COMMISSION OF THE EUROPEAN COMMUNITIES

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1995 Annual Economic Report

(presented by the Commission)

1995 Annual Economic Report

Part A: Community-wide trends

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

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Summary and Conclusions

A much improved economic outlook ...

The Community economy is experiencing a strong recovery from the sharp downturn it endured over the period 1992-93. Output is growing and the pace of its expansion is stronger than had been anticipated. Exports to the rest of the world have been increasing rapidly throughout 1994 and the growth impulses coming from the external sector have been passed on to investment which is expected to expand vigorously in 1995 and 1996. Employment is forecast to start growing again leading to a small reduction in unemployment over the forecast period.

The strength of the recovery is also creating favourable conditions for the resumption of the catching-up process of the less favoured countries and regions. Progress is also expected in relation to nominal convergence, although additional efforts are clearly needed with regard to some Member States' deficit and debt positions.

The outlook for growth, employment and convergence in the Community is therefore substantially better than that prevailing at the end of last year when the Commission presented its White Paper on "Growth, Competitiveness and Employment". However, employment growth in 1995 and 1996 would still only result in a modest reduction in unemployment which will still be just below 10 percent in 1996.

but the policy challenges remain the same.

The improvement in the economic outlook does not therefore fundamentally change the challenges the Community is facing, which remain those of

i) achieving and maintaining high rates of job creation to substantially reduce unemployment and to offer employment to all citizens that so wish;
ii) achieving the degree of nominal convergence needed for the transition to Economic and Monetary Union.

Meeting these two challenges requires the same policies, i.e.:

- making the Community more competitive and dynamic;
- implementing policies aimed at improving the functioning of the labour market;
- creating the conditions for an increase in the productive capacity of the economy; and

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- maintaining a stable macroeconomic framework, in particular through the re-absorption of the high budget deficits inherited from the recession and the insufficient adjustment of structural deficits of the second half of the 1980s.

Additional efforts are needed to improve employment creation...

Large efforts are currently being undertaken to improve the dynamism and the competitiveness of the Community's economies. These policies will result in faster rates of productivity growth and, provided that the right macroeconomic framework is maintained and that the labour market responds in a flexible way, in higher rates of growth of output and employment. For this result to be achieved, policies should:

- strengthen the growth potential and the employability of individuals by improving education and training;
- reduce the tensions which might appear on the labour market as unemployment is reduced by enhancing, via a consensus approach, flexibility and by increasing the effectiveness of public spending in this area;
- increase the labour content of growth.

and economic convergence.

At the macroeconomic level an important challenge will be to maintain a stability oriented framework which simultaneously ensures that growth can remain strong over many years and that progress is made towards the degree of nominal convergence necessary to move to stage III of EMU.

This implies maintaining conditions where monetary policy is not unduly burdened by inappropriate budgetary and wage behaviour. Another macroeconomic challenge which must be met is to create the conditions whereby the potential rate of growth of the economy increases, thereby facilitating higher rates of output and employment growth without inflationary tensions. Increases in investment, structural reforms and the current efforts to increase the dynamism of the Community economy are all essential elements in this process.

But, if they are made, unemployment could be substantially reduced ...

If present efforts to improve the dynamism and competitiveness of the Community economy are intensified and if appropriate macroeconomic policies, along the lines discussed above, are strictly adhered to, the current recovery could be transformed into a

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sustainable medium-term process characterised by strong rates of growth in both output and employment and better economic convergence.

The Commission, as well as other international organisations and independent forecasters are suggesting that, under these conditions, it is reasonable to expect a growth path of between 3 and 3 ½ percent in the second half of the present decade. This would lead to the creation of about 10 million additional new jobs by the year 2000, thereby reducing unemployment to around 7 percent of the active population; which would still, however, amount to almost 11 million people unemployed.

However, while these results look impressive, they do not correspond entirely to the objectives of the White Paper and to the expectations of the citizens of the Union. These can only be achieved if substantial efforts are devoted to improving the capacity of the Community's economy to create jobs for any given rate of output growth.

and the conditions for EMU achieved.

The inflation situation in a majority of Member States is now broadly satisfactory with wage moderation and substantial productivity increases helping to make additional progress towards convergence in the rates of inflation. Exchange rates have been stable and progress has also been made towards convergence of long-term interest rates. Unsatisfactory progress, however, has been made in reducing budget deficits.

Current forecasts show that the recovery could entail the risk of a resurgence in inflation but that this risk is manageable provided policies remain oriented towards stability. Budgetary consolidation, on the other hand, could benefit substantially from the improvement in the economic conditions. If additional efforts are made along the lines agreed in the Broad Economic Policy Guidelines of 1993 and 1994, there is a realistic chance of achieving the goal of having a majority of Member States fulfilling the convergence criteria by 1996-97.

This historic opportunity should not be missed.

The most important policy risk surrounding this favourable outlook is that the improved economic prospects might lead to a lapse in the determination of policy makers to attack the macroeconomic and structural causes of the present high levels of unemployment. During the period of strong growth in the second half of the 1980s, most Member States partly missed the opportunity to consolidate their public finance positions and to

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undertake the necessary structural reforms. Much was done but not enough. Countries must learn from this experience and avoid repeating the same errors.

Provided that the policies agreed in the Guidelines exercises are now speedily and assiduously implemented, the Community could be on track to simultaneously achieve two very significant economic objectives:

- creating 15 million new jobs by the end of the decade, thereby cutting the current rate of unemployment by half ; and
- entering stage III of EMU according to the timetable indicated in the Treaty.

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Chapter 1: A stronger than expected recovery

The Community economy is experiencing a strong recovery. Exports to the rest of the world have been increasing rapidly throughout 1994 thanks to dynamic export markets and the better competitive position of Community firms. The growth impulses coming from the external sector have been passed on to investment which has recovered from the very steep decline of 1993 and is expected to expand vigorously in 1995 and 1996. Employment is expected to increase again in 1995 and 1996 leading to a small reduction in unemployment. The pattern of the recovery and the good productivity and profitability trends suggest that it will be possible for the Community economy to experience strong rates of sustainable growth over the medium term.

1.1 A Favourable International Environment

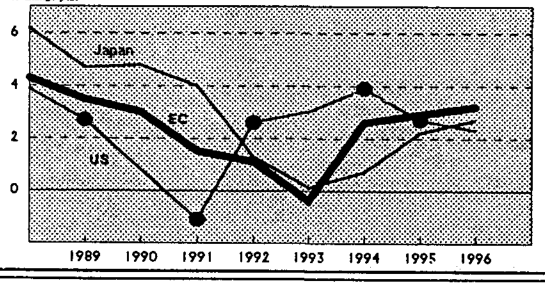
World growth continued to expand strongly in 1994. The rate of world economic growth excluding the Community increased from 2.5 per cent in real terms in 1993 to 3 per cent in 1994 (see tables 1 and 5). This good performance is expected to continue in 1995 and 1996 with rates of growth of 3 and 3 ¼ percent respectively. The 1994 performance stemmed essentially from the continuing strong evolution of the North American economies, the slow emergence of Japan from one of the deepest downturns in its recent history and the on-going very strong expansion of the dynamic Asian economies.

The strengthening of growth in the rest of the world in 1995 and 1996 is projected to occur despite expectations of a progressive slowdown in growth in both the US and Canada The forecast improvement therefore emanates essentially from stronger performances from other industrialised countries such as Japan and from a steady gain in the growth momentum of the non-OECD countries as a bloc.

World import growth in volume terms, excluding the Community, is projected to maintain a high rate of expansion. After the sharp pick-up experienced during 1993 and 1994, when import growth averaged close to 10 percent per annum, 1995 and 1996 should continue to witness buoyant rates of import growth of the order of 8 percent (see table 1). Import demand in the US will continue to grow strongly in 1995-96 but at rates lower than in 1994 reflecting the impact of cyclical

Chart 1

Growth in Japan, US and in the Community



factors. The double-digit import growth of the dynamic Asian economies in 1994 is forecast to continue with rates of growth in excess of 12 per cent expected in both 1995 and 1996. Japan, which is slowly emerging from recession, is forecast to increase imports by 5.5 and 7 per cent respectively over the next two years. While the overall rate of world import growth may be slightly lower in 1995/96 compared with 1994 this must be put in context; rates of import growth of 8 percent or more are well above the average annual rate of expansion experienced during the last two decades.

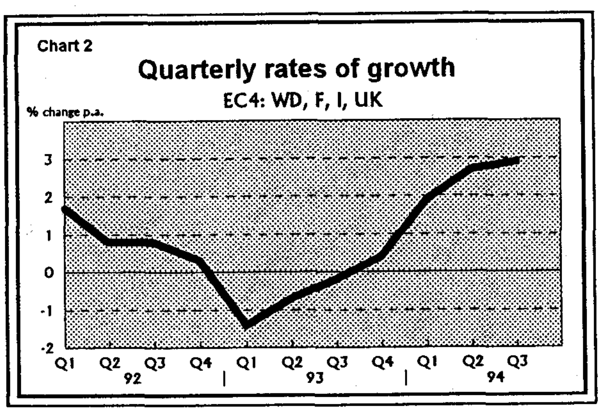
Table 1: World Growth

	1993	1994	1995	1996
GDP /GNP (annual real % change)				
World(excl. EC)	2.5	3.0	3.1	3.3
USA	3.1	3.9	2.7	2.3
JAPAN	0.1	0.7	2.2	2.7
DAE a)	6.3	7.3	7.1	7.1
IMPORTS (annual real % change)				
World (excl EC)	9.4	9.9	8.2	7.9
USA	10.8	12.8	8.0	6.5
JAPAN	6.4	11.0	5.5	7.0
DAEa)	14.9	12.6	12.4	12.2

European Commission forecasts
a) DAE: Dynamic Asian Economies

1.2 Growth and employment in the EC

In the context of a favourable international environment the Community[1] economy is witnessing a stronger than expected recovery in economic activity. GDP is now estimated to have grown by 2.6 percent this year compared with a decline of 0.4 percent in 1993. Exports to the rest of the world, which had helped reduce the size of the downturn in 1993, constituted the engine behind the recovery. Investment, which had declined significantly in 1993 picked up again in 1994 and contributed positively to output growth. In fact, the stronger than expected pace of the recovery results essentially from the unexpectedly rapid response of investment and of the other components of domestic demand to the growth stimuli coming from foreign trade which was also more vigorous than previously anticipated.



The strength of the recovery became evident in the summer of this year with the release of the growth figures for the second quarter of 1994 (see chart 2). The Community economy is expected to build on this recovery by expanding at

1 The term "Community" refers only to the 12 present Members as of December 1994. Because of the Accession of three new countries - Austria, Finland and Sweden - at the beginning of 1995 it was decided to include a box (see pages 12/13) which provides information on the economic situation and outlook for the countries concerned

real rates of around 3 per cent in both 1995 and 1996. A characteristic feature of the growth process is the convergence of growth rates amongst the Member States: only Ireland and Greece are expected to deviate more than ½ a percentage point from the average growth rate for the Community during the next two years.

Table 2 :
The Community economy : use and supply of goods and services

(annual real percentage change)	1986-90	1991-92	1993	1994	1995 a)	1996 a)
Private consumption	3.7	1.8	- 0.1	1.5	2.0	2.5
Government consumption	2.0	1.6	0.7	0.7	0.8	1.0
Gross fixed capital formation	5.8	- 0.8	- 5.5	2.4	5.7	6.3
of which: equipment	*6.9*	*- 1.6*	*- 9.1*	*1.9*	*7.3*	*7.7*
of which: construction	*4.6*	*0.1*	*- 2.0*	*2.9*	*4.5*	*5.1*
Domestic demand (incl. stocks)	3.9	1.0	- 1.8	2.0	2.8	3.1
Exports of goods and services b)	¼	5	7 ½	10	7	6 ¾
Imports of goods and services b)	6	3	- ½	4 ½	6	6
GROSS DOMESTIC PRODUCT	3.3	1.2	- 0.4	2.6	2.9	3.2

a) November 1994 Forecasts b) Extra-Community trade only (estimates)

The 1992/93 recession led to a sharp drop in employment in the Community: nearly 4 ½ million over the two years in question. During this period, the labour force continued to grow modestly notwithstanding a substantial, cyclically-induced, drop in the participation

Table 3: GDP growth
(annual real percentage change)

	1993	1994	1995	1996
B	- 1.7	2.2	2.7	3.1
DK	1.4	4.8	3.2	3.0
D	- 1.2	2.5	3.0	3.4
GR	- 0.5	0.4	1.1	1.7
E	- 1.1	2.2	2.8	3.2
F	- 1.0	2.2	3.2	3.2
IRL	4.0	6.0	5.6	5.3
I	- 0.7	2.4	3.0	3.2
L	0.3	2.3	3.0	3.2
NL	0.3	2.3	3.2	3.3
P	- 1.2	1.1	3.0	3.2
UK	2.0	3.8	2.7	2.8
EC	- 0.4	2.6	2.9	3.2

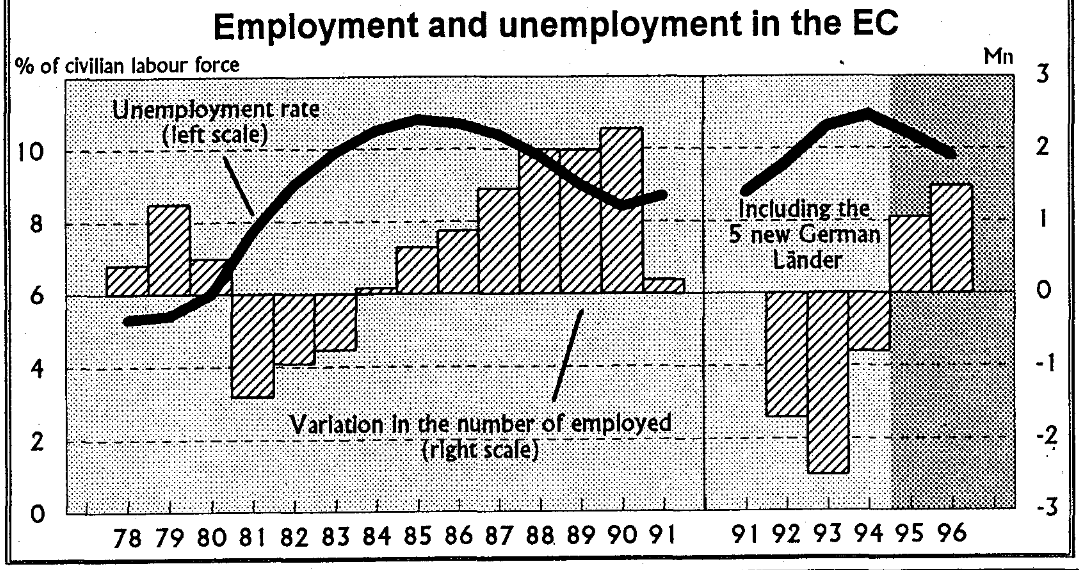
Source: European Commission's November 1994 Economic Forecasts

Table 4: Unemployment
(percentage of the civilian labour force)

	1993	1994	1995	1996
B	9.4	10.0	9.8	9.3
DK	10.3	10.2	9.0	8.0
D	7.0	7.3	7.0	6.4
GR	9.7	10.2	10.6	10.8
E	21.8	22.4	21.9	21.2
F	10.8	11.3	11.0	10.6
IRL	18.4	17.7	16.8	15.7
I	11.1	11.8	11.1	10.4
L	2.6	3.3	3.2	3.1
NL	8.8	10.0	9.8	9.4
P	5.1	6.1	6.0	5.6
UK	10.4	9.4	8.5	7.6
EC	10.6	10.9	10.4	9.8

Source: European Commission's November 1994 Economic Forecasts

Chart 3



rate. As a result, a large deterioration in the unemployment situation in the Community took place, with the numbers out of work, as a percentage of the civilian labour force, growing from 8.8 per cent in 1991 to 10.6 per cent in 1993. Given the lags with which employment trends usually follow output growth, unemployment in 1994 went on increasing and is estimated to have reached a level equal to about 11 percent of the civilian labour force (see table 4).

After three consecutive years of declining labour demand, that resulted essentially from recession and the subsequent large-scale reorganisations undertaken by many companies, employment is set to increase again in 1995 and 1996. Given the expected increase in the labour supply, these increases in employment will not be fully mirrored in reductions in average unemployment in the Community. Consequently, the unemployment rate, although diminishing, will remain at very high levels during the next few years and the concern about the creation of new jobs will continue to have priority in the economic policy agendas of the Member States and at Community level.

The average unemployment rate is expected to fall to 10.4 per cent in 1995 and to just below 10 per cent in 1996. Behind these average figures lie large differences in the level of unemployment that will not be levelled out in the near future (for example, while Luxembourg's unemployment rate is expected to be 3.1 per cent in 1996, Spain will still be experiencing a rate above 21 per cent).

1.3 Growth Promoting Factors

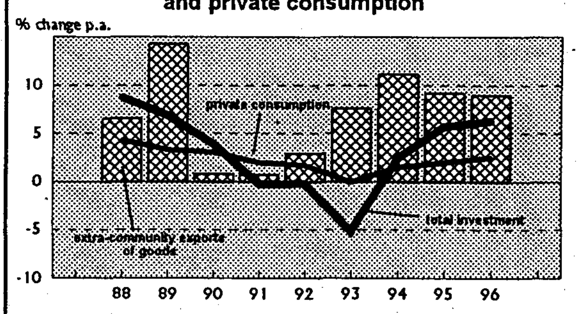
The Community is experiencing a recovery process characterised by an initial export-led rebound being followed by investment growth and, subsequently, by a revival in private consumption. Extra-Community exports underpinned recovery in late 1993 and early 1994, thanks to strong extra-EC market growth allied to market share gains. Extra and intra-Community trade growth became mutually reinforcing, bolstering a strong improvement in confidence. While intra-Community trade in 1995 and 1996 is expected to grow as rapidly as the still buoyant rates of growth predicted for extra-EC exports, the balance of growth-inducing forces is expected to shift over the forecast period with domestic demand, and in particular business investment, increasing in relative importance.

