1996 in order to ensure budgetary discipline in stage three of EMU. Member States are committed to taking further steps, in the years after 1997, to ensure a continued improvement in their budgetary positions in order to attain the medium-term objective of close to balance or a surplus in normal circumstances.

This objective is an essential condition, not only to ensure the viability and reap all the potential benefits of EMU, but also to achieve sustained, investment-supported growth in output and employment over the medium term. The latter requires a rise in government savings to maintain a proper balance between overall savings and investment, and low interest rates. The medium-term objective of close to balance or surplus will also create room for budgetary policies to adapt to cyclical disturbances without causing the deficit to exceed 3 per cent of GDP during "normal" cyclical downturns. Finally, it will be instrumental in reversing the upward trend in government interest payments, thereby reducing the crowding-out of non-interest expenditure and facilitating tax reductions while preparing for the budgetary consequences of the "ageing" of populations. Once the average budget deficit in the Community has been reduced to 3 per cent of GDP by 1997, the achievement of budget balance in the course of subsequent years will be facilitated by the return to healthy economic growth.

While budgetary consolidation measures need to be adapted to country-specific circumstances in terms of their extent, timing and design, they should be credible and socially-balanced and adhere to the main guiding principles stipulated in successive Broad Economic Policy Guidelines, including the 1996 Recommendation. This means giving prominence to expenditure restraint as opposed to further increases in the overall tax burden; shifting government spending priorities towards productive activities such as investment in infrastructure, human capital and active labour market initiatives; improving the efficiency of public services; and reducing the overall tax burden as possible, especially that on labour, but conditional upon firstly placing the budget deficit on a firm downward path.

For the first time since the adoption of the Broad Economic Policy Guidelines in 1993, average wage increases in the Community are now forecast to remain at levels which are fully consistent both with the maintenance of price stability and with the achievement of a further improvement in investment profitability in the Community, while also allowing a moderate increase in real wages. Continued respect of these conditions is essential. The strongly enhanced credibility of the monetary and budgetary policy framework in EMU will help to avoid the emergence of excessive price and wage pressures.

Continued appropriate wage developments combined with sound budgetary policies would facilitate the realisation of price stability and durably lead to a balanced policy mix and to lower interest rates in the Community. The discussions at Community level of the Commission's communication on "Action for employment in Europe -- A Confidence Pact" are helping to avoid the risk of conflict between the three major macroeconomic variables.

... and preserving monetary stability.

Progress towards EMU acts positively on exchange rate stability and reduces risk premia on interest rates. The achievement of EMU in 1999 will, by definition, eradicate the obstacle to growth stemming from intra-EC currency turbulence for participants and should also have positive effects for the "pre-ins" as they continue to make progress with economic convergence. With widespread use of the euro in intra- and extra-European trade, the Community will also be less vulnerable to the volatility of the US-dollar exchange rate.

Technological change and globalisation are not the causes of unemployment

The unsatisfactory job performance of the Community economy during the first half of the 1990s has sometimes been linked with the effects of rapid technological advances and increased globalisation. However, such views often fail to take into account the wider economic impact of these phenomena.

Technological and organisational advances, the move towards a knowledge-based economy and improved international resource allocation have been and will continue to be the key driving forces behind long-term improvements in productivity, economic growth, employment and living standards in the Community. However, such changes imply continuous changes in the structure of output and employment and tend to reduce demand for low-skilled labour.

In order fully to reap the potential benefits from technological progress and globalisation, it is essential that macroeconomic growth is strong enough to absorb the resources freed by higher productivity. On the structural side, it is necessary:

- (i) that efficiently functioning goods and services markets facilitate adjustment by allowing for swift changes in relative prices, and that sectoral changes occur smoothly and in a socially acceptable manner;

- (ii) that improved education and training increase the supply of high-skilled labour and that measures are taken to enhance employment of the low-skilled.

Enhancing the efficiency of product and services markets

In order to increase confidence and the propensity to invest, it is essential that Member States and the Community intensify their efforts to improve competition in the markets for goods and services. This involves in the first place the full completion of the European single market which has so far contributed to a rise in the level of GDP of up to 1.5 per cent and created up to 900 000 jobs. Further action is needed, however, to complete the legislative framework in areas such as taxation and company law and the liberalisation of the telecom and energy markets. Even more importantly, it is necessary to ensure the effective application and enforcement of existing Community law and competition policies, and to reduce the burden of over-regulation, particularly but not exclusively at the national level, which still impedes the operation of the single market.

The creation of a flexible economy also needs determined action in other important areas, including the realisation of the transeuropean transport and communication networks, the intensification of research and development, the promotion of the information society and the removal of barriers to entry and excessive regulation facing SME's. These policies will strengthen the endogenous growth forces, lead to positive advancements in the overall productivity of the Community economy and increase the effectiveness of macroeconomic policies.

The employment effects of policies to improve competitiveness and the functioning of product and services markets depend crucially, however, on the possibility of exploiting this potential through higher overall growth. EMU will help pave the way for strong and durable employment-creating growth.

Need for greater labour cost flexibility and employment

Over the last two decades, the annual average increase in labour productivity in the Community, of the order of 2 per cent, has resulted in more or less equal proportion from the incorporation of technological progress and a substitution of labour by capital at the macroeconomic level. By comparison, nearly no macroeconomic substitution has taken place in the United States despite an only slightly lower pace of technological progress. The substitution of labour by capital in the Community reflects three trends. Firstly, relatively more investment has been aimed at replacing labour rather than expanding capacity. Secondly, within the international division of labour the Community has specialised in high-skilled and capital-intensive production. Thirdly, certain labour-intensive, low-productivity employment opportunities have ceased to exist in the Community.

Capital-labour substitution is a means of achieving high growth in economic activity and rising living standards. In the current situation of persistently high unemployment in the Community, however, this creates a twofold problem.

Firstly, relative to stable labour productivity growth, macroeconomic growth in the Community has been insufficient to create an adequate number of jobs although as highlighted above, conditions for strong growth are improving.

Secondly, the trend towards capital-labour substitution can be seen to reflect an imbalance in the relative prices of capital and labour and an insufficient degree of adjustment in the labour market in particular. Following the first oil price shock, high wage and non-wage labour costs as well as, in some cases, rigid employment security rules have reduced the attractiveness of labour as a production factor and have compelled enterprises to keep up a strong substitution of labour by capital in order to safeguard their competitiveness. However, labour markets in the Community have adjusted gradually. Since the early 1980s, productivity increases obtained through capital-labour substitution have broadly ceased to be reflected in higher real wages, leading to a considerable improvement in profitability. These developments are laying the ground for economic growth sustained by capacity-widening and employment-creating investment as demand prospects brighten, but they impact only slowly on the employment-intensity of growth.

Another, more rapid route towards a more employment-intensive pattern of growth would be to encourage a downward widening of the wage cost scale as in the United States. Reducing wage costs at the low end would enable activities with low productivity to remain and/or to become profitable. For social and political reasons, an emulation of the US-approach which has led to a significant drop in real wage income for low-skilled labour is neither feasible nor desirable in the Community. Hence the need for strong, investment-supported macroeconomic growth assisted by pragmatic solutions, as laid down in the strategy adopted by the Essen European Council in December 1994, aimed at a higher employment-content of growth without impairing competitiveness.

In order to preserve, in a reformed and streamlined fashion, the key ingredients of the European social model, the following pragmatic approaches are worth pursuing. The social partners' wage agreements should provide for more differentiation according to qualifications, and between regions and, to some extent, sectors. Non-wage labour costs (or payroll taxes) at the lower end of the wage scale should be lowered with the government revenue losses being compensated for by a stricter control of increases in overall government spending and/or increases in other taxes (e.g. environmental levies). In a similar vein, temporary entry-wages for the low-skilled, youth or long-term unemployed could usefully be introduced. Furthermore, more flexibility in working time arrangements, tailored to the specific needs of firms and workers, the greater use of voluntary part-time work and the promotion of local employment initiatives are likely to foster both new jobs and higher participation in the labour market.

More generally, as emphasised in the 1996 Joint Employment Report "Employment and growth in the Community - The way forward" approved by the Dublin European Council, there is a continued need to improve the responsiveness of Member States' labour markets to changes in the economy through a modernisation of the organisation of work, increased geographical and professional mobility and productivity-related labour cost differentiation. In particular, it is essential to reinforce education and training so that the work force is able to adapt to evolving technological changes. These efforts are also necessary in order to avoid labour market bottlenecks and a resumption of wage inflation as unemployment is reduced.

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With the realisation of the single market and EMU, the Community is increasingly becoming an economic entity. Supply-side fundamentals are healthy and improving further, thereby underpinning the ongoing recovery. In EMU, sound budgetary policies and moderate wage

developments will facilitate the maintenance of stable monetary conditions. This fundamental change in the overall macroeconomic policy mix will be favourable to growth.

These factors provide the basis for transforming the current recovery into strong and durable economic growth supported by higher investment, thus avoiding capacity constraints and inflationary tensions. An extended period of sound economic growth of the order of 3 to 3½ per cent per year would progressively absorb the high employment potential of the Community and significantly reduce unemployment. Stronger economic growth and job creation is also required to realise the full benefits of the single market, globalisation and technological progress.

Against such a background, the consolidation and restructuring of public finances would be facilitated and the unavoidable structural adjustments would be eased. The necessary structural policies in the goods, services and labour markets would also be more effective in helping overcome rigidities, avoid inflationary pressures and make growth more employment-creating, especially with respect to low-skilled labour, without impairing competitiveness.

These considerations underline the need for adopting measures in line with the conclusions adopted by the European Councils in Florence and Dublin.

1. THE CURRENT ECONOMIC SITUATION AND THE OUTLOOK TO 1998

Following the set-back to economic expansion in the second half of 1995 and early 1996, the Community economy now appears to be back on a more favourable track. A rebound in economic growth is underway, helped by a sound rebalancing of the macroeconomic policy-mix and an EMU-related gain in the credibility of the economic policy framework in the Community which has led to strongly reinforced convergence in long-term interest rates. Against the background of good fundamentals and sound economic policies, output is expected to grow at around its trend rate in 1997 and above trend in 1998.

The rebound in economic activity should lead to progressive improvements in employment. In the short term, unemployment is likely to remain high but it is expected to decline gradually during 1997 and somewhat faster in 1998. Inflation trends are favourable in almost all Member states and the outlook is for continued convergence of inflation rates at a low level, underpinned by generally moderate wage increases.

1.1 Disappointing growth and job performance in the first half of the 1990s

The outlook for a strengthening of economic activity must be seen against the background of an unsatisfactory growth and employment performance over the first half of the 1990s. During the last six years, average GDP growth in the Community has been only 1.5 per cent per year (Table 1). This lack-lustre performance is much lower than the average 3.3 per cent growth rate achieved in the latter half of the 1980s, and it is lower also than the average 2 per cent growth rate registered during the years 1974-85 even though this

Table 1 Growth and employment EUR, USA and Japan (average annual percentage change)			
	Real GDP growth		
	1974-85	1986-90	1991-96
EUR	2.0	3.3	1.5
USA	2.3	2.8	2.3
Japan	3.4	4.6	1.7
	Employment growth ¹⁾		
	1974-85	1986-90	1991-96
EUR	0.0	1.3	-0.4
USA	1.8	2.1	1.2
Japan	0.7	1.0	0.7
¹⁾ National accounts definition. <i>Source:</i> Commission services.			

period was characterised by severe adverse supply shocks.

Low growth has been reflected in disappointing employment trends. Over the years 1991-96, employment in the Community has fallen by an average 0.4 per cent per year, amounting to a total of 4½ million jobs lost since 1990 (3½ million excluding the new German Länder). As a result, almost half the 10 million jobs created during the growth period 1986-90 have since been lost.

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surplus of 0.6 percent of GDP in 1987 to a deficit of 0.9 percent of GDP in 1991. Over the same period, average inflation accelerated from 3½ per cent to 5½ per cent while average nominal wage increases accelerated from 5½ to 7½ per cent.

In response to rising inflationary pressures, monetary conditions throughout the Community were progressively tightened from 1988 onwards, but budgetary policies were very lax. This distorted policy-mix led to a slowdown in growth in most countries in 1990-91, although the positive short-term demand effects of unification delayed the downturn in Germany. Conflicting demands on economic policies caused severe tensions in currency markets. In the winter of 1992/93, the Community economy slid into recession. Over just two years, almost 5 million jobs were lost (4 million excluding the new German Länder).

1.1.2 Mid-1993 to mid-1995: Soundly-based recovery

As inflationary pressures gradually subsided, monetary conditions were eased in almost all Member States in late 1992 and throughout 1993. Against the background of healthy fundamentals -- in terms of lower price and wage pressures and relatively sound corporate profitability -- recovery took hold in the middle of 1993 driven by a strong international economy, lower interest rates and an improvement in the competitiveness of the Community.

Table 2 Recovery and slowdown in the Community ¹⁾ (half-yearly data; percentage change at annualised rate)							
	93H1	93H2	94H1	94H2	95H1	95H2	96H1
Final internal demand	-2.9	0.2	1.9	2.0	2.1	0.9	1.9
-of which: Investment	-10.2	-2.8	3.8	4.5	3.8	-0.6	0.9
Private consumption	-1.9	1.3	1.6	1.7	2.1	1.2	2.5
Exports ²⁾	-0.9	6.9	9.2	9.4	9.3	1.8	4.2
Final demand ³⁾	-2.6	1.3	2.8	2.9	2.9	1.0	2.2
Stockbuilding ⁴⁾	-0.5	-0.2	1.4	1.1	-0.6	0.9	-0.8
Real GDP	-1.6	1.3	3.3	3.4	2.4	1.2	1.7
Employment ⁵⁾	-2.1	-1.4	-0.1	0.5	0.7	0.5	-0.3

¹⁾ EUR5 = Germany, France, Italy, Spain and the United Kingdom.
²⁾ Goods and services; exports includes intra-EC exports.
³⁾ Excluding intra-Community trade; Commission services estimate.
⁴⁾ Contribution to GDP-growth.
⁵⁾ Labour force survey; seasonal adjustment by Commission services.
Source: Commission services.

From the end of 1993 until the first quarter of 1995, the Community economy expanded at a healthy average pace of around 3½ per cent (annualised rate). The recovery was soundly based, led mainly by buoyant exports and healthy investment growth. The growth of private consumption gradually rose to some

2 per cent (at an annualised rate) for the Community as a whole. As is normal during

the early phase of an economic recovery, growth was fuelled also by a cyclical turnaround in stockbuilding. Given the rapid expansion of investment in equipment (up by 6.7 per cent in 1995), the Community appeared to be on track towards transforming the recovery into strong and sustained medium-term growth of economic activity and employment.

This short period demonstrated once again the European economy's capacity to create jobs as long as economic growth continued at a healthy pace. Overall employment increased by over 1 per cent between the first quarter of 1994 and the third quarter of 1995. The average rate of unemployment in the Community declined from around 11.3 per cent to 10.7 per cent of the labour force.

1.1.3 Abrupt slowdown and extended growth pause from mid-1995 to mid-1996

This broadly favourable growth performance was abruptly interrupted in the second quarter of 1995. The slowdown was particularly sharp in countries whose currencies appreciated during the currency turmoil in the spring of 1995. Germany and France, in particular, experienced 3 to 4 quarters of stagnation. By comparison, growth initially continued at a higher pace in most countries whose currencies had depreciated, but a clear slowdown soon appeared also in these countries.

For the Community as a whole, the healthy growth of investment came to a sudden halt and the growth of exports was markedly reduced as both intra- and extra-European trade slowed. With a lag of one to two quarters, private consumption growth stagnated as employment prospects deteriorated in countries whose currencies had appreciated while inflation and interest rates had increased in countries whose currencies had depreciated. Overall, the growth of final demand (excluding stockbuilding) decelerated from close to 3 per cent over the previous 1½ years, to just 1 per cent in the second half of 1995 (see Table 2).

1.1.4 Main causes of the 1995/96 growth pause

The principal factors accounting for the abrupt and widespread economic slowdown were the rise in real long-term interest rates during 1994 and the weaker dollar that caused the exchange rate movements in the course of 1994 and, especially, the first months of 1995. The insufficient credibility of budgetary policies in many countries played a key role in both regards. In addition, the deterioration in European cost competitiveness and a slower growth on export markets had a dampening effect on Community exports. Finally, the strong contribution to growth from stockbuilding in the early phases of the recovery was sharply reduced (from nearly 1 percentage point in 1994 to ¼ percentage points in 1995).

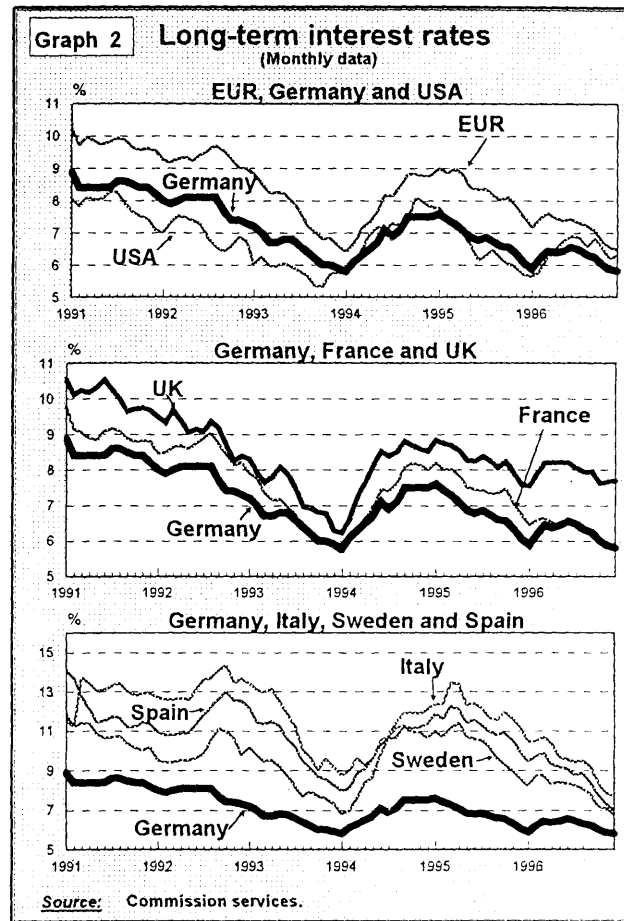
Rise in long-term interest rates

On average in the Community, 10-year benchmark bond yields rose by around 250 basis points between January 1994 and January 1995. Evidence from countries where index-linked bonds are traded suggests that real interest rates rose by at least 1 percentage point, and in some countries real rates are likely to have risen by considerably more.

These trends were partly related to a similar rise in US bond yields and partly to internal factors in the Community. The international rise in real interest rates was the result *inter alia* of prospects for a substantial rise in the demand for loanable funds reflecting an upturn in investment which was not adequately off-set by credible prospects for reduced government borrowing. As far as the Community is concerned, little fiscal consolidation took place in 1994-95. In cyclically-adjusted terms, the average fiscal deficit in the Community was reduced by a mere $\frac{1}{4}$ of a percentage point of GDP per year in 1994 and 1995. The initial failure credibly to tackle large budget imbalances led to widening risk premia and a marked tendency for long-term interest rates to rise most in countries

with high public deficit and debt ratios and/or historically weak inflation performances. While rates in Germany and several neighbouring countries rose by around 180 basis points, the increase was larger in France and the United Kingdom (around 250 basis points) and long rates in Italy, Spain and Sweden continued rising in the first months of 1995 which brought the cumulative increase in yields to between 400 and 450 basis points (Graph 2).

The rise in real long-term interest rates exerted a restraining influence on activity in most industrial economies (GDP-growth in the United States decelerated from 4 per cent in mid-1994 to less than 2 per cent in the first half of 1995, not least due to higher interest

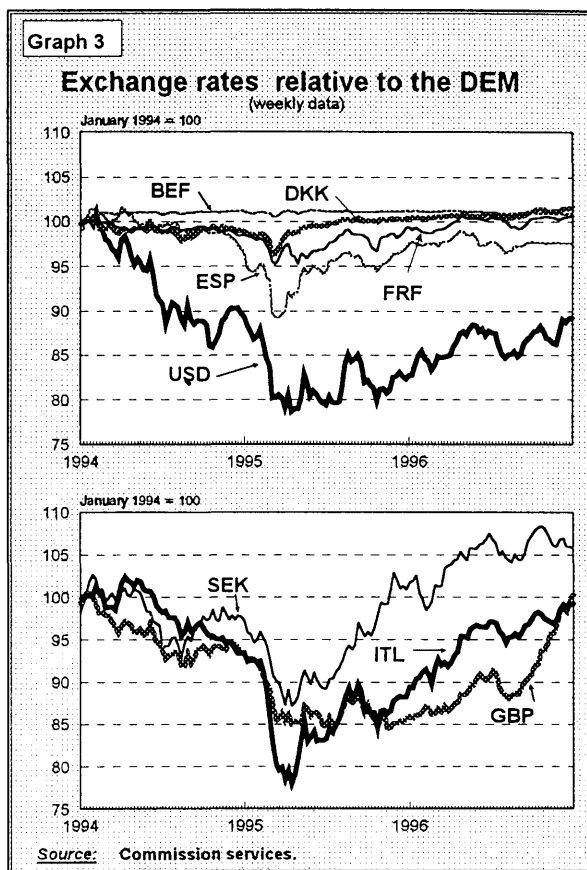


rates). In the Community, higher real interest rates played a major role, together with specific factors in some countries, in the slowdown in construction investment. Other interest-sensitive components of demand, including equipment investment, stockbuilding and consumer durables, were also negatively affected.

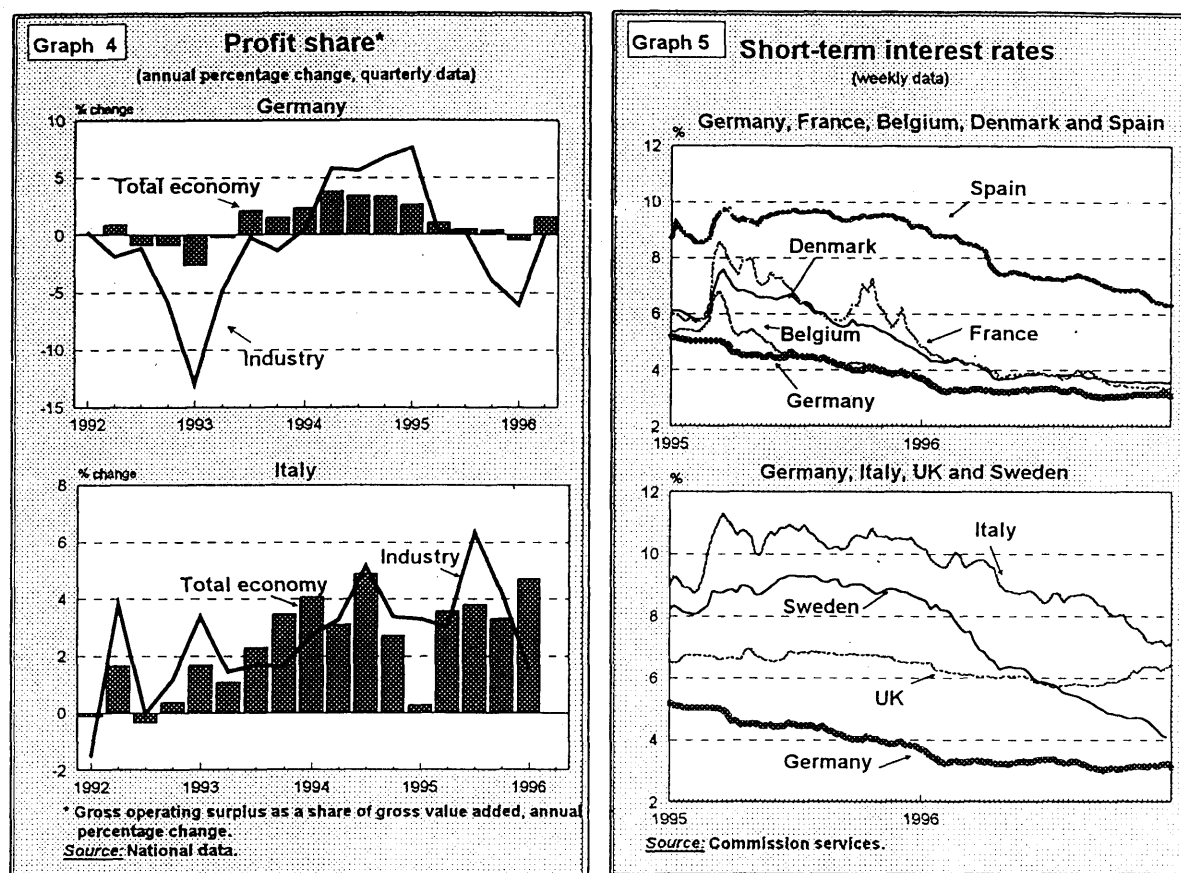
US-dollar weakness and intra-European currency turmoil

The Community economy was further hit by substantial weakening of the US-dollar during 1994 and a steep fall in early 1995. Overall, the US currency fell by some 20 per cent relative to the DEM (Graph 3). The weaker dollar, in combination with a “flight to quality” following the collapse of the Mexican peso in early 1995, led to severe strains on intra-European exchange rates.

By contrast to some previous episodes of currency turmoil, these exchange rate movements did not reflect a need to correct competitive imbalances. The turmoil negatively affected the currencies of Member States whose economic policies, in particular budgetary policies, were not yet perceived as sufficiently credible by the markets. The Italian lira, which had already been weakening during 1994, fell sharply in the first months of 1995 and both the pound sterling and the Swedish krona fell considerably in trade-weighted terms. Within the ERM, the central rates of the Spanish peseta and the Portuguese escudo were devalued in March. The German mark and currencies closely linked to the DEM appreciated by up to 6 per cent in trade-weighted terms. Relatively high wage settlements for 1995 in some industrial sectors in Germany limited the scope for interest rate reductions and thus contributed indirectly to the international strength of the DEM.



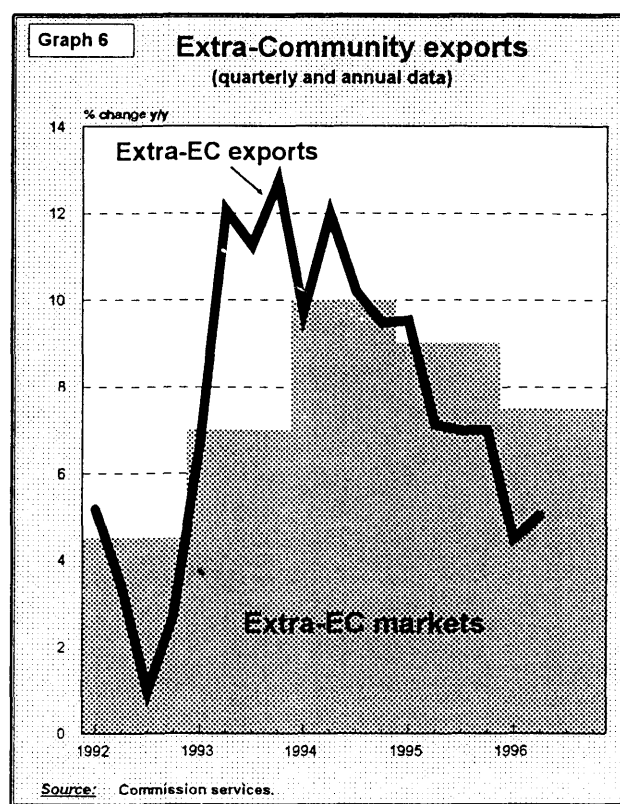
The exchange rate fluctuations exerted a negative impact throughout the European Community. In most countries whose currencies appreciated, cost competitiveness and profitability deteriorated sharply (in Graph 4 the profitability of the export sector is proxied by the industrial sector). Moreover, in several of these countries, short-term interest rates had to be raised to fend off speculative pressures (Graph 5). Exports prospects worsened and investment was rapidly scaled back. Output growth came to a standstill, and in some countries even turned temporarily negative.



In countries whose currencies depreciated, short-term interest rates were raised -- in many cases considerably -- to limit the extent of currency depreciation and to prevent the emergence of an inflationary spiral. In addition, long-term risk premia rose significantly in most depreciating countries (Graph 2). This meant that budgetary consolidation had to be carried out in much more difficult circumstances. The result was a clear economic slowdown also in these countries as domestic demand was severely restrained and the initial export boost gradually waned.

Slowdown in external demand

While the European recovery had benefited from very high export growth in 1993 and 1994, there was a slowdown in extra-EC exports during 1995 (Graph 6). This was caused by two main factors. Firstly, the appreciation of the Community currencies relative to other international currencies, in particular the US-dollar, caused a deterioration in average cost competitiveness and a loss in international market shares. Secondly, the slowdown in the US economy led to an easing of previously strong US import growth. Extra-EC export growth decelerated to around 7 per cent for the year on average (against 10 per cent in 1994).

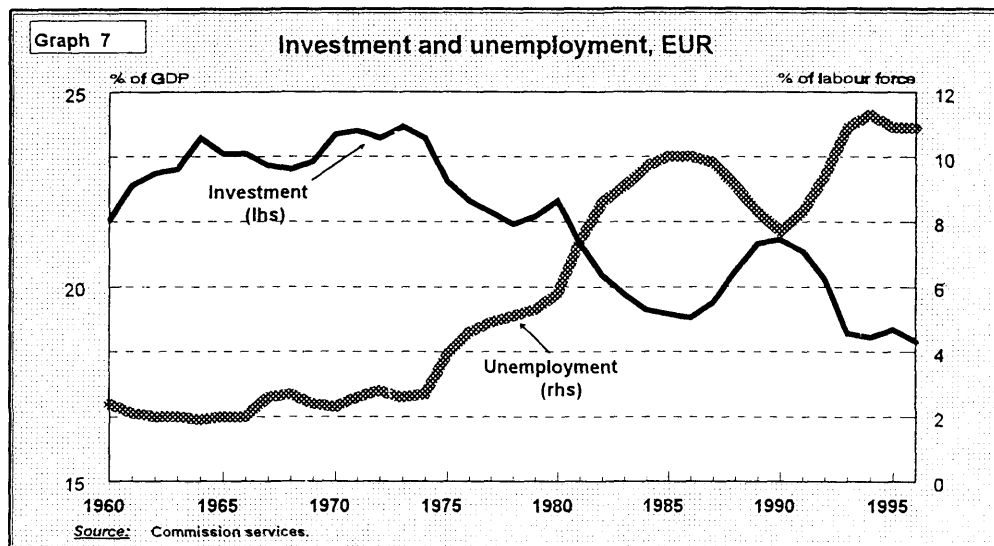


1.1.5 Macroeconomic obstacles to growth

The poor growth and employment performance of the Community over the first half of the 1990s has often been incorrectly blamed on factors such as globalisation or the emergence of new technologies (see Chapter 2). It was in fact mainly the result of macroeconomic obstacles to growth within the Community:

- (i) *Insufficient expansion of productive capacity:* in the late 1980s/early 1990s inflationary pressures built up in the Community as demand expanded too fast relative to production capacity;
- (ii) *Distorted economic policy-mix:* A distorted policy-mix led to an overburdening of monetary policy. Indeed, too lax budgetary policies (since 1988) and wage developments (since 1990) inconsistent with the objective of price stability caused a rise in interest rates which led to a slowdown in growth and job creation and the 1992/93 recession;

(iii) *Monetary turbulence*: currency crises, which to a considerable extent reflected an insufficient credibility of economic policies in several countries and a lack of policy co-ordination in the Community, have had a disruptive influence on economic growth both in countries whose currencies appreciated and in countries whose currencies depreciated.



If the Community is to achieve a sustained period of healthy economic growth capable of ensuring a significant and lasting reduction in unemployment, it has to find lasting solutions to these macroeconomic obstacles to growth.

This means, in the first place, that it is essential to maintain a high degree of credibility of economic policies in order to prevent monetary and financial turbulence. Secondly, the economic recovery must be supported by a strong rise in investment in order to secure a sufficiently rapid expansion of productive capacity in line with increasing demand. Even if the relationship between investment and unemployment is complex, Graph 7 reveals for the Community as a whole a clear negative correlation between these two variables. This illustrates that higher investment is an inescapable requirement for creating the physical working posts needed to reduce unemployment. Thirdly, budget deficits must be reduced to release savings for the necessary rise in investment, thereby preventing a rise in real interest rates which would stall the expansion of output. Equally important, all the players involved must contribute to maintain wage developments in line with price stability requirements and the need to increase employment.

EMU offers an important opportunity to overcome these obstacles to sustained growth and job-creation. The convergence process has contributed strongly to the achievement of a more balanced policy-mix and has decisively strengthened the credibility of the

stability-oriented economic policy-framework. In addition, the risk of currency instability leading to unwanted tensions and widening interest rate premia will be eliminated among the countries participating in the single currency. Such risks will also be reduced for Member States which may not initially adopt the euro provided convergent economic policies continue to be pursued.

1.2 Progressively strengthening upturn in 1996-98

The upswing in the Community economy resumed during the course of 1996 and growth is expected to strengthen in 1997 and 1998. This broadly favourable outlook is underpinned by the sound rebalancing of the economic policy-mix which has taken place in the Community, by an EMU-related improvement in the credibility of the economic policy framework, and by favourable supply-side fundamentals -- in terms of adequate wage increases and sound investment profitability -- which appear to be even better than during the recovery in 1994 and early 1995. In addition, the expansion of economic activity among the Community's international partners and the growth of world trade is expected to remain supportive.

1.2.1 An accelerating and well-balanced rebound in activity has taken hold

The pace of final demand quickened from around 1 per cent (annualised rate) in the second half of 1995 to around 2¼ per cent in the first half of 1996. As stocks were pared back, output growth accelerated significantly less but the rate of expansion for the year as a whole is estimated to have been 1.6 per cent on average for the Community. Under the impact of continued positive growth forces, output growth is forecast to strengthen to 2.2 per cent in 1997 and 2.8 per cent in 1998.

The recovery is expected to be well-balanced and broadly-based. Exports are likely to be dynamic, accelerating gradually from 4 per cent in 1996 to around 6½ per cent in 1998. This growth will be driven by healthy extra-EC exports and a rebound in intra-EC trade sustained by strengthening demand, stable exchange rates and continued progress in trade integration among Member States. Private consumption expanded at a healthy pace (2½ per cent) in the first half of 1996 helped by a rebound in purchases of consumer durables. Some slowing is likely over the short term but in line with moderate real wage growth, gradually improving employment prospects and a decline in precautionary savings, consumer spending is likely to accelerate from just below 2 per cent in 1997 to close to 2½ per cent in 1998.

With exports and consumption rising and excessive stock levels gradually being run down, capacity utilisation in industry has bottomed out and is starting to rise. This is likely to give a boost to investment in equipment which already started to recover in the first half of 1996. Underpinned by sound business profitability and low interest rates, investment in equipment is likely to grow by around 5 per cent in 1997, accelerating to almost 7 per cent in 1998. Construction activity was generally weak in the first part of 1996, but there were clear signs of a subsequent rebound and construction investment is forecast to accelerate to a growth rate of just over 3 per cent in 1998.

