COMMISSION OF THE EUROPEAN COMMUNITIES

SEC(93) 1755 final Brussels, 8 December 1993

Report

Progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market

(Article 109e, 2(b) of the Treaty on European Union)

(presented by the Commission)

REPORT ON PROGRESS IN ECONOMIC AND MONETARYCONVERGENCE AND WITH THE IMPLEMENTATION OF COMMUNITY LAW REGARDING THE INTERNAL MARKET

Table of Contents

SUMMARY

PART ONE: PROGRESS IN ECONOMIC AND MONETARY CONVERGENCE

1. INTRODUCTION

2. ACHIEVEMENTS IN CONVERGENCE: MACROECONOMIC ASPECTS

2.1 Major economic events and the current economic situation

2.2 Nominal convergence: achievements and challenges

2.2.1 Inflation
Box 1: contributions to inflation

2.2.2 Public finances
Box 2: the public finance block of the convergence programmes

2.2.3 Balance of current account

2.2.4 Long-term interest rates

2.2.5 Exchange-rate stability in the ERM

2.3 Real convergence

2.3.1 Introduction

2.3.2 Catching-up in real income

2.3.3 Unemployment

2.4 Convergence in supply performance

2.4.1 Convergence of supply conditions matters
Box 3: Global assessment of capital profitability

2.4.2 Structural reform: progress at Member State level

2.5 Progress in central bank independence

1a

PART TWO: ASSESSMENT OF THE IMPLEMENTATION OF COMMUNITY LAW REGARDING THE INTERNAL MARKET

1. INTRODUCTION

2. FUNCTIONING OF THE SINGLE MARKET

2.1 Implementation of the transposition of Community legislation

2.2 Making the Single Market work

3. ELEMENTS FOR A PRELIMINARY ASSESSMENT OF THE ECONOMIC IMPACT OF THE INTERNAL MARKET PROGRAMME

3.1 Introduction

3.2 Reduction in trade costs and removal of access barriers

3.3 Anticipation effects - foreign direct investment

3.4 Changes in intra-EC trade and competition

4. CONCLUSIONS

ANNEX TO PART ONE: CHARTS BY MEMBER STATE (1980-1993)

- Real GDP/head of population
- Unemployment rate
- Inflation
- Balance of current transactions
- Net borrowing requirement (general government)
- Long term interest rate
- Real unit labour costs

REPORT ON PROGRESS IN ECONOMIC AND MONETARYCONVERGENCE AND WITH OF THE IMPLEMENTATION OF COMMUNITY LAW REGARDING THE INTERNAL MARKET

SUMMARY

Achieving a high degree of convergence is a precondition for moving to the final stage of economic and monetary union (EMU) as defined in the Treaty on European Union which entered into force on 1 November 1993. The second stage of EMU will start on 1 January 1994. The move to stage two is not conditional on any particular achievements on convergence, neither economic nor institutional. However, the current state of play regarding economic and monetary convergence must be assessed in order to have a view of the progress made during stage one. The Treaty requires the Council to make such an assessment, based on a report presented by the Commission (article 109 e 2 (b)); moreover, the Treaty requires the assessment to cover also the progress made with the implementation of Community law concerning the internal market. The attached report is intended to fulfil these Treaty requirements.

Progress in economic and monetary convergence during stage one of EMU which started on 1st July 1990 was mixed: while on the inflation front there were positive developments, the same cannot be said about public finances. As regards real convergence, the progress achieved in improving supply conditions, namely through the implementation of the internal market programme has been obscured by the sharp rise in unemployment and the stalling of the catching-up process in the Community.

These developments in convergence must be seen against the background of a much worse than expected economic situation. Indeed, following a marked deceleration of economic activity since the early nineties the European Community entered into recession in mid 1992 (i.e. in the middle of stage one). The European Monetary System (EMS), which is the cornerstone of monetary integration, was not immune to these developments and the period of high turbulence in the exchange rate markets which started in the Summer of 1992 culminated in the significant widening of the fluctuation margins one year later; in between, two major currencies suspended their participation in the system and several realignments of parities took place. Finally, the recessionary context and the rise in unemployment made more evident some structural weaknesses still prevailing in the Community.

In spite of these adverse developments, which are in marked contrast with the expectations prevailing at the beginning of stage one, Member States have remained committed to the convergence process and to the necessary structural reform. Convergence programmes have been adopted by most Member States and, in general, projected measures were implemented at least on the scale initially envisaged as necessary. Reforms geared to the removal of structural rigidities affecting their national economies were taken by all Member States, in welcome contrast with the past when they were frequently postponed. On the institutional front, the process of central bank

independence has progressed clearly ahead of the Treaty requirements. Meanwhile, the completion of the internal market, which is the most ambitious structural reform at Community level, has been largely achieved. It is therefore fair to say that although economic developments during stage one partly veil the results of the convergence efforts made by Member States, much was achieved in the structural and institutional fields. These achievements, although less visible, will provide strong support to a sound construction of EMU.