1.3.1 Exports

Fast-growing exports to the rest of the world have been a specific feature of the current recovery in the Community, with domestic producers increasingly drawn to foreign markets to compensate for the downturn in domestic activity. A geographical breakdown of the destination of these increases in extra-EC exports in 1993 and the first quarter of 1994 indicates strong export growth to virtually all extra-Community countries and regions. The strong rates of export growth registered from the second quarter of 1993 onwards reflect the impact of strong import demand in most of the Community's main export markets: North America, Japan, South East Asia, China and Latin America.

Chart 4

EC: extra-community exports; investment and private consumption



The growth in export markets was combined with market share gains achieved following competitiveness improvements emanating from both a considerable reduction in the pace of wage increases combined with unusually high productivity growth and a real depreciation of the EC currencies as a bloc of more than 15 percent over the period August 1992 to February 1994. Extra-EC export market growth (non-EC imports weighted with the shares in the Community's total exports to non-EC countries) is expected to register annual growth of 7 - 7 ½ per cent over the forecast period.

In relation to the future growth perspectives for individual Member States it is interesting to note that intra-EC trade is staging a strong revival. While an accurate assessment of the role of intra-EC trade in any ongoing upturn is not possible, given the lack of reliable and timely data, it would appear from the available statistical evidence that intra-EC trade has picked up significantly in the first half of 1994 following a sharp fall in 1993. Intra-EC exports of goods are estimated to grow by about 7 ½ per cent in 1994 and by a similar magnitude in both 1995 and 1996. Given domestic demand growth in the Community of the order of 2-3 per cent over the same period, the strength of the recovery in intra-EC trade is evidence perhaps of a reduction in internal trade barriers driven by the impetus of the 1992 internal market programme. This rebound in trade between Member States is an important factor in underpinning the sharp pick-up in industrial confidence in 1994. With the expected continuance of strong intra-Community trade volumes in 1995 and 1996 this will undoubtedly help to support the impressive revival in investment which is projected to occur in these years.

Table 5

International economic environment

(real annual percentage changes)

	1993	1994	1995	1996
World output growth excl. EC	2.5	3.0	3.1	3.3
World import growth excl. EC	9.4	9.9	8.2	7.9
Extra-EC export market growth	6.8	8.9	7.4	7.1
Extra-EC exports (a)	8	10 ½	7 ½	7

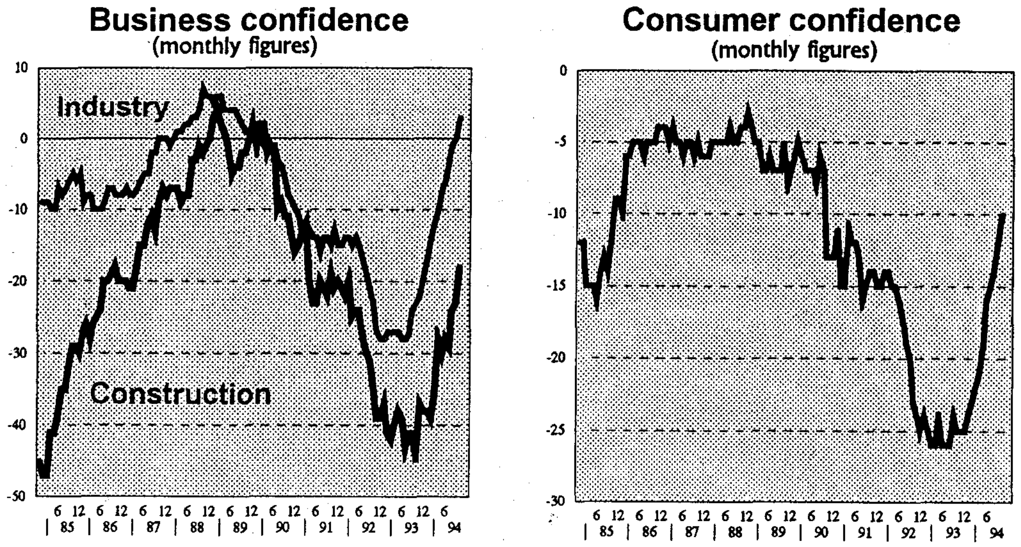
Source: Commission services November 1994 forecasts
(a) Commission services' estimates

1.3.2 Domestic Demand

The growth impulses coming from the external sector spilled over to domestic demand. Gross fixed capital formation is estimated to expand by around 2 ½ percent in 1994 and is forecast to grow by between 5 ½-6 ½ percent annually in 1995/96, a remarkable turnaround on the 1993 decline of over 5 percent. As regards private consumption, it is estimated to have grown by 1 ½ percent in 1994 and is forecast to increase by 2 and 2 ½ percent in 1995 and 1996. Although significant efforts are being undertaken to consolidate public finances, which will result in general government expenditure increasing more slowly than GDP over the next two years, public consumption should continue to grow in 1995 and, on the usual no policy-change assumption, even accelerate

Chart 5

Community-Survey indicators



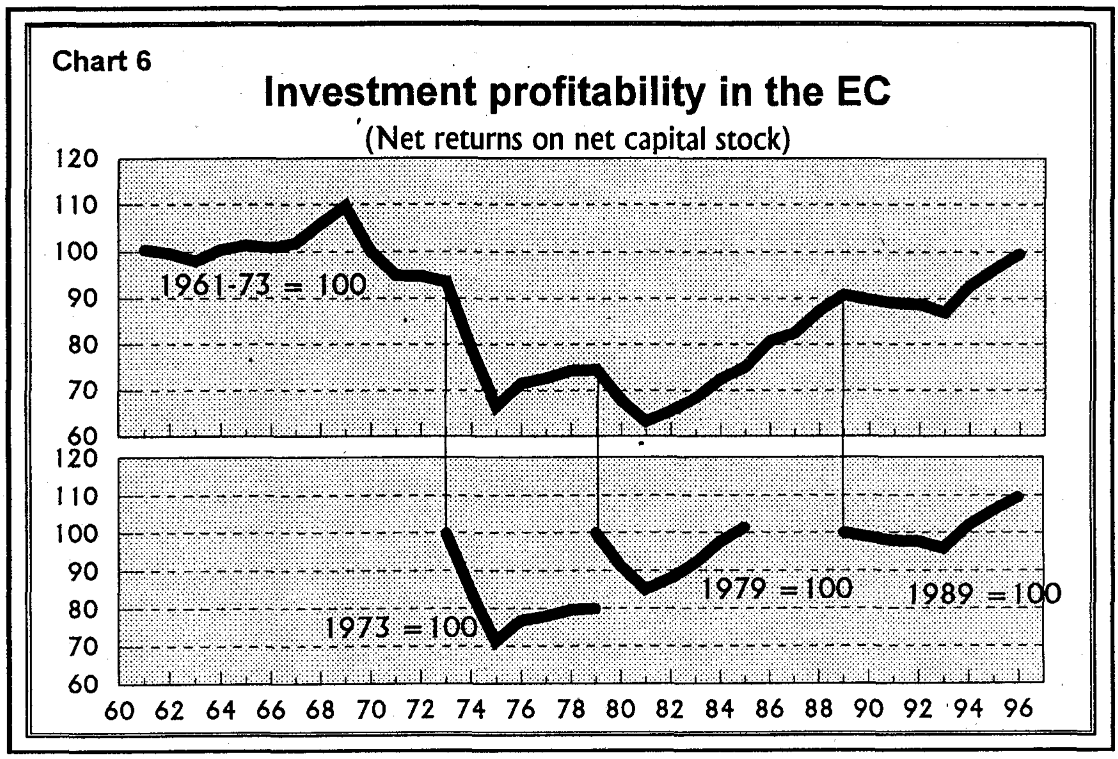
slightly in 1996. Finally, stockbuilding, which is estimated to have contributed half of a percentage point to the rate of growth of GDP in 1994, is expected to continue to contribute positively in 1995/96 but by a smaller amount. Overall, for the Community as a whole, domestic demand is expected to grow by close to 2 percent in 1994 and to expand by 2 ¾ and 3 percent in 1995 and 1996 respectively.

Investment

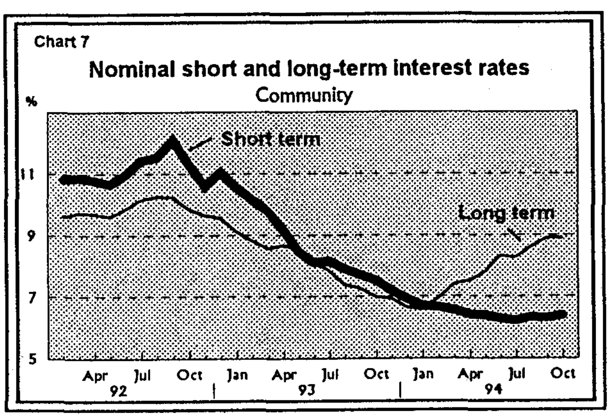
As the recovery process deepens, investment is poised to overtake exports as the major growth impetus. The White Paper on *"Growth, Competitiveness, Employment"* indicated that the transition to a medium term growth path which could open the possibility of a significant reduction in unemployment implied a real growth of capital formation of 6-7 per cent p.a. or more. Such growth rates are indeed expected in the Community over the next two years. This expected performance would exceed that experienced in the wake of the recovery following the 1975 recession and exceed, by far, the investment pattern observed during the slow recovery in the first half of the 1980s. Several factors are contributing to the improved outlook for investment:

- demand and output in the Community, supported by a favourable external environment, has been rising for a number of quarters and expectations for continued improvement are well grounded and widespread;
- capacity utilisation rates have risen significantly in recent months with a number of countries reporting capacity constraints in certain export sectors;

- investment profitability remains healthy despite the depth of the recent recession and in addition is expected to improve further in 1995-96;
- a recovery in business and consumer confidence.



Business confidence is expected to continue its upward trend with the pickup in demand filling order books and eventually inciting companies to expand their productive capacities. Improved expectations of recovery, the absence of ERM tensions and the growing degree of certainty surrounding the European integration and enlargement processes all helped to bring about a strong improvement in the confidence of economic agents (see chart 5). This is evident in the results of the recent surveys on business confidence which show a spectacular rebound in sentiment since the autumn of last year. The strength of the revival is unparalleled in previous upturns with industrial confidence



levels now back at the levels reached in 1988 and 1990. Export volume expectations, foreign order books and production expectations have all staged a strong recovery over recent quarters.

This recovery in confidence is occurring despite the sharp increase in long-term interest rates in the Community which has occurred in the course of the year. Such increases could be expected to have negative consequences on investment spending. On balance, however, the negative effects pertaining to the latter would appear to have been outweighed by the other determinants of investment, such as demand expectations and the cash flow position of firms, which have been in a strong position throughout the year. Business profitability has, in fact, remained comparatively high throughout the downturn thanks to strong productivity increases, resulting from labour shedding, and low rates of increase in wages per head. Investment profitability is expected to remain strong in both 1995 and 1996 with real unit labour costs forecast to decline by 1.4 and 1.2 percent respectively.

Table 6

Labour productivity

	1961-73	1974-85	1986-90	1991-96	1992	1993	1994	1995	1996
B	4.3	2.1	1.9	1.8	2.3	- 0.3	2.6	2.0	2.1
DK	3.2	1.5	1.2	2.3	1.4	2.0	4.7	1.5	1.4
WD	4.0	1.9	1.9	1.8	0.9	- 0.1	3.2	2.2	2.2
GR	8.1	1.6	1.0	1.0	- 0.6	- 1.5	0.7	0.9	1.3
E	6.5	3.2	1.2	2.1	2.0	3.3	2.9	1.2	1.2
F	4.7	2.1	2.4	1.7	2.0	0.2	2.4	2.4	2.2
IRL	4.3	3.7	4.0	3.1	4.5	3.3	3.3	2.6	2.1
I	5.5	1.8	2.4	2.1	1.8	2.2	4.0	2.2	2.1
L	3.0	1.2	1.3	0.1	0.0	- 1.1	0.6	1.0	1.1
NL	3.9	2.0	1.1	1.2	0.4	0.5	2.2	1.9	1.5
P	6.6	2.6	4.6	1.8	1.7	0.8	1.5	2.9	2.7
UK	2.9	1.6	1.5	2.3	1.7	3.7	3.8	1.9	1.7
EC *	4.4	2.0	1.9	1.9	1.6	1.4	3.1	2.1	2.0

* excluding the five new German Länder

Private Consumption

In 1994, the volume of private consumption increased by 1.5 per cent notwithstanding a near stagnation of households' real disposable incomes. This increase was made possible by a reduction in the household saving ratio of one percent. This drop in the ratio reflects the impact of improved consumer confidence. This confidence has been nurtured by increased optimism with regard to the sustainability of the recovery process and by evidence in recent months of a small but consistent drop in the rate of unemployment in the Community. In addition, successive years of low consumption growth in several Community countries have led to the creation of a considerable amount of pent-up demand for consumer durables. Lower interest rates and fiscal incentives appear to have prompted increased expenditure on such items in 1994.

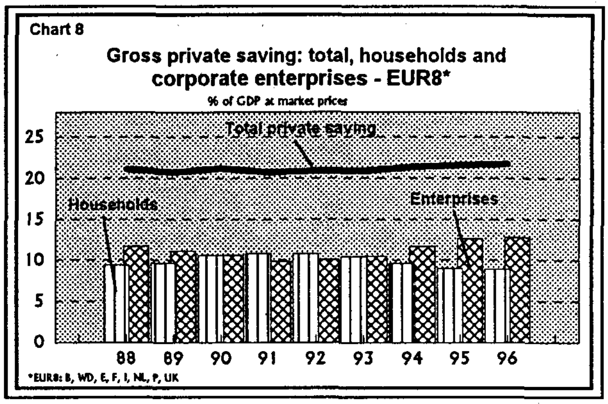


Chart 8
Gross private saving: total, households and corporate enterprises - EUR8*

These trends are forecast to continue and strengthen into the near future. Private consumption is projected to increase by 2 per cent next year and 2 ½ per cent in 1996 against smaller rates of increase in households' real disposable income. As a result the savings ratio is forecast to decline by another half a percentage point over the next two years. It should be pointed out, however, that this decline in the households savings ratio is not a source of immediate concern. This process of reduction is essentially one of normalisation following increases in the ratio during the years of slowdown and recession in the Community.

Furthermore, as chart 8 indicates, the trend for total private saving, which is an aggregation of household and corporate sector savings, has in fact not changed substantially over the recent past. In fact, total private savings are expected to grow modestly over the forecast period as a result of the strength of corporate profit growth. This overall pattern of declining household saving providing a boost to private consumption allied to increasing corporate sector saving which should underpin investment activity is in keeping with the balanced growth path to the year 2000 seen as desirable by the Commission, built on annual changes in consumption growth of the order of 2 ½ per cent and investment of 6-7 per cent.

1.4 Favourable outlook not without risks and uncertainties

The overall favourable outlook for growth and the turnaround in labour market developments should not lead to reduced attention being given to the risks and uncertainties related to economic developments in the immediate future.

The expected sharp improvement in investment relies not only on better business prospects, founded on a favourable demand outlook, but also on the anticipated further increase in profitability and on a reasonable relationship between borrowing costs and expected real returns on investment. In this context, concerns have been expressed about the possible effects on the real economy of a continuation of the upward movement of long term rates that has occurred since the beginning of 1994.

Another concern that has been discussed in recent months is the possible effect on the outlook for Community exports of renewed dollar weakness vis-à-vis European currencies. This would not only affect exports to the USA and countries whose currencies are linked to the US dollar but would also be likely to have a negative impact on market shares in all other countries. In addition, the present outlook is based on the forecast that energy prices would remain relatively stable. Any substantial departure from this assumption could have significant negative repercussions.

Substantial policy risks may also result from the projected strong economic performance itself. Progress could be negatively influenced in three main areas:

i) Firstly, the recovery is creating a positive cyclical contribution to current receipts of the public authorities and is thereby automatically reducing the net borrowing of most Member States. If governments tend to be satisfied with the improvements achieved by cyclical movements the return to sustainable debt levels in the medium term would be rendered more difficult, with negative consequences for inflationary expectations, long term interest rates and, ultimately, economic growth.

ii) Secondly, the better than expected performance of the Community economy might lead to less determined action to improve job prospects and reduce rigidities through labour market reforms, which would have grave repercussions on the prospects for reducing unemployment substantially in the medium term.

iii) Thirdly, capacity constraints may start emerging as the recovery strengthens with a risk that the monetary authorities may have to adopt a tighter policy course in the absence of appropriate budgetary and wage behaviour. It should be stressed, however, that this is not an immediate risk with the appearance of inflationary pressures not likely to emerge before the end of 1995. The timing of any re-awakening of price pressures will, of course, be dependent on the speed with which the output gap is closed. Significant differences exist, in this respect, between Member States.