In *Germany*, the economy rebounded more strongly than expected during 1996 helped by a significant easing of the DEM effective exchange rate, lower interest rates and improving business expectations underpinned by moderating wage demands. Between spring and autumn 1996, the forecast for output growth has been revised upwards by nearly a full percentage point to 1.4 per cent in 1996. The economy is expected to improve further in 1997-98 with exports continuing to provide a positive driving force and investment in equipment expanding at an accelerating pace. Private consumption is likely to grow modestly in 1997, but as employment prospects gradually improve, consumer expenditure should rise somewhat faster in 1998. Overall, output growth is expected to reach 2.2 per cent in 1997 and 2.8 per cent in 1998.

Table 3				
Real GDP growth (per cent per year)				
	1995	1996	1997	1998
B	1.9	1.4	2.2	2.7
DK	2.8	2.1	3.1	3.0
D	1.9	1.4	2.2	2.8
EL	2.0	2.4	2.5	2.8
E	2.8	2.1	2.7	3.2
F	2.2	1.1	2.1	2.7
IRL	10.7	7.8	5.8	5.2
I	3.0	0.8	1.4	2.6
L	3.4	2.3	2.8	3.8
NL	2.1	2.5	2.8	3.0
A	1.8	1.0	1.6	2.5
P	2.3	2.5	2.8	3.2
FIN	4.2	2.3	3.7	3.1
S	3.0	1.7	2.1	2.5
UK	2.4	2.3	3.0	3.0
EUR	2.4	1.6	2.3	2.8
<i>Source:</i> Commission services November 1996 economic forecasts.				

In *France*, the economy is stimulated by a pick-up in exports in line with strengthening international demand. Despite a cautious attitude among consumers, private consumption performed better than expected in 1996. Due to a large stock correction, output trailed significantly behind demand in the first half of 1996, but activity accelerated in the second half. Improving demand prospects, good fundamentals and a rise in capacity utilisation are expected to lead to a pick-up in investment in equipment. Lower long-term interest rates should underpin a recovery in construction. GDP-growth is expected to accelerate to 2.1 per cent in 1997 and to 2.7 per cent in 1998.

In *Italy*, the strengthening of the currency since mid-1995 has had a negative knock-on effect on exports and investment. Furthermore, high interest rates during 1995 and early 1996 meant that budgetary consolidation had to be carried out in difficult conditions which restrained domestic demand. However, helped by reduced inflationary pressures, prospects for agreement on a social pact entailing adequate wage increases and with greatly improved prospects for budgetary consolidation following the adoption of the budget for 1997, interest rates have fallen very considerably. The downturn in the economy is likely to have come to an end, and a gradual recovery is foreseen with output rising by 1.4 per cent in 1997 and 2.6 per cent in 1998.

In the *United Kingdom*, the economy has resumed above-trend growth following a substantial stock correction in the first half of 1996. Higher growth has been underpinned by earlier interest rate reductions and a strong pick-up in exports. Consumption is expanding rapidly, helped by rising employment, moderate real wage gains, and an improvement in the housing market, all of which are expected to lead to a fall in the household savings rate. At the same time, buoyant investment growth is set to continue. The expansion of activity is forecast at around 3 per cent per year in 1997-98.

In the *Netherlands* and *Denmark*, domestic demand expanded at a healthy pace in 1996. Helped also by improving export prospects, output growth is forecast to accelerate from 2½ and 2 per cent in 1996, respectively, to a pace of around 3 per cent per year in 1997-98. In *Belgium* and *Austria*, the prospects for domestic demand growth are more subdued over the short term, but exports are set to grow at a healthy pace and output growth is expected to improve gradually, reaching 2½ to 2¾ per cent in 1998. In *Spain* and *Portugal*, buoyant exports and gradually strengthening investment and consumption should cause economic activity to expand by around 2¾ per cent in 1997 and somewhat more in 1998. In *Sweden*, double-digit investment growth this year is expected to taper off, but as private consumption picks up and export growth continues, the rate of growth in the economy should improve. In *Finland*, buoyant domestic demand will be the main factor in sustaining healthy output growth. In *Ireland*, where growth and job creation have been very strong, the economy is likely to slow down but output growth is forecast to remain the highest in the Community. In *Greece*, the improvement in economic performance is likely to continue and output growth is set to proceed at a pace of 2½ to 2¾ per cent sustained mainly by buoyant investment growth.

1.2.2 Positive growth forces

Healthy rebalancing of the macroeconomic policy-mix

In recent years, and in particular in the course of 1996, the Community has achieved a very significant improvement in the macroeconomic policy-mix as well as an important gain in the credibility of the medium-term economic policy framework. Significant measures have been taken in virtually all Member States to improve the state of the public finances in 1996 and in 1997. Helped by an improved outlook for the maintenance of moderate wage increases and sounder public finances, abating inflationary pressures have allowed monetary conditions in the Community to be eased significantly. This rebalancing has made the economic policy-mix more conducive to a soundly-based and sustained expansion of output, investment and employment.

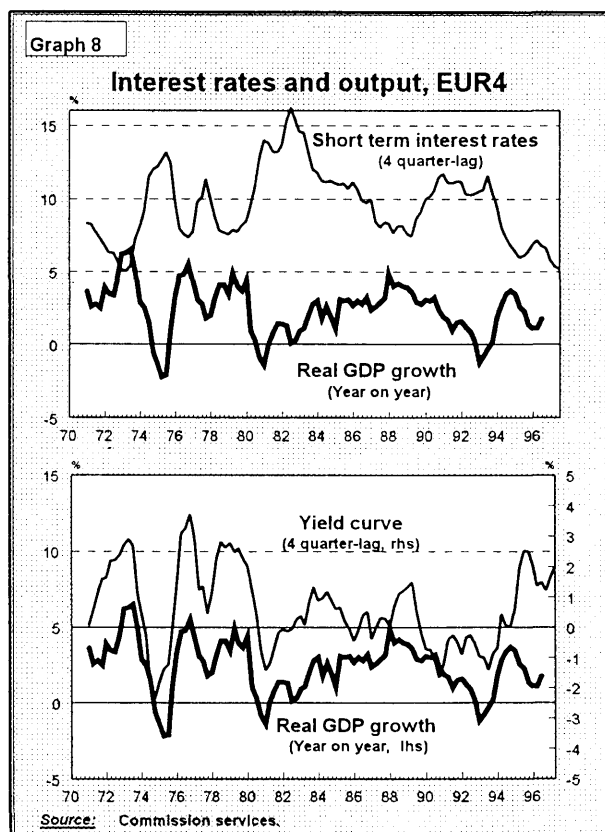
Table 4								
Improved economic policy-mix								
	Real effective exchange rate ¹⁾ (Unit labour costs) (1993 = 100)		Change in short-term interest rates since Jan. 1994 (3-month interbank)		Change in long-term interest rates since Jan. 1994 (10-year benchmark)		Annual change in cyclically-adjusted budget balance	
	Q2 1995	Q4 1996	April 1995	December 1996	January 1995	December 1996	1996	1997
B	109.1	102.5	-1.7	-3.9	1.9	-0.6	1.0	0.3
DK	104.8	103.7	0.7	-2.7	3.0	0.6	0.3	0.6
D	106.4	99.4	-1.2	-2.6	1.9	0.1	0.0	1.2
EL	112.5	122.5	-3.4	-7.5	n.a.	n.a.	0.8	1.1
E	92.9	94.5	0.6	-2.4	3.9	-1.0	2.3	1.3
F	103.8	101.9	1.5	-2.9	2.6	0.1	1.2	0.8
IRL	93.0	95.2	0.8	-0.2	2.7	-0.5	-0.7	0.8
I	82.6	102.8	2.4	-1.2	3.6	-1.0	1.0	3.4
NL	106.0	100.0	-0.5	-2.2	2.1	0.1	1.4	0.0
A	109.6	105.5	-0.8	-2.2	2.0	-0.2	2.0	1.8
P	106.0	108.3	-0.3	-4.6	3.0	-1.8	1.1	1.0
FIN	117.1	116.4	0.9	-2.0	3.7	0.2	1.6	0.0
S	96.2	115.2	1.5	-2.9	4.2	0.0	3.8	0.5
UK	95.1	102.7	1.3	0.9	2.5	1.4	1.1	0.7
EUR	100.3 ²⁾	106.4 ²⁾	0.5	-1.9	2.6	0.0	0.9	1.3
¹⁾ Relative to 23 industrialised countries.								
²⁾ Relative to 9 industrial non-EC countries.								
Source: Commission services.								

Progress towards EMU has significantly enhanced the credibility of the economic policy framework in virtually all of the Member States. The agreement on a "Stability and Growth Pact" for the third stage of EMU at the European Council in Dublin in December 1996 reinforces the prospects for sound budgetary policies over the medium-term. The anti-inflationary stance of monetary policies required by the EMU provisions in the Treaty is increasingly affecting economic operators and in particular price and wage setters as they adapt their behaviour to a low-inflation environment, thereby contributing to wage trends which are consistent with the need to enhance employment.

All of these developments have already had large beneficial effects. Exchange rates have broadly returned to the levels observed before the currency turmoil in the spring of 1995, and within the ERM there has been a large degree of exchange rate stability. Long-term interest rates have dropped significantly and there has been vastly greater convergence in yields. While the drop in interest rates during the year 1995 was broadly parallel to a coinciding fall in yields in the United States, developments in 1996 have been characterised by a high degree of decoupling from US interest rates. Notably those Member States which have announced significant adjustment measures in their budgets for 1997 have achieved a significant reduction in long-term interest rate premia.

Thus, the economic preparations for EMU are providing Member States with a significant credibility gain. This is likely to underpin private sector confidence and amounts to a positive growth factor in its own right.

The stance of monetary policy has a powerful influence on short-term growth prospects (Graph 8). To the extent that any direct demand-restraining impact of budgetary consolidation in coming years were to be less than fully off-set by an increase in private sector confidence and

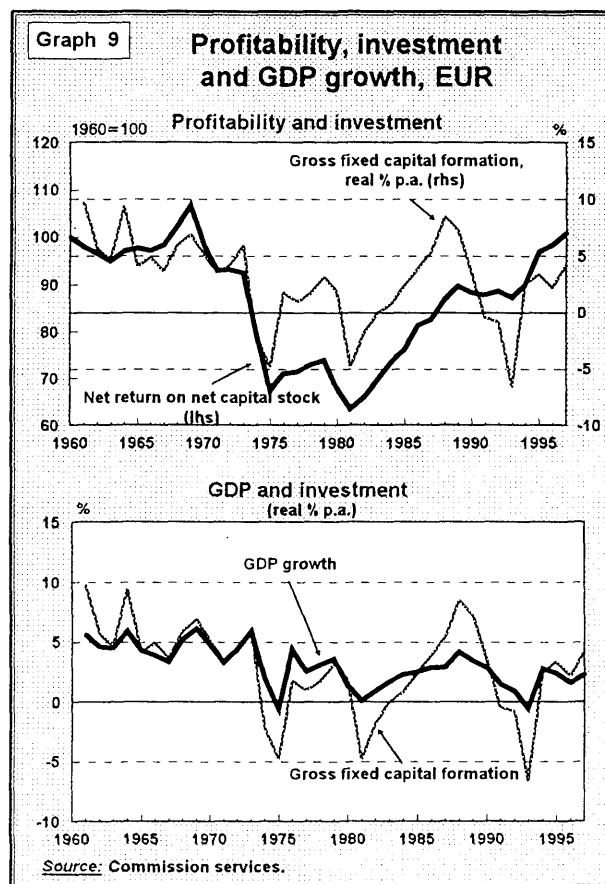


improved expectations, monetary policies would both have the necessary room and the capability to maintain adequate demand growth without prejudice to the objective of maintaining low inflation.

Furthermore, provided the credibility of the economic policy framework is maintained or even strengthened, the Community on average is likely to make further headway towards a reduction in the level of real long-term interest rates. This will stimulate investment and reduce overall cost and price pressures, thus contributing to a balanced growth of private sector demand and activity as well as a reduction in the currently high levels of non-cyclical unemployment.

Wage trends and corporate profitability consistent with pick-up in investment

Against the background of falling inflation, increased credibility of monetary policy and high unemployment, wage settlements have moderated in most countries over the last year. For the first time since the adoption of the Broad Economic Policy Guidelines in 1993, average wage increases in the Community are now forecast to remain at levels (around 3 per cent per year in 1997 and 1998) which are fully consistent both with the maintenance of price stability and with the achievement of a further improvement in investment profitability in the Community, while also allowing a moderate increase in real wages. As recommended in the Broad Guidelines, this trend should be maintained over the medium term. Indeed, a further improvement in profitability is necessary to sustain indigenous investment within the Community and to help attract foreign investment. Competition to provide good business conditions in order to attract companies, investment and jobs has become ever sharper. The rate of business profitability is an important medium-term determinant of investment (Graph 9). The average level of profitability is higher than at any time since 1970 but real interest rates are



also higher than in the 1960s. Strong profitability is not in itself sufficient to ignite a recovery in investment. But in line with rising capacity utilisation and improving demand prospects -- as exports and consumption are expected to pick up -- the healthy level of profitability is likely to lead to an early and strong recovery in investment. Greater exchange rate stability reduces uncertainty and thus also influences investment decisions positively.

Continued favourable external environment

The Community is expected to continue to benefit from a strong expansion of trade with its international partners. In overall terms, the expansion of *Community export markets* is forecast to remain buoyant in the coming years (around 8 per cent per year). However, the appreciation of the Community's real effective exchange rate in the course of 1994-96 is expected to have a moderating influence on international export market shares also in the years ahead. Nevertheless, the overall pace of extra-EC exports is likely to remain relatively strong in 1997-98 at around 7 per cent per year.

In the *United States*, the expansion of economic activity remains healthy. Although the economy is operating at employment and capacity utilisation levels which have previously been associated with an upturn in price and wage pressures, so far there has been few signs of such pressures. Thus, in the absence of any unexpected upturn in inflation, the economy is forecast to expand at rates of 2¼ to 2½ per cent in 1997-98, close to the potential growth rate of the economy. With high utilisation of domestic resources, strong growth of investment in equipment and a high marginal propensity to import, US demand from overseas is expected to grow by 7 to 7½ per cent per year in 1997-98 (up from 6¾ per cent in 1996).

In *Japan*, the recovery is expected to proceed in the coming years. The shift towards higher import content in domestic demand in recent years, which has been enhanced by liberalisation measures aimed at opening up the Japanese market, is expected to continue in the near future. Together with healthy domestic demand growth, this is likely to keep Japanese import growth at high rates in 1997-98.

Notwithstanding a predicted deceleration in the growth of their imports, Community trade with *emerging market economies* in Asia, Latin America and Central and Eastern Europe is expected to continue to expand vigorously. Under the impact of continued reform and rapid productivity gains, relatively strong GDP growth in the economies of Central and Eastern Europe is expected to be maintained or strengthened in 1997-98 with few exceptions. Also in Asia and Latin America, strong growth is expected to continue in 1997-98.

Table 5					
External environment (real annual percentage change)					
	Weights	1995	1996	1997	1998
Real GDP					
World excl. EC	100.0 ¹⁾	3.6	4.2	4.3	4.6
USA	26.9	2.0	2.4	2.3	2.4
Japan	10.0	0.8	3.8	1.8	2.8
DAE ³⁾	6.6	8.0	7.1	7.2	7.2
CCEEs excl. FSU ⁴⁾	2.5	5.4	3.9	4.1	4.5
Imports					
Extra-EC markets	100.0 ²⁾	9	7.5	8	8
USA	17.8	8.9	6.8	7.5	7.2
Japan	5.8	11.4	10.5	6.7	9.8
DAE ³⁾	11.5	15.1	10.2	9.5	9.4
CCEEs excl. FSU ⁴⁾	9.4	17.5	10.9	9.3	8.9
Extra-EC exports		7	6	7	7
¹⁾ Relative weights based on GDP in 1995. ²⁾ Relative weights based on extra-EC exports in 1995. ³⁾ Dynamic Asian Economies: Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand. ⁴⁾ CCEEs excl. FSU: Albania, Bulgaria, Czech republic, Slovakia, Hungaria, Poland, Romania and Slovenia. Source: Commission services; November 1996 forecasts.					

1.2.3 Uncertainties and short-term risks

The uncertainties surrounding the economic outlook appear to have declined considerably since the beginning of 1996. The main risk to the broadly favourable outlook would seem to reside in the possible emergence of doubts on the determination of governments to accomplish the process of budgetary consolidation in terms of full implementation of the 1997 budgets. If the credibility of policies aimed at nominal convergence were to suffer in some Member States and if budgetary outcomes were to disappoint relative to stated objectives, this could lead to renewed pressure on interest rates and exchange rates with potentially damaging effects on output and employment in the Community at large. However, the firm commitment to the achievement of the economic conditions for EMU - as reflected in political declarations, in budgetary measures already decided upon and in the state of the advancement of the technical preparations -- to a large extent attenuate this uncertainty.

Tensions might also surface if insufficient growth and job creation in some countries were to give rise to perceptions of internal policy dilemmas in the Community. This could be the case if consumer and investor confidence failed to pick up as expected in some

Member States. Also, budgetary consolidation might result in smaller-than-expected confidence gains if the measures taken were perceived to be only short-term and ad hoc in nature rather than expressing a firm commitment to sound public finances and addressing the problem of very high public expenditures and taxes relative to GDP.

On the other hand, if the credibility of economic policies and of moderate wage trends is maintained, growth and job creation could turn out to be stronger than forecast. The prospect of strong economic benefits from EMU could lead to a significant boost to private sector expectations and confidence, similar to the positive impact which the Internal Market programme had in the late 1980s. This could unleash higher investment, lead to a reduction in precautionary savings in most Member States, and help the Community to achieve a robust growth and employment creation performance.

An additional uncertainty could lie in the risk of a reawakening of wage pressures towards the end of the forecasting period. Although wage trends consistent with low inflation and enhanced investment and employment now seems to be more firmly established, the developments in 1994-95 in some countries have shown that inappropriate wage demands may resurface at an early stage of recovery. As highlighted in their recent joint opinion on the stance of economic policies, the social partners at the Community level recognize the need to avoid excessive wage settlements. Too high wage increases would fuel inflationary pressures which in turn would induce a dampening response from the monetary authorities, put upward pressure on long-term interest rates and undermine the ability of the European economies to promote higher levels of employment.

1.3 Gradually improving employment outlook

1.3.1 Recent and prospective trends in employment and unemployment

A detailed analysis of the latest labour market trends and the policy issues which have to be addressed in the Community is presented in the Commission's Employment in Europe Report 1996 and in the 1997 Joint Employment Report prepared for the Dublin European Council. The key features of the labour market outlook in the Community are briefly outlined in the following section along with an overview of the labour market experiences of a number of countries which have achieved a significantly better performance than the majority of other Member States in recent years.

Employment

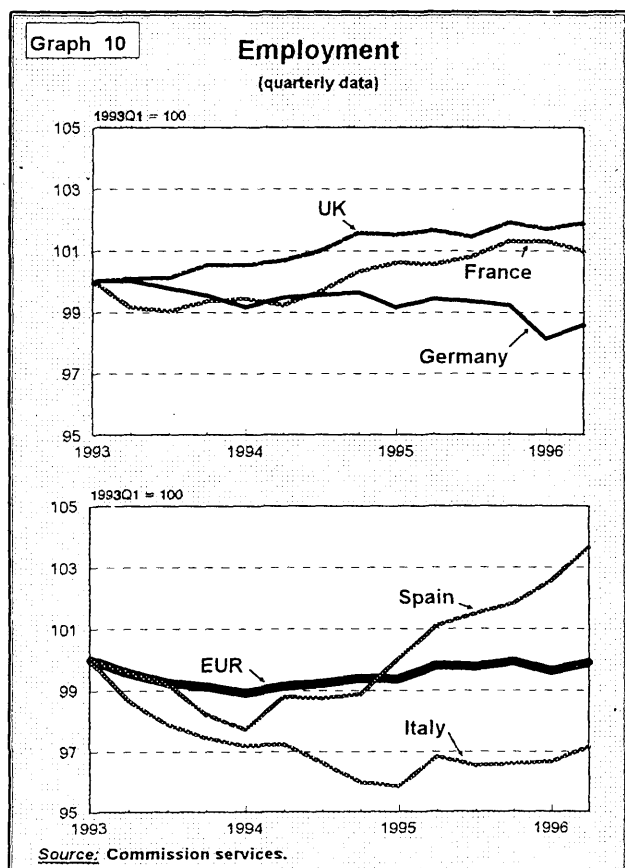
The relatively strong rate of expansion of economic activity during 1994 and early 1995 brought with it a moderate improvement in the employment situation. For the year 1995, total employment growth amounted to 0.5 per cent or some 750.000 jobs in the Community as a whole. However, this improvement was brought to a standstill when economic growth started faltering in the second half of 1995 and in early 1996. Reflecting a weak trend in Community-wide employment in the first part of 1996 as well as a gradual improvement in job prospects in the second half of the year -- in line with strengthening economic activity -- employment growth for 1996 as a whole amounted to a meagre 0.1 per cent. However, as the recovery of economic activity is expected to take firmer hold in 1997-98, and helped by low wage increases in almost all Member States, employment creation is expected

Table 6

Employment growth (per cent per year)

	1995	1996	1997	1998
B	0.4	-0.1	0.2	0.3
DK	1.6	0.7	0.8	0.7
D	-0.3	-0.8	-0.0	0.7
EL	0.9	1.2	1.3	1.3
E	1.7	1.3	1.6	2.0
F	1.2	-0.2	0.3	0.9
IRL	4.4	3.4	2.5	1.7
I	-0.4	0.3	0.1	0.5
L	2.5	1.1	1.7	2.3
NL	1.9	1.5	1.6	1.6
A	-0.3	-0.7	-0.3	0.0
P	-0.6	0.5	0.6	0.7
FIN	1.1	1.2	1.9	1.5
S	1.6	-0.6	-0.2	0.5
UK	0.7	0.4	1.1	1.1
EUR	0.5	0.1	0.6	0.9

Source: Commission services November 1996 economic forecasts.



to quicken somewhat to 0.6 and 0.9 per cent in 1997 and 1998, respectively, corresponding to the creation of 2.2 million jobs over the two years.

The employment outlook varies considerably across Member States, mainly, but not exclusively, reflecting differences in the outlook for output growth. In Ireland, employment is expected to grow at a rate of over 2 per cent per year on average in 1997-98 (after almost 4 per cent per year in 1995-96). Job growth in 1997-98 is also expected to be high in Greece,

Spain, Luxembourg, the Netherlands and Finland (around 1½ to 2 per cent per year) as well as in the United Kingdom and Denmark (around 1 and ¾ per cent per year, respectively).

In contrast, disappointing employment trends in 1996 are likely to have a negative carry-over effect on job growth in 1997 in Germany, Austria and Sweden, where employment is expected to fall slightly further, as well as in Belgium, France and Italy where job creation is expected to be very modest. However, in line with strengthening economic activity, employment growth is expected to pick up in 1998 when virtually all Member countries are expected to achieve positive job growth.

Unemployment trends

The gradual decline in the rate of unemployment in the Community since March 1995 came to a halt in late 1995 and early 1996. The average rate of unemployment in the Community rose somewhat in the second half of 1996 and the jobless rate amounted to 10.9 per cent of the labour force for the year as a whole.

Table 7 Unemployment rate (per cent of civilian labour force)				
	1995	1996	1997	1998
B	9.9	9.9	9.9	9.8
DK	7.1	6.2	6.0	5.7
D	8.2	9.0	9.1	8.7
EL	9.1	9.1	9.0	9.0
E	22.9	22.0	21.5	20.7
F	11.5	12.3	12.4	11.9
IRL	12.4	12.5	12.0	11.7
I	11.9	12.1	12.3	12.1
L	2.9	3.1	3.0	2.9
NL	7.3	6.8	6.3	5.8
A	3.8	4.2	4.5	4.6
P	7.3	7.3	7.1	6.8
FIN	17.2	16.0	14.9	14.2
S	9.2	9.8	9.4	9.0
UK	8.8	8.3	7.8	7.4
EUR	10.9	10.9	10.8	10.4
<i>Source:</i> Commission services November 1996 economic forecasts.				

The moderate strengthening of employment growth in the Community in the coming years is expected to be sufficient to achieve only a modest reduction in unemployment. With the prospects of finding employment becoming more positive, the growth of the labour force is expected to revert to its medium-term trend of around ½ per cent per year. For the Community as a whole, the average unemployment rate is expected to decline slowly to 10.8 per cent in 1997 and somewhat faster to around 10.4 per cent in 1998.

Some countries are likely to see a significantly faster reduction in unemployment. The rate of joblessness is forecast to fall considerably in the United Kingdom -- where it is already the lowest among the Community's largest Member States --

and in the Netherlands. This is the case also in Spain, Ireland and Finland although the level of unemployment will remain very high in these three countries. A more moderate but continuous reduction in unemployment is likely to be achieved in Denmark, Sweden and Portugal.

By contrast, the rate of unemployment is expected to remain unchanged or to rise further over the near term in Belgium, Germany, France, Italy and Austria. However, with the possible exception of Austria, the upward trend in unemployment is expected to be reversed in the course of the year and the jobless rate is expected to decline in 1998. In most cases, this is expected to reduce unemployment to below its 1996 level.

1.3.2 Recent labour market performance of selected countries

In contrast to the disappointing job performance of the Community as a whole, a number of Member States have achieved a considerable improvement in employment and/or a large reduction in unemployment over the last two to three years (Denmark, Spain, Ireland, the Netherlands and the United Kingdom)¹. From a macroeconomic point of view, the performance of these economies in terms of output growth, employment creation and labour force trends has been very different. In *Ireland*, strong employment growth has been driven mainly by a rapid expansion in output. In *Denmark* and the *United Kingdom*, healthy GDP-growth has been accompanied by positive but not exceptional job creation and the reduction in unemployment has partly been due to a reduction in the labour force and/or increased part-time employment. In *Spain* and the *Netherlands*, more modest output growth has coincided with relatively strong net job creation (Table 8).

Particularly high economic growth has been the main factor behind the large gain in job numbers in *Ireland*. Strong growth has been facilitated both by a strengthened supply side -- including significantly improved profitability, better competitiveness and a continued upgrading of average work force qualifications -- and macroeconomic policies aimed at securing low inflation, sound public finances and low interest rates. This has been underpinned by Community assistance under Structural and Cohesion Funds. An important element has been the tripartite agreements between employers, unions and the government to maintain moderate wage increases, helped by a lower income tax burden and carrying the benefit of significant job creation. Wage moderation, in combination

¹ In addition, the unemployment rate has fallen by more than 2 percentage points in Finland between 1994 and 1996. However, Finland is to some extent a special case reflecting the ongoing adjustment to exceptional factors which occurred during the late 1980s.

Table 8 Recent labour market performance of selected countries (1994-96)							
	Ireland	Denmark	UK	NL	Spain	Rest of EUR	EUR15
Unemployment	-- per cent of the labour force --						
Unemployment rate 1993	15.6	10.1	10.4	6.6 ¹	22.8 ¹	9.5	10.9
1996	12.5	6.2	8.3	6.8	22.0	10.4	10.9
Change since 1993	-3.1	-3.9	-2.1	0.2 ¹	-0.8 ¹	0.9	0.0
Employment and labour force	-- average growth rate 1994-96; per cent per year --						
Labour force growth	2.1	-0.9	-0.2	1.3	0.5	0.1	0.1
Employment growth ²	3.6	0.6	0.4	1.2	0.8	-0.2	0.1
GDP, wages and productivity	-- average growth rate 1994-96; per cent per year --						
GDP	8.6	3.1	2.8	2.7	2.3	2.0	2.3
Labour productivity	4.8	2.5	2.5	1.5	1.5	2.3	2.2
Real wage costs per head ³	1.1	2.0	0.8	0.1	-0.9	0.8	0.6
Real unit labour costs ⁴	-3.5	-0.5	-1.6	-1.3	-2.4	-1.5	-1.6
Capital/labour substitution ⁵	-0.4	-0.1	0.5	0.4	0.7	0.8	0.7
Participation and employment	-- in per cent of working age population (aged 15 to 64) --						
Participation rate 1993	60.8	82.2	75.2	67.8	58.8	65.7	66.7
1996	62.5	79.3	73.8	69.8	58.7	65.4	66.3
Employment rate 1993	51.2	73.9	67.3	63.4	45.6	59.5	59.5
1996	55.0	74.5	67.7	65.3	46.1	58.7	59.2
¹ The unemployment rate peaked in 1994 at 7.2 per cent in the Netherlands and 24.1 per cent in Spain; it changed by -0.4 and -2.1 percentage points, respectively, between 1994 and 1996. ² National accounts definition (for the Netherlands: full-time equivalent basis). According to labour force surveys, the average growth of employment over the 1994-96 period was slightly higher on this basis in Spain (1.0 per cent), the Netherlands (1.4 per cent) and the United Kingdom (1 per cent). ³ Nominal compensation per employee deflated by the GDP deflator. ⁴ Real labour costs per head divided by labour productivity per head. ⁵ A positive figure indicates substitution of capital for labour in the production process (a higher capital/labour ratio). Over short periods, the concept is influenced by cyclical effects. See chapter 2 for medium-term analysis of the role of capital-labour substitution in the Community's employment performance. Source: Commission services.							

with a shift in the composition of growth towards indigenous sectors, has helped arrest the previous trend towards capital-labour substitution in the economy. The average annual rate of substitution of labour by capital has declined from 1.4 per cent per year over the 1974-85 period to 0.4 per cent in the second half of the 1980s and 0.1 per cent per year in the first half of the 1990s. At the same time, high capacity-expanding investment has led to a fast incorporation of technical progress. Thus, helped also by improving skills and qualifications, labour productivity growth has remained high. Agreement on a renewal of the tripartite agreement is expected to underpin continued wage moderation and high employment growth in the coming years.

The large reduction in unemployment in *Denmark* since 1993 has resulted not just from improved job creation in line with stronger economic growth but predominantly from a decline in the labour force due to the introduction of government subsidised leave schemes (mainly for the purposes of education or child care) and an increase in the number of workers taking early retirement. While the employment rate in Denmark remains among the highest in the Community there is also a high proportion of the working age population which receive transfer incomes in the form of unemployment benefits, social security benefits, early retirement benefits, disability benefits, leave schemes etc. These schemes represent a considerable cost and reduce effective labour supply. Recent tightening of some schemes and positive labour market reforms are intended to reduce passive dependency and enhance job creation. In recent years, real wage costs have risen somewhat faster than in other countries whose currencies are linked to the DEM. If sustained and robust employment gains are to be made in the coming years it is essential to avoid excessive labour cost increases.

In the *United Kingdom*, the reduction in unemployment since 1993 has resulted partly from growing employment, in line with higher output growth and reflecting an increase in part-time work, and partly from a reduction in the labour force. Labour force participation has failed to pick up as in previous economic upturns *inter alia* because of an upsurge in the number of young people entering higher education. Notwithstanding the considerable reduction in unemployment, there has as yet been no significant upturn in earnings growth. Wage increases have been moderate and real wage costs (compensation per employee deflated by the GDP deflator) have been growing at a pace considerably below the growth in productivity. This may indicate that the structural reforms carried out in the United Kingdom since the early 1980s have helped increase labour and product market flexibility and thus to reduce price and wage pressures. If robust and sustained employment gains are to be made in the years to come it is essential that favourable wage trends are maintained.

In the *Netherlands*, the favourable job performance since 1994 is a continuation of a relatively strong employment creation trend since the mid-1980s. In addition, while increased part-time employment accounted for almost half of the job creation between 1983 and 1994, this factor did not contribute significantly to the increase in job numbers in the last two years. Since 1983, employment growth has been underpinned by a policy of wage moderation based on a consensus between unions, employers and the government. Compared to other Member countries, moderate nominal and real wage growth in the Netherlands has reduced the substitution of capital for labour, lowered the

employment threshold of growth and resulted in comparatively strong job creation. These trends have reasserted themselves during the current economic upturn. Continued wage moderation has been underpinned by an almost universal consensus on the necessity of wage restraint, the maintenance of a stability-oriented macroeconomic framework and by rapid increases in the labour force. Structural improvements in the labour market have included lower taxes and social security contributions, particularly for low income/low skilled workers, efforts to limit the growth of the legal minimum wage, reduced access and generosity of disability benefits, and increased flexibility in the implementation of wage agreements at the sectoral or firm level.

In *Spain*, economic growth in line with the average of the Community has coincided with comparatively strong job creation since 1994. The favourable job performance has been helped by moderate wage increases -- contributing to a fall in real wage costs per head in 1994 and in 1995 -- and by labour market reforms which have eased restrictions on working time, dismissals, job demarcation lines and, to some extent, wage setting. A large part of the recent increase in employment has taken place in temporary and part-time jobs. Although this may have reduced the unemployment risk for non-temporary workers and reinforced their insider power, recent wage trends are encouraging and wage costs are expected to grow only slightly faster than prices in 1996.

Just as the reasons for the relatively favourable labour market performance in these selected countries vary considerably, so too do the reasons for the less favourable performance in the majority of the remaining Member States. One important factor is that economic growth has been considerably lower in most other countries as compared to Denmark, Ireland, the Netherlands and the UK. At the same time, the rate of job creation relative to economic growth has generally not improved to the same extent as in Spain and the Netherlands. In some countries, labour shedding has continued despite recent wage moderation, partly reflecting the previous build-up of excessive labour cost levels and/or low economic activity. In sum, cyclical divergences and varying degrees of labour market reform has so far prevented the benefits of improved fundamentals from fully asserting themselves in a number of Member countries.

1.4 Encouraging inflation outlook

Progress with the achievement of a high degree of price stability has been examined in detail in the 1996 Report on Convergence presented by the Commission in accordance with Article 109J of the Treaty on European Union. The recent trends and the short-term outlook for inflation convergence are briefly reviewed in this section.

Member States have been making considerable headway towards price stability and inflation convergence which is an essential requirement for the adoption of the single currency. Average inflation (as measured by the private consumption deflator) in the Community decelerated to 2.6 per cent in 1996 and inflation dispersion among the Member States narrowed significantly.

In Belgium, Denmark, Germany, France, Ireland, Luxembourg and the Netherlands, having been in the narrow band of the ERM, as well as in Austria, broadly sound wage trends and low import price increases promoted price stability in 1996. Inflation (private consumption deflator) remained at or below 2 per cent in all those countries.