Visible progress was achieved in inflation performance during stage one, both as regards the level and the degree of convergence. The inflation rates in 1993 in seven Member States are estimated to be within the limits to be aimed for according to the Treaty, which is of the order of 3 - 4% this year. Of these Member States, six have shown a remarkable regularity during the period (Belgium, Denmark, France, Ireland, Luxembourg and the Netherlands), while the United Kingdom has entered the reference range for the first time this year. As regards the remaining Member States, the somewhat poorer performance of Germany in the recent period has been mainly due to the special circumstances of unification; in Spain and Italy inflation has been decelerating and the 5% plateau has been broken this year; in Portugal inflation is now much closer to the reference range compared with the double digit inflation in the early nineties. Although progress has been achieved, inflation in Greece remains far above the Community average.

Member States' public finances deteriorated significantly during stage one of EMU. It appears that fiscal policy has had to play a major role in accommodating the recession either through the working of the automatic stabilizers or, in a few cases, as a result of a deliberately anti-cyclical budgetary stance. The deficit of the general government represented, for the Community as a whole, 6.4% of GDP in 1993, a figure clearly above that of the beginning of the decade. Although more than three quarters of this deterioration can be accounted for by cyclical factors, the current situation is hardly sustainable. Decisive action is necessary to reduce budgetary imbalances in the Community, supported by an adequate policy mix leading to steady and sustained economic growth; indeed, developments during stage one have shown that the convergence of budgetary positions to the benchmark values of the Treaty while recession persists is a very difficult task.

The deterioration of the budgetary situation has been generalised throughout the Community. In 1993, with the exception of Ireland and Luxembourg, no other Member State is expected to comply strictly with the deficit benchmark of 3% of GDP. The deterioration is most evident in Denmark, Germany, France and the United Kingdom (where the public deficits in percent of GDP in 1993 are estimated to reach 4.4%, 4.2%, 5.9% and 7.6%, respectively), given the low level of earlier deficits. Except for Germany, these countries took deliberate measures to mitigate the effects of the economic slowdown. In Spain, the widening of the deficit in 1993 to 7.2% of GDP more than offset the progress achieved in the previous year; a similar development occurred in Portugal. Some other Member States aiming at fiscal consolidation either remained on a gradual upward trend or achieved a stabilization in their government deficit, e.g. Italy. In the Netherlands, the deficit was brought down after 1990 and was kept at relatively low

level (4.0% of GDP in 1993), while Ireland and Luxembourg stand as the Community Member States with the lowest deficits.

Having ocurred in a period of low, if not negative, real growth and of low or decelerating inflation, the widening of governments deficits has led to a rise in the public debt to GDP ratios throughout most of the Community. This situation is particularly worrying for those Member States where the public debt to GDP ratio is clearly above the 60% benchmark; the public debt to GDP ratio is now over 100% in three Member States and has not yet been stabilized, which must first be achieved before the required steady decline.

Progress was achieved as far as convergence in long term interest rates within the Community is concerned. Long term interest rates have declined since 1990 and the dispersion among Member States has narrowed; all but four Member States already satisfy the interest-rate criterion of the Treaty. This trend largely reflects the favourable development of inflation and illustrates the high level of financial integration achieved in the Community.

The stability of exchange rates within the exchange rate mechanism (ERM) of the European Monetary System came under increasing pressures from mid 1992 as uncertainties were created about progress towards EMU by the delays in the ratification of the Treaty on European Union. For several of the currencies which have been realigned or for which participation in the ERM has been suspended, this was a reflection of accumulated divergences in inflation and cost performance. More generally, the continuing pressures on other currencies and the decision in early August 1993 to widen the fluctuation margins to +/-15% resulted from the problems created by the high interest rates needed in Germany to cope with the effects of unification for other countries faced with recession. The cautious approach to interest-rate reductions that has been adopted since August indicates a desire to maintain a commitment within the Community to monetary cooperation based on stable exchange rates.

Although not spelled out in Article 109 of the Treaty, real convergence cannot be ignored. Achievements in this domain were disappointing given the sharp increase in the unemployment rate in the Community, from 8.3% in 1990 to 10.6% in 1993, which means a jobless total of about 17 million on average this year. In addition, the process of catching up, which made significant progress during the late eighties stalled with the current recession. However, supply conditions have improved in the Community through the implementation of structural reforms; in addition, the profitability of investment, which is important to cope with the challenge of unemployment, does not seem to have been damaged overmuch by the current cyclical downswing.