While not downplaying the seriousness of these risks, the present momentum of the recovery seems strong enough to warrant the relatively optimistic forecasts presented in this report. In addition, the progress made in increasing productivity, in maintaining and improving profitability levels and in enhancing the Community's competitive position suggest the capacity to withstand external developments less positive than those presented here. Indeed, it cannot be excluded that the growth path during the next two years will be even more favourable than currently assumed if the growth promoting factors expected to be at work turn out to have a more significant effect on the economy than presently envisaged.

BOX 1

The Economies of the New Member States

Enlarging the Union: The three countries scheduled to join the European Union at the beginning of 1995 will augment the Union area by a good third (37%) and the number of Union citizens by around 6%, whilst Union GDP will increase by 7%. In 1993, GDP per head of population measured in PPS was above the EU average in Austria (9%), while it was just below average in Sweden and 14% below average in Finland.

General economic situation: The European Union is the most important trading partner for the new member countries, comprising between 47% (Finland) and 66% (Austria) of their external trade. Cyclical developments and synchronisation in the Nordic countries have differed from the EU, while the correlation of the Austrian and the Union cycle has been particularly marked. While the cycle in Austria slowed down in line with the EU in the early 1990s, Sweden's economy contracted sharply after substantial overheating during the 1980s and output in Finland slumped after domestic overheating and as previously significant exports to the Soviet Union collapsed after 1989.

Labour market: Historically, all three countries had an outstanding employment and unemployment record, compared with most Union countries. In all these countries, incomes policies have been highly centralised and extensive labour market measures were in place especially in the Nordic countries. The recent economic downturn has, however, pushed open unemployment in Sweden from 2% to an unprecedented 8% (an additional 5% are in active labour market programmes) and in Finland from 4.5% to an extraordinary 19%.

Inflation and interest rates: While the Austrian inflation rate (CPI) has been below the EU average for a long time due to the peg of the Schilling to the DM, Finland's rate was mostly slightly above the Union average and Sweden's inflation used to be substantially above the Union average in the 1980s. After the 1992 currency turmoil, monetary policy in the Nordic countries has been set to contain inflation. Thus, the underlying inflation rates are under control in all the new member countries. Long-term interest rates in Austria are presently well below the Union average, with those of Finland and Sweden being above, reflecting, inter alia, the state of the public finances in the latter countries.

External balance: The current account balance in Austria has been broadly balanced since the early 1980s, benefiting from compensating cyclical movements of its elements. Finland's balance deteriorated in 1989 to 5% of GDP due to the slump in exports. The recent export-led upswing has reversed this unsustainable deficit to a surplus of some 2%. Sweden mirrored Finland on a more moderate scale, as the deficit was mainly due to domestic factors.

Public finances: Shares of public expenditures in GDP have exceeded the EU average substantially in Sweden and slightly in Austria. In Finland it has exceeded the EU average only during the recent recession, while it was markedly smaller before. While the general government net financial balance has fluctuated closely around -3% of GDP for 20 years in Austria and was moving between +1% and +7% in Finland, swings were marked in Sweden. The recent recession has led to a deterioration in Austria's general government deficit by more than 2 percentage points to 4.1% of GDP in 1993. The recession had an even more serious effect on Finland and Sweden, with deficits of 7% and 13% of GDP, respectively, in 1993. Government debt as a percentage of GDP has risen recently just above 60% in Austria. While recession and devaluation of the currency have pushed the gross debt ratio up by 36 percentage points to some 88% of GDP in Sweden in the period 1990-1994, these factors increased the Finnish debt ratio by 58 percentage points to about 72% of GDP over the same period.

Exchange rate policy: All the new member countries pursued fixed exchange rate policies prior to the turmoil in European currency markets in the second half of 1992. Austria was unaffected by the turbulence and was able to maintain its exchange rate objective, vis-à-vis the DM in this case. After substantial devaluations of the Finnish and Swedish currencies, the Nordic new member countries have opted for floating regimes, which required new guidelines for monetary policy. Both Finland and Sweden have chosen explicit inflation targets.

Economic outlook for 1995/1996

In general, the three new Member States are expected to perform well during the next two years, but there are notable differences between them. The new Member States have to undertake the same efforts as existing Union Members in order to reach the policy objectives of the Community.

In **Austria**, exports of goods and investment push real GDP growth close to and then slightly above 3% in the period 1994-1996. Price increases remain moderate at 3%, with only 2 ½% in 1995, due to lower food prices as a result of accession. As employment increases quickly, unemployment should come down some ¾ of a percentage point to 5 ¼%. The transfers to the EU budget and adjustment measures push the general government deficit to almost 5% of GDP in 1995, before automatic stabilisers reduce it.

Finland emerges from the deep recession via an exceptionally strong export performance, helped by the currency devaluation, which boosts investment in equipment at outstanding growth rates above 20% in 1995 and 1996, though mainly in export industries. GDP growth of 4 ¾% on average during the three years should lower unemployment from 18% to a still high 14% in 1996. Inflation remains at moderate levels, as private consumption is still subdued relative to capacity in the domestically oriented sector. The general government deficit will stay around 5% in 1994 and 1995 due to postponed tax refunds, before it comes down to 2 ½% in 1996. The net transfers vis-à-vis the EU budget should be close to balance.

Sweden's economic activity is forecast to expand by close to 3% per year through to 1996. While high export growth and associated investment pulled Sweden out of recession in 1994, domestic demand gradually takes over as the driving force in the forecast period. Inflation, after having been pushed upwards by the currency devaluation, should benefit from moderate unit labour cost increases, supplemented, however, by pressure from indirect tax increases in the forecast period. Employment, which contracted in 1994 by close to 1%, should expand at around 1 ½% in 1995 and 1996, thereby gradually reducing open unemployment to just below 7%. Public consumption is expected to decline in real terms in order to regain control of the general government deficit. The deficit peaked at 13 ¼% of GDP in 1993 and should come down to a still high 7 ¼% in 1996.

Chapter 2: Further progress in convergence

Wage moderation, substantial productivity increases and a still relatively low degree of capacity utilisation have all helped to make additional progress towards convergence in the rates of inflation. The inflation situation in a majority of Member States is now relatively satisfactory. Unsatisfactory progress, however, has been made in reducing budget deficits. The strength of the recovery is offering an opportunity to step up efforts in this area. Exchange rates have been stable and progress has also been made towards convergence of long term interest rates. Provided that additional efforts are made, especially in the budgetary area, it is now realistic to expect that a majority of Member States could meet the EMU criteria by the deadlines set out in the Treaty. The strength of the recovery is also creating favourable conditions for a resumption of the catching-up process of the less favoured countries and regions.

2.1 The recovery favours real convergence

Recent real convergence trends are conventionally examined on the basis of the relative position of countries in terms of GDP per capita. However, limiting the analysis to the level of the Member States very often masks some important differences between smaller geographical units such as regions[2]. Indeed, disparities between the regions of the Community in general show a more varied picture than that suggested by an analysis at the level of the Member States. Unfortunately, regional data are available only with a substantial delay and the assessment of recent real convergence trends must therefore be conducted on the basis of country data. On this basis, progress was mixed in 1993-94: while Ireland improved its relative position in terms of GDP per head, that of Spain hardly changed and those of Portugal and Greece deteriorated somewhat. In 1995 and 1996, the real convergence process is expected to continue for Ireland, to resume in Spain and Portugal, while the relative position of

Table 7: GDP per head
(PPP, Community = 100)

	1980	1985	1990	1992	1994	1996
B	106.8	104.5	103.6	107.0	105.8	105.9
DK	105.9	113.7	105.0	103.4	108.3	108.9
WD	117.8	118.3	116.5	120.1	116.1	114.5
D	-	-	-	105.7	104.9	105.3
GR	64.1	62.5	58.2	59.7	58.3	56.5
E	71.7	70.1	74.5	75.1	74.9	75.3
F	112.8	111.5	110.0	108.7	108.0	108.3
IRL	62.0	63.5	71.1	75.7	82.3	86.9
I	102.5	102.9	103.2	103.8	104.3	105.5
L	115.6	119.8	125.8	127.3	129.7	128.4
NL	107.6	103.8	101.2	99.4	99.6	99.4
P	52.8	51.1	55.5	59.9	59.2	59.7
UK	97.1	100.3	100.8	95.6	99.7	99.6
EC(1)	100.0	100.0	100.0	100.0	100.0	100.0
EC	_	_	_	97.6	98.1	98.5

(1) Excluding the five new German Länder

2 Regional trends are analysed in: European Commission (1994), Competitiveness and cohesion: trends in the regions, Fifth Periodic Report on the Social and Economic Situation and Development of the Regions of the Community.

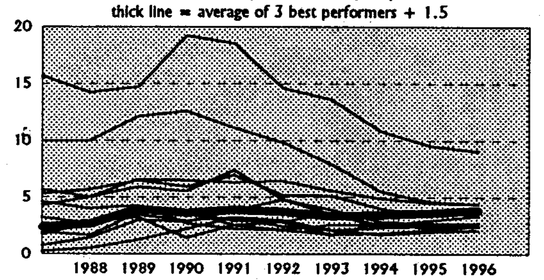
Greece is projected to deteriorate further.

These trends are best assessed against the overall trend in real convergence over the last decade which saw a slight widening in disparities between 1980 and 1985 followed by a period of narrowing which came to a halt in 1992 due to the slowdown in activity in the Community. Spain and Portugal were able to improve their relative positions by 4.9 and 7.4 percentage points of the Community average respectively since 1986, the year in which they joined the Community. An even more impressive performance was registered in Ireland, which increased its relative position by around 21 percentage points of the Community average during the same period. Despite a slight improvement between 1990 and 1992 Greece was the only country in this group to register a deterioration in its relative position compared to the situation prevailing in the early 1980s.

Chart 9

Inflation convergence in the Community

Deflators of private consumption, thick line = average of 3 best performers + 1.5



2.2 Nominal convergence on a promising trend

Following a significant setback during the early 1990s, renewed progress has been made towards greater nominal convergence in the Community. However, what has been achieved is not yet entirely satisfactory and in order to achieve the targets set out in the Maastricht Treaty additional efforts will have to be undertaken.

2.2.1 Moderate price increases achieved and expected

The inflation performance of the Community has improved significantly. After a peak of 5.4 percent in 1991, the average rate of inflation, measured by the private consumption deflator, declined continuously and is estimated to have reached 3.1 per cent in 1994. It is expected that average price increases in the Community will decline further in 1995 but that there could be a modest acceleration in 1996.

Average inflation in the Community, on the basis of the private consumption deflator, was 4.7 percent in 1990, and in terms of the GDP deflator, 5.2 percent. A further deterioration in inflation occurred in 1991, with both indices recording inflation at 5.4 percent. In the case of Germany, the increase reflected the strong growth in internal demand resulting from unification-induced public expenditure and tax increases, but several other Member States (France, Ireland, Italy, the Netherlands and the UK) also experienced an acceleration in inflation.

Early signs that inflation was decelerating emerged in 1992 and inflation has been on a downward trend since. The private consumption and the GDP deflator recorded average inflation at virtually the same rate (4 ½ percent) in 1992, and at 3.9 and 3.7 percent, respectively, in 1993. In the course of 1994, additional declines in inflation were achieved bringing the figures for the Community as a whole to historically low levels: the private consumption deflator is expected to rise by 3.1 percent and the GDP deflator by 2.7 percent.

Table 8

Inflation developments

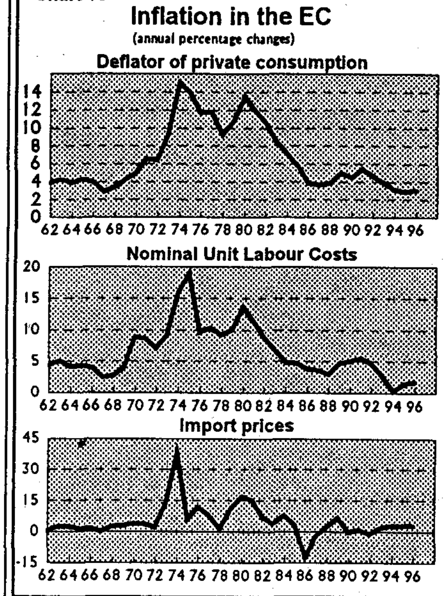
(percentage change in the deflator of private consumption)

	1990	1991	1992	1993	1994	1995	1996
B	3.6	2.5	2.1	2.6	2.6	2.5	2.6
DK	2.7	2.2	2.1	1.7	1.8	2.1	2.4
D *	2.8	3.8	4.8	3.9	2.8	2.2	2.4
GR	19.2	18.5	14.6	13.6	10.8	9.5	9.0
E	6.5	6.3	6.4	5.6	4.9	4.5	4.4
F	2.9	3.2	2.4	2.1	1.7	1.9	2.1
IRL	1.6	2.5	2.8	1.6	2.8	2.7	2.7
I	5.9	6.9	5.2	5.1	4.0	3.5	3.5
L	3.6	2.9	2.8	3.6	2.3	2.5	2.7
NL	2.2	3.2	3.0	2.1	2.3	2.4	2.5
P	12.6	11.1	9.8	7.9	5.5	4.6	4.4
UK	5.5	7.4	4.8	3.5	2.5	2.9	3.3
EC12	4.7	5.4	4.6	3.9	3.1	2.9	3.1
GDP Deflator EC12	5.2	5.4	4.5	3.7	2.7	2.8	3.0
Unit Labour costs EC12	6.0	5.5	4.6	2.7	0.2	1.4	1.8

Source: November 1994 forecasts by the Commission services * West Germany for 1990 and 1991

The reduction in inflation to the low rate recorded this year has been the result of several factors. First, actual inflation is still reflecting the effects of the recession; with the output gap, by most estimates, remaining wide and price changes having consequently slowed down. Furthermore, wage moderation, high productivity increases, a relatively low degree of capacity utilisation and the appreciation of Community currencies against the US dollar have all had a beneficial impact on restraining inflation.

Chart 10



Wage settlements have also moderated in line with the deceleration of inflation and in 1994 nominal compensation per employee is expected to grow by 3.4 percent; this compares to an average of around 7 percent recorded in the period 1990-92 and to 4.2 percent seen in 1993. Labour productivity, on the other hand, is estimated to grow by over 3 percent this year, reflecting the rapid expansion of output and the impact of restructuring measures; this productivity growth is not, however, atypical of recovery phases. As a result, nominal unit labour costs have increased by only 0.2 percent this year compared with an average of 4 ½ percent in the period 1990-93. Finally, import price inflation has averaged around one percent during this period.

The good inflation performance this year has been shared by virtually all Member States. On the basis of the private consumption deflator, inflation appears to have stabilised in Belgium at around 2.5 percent, while in three Member States (Denmark, Ireland, the Netherlands) it has accelerated marginally since 1993, while remaining low. Marked improvements have been made in Germany (down 1.1 percentage points to an estimated 2.8 percent in 1994), Greece (2.8 percentage points to 10.8 percent), France (0.4 percentage points to 1.7 percent), Spain (0.7 percentage points to 4.9 percent), Italy (1.1 percentage points to 4 percent), Luxembourg (1.3 percentage points to 2.3 percent), Portugal (2.4 percentage points to 5.5 percent) and the UK (1 percentage point to 2.5 percent).

These favourable price trends are expected to continue in 1995 and 1996. Unit labour costs are expected to increase somewhat but the projected rates of increase, at significantly less than two per cent a year, will remain at historically low levels. Tighter demand conditions, however, will allow firms to edge prices up and, after a further slight slowing down in 1995, the deflator of private consumption is expected to accelerate to 3.1 per cent in 1996 (3 per cent for the deflator of GDP).

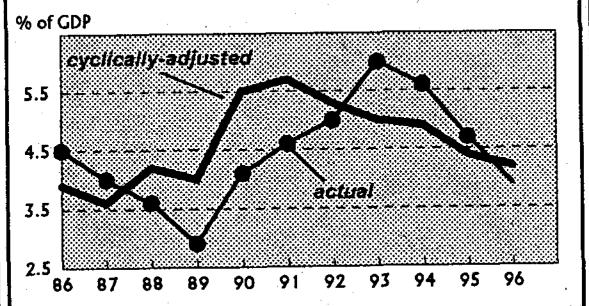
Seven Member States are expected to show a broadly acceptable inflation path - within the intermediate 2 to 3 per cent range set in the Broad Guidelines - while the situation in the other five remains unsatisfactory, albeit to different degrees. In 1996, Portugal, Spain and Italy, notwithstanding some additional improvement, are expected to be still outside the desired range (about 4 ½ percent in Spain and Portugal and 3 ½ percent in Italy). In the United Kingdom, the rate of inflation, which in 1994 was well within the Guidelines target range, is expected to progressively increase and be above 3 per cent in 1996. The Greek rate of inflation is projected to decline although the pace of decline may be slower than in the recent past. Additional efforts are required in most of these countries in a large number of areas but especially with regard to wage behaviour and budgetary trends. All Member States, irrespective of their relative success in reducing inflation, must maintain policies aimed at securing the objective of price stability. This means maintaining a stable macroeconomic framework, conducting prudent budgetary and monetary policies and strengthening competition in markets.

2.2.2 Insufficient progress in budgetary consolidation

While the recession brought budget deficits to record heights in 1993 (6 per cent of GDP), 1994 saw the beginning of a turnaround which is expected to lead to a reduction in the Community's average budget deficit to about 4 per cent of GDP in 1996. A large part of this reduction, however, will be the automatic result of both the expansion in GDP and renewed employment growth on government receipts and expenditure. In 1996[3], the average cyclically-adjusted government deficit in the Community is still expected to be about 4 ¼ per cent of GDP, which is clearly too high.