Table 9

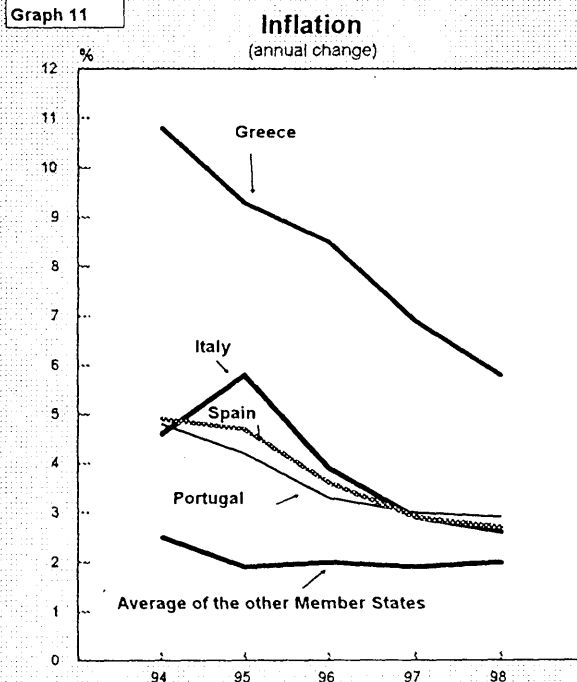
Inflation (percentage change)						
	IICPs ¹⁾		Private consumption deflator			
	1995	Nov. 1996 ²⁾	1995	1996	1997	1998
B	1.4	1.9	1.6	2.0	2.1	2.0
DK	2.3	2.3	2.1	2.0	2.4	2.7
D	1.6	1.3	1.9	1.8	1.7	1.8
EL	9.0	8.3	9.3	8.5	6.9	5.8
E	4.7	3.6	4.7	3.6	2.9	2.7
F	1.7	2.1	1.7	1.9	1.4	1.5
IRL	2.4	2.1	2.0	2.0	2.2	2.6
I	5.4	4.2	5.8	3.9	2.9	2.6
L	1.9	1.4	2.0	1.7	2.1	2.1
NL	1.1	1.4	0.9	1.9	2.0	2.0
A	2.0	1.8	2.3	2.0	1.9	2.0
P	3.8	2.9	4.2	3.3	3.0	2.9
FIN	1.0	1.1	0.2	0.9	1.6	2.0
S	2.9	1.1	2.7	1.7	2.3	2.6
UK	3.0	3.0	2.6	2.5	2.4	2.5
EUR	3.0	2.6	3.0	2.6	2.2	2.2

¹⁾ Interim indices of consumer prices.

²⁾ Measured by the percentage change in the arithmetic average of the twelve monthly indices relative to the arithmetic average of the twelve monthly indices of the previous period.

Source: Commission services and November 1996 economic forecasts.

Graph 11



Source: Commission services.

Furthermore, among the countries where monetary policy is conducted with reference to an inflation target, the rate of price increases remained low at around 2.5 per cent in the UK, and reached a level of less than 1 ¾ per cent in Sweden and Finland, helped by a significant appreciation of their currencies from previous lows.

Also the four remaining Member States, in which inflation ranged from 4.2 per cent to 9.3 per cent in 1995, have made significant progress towards price convergence (Graph 11). In Portugal, the inflation rate dropped to 3.3 per cent and in Italy and Spain, the rate of price increase slowed to 3.6 per cent in Spain and 3.9 per cent in Italy in 1996. In Greece, the rate of inflation declined to 8.5 per cent. In the countries whose currencies had depreciated significantly in early 1995, the tightening of monetary conditions and enhanced prospects for sounder budgetary positions brought about the subsequent exchange rate appreciation. Together with prudent wage agreements this helped bring down inflation rapidly in late 1995 and early 1996.

The credibility of anti-inflationary policies has increased everywhere and the objective of low inflation is now widely accepted throughout the Community. Against this background, price convergence is expected to strengthen further in the coming years. The average rate of inflation in the Community is forecast to decelerate further to 2.2 per cent in 1997 and in 1998. These rates are historically low and close to what is normally meant by price stability.

In Germany and in the countries whose monetary policies are closely linked to that country, inflation is expected to remain below or around 2 per cent in 1997-98 with two exceptions: in Denmark and Ireland, continued strong domestic demand and wage cost increases in excess of those of other countries whose currencies are closely linked to the DEM (around or above 4 per cent per year) could lead to an acceleration of inflation to above 2½ per cent.

Table 10 Nominal compensation per employee ¹⁾ (percentage change)				
	1995	1996	1997	1998
B	2.5	1.6	2.6	2.6
DK	3.6	4.1	3.8	4.2
D	3.6	2.6	2.5	2.5
EL	12.7	11.1	9.2	7.5
E	3.0	3.9	3.2	3.0
F	2.3	2.2	2.2	2.5
IRL	1.1	4.0	4.2	4.3
I	5.2	6.2	4.1	3.1
L	3.3	3.4	3.8	3.6
NL	2.0	1.0	2.3	2.9
A	3.8	2.9	2.4	3.2
P	5.3	5.8	5.0	4.0
FIN	4.7	4.0	3.2	2.9
S	3.1	6.6	4.3	2.9
UK	2.9	3.3	4.1	4.3
EUR	3.4	3.4	3.2	3.1
¹⁾ Total wages and indirect wage costs. <i>Source:</i> Commission services, November 1996 economic forecasts.				

In the United Kingdom, Sweden and Finland, continued prudent monetary policies are expected to secure the maintenance of inflation in the range of 2 to 2½ per cent, helped in the latter two countries by a significant reduction in the pace of nominal compensation of employees. Italy, Spain and Portugal are all expected to achieve a further reduction of inflation to a rate of around 2¾ per cent by 1998 against the background, *inter alia*, of decelerating wage costs. In Greece, the inflation rate is forecast to drop to around 5¾ per cent by 1998.

Box 1 : Regional unemployment in the Community

Unemployment rates across Member States differ widely, ranging from 3 per cent in Luxembourg to nearly 22 per cent in Spain (1995 data). At the level of individual regions, the disparity across the Community is even larger. In 1995, among the nearly 100 regions for which harmonised regional unemployment data are available, the unemployment rate ranged from less than 4 per cent in the central region of Portugal to nearly 32 per cent in the south of Spain (Table B1.1).

Table B1.1

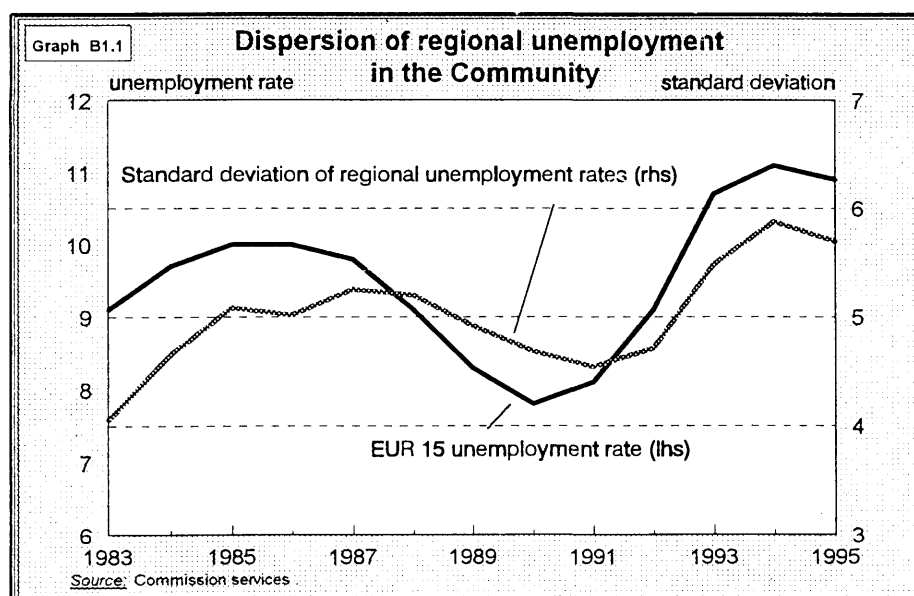
Regional unemployment in the Community - 1995 (NUTS1 regions)

	B	DK	WD	EL	E	F	IRL	I	NL	P	FIN	S	UK	EUR
Highest regional rate	12.9	12.3	11.2	11.0	31.8	15.3	15.8	25.9	8.9	11.4	21.2	12.0	11.0	31.8
National rate	9.9	7.1	6.6	9.1	22.9	11.5	14.3	11.9	7.3	7.3	17.2	9.2	8.8	10.9
Lowest regional rate	6.9	4.5	5.5	7.4	18.5	8.7	13.5	6.0	6.9	3.9	15.2	7.7	6.7	3.9
Ratio: high/low	1.9	2.7	2.0	1.5	1.7	1.8	1.2	4.3	1.2	2.9	1.4	1.6	1.6	8.2

Source: Commission services.

In 1995, the unemployment rate was below 6 per cent of the labour force in 10 of the around 100 regions (Table B1.2). To some extent, the low-unemployment regions were concentrated in a limited number of areas: the south of Germany, the adjacent north of Italy, the south of the Netherlands, regions in the north-east and south-west of Denmark, and the north and centre of Portugal. This picture has been relatively stable during the past ten years. Noticeable exceptions are regions in the south and east of Sweden and most of Finland which used to be low unemployment regions, as well as the Ile de France (Paris) and south-eastern regions of the UK which saw a deterioration in the unemployment situation at the beginning of the 1990s. In all of these cases, the deterioration resulted not from specific regional causes but rather from an increase in nation-wide unemployment.

At the opposite end of the spectrum, around 20 regions experienced an unemployment rate above 15 per cent in 1995. These regions were concentrated in Spain, the south of Italy and parts of Ireland and Finland. With the exception of Finland, the regions which suffered most from high unemployment were broadly the same throughout the last ten years.



In addition to the inertia of the geographical concentration of unemployment there has been a widening of the unemployment dispersion between regions over the last few years. One way of measuring the dispersion is the standard deviation of the regional unemployment rates¹. This standard deviation is positively correlated with the cyclical fluctuations in the Community unemployment rate (Graph B1.1).

Table B1.2 Distribution of regional unemployment rates		
Jobless rate	Number of regions	
	Average 1983-95	1995
< 5%	7	4
5 - 6%	9	6
6 - 7%	10	13
7 - 8%	14	13
8 - 9%	13	11
9 - 11%	15	15
11-13%	10	10
13-15%	2	6
15-17%	8	4
17-20%	7	5
20-25%	1	8
> 25%	1	2
Total	97	97

This picture of worsening regional imbalances has been valid for most Member States between 1983 and 1995 which are comparable years in terms of their position in the business cycle (Table B1.3). The change in the dispersion is positively correlated with the change in the national unemployment rate. In some countries where substantial labour market reform has been implemented (Netherlands, United Kingdom), the dispersion of unemployment and the national employment rates have both decreased.

Notwithstanding the persistent gap between high and low unemployment regions in most countries, unemployment was highly cyclical in both types of regions (for selected countries, see Graph B1.2). In most countries, the peaks and troughs of the jobless rate in high unemployment regions have tended to follow those of the low unemployment regions with a lag of around one year. This shows that high unemployment regions remain responsive but also dependant on the level of activity in low unemployment regions. This is mainly because of demand linkages: high and rising levels of activity in low unemployment regions generate increased

demand from these regions. Furthermore, more companies choose to expand in regions with abundant labour supply. And with the increased probability of finding a job in regions with low and falling unemployment more workers are willing to move from high unemployment to low unemployment regions.

The persistence of regional unemployment imbalances in most Member States generally reflects a relatively low responsiveness to changes in the economic environment and a relatively high rigidity of regional wage structures in particular. With limited wage flexibility, productivity differentials between regions are often not adequately reflected in wage cost differentials. Therefore, reducing regional unemployment disparities may require a higher degree of regional wage flexibility. Both the relocation of activity towards less favoured regions, the mobility of workers between regions and the avoidance of excessive nation-wide wage increases in the face of wage pressures in low unemployment regions would all be facilitated by a higher degree of regional wage differentiation in accordance with regional differences in productivity levels.

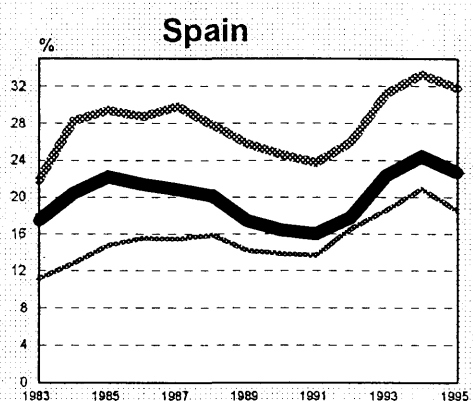
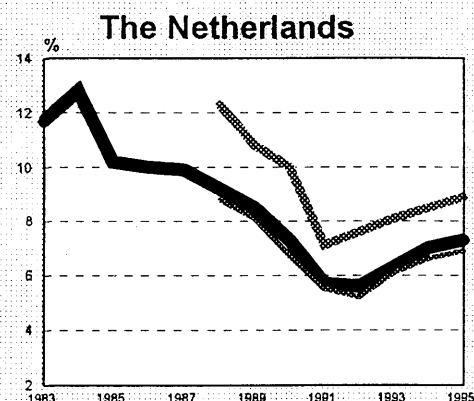
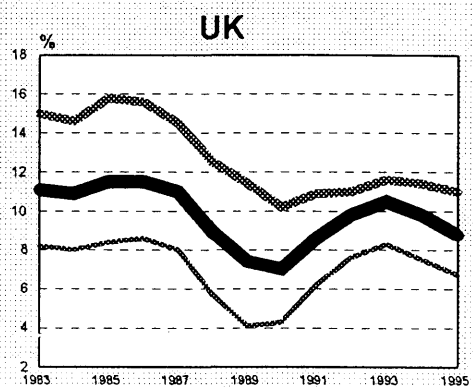
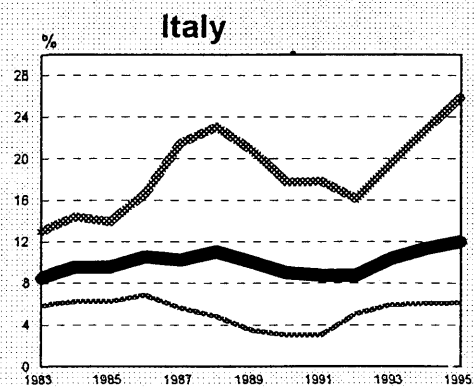
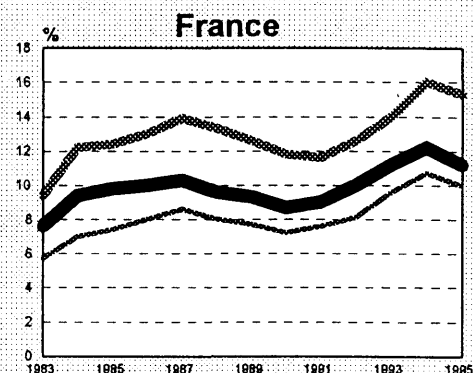
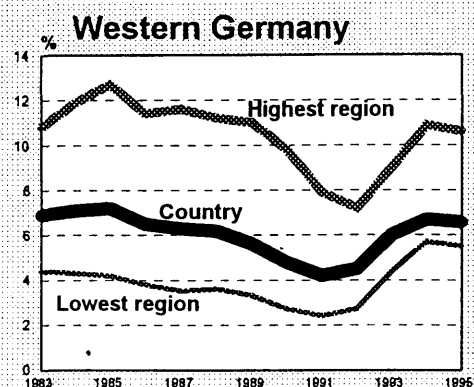
Table B1.3 Dispersion of regional unemployment rates				
	Standard deviation		National unemployment rate	
	1983 ¹	1995	1983 ¹	1995
B	0.81	3.40	11.9	9.9
DK	2.08	2.01	9.5	7.1
WD	1.71	1.84	6.9	6.6
EL	2.02	2.23	7.8	9.1
E	3.28	4.69	21.4	22.9
F	1.45	1.89	7.6	11.5
IRL	0.58	0.86	14.8	14.3
I	2.77	7.14	8.5	11.9
NL	1.31	0.58	11.7	7.3
P	3.18	1.97	8.6	7.3
FIN	1.87	2.38	3.7	18.1
S	0.55	1.29	1.4	9.2
UK	2.79	0.87	11.1	8.8
EUR	4.06	5.70	9.1	10.9

¹ 1988 for EL and NL, 1986 for P, 1989 for FIN, 1990 for S.

¹ The standard deviation is sensitive to the degree of regional disaggregation. For a measurement of the standard deviation at NUTS2 level, see the Commission's "First Cohesion report" (Nov. 1996).

Graph B1.2

Cyclical trends in regional unemployment rates



Source: Commission services.

2. KEY STRUCTURAL CHALLENGES FACING THE COMMUNITY

The unsatisfactory performance of the Community economy during the first half of the 1990s has sparked new concerns about the effects of certain long-term structural trends affecting the Community. One is the emergence of new technological advances which, it is often felt, not only tend to be skill-biased but also labour-saving, reducing the demand even for skilled workers. Another trend is the increased globalisation of the world economy which has given rise to fears that jobs are being siphoned out of the Community by the newly industrialised countries, especially in Southeast Asia, and that under these market forces, low-skilled workers in the Community face either downward pressure on wages or high unemployment. These apprehensions have been exacerbated by the relocation activities of Community-based firms towards emerging newly-industrialised countries.

While these concerns and fears are understandable, they tend to be built upon an erroneous analysis of the economic impact of technological progress and globalisation. These factors have been and will continue to be the key driving forces behind long-term improvements in productivity, growth, employment and living standards in the Community. But in the short run they require sometimes painful adjustments in some sectors of the economy. The achievement of the potentially significant long-term gains of enhanced technological progress, greater globalisation and intensified efforts to improve competitiveness crucially hinges upon the fulfilment of two essential conditions: the inevitable adjustments must occur in a smooth and socially-acceptable manner and economic growth must be sufficiently strong to absorb the resources freed by technological progress and globalisation.

2.1 Technological progress

The last three decades have seen the emergence of a new wave of technological advances in important areas such as electronics, computers, telecommunications and bio- and ecotechnologies. Most of these new technologies have ramifications for all sectors of the economy. In particular, information and communication technologies (ICT) are driving the ongoing process of structural change. Their impact on the economy is pervasive. They not only entail rapidly falling costs but they also bring about fundamental modifications in working methods and relations, the organisation of companies and the way in which knowledge is produced and distributed.

In macroeconomic terms, the role of technology in the economy can be assessed by the trend in total factor productivity (TFP) growth. The latter is defined as the proportion of output growth which is not accounted for by increases in inputs of labour and capital, the two most fundamental factors of production². In this sense, improvements in TFP reflect the impact of technological progress, human capital endowments and organisational efficiency incorporated in the economic process. TFP can therefore be interpreted as an indicator of the strength of the endogenous growth forces in the economy.

As shown in Table 11, TFP growth in the Community, as well as among the Community's main partners, slowed down significantly between 1960-73 and 1974-85. For the Community, this slowdown can to a large extent be explained by three factors: the substantial narrowing of the room

Table 11 Long-term trends in TFP growth ¹⁾					
	1961-73	1974-85	1986-95	1986-90	1991-95
EUR	2.8	1.0	1.2	1.5	1.0
USA	1.6	0.4	0.8	0.6	0.9
Japan	6.3	1.1	0.9	2.3	-0.5
¹⁾ Total factor productivity: average labour and capital productivity weighted by factor income shares. <i>Source:</i> Commission services.					

to catch-up with the technological leader, the United States; the adverse impact of macroeconomic shocks resulting from large and abrupt changes in relative prices with slow adjustment to the new conditions in the post-1973 era; and the trend decline in the share of investment in GDP in the Community.

During the last decade, despite significant changes in technology, especially in the field of information and communication, there has not been a pronounced rebound in TFP growth from the low rate experienced during the second half of the 1970s and the early 1980s. Nevertheless, since the launching and implementation of the Single Market Programme, the slowdown has been arrested and a slight recovery is even noticeable. The latter

² Total factor productivity has been calculated within a production function framework where the level of output is assumed to be determined by the level of input of two production factors, labour and capital, and a certain rate of technological progress (total factor productivity): $Y = A(t)F(L, K)$ where Y is the level of output, L and K the inputs of labour and capital, and $A(t)$ the effect of technological progress. Under the assumption of constant returns, the rate of technological progress can be calculated approximately as $g = y - ak$ where g is the rate of technological progress (change in total factor productivity), y is the growth rate of the volume of GDP per person employed, a is the share of profits in GDP at factor cost and k is the growth rate of the capital stock per person employed. Thus total factor productivity is measured *ex post* as a residual item and includes factor inputs other than capital and labour. In the new growth theories, by contrast, technical progress is an endogenous element of the economic system that can be influenced by economic policies and investment in physical and human capital.

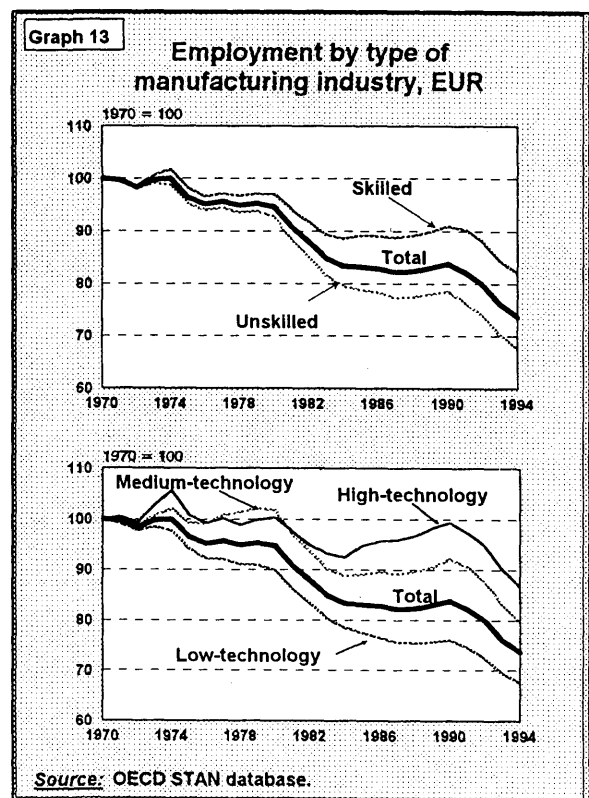
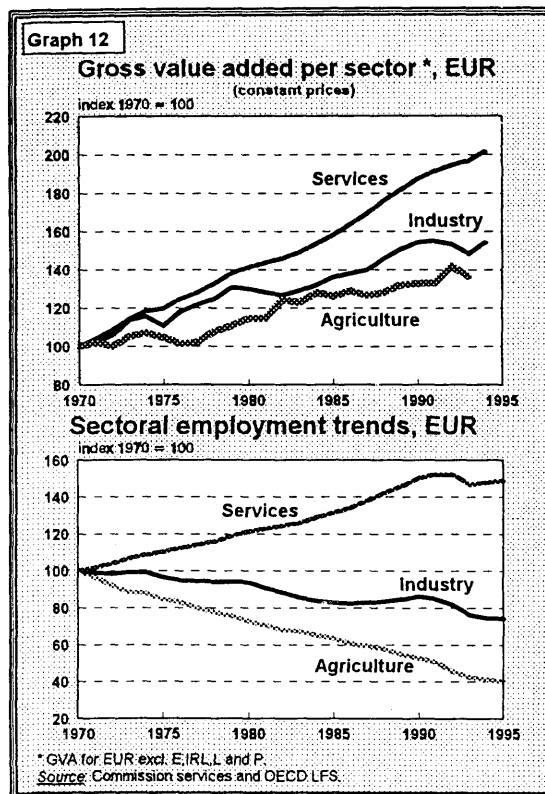
essentially reflects a partly cyclical pick-up in TFP growth in the second half of the eighties when buoyant investment characterised the Community economy. Over the last two decades, TFP in the Community grew at a broadly similar pace as in Japan and about twice as fast as in the United States.

The failure of the rapid technological advance to show up in economy-wide TFP growth in the 1980s and 1990s (the so-called “productivity or Solow paradox”) may be related largely to insufficient economic growth and, particularly, low investment. Other explanations have also been offered³, including problems in measuring technological change and productivity, especially in services; the need for complementary organisational investment and institutional changes; shifts in the nature of innovation, with more effort devoted to product differentiation rather than to productivity enhancement or radically new products; and lags for new technologies to ripple through the economy.

None of these explanations puts into doubt, however, that technological progress and the move to a knowledge-based economy are the driving forces behind medium and long run growth of economic activity, productivity and living standards in the Community. Technological progress implies a continued shift in the structure of output and employment, out of agriculture and manufacturing and into services and the new growth areas of communication, bio- and ecotechnologies, health care, leisure, and the environment. In particular, the use of new technologies eliminates certain low-wage, low-productivity jobs of the unskilled and creates jobs that are more productive, high-skill and better paid. Such a transformation process has continuously taken place in the Community since its inception.

As shown in Graph 12, over the last 25 years, employment in agriculture and industry has been on a downward trend. But in contrast with the steady fall in the number of persons employed in agriculture, employment in industry stabilised or even increased at times when macroeconomic growth was relatively strong. The job losses in agriculture and industry have been compensated for by increased employment in the services sector. The latter upward trend was only temporarily interrupted during the 1992/93 recession, partly under the impact of a more competitive environment, for instance in financial services, and due to the cyclical vulnerability of many small and medium-sized enterprises.

³ See OECD (1996), “Technology, productivity and job creation. Analytical report.”, especially pp. 26-29.



Within the manufacturing sector, Graph 13 indicates that employment in the high-technology manufacturing industries in the Community has expanded markedly during the 1980s although these employment gains have been lost during the slow-growth period of the first half of the 1990s. By contrast, low-technology manufacturing industries have seen pronounced and steady job losses since the early 1970s.

To reap the full benefits of the new wave of technological progress, it is necessary that four requirements are met.

Firstly, efficient goods and services markets must allow for swift changes in relative prices. In sectors where productivity rises relatively fast under the influence of technological innovation, the opening-up of markets or deregulation, relative prices must fall in order to pass on the productivity gains to the rest of the economy. In this way, relative prices could increase in sectors with below-average productivity growth. Only under this condition will the more labour-intensive sectors be capable of creating profitable jobs. There is evidence that this requirement is relatively well respected in the

Community⁴. Competitive pressures and effective competition policies should ensure that this condition is even better fulfilled in future.

Secondly, the unavoidable sectoral changes must occur smoothly and be socially acceptable. In the Community economy it appears that this condition is fulfilled albeit with some difficulties. Increased professional and geographical mobility as well as a lowering of non-wage labour costs and temporary entry wages targeted at low-skilled workers could help cushion the adjustments resulting from technological progress, globalisation and falling subsidies for ailing sectors and industries.

Thirdly, the move towards a knowledge-based pattern of production of goods and services must be assisted by policies to improve human capital formation in the Community in general and by measures to enhance the employability of the low-skilled in particular (for instance through lower non-wage costs, lower taxes, temporary entry wages, better education and training, etc.)

Fourthly, the production potential created by technological progress and enhanced competition must actually be absorbed by higher economic growth, exceeding the productivity trend. If the resources freed are not put to use, the overall balance between job creation and job destruction will not be sufficiently positive to employ the growing labour force and to reduce unemployment. Deficient economic growth has been the Community's major problem, underscoring the need to resolutely eliminate the obstacles to macroeconomic growth highlighted in Chapter 1.

2.2 Globalisation

Technological progress, competition and globalisation are mutually reinforcing. Globalisation can be defined as the process by which markets and production in different countries are becoming increasingly interdependent due to the dynamics of trade in goods and services and flows of capital and technology. It is not a new phenomenon but the continuation of developments that have been in train for some considerable time. Indeed, a greater integration of the world economy has been actively pursued since the end of the second world war. The well-recognised case for globalisation is that it has played, and will continue to play, a major role in the rise in living standards by improving the allocation of resources and by exerting discipline on economic policies. Since its

⁴ For a more detailed analysis of the relationship between productivity and employment growth, see Box 6 in AER1996, *European Economy*, n° 61, p. 64.

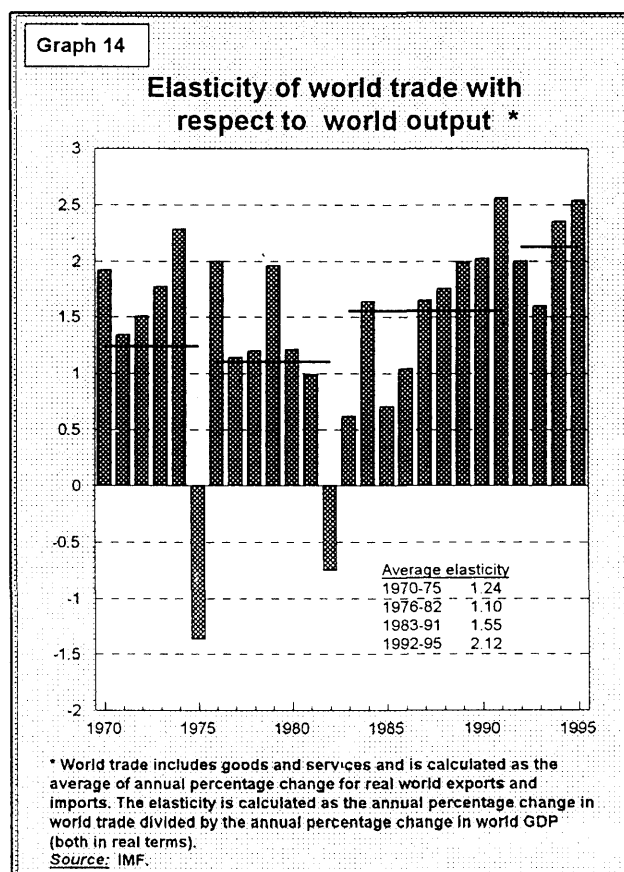
inception, the Community has had an important effect on this process. European integration may not only be considered as an integral part of this process, it also adds another dimension. The quest for further integration through *inter alia* the creation of a customs union, the completion of a single market and the forthcoming economic and monetary union has been accompanied by important institutional developments and a sharing of sovereignty in certain policy areas.

Over the last two decades, globalisation has gained additional momentum. Driven by various powerful forces, the economic links between the industrialised countries have intensified significantly since the mid-1970s. Chief amongst these forces are the impressive reductions in communication and transport costs, the progressive world-wide reduction of barriers to trade (including since the Uruguay Round agricultural products and with the GATS agreement a first liberalisation of services), the continued liberalisation of capital movements and, finally, changes in enterprise organisation and strategy. In addition, hitherto inward-looking developing countries have gradually opened up their markets and have increasingly become integrated in the world economy. The most recent development in this context is the opening of the former state-controlled countries of central and eastern Europe (CCEs) and the Former Soviet Union (FSU). In the medium to longer run, this trend is bound to accelerate and to encompass a larger, more populated group of countries.

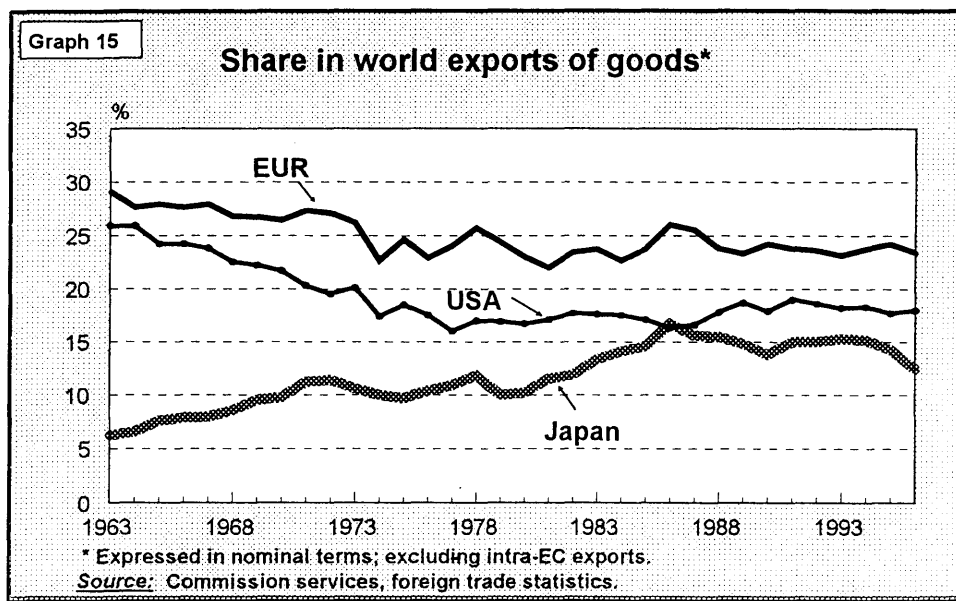
The scale of globalisation can be assessed on the basis of trends in international trade and capital flows.

2.2.1 Trade

During 1950-73, the volume of world trade (in goods and services) increased at an annual rate of nearly 8 per cent, while world GDP rose annually by 5 per cent in volume. In the decade following the abandoning of the fixed exchange rate regime under Bretton Woods and the first oil price shock, the rate of expansion of both world trade and world GDP slowed down substantially.



However, since 1983, the pace of world trade has accelerated again (average annual rate of 5.7 per cent) thereby well outpacing the expansion of world GDP (which rose at only 3.4 per cent per year). Since the beginning of the 1990s, the elasticity of world trade to world GDP has even jumped to above 2 (see Graph 14). As a corollary, the ratio of exports (goods and services) to GDP for the world as a whole has risen considerably. Having doubled between 1950 and 1973 to 16 per cent, it reached almost 25 per cent in 1995⁵.



The Community has participated actively and positively in this globalisation process. It has also withstood the increased competitive pressures relatively well. Since the early 1970s, the Community's share in world merchandise exports has shrunk but it remains high at about 24 per cent (excluding intra-EC trade). To the extent that the drop in its world market share reflects the emergence of new trading partners on the world scene and increased trade integration amongst member countries, this is not a worrying phenomenon. In this respect, it is noteworthy that the bulk of the rise of the share in world trade of the Asian countries⁶ came primarily at the expense of the other developing countries.

⁵ Including intra-EC trade.

⁶ The share of the Dynamic Asian Economies in world exports has increased from 5 to 6 per cent in the early 1970s to about 15 per cent at present.

Table 12

Geographical structure of extra-Community trade
(goods, extra-EC)

	As % of nominal GDP			% change p.a. in value			% of total
	1976 ¹⁾	1982 ²⁾	1995 ³⁾	82/77 ¹⁾	87/82 ²⁾	95/87 ³⁾	1995
Exports to:							
• Total	10.9	11.5	9.8	12.5	3.3	8.7	100.0
• OECD	4.6	5.0	4.9	13.0	9.3	4.9	49.7
<i>of which:</i>							
USA	1.2	1.7	1.6	17.9	10.9	3.3	15.8
Japan	0.2	0.3	0.5	14.6	15.5	10.2	5.0
• Non-OECD	6.2	6.4	4.9	12.1	-2.5	12.9	50.3
<i>of which:</i>							
DAEs ⁴⁾	0.3	0.4	1.1	17.7	11.3	16.4	10.6
China	0.1	0.1	0.2	10.5	18.7	11.3	2.2
Rest of Asia ⁵⁾	0.2	0.5	0.4	25.9	3.7	8.5	4.0
CCEEs ⁶⁾	0.9	0.7	1.0	5.7	1.4	16.4	10.7
Imports from:							
• Total	12.1	12.9	9.6	12.6	0.8	8.2	100.0
• OECD	4.9	5.7	5.1	14.3	5.6	5.9	53.2
<i>of which:</i>							
USA	1.9	2.2	1.6	13.5	0.9	7.2	17.1
Japan	0.5	0.7	0.8	18.8	12.4	4.8	8.8
• Non-OECD	7.2	7.2	4.5	11.4	-3.9	10.7	46.8
<i>of which:</i>							
DAEs	0.5	0.6	0.9	14.7	10.3	9.3	9.4
China	0.1	0.1	0.4	12.0	14.2	21.5	4.3
Rest of Asia	0.3	0.3	0.4	13.3	5.8	10.0	3.9
CCEEs	0.8	1.0	1.0	15.9	0.8	13.2	10.9
Trade balance				(7)	(7)	(7)	
• Total	-1.3	-1.4	0.3	-1.2	-0.5	-0.5	-
• OECD	-0.3	-0.7	-0.2	-0.4	-0.1	-0.4	-
<i>of which:</i>							
USA	-0.7	-0.4	-0.1	-0.5	0.2	-0.1	-
Japan	-0.3	-0.5	-0.3	-0.4	-0.5	-0.5	-
• Non-OECD	-1.0	-0.7	0.5	-0.8	-0.4	-0.1	-
<i>of which:</i>							
DAEs	-0.2	-0.1	0.1	-0.2	-0.1	-0.1	-
China	0.0	0.0	-0.2	0.0	0.0	-0.1	-
Rest of Asia	-0.1	0.1	0.0	0.0	0.1	0.0	-
CCEEs	0.1	-0.3	0.0	-0.1	-0.3	-0.1	-

1) EUR9: EUR15 excluding EL, E, A, P, FIN and S

2) EUR10: EUR15 excluding E, A, P, FIN and S.