Progress in implementation of Community Law regarding the Internal Market:

The legislative framework for an Internal Market, as defined in the Commission's White Paper of 1985, is now almost fully in place. 95% of the checklist of White Paper legislation has now been adopted, and is in the process of being implemented by the EC

institutions and Member States. This accomplishment is all the more impressive as the measures which require the greatest adjustment on the part of the Member States - the switchover to the"transitional" VAT regime, the abolition of capital controls, the freedom to provide banking and insurance services throughout the EC, a framework for the liberalisation of public procurement in all sectors including the utility sectors, the liberalisation of air and road transport - have all been successfully negotiated and adopted. The legislative steps which have already been taken constitute the principal elements of the Internal Market framework, and will be sufficient to trigger the bulk of the procompetitive and resource allocation gains which will flow from internal market completion.

A handful of White Paper measures remain on the table, many of which would greatly facilitate the exercise of cross-border activities by economic operators. In particular, progress on proposals relating to the introduction of a Community trade mark, the alleviation of double taxation problems, and the creation of a European Company Statute are eagerly awaited by the business community. The Community must also look beyond the White Paper to areas where additional trade barriers have been identified. As regards the abolition of frontier controls on the free movement of persons, the recent Schengen Ministerial meeting fixed February 1, 1994 as the target date for the removal of these controls. Another area for further action includes sectors where the granting of exclusive rights at national level has precluded cross-border competition. The Commission has now tabled proposals or launched discussion on possible forms of liberalisation in voice telephony, energy, and postal services. Internal market completion in these sectors has progressed at varying speeds and with varying degrees of success.

On the whole, the back of the legislative work has been broken. The task of the Community is now to ensure that the legal openings stemming from this legal framework are now effectively translated into commercial opportunities. The first and most crucial stage of this process will be to ensure that Internal Market enabling legislation is properly transposed in all Member States. At this stage, 86% of necessary transposition measures have now been taken, and there is continual improvement on this front. Member States have been less diligent in transposing Internal Market legislation in the fields of company law, public procurement, and financial services, possibly because these measures entered into force at a later date and transposition was accorded a lower priority.

However, the task of making the Internal Market work does not stop at monitoring the rate of transposition. The Commission is currently elaborating its Strategic Programme for the Internal Market, which is designed to maximise the benefits of the Internal Market framework for consumers, citizens, and enterprises. This involves coherent action on a number of fronts. In particular, the Community must now devote increased attention and resources to the following themes:

- monitoring the quality, as well as the rate of transposition, and improving the transparency of national transposition measures:

- ensuring the quality of enforcement by setting up necessary channels for administrative cooperation, and developing new instruments for monitoring enforcement:

- preventing the emergence of new barriers to trade through stringent application of competition policy safeguards, and the reinforcement of early-warning systems for the detection and prevention of new regulatory or administrative trade barriers:

- enforcement can also be improved by imposition of sanctions on recalcitrant Member States:

- empowering businesses and consumers to defend their rights within the Internal Market by improving access to justice, and ensuring an even interpretation and application of EC law:

- ongoing monitoring and evaluation of Internal Market legislation and its impact with a view to upgrading its performance.

In addition, the Community must look at ways of improving the interaction between Internal Market measures and other Community policies which can make a contribution to the improved functioning of the single market - notably, policies to assist SMEs, standardisation, conformity assessment, competition policy, environmental policy, and the common commercial policy.

Internal Market enabling legislation, whose impact will be amplified by the Strategic Programme, creates a legal and administrative environment in which economic operators can develop their activities on a pan-European scale. It allows them to exploit market opportunities or tap resources in other Member States. At this stage, economic operators are beginning to witness some of the concrete benefits of a single market. For instance,

- Border controls and formalities on cross-border shipments of goods are now a thing of the past.

- Technical harmonising legislation which was adopted at an early stage of the Internal Market programme is eroding technical trade barriers in sectors such as toys, medico-surgical equipment, and pressure vessels.

- The removal of controls on capital movements has contributed in no small measure to the increased integration of some Member States into international capital markets. This in turn has facilitated cross-border investment and eased credit shortages in those Member States.

Although the advantages of internal market integration are beginning to filter through, it would be premature to undertake a global assessment of the Internal Market at this stage. For a start, much Internal Market legislation has yet to enter into force, or to be transposed into national legislation. Secondly, complementary actions to capitalise fully on the potential of the single market must be implemented in parallel with the legislative

framework (e.g, Trans-European Networks, the development of European standardisation, etc). Last but by no means least, economic operators must become acclimatised to the new legislative environment and learn how to turn legal developments into commercial opportunities. This learning process may take some time, and the current recession has reduced the scope and willingness on the part of companies to undertake adventurous cross-border expansion.