Chart 11

EC: actual and cyclically-adjusted government deficits



In 1994, budgetary trends have been disappointing in several Member States (see chapter 4, section 4) and in October 1994 the Council, in its first application of the new procedure aimed at avoiding "Excessive Budget Deficits", decided that ten out of the twelve Member States were in a situation of excessive deficit.

In particular, in Greece the budget deficit continues to be the highest in the Community and remains well above the reference value in the Treaty. In Italy, the budget deficit

3 The Commission's forecasts are based on the usual "no-policy-change" assumption. This has important implications in the case of budgetary policy since most governments will announce in the course of 1995 measures designed to influence trends in 1996 which could not be incorporated in the present forecasts. Budgetary projections for 1996 simply extrapolate the effects of measures already in force.

remained practically stable for the third year running at the very high level of 9 ½ per cent of GDP. Spain and France achieved small reductions in their deficits, which, however, remain too high (7.0 and 5.6 per cent of GDP respectively in 1994).

According to the November 1994 Commission forecasts, the outlook for next year and for 1996 suggests that, under current policies, fiscal consolidation will not fully exploit the opportunities offered by the emergence of a stronger growth performance, even though the projected deficits will be on a downward path.

Table 9

	General government net borrowing (-) or lending (+)			General government gross debt		
	percentages of GDP					
	1994	1995	1996	1994	1995	1996
B	-5.5	-4.7	-4.0	140.1	138.7	136.0
DK 1)	-4.3	-3.0	-2.2	78.0	78.0	78.2
D	-2.9	-2.4	-2.0	51.0	2) 59.4	58.9
GR	-14.1	-13.3	-12.9	121.3	125.4	128.1
E	-7.0	-6.0	-4.7	63.5	65.8	66.1
F	-5.6	-4.9	-3.9	50.4	53.4	55.6
IRL	-2.4	-2.0	-1.5	89.0	83.7	79.1
I	-9.6	-8.6	-7.9	123.7	126.8	128.6
L	1.3	1.6	2.0	9.2	9.8	9.9
NL	-3.8	-3.5	-2.7	78.9	78.8	78.0
P	-6.2	-5.8	-4.8	70.4	71.7	72.3
UK	-6.3	-4.6	-3.4	50.4	52.4	53.1
EC	-5.6	-4.7	-3.9	68.8	72.7	73.2

European Commission estimates of November 1994
1) Government deposits with the central bank, government holdings of non-government bonds and public enterprises related debt are expected to amount to 24.4% of GDP in 1994.
2) The sharp increase in the German debt ratio in 1995 is mainly caused by the take-over by the government of off-budget unification-related liabilities, the most important of which is the debt of the "Treuhandanstalt".

For the Community as a whole, net borrowing as a percent of GDP is expected to narrow to 4.7 per cent next year and to 3.9 per cent in 1996. In five Member States (Denmark, Germany, Ireland, the Netherlands and the UK) the projected reductions in general government net borrowing are consistent with the objectives set in the national convergence programmes. On the other hand, the projections for Belgium, Spain, France, Italy, and Portugal indicate that continued efforts or additional measures are needed to reach these objectives. Finally, the projection for Greece points to only a small reduction in the budget deficit from its present very high level[4].

Public debt will grow at a slower pace

As shown in Table 9, the ratio of government debt to Community GDP has already reached worrying dimensions and continues to deteriorate. In the Commission's Autumn 1994 forecast the debt ratio is expected to increase faster than predicted in the convergence programmes in the cases of Greece, France, Italy, and Portugal. Movements in the debt ratio which are broadly consistent with the convergence programme estimates are projected for Belgium (gradually declining), Denmark (generally stable), Spain (rising) and the UK (modestly rising).

In the case of Germany, it is expected that the debt ratio will peak in 1995, as predicted in the convergence programme, and in the case of Ireland, faster economic growth and lower deficits will contribute to the debt ratio declining faster than in the convergence programme; a similar path is also expected in the case of the Netherlands. Finally, Luxembourg's debt ratio is expected to stabilise at below 10 percent of GDP over the next two years.

The projected increase in the debt ratio in 1995 and 1996 provides a measure of the adjustment which is necessary in order to put the debt ratio on a declining trend. Clearly, some Member States are confronted with substantially greater and more urgent adjustment needs than others (Belgium, Italy, Greece) but the need to reduce the debt ratio applies to almost all. Since the debt ratio is in most cases so large, all Member States are vulnerable to adverse interest rate shocks.

2.2.3 Relatively stable exchange rates

Since 2 August 1993, the ERM has been functioning with bands of +/-15 percent. The tensions, which characterised the period June 1992 to the summer of 1993, have subsided since the August decision and, after some initial downward movements, most ERM currencies have now moved substantially back towards their unchanged central rates. 1994 to date has been characterised by a continuation of this relatively high degree of stability in the ERM. The non-ERM currencies, however, experienced, to different degrees, additional depreciations in the course of 1994.

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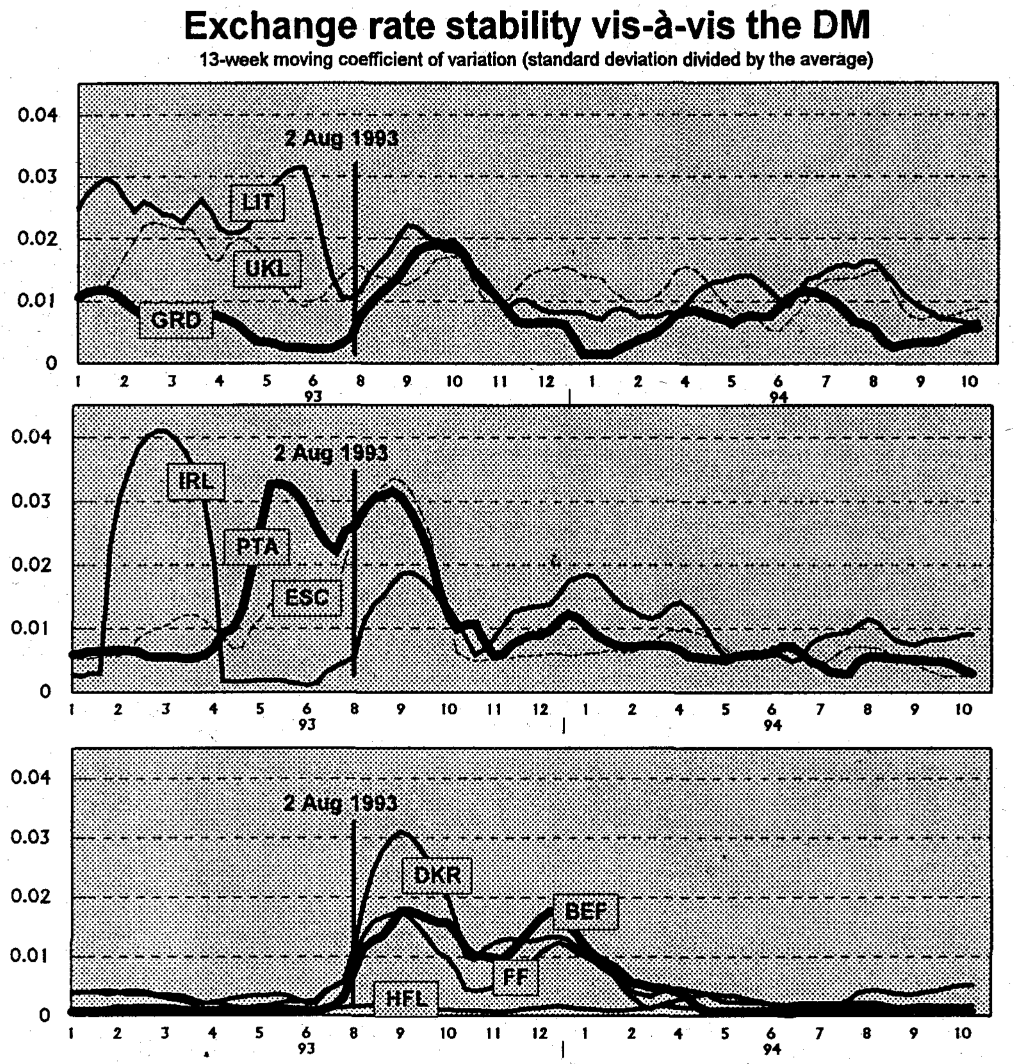
[4]The Commission's projections were finalised before the adoption of the 1995 Greek budget.

Chart 12



This lack of turbulence has been due to the cautious manner in which monetary decisions have been taken in Member States and to the general improvement in economic conditions which has increased the room for manoeuvre of the authorities. The credibility of the central rates have been strengthened by the operation of monetary policy and the functioning of the ERM since August 1993. In addition, the re-introduction of two-way risk into the system has done much to eliminate the sources of speculative pressure.

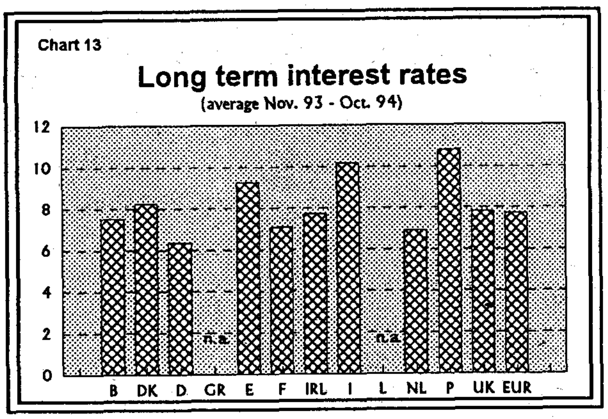
From the beginning of 1994, a policy of cautiously lowering official or key interest rates, in line with cuts in German official rates, has been followed by most Community central banks leading to an overall reduction in short-term interest rates throughout the

Community. This policy has been facilitated by continued progress in reducing inflationary pressures.

2.2.4 Progress on interest rate convergence

Convergence of long term interest rates depends closely on the progress towards price stability and budgetary consolidation required for exchange rate stability. Progress in these two areas led to a narrowing of differentials in the second half of 1993; but during the course of 1994 differentials have widened again. This emphasises the need for markets to be convinced of the durability of progress in these areas. All in all, convergence of long term interest rates presents an encouraging, if not a totally satisfactory, picture (see chart 13).

The gradual downward trend in short-term interest rates which occurred in most Member States contrasted with developments with regard to the long end of the market. Long-term interest rates abruptly changed direction at the beginning of 1994. The downward trend in both long term interest rates and differentials with Germany, which had been a feature of developments in 1993, came to an end in February 1994. By October, nominal long term interest rates (benchmark 10 years) were about 250 basis points (Community average) higher than earlier in the year.



This development appears to have been triggered by the rise in US bond yields following concerns about future inflationary trends in the US. Internal EC factors, such as the implications for inflationary expectations of improving growth prospects, growing market concerns in relation to underlying budgetary imbalances in a large number of Member States and perceptions of undershooting of the budgetary targets at the end of 1993, must also share part of the "responsibility" for the significant increases which occurred in virtually all Member States. The increases in the individual Member States were significantly different reflecting the stage of the cycle in different countries and, in some cases, uncertainty about the future evolution of public debt that has given rise to inflationary premia.

Chapter 3: The Medium Term to the year 2000

The major task facing economic policy at the present time is to transform the current recovery into a sustainable medium-term process characterised by strong rates of growth in both output and employment and better economic convergence. The policies required to achieve these two objectives are the same. The improvement in the economic outlook opens up the perspective of a return to a medium-term growth path similar to that experienced in the second half of the 1980s and similar to the path laid out in the Commission's White Paper on "Growth, Competitiveness, Employment" as being a necessary condition for achieving a substantial reduction in unemployment by the end of the present decade. The realisation of this objective demands that present efforts to improve the dynamism and competitiveness of the Community economy and the functioning of the labour markets are intensified and that appropriate macroeconomic policies are strictly adhered to.

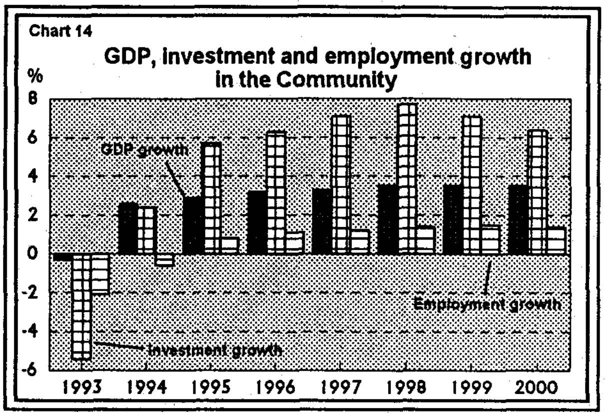
3.1 Medium-term projections for growth and employment

The nature of the present recovery process in the Community, which was driven initially by exports and subsequently by a strong rebound in investment, bodes well for the achievement of the main medium-term targets in terms of growth and employment. The present upturn offers an opportunity to introduce far-reaching structural reforms that allied to consistent macroeconomic policies hold out the possibility of significantly reducing unemployment by the year 2000. The current upturn is, in fact, developing according to the path envisaged in the White Paper.

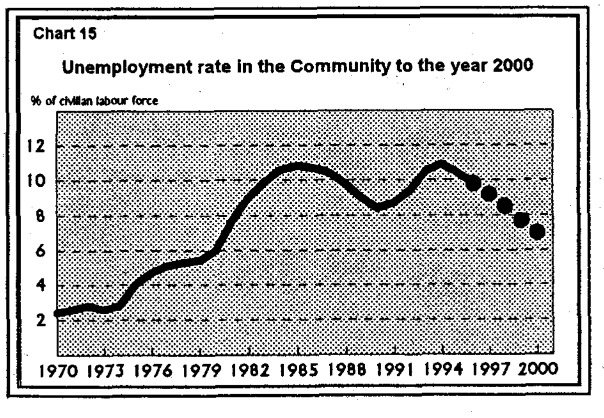
The medium-term projections of the services of the Commission as well as those of the IMF and the OECD suggest the possibility of a medium-term growth path of between 3 and 3 ½ per cent per annum to the year 2000. Such a favourable outcome is dependent however on the realisation of the following crucial assumptions;

- a neutral international environment, in terms of its impact on economic conditions in the Community;
- a stability-oriented monetary policy which will not be burdened by inappropriate budgetary and wage behaviour;
- the continuation of budgetary consolidation efforts in a large number of Member States;
- an evolution of wages similar to that which occurred in the 1980s;
- the continuation of the structural reform measures undertaken in the past.

Given the nature of these assumptions, the outcome of the medium-term projections is essentially an illustration of the fact that, given the implementation of sound policies, the achievement of strong and healthy economic developments is possible. The growth path of 3-3 ½ per cent annually until the end of the century will, according to the Commission projections, be mainly driven by internal forces i.e. investment and consumption. Investment leads the recovery, progressively returning towards growth rates of 6-7 per cent over the period 1996-2000. This strong and sustained rate of growth results from an ongoing improvement in the profitability of capital, a trend which had been interrupted in the early 1990s, and by the increasingly favourable prospects for the evolution of final demand.



With investment growing at a faster rate than total output, the share of investment in GDP is expected to increase to around 22-23 per cent in the year 2000. This growth in investment will have positive effects both in terms of the additional capacity generated and in terms of adding directly to demand and employment creation. Increases in employment combined with real wage increases per head remaining positive, but below the rate of increase in labour productivity, will support households' real disposable incomes and consequently private consumption. The latter is forecast to grow on average by about 2 ½ per cent annually over the period to 2000.



If these investment and consumption trends can be realised, a sustained 3-3 ½ per cent overall growth rate is possible over the medium-term. In these circumstances, assuming that labour productivity trends are maintained at their 1974-94 average of about 2 per cent per year, these rates of GDP growth would involve employment growth of 1 to 1 ½ per cent annually. Such employment increases would translate into yearly falls in unemployment of between a half and one per cent of the labour force under the assumption that the labour supply will grow to the year 2000 at about half a per cent a year (resulting, in equal proportions, from demographic factors and an increase in the participation rate). Unemployment could consequently be reduced to around 7 per cent of the active population by the year 2000.

A rate of unemployment of about 7 per cent of the civilian labour force, while impressive compared to recent experience, would not correspond entirely to the White Paper objective of halving the rate of unemployment by the year 2000. This can only be achieved if, first, the structural measures aimed at increasing the endogenous growth forces in the Community are successful and growth can therefore be at the upper end of the expected scale of 3-3 ½ per cent. Secondly, achievement of the objective requires that policies to increase the Community's capacity to create jobs for any given rate of output growth are implemented quickly and with determination. If the above conditions are met, then the White Paper objective becomes achievable. These medium-term projections illustrate not only that significant progress in reducing unemployment can be made but also indicate the nature of the policy challenge ahead and the limits to what can be achieved on the basis of present trends.

3.2 Conditions necessary for stronger growth and employment creation

Sustained rates of growth at the high level mentioned in the previous paragraphs cannot be obtained by direct government intervention. Such an economic evolution will depend both on the establishment and maintenance of appropriate macro- and microeconomic policies and on adaptations in the behaviour of economic agents. Respect for these conditions will be essential in ensuring that any such growth process is sustainable, non-inflationary and respectful of the environment.