3) EUR12: EUR15 excluding A, FIN and S.

4) Hong Kong, Korea, Malaysia, Singapore, Taiwan, and Thailand.

5) Afghanistan, Pakistan, India, Bangladesh, Maldives, Sri Lanka, Nepal, Bhutan, Myanmar, Laos, Vietnam, Kampuchea, Indonesia, Brunei, Philippines, Mongolia, Macao

6) Albania, Bulgaria, Czech republic, Slovakia, Hungary, Poland, Romania, Ex-USSR and Slovenia.

7) Average trade balance over the period in % of GDP.

Source: Commission services.

The Community has a comparatively low share of extra-EC exports directed towards the Asian markets which have been growing quickly and are likely to continue to do so in the foreseeable future. In 1995, Community exports to Asia (including China) represented only 17 per cent of total extra-EC exports against 20 per cent and 44 per cent for the United States and Japan respectively. It should be noted, however, that Community exports to these countries have risen strongly since the late 1980s (see Table 12). Furthermore, the share of Community exports directed towards the CCEEs, which also constitute high-growth markets, is significantly higher than that of the United States and Japan.

However, there is some cause for concern. The Community exhibits a comparatively low degree of specialisation in the strong-demand, high-tech sectors. The share of the high-demand sectors in total extra-EC exports amounted to 30 per cent in 1994 which compares with 39 per cent in the United States and 34 per cent in Japan; the share of the high-tech sectors in total extra-EC exports (in 1993) amounted to 23 per cent against about 37 per cent in the United States and Japan.

One of the most prominent features of the recent globalisation process is the emergence of newly industrialised countries as major suppliers and exporters of internationally traded goods (especially manufactures). Imports from Asian countries to the EC rose dramatically during the last decade, resulting in a sharp increase in their share in extra-EC imports. While imports from Asian countries only accounted for 1.3 per cent of Community GDP in 1995, these countries are increasingly establishing themselves as serious competitors in EC markets. In 1995, they accounted for around 18 per cent of total EC imports from the rest of the world (Table 12).

Table 13 shows that the growth of Asian exports to the Community is not restricted to traditional, low-skilled sectors such as clothing and textiles. High-skilled, capital-intensive sectors such as machinery and transport equipment and high-tech products represent a rising share of Asian exports to the Community. Greater global mobility of financial capital and easier access to technology since the early 1980s have contributed importantly to this trend. Moreover, restricted market access for “sensitive” products (e.g. textiles and clothing, steel and iron) may have encouraged the shift in Asian countries towards a greater specialisation in more sophisticated market segments. As a result, part of the adjustment burden in the EC has been shifted towards sectors in which EC countries have not until very recently faced direct competition from Asian exports.

Table 13 The regional structure of extra-EC ¹⁾ imports of manufactured products						
		Total	% of total imports of manufactured goods from each country or group of countries.			
		% of total extra-EC imports of manufactured goods	Machinery transport equipment	Chemicals	Clothing and textile	Hi-tech
USA	1980	22.9	26.4	9.1	4.3	24.3
	1995	21.6	30.8	8.9	2.2	33.5
Japan	1980	8.6	37.6	3.5	3.1	38.9
	1995	12.4	47.4	5.0	1.4	36.1
Developing countries ²⁾	1980	27.4	4.7	6.2	23.7	7.4
of which:	1994	36.4	13.7	4.7	23.7	17.3
DAE	1980	7.6	3.1	0.4	31.3	20.2
	1995	12.2	30.8	1.7	11.1	34.3
China	1980	0.9	0.8	13.5	44.1	1.9
	1995	5.7	9.6	5.8	23.9	21.3
Other Asia	1980	2.5	1.5	1.1	42.2	2.9
	1995	4.6	4.1	2.9	50.2	8.6
CCEEs	1980	5.2	9.8	12.7	16.9	3.6
	1995	11.6	14.0	7.3	17.5	9.0
¹⁾ EUR 9 for 1980 and EUR 12 for 1995. ²⁾ African-, Caribbean- and Pacific countries signatories of the Lomé convention, Central and South America, Middle East, DAEs, China, Other Asia, CCEEs. Source: Commission services.						

Growth in Community exports to and imports from other regions in the world have remained roughly in balance. At the same time, the Community's trade balance against the developing countries has shifted from a deficit of the order of 1 per cent of GDP just after the first oil price shock to a modest surplus at present. On the other hand, trade with the new "emerging" economies of Asia and the CCEEs has been broadly in balance during the last two decades.

2.2.2 Foreign direct investment (FDI)

Since the second half of the eighties, world-wide FDI flows have grown very rapidly, both absolutely and relative to trade flows and output growth. Annual flows jumped from an average of \$50 billion during the period 1981-85 to an average of \$155 during the period 1986-90, reaching \$200 billion in 1990. In the early 1990s, in line with the slowdown of

the world economy and weak corporate balance sheets in a number of industrialised countries, FDI flows dropped substantially but have recovered remarkably strongly from 1994 onwards. According to UNCTAD⁷, the level of global FDI flows reached \$315 billion in 1995. Over the last 10 years, global FDI flows rose in nominal terms on average more than twice as fast as world GDP.

The Community has been both a major source and destination for FDI flows. Although there was a setback in the early 1990s under the impact of the economic slowdown, the level of both inward and outward FDI flows was high by historical standards (see Table 14). The Community (including intra-EC flows) was the source of 42 per cent of global FDI flows in 1995 and absorbed 36 per cent of inflows.

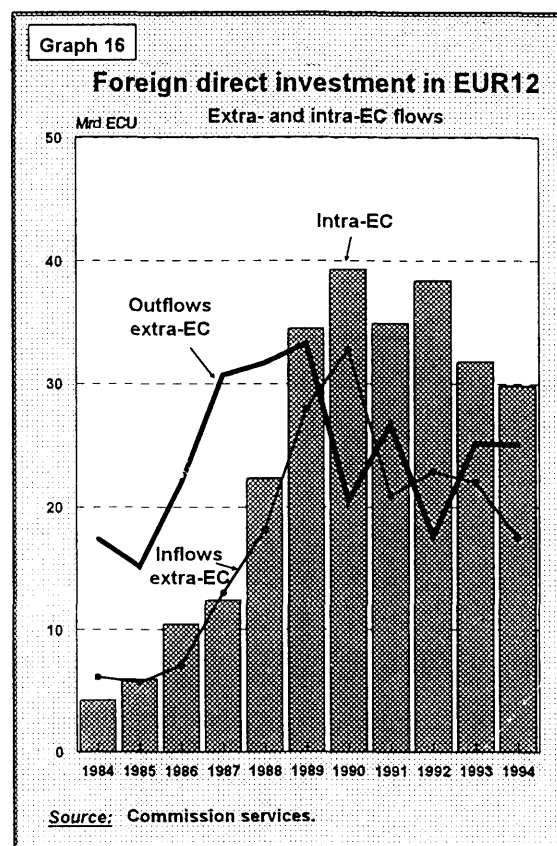
Following the launch of the Single Market Programme in the mid-eighties, the Community has become an increasingly attractive destination for both traditional investors like the United States and Japan and also the newcomers of Southeast Asia as they sought to strengthen their position in the internal market. The abolition of non-tariff barriers, the simplification of administrative formalities, the prospect of a large and growing market demand and the scope for economies of scale seem to have provided strong incentives to invest in the EC. The Single Market Programme has also provoked unprecedented amounts of FDI between EC member countries. As a proportion of total EC FDI outflows, intra-EC FDI flows soared from 20 per cent in 1983 to 59 per cent in 1994.

Table 14					
Foreign direct investment (Mrd \$)					
	1975	1980	1985	1990	1995
	EUR15 (extra + intra)				
Inflows	9.9	21.3	15.4	97.4	111.9
% World	45.9	40.9	31.1	47.8	35.5
% GFCF ¹⁾	2.6	2.8	2.9	7.0	7.0
Outflows	9.9	27.0	25.5	133.0	132.3
% world	36.0	46.8	42.6	55.4	41.6
% GFCF ¹⁾	2.6	3.6	4.8	9.5	8.3
Net flows	0.0	5.7	10.1	35.6	20.4
	USA				
Inflows	2.6	16.9	19.2	47.9	60.2
% GFCF ¹⁾	0.9	3.1	2.5	5.1	4.9
Outflows	14.2	21.9	15.2	27.2	95.5
% GFCF ¹⁾	5.1	4.0	1.9	2.9	7.8
	Japan				
Inflows	0.2	0.3	0.6	1.7	0.5
% GFCF ¹⁾	0.1	0.1	0.2	0.2	0.0
Outflows	1.8	2.4	6.4	48.0	21.3
% GFCF ¹⁾	1.1	0.7	1.7	5.1	1.5
¹⁾ Gross fixed capital formation. Source: UNCTAD.					

⁷ UNCTAD (1996), *World investment report*, Geneva.

As regards outward investment flows from the EC to non-EC countries, a large proportion (about 60 per cent in 1994) is directed towards other industrialised countries. This figure is on a declining trend, down from about 75 per cent in the mid-eighties. Among the developing countries, the Asian countries are increasingly important recipients of investment from the EC. The same holds for China whose share in EC FDI outflows has grown strongly in recent years. It is noteworthy that the size of EC FDI outflows is small relative to gross fixed capital formation in the Community (about 2 to 3 per cent for total extra-EC FDI outflows)⁸.

Direct investment abroad is a normal element in corporate growth strategies that enables a company to exploit its particular strength on a broader scale. From this perspective, FDI outflows to dynamic, fast-growing economies might be an indicator of a competitive edge. It is only when this relocation is not matched with broadly equivalent FDI inflows or when it is accompanied with weak domestic investment that the attractiveness of a country as a production site may be in question. So far, the Community has done fairly well in international competition for direct investment as witnessed by both the strong growth in inflows and its moderate surplus in *net* FDI flows. It seems that Community location and foreign production are complementary given the strong, albeit declining, correlation between the direction of exports and FDI outflows. Furthermore, there are no signs that the foreign transfer of production is predominantly



⁸ This analysis is confined to Community-wide trends which mask important differences between countries. For instance in Germany the size of FDI inflows has traditionally been low relative to outward FDI. Whereas during the 1980s substantial *net* FDI outflows were the mirror-image of a solid surplus on the current account, the widening gap since unification when the current account turned negative has fueled the current debate on the attractiveness of Germany as a production site. The strong appreciation of the DEM over recent years has undoubtedly played a role, though structural weaknesses in the German economy have significantly added to current concerns in this field. Conversely, following the deregulation and privatisation of the early 1980s, the United Kingdom experienced a sharp increase in inward FDI in the late 1980s, especially by Japanese firms.

determined on wage-cost grounds, even if this might be the case for some labour-intensive sectors such as clothing, footwear or toys.

2.2.3 Financial capital movements

Not only have FDI flows risen significantly over the last 20 years, but also international financial capital movements have expanded enormously under the combined impact of financial deregulation and innovation. For instance, cross-border transactions in bonds and equities soared in major industrial countries from less than 10 per cent of GDP in 1980 to between 150 and 250 per cent in 1995. The world-wide volume of foreign exchange trading has also risen very fast, with the daily turnover now amounting to \$1500 bn. It should be noted that these transactions primarily concern movements in stocks of financial assets (including government bonds) which have been built up over time and which react instantaneously to even marginal differences in yields.

Table 15 Structure of foreign direct investment in the EC (Mrd ECU)			
	1984 ⁽¹⁾	1990 ⁽¹⁾	1994 ⁽²⁾
From:	Extra-EC inflows		
- USA	3.0	9.2	8.5
- Japan	0.4	5.4	1.4
- Asia ⁽³⁾	-	-	0.5
- Others	2.8	18.2	9.5
To:	Extra-EC outflows		
- USA	11.5	7.2	6.4
- Japan	0.3	0.9	0.3
- Asia ⁽³⁾	-	-	2.4
- China	-	-	0.5
- CCEEs	0.0	0.2	3.3
- Others	5.6	12.2	8.6
Intra-EC	4.2	39.3	37.4
⁽¹⁾ EUR12. ⁽²⁾ EUR15. ⁽³⁾ Asia: Thailand, Malaysia, Indonesia, Singapore, Philippines, South Korea, Taiwan, Hong Kong and India. <u>Source:</u> Commission services.			

The liberalisation of financial markets also contributes to a better allocation of resources. Since holdings of financial assets are very sensitive to shifts in sentiment in international financial markets, they exert a strong discipline on exchange rates and economic policy. Ignoring market signals inevitably leads to turbulence on currency and bond markets which in turn -- as shown in Chapter 1 -- constitutes an important obstacle to macroeconomic growth.

2.2.4 Economic implications

There is little evidence that globalisation in itself, and especially increased trade and investment with developing countries, is a major cause of unemployment in the Community. On the contrary, increased trade is a major source of economic growth and rising living standards due to improved allocation of resources.

First of all, it should be borne in mind that the degree of openness of the Community to the world economy is relatively small and broadly similar to that of the United States and Japan. In 1995, the degree of openness⁹ in the Community was about 10 per cent, compared with 12 per cent in the United States and 9 per cent in Japan. This implies that the globalisation of trade directly affects only a limited part of the Community economy.

Secondly, it should be noted that the majority of the EC's economic links are within the Community and with its major industrial partners. This means that globalisation is primarily taking place between countries with broadly similar economic structures, factor endowments and wage and productivity levels. Hence, the primary impact of international trade and FDI flows on employment creation is within the Triad (i.e. between the Community, the United States and Japan). The intensification of economic links between industrial countries should not be perceived as a disadvantage but rather as a boon for the Community's prosperity. This has been the motivation for a variety of EC policies, notably the new Market Access Initiative, which seek to maximise the benefits accruing to the Community from globalisation.

Thirdly, the size of the Community's trade with low-wage economies is still small: extra-EC imports from low-wage countries amount to less than 3 per cent of Community GDP at present and the Community's trade with these economies is broadly in balance. It is sometimes argued that even a balanced trade account with these countries could involve overall job losses for the Community because imports from low-wage economies tend to have a higher (low-skill) labour-intensity than the Community exports to these countries. However, this argument does not take account of the dynamic effects resulting from a better resource allocation nor of the fact that cheap imports mean an increase in Community real incomes and internal demand. Overall, this trade embodies the exchange of low-skilled work against high-skilled and better paid work.

Fourthly, the extent of outward relocation of certain types of economic activity should not be exaggerated nor is it necessarily undesirable. A job created in the low-wage countries cannot be equated with a job lost in the Community and it cannot be assumed that this foreign production and employment could be relocated to the Community. Rather than displacing Community exports, sales-oriented investment abroad can open up markets and lead to additional exports by competitive Community industries. Community businesses are exploiting these opportunities as can be seen from the Community's continued trade surplus with the CCEs and the newly industrialised countries of Asia.

⁹ Arithmetic average of exports and imports of goods and services as a percentage of nominal GDP.

Nevertheless, the globalisation of product and financial markets accelerates sectoral change and exerts downward pressures on the wages of low-skilled labour. It also exercises powerful pressures on the Community economy to apply new technologies, to maintain and improve competitiveness, to optimise the allocation of resources and to conduct sound economic policies.

2.3 Competitiveness

Technological progress and globalisation puts constant pressure on Member States to maintain and improve their competitive position. Competitiveness is a complex and ambiguous concept that is often confused with other notions, for instance profitability.

At the firm level, the meaning of competitiveness is clear-cut: an enterprise is competitive if it can sell its products at the market price and be profitable in the medium and long term.

At the country level, the notion of competitiveness is less straightforward. For a country, the ultimate policy objective is to improve its citizens' living standards and well-being. In this context, the external performance of a country is generally considered important because it is a useful indicator of the long-term ability to raise productivity and to turn international economic growth into domestic jobs. In this respect, a country's competitiveness is often assessed on the basis of trends in its export performance. As shown in Table 16, the Community has experienced a steady, moderate decline in export markets shares

since the mid-1980s. As regards the other regions listed in the table, it is noteworthy that Japan also has suffered from continued, marked losses in export market shares whereas the United States (in the second half of the 1980s) and the Asian economies (since the early 1980s) have enjoyed considerable gains.

Table 16

Export performance, total goods

% gain or loss of market share in real terms¹⁾,
(annual average change)

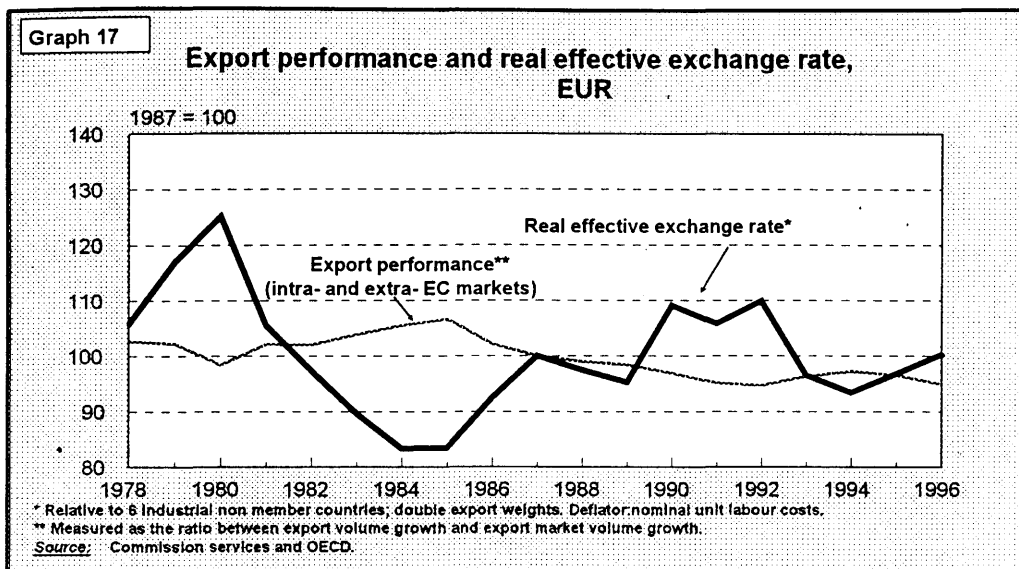
	1981-85	1986-90	1991-95	1996 ⁽²⁾
EUR	1.6	-1.9	-0.1	-1.6
USA	-2.8	4.3	-0.2	1.7
JAP	1.6	-3.9	-7.8	-5.9
Non-OECD	-1.4	1.0	1.6	1.9
<i>of which:</i>				
- DAEs ⁽³⁾	3.0	3.3	1.7	3.1
- Rest Asia	2.5	2.4	5.5	3.6

1) Measured as the ratio between export volume growth and export market volume growth.

2) Estimated.

3) DAEs excl. Thailand and Malaysia.

Source: OECD.



The evolution in export market shares can in part be explained by movements in international cost competitiveness (as measured by real effective exchange rates). In this context, Graph 17 reveals that the deterioration in export performance over the last decade in the Community has partly been a consequence of the substantial appreciation of its real effective exchange rate. A negative correlation between the two variables is apparent at the time of the hike in the value of the Community currencies in the mid-1980s and the early 1990s.

Though trends in export performance and cost competitiveness may contain interesting insights, they only shed a partial light on the competitiveness of a country. In macroeconomic terms, and viewed in a medium to long-term perspective, a convenient, comprehensive definition of the notion of competitiveness¹⁰ is as follows: A country is internationally competitive if concurrently:

- its productivity increases at a rate which is similar to or higher than that of its major trading partners with a comparable level of development;
- it maintains external equilibrium in the context of an open free-market economy; and
- it realises a high level of employment.

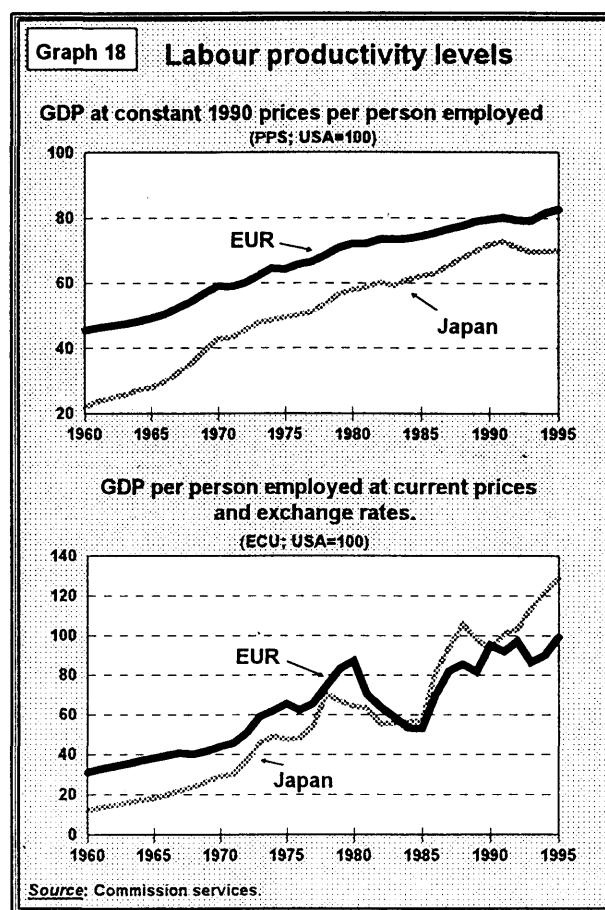
¹⁰ See also Competitiveness Policy Council (1993), "*A competitiveness strategy for America*".

Table 17 shows that according to this definition the Community's record is mixed. The Community has had higher labour productivity growth than the United States and, in recent years, Japan while maintaining external equilibrium, but its employment performance is significantly worse than in its two main trading partners.

Table 17 Macroeconomic competitiveness in the Triad					
	1961-73	1974-85	1986-95	1986-90	1991-95
EUR USA Japan	Labour productivity growth (% p.a.)				
	4.4	2.0	1.9	1.9	1.9
	1.9	0.5	0.8	0.6	1.1
	8.2	2.7	2.0	3.6	0.6
EUR USA Japan	Current account (% of GDP)				
	0.3	-0.3	-0.2	0.1	-0.4
	0.5	-0.4	-1.9	-2.5	-1.3
	0.6	0.9	2.7	2.8	2.7
	1960	1973	1985	1990	1995
EUR USA Japan	Employment rates (%) ¹⁾				
	67.0	64.8	59.1	62.2	59.6
	62.7	66.7	68.5	72.6	73.0
	74.3	70.8	70.6	72.6	73.9
EUR USA Japan	Unemployment rate (%)				
	2.4	2.6	10.0	7.8	10.9
	5.5	4.9	7.2	5.5	5.4
	1.7	1.3	2.6	2.1	3.3
¹⁾ Ratio of employment to the working population (15-64 years). Source: Commission services.					

All industrial countries have been affected by a structural break in apparent labour productivity growth in the wake of the first oil price shock. In the Community, labour productivity has risen at a stable rate of 2 per cent per year on average over the last twenty years, thereby increasing about three times as fast as in the United States. In Japan, which showed the strongest performance over the period 1960-90, labour productivity growth fell dramatically in the first half of the 1990s, to rates well below those experienced in the Community and even the United States. Japan's recent record reflects labour hoarding during the strong and protracted economic downturn in the early 1990s.

The better labour productivity growth performance of the Community has resulted in a steady catching-up with the productivity level of the United States (see Graph 18). The economy-wide Community productivity level (on a purchasing-power-standard basis) relative to the United States increased from 45 per cent in 1960 to 82 per cent in 1995, still well above the Japanese level despite the latter's leadership in some manufacturing industries. However, over this period, the Community did not succeed in narrowing the gap in living standards with the United States to a similar degree. GDP per head of population relative to the United States increased from 55 per cent in 1960 to only 71 per cent in 1995. This essentially reflects divergent trends in employment rates in both economies (see below).



Community output per person employed measured in *current* prices and exchange rates is now similar to that in the United States but well below the Japanese level. This means that, at prevailing exchange rates, a worker in the Community on average creates a similar amount of economic wealth as a worker in the United States.

Historically, the Community has never experienced real problems concerning the external equilibrium. From 1960 until the late 1980s, the Community's current account was generally broadly balanced or in slight surplus. This good performance is somewhat concealed in Table 17 (which presents period averages) by the short-lived but non-negligible deficits on the Community's current transactions with the rest of the world at the time of the two oil price shocks. In the wake of the overheating of 1989-90 and German unification, the current account turned temporarily negative but since 1995 the Community has again shown a surplus of the order of $\frac{3}{4}$ per cent of GDP. Conversely, the United States has run significant current account deficits since the early 1980s whereas Japan has experienced a strong external surplus, reflecting a significant structural excess of national saving over domestic investment.

Compared with its two major trading partners, the Community economy displays dismal employment performance. In the Community, employment was not a major worry until the early 1970s. But since then, apart from the growth period of the second half of the eighties, the rate of job creation has been too slow and below the comparatively modest rise in the labour force. The United States, by contrast, has enjoyed rapid employment growth since the early 1960s, broadly in tandem with a strong increase in the labour force. As a result, the two regions experienced opposite trends in the employment ratio (i.e. employment relative to the working age population). Starting from a level somewhat below that in the Community, the employment rate in the United States rose to around 73 per cent at present whereas it declined to below 60 per cent in the Community.

2.4 Capital-labour substitution and employment growth

2.4.1 Substitution of labour by capital

Against the backdrop of rapid technological progress and increased globalisation, constant efforts to maintain and reinforce competitiveness are required. The Community and its two main trading partners have been confronted with similar adjustment problems but the results for the labour market have been strikingly different. A major explanation for the divergent employment trends on both sides of the Atlantic seems to reside in the interplay of labour productivity, capital-labour substitution and growth¹¹.

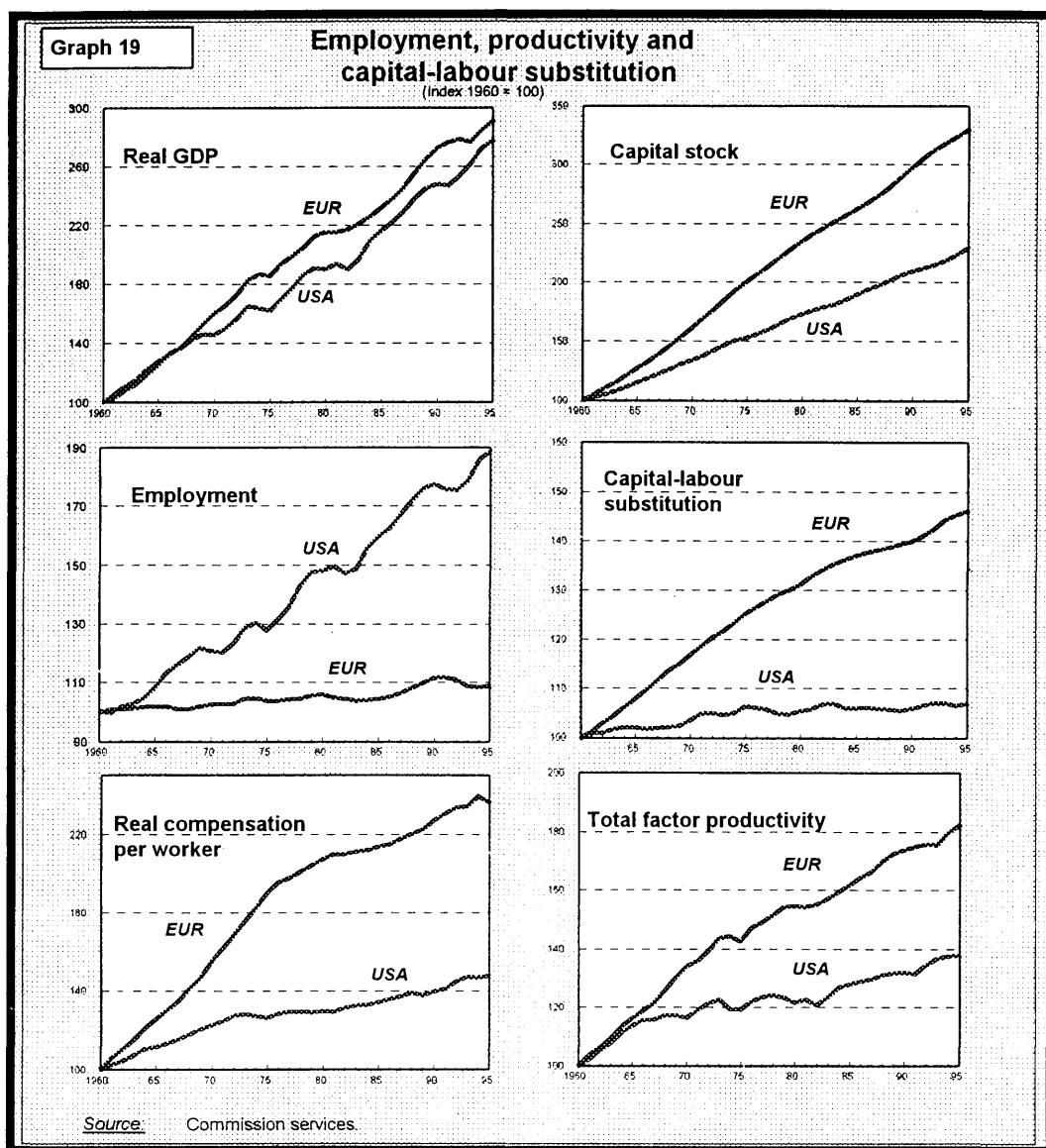
As discussed in the previous section, over the last 35 years the Community has continuously experienced stronger labour productivity growth than its principal trading partner, the United States, and recently even outperformed Japan. However, it appears that almost half of the increase in labour productivity has resulted from substitution of labour by capital.

Labour productivity growth can be decomposed into growth of embodied technological progress (total factor productivity) and capital-labour substitution. Table 18 indicates that in the Community about 3 points of the annual increase in labour productivity of 4½ per cent in the period 1961-73 can be attributed to an increase in total factor productivity and the remainder or 1½ points to the substitution of labour by capital. During the two decades following the first oil price shock, labour productivity rose at a stable annual rate of 2 per cent. Only a little over half of this can be explained by technological progress. Nearly half of labour productivity growth is caused by substitution of labour by capital.

¹¹ No comparison is made with the Japanese performance as its approach is too specific, culturally and socially, to be applicable to the Community.

Table 18 Output, employment, productivity and capital-labour substitution (annual % change)					
	1961-73	1974-85	1986-95	1986-90	1991-95
EUR USA Japan	1. Technical progress = Total factor productivity = endogenous growth				
	2.8	1.0	1.2	1.5	1.0
	1.6	0.4	0.8	0.6	0.9
EUR USA Japan	6.3	1.1	0.9	2.3	-0.5
	2. Macroeconomic capital-labour substitution = labour-saving growth (2 = 3 - 1)				
	1.5	1.0	0.7	0.4	1.1
EUR USA Japan	0.3	0.1	0.1	0.0	0.2
	1.8	1.6	1.1	1.2	1.1
	3. Apparent labour productivity = GDP per person employed = economic growth without employment (3 = 1 + 2)				
EUR USA Japan	4.4	2.0	1.9	1.9	1.9
	1.9	0.5	0.8	0.6	1.1
	8.2	2.7	2.0	3.6	0.6
EUR USA Japan	4. Employment = employment-creating growth (4 = 5 - 3)				
	0.3	0.0	0.4	1.3	-0.5
	1.9	1.8	1.7	2.1	1.2
EUR USA Japan	1.3	0.7	0.9	1.0	0.7
	5. Actual GDP growth (5 = 1+2+4 = 3+4)				
	4.7	2.0	2.3	3.3	1.4
EUR USA Japan	3.9	2.3	2.5	2.8	2.3
	9.7	3.4	2.9	4.6	1.3

A strikingly different picture is noticeable in the United States. During 1961-73 and 1974-95, the growth in labour productivity was about one third of that in the Community, and capital-labour substitution contributed only a marginal fraction. The US economy has thus been expanding its input of capital and labour broadly in parallel. It is noteworthy that since the mid-1980s the rate of TFP growth in the United States seems to have risen from the very low rate experienced in the previous decade, in part reflecting a strong expansion of investment.



In itself, capital-labour substitution is not a distressing phenomenon. A high degree of capital-labour substitution allows continued high growth in economic activity and living standards. But with a large part of the available labour reserve unemployed, as has been increasingly the case in the Community since the first oil price shock (see Table 18), a twofold problem emerged:

- a lack of adjustment in the labour market compelled enterprises to keep up a strong substitution of labour by capital in order to safeguard their competitiveness through productivity increases;
- macroeconomic growth was insufficiently strong relative to the given and stable labour productivity growth to create an adequate number of jobs.

The potential labour reserve, amounting to about 17 million persons if the average employment rate of the period 1961-73 is taken as a yardstick or to some 26 million if the benchmark is the employment rate in the Scandinavian countries, the USA and Japan, constitutes an important growth potential. But this implies that adequate policies should be implemented to take advantage of this labour reserve.