Nevertheless, there are some preliminary indications that anticipation effects unleashed by the the Internal Market programme have been the catalyst for a revitalisation of corporate strategies and a shake-up of market structures in many industrial and services sectors. Many companies have responded proactively to the emerging Internal Market and this has been reflected in the following trends:

- a surge in intra-EC foreign direct investment which has been heavily concentrated in those sectors most directly concerned by internal market liberalisation:

- the wave of cross-border mergers and acquisitions which has formed part of the increase in intra-Community FDI:

- increased interest on the part of third country investors in locating in the Community:

- indications that the Internal Market has been accompanied by profound changes in the degree of market integration in banking and insurance markets.

- marked evolution in the proportion of output from particular sectors which is sold on other Community markets, and an increasing share of national consumption which is met by intra-Community imports.

These trends suggest an increasing Europeanisation of companies sales strategies and increased competitive discipline on domestic incumbents in the markets concerned. The impact of the Internal Market on business dynamics and market structures will be examined in greater detail in the study which is to be finalised by the Commission before the end of 1996. This study will also analyse the contribution of the Internal Market to the realisation of other Community objectives, such as economic and social cohesion and the achievement of sustainable non-inflationary growth which respects the environment.

The Internal Market programme is not being constructed in an economic vacuum. The current recession, which has been provoked by forces unrelated to the completion of the Internal Market, has overshadowed the process of adaptation to the emerging single market framework. The depressed state of EC markets obscures the potential market openings created by the Internal Market. In addition, many, particularly small and medium sized, companies do not have the resources or are wary of positioning themselves in order to take advantage of opportunities which lie around the corner. However, there are reasons to believe that the restructuring and investment undertaken during the late 1980s in anticipation of the internal market have strengthened the underlying competitiveness of Community industry and services. These latent strengths

1 h

will provide individual companies with a springboard once economic recovery gets underway. In addition, the Internal Market has acted as a brake on any temptation on the part of Member States to renationalise certain elements of economic, monetary or commercial policy. Any misguided return to "go-it -alone" policies would have proved counterproductive for economic operators and the Member States concerned.

The recent widening of margins for exchange rate fluctuation contains some potential dangers for the operation of the single market, should these new exchange rate arrangements not be managed carefully. In particular, the increased scope for exchange rate fluctuations could disrupt the operation of capital markets, while sudden changes in relative competitiveness provoked by nominal exchange rate fluctuations could generate demands for safeguard restrictions on cross-border trade. To this extent, a return to greater exchange rate stability represents a precondition for the proper functioning of the Internal Market. Conversely, the Internal Market programme can promote structural and microeconomic convergence which is needed to sustain further progress towards Economic and Monetary Union.

PART ONE

PROGRESS IN ECONOMIC AND MONETARY CONVERGENCE

1. INTRODUCTION

The first stage of economic and monetary union (EMU) started on 1 July 1990. During this stage, the idea of economic convergence is embedded in the multilateral surveillance procedure (Council decision 90/141/EEC of 12.3.1990 on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union, OJ, L-78, 24.3.1990). This report is intended to fulfil the requirement of the Treaty on European Union (Article 109e, 2(b)) according to which, before the beginning of the second stage of economic and monetary union on 1 January 1994,

"The Council shall, on the basis of a report from the Commission, assess the progress made with regard to economic and monetary convergence, in particular with regard to price stability and sound public finances, and the progress made with the implementation of Community law concerning the internal market".

Part I of this report deals with the progress made in economic and monetary convergence. It covers aspects of nominal convergence, real convergence and convergence in supply conditions. Part II of the report focuses on progress with the implementation of Community law concerning the internal market.

Convergence is a wide and dynamic issue. Achieving a large degree of nominal convergence is the precondition for a smooth working of a stability-oriented monetary policy. Price stability is one of the main objectives of economic and monetary policy in the Treaty on European Union. A low inflation level is the basic target of monetary policy, while sound public finances contribute to achieving that goal. In countries where disinflation and fiscal consolidation must be achieved simultaneously, the need to avoid serious repercussions on employment will focus attention on complementary labour market policies. While achieving convergence in inflation and fiscal positions mainly depends upon the economic framework in an individual Member State, the stability of other variables, e.g. interest and exchange rates, depends also upon market perceptions of economic policies.

On the macroeconomic side the Treaty on Economic Union spells out nominal convergence requirements, but real convergence cannot be ignored. The Treaty lists four convergence criteria (Article 109 j and a separate protocol to the Treaty) to which the Member States[1] should make progress. Although Member States are not obliged to fulfil these criteria during the first stage of EMU, they clearly act as reference targets to which Member States should converge. This report, therefore, takes these criteria as

1) Denmark and the United Kingdom have opt-out clauses concerning the move to the third stage.