3.2.1. The role of structural policies

As growth accelerates, the environment for implementing structural adjustment policies will become more favourable. Resistance will be reduced to the implementation of policies directed towards removing obstacles to competition and other rigidities. Furthermore, active labour market policies will acquire a more meaningful perspective with recipients of these policy interventions having an increased likelihood of actually finding jobs. However, complacency on the part of governments in implementing the necessary reforms should not be underestimated in an improving economic environment. This reaction, while understandable, would be a serious mistake since opportunities to enhance the dynamism of the Community's economy and its capacity to create jobs will rarely be as favourable as at the present time.

3.2.1.1 Competitiveness

Support for structural measures aimed at increasing the endogenous growth forces of the Community (such as those put forward in the 1993 White Paper) is strong throughout the Member States. Promoting the competitiveness, the dynamism and ultimately the productivity of all sectors of the Community's economy is essential to secure its long-term prosperity. If the appropriate macro-economic conditions are created and effective labour market policies are implemented, the structural efforts to improve productivity and competitiveness will result in stronger growth and employment creation.

Given the differences in the nature of the production process, however, the productivity gains will be stronger in some sectors than in others. In the former sectors, the employment gains for any given rate of output growth will be smaller as a result of the faster productivity growth, but this will be offset by strong employment increases in the sectors where productivity growth is, because of technical constraints, slower.

Table 10

Employment, productivity and relative prices in agriculture, industry and services

(Belgium, West Germany, France, Italy and the Netherlands; changes in per cent per year)

Indicator	Period	Total	Agriculture	Industry	Market Services	Non-market Services
Value added	1961-73	4.9	1.8	5.5	5.6	3.7
	1974-85	2.1	1.7	1.0	3.2	2.3
	1986-90	3.1	1.7	2.4	4.0	1.4
Employment	1961-73	0.3	-4.6	+0.5	1.6	2.2
	1974-85	0.2	-2.9	-1.4	1.7	2.0
	1986-90	1.0	-3.1	+0.3	2.4	1.0
Productivity	1961-73	4.6	6.5	5.0	4.0	1.5
	1974-85	1.9	4.7	2.4	1.5	0.3
	1986-90	2.1	4.9	2.1	1.6	0.4
Relative prices 1)	1961-73	-	-0.4	-1.0	0.7	3.4
	1974-85	-	-2.5	-0.4	0.5	3.5
	1986-90	-	-2.0	-0.4	0.4	2.9

Source: EUROSTAT and Commission services 1) Increase in the deflator of gross value added for the sector relative to the increase in the GDP deflator

The process of job creation in the latter group of sectors will be financed by a transfer of wealth operated through changes in relative prices: under the pressure of competition, the prices of the products of the sectors with the fastest productivity increases will fall when compared to other sectors of the economy; conversely those of the sectors where productivity increases are smaller will increase. This mechanism has worked well during the 1950s and 60s, as well as in 1985-90 and could thus be revived in the framework of a strong macro-economic growth process. These sectoral shifts are indeed the very process by which employment is created in a market economy in the course of modernisation, ensuring that the desired productivity increases result not in a net job destruction but in the creation of wealth, part of which must be used to cushion the social costs of the unavoidable adjustment process. For this process to work effectively and yield net increases in jobs, three conditions must be met: i) changes in relative prices must be allowed to take place; this means in essence that competition must be allowed to operate; ii) policies must be oriented towards accommodating structural adjustment - if necessary by cushioning its adverse social effects - instead of hindering it and iii) overall economic growth must be sufficiently strong.

3.2.1.2 Employment

The present momentum of the recovery should allow a return to a level of output close to potential and should entail the elimination of the so called *"cyclical unemployment"*, which can be roughly estimated at 1 to 2 percentage points of the peak level (11 per cent) reached in 1994. Indeed, the remaining part of unemployment (9 to 10 % of the labour force), the so-called "classical" part, can only be absorbed by the creation of new physical working posts, i.e. by a strong expansion of productive capacity. This condition, however, is not sufficient because classical unemployment is overlapped by the inadequacy of a part of the labour force to secure the kind of jobs that will become available through the growth process. The size of this overlap, which represents ***structural unemployment stricto sensu***, is difficult to assess but the amount of long term unemployment (about 45% of the unemployed, i.e. 5% of the active population) can be used as a rough approximation. The limit between classical and structural is somewhat floating and tensions on the labour market may appear even before it is reached. However, this limit could also be made less constraining by adequate labour market policies.

The reduction of unemployment to the rates mentioned in the White Paper will require the net creation of 15 million jobs through a combination of strong growth and actions aimed at increasing the job content of that growth. Labour market policies can make a significant contribution to achieving this goal through three main channels:

- increasing the employability of workers in general and especially that of the young and of the long term unemployed (reducing skills mis-match);
- avoiding the labour market tensions, also with regard to wages, which tend to appear during periods of high growth and employment creation;
- enhancing the employment content of growth.

3.2.2 Avoiding or overcoming the macro-economic obstacles to growth

The policies to improve both competitiveness and the functioning of the labour markets discussed in the previous section would not be in a position to realise their full potential unless the growth process in the Community is allowed to develop without encountering two major macro-economic obstacles to growth:

i) an unbalanced policy mix, which might result from tensions between the stability objective and inappropriate budgetary and wage behaviour; and

ii) an insufficient growth of potential output, which could lead to inflationary pressures.

As regards the ***first obstacle***, the easing in monetary conditions during the course of the past two years shows the extent to which the policy mix has been rebalanced but clearly more is needed. The opportunity created by the improvement in the economic outlook must be taken advantage of to prevent the re-emergence, for different reasons, of the distorted policy mix that has characterised the Community's policy framework over recent years. The objective of deficit reduction should be pursued with particular vigour in those countries where high public debt ratios have placed an excessive burden on monetary policies irrespective of cyclical conditions. There must be a credible framework of price stability to which economic agents can adapt their expectations. In this respect, the moves in a number of countries to make their central banks independent represent a very important step.

In the foreseeable cyclical circumstances of the next two years, ones of relatively strong growth, the reduction of budget deficits necessary to buttress confidence in financial stability and to improve the allocation of resources over time is likely to have short-term demand effects that go in the direction of restraining inflationary pressures. The need for any monetary response to avoid overheating would be correspondingly reduced.

As regards wage trends, recent developments are displaying greater consistency with the intermediate stability objective, set in the December 1993 guidelines exercise, of a rate of inflation of no more than 2-3 per cent. The current wage behaviour is similar to the pay trends recorded during the expansion phase of the last cycle i.e. between 1982 and 1988. At that time, moderate wage settlements contributed significantly to the disinflation process which occurred. With regard to the Community's present situation, it is essential that the moderate wage evolution experienced in 1994 and forecast for 1995 is maintained over the medium-term. This is necessary not only for the maintenance of a low rate of inflation but for the success of any ambitions to generate an employment-creating growth performance.

It is to be hoped that the increasing credibility of the overall policy framework, the implementation of the previously mentioned reform measures in the labour market as well as the initiation of an active social dialogue process will all help in generating the type of outcome which is both socially and economically desirable. Given the extent of the jobs challenge to be faced, distributional struggles should be avoided. For the foreseeable future, the priority must continue to be the promotion of those macro and microeconomic policies which are essential for job creation.

Economic and Monetary Union will only be achieved if policies succeed in maintaining a stable, non-inflationary macroeconomic framework of the type just described. But EMU itself, once achieved, will contribute powerfully to the future maintenance of such a framework and, through this channel, to growth and employment.

Regarding the ***second macroeconomic obstacle***, it is necessary to take action to increase the Community's potential rate of growth. This has been reduced by the recession and by the strong fall in fixed capital formation to around 19 per cent of the Community's GDP. Potential output is now growing at an annual rate of around 2 ¼ per cent. The strong growth rates envisaged for the period 1996-2000 cannot be sustained for long unless productive capacity follows suit and grows towards the 3-3 ½ per cent range over the same period.

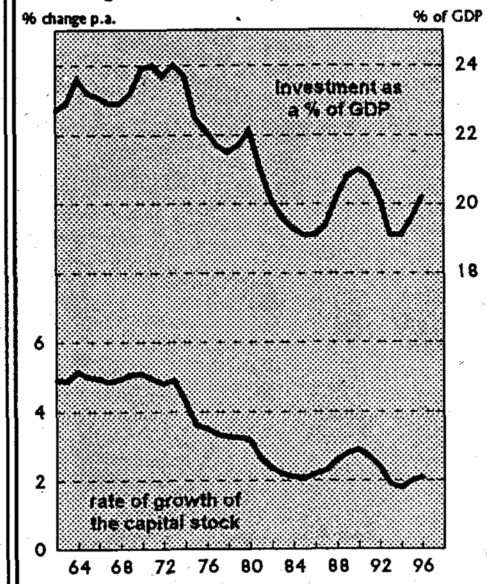
Structural reforms and the current efforts to increase the dynamism of the Community economy are essential parts of this process which, at the macro-economic level, requires an increase in ***investment***. Structural changes may increase the productivity of the stock of capital, but progress in this area is inevitably very slow. As a result, the return to sustainable higher rates of growth will have to be accompanied by an acceleration in the rate of increase in the capital stock. This implies that for a number of years investment must increase faster than GDP.

The increase in investment necessary to maintain strong rates of growth will be the result of market forces. But economic policy can help by creating the conditions that will allow them to operate more effectively.

Improving ***business confidence*** constitutes the first requirement in creating a framework more favourable to economic activity and investment. This calls for a series of actions which range from the maintenance of a stable macroeconomic environment to the determination to continue with the process of structural adjustment.

Chart 16

EC : Investment share and rate of growth of the capital stock



Another important determinant of investment is ***capital profitability*** which depends to a very large extent on the distribution of productivity gains among capital and labour. During the 1970s, profitability was negatively affected by real wage increases in excess of productivity gains. The situation was partly corrected during the 1980s when, for most of the period, real wages per head increased in the Community on average by one percentage point a year less than productivity. The improvement was interrupted in 1991 and 1992, but has since resumed strongly in 1993-94. Further increases in capital profitability are needed to encourage investment. This underlines the importance of the maintenance of the current trend of real wage increases per head below the rate of increase in labour productivity. The trend of the 1980s (one percentage point a year less than productivity over the period 1982-89) could constitute a pragmatic benchmark for the years ahead.

Table 11

Community[1]: Real unit labour costs [2]

(average annual rate of change for the period)

1961-70	1971-81	1982-90	1991-96	1991-92	1993-96
0.0	+ 0.2	- 1.1	- 1.0	- 0.1	- 1.4

1) Excluding the five new German Länder. 2) Nominal unit labour costs deflated by the deflator of GDP; the figures for 1994-96 are based on the November forecasts of the Commission's services

To reduce tensions on the market for loanable funds which could result in higher interest rates and to avoid excessively large balance of payments disequilibria, an increase in investment, however achieved, has to be accompanied by a roughly corresponding increase in the rate of national ***saving***. The necessary increase in the rate of national saving must come essentially from an increase in public saving (reduction of public deficits) since the savings behaviour of the private sector (households plus enterprises) is relatively stable and, probably, difficult to influence. Budget deficits might have to be almost eliminated by the year 2000 as indicated in the December 1993 Broad Guidelines. The deterioration in national saving which has taken place in the Community over the last 30 years is due almost entirely to the deterioration in the public sector's position. Thus, from the perspective of potential long term growth and employment, budgetary consolidation is of central importance.

3.2.3 Growth and the environment

Strong economic growth is not in contradiction with the protection of the environment provided an appropriate policy framework is put in place. In fact, environmental sustainability implies changes in the use of resources and of intermediate and final consumption patterns that are far easier to implement in a high growth, high income context.

The policy framework to promote a high growth and employment path discussed in the previous sections must be allied to the development of appropriate environmental initiatives. It is incumbent on the Member States collectively to analyse the various options available in which environmentally sustainable economic growth can be generated which contributes simultaneously to a higher intensity of employment use and a lower intensity of energy and natural resource consumption.

The White Paper has put forward for discussion a large number of policies which, if fully implemented, would amount to a new Development Model which could be created in the Community. Such a model would be characterised by such features as: greater use of market-based instruments within the mix of environmental policy instruments; the integration of environmental requirements into other policies including economic policy; the revision of taxation policies; better integration of economic and environmental accounting systems; widespread and quicker implementation of clean technology, and finally measures aimed at facilitating the development of new investments and activities aimed at enhancing the quality of life and the environment.

At present, an ongoing discussion on economic growth and the environment is taking place within the EcoFin Council on the basis of a Commission communication [COM (94) 465 final] putting emphasis on: the need to transform the concept of sustainable development into a more operational concept by developing adequate statistical indicators; the effective inclusion of environmental costs in market prices; the identification and, where appropriate, the elimination of incentives to polluting activities and the greater use of environmental taxes and levies in the context of reforming the present tax system in a way more favourable to both employment and the environment.

Chapter 4: The policies

Following-up on the recommendations of the White Paper on "Growth, Competitiveness, Employment", substantial progress were made in implementing policies aimed at increasing the dynamism and the competitiveness of the Community economies and at improving the functioning of their labour markets. Progress in these areas is reviewed in a number of reports which have been addressed to the Essen European Council. Monetary policy has been conducted in a prudent way and interest rate reductions have accompanied the decline in inflation while achieving a remarkable degree of exchange rate stability. National budgetary policies have been largely conducted within the framework of the convergence programmes with results, however, falling short of what was desired or what was possible.

As regards the future, it is essential that structural policies continue to be implemented in order to achieve greater dynamism of the economies and better functioning of labour markets. Monetary policy should continue its present stability-oriented course, while efforts aimed at consolidating budgetary positions must be stepped up.

Chapter 3 discussed how the various macro- and microeconomic policies interact in order to generate a sustainable medium-term process highlighted by strong output and employment creation allied to improved economic convergence. The present chapter will examine the individual economic policies in order to review progress made in the course of 1994 and to assess the likelihood of further improvements occurring in the forecast years 1995 and 1996. However, given the large number of recently produced reports on policies for improving competitiveness and enhancing the functioning of employment systems, it is intended, in order to avoid needless repetition, to restrict the focus of the present chapter to monetary and budgetary policies. These competitiveness and employment reports have been produced in the context of the annual review of the Brussels European Council's Action Plan which has taken place at the Essen European Council[5]. They adequately review progress with regard to the implementation of policy initiatives in these areas and put forward recommendations on how these policies can be

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[5] Among the most important documents on competitiveness and the labour market which were submitted to the European Council meeting in Essen were the following:

<u>Employment</u>:

1. Economic Policy Committee (EPC) Report on "Member States' Progress in Pursuing Policies with a View to Employment Creation".
2. Social Affairs Council Report on "Combatting Unemployment".
3. EcoFin Council Report on the Employment Situation (based on EPC and Social Affairs Council Reports).
4. Commission document "Action to Turn Growth into Jobs" (COM(94)529/2).
5. Report on the Reduction in indirect Labour Costs.

<u>Competitiveness</u>

1. Report on the Functioning of the Internal Market.(COM (94) 553)
2. Action Plan on the Information Society.
3. Report of the Christophersen Group on the Trans-European Networks & the EcoFin Council's conclusions on the latter report.
4. Implementation of the SME part of the Action Plan (SEC (94) 2023)

further enhanced to contribute in a more effective way to the achievement of the Community's policy objectives.

On the basis of the documents received and taking note of the improvement in the economic situation, the Essen European Council stressed the need to make further efforts to solve the structural problems which stand in the way of a better employment performance. In particular, the Council called for action in five key areas:

i) Improving employment opportunities for the labour force by promoting investment in vocational training.
ii) Increasing the employment intensity of growth.
iii) Reducing non-wage labour costs extensively enough to ensure that there is a noticeable effect on decisions concerning the taking on of employees and in particular of unqualified personnell.
iv) Improving the effectiveness of labour market policy.
v) Improving measures to help groups which are particularly hard hit by unemployment.

The Essen European Council requested the Labour and Social Affairs and Economic and Financial Affairs Councils and the Commission to keep close track of employment trends, monitor the relevant policies of the Member States and report annually to the European Council on further progress on the employment market, starting in December 1995.

In relation to competitiveness, the European council, in agreement with the Commission report, stressed the importance of the internal market and in particular the need to achieve uniform and effective application of the internal market rules. It also stressed the need to monitor Community and national law for over-regulation and welcomed the Council Resolution of 10 October 1994 aimed at removing legal and bureaucratic obstacles in the way of SMEs. The European Council intends also to pay particular attention in the future to the competitiveness of the European economy and welcomes the Commission's intention of setting up a high level group which will deal with these matters and submit appropriate reports. Finally, the European Council endorsed the most important recommendations of the report of the Christophersen Group and emphasised that the Commission's Action Plan "Europe's Way to the Information Society" and the conclusions of the Ministers for Industry and Telecommunications have set the agenda for the development of an information society.

4.1 Monetary policy

Since the widening of the ERM bands in August 1993 exchange market conditions within the Community have generally being characterised by a high degree of stability. This has largely been due to the prudent and cautious manner in which monetary policy decisions have been taken in most Member States in the course of 1994. Furthermore, this exchange rate stability has been achieved without greater volatility in interest rates. This reflects, to a considerable extent, a convergence of policies as well as progress in inflation convergence among the Member States. In addition, it reflects the discouragement of speculation following the widening of the bands and, more recently, the beneficial impact of the renewed optimism concerning growth on the consistency of monetary policies. Such stability should be encouraged further, especially as the capacity to grow without inflation over the coming quarters will be narrowing in a large number of Member States.