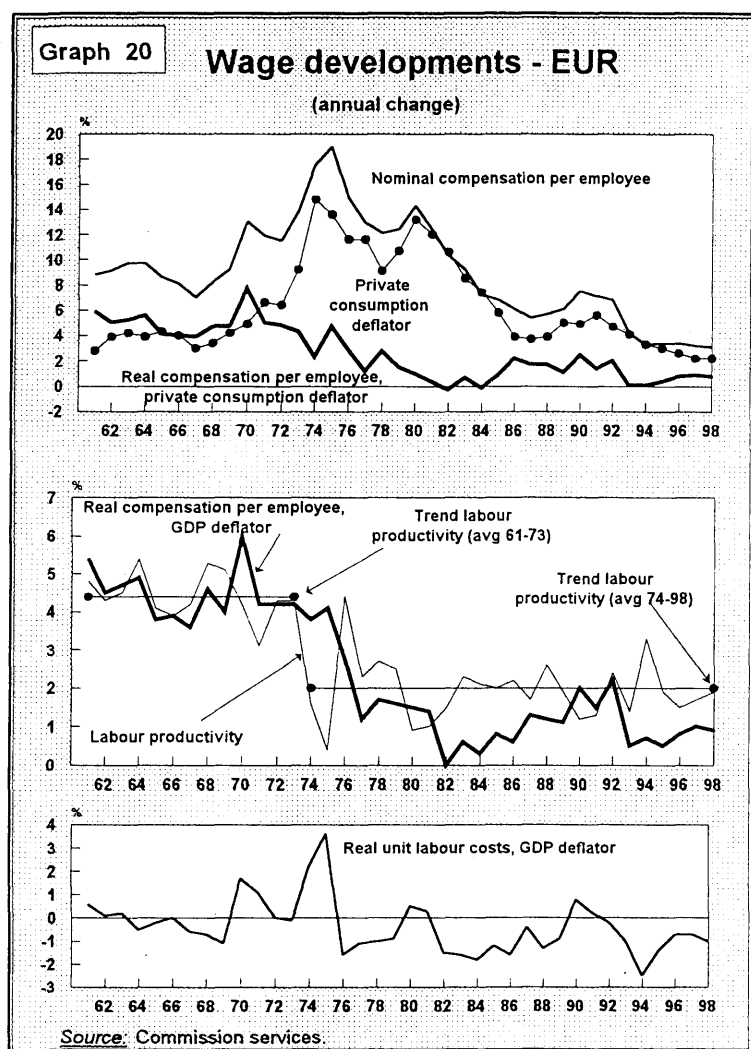
Table 19							
Employment potential, EUR (1960-95, in mio)							
	1960	1973	1985	1990	1991 ¹⁾	1991 ²⁾	1995
1. Population in working age groups (15-64 years)	193.8	208.4	229.7	234.2	235.4	246.0	249.0
2. Activity rate in % (= 3 / 1)	68.9	66.9	65.7	67.2	67.3	67.7	66.6
3. Active population (= 4 + 5)	133.4	139.5	150.9	157.5	158.3	166.6	165.9
4. Unemployment	3.1	3.5	14.8	12.0	12.7	13.6	17.9
5. Total employment	130.4	136.0	136.2	145.4	145.6	153.0	148.1
6. Employment rate (= 5 / 1)	67.3	65.2	59.3	62.1	61.9	62.2	59.5
7. Potential employment at 1961-73 average employment rate (66.2%)	128.4	138.1	152.2	155.2	155.9	163.0	165.0
8. Employment gap 1 (= 5 - 7)	2.0	-2.1	-16.0	-9.7	-10.3	-10.0	-16.9
9. Potential employment at 70% employment rate ³⁾	135.6	145.9	160.8	163.9	164.8	172.2	174.3
10. Employment gap 2 (= 5 - 9)	-5.3	-10.0	-24.6	-18.5	-19.1	-19.3	-26.2
¹⁾ 1960-91 with West Germany, ²⁾ 1991-95 with unified Germany. ³⁾ Comparable to highest employment rates registered in Northern Europe, USA and Japan. Source: Commission services.							

2.4.2 Substitution and wage developments

As highlighted above, in the Community substitution of labour by capital explains about half the growth in labour productivity. In the United States, which has had an only slightly weaker pace of technological progress, nearly no macroeconomic substitution has taken place. The question therefore arises of whether it is possible to slow down this substitution process without impairing competitiveness.

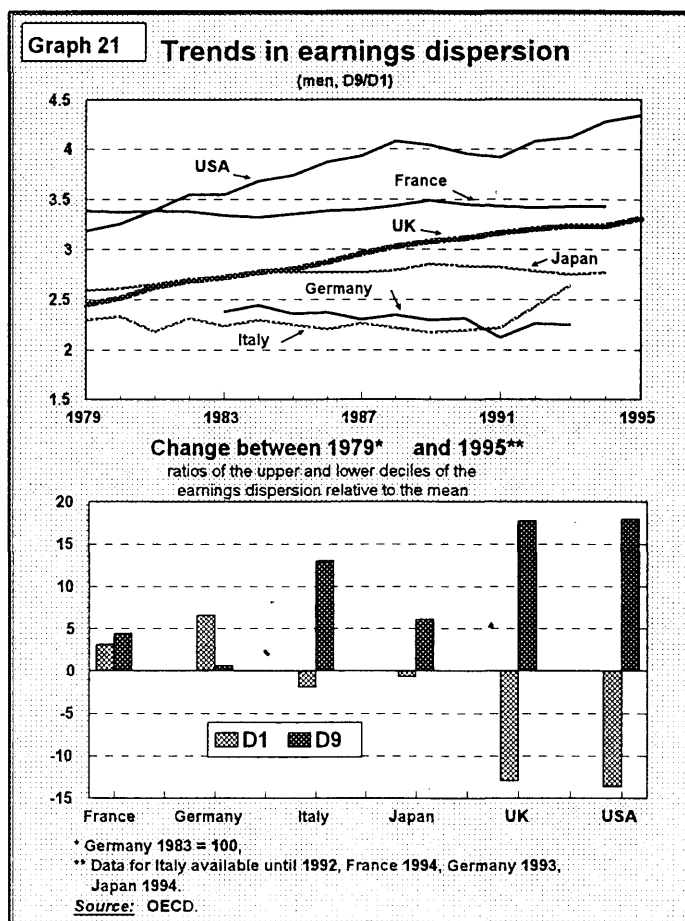
A first answer to this question is provided by developments in relative factor prices at the macroeconomic level. Following excessive wage increases in the wake of the two oil price shocks, which laid the ground for the upsurge in unemployment, macroeconomic wage behaviour in the Community has become increasingly appropriate. Since 1982, with the exception of 1990-92, the trend in total wage costs (including social security contributions) per head has kept in line with the fall in inflation. The growth of unit labour costs has remained below increases in the GDP price deflator and the rise in real

wages has stayed about 1 percentage point behind overall labour productivity growth (Graph 20). This evolution has led to a remarkable improvement in the profitability of capital (see Graph 9 in Chapter 1) and constitutes a solid foundation for higher, investment-driven economic growth as demand prospects brighten. As a consequence, appropriate macroeconomic wage developments are important to reduce unemployment through investment-supported growth (in line with the macroeconomic part of the Broad Economic Policy Guidelines). However, econometric analyses suggest that favourable aggregate wage trends slow down the macroeconomic substitution of labour by capital only very gradually.



A faster way to weaken the substitution process is a downward widening of the wage (cost) scale. The market forces acting in this direction are strong and will probably strengthen as a result of globalisation, especially with the opening up of the CCEEs and the Former Soviet Union. In the case of a very dispersed wage structure, economic growth becomes more employment-creating because the wide wage spread enables activities with low productivity to remain and/or to become viable.

During the 1970s and 1980s, in the United States the wage scale for male workers underwent a downward widening of more than 30 per cent¹². This means that the relatively small increase in average real wages observed in the United States (annual average rate of growth of around ½ per cent during the period 1974-90) was accompanied by a dramatic fall in real wages at the lower end of the earnings distribution. It can be argued that the large degree of wage dispersion in the United States has been the price to pay for high employment. The downward wage flexibility has ensured a closer match between relative wages and the widening of labour productivity differentials (resulting from technological progress and globalisation).



Although this tendency may have tended to weaken somewhat in the United States in recent years, the wage distribution remains very wide and continues to influence the employment-intensity of output growth positively. Furthermore, the United States is implementing policies aimed at more investment, higher productivity growth and higher wages for the unskilled. In this context, evidence suggests that the bulk of the jobs which have been created in recent years in the United States are not low-paid, low-quality jobs but rather they have been concentrated in highly skilled activities. Indeed, 68 per cent of the net growth in full-time employment between 1994-96 was found in job categories paying above-median wages¹³.

¹² See BURTLESS, G. (1993), "The contribution of employment and hours changes to family income inequality", *American Economic Review, Papers and Proceedings*, Vol. 83, n° 2, pp. 131-135.

¹³ US Council of Economic Advisers (1996), "Job creation and employment opportunities: The United States labour market, 1993-96".

Conversely, in the Community, the earnings distribution either remained broadly unchanged or widened only slightly despite the changes in the pattern of labour demand. The exceptions to this general situation have been the United Kingdom and, to a lesser extent, Italy since 1991 (see also Box 3). A major explanation for the discrepancy in the degree of earnings inequality between the United States and the Community are differences in labour market institutions. These differences reside essentially in a much greater reliance on market forces in the United States than in the Community. For example, compared with the Community, minimum wages are low and unemployment benefits and other social transfers are markedly less generous in the United States. Other differences are less widespread collective wage bargaining, a smaller proportion of government employment and less support for education and job training in the United States than in the Community.

For social and political reasons, an emulation of the US-approach is neither feasible nor desirable in the Community as it would mean a dramatic change in the European social model. For instance, the application of the US model to the Community would require a substantial lowering of unemployment compensation and social benefits. This would *ceteris paribus* imply a widening of the wage structure and generate greater income inequality. It would introduce in the Community the working poor syndrome -- a form of exclusion just as harmful for the social fabric as unemployment.

The above considerations do not mean, however, that some relief should not be sought through pragmatic solutions, in line with the strategy adopted by the Essen European Council aiming at a higher employment-intensity of growth. In particular, the following principles are worth pursuing in this context. The wage agreements of the social partners should provide for more differentiation according to qualifications, between regions and, to some extent, sectors. Non-wage labour costs (or income taxes) at the lower end of the wage scale should be lowered with the government revenue losses being compensated for by a stricter control of increases in overall government spending and/or increases in other taxes (e.g. environmental levies). In a similar vein, temporary entry-wages for the low-skilled, youth or long-term unemployed could usefully be introduced. Such measures should be carefully targeted and gradually phased out. Furthermore, a higher flexibility of working time arrangements, tailored to the specific needs of firms and workers, greater use of voluntary part-time work and the promotion of local employment initiatives are likely to foster both new jobs and higher participation in the labour market.

Hence, the solution to the Community's unemployment problem must primarily be found through high economic growth, structural reforms and microeconomic flexibility.

2.5 Policy implications

Since the early 1960s, unemployment in the Community has risen from around 2¼ per cent of the civilian labour force to about 11 per cent at present. During this period, employment has grown at an average annual rate of barely 0.3 per cent whereas both the activity rate and the employment ratio have been on a downward trend. The result has been that the Community presently displays a large reserve of unused labour. As discussed above, there is little evidence to suggest that the Community's dismal labour market performance is closely related to technological progress, globalisation and competitiveness.

Nevertheless, the inherent consequences of technological advances and globalisation, *viz* fierce world-wide competition and far-reaching sectoral change, underscore the urgent need to implement measures to enhance competitiveness on the one hand and to modernise product and labour markets on the other. The policy requirements are those already presented in the White Paper on "Growth, competitiveness and employment" and in successive Broad Economic Policy Guidelines adopted since 1993. Recognizing this urgency, Member States have introduced, sometimes bold, reform programmes aimed at responding positively to the key structural challenges confronting their economies. Efforts should continue and be stepped up, especially in those areas where progress has been less visible or lacking.

In order to safeguard and promote the EC's competitiveness and employment in a world of free trade and evolving technological change it is essential that Member States and the Community, in line with the Broad Guidelines for Economic Policies, intensify their efforts to modernise their markets for goods and services. This involves in the first place the full completion of the European Single Market, the importance of which has clearly been highlighted in the Commission's recent evaluation¹⁴. According to this study, the Single Market Programme has so far contributed to a rise in the level of GDP of up to 1.5 per cent and created up to 900 000 jobs due to increased trade and competition. Further action is needed to complete the legal framework in areas such as taxation and company law and the liberalisation of the telecom and energy markets. Even more importantly, it is necessary to ensure the effective application and enforcement of existing Community law and reduce the burden of over-regulation, particularly but not exclusively at the national level, which still impedes the operation of the single market. The creation of a flexible

¹⁴ European Commission, (1996), "The impact and effectiveness of the Single Market", COM(96) 520 final.

economy also needs enhanced structural reforms in other important areas, including the realisation of the transeuropean transport and communication networks, the promotion of research and development, the promotion of the information society and the removal of barriers to entry and excessive regulation facing SME's. These policies will all strengthen endogenous growth and lead to strong improvements in the overall productivity of the Community economy. Provided the appropriate policy framework is put in place, there need not be any contradiction between sustained, investment-supported growth and the preservation of a healthy environment (see Box 4).

As emphasised in the 1996 Joint Employment Report from the Council and the Commission "Employment and growth in the Community - The way forward" approved by the Dublin European Council, there is a continued need to further improve the responsiveness of Member States' labour markets to changes in the economy through a modernisation of the organisation of work, increased geographical and professional mobility and productivity-related labour cost differentiation. In particular, it is essential to reinforce education and training so that the skills of the workforce are able to adapt to evolving technological and other changes. These efforts are also necessary in order to avoid labour market bottlenecks and a resumption of wage inflation as unemployment comes down. Furthermore, pragmatic solutions to increase the labour-content of growth (see sub-section 2.4.2) should be pursued actively. They not only contribute to increased employment but they also help to cushion the painful adjustment efforts.

¹⁵ See "The composition of unemployment from an economic perspective", *European Economy*, n° 59, 1995 and "Growth, employment and employment-intensive growth", *European Economy*, n° 62, 1996.

Box 2: The impact and effectiveness of the Single Market - the 1996 Review

The Single Market Programme (SMP) is the most ambitious and comprehensive supply-side programme ever launched. It aimed to remove all remaining non-tariff barriers to trade between EC Member States. The Commission's recent evaluation – The Impact and Effectiveness of the Single Market Programme (COM(96) 520 final) presented in October 1996 – and a more detailed analysis to be published in a forthcoming edition of European Economy entitled *Economic Evaluation of the Internal Market*¹ offer some economic evidence of the impact of the Single Market so far. It concludes that there have clearly been positive effects on the Community economy, especially in the manufacturing sectors. Problems remain to be tackled, and vigilance is still essential to guard against any refragmentation of the Community market, but the Single Market is undoubtedly becoming a reality.

The positive effects of the Single Market fall into three main areas:

- **changes in trade and foreign direct investment flows;** according to theory, removing trade barriers between countries would expand trade between Member States and replace less efficient domestic production with imports produced more efficiently, thereby improving welfare. The SMP may also lead either to greater Member State specialisation on the basis of comparative advantage, increasing inter-industrial trade between Member States, or to the exploitation of scale economies, imperfect competition and product differentiation, increasing intra-industry trade (i.e., the simultaneous import and export of similar product lines, such as cars for cars). The former carries efficiency gains as Member States specialise in activities where they are relatively more efficient, and consumers benefit from lower prices, but it can also be accompanied by painful industrial restructuring. By contrast, intra-industry trade offers the consumer a wider variety of products, and producers lower adjustment costs. Meanwhile, by changing the attractiveness of the EC relative to other sites around the world as a location for multinationals' production facilities, the SMP was also expected to have an impact on foreign direct investment flows (FDI);
- **changes in Member States' production structures, levels of competition and the consequent impact on prices;** it was expected that many of the beneficial effects of the SMP on the Community economy would result from competitive forces unleashed by integration, stimulating greater efficiency, with lower costs and prices, and increased product variety. Driving these forces were expected to be the exploitation of scale economies and increased competition. As a result, inefficient firms would be eliminated and industry restructured. Greater competition would also ensure that lower production costs resulting from efficiency gains would translate into lower consumption prices.
- **changes in EC total factor productivity, growth, employment and convergence;** the SMP can be expected to have a positive impact on the accumulation of production factors, leading to higher growth rates in the EC. First of all, the static, efficiency gains of the SMP translate into higher incomes, which may generate investment and raise growth in the medium-term. Secondly, the SMP could improve the benefits and reduce the costs of producing innovations in the EC, boosting growth in the long run.

1. Changes in trade and foreign direct investment flows

Analysis estimates that the SMP impact of lifting trade barriers has increased trade volumes between Member States of manufacturing products by 20-30%. Moreover, from 1985 to 1995, the share of intra-EC imports in total manufacturing imports increased by 6.7 percentage points from 61.2% in 1985 to 67.9% in 1995. For services during the same period, the share of intra-EC imports in total imports of services increased 3.1 percentage points from 46.9% in 1985 to 50.0% in 1995. Such increases in trade amongst Member States have not, however, come at the expense of trade with third countries - extra-EC manufacturing imports have increased their share of consumption over the period 1980-93 from 12 to 14%, and it is estimated that 70% of this increase is down to the SMP.

¹ *Economic Evaluation of the Internal Market*, European Economy - Reports and Studies, 1997, Office for Official Publications of the European Communities, Luxembourg.

At the beginning of the 1980s, intra-Community trade could be classified as mainly inter-industry (around 45% of total manufacturing trade) corresponding to specialisation based on Member States' comparative advantages. Due to the SMP, this started to decline in the mid-1980s whilst the share of intra-industry trade rose. However, intra-industry trade can be further sub-differentiated: either as trade in similar products in terms of both prices and quality, or in trade in products differentiated by price and quality (e.g., one country exporting brand-name expensive shirts and the other inexpensive low quality shirts). The rise in intra-industry trade has predominantly been the latter type (from less than 35% of total manufacturing trade in 1985 to more than 42% in 1994), whilst the former type has remained broadly stable (around 20% of total intra-EC manufacturing trade). In other words, Member States' production structures appear to be converging as a result of specialising in increasingly similar sectors but different price-quality niches. This facilitates the move to EMU.

Meanwhile, the SMP impact on FDI seems to have been even more positive than its impact on trade. The EC absorbed 44.4% of FDI inflows from all countries in the world at the beginning of the 'nineties, compared to 28.2% in the period 1982-87. Between 1984 and 1992, intra-EC FDI increased four times faster than intra-EC trade.

2. Changes in Member States' production structures, levels of competition and the consequent impact on prices

Industrial restructuring inside the EC has been characterised by an explosion in the number of mergers and acquisitions (M&A). This growth has been particularly strong in cross-border activity, although the bulk of M&A operations have remained domestic (over 70% of operations for the EC-15 between 1990 and 1995), indicating that restructuring is taking place, at least initially, through changes to domestic market structures. Between 1988 and 1992, manufacturing was the more active target for M&As. Latterly, services have taken the lead, in accordance with the delayed introduction of SMP measures in these sectors. This has led to greater industrial concentration at the EC level (but not at the Member State level). Many industries have experienced increases in concentration exceeding five percentage points, especially technologically intensive industries.

Such increases in concentration could result in reduced economic welfare were it to stifle competition. The promotion of an active competition policy is therefore particularly important. However, evidence on price cost margins and business perceptions seems to indicate that the efficiency gains associated with large size have been passed on to consumers thanks to increased competition. The key to this seems to be the intensification of cross-border trade.

3. Changes in EC total factor productivity, growth, employment and convergence

Community income in 1994 is estimated to have been 1.1 to 1.5 percentage points higher than it would have been in the absence of the Single Market. Outlying Member States have, in general, benefited most from this improvement. In other words, there has been convergence of Member States' real per capita income levels. Levels of employment are also higher with somewhere between 300,000 and 900,000 extra jobs created thanks to the SMP, although the effect has been overshadowed by unfavourable economic conditions unconnected with the Single Market. The significant growth in the Structural Funds corroborated the growth impact of the SMP.

To arrive at these conclusion, the *Economic Evaluation of the Internal Market* distills the economic findings of almost 40 studies carried out for the 1996 Single Market Review - a two year long major Commission research project on the SMP launched in response to a request from the Council at the end of 1992. Around half the studies were devoted to analysing developments in some relevant manufacturing and service sectors (i.e., sectors where the Community market in 1985 was highly fragmented by those significant non-tariff trade barriers targeted for elimination in the Single Market Programme), the other half to horizontal issues (e.g., the development of prices around the Community thanks to the Single Market, progress in eliminating the most important non-tariff barriers, and the impact on trade both within the Community and with third countries, amongst others). Most of the studies were carried out by independent consultants, each one supervised by an evaluation committee made up of Commission Services. To complement the essentially quality control role of the evaluation committees and to enhance the objectivity of the studies, an advisory panel of independent academic experts from around the Community was constituted. These experts also played a key advisory role during the drafting of the *Economic Evaluation of the Internal Market*.

Box 3: Wage dispersion in the Community in 1994

The new EC Household Panel-94 survey provides a good opportunity to get a recent and fairly detailed picture of the dispersion of **gross** wages in the EU. Table B3.1 presents data on the distribution of gross earnings for full-time workers in 1994. By surveying these measures of wage inequality, some major conclusions seem to emerge:

- overall wage disparity is markedly high in E, F, L, A, UK and, especially, IRL and P, which are well above the Community average. The presence in this group of countries with high and low employment growth seems to suggest that at the macroeconomic level, the degree of wage dispersion is only one, albeit important, factor explaining employment growth.
- relatively wide disparity affects both the higher and lower wage deciles for the same countries except for P and F, where the lower half of the earnings scale appears to be relatively compressed (most likely, because of the incidence of relatively high wage minima).
- the distribution of gross wages is markedly compressed in B, DK, I, NL, FIN and S, in particular as regards the lower wages in the case of B, DK and S. A greater homogeneity of the economic structure of these countries, alongside with historical and social reasons, helps in explaining the narrower wage hierarchy.

Table B3.1.

Wage dispersion in the EC

	ECHP	OECD(96)	ECHP	OECD (96)	ECHP	OECD (96)
	Overall Dispersion (D9/D1)	Overall Dispersion (D9/D1) (3)	Upper-Half Dispersion (D9/D5)	Upper-Half Dispersion (D9/D5)	Lower-Half Dispersion (D5/D1)	Lower-Half Dispersion (D5/D1)
B	2.42	2.25	1.64	1.57	1.47	1.43
DK	2.10	2.17	1.53	1.57	1.37	1.38
D(1)	2.95	2.32	1.76	1.61	1.68	1.44
GR	2.50	n.a.	1.60	n.a.	1.56	n.a.
E	3.64	n.a.	2.04	n.a.	1.78	n.a.
F	3.20	3.28	1.98	1.99	1.62	1.65
IRL	4.18	n.a.	2.00	n.a.	2.08	n.a.
I	2.13	2.80	1.52	1.60	1.40	1.75
L	3.38	n.a.	1.94	n.a.	1.74	n.a.
NL	2.33	2.59	1.62	1.66	1.44	1.56
A	n.a.	3.66	n.a.	1.82	n.a.	2.01
P	4.20	4.05	2.63	2.47	1.60	1.64
FIN	n.a.	2.38	n.a.	1.70	n.a.	1.40
S	n.a.	2.13	n.a.	1.59	n.a.	1.34
UK	3.73	3.38	1.94	1.87	1.92	1.81
EUR12	3.05	n.a.	1.83	n.a.	1.66	n.a.
US	n.a.	4.39	n.a.	2.10	n.a.	2.09

Key: (1) OECD data referring to Western Germany only.

(2) Average 5 yearly change of the decile ratios D9/D5 and D5/D1 respectively, since 1989.

(3) $(D9/D1) = (D9/D5) * (D5/D1)$

Note: Based on (provisional) data of the ECHP-94, the earnings dispersion have been calculated on normal gross monthly earnings (for NL : net monthly earnings) for full-time employees. Figures are ratios of upper/lower deciles in the distribution of earnings. The ratios for EU12 have been calculated as the sum of the dispersion rates for each Member States, weighted with the respective share in total employment (from Labour Force Survey 1994).

Source: Commission services and OECD.

Box 4: Economic growth and the environment

Would sustained economic growth automatically lead to increased environmental degradation? Empirical work indicates that there is no linear relationship between economic growth and its impact on the environment. Although an increase in the production of goods and services would *a priori* lead to an increase in resource use and in pollution, countervailing forces – like technological progress, structural change, and increasing preferences for a clean environment – frequently compensate for this increase. Economic growth necessitates investment and, if an adequate environmental policy framework is put in place, the new capital stock will be characterised by higher resource efficiency and cleaner technologies. Under the same conditions, growth will facilitate structural change implying a gradual phasing-out of traditional polluting heavy industries and an increase in more environmentally-friendly service activities.

Hence, the often perceived trade-off (including a high level of employment) between economic growth and environmental protection does not have to be accepted as unavoidable. Moreover, it should not be forgotten that GDP as traditionally measured largely ignores the economic costs of environmental depletion and pollution. Policy makers have a number of concepts and instruments at hand that allow the integration of both concerns. There are even convincing indications that **economic growth and sound environmental policy making are mutually supportive**. In any case, an economy cannot remain prosperous in the long run if it has run down its natural environment and resource base. However, it has to be underlined that a decoupling of economic growth from rising environmental pressures can only be achieved if environmentally effective and economically efficient policy actions are taken, i.e. an appropriate environmental policy framework is established.

Elements of an **appropriate policy framework** are (1) providing economic actors with the right price signals for environmentally sustainable behaviour, (2) designing environmental policy measures in the most cost-effective way possible taking into account local environmental conditions and the likely impact on the functioning of the Single Market, (3) seeking to integrate environmental objectives into other policies.

By providing the **appropriate price signals**, i.e. by internalising environmental costs into market prices, **market-based policy instruments** such as environmental taxes or tradable emission permits have a number of advantages over traditional regulatory policies. For instance, they give a permanent economic incentive for reducing pressures on the environment and hence push for innovative and cost-effective long-run solutions. They also tend to compress the costs of policy measures by simultaneously exploiting several channels for reducing a given environmental problem. For example, a carbon tax to limit global warming reaches emission reductions on functioning markets by providing incentives for improvements in equipment energy efficiency, behavioural changes (e.g. driving a car less often), and favourable structural change (e.g. towards 'clean' sectors of the economy). However, **introducing price signals for environmental protection makes little sense if existing prices are distorted**, e.g. if existing taxes or tax provisions and subsidies produce unintended and unwanted environmental effects.

In the Report on the Development of Tax Systems - Taxation in the European Union (COM(96) 546) presented in October 1996, the European Commission laid down its views on future environmental taxation in the Union. The documents highlights the necessity for national environmental tax schemes to be well designed and compatible with the functioning of the Single Market. It also identifies energy taxation as a domain of Community action which has an important bearing on CO₂ emission limitation. Consequently, the Commission is preparing new proposals for a future EU system of energy taxation. It aims at further harmonisation of energy excise rates as well as exploring how Member States can integrate environmental objectives into their energy taxation schemes. In the transport field, the Commission proposed a Council Directive in July 1996 on the charging of heavy goods vehicles for the use of certain infrastructures (COM(96) 331). An important objective of the legislative proposal is to provide a harmonised framework for Member States to better ensure recovery of costs associated with road use, including externalities, and to allow for greater differentiation in charges in line with costs.

Designing cost-effective environmental policy approaches is a major prerequisite for making environmental protection economically sustainable. The aim must be to provide environmental policy improvements at least cost to society. This can be done by using a thorough **economic evaluation of the policy design**, for instance by applying cost-benefit analyses or cost-effectiveness analyses. A recent example of such *ex-ante* policy evaluation is the Community Auto-Oil Programme – a collaborative exercise with the industry concerned – which was completed in June 1996. This programme prepared a strategy for the control of road transport emissions mainly focusing on emission standards for passenger cars and quality standards for petrol and diesel fuels (COM(96) 248 final). Prior to defining the strategy, an extensive cost-effectiveness analysis considering technical and non-technical measures was carried out.

Broadening the range of instruments in order to respond to local environmental conditions and at the same time foster a smooth functioning of the Single Market often increases the cost-effectiveness of environmental policies. Clarifying the legal and institutional framework for policy mixes at national level is a prime area of Community action. For instance, in its Communication on Environmental Agreements (COM(96) 561) the Commission discusses a set of guidelines for an environmentally effective application of voluntary policy approaches. A similar Communication on environmental taxes and charges in the Single Market is currently being prepared.

The **integration of environmental policy concerns into other policy areas** would allow the existing potential to improve economic efficiency to be tapped and this would improve the economic and environmental performance of the European economy simultaneously. For instance, a number of Member States are currently exploring the possibilities of reaping **synergies in the field of ecological tax reforms and employment policies**. In some countries such as Denmark, the Netherlands, Belgium and Sweden so called 'Green Tax Commissions' have been set up to assess, to implement and to monitor such tax reforms.

An important potential for synergies from policy integration exists in **industry**. In the 1996 Competitiveness Report (SEC(96) 2121), a Working Document of the Commission services, it is stressed that sound environmental policies can open up business opportunities by enhancing economic efficiency and innovation. The report identifies a significant efficiency potential which could be tapped, for instance, in water and energy use. "Greening" of industry and the provision of environmental goods and services are associated with an expanding employment trend. Firm but economically sound environmental policies can provide the incentives for the supply of competitive and innovative environmental technologies and create a corresponding demand for such technologies on markets. Table B4.1. illustrates the magnitude of employment related to environmental protection in Germany in 1994 compared to 1990.

Table B4.1. Estimation of employment effects through environmental protection in Germany 1990 and 1994				
	1990 (1) in 1000	1990 (1) In % of total civilian employment	1994 (2) in 1000	1994 (2) in % of total civilian employment
Environmental protection activities (e.g. nature conservation, water purification)	255	0.9	508	1.5
Provision of environmental goods and services	341	1.2	448	1.3
- direct	203	0.7	256	0.7
- indirect	137	0.5	192	0.6
Total	597	2.1	956	2.8
(1) West Germany (2) United Germany Note: The figures have to be interpreted with caution. Especially the 1994 employment figures may be dominated by the impact of German unification. Furthermore, the definition of the "environmental protection sector" used in the underlying IFO survey does not correspond to the OECD/Eurostat definition. Sources: Ifo Schnelldienst 28/1996 and Commission services.				

3. CONSOLIDATING AND RESHAPING PUBLIC FINANCES IN THE COMMUNITY

A determined correction of existing fiscal imbalances is an indispensable macroeconomic and structural requirement for virtually all Member States today. This correction is required to provide the conditions for a strong and durable expansion of investment, output and employment over the short and medium term; to reduce the burden of government indebtedness and debt-servicing; and to ensure that budgetary policies can regain their flexibility in response to cyclical fluctuations without causing a continued escalation of government debt. Furthermore, the objective of achieving fiscal discipline is embedded in the wider aim of reducing the share of public finances in the economy, of creating an environment more conducive to business activity, and of improving competitiveness against the backdrop of increased globalisation. Finally, and equally importantly, it is necessary to ensure a successful transition to, and the lasting success of, EMU.

In recent years, most Member States have made progress in reducing the budgetary imbalances that had built up over the two decades following the first oil price shock. However, more is clearly needed. While budgetary consolidation measures need to be adapted to country-specific circumstances in terms of their extent, timing and design, the main guiding principles have been stipulated in successive Broad Economic Policy Guidelines, including the 1996 Recommendation:

- giving prominence to expenditure restraint as opposed to further increases in the overall tax burden;
- shifting government spending priorities towards productive activities such as investment in infrastructure, human capital and active labour market initiatives;
- improving the efficiency of public services;
- reducing the overall tax burden, especially that on labour, but conditional upon firstly placing the budget deficit on a firm downward path.

By basing their consolidation programmes on these principles, Member States will simultaneously ensure budgetary discipline and reap large efficiency and employment gains through the control and rationalisation of government expenditures and the reduction and shifting of the tax burden. The process of fiscal consolidation provides a valuable opportunity for Member States to scrutinise the design and structure of their respective expenditure programmes and taxation systems.

3.1 Long-term trends in public finances in the Community

The current large fiscal imbalances in the Community are the result of certain long-term trends in spending and taxation which have to a large extent been common to all, or nearly all, Member States.

3.1.1 Government spending

Over the last 35 years, the Community has witnessed a rapid growth in the share of public finances in the economy. General government expenditure, which represented 34 per cent of GDP in 1961, rose to above 52 per cent in 1993, before falling back somewhat in recent years. While the rising share of government expenditure in GDP was a common phenomenon in all industrial countries at least until the early 1980s, it was more marked in the Community than in its major trading partners (see Table 20).

Public spending in the Community in fact has climbed markedly in every downturn phase in economic activity, while the subsequent periods of recovery have failed to reverse this upward shift.

Table 20 Size of public finances in the EC, US and Japan (% of GDP)				
	1961	1973	1982	1996
Total expenditure				
EUR	33.6	38.7	49.3	50.6
USA	30.3	32.9	38.9	36.7
JAP	17.3	22.3	33.6	36.6
Total current receipts				
EUR	34.3	38.2	44.3	46.2
USA	29.5	33.2	35.0	34.6
JAP	19.7	22.8	30.0	31.6
Net lending(+)/ borrowing(-)				
EUR	0.7	-0.6	-5.1	-4.4
USA	-0.6	0.3	-3.9	-2.2
JAP	2.4	0.5	-3.6	-5.0
<i>Source:</i> Commission services.				

The fastest-growing spending category since the early 1960s has been current transfers, the growth of which has accounted for more than half of the increase in the total government spending ratio in the Community (see Table 21). At present, current transfers is the largest spending category representing almost one quarter of GDP and about half of total government expenditure. The rapid increase in current transfers have almost entirely been due to rising transfers to households whereas, as a proportion of GDP, direct subsidies to enterprises have remained broadly stable at around 3 per cent.

The growth in household transfers was essentially due to the expansion of three major social policy areas: pensions, health care and unemployment compensation. The expansion of the welfare state during the 1960s and 1970s, which was characterised by a

broadening of the coverage of programmes, a widening of the eligibility criteria and an increase in the levels of benefits, contributed to a marked increase in payments in these areas. In addition, demographic and economic developments (ageing, higher unemployment as well as rising costs and a high income elasticity of demand for health care) have played an important role. Since the mid-1980s, growing concerns regarding the pressures on government budgets and labour market disincentives have led to a tightening of transfer schemes in many Member States. This has resulted in a deceleration of the growth of these expenditures during the last decade but undiminished demands for welfare services and the renewed rise in unemployment in the 1990s have exerted continued upward pressure. To control the growth of social transfers in the future, policies need to be aimed at achieving sustained high economic growth and rising employment and, in order to prepare for mounting demographic pressures, at restructuring and/or streamlining pension, health care and unemployment schemes.

Table 21

Receipts and expenditures of general government - EUR ^{a)}
(in % of GDP)

	Levels						Changes				
	1961	1973	1982	1989	1993	1996	73/61	82/73	89/82	93/89	96/93
Total expenditure	33.6	38.7	49.3	47.2	52.4	50.6	5.1	10.6	-2.1	5.2	-1.8
<i>of which:</i>											
1. Current transfers	11.5	16.0	21.6	20.7	23.7	23.3	4.5	5.6	-0.9	3.0	-0.4
1bis. <i>of which:</i>											
Households	:	13.0	17.9	17.1	19.9	19.8	:	4.9	-0.8	2.8	-0.1
2. Actual interest payments	3.1	1.7	4.1	4.6	5.4	5.4	-1.4	2.4	0.5	0.8	0.0
3. Public consumption	13.7	16.4	19.6	18.2	19.6	18.9	2.7	3.2	-1.4	1.4	-0.7
4. Net capital transfers	0.8	0.9	1.0	0.9	1.1	0.6	0.1	0.1	-0.1	0.2	-0.5
5. Gross capital formation	4.5	3.7	2.9	2.8	2.8	2.4	-0.8	-0.8	-0.1	0.0	-0.4
Current receipts	34.3	38.2	44.3	44.8	46.3	46.2	3.9	6.1	0.5	1.5	-0.1
<i>of which:</i>											
6. Indirect taxes	13.9	12.9	13.2	13.5	13.6	14.0	-1.0	0.3	0.3	0.1	0.4
7. Direct taxes	8.7	10.7	12.4	13.3	12.9	12.8	2.0	1.7	0.9	-0.4	-0.1
8. Social security contributions	10.2	11.8	14.7	14.6	16.0	16.1	1.6	2.9	-0.1	1.4	0.1
9. Other current receipts	1.5	2.8	4.0	3.4	3.7	3.4	1.3	1.2	-0.6	0.3	-0.3
Memory items											
10. Gross saving	6.0	4.1	-1.0	1.2	-2.5	-1.3	-1.9	-5.1	2.2	-3.7	1.2
11. Net lending(+)/ borrowing(-)	0.7	-0.6	-5.1	-2.4	-6.3	-4.4	-1.3	-4.5	2.7	-3.9	1.9
12. Gross public debt ^{b)}	65.2	35.3	45.6	54.1	66.1	73.5	-29.9	10.3	8.5	12.0	7.4

a) 1961 : EUR 15 excluding Greece, Portugal, Austria, Sweden and Finland; 1973 : EUR 15 excluding Luxembourg, Greece and Portugal.

b) 1973 : EUR 15 excluding France and the Netherlands.

Source: Commission services.

Interest payments on outstanding public debt have been another important component of the rise in government spending. Having declined to below 2 per cent of GDP at the beginning of the 1970s, debt interest payments have risen rapidly thereafter to reach 5.5 per cent of GDP at present. This strong rise reflects the interplay of an increased recourse to borrowing rather than taxation to finance the surge in government expenditure, a concomitant steep upward trend in the government debt to GDP ratio and high interest rates. The rising share of the debt service burden has severely hampered budgetary flexibility and increased the vulnerability of the budget to increases in interest rates. To reverse this trend it is essential to create a stable macroeconomic framework conducive to reductions in borrowing costs.

Public consumption contributed importantly (about 6 percentage points) to the rise in the total government spending ratio during the 1960s and 1970s, but since then its share has been relatively stable, fluctuating around 19 per cent of GDP in the Community on average.

In contrast to other spending categories, public investment as a share of GDP has been falling steadily over the last 35 years. Its present share of 2.5 per cent of GDP is just above half the level it attained in 1961. While to some extent this reflects the completion of major infrastructure systems, it also reveals the political reality that constraining public investment has proved easier than controlling current spending. The privatisation of certain public utilities may also have played a role. Savings on public investment may entail considerable long-term economic costs since these expenditures are an important contributor to productivity growth in the private sector as is highlighted by recent analyses on the potential benefits of realising the Trans-European Transport Networks¹⁶.

3.1.2 Government receipts

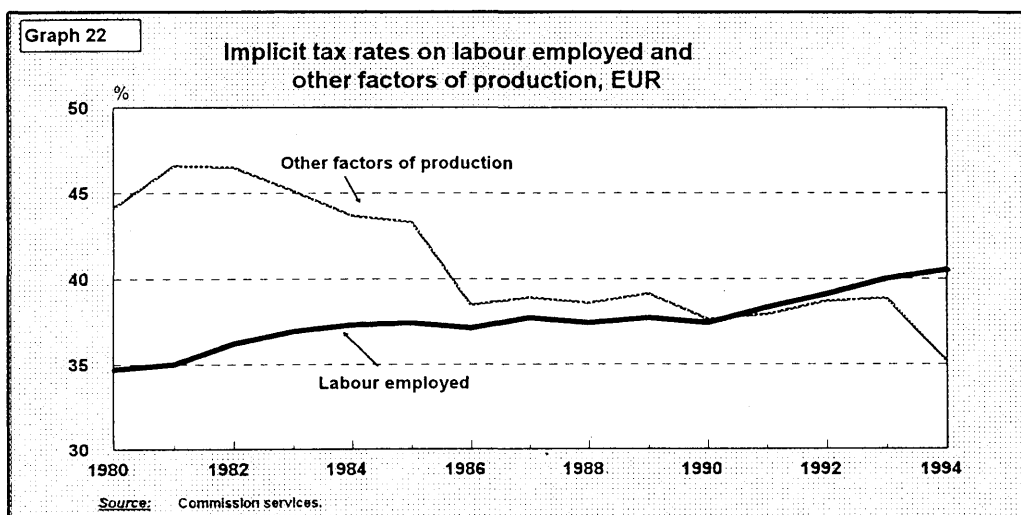
The growth of public expenditure in the Community has brought with it a significant rise in the overall tax burden (i.e. the sum of indirect taxes, direct taxes and social security contributions). Over the last three decades and a half, government receipts, as a share of GDP, have grown by 12 percentage points to reach 46 per cent in 1996. The bulk of the rise in the government receipts ratio occurred in the period 1960-82 while the tax burden remained broadly stable during the rest of the 1980s. In the early 1990s, a sharp rise in expenditure -- partly caused by the economic downturn -- was accompanied by a further

¹⁶ See "Trans-European Networks: 1996 Annual Report", COM(96) 645 final.

increase in tax pressure. While not fully successful, widespread government efforts since the early 1980s to stabilise or to reduce the tax burden reflect various factors. Firstly, greater awareness of the distortionary and employment-dampening effects of high taxation as well as voters' resistance have made many governments reluctant to introduce further tax increases. Secondly, both a flattening of the tax scales and the indexation of tax systems as well as reduced inflation have resulted in a reduction in fiscal drag. Thirdly, tax reforms, increased tax competition between countries and, in some cases, the growth in the underground economy may also have contributed to slower tax revenue growth.

The growth of the tax burden has been accompanied by considerable changes in the tax structure. The main factors contributing to the overall growth of government receipts were social security contributions and, to a somewhat lesser extent, direct taxation. The fall in the average employment ratio (from 67 per cent of working age population in 1961 to 59 per cent in 1996) implied a reduction in the number of persons paying taxes and contributing to social security funds while leading to an increase in the number of recipients. The strong increase in social security contributions was not sufficient to match the upsurge in social benefits. As a result, a growing proportion of the latter had to be financed through other fiscal resources, notably direct taxes. Indirect taxes remained almost unchanged as a proportion of GDP throughout most of the period but in recent years there has been a tendency to increase indirect taxes while reducing the relative importance of other government receipts.

The changes in the structure of taxation have resulted in an increasing tax burden being imposed on employed labour with the opposite trend evident for other factors of production such as capital, energy and natural resources. Over the period 1980 to 1994, the Community's average implicit tax rate on employed labour (i.e. tax revenues divided by the tax base) increased from an already high level of 35 percent to over 40 per cent.



On the other hand, the implicit tax rate on the other factors of production fell from around 44 per cent to a little over 35 per cent (see Graph 22). The upward trend in the taxation of labour is discouraging employment creation since it increases non-wage labour costs, adds to wage pressures and reduces incentives to work. High social security and income tax rates interact with transfer and benefit systems to produce high effective marginal tax rates on low-income workers, high reservation wages and high “wedges” between the cost of labour to employers and the net income received by employees.

One factor underlying the changes in the structure of taxation has been the progressive erosion of tax bases in Member States, linked to factors of both domestic and international origin. At the domestic level, high levels of taxation and high tax wedges for labour-income appear to have stimulated the development of the underground economy. Internationally, tax competition between countries has led to fiscal erosion of the mobile tax sources, such as capital, with international relocation of taxable bases responding to differentials in effective tax rates. These developments have provoked a change in the structure of the tax systems of many Member States, with the tax burden being shifted towards labour, which is relatively immobile, in order to recover the tax lost from the steady erosion of other more “exportable” sources of government revenue.

There is broad agreement amongst Member States that the long-term trend towards higher taxation on labour must be reversed. This may be achieved both through targeted approaches (for instance reduction in non-wage labour costs for specific categories of workers such as the low-skilled, young or new entrants) and through general measures, notably a lowering of public expenditure as a share of GDP and a shifting of the tax burden towards other factors, especially energy and capital. Actions in this field must be compatible with and should contribute to the achievement of other objectives in the Community, namely stabilising Member States’ fiscal systems and removing tax obstacles to the internal market whilst creating a tax environment conducive to a strong, employment-creating growth process and an efficient environmental policy.¹⁷

¹⁷ The need for a comprehensive approach was underlined in the Commission’s Communication “Taxation in the European Union” presented to the informal Ecofin Council in Verona in April 1996 and in the Commission’s “Second Report on Taxation in the European Union”, October 1996.

3.2 Budgetary developments in 1996 and outlook for 1997 and 1998

Efforts to achieve sound public finances have recently been stepped up throughout the Community. In their budgets for 1996 and for 1997, a large majority of Member States have taken significant steps to reduce their deficits to 3 percent of GDP or less as a step towards reaching budget balance over the medium term. The driving forces behind this process are twofold. First, the experiences of recent years have underlined the adverse consequences for interest rates, exchange rate pressures and ultimately economic growth which may result from excessive budget deficits and insufficient credibility of consolidation efforts. Second, the need to make headway towards the fulfilment of the convergence criteria for participation in EMU has provided an imminent focus for the budgetary adjustment efforts of Member States and has, in many countries, been seen as offering a unique opportunity for achieving significant up-front gains in the credibility of such efforts.

As a result of these efforts and given the forecast for economic growth and interest rates, the average budget deficit in the Community is expected to be halved between 1995 and 1998, falling to 2½ per cent of GDP. This represents a large step towards the re-establishment of sound public finances.

3.2.1 Accelerated progress in the reduction of budget deficits

Almost all Member States made progress towards further reducing their budget deficits in 1996. The only exceptions were Germany, where the deficit widened for the second year running, and Luxembourg where the surplus declined. Particularly large reductions in the deficit were achieved in Sweden, Spain and Finland but deficit reductions of 1 percent of GDP or more were achieved also in several other countries (Table 22).

The budget deficit remained comfortably below 3 per cent of GDP in the three countries which are currently not subject to a Council Decision on the existence of an excessive deficit (Denmark, Ireland and Luxembourg). And in the Netherlands, the budget deficit was reduced to below the Maastricht reference value.

According to the Autumn 1996 forecasts of the Commission services, virtually all Member States are expected to make additional headway in 1997. Progress is expected to be very significant in Italy (around 3½ percentage points of GDP) and it is forecast to be in the range of 1 to 1½ percentage points in almost all the remaining Member States.

Against this background of widespread and significant deficit reductions, no less than 12 Member States are expected to achieve a deficit at or below 3 percent of GDP in 1997. The only exceptions are Greece, where the budget deficit is high but declining, and Italy and the United Kingdom both of which are expected to have a deficit of around 3½ percent of GDP on current projections¹⁸. Among the countries whose deficit is below 3 percent of GDP, both Denmark and Ireland are likely to come closer to achieving budget balance.

No budgets are yet available for 1998. In the forecast scenario for 1998, which is based on an extrapolation of expected trends in 1997, budget deficits are generally projected to decline further and all Member countries except Greece are expected to have deficits below 3 per cent of GDP by 1998.

Table 22

**General government net lending (+)
or net borrowing (-)
(% of GDP)**

	Level				Change		
	1995	1996	1997	1998	1996	1997	1998
B	-4.1	-3.3	-2.9	-2.5	0.8	0.4	0.4
DK	-1.6	-1.4	-0.3	-0.3	0.2	1.1	0.0
D ¹⁾	-3.5	-4.0	-2.9	-2.4	-0.5	1.1	0.5
EL ²⁾	-9.1	-7.9	-6.5	-5.3	1.2	1.4	1.2
E	-6.6	-4.4	-3.0	-2.8	2.2	1.4	0.2
F ³⁾	-4.8	-4.0	-3.0	-2.9	0.8	1.0	0.1
IRL ²⁾	-2.0	-1.6	-0.9	-0.5	0.4	0.7	0.4
I ⁴⁾	-7.1	-6.6	-3.3	-3.0	0.5	3.3	0.3
L	1.5	0.9	0.5	0.9	-0.6	-0.4	0.4
NL ⁵⁾	-4.0	-2.6	-2.5	-2.0	1.4	0.1	0.5
A	-5.9	-4.3	-3.0	-2.9	1.6	1.3	0.1
P	-5.1	-4.0	-2.9	-2.9	1.1	1.1	0.0
FIN	-5.2	-3.3	-2.2	-1.4	1.9	1.1	0.8
S	-8.1	-3.9	-2.9	-1.0	4.2	1.0	1.9
UK ²⁾	-5.8	-4.6	-3.5	-2.2	1.2	1.1	1.3
EUR	-5.0	-4.4	-3.0	-2.5	0.6	1.4	0.5

¹⁾ Not including unification-related debt and asset assumptions by the federal government in 1995 (Treuhand, eastern housing companies and Deutsche Kreditbank), equal to DEM 229 bn.

²⁾ At the time of the elaboration of the Commission forecasts Greece, Ireland and the UK had not yet presented their budgets for 1997. The "no policy change" assumption was used also in 1997. According to new data for Greece the deficit for 1996 is estimated at 7.6%.

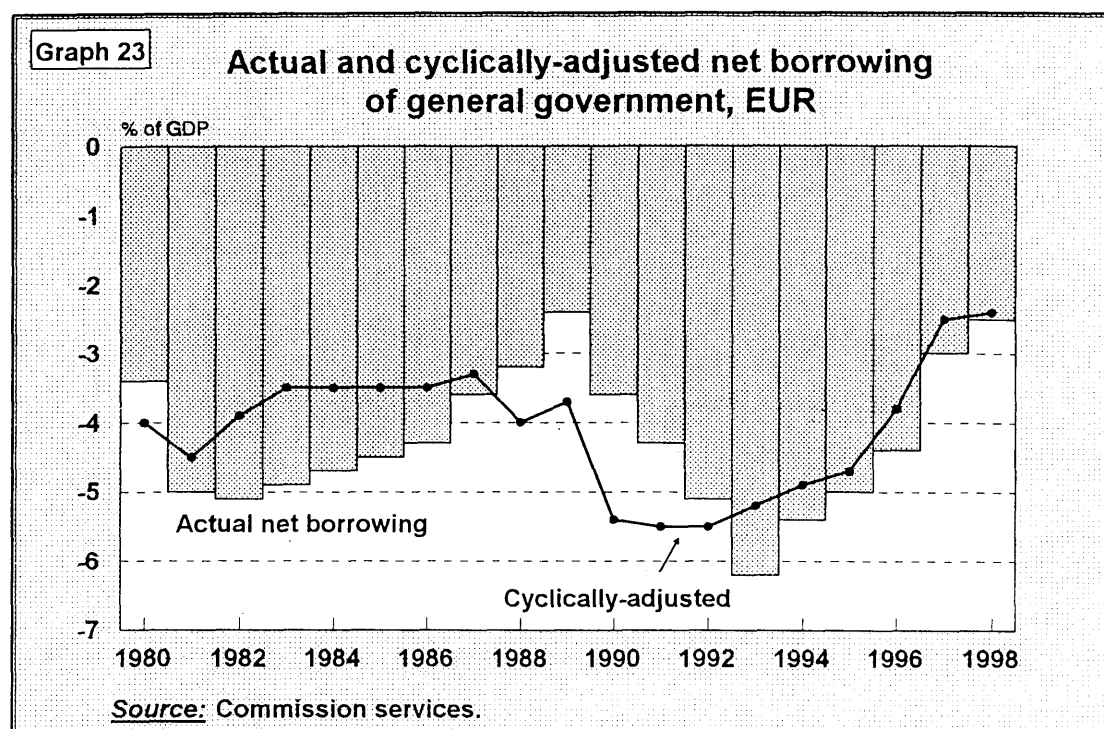
³⁾ Including for 1997 the payment by France Telecom to the French state of FRF 37.5 bn.

⁴⁾ Including for 1997 6 trillion ITL of reductions in transfers to state owned enterprises, but not including 6.5 trillion ITL of other operations whose conformity with ESA rules is currently being examined.

⁵⁾ Not including for 1995 a net amount of NLG 32.84 bn of exceptional expenditure related to the reform of the financing of the social housing societies.

Source: Commission services.

¹⁸ The Commission services' Autumn 1996 deficit forecast for Italy does not include ITL 6.5 trillion of deficit-reducing operations whose conformity with the ESA rules is currently being examined. As regards the United Kingdom, the forecast does not incorporate measures announced in the November 1996 Budget. These measures are expected by the UK authorities to result in an additional budgetary consolidation in the financial year 1997/98.



3.2.2 The pace and size of consolidation efforts

For the Community as a whole, the deterioration in the cyclical position in 1996 had an adverse impact on spending and tax revenues. Therefore, while actual deficits were on average reduced by 0.6 percentage points of GDP in 1996, the general government balance adjusted for the budgetary impact of cyclical deviations of output from its trend (the “cyclically-adjusted” budget balance) improved somewhat more, by an estimated 0.8 percentage points of GDP¹⁹. In 1997, changes in the cyclical position are expected to have a broadly neutral budgetary impact for the Community as a whole, and the expected deficit reduction of around 1.4 percentage points of GDP fully reflects a reduction in the cyclically-adjusted deficit. This represents an unprecedented effort and clearly highlights the strong resolve of Member States to place their public finances on a sound footing.

¹⁹ Estimates of the cyclically-adjusted budget balance are surrounded by considerable uncertainty, relating both to the level of trend (potential) GDP and to the budgetary impact of cyclical deviations from trend (potential) GDP. The Commission services’ method of cyclical adjustment takes a cautious approach in that it produces *levels* of cyclically-adjusted budget deficits which tend to be higher compared to those of other methods, such as those used by the OECD and the IMF. Given that these discrepancies mainly relate to differences in the estimated *level* of trend (potential) GDP, annual *changes* in the cyclically-adjusted deficit do not vary significantly across the various methods.

The cyclically-adjusted budget deficit is estimated to be at or below 3 percent of GDP in 13 countries by 1997 according to the method used by the Commission services. For the Community as a whole, the total reduction in the cyclically-adjusted deficit between 1992 and 1998 is expected to amount to more than 3 percentage points of GDP with most of it occurring in 1996 and 1997.

For 1996 and 1997 taken together, the cyclically-adjusted budget deficit is expected to decline in all Member States (except Luxembourg). Four countries (Spain, Italy, Austria and Sweden) are expected to achieve extraordinarily large reductions in the underlying deficit ranging from 3½ to 4½ percentage points of GDP over the two years. In addition, large reductions of between 1 and 2 percentage points of GDP are

expected in the eight other Member States where the actual deficit exceeded 3 percent of GDP in 1995.

Several of these countries have concentrated the bulk of their consolidation efforts already in 1996. This applies in particular to Belgium, the Netherlands, Finland and Sweden where only moderate tightening is expected in 1997, if at all. In contrast, in Germany there was no underlying improvement in 1996 and consolidation efforts will occur exclusively in 1997, while in Italy a very ambitious budget for 1997 implies a particularly large effort in that year.

Table 23

**Cyclically-adjusted general government
balances¹⁾**
(% of GDP)

	Level				Change		
	1995	1996	1997	1998	1996	1997	1998
B	-3.7	-2.7	-2.4	-2.5	1.0	0.3	-0.1
DK	-1.5	-1.2	-0.6	-1.1	0.3	0.6	-0.5
D²⁾	-3.5	-3.5	-2.3	-2.0	0.0	1.2	0.3
EL	-8.3	-7.5	-6.4	-5.7	0.8	1.1	0.7
E	-5.8	-3.5	-2.2	-2.3	2.3	1.3	-0.1
F	-4.6	-3.4	-2.6	-2.9	1.2	0.8	-0.3
IRL	-3.2	-3.9	-3.1	-2.4	-0.7	0.8	0.7
I	-7.1	-6.1	-2.7	-2.8	1.0	3.4	-0.1
L	1.7	1.3	0.9	0.6	-0.4	-0.4	-0.3
NL	-3.7	-2.3	-2.3	-2.1	1.4	0.0	0.2
A	-6.1	-4.1	-2.3	-2.5	2.0	1.8	-0.2
P	-4.6	-3.5	-2.5	-2.9	1.1	1.0	-0.4
FIN	-3.8	-2.2	-2.2	-2.1	1.6	0.0	0.1
S	-6.8	-3.0	-2.5	-1.3	3.8	0.5	1.2
UK	-5.1	-4.0	-3.3	-2.2	1.1	0.7	1.1
EUR	-4.7	-3.8	-2.5	-2.4	0.9	1.3	0.1

¹⁾ General government balances adjusted for an estimate of the budgetary impact of the cyclical deviation of GDP from its trend level; Commission services' estimates. The methodology is explained in European Economy, n° 60, 1995, pp. 35 - 90.

²⁾ See footnote 1 in table 19.

Source: Commission services.

3.2.3 The composition and durability of consolidation efforts

For the Community as a whole, budgetary adjustment in 1996 was achieved in broadly equal measure through reductions in the share of public expenditures in GDP and increases in the already high share of government revenues in GDP. Provided current spending plans for 1997 are adhered to, budgetary consolidation in that year is expected to be achieved mainly through expenditure restraint. The slight rise in tax pressure is likely to be reversed in 1998. Thus, for the three years as a whole, the Community is expected to achieve a significant reduction in the share of public expenditure in GDP (of around 2½ percentage points) while tax pressure is forecast to remain broadly unchanged.

Table 24
General government receipts and expenditures
(% of GDP)

	Receipts				Expenditures			
	1995	1996	1997	1998	1995	1996	1997	1998
B	50.3	50.5	50.1	49.7	54.5	53.8	53.0	52.1
DK	58.1	58.8	58.0	56.4	59.7	60.3	58.2	56.7
D	46.3	45.7	46.0	45.9	49.9	49.7	48.9	48.2
EL¹⁾	37.6	38.0	38.4	38.7	46.7	46.0	44.9	44.0
E	39.7	40.3	40.5	40.2	46.3	44.8	43.5	43.0
F¹⁾	49.5	50.6	50.5	50.2	54.3	54.7	53.5	53.1
IRL¹⁾	35.4	34.7	34.3	33.9	37.4	36.3	35.2	34.3
I¹⁾	44.8	46.3	47.7	47.1	51.8	52.9	51.0	50.1
L	40.8	41.7	41.2	40.8	40.0	40.7	40.7	39.9
NL¹⁾	49.1	48.3	47.7	47.0	53.2	50.9	50.1	49.0
A	46.9	48.2	48.7	48.3	52.8	52.5	51.7	51.2
P	40.1	40.4	41.3	41.1	45.3	44.5	44.3	44.0
FIN	53.5	55.3	54.3	53.9	58.8	58.7	56.5	55.3
S	60.1	63.0	61.7	60.5	68.2	66.9	64.6	61.5
UK¹⁾	37.8	37.6	37.7	38.0	43.5	42.3	41.3	40.2
EUR	45.8	46.2	46.4	46.1	50.9	50.6	49.4	48.5

¹⁾ See footnotes in table 19.

Source: Commission services.

Both with respect to the balance between expenditure and revenue measures and with respect to the durability of consolidation measures, differences are discernible between Member States. Nevertheless, public expenditure as a share of GDP is expected to be reduced significantly in all Member States except Portugal and Luxembourg. The encouraging outlook for expenditure restraint is contingent upon strict spending plans being adhered to. Most of the expected reduction in expenditure growth reflects efforts to restrain the growth of public consumption and transfer payments. In general, these measures appear likely to have lasting effects.

In several countries where the debt-to-GDP ratio has been placed on a downward path and where interest rates have fallen considerably, reduced debt-servicing is likely to make a significant contribution to budgetary consolidation in the years to come. In Italy,

interest payments are forecast to fall by 3 percentage points of GDP between 1995 and 1998. Interest payments are expected to decline significantly also in other Member States where the debt ratio is set to decline. In 1998, debt servicing is expected to decline in all Member States.

Table 25

General government expenditures
(changes in % of GDP)

	Public consumption		Public investment		Transfers to households		Transfers to companies		Capital transfers		Interest payments		Total	
	97/95	98/97	97/95	98/97	97/95	98/97	97/95	98/97	97/95	98/97	97/95	98/97	97/95	98/97
B	-0.4	-0.3	0.0	0.0	-0.3	-0.3	-0.3	-0.1	0.1	0.0	-1.0	-0.2	-1.5	-0.9
DK	-0.3	-0.4	0.0	0.0	-1.2	-0.7	-0.6	-0.1	1.0	0.0	-0.8	-0.3	-1.5	-1.5
D	-0.2	-0.4	-0.4	-0.1	0.1	-0.1	-0.3	0.0	-0.1	0.0	0.2	0.0	-1.0	-0.7
EL	0.2	-0.1	-0.1	0.1	0.3	-0.1	-0.1	0.0	-0.2	-0.1	-1.9	-0.6	-1.8	-0.9
E	-0.9	-0.3	-0.9	0.1	-0.6	-0.2	-0.2	0.0	-0.2	0.0	-0.1	-0.1	-2.8	-0.5
F	-0.2	-0.2	-0.3	0.0	-0.1	-0.3	0.3	-0.1	-0.5	0.4	0.1	0.0	-0.8	-0.4
IRL	-0.7	-0.2	0.0	0.0	-0.9	-0.3	-0.3	-0.1	-0.1	0.0	-0.8	-0.3	-2.2	-0.9
I	0.0	-0.2	-0.1	0.1	0.8	0.1	-0.7	0.1	0.3	0.4	-1.6	-1.5	-0.8	-0.9
L	0.4	-0.2	0.2	0.1	0.0	-0.4	-0.2	-0.2	0.0	0.0	0.1	0.0	0.7	-0.8
NL	-0.4	-0.1	-0.1	0.0	-1.7	-0.8	-0.2	-0.1	-0.2	0.0	-0.6	-0.1	-3.1	-1.1
A	-0.6	-0.3	-0.1	0.0	-0.4	-0.3	-0.4	-0.1	-0.1	0.0	0.3	0.1	-1.1	-0.5
P	0.8	-0.2	0.5	0.3	0.6	0.1	-0.1	0.0	-0.5	-0.1	-1.1	-0.3	0.2	-0.2
FIN	-0.4	-0.5	0.2	0.0	-1.7	-0.8	-0.2	-0.1	-0.5	-0.1	0.4	0.0	-2.3	-1.2
S	-0.6	-0.7	-0.2	-0.1	-1.8	-1.0	-0.7	-0.2	-0.1	0.0	-0.1	-0.8	-3.6	-3.1
UK	-0.9	-0.4	-0.4	-0.1	-0.5	-0.4	0.0	-0.1	-0.4	-0.1	0.2	0.0	-2.2	-1.1
EUR	-0.4	-0.3	-0.3	0.0	-0.2	-0.3	-0.2	0.0	-0.2	0.1	-0.1	-0.3	-1.5	-0.9

Source: Commission services.

Reflecting reforms to contain social spending and in some cases falling unemployment, transfers to households are expected to decline as a share of GDP in nearly all Member States. As a proportion of GDP, government consumption is set to decline in virtually all Member States over the period 1995-1998, and especially so in Spain, Sweden and the United Kingdom. Public employment is likely to be reduced in several countries (Germany, Spain, Italy, Sweden, Austria, the United Kingdom) and to remain broadly stable in others (Belgium, France). Some Member States have made savings from reduced wage growth in the public sector.

A number of countries are relying to a considerable extent on reductions or deferrals of public investment. This is the case particularly in Spain (albeit from a high level) and, to a lesser extent, in Germany, France and the United Kingdom. In some countries, such

reductions may be related to an increased efficiency in the use of public funds, but in general, savings on public investment may turn out to be temporary or otherwise prove costly in the long run. In the United Kingdom, this trend reflects a switch from public to private provisions.

According to the assumptions underlying the Commission services' Autumn 1996 forecasts, budgetary adjustment in some Member States has to some extent relied on one-off measures, including in France capital transfers from French Telecom as part of restructuring and privatisation of the utility and treasury operations in Italy. Needless to say, the temporary nature of such measures does not contribute to an improvement in the underlying fiscal position.

In early 1998, when the decision will be made as to which countries have achieved a high degree of sustainable convergence required for participation in the third stage of EMU from 1.1.1999, an assessment will be made of the extent to which once-off measures in some countries in 1996-97 have been complemented by lasting improvements to budgetary positions.

On the receipts side, tax pressure increased in a majority of countries in 1996 and in some cases it may increase further in 1997. Only in Ireland and the Netherlands is the share of public revenues in GDP on a firm downward path. On the other hand, the overall tax burden is expected to decline in almost all Member States in 1998. In some cases, revenue-enhancing measures have included increases in social security contributions which place a further burden on employment (e.g. Germany, Austria). However, many countries have increased various consumption taxes which can be expected to be less distortionary with respect to employment to the extent that wage demands are not adjusted upwards proportionately to compensate for higher prices.

3.2.4 Trends in government debt-to-GDP ratios

The average debt-to-GDP ratio in the Community increased by some 2 percentage points in 1996 to reach 73½ percent of GDP. However, the upward trend is likely to come to a halt in 1997 and the debt-ratio is expected to subside modestly in 1998. This is the result of the significant efforts made by virtually all Member State governments to reduce budget deficits as well as the expected recovery in economic growth and falling interest payments. In addition, privatisation efforts will play a role in reducing the debt-ratio in several Member States.

In France, Luxembourg and the United Kingdom, the debt-to-GDP ratio is expected to remain below 60 per cent of GDP in the coming years. In Germany and Finland, the deficit ratio climbed above 60 per cent of GDP in 1996 and on current projections it may stay just above that level in 1997 and in 1998.

In the majority of countries in which the gross debt-to-GDP ratio is above 60 per cent, progress is expected to be made in reducing the debt burden over the years 1996-98. In Denmark and Ireland, the debt ratio is expected to rapidly approach the 60 percent reference value (falling by 6½ and 16 percentage points respectively, to a level of around 65 percent of GDP). In Belgium, Greece and Italy, where the debt-ratio is particularly high, as well as in the Netherlands, Sweden and Portugal, the debt-ratio is expected to fall by between 4 and 10 percentage points of GDP over the period 1996-98.

Table 26

Gross public debt
(% of GDP)

	Level					Change	
	1993	1995	1996	1997	1998	95/93	98/95
B	137.0	133.7	130.6	127.0	123.9	-3.3	-9.8
DK¹⁾	80.1	71.9	70.2	67.8	65.5	-8.2	-6.4
D	48.2	58.1	60.8	61.9	61.9	9.9	3.8
EL²⁾	111.8	111.8	110.6	109.3	107.2	0.0	-4.6
E	60.5	65.7	67.8	67.1	65.8	5.2	0.1
F	45.6	52.8	56.4	58.1	59.2	7.2	6.4
IRL²⁾	94.5	81.6	74.7	70.0	65.4	-12.9	-16.2
I	119.3	124.9	123.4	122.3	119.4	5.6	-5.5
L	6.2	6.0	7.8	8.8	9.2	-0.2	3.2
NL	80.8	79.7	78.7	76.8	75.1	-1.1	-4.6
A	62.8	69.0	71.7	72.2	72.2	6.2	3.2
P	68.2	71.7	71.1	69.0	67.8	3.5	-3.9
FIN	57.3	59.2	61.3	61.5	61.7	1.9	2.5
S	76.0	78.7	78.1	77.6	74.9	2.7	-3.8
UK²⁾	48.5	54.1	56.2	57.0	56.5	5.6	2.4
EUR	66.1	71.3	73.5	73.7	72.9	5.2	1.6

¹⁾ Government deposits with the central bank, government holdings of non-government bonds and public enterprise related debt amounted to some 18 % of GDP in 1995.

²⁾ See footnote 2 in table 19.

Source: Commission services.

3.3 The economic impact of budgetary consolidation in the Community

3.3.1 Short-term growth impact of budgetary consolidation in 1996-97

The substantial scale of the planned reductions in the budget deficit in most Member States in 1996-97 has prompted fears among some commentators that the efforts to comply with the Maastricht fiscal criteria could have a significant restraining impact on output growth and employment creation over the near term. However, such fears fail to appreciate both the overall economic policy context within which budgetary consolidation is taking place and the urgency, irrespective of the Maastricht process, of the economic need to consolidate the public finances in the Community.

In most Member States, budgetary consolidation is inescapable if the rise in public indebtedness and the upward trend in debt servicing is to be arrested. Continuing large budget deficits would be reflected in a rapid rise in interest payments in the coming years which would put additional upward pressure on taxation to the detriment of employment, and reduce the scope for more productive or desirable public expenditures. Therefore, the current need for a growth-enhancing stance of economic policies cannot and should not be provided by "expansionary" budgetary policies. In most Member States, budgetary consolidation is necessary and desirable on its own merits. Progress towards EMU strengthens the framework within which the necessary adjustments are being made.

Furthermore, even over the short-term, any hoped-for benefits of reduced consolidation efforts would most likely prove illusory. A let-up in budgetary consolidation would have immediate and severe adverse consequences in financial markets, leading to a rise in interest rate premia and most likely causing renewed exchange rate turmoil. As was amply demonstrated following the currency movements in 1995 (see Chapter 1), the net impact of such turmoil on short-term growth in the Community would be negative and would add to existing problems of high and rising unemployment in most countries. Therefore, in practice there is no alternative to continuing the policy of budgetary restraint.

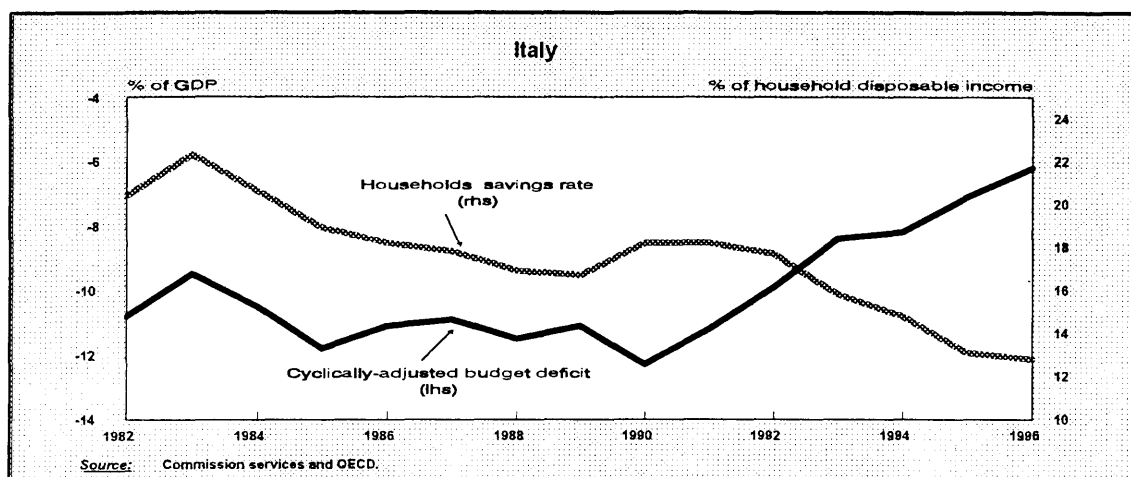
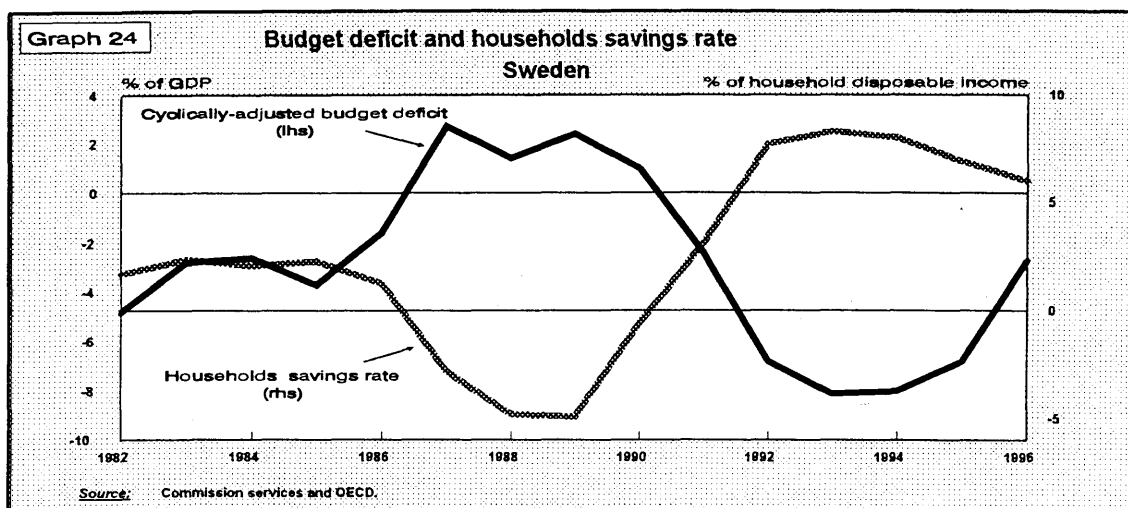
The overall effect of the current and planned budgetary policies on demand and growth cannot be considered in isolation from the repercussions on interest and exchange rates, the stance of monetary and other economic policies and the international and cyclical conditions in which consolidation is undertaken. The direct restraining impact of budgetary consolidation in 1996-97 is likely to be off-set by a number of factors which fall under two broad headings.