The process of gradual reductions in short-term interest rates continued throughout the first half of 1994. German short rates declined steadily, with other central banks within the ERM taking roughly equivalent action. Short-term interest rates reached a low of 6.2 percent (Community average) in July and in so doing contributed to a more balanced policy mix between monetary, fiscal and pay policies. The period of interest rate declines, however, came to a halt in the second half of 1994 as it became evident that the potential for a strong economic recovery was in place. This led to a cautious approach in short-term monetary policy adjustments despite continuing favourable developments in relation to price and wage patterns.

With regard to interest rate differentials vis-à-vis Germany, the latest data show a substantial narrowing of the gap compared with the average for 1993, in Belgium, Denmark, Spain, France and Ireland. The negative differential in the Netherlands has been gradually eliminated while the Portuguese differential of 6 percentage points in 1993 has persisted. Outside the ERM, the negative differential which the UK enjoyed in 1993 has now been eliminated. This turnaround has resulted from the fact that UK key rates had remained unchanged, until recently, since November 1993. The upward movements in UK official rates in the autumn of 1994 were essentially a pre-emptive strike, within an explicitly forward-looking monetary policy framework, to avoid a build-up of inflationary expectations. As regards Italy, the pace of reduction in rates had slowed down relative to other countries in June/July 1994 with the recent increase being introduced to ward off incipient inflationary pressures.

As regards future monetary policy prospects, for those countries whose monetary policy frameworks give priority to exchange-rate stability vis-à-vis the DM, these will, as in the past, be strongly influenced by developments in Germany. The Bundesbank is presently adopting a cautious stance although the rate of consumer price inflation has fallen in recent months and is currently at low levels and despite the fact that money supply growth in Germany has been slowing down, albeit from exceptionally high rates, and may even be inside the initial target range by the end of 1994. The reason for this prudent approach would appear to lie in developments in the real economy which have been much stronger than had been predicted earlier in the year. Given the conflicting signals coming from nominal and real developments in Germany the most reasonable assumption would appear to be a continuation of the trends of the previous months. The other Community countries are expected to broadly follow these trends with short-term interest rate differentials vis-à-vis the DM forecast to narrow in the course of the next two years.

The overall decline in short-term rates in 1994 was in stark contrast with developments at the long end of the market. The sharp increase in long-term rates since January 1994 was partly due to a phenomenon of undershooting at the end of 1993 and partly the result of latent inflationary fears related to the anticipated pick-up in economic conditions. The increases in long-term interest rates which have taken place so far this year can be interpreted as suggesting that the outlook for inflation is uncertain and that the risk of accelerating inflation remains prominent. As economic growth is projected to accelerate in the coming quarters, it is essential that this risk is minimised. This implies that monetary policy will have to tread a cautious path, aimed at establishing stable prices and low inflation as an anchor to medium-term inflationary expectations. To support this, it will be essential that economic agents see the commitment to low inflation as credible.

With the gradual transition of European central banks to independence during stage II of EMU, as stipulated by the Treaty establishing the European Community, monetary policy should gain substantial credibility and will, to a greater extent, in the future be able to pursue its price stabilisation objective in more favourable conditions. To ensure that the latter desired outcome becomes a reality it will be essential that budgetary and wage developments materialise in such a way that the monetary authorities are not forced to excessively tighten the interest rate reins. Clearly, a balanced policy mix, where fiscal policy supports the objectives of monetary policy is essential in this respect. Furthermore, fiscal consolidation is also necessary in order to reduce uncertainty about future inflation developments, associated with the possibility that the burden of debt will inhibit the counter-inflationary tasks of monetary policy. Finally, wage developments must also be consistent with the price objectives of the monetary authorities in all Member States, especially where price trends are projected to continue to be unsatisfactory.

4.2 Budgetary policy

The conduct of budgetary policy in the course of 1994 was characterised by the need to consolidate budgetary positions. All the Member States, with the exception of Luxembourg, have now prepared convergence programmes and most of them in the past year or so have revised or updated their original programmes setting targets for the medium term path of fiscal adjustment. The revision of the early convergence programmes was made necessary principally by the severe impact of the recession on the public finance performance of the Member States.

Table 12
Actual and cyclically adjusted General Government Net Borrowing
(percent of GDP)

	1993		1994		1995		1996	
	Actual	C-adj	Actual	C-adj	Actual	C-adj	Actual	C-adj
B	6.6	5.6	5.5	4.6	4.7	4.3	4.0	4.2
DK	4.4	2.3	4.3	4.3	3.0	3.8	2.2	3.7
D	3.3	3.0	2.9	2.4	2.4	2.0	2.0	2.0
GR	13.3	13.2	14.1	13.7	13.3	12.8	12.9	12.7
E	7.5	6.7	7.0	6.1	6.0	5.3	4.7	4.5
F	5.8	4.7	5.6	4.7	4.9	4.6	3.9	4.3
IRL	2.5	2.4	2.4	2.7	2.0	2.5	1.5	2.1
I	9.5	8.3	9.6	8.7	8.6	8.3	7.9	8.2
L	- 1.1	- 1.6	- 1.3	- 2.2	- 1.6	- 2.6	- 2.0	- 2.8
NL	3.3	2.6	3.8	3.1	3.5	3.4	2.7	3.1
P	7.2	6.7	6.2	5.2	5.8	5.1	4.8	4.6
UK	7.7	6.0	6.3	5.8	4.6	4.6	3.4	3.9
EC-12	6.0	5.0	5.6	4.9	4.7	4.4	3.9	4.2

Note: a negative sign indicates a surplus
Source: Commission Services, November 1994 Economic Forecast

The acceleration in economic growth in the course of 1994 provided the opportunity to recover some of the fiscal ground lost during the previous year. Current estimates suggest that in eight Member States (Belgium, Denmark, Germany, Spain, France, Ireland, Portugal and the UK) general government net borrowing as a percent of GDP has declined in 1994. However, fiscal outcomes fully in line with or better than the targets for 1994 contained in the convergence programmes have been realised only in the cases of Denmark, Germany, Ireland, Portugal and the United Kingdom. In the remaining countries some slippage has emerged or the adjustment achieved fell short of the programme plans[6].

Despite the severity of the recession, some progress took place in 1993 in reducing structural imbalances. It is disappointing to observe that in 1994 progress in this area was negligible. Current estimates indicate that in five Member States (Belgium, Germany, Spain, Portugal, the UK) the cyclically-adjusted net borrowing will decline. However, it will increase in five Member States (Denmark, Greece, Italy, Ireland, the Netherlands), and will remain unchanged in the case of France.

Seen against the background of the convergence programmes, fiscal developments in 1994 suggest that additional measures should be initiated in the course of 1995 to take advantage of the strengthening economic growth. Most countries are doing something in 1995 but more is clearly needed. Given budgetary timetables, however, it will be difficult, although desirable, to substantially alter the course of budgetary policy in 1995. Because of this it is particularly important that, in preparing their 1996 budgets, countries take the necessary adjustment measures to stay on their convergence programmes' paths or indeed to do better so as to ensure a faster return to sustainability. The present 1996 forecasts do not incorporate budgetary measures yet to be taken.

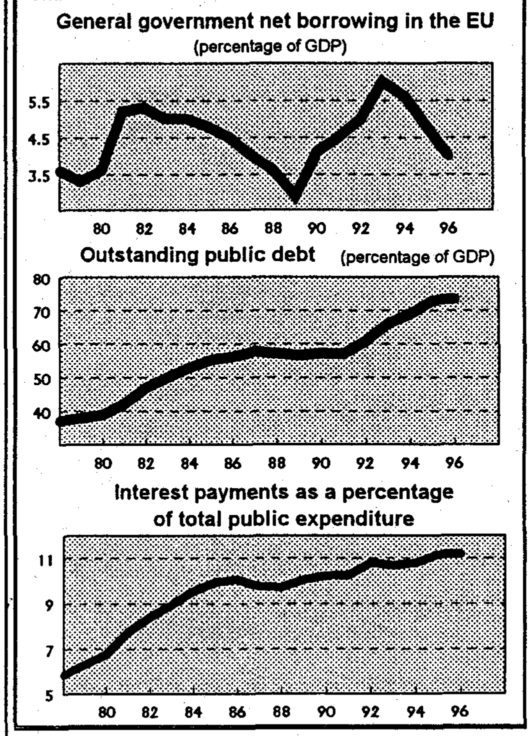
In recent months the urgency to foster fiscal consolidation has become more pronounced as a result of two new factors: first, servicing the rapidly growing government debt in the Community will undoubtedly burden fiscal policy over the medium term; and, secondly, the recent increases in long-term interest rates have not only diminished the prospects for reducing this burden but also, by the additional pressures they exert on the public finances, they bode badly for future interest rate reductions. An additional factor, whose importance has now become more widely recognised, and which will burden

6 The 1995 Greek budget reports an outturn for 1994 for the central government budget deficit in line with budgetary objectives.

severely the public finances in the longer term, is the requirement to finance increased pension expenditure in the coming years.

The projections presented in chapters 2 and 3 suggest that practically all Member States will have to bolster their fiscal consolidation plans over the immediate future. Clearly, some Member States are confronted with substantially greater and more urgent adjustment needs than others but the need to reduce the debt ratio applies to almost all. Since the debt ratio is in most cases very large, all Member States are vulnerable to adverse interest rate shocks.

Chart 17



In the two Member States where the debt ratio is high and rising and interest payments are a crucial budgetary item (Greece and Italy), a determined effort to restore sustainability to the public finances continues to be urgent.

In the case of Italy, where net borrowing is expected to amount to almost 8 per cent of GDP in 1996, little progress is expected in reducing the structural imbalances (see table 12) and more ambitious fiscal adjustment measures are clearly necessary in order to restore sustainability and to reduce the deficit towards the 3 per cent mark set in the convergence rules.

In the case of Greece the fiscal outlook remains difficult. The 1995 Greek budget - which had not been adopted at the time the Commission's projections were finalised - contains proposals in line with the profile for the reduction in the budget deficit contained in the convergence programme, but continued vigilance will be necessary.

In Belgium, progress is expected in reducing net borrowing while both the structural deficit and burden of servicing the public debt are projected to decline as a percentage of GDP. Given the high government debt, this progress needs to be sustained in a medium-term framework and the provisions of the Global Plan pertaining to the budget should be fully implemented.

According to the Commission's November forecasts, in Denmark and France the structural deficit is not expected to post anything but a marginal improvement over the next two years, notwithstanding the projected strong economic growth; thus, fiscal expansion undertaken by these Member States in recent years is not expected to be fully reversed in structural terms. In addition, no structural progress is expected in the case of the Netherlands. Nevertheless, both the Netherlands and Denmark are expected to experience budget deficits of less than 3 percent of GDP in 1996.

In four Member States significant progress in reducing structural fiscal imbalances is projected. Between 1993 and 1996 the cyclically-adjusted budget balance is forecast to decline by one percentage point of GDP in Germany, by over 2 percentage points in Spain, Portugal and in the UK. In 1996, however, the respective net borrowing of the general government will continue to be above the Maastricht mark of 3 per cent in the four Member States except Germany; where it is projected to be at 2.0 per cent of GDP.

The strength of the current recovery offers a unique chance to carry out the inevitable budgetary adjustment with a lower cost in terms of output and employment. A similar opportunity in the second half of the 1980s was not fully exploited and it is clearly essential to avoid a repetition of the same policy error. For the Member States which have already prepared budgets for 1995, the course of fiscal policy has been incorporated in the Commission's forecast and, as noted previously, the deviation between the fiscal objectives of the convergence plans and the Commission's projections provides a measure of the needed adjustment effort to achieve the fiscal targets.

A strict implementation of the measures announced in the convergence programmes will lead to the achievement of the objectives incorporated therein and result in the necessary reduction in budget imbalances.

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1995 ANNUAL ECONOMIC REPORT

PART B

ECONOMIC SITUATION AND POLICY ISSUES IN THE INDIVIDUAL MEMBER STATES

12-12-1994

BELGIUM

Economic recovery due to buoyant exports whereas domestic demand remains weak

The evolution of most economic indicators during 1994 suggests a relatively strong pace of recovery; GDP is expected to grow by an estimated 2¼% mainly under the impulse of exports, as domestic demand remained rather weak, growing by no more than 1%. Private consumption expenditures are expected to rise by about ¾%; the saving rate, which reached in 1993 the historical peak of nearly 22% (in percentage of disposable income) due to sagging confidence and the worsening labour market situation, decreased moderately in 1994, following the recent marked improvement in consumer confidence indicators. Private investment is expected to stagnate in 1994, picking-up progressively only as capacity utilisation rates in the manufacturing industry increase. Residential investment is estimated to remain rather weak in 1994 due to the rise in mortgage interest rates registered since the beginning of the year.

Table 1
Belgium: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	2.5	-1.7	2.2	2.7	3.1
Total domestic demand (% change)	2.5	-1.7	0.9	2.4	2.8
Employment (% change)	0.5	-3.0	-0.4	0.7	1.0
Unemployment rate (%)	7.8	9.4	10.0	9.8	9.3
Inflation (% change)	2.7	2.6	2.6	2.5	2.6
Balance of current account (% of GDP)	1.6	4.6	4.8	5.0	5.2

For defintions, see Table 2
Source: Commission services, economic forecasts, Autumn 1994

In 1994 exports of merchandise goods are expected to increase by about 7%, basically reflecting the impressive upswing in foreign demand (from -2½% in 1993 to approximately 7% in 1994), together with the introduction of some degree of wage moderation, following the implementation of the "Global Plan". However, the trade balance is expected only to improve slightly (from -0.3% of GDP in 1993 to 0.1% in 1994) due to the deterioration in terms of trade, and despite the lower dynamism of imports. The surplus in the balance on current transactions is expected to remain in 1994 at about 4¾% of GDP.

The evolution in the labour market, particularly since the second quarter of 1994, is also favourable, suggesting that entrepreneurial confidence in the sustainability of the current recovery improved markedly. The unemployment rate rose from 7.4% in mid 1991 (Eurostat definition) to 10.1% in April 1994, since then it has levelled off and is expected to decline on an annual average in 1995. As regards employment, a particularly encouraging sign is the creation of a significant number of jobs for young people in 1994, reducing the youth unemployment rate, ensuing specific measures adopted in the "Global Plan" (November 1993).

Inflation (measured by the CPI) is expected to stay at around 2½% in 1994 (i.e. below the Community average). However, gross nominal wages per employee are forecast to grow by about 3.2%, despite the implementation of the measures taken in the "Global Plan" to secure wage moderation. Although the introduction of the "Health Index"[1] limited wage indexation, real wages in the private sector increased on average by approximately 1.4%, due to the application of previously agreed wage settlements, whereas real wages in the public sector rose by 3% by the second consecutive year. The measures decided in the "Global Plan" to secure wage moderation will only be fully implemented in 1995 and 1996 with the freeze of real wages in the private sector.

Fiscal policy in Belgium is conducted in the framework of the convergence programme which was initially approved in June 1992, but since twice informally revised (in April 1993 and June 1994). These two revisions consisted of adjustments in the deficit profile for the period 1993-1995, while maintaining the 3% of GDP deficit target for 1996. Since taking office in March 1992, the government has taken a number of fiscal saving packages, involving both the Federal government and the social security sector, in order to fulfil the budgetary targets set in the (revised) convergence programme

Table 2
Belgium: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	:	:	:	:	:
Government budget balance (% of GDP)	-6.2	-6.6	-5.5	-4.7	-4.0
Gross government debt (% of GDP)	132.5	138.9	140.3	138.9	136.2
Nominal wages per head (% change)	7.0	4.2	3.2	2.8	3.3
Real wages per head (% change)	4.2	1.6	0.6	0.3	0.7

Source: Commission services, economic forecasts, Autumn 1994

Definitions

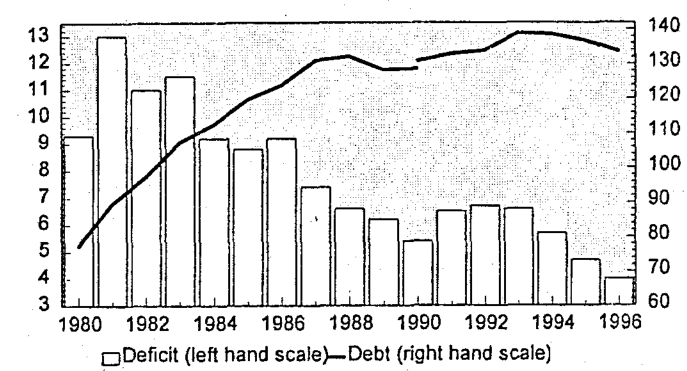
Unemployment rate: harmonized Eurostat definitions.
Inflation: private consumption deflator.
Money growth: broad money (M2/M3)
Government budget balance: net lending/borrowing of general government.
Gross government debt: general government.
Nominal wages: compensation of employees per head.
Real wages: compensation of employees per head deflated by private consumption prices.

[1] The CPI excluding tobacco, alcohol products, petrol and diesel.

and counterbalance the budgetary effects of the recession. Given the data available on the execution of the Federal government budget, pointing to a near stagnation of primary expenditures and a strong increase in tax receipts, together with the relative success of the measures taken in the "Global Plan" to curb social outlays, the general government deficit is expected to decrease from 6.6% of GDP in 1993, to 5.5% in 1994.The debt ratio is expected to begin decreasing in 1995.

Chart 1 - Belgium

Deficit and debt ratios in percentage of GDP



Note: in case historical government debt data do not exactly match the debt definition in Regulation (EC) n°3605/93, a break in series is introduced.

Source: Commission services, Economic Forecasts Autumn 1994.

Continuing expansion of activity but persisting problems on employment creation

Real GDP growth is expected to reach 2.7% in 1995. Exports of merchandise goods are estimated to rise by about 6½%, reflecting strong foreign demand growth and a satisfactory price-competitiveness position. Whereas in 1994 the economic recovery was largely export led, in 1995 and beyond domestic demand is expected to play a considerably more dynamic role in the economic expansion. Private consumption expenditures are estimated to grow slightly above real disposable income in 1995, as improved consumer confidence brings about a moderate reduction in the saving rate. Firms' investment is expected to increase strongly in that year as capacity utilisation rates in the manufacturing industry increase.

Employment growth generated by the output expansion should allow for a reduction in the unemployment rate already in 1995. However, non-wage labour costs in Belgium are extremely high even when compared with other Community member countries with similar social security systems - in terms of coverage and generosity. The financing of the social security system in Belgium is too heavily dependent on labour income contributions, distorting factor prices and encouraging the use of more capital intensive techniques of production. This distortion affects particularly the lower productive segments of the labour force, effectively pricing out of the market many low paid jobs. Although some important steps were already taken, particularly with the approval of the "Global Plan", to correct this situation, additional measures are needed in order to broaden the social security tax base and make its financing less distortionary.

The economic expansion together with the various saving measures taken in the framework of the convergence programme, especially the "Global Plan", are expected to reduce the general government deficit from 5.5% of GDP in 1994 to 4.7% in 1995. Nevertheless, attainment of the convergence programme deficit target of 3% of GDP in 1996 will most likely require taking additional saving measures, which are estimated to amount to approximately 1% of GDP.

DENMARK

Strong fundamentals are beginning to exhibit results

After several years of disappointing growth, the Danish economy experienced a strong recovery in 1994. Growth this year is expected to exceed 4% primarily based on the upswing in private consumption. Consequently, imports are catching up and the surplus in the trade balance is being perceptibly reduced. Because of favourable market growth exports are growing at a healthy pace, and the trade balance will thus remain positive (around 3% of GDP). A too rapid narrowing of the output gap would suggest some danger of overheating which could jeopardise maintaining a low rate of inflation. This, however, has not as yet become a problem. Consumer prices rose by only 2% in autumn. Unemployment remains the biggest challenge to the Danish economy. In spite of high growth figures, unemployment rates did not come down significantly until the second half of 1994.

Table 1
Denmark: Macroeconomic performance

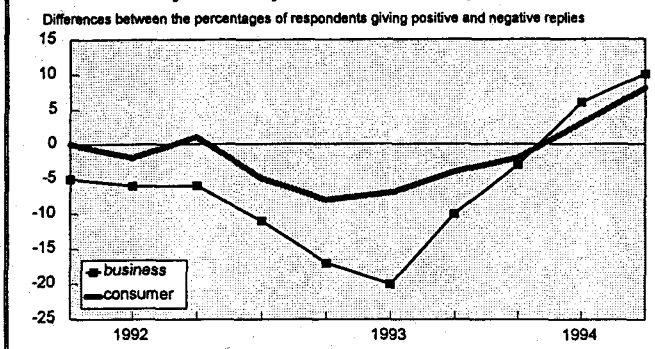
	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	1.3	1.4	4.8	3.2	3.0
Total domestic demand (% change)	-0.7	0.5	6.9	4.2	3.3
Employment (% change)	0.0	-0.6	0.1	1.7	1.5
Unemployment rate (%)	8.8	10.3	10.2	9.0	8.0
Inflation (% change)	2.3	1.7	1.8	2.1	2.4
Balance of current account (% of GDP)	1.6	3.7	2.6	2.2	2.2

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The turnaround of activity occurred in the second half of late 1993 when consumer spending reacted to improving confidence. Confidence indicators started recovering from their trough in early 1993. At that time, the Danish government adopted a programme of economic reform involving both temporary expansionary fiscal measures to mitigate the effects of the recession, in accordance with the Edinburgh conclusions, and structural reform, in particular on the labour market, devoted to strengthen the efficiency of the Danish economy in the medium term. The strong recovery in confidence since the adoption of the programme which even accelerated well into 1994 indicates that the private sector gained confidence in the policy approach of providing a fiscal stimulus in the short term while committed to a medium term fiscal consolidation strategy.

Chart 1 - Denmark

The economy driven by confidence in the private sector



Source: Commission services

Indeed, after many years of sluggish growth, the Danish economy is driven mainly by domestic demand growth in 1994. Both private consumption and investment reacted positively to the expansionary measures. Domestic demand growth was also supported by a favourable financial environment. Lower interest rates and buoyant bond prices stimulated purchases of consumer durables. However, as financial markets have become less supportive and pent-up demand is being gradually satisfied, consumer demand growth should normalise throughout next year. Thus, private consumption which grows by around 5½% in 1994, should grow at a noticeable lower rate in 1995 (4%) and 1996 (3½).

The current upswing in production has led to a rising capacity utilisation rate. Strong growth in productivity together with continued moderate wage settlements have a favourable effect on profits. Indeed, profit margins can be improved without increasing sales prices too much. Given that these fundamentals remain in place, investment in equipment should pick up significantly. As the financial situation of the corporate sector is expected to improve further, the retarding effect of high interest rates on investment of equipment might prove to be of relative little importance. In the short term construction could be affected to a larger extent while better income expectations might support residential construction when the recovery matures.

Table 2
Denmark: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	4.5	14.6	5.4	5.4	:
Government budget balance (% of GDP)	-2.0	-4.4	-4.3	-3.0	-2.2
Gross government debt (% of GDP)	64.3	79.5	78.0	78.0	78.2
Nominal wages per head (% change)	4.0	1.9	2.6	2.7	3.0
Real wages per head (% change)	1.7	0.2	0.8	0.6	0.6

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Despite the openness of the Danish economy and strong domestic demand growth, the external situation will remain favourable. Satisfactory market growth and favourable competitiveness should prevent a drastic deterioration in the external balance although imports have risen at double digit rates in 1994. Favourable developments in services and lower net factor payments to abroad will sustain a solid surplus of the current account of the balance of payments.

Economic policies geared to maintain stability

The widening of the ERM bands has not changed the basic approach of Danish economic policy. The authorities maintained their stability oriented policy by keeping monetary conditions relatively tight. The stability of the exchange rate was not challenged by financial markets and interest rate spreads vis-à-vis Germany have narrowed indicating a great deal of confidence into the adopted policy approach.

Nevertheless, in order to maintain confidence the phase of fiscal consolidation has to show the results which are projected in the revised convergence programme of November 1994. This programme envisages a step by step reduction of net general government requirements to 0.3% of GDP in 1997 (to 3.0% in 1995, 1.3% in 1996). According to the Commission forecast, the deficit reduction path is fully on track. In 1995 the deficit will be around 3% of GDP and in 1996 the 3% threshold will be clearly undershot. Given the good cyclical situation the question arises as to what extent the consolidation path could be accelerated. This would certainly become a first best option if demand were to continue to expand at the now prevailing rates. Otherwise, monetary policy's goal of preserving price stability would be put in jeopardy.

Unemployment remains the biggest challenge to the Danish economy. While most economic indicators are gradually improving unemployment remains high. Unemployment is expected to fall from 12.3% (national definition) in 1994 to less than 10% in 1996 due to the recovery. However, structural problems in the labour market will make it more difficult to reduce unemployment further as structural unemployment is currently at 8-9%. To increase flexibility in the Danish labour market, a labour market reform package was introduced. The reform includes both passive and active measures mainly directed at reducing structural unemployment. Firstly, efforts have been made to improve education. This together with a leave of absence reform, which allows recipients time for education, child care or - less frequently - a sabbatical year while maintaining the right to draw 80% of normal benefits (100 percent for educational leave) provides more room for active measures. Also, it will no longer be possible to stay in the unemployment benefit system by working in various employment generating programs and people will be provided with a job offer within 4 years, thereby reducing the risk of remaining in long term unemployment. Furthermore, a reform of the financing structure of the unemployment benefit system will create a link between unemployment and contributions to the unemployment benefit system. Finally a gradual reduction of marginal tax rates will improve employment incentives.

It will be difficult to sustain high economic growth and reduce unemployment significantly if the structural problems in the labour market persist. Currently, the impact of the labour market reform is not clearly visible but it will, presumably, manifest itself in the long run. However, changes in the unemployment benefit system and increased wage flexibility are necessary in order to reduce the rate of unemployment at which inflationary pressures will emerge. In the second part of November 1994, the Danish government and two major opposition parties concluded a budget policy agreement, which i.a. implies a reduction of the State budget deficit foreseen in 1995 and makes adjustments of labour market policies (less generous leave of absence schemes, tightening of eligibility and enforcement practices in the unemployment benefit system).

GERMANY

The German economy is gathering pace

Economic activity in Germany has accelerated in 1994 and is expected to continue strengthening thereafter. The basis for higher growth seems to be rising productivity, which has enabled German producers to fully participate in the unfolding of world trade subsequent to the slow growth period earlier this decade. At the same time it has contributed to regaining or improving profitability, and to reviving confidence. Capital spending begins to react. While the general improvement is advancing all over Germany, substantial regional differences with regard to structures and growth remain for the time being. Therefore, the two parts of the country will be looked at separately where appropriate.

Table 1
Germany: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	:	-1.1	2.5	3.0	3.4
Total domestic demand (% change)	:	-1.2	2.1	2.6	3.1
Employment (% change)	:	-1.8	-0.9	0.5	0.8
Unemployment rate (%)	:	7.0	7.3	7.0	6.4
Inflation (% change)	:	3.9	2.8	2.2	2.4
Balance of current account (% of GDP)	:	-1.4	-1.4	-1.1	-0.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

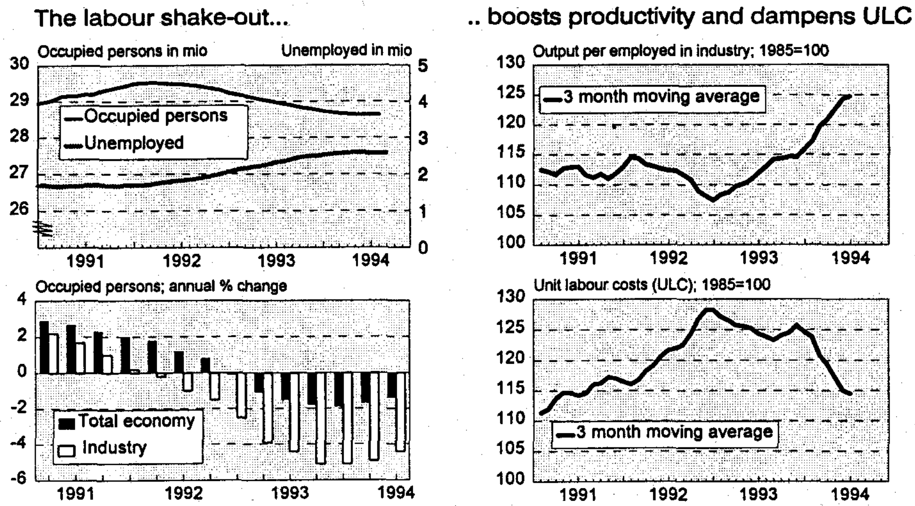
Improving profitability drives the west German recovery

In various respects, the 1993 recession was similar to earlier periods of contracting output in west Germany. The accompanying decline in employment was not particularly strong, considering the depth of the recession (GDP fell by 1.7%). In fact, productivity growth was relatively weak. As earlier, industry was hit hardest amongst all sectors. Yet the loss in output was the strongest on record, for the economy as a whole and in industry, where real value added fell 6.4% in 1993. Industry had to cope with a fading of the unification boom, substantial pay awards and a revaluation of the DM. As the economy headed into recession, unit labour costs soared.

Producers had their profits squeezed. The risk of not being able to stay in business triggered rigorous adjustments. The labour shake-out in industry spread to the economy at large (see chart 1, left). Substantial restructuring has since allowed for industrial productivity to catch up and, coupled with noticeable wage moderation since 1993, has made unit labour costs not only to reverse the adverse earlier developments but to fall back during 1994 to levels last seen three years earlier (cf. chart 1, right). In this respect the 1993 setback is different from its predecessors: the current relief in cost terms is

Chart 1 - Germany

Employment and productivity in west Germany



Sources: Commission services, Statistisches Bundesamt, Deutsche Bundesbank

more pronounced than after the three previous recessions. This holds also for the economy at large, albeit to a lesser extent. Possibly this reflects both recent additional efforts to regain flexibility mainly in industry and the higher level of unemployment than experienced earlier.

Thus industry in particular has prepared for recovery and has been able to respond positively to expanding international trade. With competitiveness improving and profitability rising, the business climate in west German manufacturing crossed the watershed between recession and expansion in September 1994.

In this setting, capital spending has started to expand again. Construction, in particular housing which is booming ahead of a scaling back of fiscal stimulus as of 1995, has already been quite dynamic earlier this year. From now on, a considerable knock-on effect should spur investment in machinery and equipment. This has suffered a setback of about one quarter from peak to trough and capacity utilisation is on the rise since end 1993.

There will have been more than 2½ million registered unemployed in 1994, in absolute terms more than anytime since the 1950s. But when the recovery advances further, the first timid signs of a turn-around on the labour market registered since summer 1994 will become more pronounced, albeit at a moderate pace. Later on, this should gradually allow for the consumer, who continues to be restrained by the (un-) employment situation, ensuing moderate wage increases and a tight fiscal policy stance, to increasingly support a continued upswing. In 1995, GDP growth could attain 2½%, after some 2% in 1994.

Intra-German convergence is advancing

The east German economy is making progress. GDP growth is likely to rise to some 9% in 1994, up from 5.8% the year before, and should remain buoyant. The region is now the fastest growing area in the EC. Contrary to the initial adjustment period, industry has been doing better than the economy at large since mid-1992.

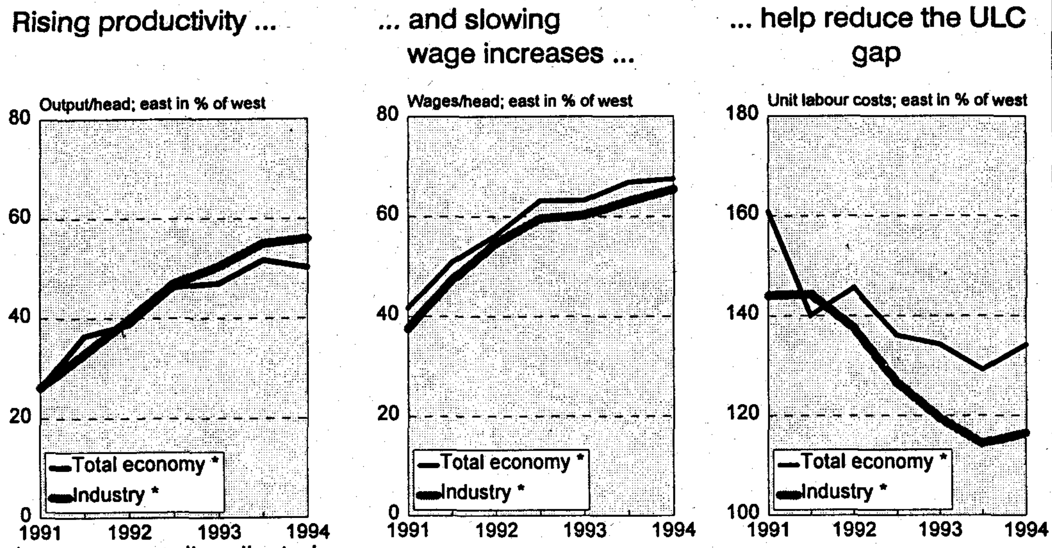
Certainly, east Germany continues to rely on support from outside the region which allows domestic demand to exceed GDP by some two thirds. Most of this is fiscal transfers. They amounted to more than 4% of German GDP in 1993 and primarily supported private consumption. The overhaul of run down housing has been propelled by the spring 1993 solidarity pact decision to shift two thirds of the sector's debts to the federal government as of 1995.

There is not only an advancing standard of living, there are also improvements in competitiveness. Initially, productivity was driven by massive lay-offs; from the old days of artificial full employment to summer 1994, when overall employment seems to have bottomed, one third of the 1989 labour force was set free. From now on, productivity improvements will primarily rely on the ongoing upgrading of the capital stock. Spending on machinery and equipment, too, continues to benefit from considerable fiscal incentives. Equipment investment per employee has been stronger than in west Germany since 1993. This will help to gradually reduce the productivity gap between east and west Germany (cf. chart 2, left) over the years to come.

The catching-up of eastern wages to western levels is decelerating. Hence eastern unit labour costs, which considerably overshot those of western competitors, are gradually edging lower. Industry is taking the lead (see chart 2, right). Emerging competitiveness, reflected also in improving profitability, albeit on average entrepreneurial incomes are still rather depressed, should over time provide the basis to very gradually reduce the absorption-production gap and to make the region less dependent on external support.

Chart 2 - Germany

Nominal productivity, wages and ULC in east and west Germany



* non-seasonally adjusted

Sources: Commission services, Statistisches Bundesamt

Fiscal policy remains geared towards consolidation

Overall, the growth outlook for the German economy has brightened considerably in line with improved competitiveness and profitability. After a 1.1% decline in 1993, GDP is expected to grow 2½% this year and some 3% in 1995. Thus an export-led recovery should be advancing while fiscal policy is geared towards consolidation.