Firstly, budgetary consolidation forms an integral part of the overall rebalancing of the economic policy-mix which has taken place in the Community and which is reflected *inter alia* in lower interest rates and improved exchange rate stability. These benefits extend to virtually all Member States and have resulted in a particularly large reduction in interest rates in countries which formerly suffered from high risk premia. The most striking examples are Spain, Italy and Sweden where long-term interest rate differentials relative to Germany fell by around 380, 430 and 340 basis points, respectively, from their 1995 peak until December 1996. In each case, the bulk of this fall was achieved in the wake of the announcement of credible and significant efforts to reduce budget deficits to 3 per cent of GDP or less in 1997 and to bring it down further in subsequent years. The decline in

interest rates significantly eases the burden on the public finances as well as on private sector activity in nearly all countries. Lower real interest rates are likely to support the “crowding-in” of investment. Since investment profitability is currently sound, and since current and prospective demand trends are being supported by monetary relaxation, investment appears to be set to take off in a relatively strong manner.

Secondly, a credible and well-designed policy of budgetary consolidation is likely to result in an improvement in confidence among businesses as well as consumers. Especially in countries with large budgetary imbalances and/or where public expenditures have been rising fast, a general perception that substantial tax increases would follow -- coupled with uncertainty about which measures were going to be taken and who would have to bear the burden of adjustment -- have contributed to a cautious mood and precautionary savings in the private sector. In such cases, action to curb the rise in public expenditures and raise taxes by less than what had previously been expected may well result in an improvement in “confidence” in the private sector and may stimulate both consumption, investment and companies’ willingness to hire more employees.

With respect to private consumption, there is an accumulating body of empirical evidence which points towards the existence of confidence or “non-Keynesian” effects, particularly in cases where large budgetary imbalances are addressed through credible efforts to restrain the growth of public expenditures. The negative correlation between the cyclically-adjusted budgetary position and the household savings ratio during periods of large fiscal adjustments/expansions is illustrated by the two country examples in Graph 24. Furthermore, lower interest rates and reduced financial uncertainty provides a boost to asset prices (including share, bond and house prices) and raises private sector wealth which, at least in some countries, is likely to provide a substantial impetus to private consumption.



Against the background of low inflation, healthy fundamentals and a favourable international setting, the forecasts of the Commission services indicate that the current and expected stance of budgetary and monetary policies is consistent with a well-balanced pick-up in economic growth to around its trend rate in 1997 and above-trend growth in 1998. This assessment is broadly in line with that of other international institutions and most private forecasters.

Even if economic growth should fail to pick up to the extent foreseen, there should be no let-up in budgetary consolidation efforts. Slippages from budgetary targets would put at risk the favourable trends in interest and exchange rates and therefore undermine the prospects for stronger economic growth.

3.3.2 Budgetary policy in a medium-term perspective

Achieving and maintaining sound and disciplined public finances in the Member States is necessary to create the appropriate conditions for strong and sustained output growth with improved employment creation over the medium term. The widespread recognition of this fact led the Community to adopt the objective of achieving a government financial position close to balance over the medium term in successive Broad Economic Policy Guidelines since 1993²⁰. This objective has been reiterated and given increased credibility and importance within the framework of the "Stability and Growth Pact" for ensuring budgetary discipline in stage three of EMU. Thus, Member States are committed to take further steps, in the years after 1997, to ensure a continued improvement in their budgetary position in order to attain the medium-term objective of close to balance or a surplus in normal circumstances.

It has sometimes been argued that this commitment to disciplined budgetary policy would have a restraining impact on economic activity in the years following 1997. However, such fears seem to be based on a misunderstanding of the medium-term growth effects of sound budgetary policies and ignore the fact that fiscal discipline is an essential condition to ensure the viability of EMU and to reap all the potential benefits of the single currency. In addition, once the average budget deficit in the Community has been reduced to 3 per cent of GDP by 1997, the achievement of budget balance in the course of subsequent years will be facilitated by the return to strong medium-term growth.

Indeed, pursuing a medium-term budgetary objective of close to balance or surplus is necessary in order to:

- (i) achieve sustained, investment-led, growth of output and employment over the medium term while maintaining a proper balance between savings and investment;
- (ii) create room for budgetary policies to adapt to cyclical disturbances without causing the deficit to exceed 3 per cent of GDP during "normal" cyclical downturns;
- (iii) reverse the crowding-out of non-interest expenditure and facilitate tax reductions;
- (iv) prepare Member States' public finances for the budgetary consequences of the "ageing" of populations.

²⁰ In line with the policy recommendations of the Broad Economic Policy Guidelines, four countries, namely Denmark, Finland, Sweden and the United Kingdom, have introduced the objective of eliminating the deficit or moving to a surplus in their convergence programmes.

Sound public finances are necessary for sustained medium-term growth and employment

The central plank of the Community's strategy to ensure a sustained upturn in economic growth and job creation over the medium term is to create the right conditions for a significant pick-up in investment in order to ensure a sufficiently rapid expansion of productive capacity. Investment growth is forecast to pick up significantly in 1997 and 1998 and, provided that the right conditions are maintained, it is expected to continue to expand over the following years. This upturn in investment needs to be accompanied by an upturn in national savings in the Member States, if it is not to be associated with a serious current account deterioration for the Community as a whole and with severe upward pressures on real interest rates. In particular given the relative constancy of the private sector savings rate (households plus enterprises) as a share of GDP in the Community, this increase in savings needs to come essentially from the achievement of sound public finances and the restoration of positive public savings²¹.

Empirical evidence shows that the rising public sector indebtedness of the industrialised countries over the last two decades has been a major factor behind the observed rise in world-wide real long-term interest rates (estimates range from around 1 to 2.5 percentage points)²². Conversely, the expected lower budget deficits in the Community in the coming years, in line with the Maastricht Treaty and the enhanced framework for budgetary discipline under the Stability and Growth Pact, will lead to lower borrowing costs in the Community. Since the Community is a sufficiently large player in the world economy, it would also contribute to lower long-term interest rates world-wide. Improved prospects for budgetary discipline amongst the Community's international partners, and in particular in the United States, would likewise contribute to lower world-wide real long-term interest rates.

²¹ See "Trends in and structure of gross national saving in the Community", *European Economy, Supplement A*, n° 11/12, 1992.

²² See IMF, *World Economic Outlook* (May 1996) and Group of Ten (1995), "Saving, Investment and Real Interest Rates", October 1995, and references mentioned therein.

Restoring the stabilisation function of budgetary policies

In EMU, the use of budgetary policies for stabilisation purposes is likely to take on increasing importance, at least for those countries which have hitherto made use of some degree of independent monetary or exchange rate policies. At the same time, in order to ensure budgetary discipline, the Maastricht Treaty stipulates that the budget deficit in participating Member countries is not allowed to exceed 3 per cent of GDP except in “exceptional and temporary” circumstances. Such circumstances do not include normal cyclical downturns.

Therefore, achieving budget balance or, according to national circumstances, a budget surplus during “normal” times is a necessary condition for restoring the flexibility of budgetary policies within a sound and credible medium-term framework. It will create sufficient room for budgetary policies to allow the automatic stabilisers to work without exceeding the 3 per cent of GDP reference value for the budget deficit during normal cyclical downturns and without this leading to a relentless upward trend in government indebtedness and debt servicing relative to GDP. Indeed, over the period 1960-96, the cyclical component of budget deficits for all but two Member States never surpassed 3 per cent of GDP on either side and even remained below 2 per cent of GDP in most Member States (see Box 5). Furthermore, the automatic stabilisers are likely to work more effectively when underlying budgetary positions are sound, because the risk of either negative financial market reactions or of undermining confidence is smaller. On past experience, countries with sound underlying budgetary positions have been able to use the automatic stabilisers and counter-cyclical budgetary policies in a positive way, while countries with large deficits and debt have repeatedly been forced to tighten budgetary policies at the height of a cyclical downturn.

Reversing the crowding-out of non-interest expenditure and the upward trend in taxation

Over the last two decades, the rise in government interest payments has “crowded out” other public expenditures. The achievement of budget balance or surplus in “normal” times will lead to a self-feeding virtuous circle of reduced deficits, reduced debt, and lower debt-servicing costs. By reducing the debt servicing burden, fiscal discipline will allow a restructuring of government expenditures towards productive types of spending such as infrastructures, education and active labour market policies.

The bid to restore sound and disciplined public finances offers the opportunity to introduce lasting measures and reforms to stem the upward pressures on public expenditures in many Member States. Reduced expenditure growth and lower debt servicing will make it possible to reverse the long-standing upward trend in taxation. Reducing taxation, in line with a lower share of public expenditure in GDP, will have positive supply side effects. Lower effective tax rates, and in some cases an increased targeting of social expenditure, will improve incentives to save and invest, to increase work effort and to create jobs, thereby contributing to higher employment.

Preparing for the “ageing” of populations

Generating higher public savings is urgent and necessary in order to prepare Member States’ public finances for the great challenges associated with the ageing of populations in the 21st century and the consequent rise in dependency ratios. These demographic trends will put upward pressure on social spending, especially for pensions and health costs (see Box 6). In part, this must be compensated by efforts to tighten spending under these social policies whereas higher private sector savings related to the possible proliferation of private pension schemes may contribute to the attenuation of these budgetary pressures.

Box 5: Automatic stabilisers in the Community

Cyclical fluctuations in economic activity significantly affect government budget balances: tax receipts weaken and social transfers increase during recessions and show reversed movements during expansions. These cyclically-induced changes in the budget balance in turn exert a stabilising influence on economic activity, i.e. they fulfil the role of automatic stabilisers.

The Commission services have developed their own methodology for estimating the cyclical impact on government budgets¹. These calculations show that in the Community the size of the automatic stabilisers, as measured by the cyclical component of budget balances, is quite important and varies substantially over time and across Member States (see Table B5.1). The automatic stabilisers are relatively higher and show a relatively higher degree of variability in the smaller Member States but also in Spain and the United Kingdom. The size and volatility of the cyclical component for the Community as a whole is dampened because it averages out the different cyclical positions of the Member States at a given moment.

As can be seen from the minimum and maximum values of the cyclical components, over the period 1960-1996 the cyclical component for all but two Member States never surpassed the 3 per cent value on either side and even remained below the 2 per cent value for most Member States. Cyclical components around 4 to 5 per cent were only registered in Finland and Sweden at the beginning of the 1990s.

Table B5.1. Size of the cyclical component of budget balances in the EC (1960-1996)					
	Standard deviation	Minimum		Maximum	
		Value	Year	Value	Year
B	1.0	-1.8	1986	2.0	1974
DK	1.1	-2.3	1981	2.5	1986
D	0.9	-1.6	1967	1.9	1991
EL	0.7	-1.0	1987	1.6	1973
E	1.3	-2.1	1984-85	2.7	1990
F	0.6	-1.2	1985	1.5	1990
IRL	1.0	-2.2	1986	2.1	1996
I	0.6	-1.2	1975	1.1	1980-90
L	1.2	-2.8	1982-83	4.1	1974
NL	1.3	-2.8	1983	1.8	1974
A	0.8	-1.4	1987	1.4	1973-74
P	1.1	-2.4	1984	2.4	1973
FIN	2.1	-5.2	1993	5.2	1989
S	1.8	-3.8	1993	3.2	1990
UK	1.3	-2.7	1982	3.1	1989
EUR	0.7	-1.2	1983	1.6	1990

The extent of the automatic stabilisers is influenced by the degree of openness of the economy, the size of the government sector, the progressivity of the tax system, the generosity of the unemployment compensation schemes and the sensitivity of unemployment to fluctuations in output. Variations across Member States in these elements explain the observed disparities in the magnitude of the automatic stabilisers.

Schematically, the influence of the above elements are captured by two factors: the size of the output gap, on the one hand, and the sensitivity of budgetary receipts and expenditures to cyclical fluctuations on the other.

Cyclical fluctuations can be estimated by determining the trend output path² and by subtracting these trend output estimates from the actual output levels. The output gap is then defined as the difference between the levels of actual GDP and trend GDP, expressed as a percentage of trendGDP. When the output gap is positive (negative), the cycle has a positive (negative) influence on the government balance.

As can be seen in Table B5.2, the volatility of the output gap, as measured by the standard deviation, is relatively small for the Community as a whole, as cyclical positions differ among

¹ See European Commission, "Technical note: the Commission services' method for the cyclical adjustment of government budget balances", *European Economy*, n° 60, November 1995.

² The trend estimation method used to produce the output gaps (Hodrick-Prescott filter) produces output gaps which are symmetric over the series, and therefore sum to zero on average over the period 1960-1996. In addition, the negative output gaps produced by this method are relatively small compared to those produced by other methods, such as for example the production function approach, and the method smoothes over structural breaks, such as those which occurred in FIN and S at the beginning of the 1990s.

Member States, but is relatively high in the "catching-up" countries (Greece, Spain, Ireland and Portugal) as well as in Luxembourg and the United Kingdom. The large variability of the output gaps in Finland and Sweden, as indicated by their minimum and maximum values, can be partially attributed to the deep recessions in these countries at the beginning of the 1990s.

The cyclical sensitivity of budget receipts and expenditure are calculated separately. As regards receipts, the following categories are taken into account: corporate taxes (which vary most with the cycle due to the cyclical sensitivity of profits), personal income taxes, indirect taxes and social security contributions (which vary least with the cycle due to their regressive nature). The overall revenue elasticity with respect to GDP is close to 1.0 for the Community as a whole, and ranges from 1.38 for the United Kingdom to 0.77 for Italy, reflecting differences in Member State tax rates and tax structures. The application of the revenue elasticity to the tax to GDP ratio gives the marginal sensitivity of budgetary receipts to GDP.

The estimated sensitivity of budget revenues to the cycle for the Community as a whole is 0.4 for 1995. This means that each widening of a negative output gap by 1 percentage point reduces government budget revenues by 0.4 percentage points of GDP. The revenue sensitivity varies from 0.3 for Greece and Italy to 0.6 for Sweden.

Government transfers to households to cover costs related to unemployment are the main government expenditure category which reacts automatically to cyclical variations. As a result, the sensitivity of government spending to cyclical fluctuations is significantly lower than that of budget revenues. The estimated sensitivity of budget expenditures to the cycle for the EC as a whole is -0.1 for 1995, which means that each widening of a negative output gap by 1 percentage point increases government spending by 0.1 percentage points of GDP. The expenditure sensitivity does not vary widely among Member States: it ranges from -0.05 for France to -0.26 for Denmark.

For the Community as a whole, the sum of the marginal revenue sensitivity to the cycle and the marginal expenditure sensitivity gives the marginal rate of change of the budget balance with respect to GDP. The sensitivity of the budget balance to the cycle lies around 0.5 for the Community as a whole. This means that each deterioration of a negative output gap by 1 percentage point increases the average government deficit by 0.5 percentage points. The sensitivity of the budget balance to the cycle ranges from 0.4 for Greece to 0.85 for Sweden.

Table B5.2. Size of the output gaps in the EC (1960-1996)					
	Standard deviation	Minimum		Maximum	
		Value	Year	Value	Year
B	1.7	-2.7	1986	3.9	1974
DK	1.8	-3.6	1981	3.7	1986
D	2.0	-3.9	1967	4.2	1991
EL	2.1	-3.4	1962	5.8	1973
E	2.5	-4.5	1960	5.3	1974
F	1.4	-2.2	1985	3.0	1990
IRL	2.2	-4.2	1966	4.2	1978
I	1.8	-3.4	1975	3.1	1980
L	2.8	-4.6	1967	8.6	1974
NL	1.6	-3.4	1983	2.4	1974
A	1.6	-2.8	1987	3.2	1974
P	2.9	-5.5	1984-85	8.2	1973
FIN	3.5	-7.4	1993	9.0	1989
S	1.9	-4.3	1993	3.6	1990
UK	2.2	-4.0	1982	5.1	1988-89
EUR	1.4	-2.2	1983	3.2	1973

Table B5.3. Cyclical sensitivity of budget revenue and expenditure in the EC (1995)*			
	Budgetary receipts	Budgetary expenditure	Budget balances
B	0.5	-0.1	0.6
DK	0.5	-0.3	0.7
D	0.4	-0.1	0.5
EL	0.3	-0.1	0.4
E	0.5	-0.2	0.6
F	0.5	-0.1	0.5
IRL	0.4	-0.2	0.5
I	0.3	-0.1	0.5
L	0.4	-0.2	0.6
NL	0.5	-0.2	0.8
A	0.4	-0.1	0.5
P	0.4	-0.1	0.5
FIN	0.5	-0.2	0.6
S	0.6	-0.2	0.9
UK	0.5	-0.2	0.6
EUR	0.4	-0.1	0.5

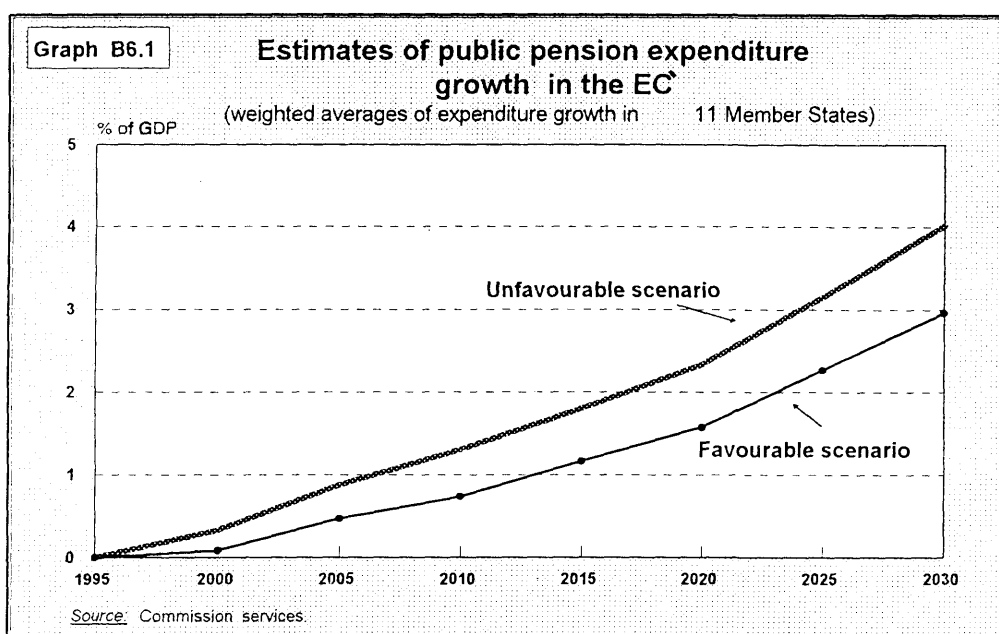
* Figures are rounded off.

Box 6: Pension expenditure and liabilities in the Community

1. The prospects for public pension expenditure

The demographic structure of European countries is changing considerably. The old-age dependency ratio (i.e. the ratio of the elderly to working age population) is increasing in most countries and reaching historically unprecedented levels. Although the long-term effects of the ageing process on public budgets are uncertain and depend on the way the economy and society will adapt to the process, a significant pressure towards higher public expenditure is very likely to occur in the coming decades. Public pension schemes will bear much of the strain since their expenditure is highly dependent on the age structure of the population.

In order to evaluate these prospects, all Member States have carried out pension expenditure projections over recent years. These projections, which are not homogeneous in the coverage of pension expenditure, have been examined in a report recently published by the Commission services¹. The report focuses on the most recent unchanged policy projections produced by public institutions; it provides comparable estimates of the impact of pension expenditure on public sector accounts on the basis of national expenditure projections and 1995 ratios of total public pension expenditure to GDP. Graph B6.1 presents the weighted average² of the increase in the ratio of public pension expenditure to GDP in the 11 Member States that produced projections up to the year 2030.



Over the period 1995-2030, the ratio of pension expenditure to GDP in the 11 countries will increase by 3 to 4 percentage points (respectively under favourable and unfavourable economic assumptions). Expenditure pressures, although non-negligible, are expected to be relatively limited over the next 5 years. The outlook worsens in the first decade of the next century, when the expenditure to GDP ratio is expected to increase in most countries, and, even more, after the year 2010, when the baby-boom generation retires. In several countries expenditure pressures will peak in the period 2030-2040.³

The efforts to reform European pension systems - In most countries present pension policies are quite different from those implemented in previous decades. The phase of extension of coverage and improvement of benefits is over. Since the mid-eighties most pension schemes have been reformed in order to reduce pension expenditure growth. Major reforms were

¹ See D. FRANCO and T. MUNZI, 1996, "Public pension expenditure prospects in the European Union: A survey of national projections", *European Economy*, No. 3.

² Weighted by 1995 GDP in units of Purchasing Power Standard.

³ Over the last decade, several national projections have been revised upward. Some changes have been quite substantial. Past revisions do not give any indication about future revisions of present estimates. However they point to the usefulness of carrying out regular reviews of projections and analysing past projection errors.

introduced in Austria, Finland, Germany, Italy, France, Greece, Portugal, Sweden and the United Kingdom. According to national projections, in several Member States the effects of demographic trends (i.e., the increase in the old-age dependency ratio) will be substantially offset by reforms cutting eligibility and transfer ratios.⁴ While cost containment was the main objective of the reforms, they also aimed at making the pension systems more able to tolerate demographic change, more transparent as to their distributive effects, less distortive of individuals' choices.

In spite of these reform efforts, in several countries the preservation of present benefit levels and eligibility rules will require a substantial increase in the national resources devoted to pension systems. Alternatively, the stabilisation of pension expenditure will require further substantial reform in pension benefit levels and restrictions in pension eligibility.

In conclusion, while the adjustment of European pension systems to the new demographic scenarios is well under way, with reforms gradually affecting pension expenditure dynamics, the large expected changes in demographic structure require further policy changes.

2. Pension liabilities

Pay-as-you-go (PAYG) pension schemes give rise to unfunded liabilities. Within these schemes each generation provides the resources for paying the pensions of older citizens and later receives pensions financed by younger citizens. Therefore, at any point in time there exists a number of retired citizens who are entitled to a pension for the remainder of their life (and sometimes also of the life of their widowed spouse) and a number of working citizens who can claim a right to a pension in the near or distant future.

Table B.6.1

Public Pension Liabilities: Present value of accrued rights

	Van Den Noord - Herd (1993, 1994) % of 1990 GDP				ABP (1993) % of 1990 GDP	IMF (1996) % of 1995 GDP	
Country	Gross Liabilities			Existing assets	Net liabilities	Gross liabilities	
	Retired	Work force	Total				
B						68	
DK						69	
D ¹⁾	54	103	157		157	122	221
EL						118	
E						109	
F	77	139	216		216	69	265
IRL						54	
I	94	148	242		242	107	357
L						138	
NL						137	
P						96	
UK	58	81	139		139	42	117
USA	42	70	113	23	89		108
Japan	51	112	163	18	144		166
Canada	42	71	113	8	105		94

¹⁾ West Germany in Van Den Noord-Herd (1993, 1994) and ABP (1993).

Sources: Kuné J. B. - Petit W. F. M. - Pinxt A. J. H., "The Hidden Liabilities of Basic Pension Systems in the European Community", *CEPS Working Document*, No. 80, November, 1993. Van den Noord P. - Herd R. "Pension liabilities in the seven major economies", OECD, *Economics Department Working Papers*, n. 142, 1993. Van den Noord P. - Herd R., "Estimating pension liabilities: A methodological framework", OECD, *Economic Studies*, n. 23, 1994, pp. 131-166. IMF, *Aging Populations and the Fiscal Consequences of Public Pension Schemes*, 1996.

⁴ Respectively the ratio of the number of pensions to the number of elderly citizens and the ratio of the average pension to the average wage.

In recent years a number of studies have estimated the liabilities of PAYG schemes. Table 1 reports some estimates of accrued pension liabilities, which represent the present value of pensions to be paid in the future on the basis of accrued rights.⁵ Estimates vary considerably and the ranking of countries changes.

The relevance of pension liabilities - Estimates of pension liabilities represent a useful complement to conventional debt and deficit measures.

- a) They provide a measure of the cost of terminating PAYG pension schemes when complying fully with present benefits rules.⁶
- b) They bring a clearer understanding of the impact of fiscal policies (by representing a relevant part of households' assets, pension rights influence consumption and saving decisions).
- c) They are useful for the measurement of deficits on accrual basis; the estimates available for some countries show that over the last few decades accrual deficits have been much larger than conventional cash flow deficits.

On the other hand, the ratio of accrued pension liabilities to GDP is not an indicator of pension schemes' sustainability. A high liabilities to GDP ratio does not necessarily imply an imbalance in PAYG pension schemes. Nor does it imply that an imbalance will occur in the future. Any judgement about the sustainability of pension schemes and the pressure they exert on public budgets requires estimates about the resources available to pay for the accrued pensions, namely about the evolution of employment and per capita income. The sustainability issue should be addressed with other indicators, such as the pension expenditure to GDP ratio and the contribution rate that assures the cash balance of pension schemes.

Pension liabilities and public debt - Accrued pension rights differ in many ways from conventional public debt and there are practical as well as theoretical reasons for not including accrued pension liabilities in the deficit and debt statistics used in defining and evaluating current fiscal policy.

- i) While conventional public debt can be measured precisely and unambiguously at any point in time, pension liabilities are uncertain and depend on the specific assumptions adopted upon a variety of factors, such as life expectancy, price and wage trends, etc. Present value calculations are extremely sensitive to changes in assumptions.
- ii) Pension rights are not embodied in formal contracts. The debtor can modify both the timing and the amount of the payment. Over recent years in several countries benefit rule reforms have substantially reduced the future entitlements of current workers and pensioners. The assimilation of pension liabilities to financial liabilities might hamper further reforms.
- iii) While public bonds are usually bought freely on the market by individuals or companies, the acquisition of pension rights is usually compulsory. This means that a large pension-debt does not determine any direct pressure on financial markets. It also implies that the debt is automatically renewed. The inclusion of pension liabilities in the debt and deficit measures would conceal the pressure of the public sector on financial markets.
- iv) Pension rights are not tradable. This implies that changes in the relative yield and the relative risk of pension rights comparatively to other assets have no effect on financial markets. Non tradability also implies that social security claims can be altered selectively, taking individual characteristics (e.g., income, demographics) into account.

The inclusion of accrued pension liabilities in the public debt definition would require an analogous change in the deficit definition. Contributions would become loans to the public sector; pensions would be considered, in part, as loan repayments and in part as an implicit interest payment.

⁵ The different definitions of pension liabilities and their role in the assessment of fiscal policies are examined in D. FRANCO, 1995; "Pension Liabilities - Their Use and Misuse in the Assessment of Fiscal Policies", *Economic Papers*, European Commission, N. 110.

⁶ If there is a switch from a PAYG system to a funded system, and all new contributions are paid into the new system, accrued rights measure the amount of resources which have to be financed from general taxation.

4. EXCHANGE-RATE STABILITY AND INTEREST-RATE CONVERGENCE IN THE COMMUNITY

4.1 Overview

Monetary developments in the European Community in 1996 were influenced by two main factors: (i) an overall - albeit unsteady - appreciation in the US dollar and (ii) an improved financial-market perception of the prospects for EMU. Both factors were reflected in stable exchange rates and converging interest rates. Monetary conditions in the EC eased overall, consistent with the cyclical position of the economy and a reinforced commitment to budgetary consolidation in many Member States ahead of the launch of EMU on 1 January 1999.

The firmer US dollar was mainly attributable to the relative strength of the US economy. However, market sensitivity to a possible economic downturn and the consequences for monetary policy made for an uneven appreciation. As the dollar moved higher, the DEM eased against most of the other EC currencies providing scope for a narrowing of short-term interest rate differentials relative to Germany.

The generalised easing of the DEM against other EC currencies also reflected financial-market sentiment on the prospects for EMU. EMU optimism was inspired by reaffirmation of political support for the project throughout the Community, visible progress in technical preparations for the changeover to the euro and a reinforced commitment to budgetary adjustment in many Member States. As confidence improved about the possibility of a significant number of Member States adopting the single currency from the outset, there was an intensification in the convergence of short and long-term interest rates toward the levels in the lower-yielding Member States.

Given the overall improvement in monetary conditions and the effect of budgetary consolidation in lowering long-term interest rates, the macroeconomic policy mix has become more supportive of economic growth. The more aggressive approach to budgetary consolidation presents the prospect of a "virtuous circle" of falling interest rates supporting economic growth and greater credibility of budgetary adjustment efforts as the economy strengthens. Successful budgetary consolidation is, of course, the key element in sustaining these developments and it is essential that budgetary targets be realised if the currently favourable trends are to be sustained.

4.2 Uneven appreciation in the US dollar

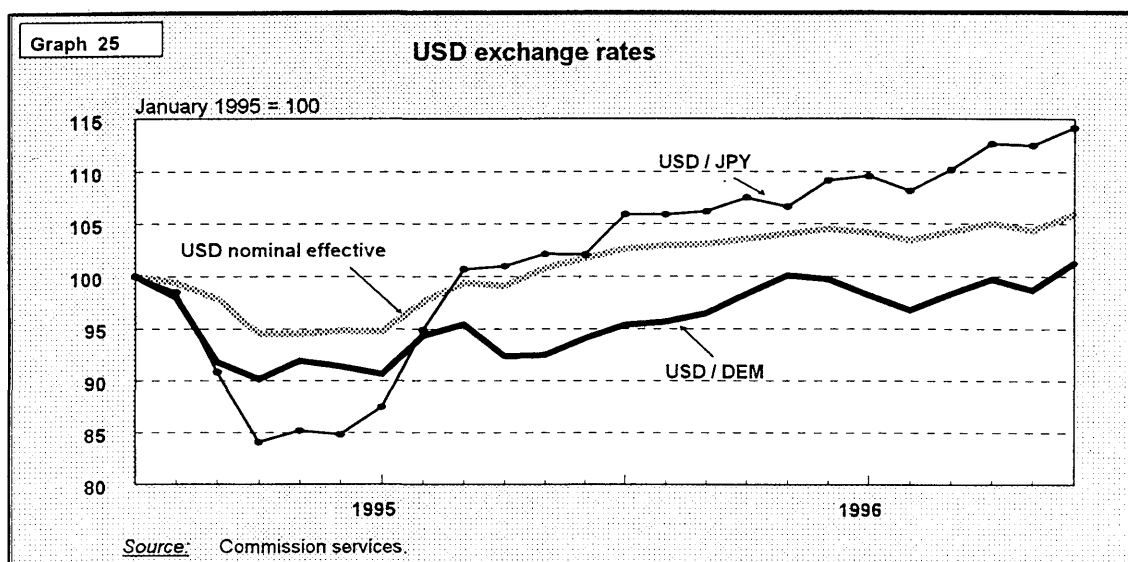
Early boost for dollar from US bond-market rally

In the wake of a monetary easing in Germany on 14 December 1995, the dollar began the year on a rising trend against the DEM. By early February, the DEM/USD exchange rate was close to 1.49; this implied an appreciation of about 3.5% since the beginning of the year and of about 7% from a low of 1.39 DEM recorded in October 1995. The dollar gained more modestly against the Japanese yen in the early part of 1996, having surged higher in the final weeks of 1995 amid gloomy prospects for the Japanese economy.

Demand for the dollar in the early weeks of the year was reinforced by buoyancy in US financial markets. With inflation expectations subdued by a relatively modest pace of expansion in the US economy, bond and equity prices were discounting the continuation of an accommodating monetary policy. Market expectations were validated on 31 January, when US money-market rates - which had been falling steadily throughout 1995 - were again steered lower by the Federal Reserve; however, this proved to be the only monetary easing by the Federal Reserve in 1996. Apart from interest-rate factors, activity in the US financial markets was also supported by continued capital inflows from Japanese sources in response to relatively high rates of return.

Dollar underpinned by stronger economy as bond market ebbs

By mid-February, the data suggested that the outlook for the US economy had brightened considerably. Financial-market expectations of inflation were revised upward and the prospect of a further monetary easing by the Federal Reserve faded. US money-market rates climbed and longer-term rates also moved upward as sentiment in the bond market deteriorated. Despite the loss of bond-market support, the dollar strengthened further against both the DEM and the yen as markets now began to discount a near-term monetary tightening by the Fed at the same time as a monetary easing by the Bundesbank. The DEM/USD exchange rate climbed to about 1.55 by early May and was hovering around 1.53 at the end of the second quarter; this implied an appreciation of more than 6% in the first half of the year. Meanwhile, the JPY/USD exchange rate ended the second quarter above 109, implying an appreciation of more than 5% in the first half of the year.



Equity sell-off triggers temporary reversal in dollar rise

The appreciation in the dollar was interrupted early in the third quarter of the year. An abrupt deterioration in sentiment toward the US currency was triggered by a significant one-off fall in US equity prices in July, although the US bond market was relatively unaffected. Demand for the dollar was further undermined by mixed signals on the strength of the US economy and a growing market perception that the interest-rate cycle in Germany had bottomed following a cut in the Bundesbank's key intervention rates in April. Speculation concerning a possible monetary tightening in Japan also weighed on the dollar, as the DEM/USD exchange rate moved below 1.48 and the JPY/USD exchange rate fell to 108 at the end of August. This episode of weakness was short-lived, however, and the dollar subsequently recouped much of its losses on new evidence of a robust expansion in the US economy. With market expectations of a near-term monetary tightening in the United States fully revived, the DEM/USD exchange rate ended the third quarter at close to 1.54 -- helped also by a generalised strengthening of the other EC currencies against the DEM -- while the JPY/USD exchange rate ended the quarter at about 111.6.

Dollar ends the year strong despite uncertainty on US economy.

The dollar consolidated its gains against the yen in the fourth quarter as the performance of the Japanese economy continued to disappoint the markets. The JPY/USD exchange rate ended the year at 116.1, up by about 11.5% relative to its level on 1 January. Against

the DEM, the dollar followed a more uneven trend as markets remained highly sensitive to prospects for the US economy and to the implications of official comments for the direction of monetary policy in the United States and in Germany. From mid-October, the dollar eased against the DEM amid a reassessment of the expected strength in the US economy and a perception that the European economies had bottomed out. However, renewed concerns at the pace of recovery in Europe emerged in late November and the DEM/USD exchange rate surged on market speculation of another monetary easing in Germany. Despite a temporary downward blip linked to a second sharp sell-off in US equities in early December, the DEM/USD exchange rate ended the year at about 1.55, up by almost 8% relative to 1 January. In nominal effective terms, the dollar appreciated by about 4%²³ in 1996.

4.3 Appreciating dollar and EMU optimism favour monetary stability in the Community

4.3.1 Strong dollar reflected in intra-EC exchange-rate movements

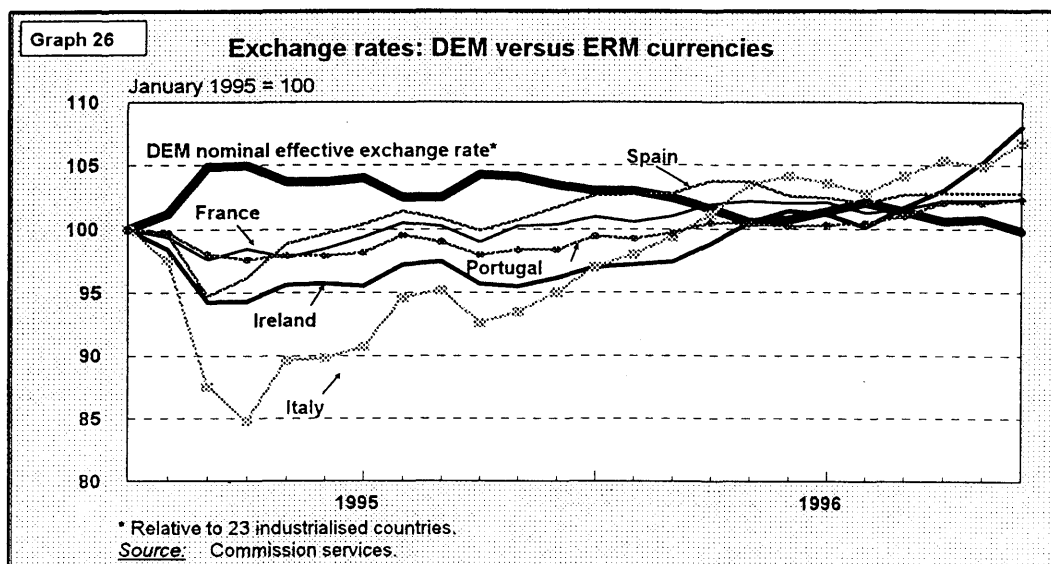
The appreciation of the US dollar in the course of 1996 contributed to an overall easing in monetary conditions in the EC. The strength of the dollar against the DEM was mirrored in other EC currencies, particularly in the "high-yielding" currencies. By the end of the year, the decline in the DEM against the other EC currencies had largely reversed the nominal effective appreciation which had resulted from the exchange-rate disturbances of Spring 1995.

For presentational purposes, it is convenient to differentiate between Member State currencies on the basis of their participation or non-participation in the ERM. The trend in the exchange rates of ERM currencies which moved significantly against the DEM is illustrated in Graph 26. The high-yielding Italian lira²⁴ (+11%) and Portuguese escudo (+3.3%) experienced a significant appreciation, together with the Irish pound (+13.3%) which moved in line with sterling. The French franc (1.3%) also benefited from the generalised easing in the DEM, despite experiencing a bout of selling pressure linked to political uncertainties in August. The remaining ERM currencies²⁵ were either stable or marginally weaker against the DEM over the year.

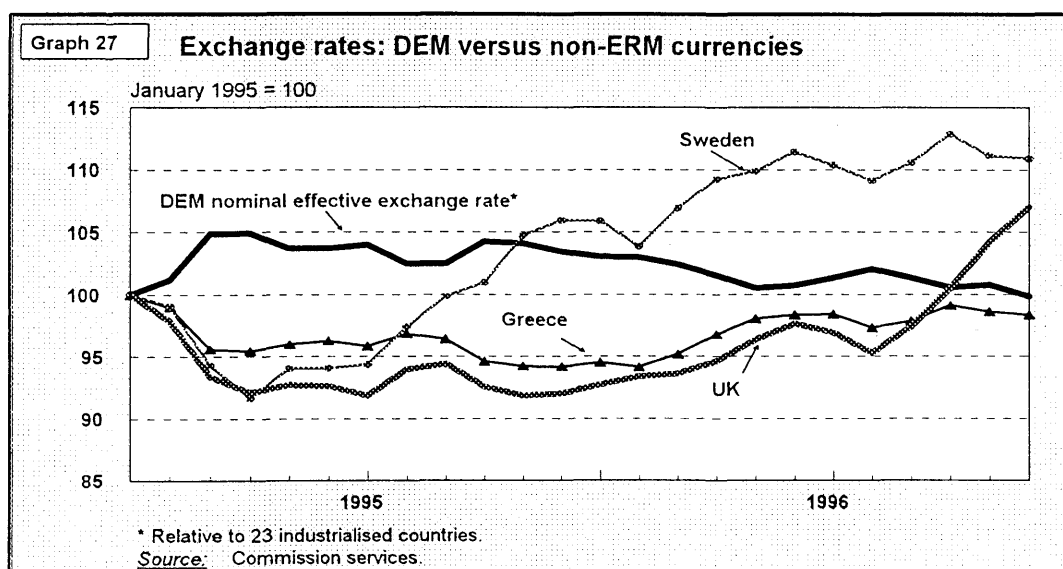
²³ Against 23 industrial countries.

²⁴ Which re-entered the ERM on 25 November, 1996.

²⁵ Including the Finnish markka, which entered the ERM on 14 October, 1996.



Systemic conditions in the ERM generally improved in 1996. The spread between the strongest and weakest currencies in the grid -- which had already come down in late 1995 -- narrowed progressively throughout most of the first three quarters. The spread fell from about 5.6% (Spain versus Ireland) in early January to a low of about 1.99% (Ireland versus France) on 27 September but widened again to about 2.29% (Ireland versus France) on 30 September. While the vast majority of ERM currencies remained inside or close to their former narrow fluctuation margins in the fourth quarter, a continued appreciation of the Irish pound resulted in a widening of the spread to a peak substantially above 9% before ending the year at 8.9% (Ireland versus France). The width of the spread reflected the strength of the Irish pound rather than the weakness of the French franc, which although at the bottom of the grid was still relatively close to its central parity against the DEM. Continued appreciation of the Irish pound within the grid could

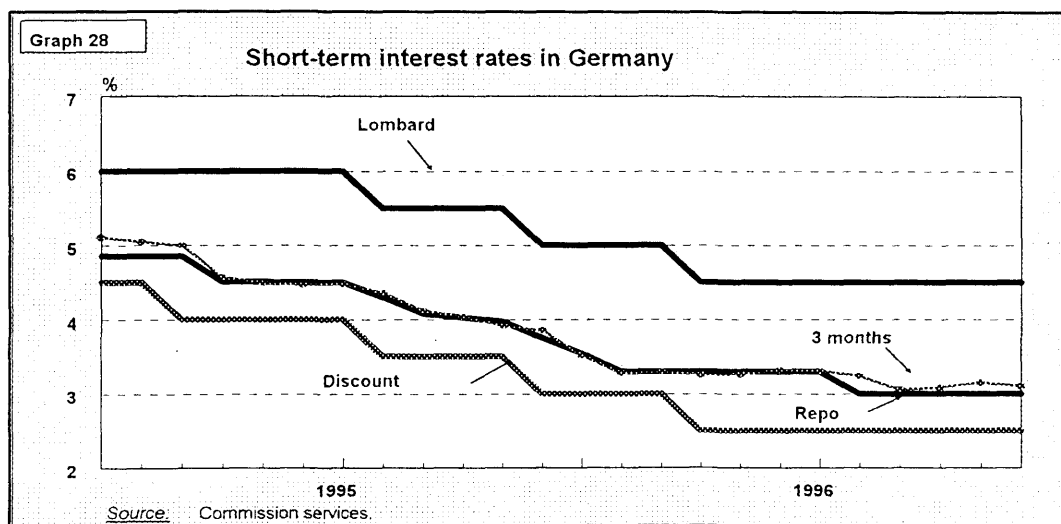


pose a policy dilemma for the national authorities; the Irish economy has been accelerating at a rapid pace in recent years and the need for a further monetary tightening -- implying a further widening of the spread -- cannot be ruled out. Overall, however, spreads within the ERM narrowed so that most participating currencies -- including the Finnish marka and the Italian lira which did not participate for the full year -- ended the year very close to or within the former narrow fluctuation margins of $\pm 2.25\%$.

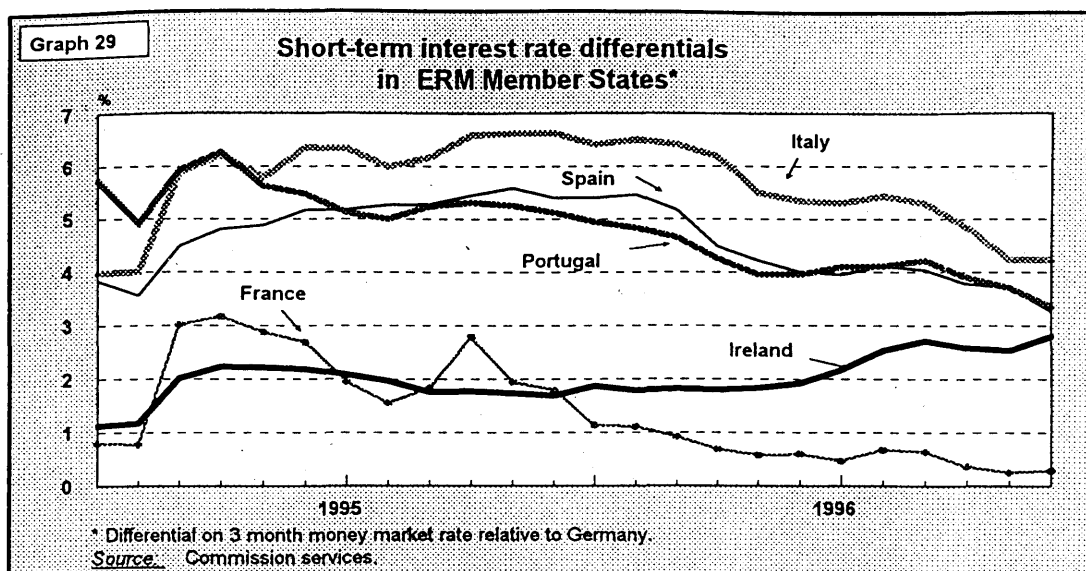
The non-ERM currencies -- which are high yielding and relatively dollar-sensitive -- also appreciated against the DEM. The traditional linkage between movements in sterling and the dollar, reinforced by evidence of a sustained recovery in the domestic economy, boosted the UK currency (+18.2%), while the Swedish krona (+3.5%) and the Greek drachma (+3.7%) also made steady gains over the year.

4.3.2 *Appreciation of other EC currencies against DEM accompanied by convergence in short-term interest rates*

The generalised appreciation of other EC currencies against the DEM was accompanied by a significant narrowing in short-term interest-rate differentials with respect to Germany. German short rates moved modestly lower over the year, with the three-month money-market rate falling by about 65 basis points to 3.1% over the year in line with monetary-policy developments. As indicated in Graph 28, the Bundesbank's key discount rate and Lombard rate were both lowered by 50 basis points to 2.5% and 4.5% respectively on 19 April; however, the pace of decline in German money-market rates was dictated by a fixed repo rate of 3.3% between 1 February and 22 August, before it was lowered to a fixed level of 3% until the end of the year. The relatively moderate pace of monetary easing by the Bundesbank reflected high rates of growth in the domestic money supply (M3), which expanded at a monthly rate above the target range of 4% - 7%²⁶ throughout the year, falling from a peak of 12.8% in February to 8% in November.



²⁶ Relative to the average monthly growth rate in the fourth quarter of 1995.



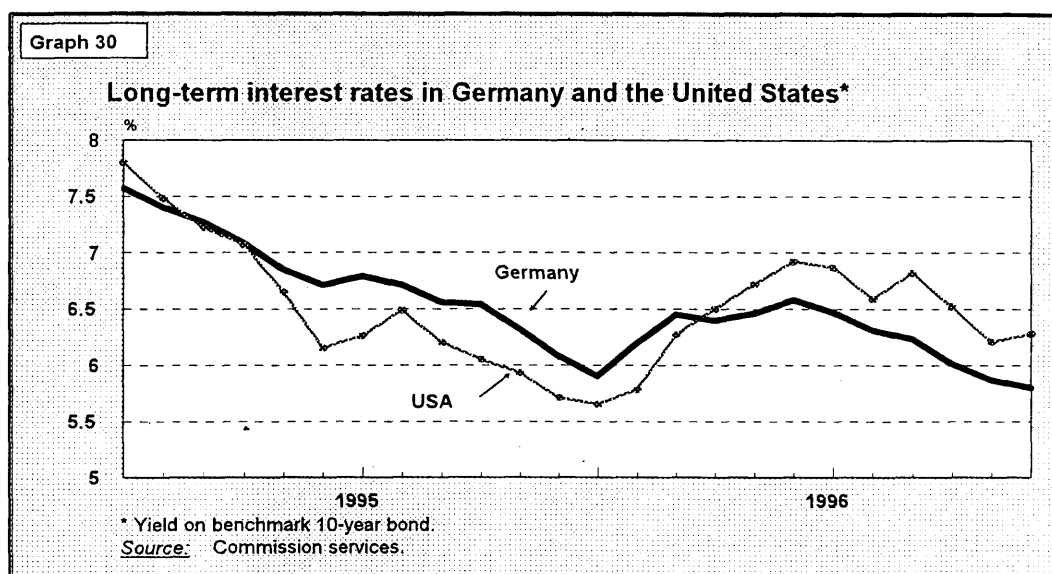
The decline in short-term interest rates was more pronounced in other Member States, in most cases reflecting a more significant relaxation of monetary policy than in Germany. Over the year, the average differential -- among all the other Member States²⁷ -- on three-month money market rates relative to Germany fell from about 230 basis points to about 145 basis points. There was, however, a significant variation between Member States. Graph 29 indicates that the decline in short rates among the ERM Member States was most striking in Italy, Spain and Portugal, where the differential on the three-month money market rate fell from 650 basis points to about 420 basis points, from 550 basis points to about 325 basis points and from about 500 basis points to about 335 basis points, respectively. Budgetary consolidation and other measures that have helped to bring inflation down have allowed central banks to reduce interest rates. In France, the differential fell from about 120 basis points to about 30 basis points. Ireland, where the differential widened from about 170 basis points to about 280 basis points, was a notable exception to the convergent trend among the ERM Member States.

Among the non-ERM Member States, the differential on three-month money market rate in the United Kingdom with respect to Germany widened from about 280 basis points to about 340 basis points. The United Kingdom was the exception to a narrowing trend in short-term interest rate differentials among these Member States. The narrowing was particularly notable in Sweden, where the differential on the three-month money market rate fell from about 485 basis points to about 90 basis points. The Swedish experience reflected a particularly aggressive monetary easing by the Riksbank in the early part of the year, involving a long sequence of cuts in the key repo rate.

²⁷ Excluding Luxembourg and Greece.

4.3.3 Long-term interest rates also converge, helped by EMU optimism

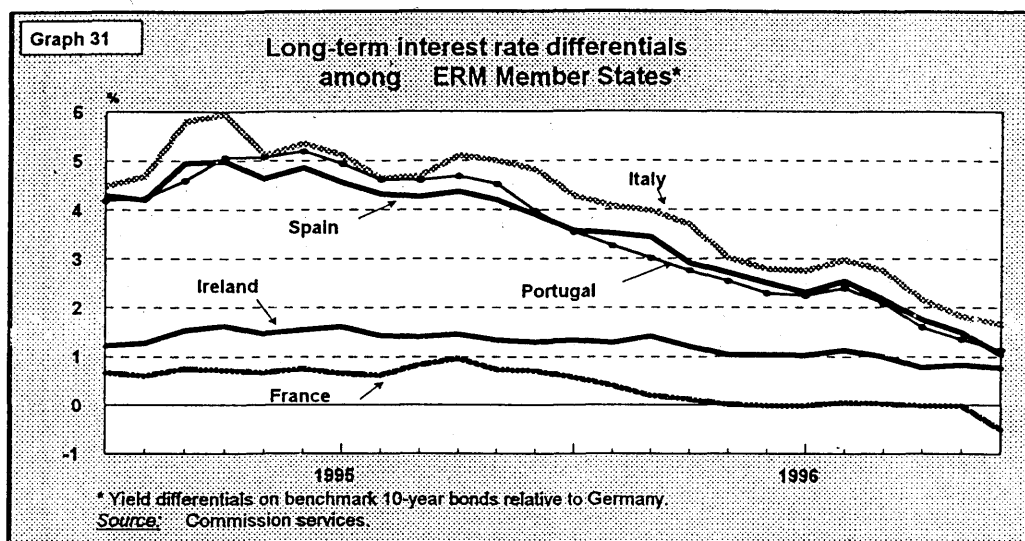
As with short rates, there was a significant convergence in bond yields toward the German level in the other Member States. This phenomenon was again relatively conspicuous among the high-yielding Member States. Graph 30 indicates that German long rates moved moderately upward over the first half of the year in line with a similar (but more pronounced) trend in the United States. The rise in US yields began with the reverse in bond market sentiment early in February and was largely sustained until early September, when yields began to fall in response to revised expectations of a monetary tightening by the Federal Reserve. German yields had been above the corresponding US levels since early 1995, but in mid-April the positive differential turned negative reflecting a partial decoupling between the US and German bond markets. The negative differential widened in subsequent months and the yield on the benchmark ten-year bond in Germany ended the year about 15 basis points lower than its level on 1 January (the corresponding US yield was about 70 basis points higher over the same period).



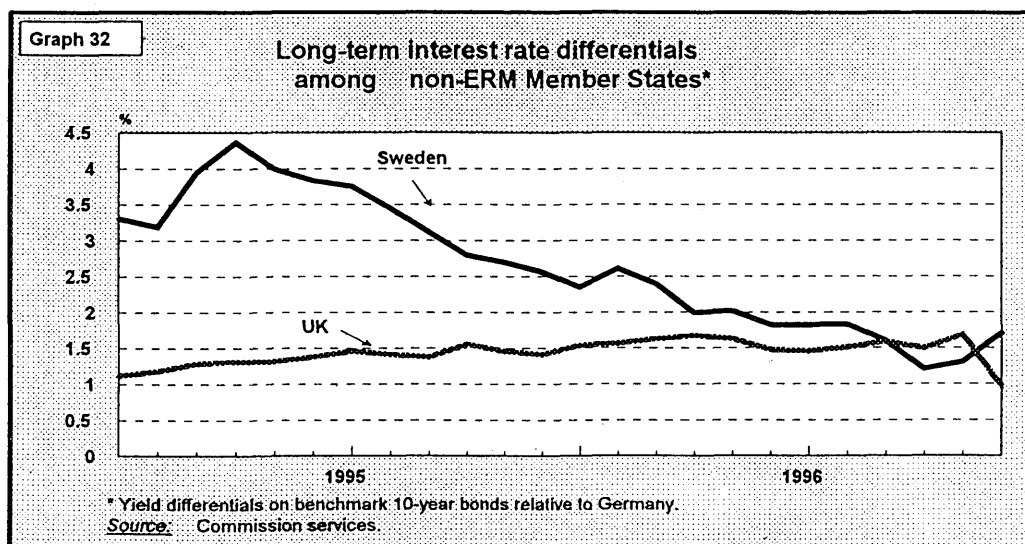
Trends in bond yields in the other Member States varied. The average differential -- among all other Member States²⁸ -- in the yield on benchmark ten-year bonds relative to Germany fell from about 160 basis points at the beginning of January to about 65 basis points at the end of December. As indicated in Graph 31, this decline mainly reflected a sharp fall in yield differentials in Italy (from about 445 to about 165 basis points) in Spain (from about 360 to about 105 basis points) and in Portugal (from about 375 to about 115 basis points). In each case, the decline in yields reflected a lowering of inflation

²⁸ Excluding Luxembourg and Greece.

expectations and a firmer exchange rate against the DEM. Among the non-ERM Member States, the differential in the United Kingdom widened marginally over the first nine months of the year, on rising expectations that domestic monetary policy would be tightened in view of the strong cyclical position of the UK economy relative to that of other Member State economies (see Graph 32).



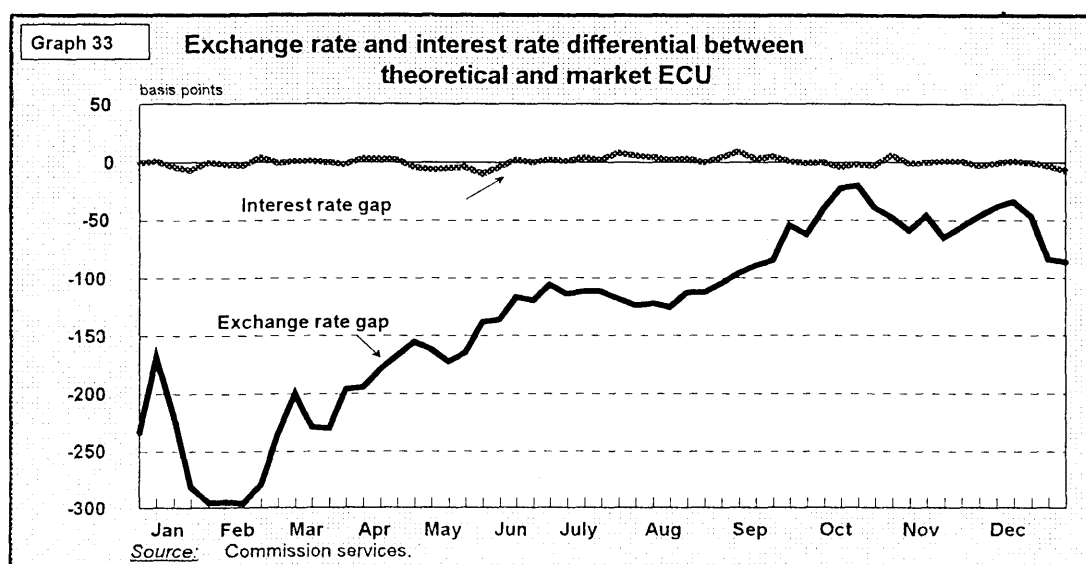
Convergence in long-term interest rates toward the German level accelerated sharply in the final quarter. Inflationary pressures remained subdued throughout most of the Community. In Italy, Spain and Portugal, but also, to some extent in Greece, anti-inflationary policies coupled with reinforced fiscal consolidation have succeeded in reducing inflation and stabilising expectations towards a lower rate of inflation. As shown in Graph 30, German long rates moved lower in the final quarter -- once again helped by US developments -- but the fall in other EC long rates was more dramatic. Final-quarter developments brought all EC ten-year bond yields within 200 basis points of the corresponding German yields for the first time since capital liberalisation was completed within the Community.



4.4 EMU prospects confirmed in ECU market and forward interest rates

Despite the convergence in long-term interest rates, wide (albeit narrowing) differentials relative to Germany persisted in many Member States in the first three quarters of 1996. Moreover, a substantial negative differential between the theoretical exchange rate and the corresponding official rate in the ECU market was interpreted as implying some continued hesitation in the markets with respect to EMU. This was confirmed by differentials in forward interest rates, which were discounting significant exchange rate movements in many Community currencies and the ECU well beyond the projected starting date of EMU.

From September onward, there was a marked improvement in market sentiment toward EMU and the prospect of a significant number of countries participating in the euro zone from the outset. The more favourable market view of EMU was the combined result of several factors. Firstly, there was evidence of a strong political commitment to the project; as manifested in the agreement on the Stability and Growth Pact, on a new exchange-rate mechanism and on the legal framework for the euro reached in mid-December. Secondly, the prospects for growth in the EC economy in 1997 brightened considerably. Finally, budgetary adjustment efforts were reinforced in most Member States with a view to complying with the relevant Maastricht criteria. The improvement in market sentiment toward EMU quickly became the main factor driving convergence in long-term interest rates toward the (declining) German level. The fall in German long-term interest rates amid rising EMU optimism seems to confirm that there is no EMU-specific risk premium on German bonds. Furthermore, the accelerated decline in differentials among the high-yielding Member States has been interpreted as striking evidence of an increased financial-market acceptance of a significant number of countries adopting the euro from the outset of EMU.



A further indicator of growing EMU credibility in the final quarter was the performance of the ECU market. Although trading volume remained modest, Graph 33 indicates that risk premia with respect to the exchange rate fell in the course of 1996, particularly in the fourth quarter. While the gap between the theoretical value of the ECU and the market value was 300 basis points at the beginning of the year, it had fallen to about 86 basis points by the end of the year. At the same time, the interest-rate spread which had been low throughout the year virtually disappeared.

Finally, the growing credibility of the EMU project was evident in the movement of forward interest rates on all Member State currencies. Forward rates on contracts with a settlement date after the creation of EMU on 1.1.1999 should be the same for all currencies expected to participate in the euro zone from the outset. The existence of a significant divergence in such forward rates in any Member State can be considered as evidence of a "credibility gap" with respect to their participation in the euro zone. Table 27 presents the differential relative to Germany (which is assumed to be a certain participant in the euro zone) in five-year forward rates on five year loans for a selection of Member States for which data is available.

The forward rates are derived using estimated zero coupon yield curves in the relevant Member States.²⁹ It is clear from the table that the relevant forward rates on the "hard core" currencies have been highly convergent for some time, but a significant divergence has existed in the forward rates of the other currencies. As with developments in spot markets, however, this divergence has been narrowing steadily since the

Table 27				
Five-year forward rate on five-year loans				
Differential vis-à-vis Germany in basis points				
Date	Jan-Mar 1996	July 1996	Oct. 1996	Dec. 1996
B	45	43	-2	-7
E	239	184	83	21
FIN	n.a.	n.a.	62	43
F	-6	-7	-24	-31
I	n.a.	198	-4	42
NL	-7	-5	-4	-10
A	n.a.	2	2	-5
S	183	n.a.	96	59
UK	94	123	79	82
ECU	57	n.a.	4	10

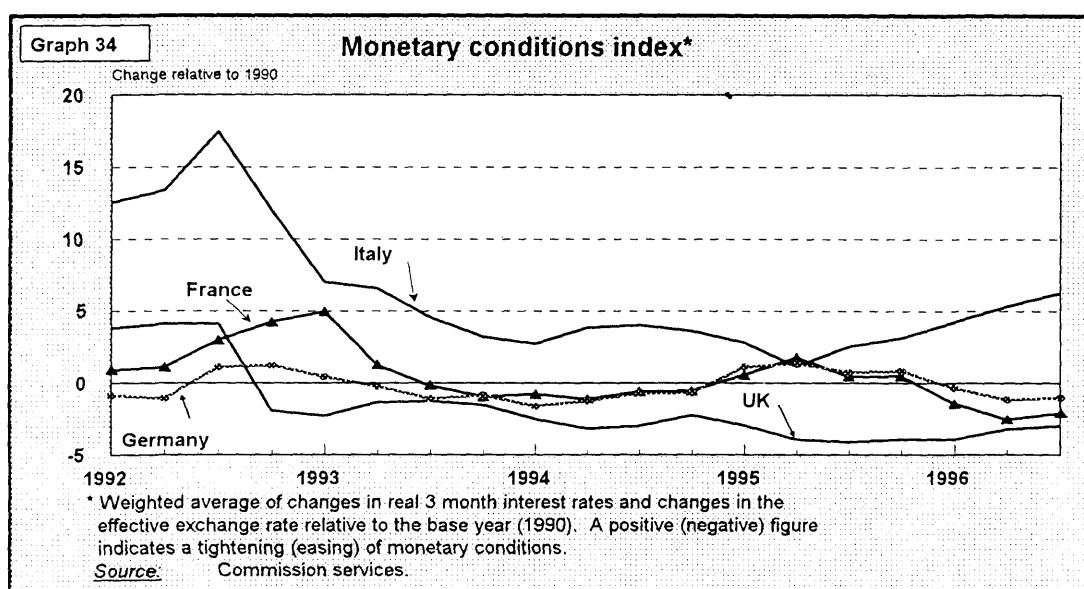
beginning of the year and particularly in the final quarter. The differential in the ECU forward rate early in the year was seen as evidence of market scepticism about the EMU project itself but this differential had largely disappeared by the end of the year. Moreover, the convergence in forward rates on the various EC currencies offers confirmation of a growing financial-market acceptance of a significant number of participating Member States in the euro zone from the outset of the third stage of EMU.

²⁹ Estimation of zero-coupon yield curves is not exact and, in consequence, the derived forward rates may be subject to measurement error.

4.5 Easing monetary conditions combines with budgetary consolidation to rebalance the macroeconomic policy mix

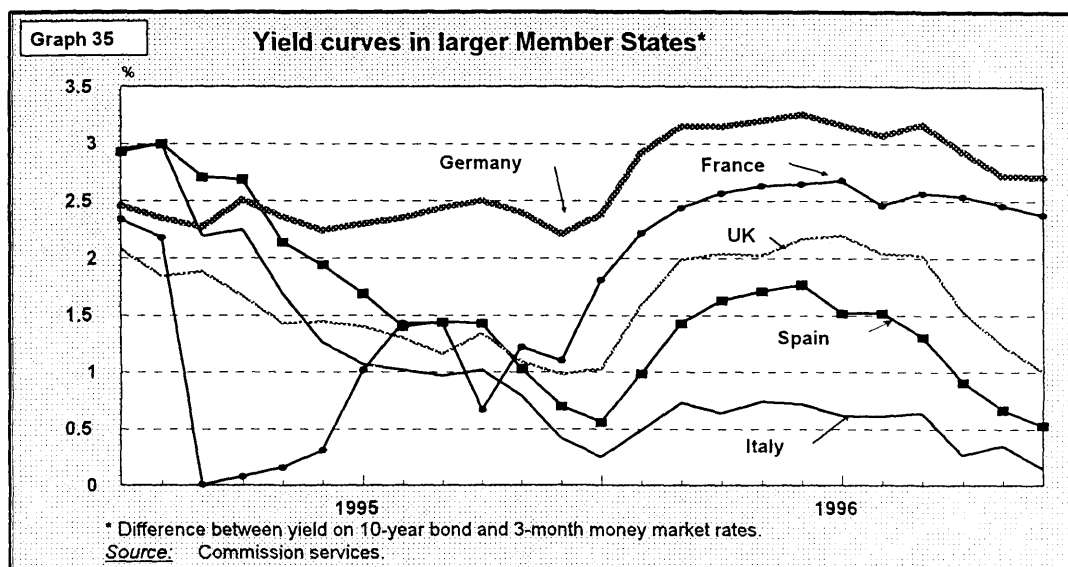
4.5.1 Monetary conditions ease over the year

The strength of the US dollar and the generalised decline in short-term interest rates throughout most of 1996 implied an improvement in monetary conditions within the European Community. Graph 34 indicates the movement in the Monetary Conditions Index or MCI³⁰, (which combines the movements in short-term interest rates and exchange rates to indicate the change in monetary conditions within an economy) for the larger Member States. The movement in the MCI for Germany and France point to a significant relaxation in monetary conditions in 1996 relative to 1995. A similar trend was



³⁰ The MCI expresses changes in domestic monetary conditions *relative* to a pre-specified base period in terms of a weighted average of developments in short-term interest rates and developments in the effective exchange rate. The attractiveness of the MCI as a tool of current analysis is that it summarizes the (contractionary or expansionary) impact of movements in the principal transmission mechanisms of monetary policy to the economy: the interest rate and the exchange rate. An increase in the nominal short-term interest rate -- implying an initial rise in real rates because of slow price adjustments -- results in a decline in real money balances and so reduces demand in the economy. Similarly, an appreciation of the nominal exchange rate -- implying a real appreciation in the short run -- leads to a reduction in net exports and so imparts a contractionary impulse to demand in the economy. Of course, the opposite is true in the case of a reduction in short-term interest rates and an exchange rate depreciation. Movements in the MCI should, therefore, mirror movements in output growth over the policy horizon. The choice of base period for the MCI is arbitrary so that the absolute level of the index is not in itself significant and the component variables can be expressed in either nominal or real terms. The relative weighting of the two variables is derived as the ratio of the elasticity of real output with respect to the short-term interest rate and the elasticity of real output with respect to the exchange rate.

recorded in the MCI for most of the other ERM countries. On the other hand, movement in the MCI indicates a tightening in monetary conditions in Italy (where the exchange rate appreciated) and in the United Kingdom (where both short-term interest rates and the exchange rate firmed over the year).



The scope for a further easing of monetary policy in most of the Member States will, of course, depend on developments in longer-term interest rates. While the favourable inflation environment was reflected in a general decline in EC bond yields, the pace of decline in yields in many Member States was somewhat less than that in short-term rates. In consequence, the easing of monetary policy in the Community for much of the year was reflected in a simultaneous lowering and steepening of yield curves as illustrated for the larger Member States in Graph 35. The "stickiness" in EC bond yields in this period was not attributable to latent inflationary pressures but to the failure of EC yields to decouple fully from corresponding yields in the United States. US yields followed an upward trend for much of the year on market expectations of a monetary tightening by the Fed. However, the graph also indicates a marked flattening in EC yield curves (except for Italy) in the fourth quarter, as German yields moved lower and EMU optimism favoured convergence in EC long rates.

4.5.2 Monetary easing provides scope for continued budgetary consolidation

Many Member States have availed of the improved growth prospects helped by easier monetary conditions to rebalance the macroeconomic policy mix by intensifying budgetary consolidation. The credibility of budgetary consolidation efforts -- and reinforced commitments to maintaining and intensifying such efforts in the future -- was greatly enhanced by the prospect of a stronger economic performance. The credibility of budgetary adjustment efforts in most Member States was the determinant factor underlying the decline in long-term rates linked to EMU optimism in financial markets toward the end of the year. The macroeconomic policy mix is now more growth supportive.

For many Member States, the more aggressive approach to budgetary consolidation presents the prospect of a "virtuous circle" of falling interest rates supporting economic growth and greater credibility of budgetary adjustment efforts as the economy strengthens. Successful budgetary consolidation is, of course, the key element in sustaining these developments and it is essential that budgetary targets be realised if the currently favourable trends are to be sustained.

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