Initially, unification resulted in an expansionary fiscal policy stance. To avoid a weakening of confidence in German public finances and in view of the Treaty convergence criteria, the government enforced consolidation. The 1993 general government borrowing requirement was 3.3% of GDP and the government debt ratio is expected to rise, from some 40% in 1989, to close to 60% next year when the government will have taken on board basically all unification-related debt, which so far has accrued off-budget. In line with the German convergence programme of November 1993, substantial discretionary measures on both the revenue and expenditure sides have become effective in 1994. More is to follow in 1995 with the re-introduction of the solidarity surcharge on income taxes to help fund the rising interest burden.

Over and above the discretionary measures taken, accelerating growth facilitates the rolling-back of the deficit, which could fall just below the 3% threshold already in 1994 and is forecast to decrease further in the following years. Provided growth accelerates as expected, the debt ratio should peak in 1995 at about 60%. The fiscal performance would then fully match the targets set in the convergence programme.

Table 2
Germany: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	:	10.9	5.7	6.2	:
Government budget balance (% of GDP)	:	-3.3	-2.9	-2.4	-2.0
Gross government debt (% of GDP)	:	48.1	51.0	59.4	58.9
Nominal wages per head (% change)	:	4.5	3.2	3.0	3.4
Real wages per head (% change)	:	0.6	0.3	0.8	1.0

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

However, given the tight fiscal stance (overall taxation, i.e. taxes proper and social security contributions will rise to more than 44% of GDP in 1995, an all-time high) and the pace of consolidation (the primary balance is expected to rise to 2% of GDP in 1995 after 0% in 1993), it appears important to be ready to react, if necessary, to avoid any combination of retarding influences to hinder recovery to unfold as predicted.

Rising long-term interest rates may have contributed to revive investment by means of advancing projects earlier in 1994; further rises may well have adverse effects. However, inflation is on the retreat and short-term prospects are good: next years' wage increases are expected to be still moderate, given the gradual nature of improvements on the labour market, and further out higher supply side flexibility achieved by restructuring may allow for inflationary pressures to re-emerge less forcefully than during earlier upswings.

Another encouraging fact with respect to the inflation outlook is that M3 is approaching its 1994 target-range after important deviations earlier this year. Thus, all-in-all, monetary policy seems to have regained some flexibility. This could prove helpful if there were to be some weakening of growth, possibly triggered by renewed upward pressure on the DM, when the real economy is just about to cope with the levels arrived at after the twofold challenge of the early 1990s, i.e. lower German average productivity after unification and an effective revaluation of more than 5% in 1992/93.

Advancing on the expected path of ascending growth will facilitate continuing fiscal consolidation. This appears to be important for at least two reasons. First, it should strengthen confidence and contribute to lower interest rates triggering fiscal crowding-in effects. Second, it will, in due course, allow for regaining some room for action. In view of the high level of taxation, it could be cautiously used to improve supply side conditions.

GREECE

Against the background of a weak long term performance and sustained macroeconomic imbalances, the Greek authorities in recent years have implemented policies of stabilisation and reform. Since 1991 restrictive monetary and fiscal policies have been applied and in particular incomes policies have been very tight. The result of these policies, together with a worsening external economic environment, was that growth slowed and the Greek economy moved into recession in 1993 with very weak growth in domestic demand and negative growth in GDP. The decline in real wages, 3.7% p.a. in 1990-93 and the tightening of fiscal policy combined with real exchange rate appreciation led to falling inflation with the private consumption deflator falling to an estimated 10.8% in 1994.

In 1994 there are indications of an improving performance and growth is likely to be positive. Thus manufacturing output after a number of years of decline has begun to grow while the volume of retail sales is also rising. On the other hand residential construction and private sector investment remain weak while public sector investment, although weaker than expected, nevertheless continues to be one of the main stimulatory forces in the economy.

Table 1
Greece: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	1.0	-0.5	0.4	1.1	1.7
Total domestic demand (% change)	1.6	0.4	0.6	1.4	1.8
Employment (% change)	0.1	1.0	-0.3	0.2	0.4
Unemployment rate (%)	7.8	9.7	10.2	10.6	10.8
Inflation (% change)	17.7	13.6	10.8	9.5	9.0
Balance of current account (% of GDP)	-5.7	-3.0	-2.5	-2.6	-3.0

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Reflecting the weak economy there has been almost no employment growth in the period 1990-1993 while unemployment rose from 7% of the labour force to almost 10%. Employment in agriculture and in manufacturing has continued to decline while employment in the services sector has expanded. These trends have continued in 1994 but some improvement in the labour market can be expected in subsequent years.

Weakening growth, restrictive policies and structural measures led to falling inflation through to early 1994. Thus consumer price inflation fell from a peak of 23.9% in

November 1990 to 10.2% in March 1994. However, this downward trend in inflation seems to have been interrupted since then given that CPI inflation subsequently rose to 11% in October. This development in inflation performance might reflect the ending of recession, the rise in real wages and the continued large scale fiscal deficits.

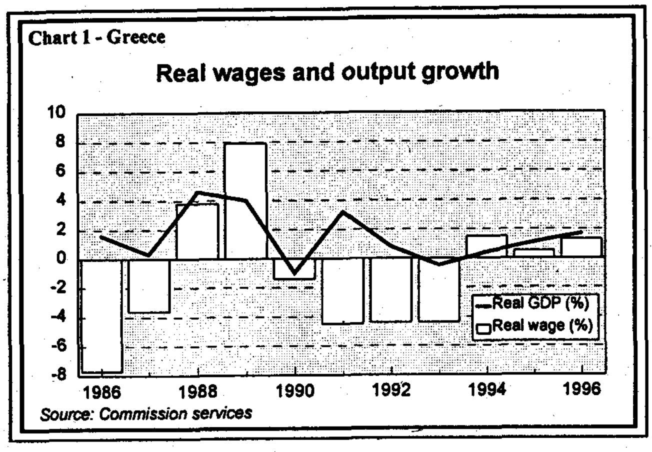
Table 2
Greece: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	14.0	15.2	:	:	:
Government budget balance (% of GDP)	-12.9	-13.3	-14.1	-13.3	-12.9
Gross government debt (% of GDP)	87.0	115.2	121.3	125.4	128.1
Nominal wages per head (% change)	13.6	8.6	12.4	10.1	10.5
Real wages per head (% change)	-3.4	-4.4	1.5	0.5	1.3

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Efforts to tackle the public sector deficits have been insufficient in the face of rising real interest rates and growing debt. Thus while the primary deficit has been reduced from 7.9% of GDP in 1989 to a surplus in 1994 the general government deficit remains at over 13% of GDP. The interest cost of the debt has been rising sharply from 6.7% of GDP in 1989 to an estimated 15% in 1994. Apart from the continued costs of the deficits two other factors have played a significant role in increasing debt servicing costs; firstly, the central government has taken over substantial debts from both the wider public sector and from the private sector thus increasing the general government debt level and secondly, partly because of EC pressures and developments (conditions associated with the 1991 balance of payments loan and Community Treaty provisions) the use of administrative devices to lower interest costs have been eliminated and the deficits are now financed mostly at market interest rates. Reflecting the insufficient fiscal adjustment and the consequent high levels of inflation Greece has the highest levels of nominal and real interest rates in the Community.

The prospects are for a continuation of the modest upswing evident in 1994. The recovery will be led by domestic demand and in particular by public sector investment driven by the Community Support Framework. Private investment, however, will continue to be restrained by high real and nominal interest rates. Exports will gain from the recovery in the rest of the Community but because of the wide absolute gap between exports and imports the balance of trade will deteriorate. Domestic demand will be sustained by growing incomes in both nominal and real terms as both labour income and non-labour income rise.



In 1995 inflationary pressures will be mitigated by restrained income growth as a result of the public sector incomes policy and the existing private sector agreement which provides for wage increases to be based on the official inflation target (with partial ex-post compensation in 1996 in the event of actual inflation being in excess of the official target). However, underlying inflationary expectations are likely to persist in the absence of vigorous and successful fiscal adjustment.

Crucial to the prospects for Greece is the extent of fiscal adjustment. The revised convergence plan, adopted by the government in June 1994, foresees declining deficits through the period to 1999. The central government budget proposal for 1995[2] is in line with the profile for the reduction of the deficit in the convergence programme. The authorities have expressed their determination to implement the necessary policies to achieve the convergence programme targets and if these are implemented effectively disinflation might well accelerate which would help to increase the prospects for lower rates of interest thus stimulating economic growth and reducing further the fiscal deficit.

2 Presented on 30 November 1994.

SPAIN

Stronger than expected economic recovery led by exports

After having suffered its deepest recession of the last few decades (GDP declined for six quarters in a row between the second quarter of 1992 and the third quarter of 1993, falling 1.1% in 1993), the economic activity in Spain has since been recovering at a pace stronger than previously expected by any forecaster. In fact, GDP is currently estimated to have increased by 2.2% in 1994 and is forecast to rise around 3% in 1995.

The economic recovery has been led mainly by exports, which in 1994 rose at very high levels by any historical standards. This seems to be a result of the international economic recovery, a gain in competitiveness entailed by the three peseta devaluations in 1992 and 1993 and the weakness of domestic demand which fell until the fourth quarter of 1993. In the course of 1994 both consumption and investment held up very markedly, thus leading to a profile of domestic demand much more supportive of economic activity. Although this recovery in domestic demand and the phase down of the deterioration in the terms of trade have spurred a sharp rise in imports, the contribution of the external sector to GDP growth still remained strongly positive in 1994. The current account deficit-to-GDP ratio shrank hence further in 1994 to 1.2% from 1.9% in 1993 and 3.7% in 1990-92.

Table 1
Spain: Macroeconomic performance

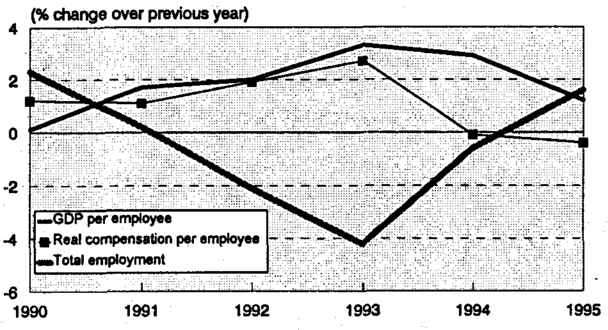
	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	2.2	-1.1	2.2	2.8	3.2
Total domestic demand (% change)	2.9	-4.1	-0.1	3.0	4.2
Employment (% change)	0.1	-4.2	-0.6	1.6	1.9
Unemployment rate (%)	16.9	21.8	22.4	21.9	21.2
Inflation (% change)	6.4	5.6	4.9	4.5	4.4
Balance of current account (% of GDP)	-3.7	-1.9	-1.2	-1.6	-1.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

In 1995 domestic demand is forecast to take the lead on supporting economic growth, while the contribution of the external demand could turn slightly negative, despite a still relatively strong growth expected for exports. Investment is set to increase by more than 5%, as a result of better demand prospects, the improvement in the economic and financial situation of the business sector and the effects of some structural reforms, particularly on the labour market. Private consumption is growing mainly because of higher confidence, which brings down the households' savings rate, and increasing employment.

Chart 1 - Spain

Real wages, employment and productivity



* Compensation per employee deflated by the GDP deflator

Source: Commission services

The deepness of the economic recession compounded with an inadequate wage behaviour led to a very sharp fall in employment in 1992-93, when it receded by more than 6%. Chart 1 shows first that labour productivity proxied by GDP per worker has shown an unusual, by other countries' standards, counter-cyclical behaviour and second, that labour productivity has been much correlated with real labour costs. Indeed, constrained by increased competition and until late in 1993 by low total demand, companies reacted to increases in wages clearly above inflation, mainly through adjustments in their workforce, which in turn featured into high productivity increases. Hence, too high wage increases during the recession fed strong labour shedding. In 1994 and, as expected, in 1995, a more moderate behaviour of wage costs will contribute to some deceleration in labour productivity and better employment prospects.

A continued and desirable rise in the activity rate, due to the strong growth in population in working age and to the medium term trend for a higher participation of women in the labour force has contributed to aggravate further the unemployment figures. This led to a all time high unemployment rate of 24.6% in the first quarter of 1994 (according to the labour force survey, EPA). However, as a result of the wide-ranging labour market reform which entered into force in 1994 and the improving economic situation, employment should fall in 1994 substantially less than previously expected, followed by significant increases in 1995, though the unemployment rate is expected to decrease only by less than a percentage point in 1995.

Table 2
Spain: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	10.8	7.5	5.6	7.0	:
Government budget balance (% of GDP)	-4.3	-7.5	-7.0	-6.0	-4.7
Gross government debt (% of GDP)	46.4	59.8	63.5	65.8	66.1
Nominal wages per head (% change)	8.5	7.2	4.0	3.9	4.2
Real wages per head (% change)	1.9	1.5	-0.9	-0.6	-0.2

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The recession also led to a sharp rise in the general government deficit, which was furthermore aggravated by some revenue lags and losses in VAT in 1993. Hence the general government deficit rose from 4.5% of GDP in 1992 to 7.5% in 1993. In 1994, despite some control in public expenditure, which allowed for some reduction in the structural deficit, and the higher than expected economic growth, only a limited reduction in the general government deficit is expected to have taken place, what is partly explained by lower profits than in 1993 by the Bank of Spain (of about 0.6% of GDP). The upward trend in general government debt is another factor of concern. It has been rising sharply from past low levels and crossed the Treaty reference value of 60% of GDP in 1994. The expected reduction in public deficit in 1995, due to both fiscal restraint and higher economic growth, will not be enough yet to reverse that upward trend in public debt.

After having receded from 5.9% in 1992 to 4.6% in 1993, inflation, as measured by changes in the consumer price index, is expected to remain broadly unchanged in 1994. This mainly reflected the sharp acceleration in food price rises which edged up from 1.1% in 1993 to more than 5.5% in 1994 whereas core inflation (which excludes energy and non-processed food) fell by about one percentage point from 5.6% in 1993. The stagnation of disinflation in 1994 led almost to a halt in nominal convergence with the three EC countries with lowest inflation, which remained at 3.2% in September 1994, as compared to 3% in 1993. In 1995 progress in disinflation will be made harder by a number of factors such as the economic recovery, the temporary effect of VAT increases combined with a reduction in social security contributions and possible deferred temporary effects of the peseta depreciation on domestic prices. Hence, further wage moderation will be of the utmost importance to allow for continued progress in disinflation.

The widening in the ERM bands decided in August 1993, lower inflation and reductions in German short-term interest rates allowed the Bank of Spain to continue cutting interest rates significantly until August. The intervention rate thus fell from 9% in December 1993 to 7.35% in early August 1994. However, after having reached a trough in January, slightly below 8%, medium and long term rates have since been rising significantly (by about three percentage points until October) in parallel with a similar move world-wide.

The reforms and the challenges ahead

Whereas the economic recovery seems to be already on sound ground, led more and more by private consumption and investment, the soundness of the recovery will hinge upon the functioning of the markets and progress in nominal convergence. In 1994 the Spanish authorities took some further key steps to improve real and nominal prospects. As regards structural reforms, a special reference has to be made to the wide ranging labour market reform approved by the government in December 1993 and by the parliament in May 1994. Then in July the Spanish government approved a revised convergence programme for 1995-97, whose priorities appear reflected in the draft budget law for 1995.

The general philosophy of the labour market reform was to shift much of the administrative regulations previously set by the authorities towards bilateral agreements between workers and employees. It eased the regulations concerning redundancy and working time, allowing companies to adjust working hours better to demand. Moreover, it boosted the possibilities of functional and geographical mobility and permitted a more flexible wage setting. Interim temporary employment agencies and private non-profit job agencies were legalised. New hiring procedures were set, introducing new apprentice contracts, vocational training contracts and part-time and temporary replacement work. The first results of the labour market reform appear encouraging, taking into account the high number of hirings under the new contracts, particularly on part-time jobs.

Further structural reforms are included in the revised convergence programme, which updates the 1992 programme. It keeps essentially the same objectives as the 1992 programme, i.e., to progress both in nominal and real convergence, which requires the correction of the major macro and micro-economic disequilibria as two main pre-conditions. A balanced policy mix, relying on a fiscal consolidation programme, and more structural reforms are thus at the centre of the revised programme which covers the period 1995-97.

The revised programme includes a fiscal consolidation scenario aimed at a gradual reduction of the budget deficit and at stabilising the debt-to-GDP ratio. The general government net borrowing is targeted to fall from 7.3% of GDP in 1993 (more recently revised to 7.5%) to 5.9% in 1995, 4.4% in 1996 and 3% in 1997. The debt-to-GDP ratio is in turn expected to rise up to 67.5% in 1996 and then just begin decreasing slightly to 67.2% in 1997.

After the recent labour market reform, the main thrust of the forthcoming structural measures relates to a number of areas sheltered from competition, especially in the services sector. Particularly important are some further liberalisation measures announced for the telecommunications sector. Moreover the programme makes reference to the taking forward of the reform of the education system. Finally, worth mentioning is a new law on housing rents, approved by the Parliament in early November, which aims at bolstering rent housing supply.

Despite better economic growth prospects and the mentioned reforms, the authorities are still faced with significant challenges ahead. First, despite strong economic growth and a more flexible functioning of the labour market, unemployment could remain above 20% in the next two years. Second, inflation appears to show some downward resilience, a phenomenon which could be reinforced by the recovery in domestic demand and the temporary effect of a VAT increase combined with a reduction in social security contributions. Third, fiscal consolidation cannot rely only in the operation of the automatic stabilisers but requires an important reduction of the structural deficit, which should be mainly achieved through discretionary measures to cut expenditure growth.

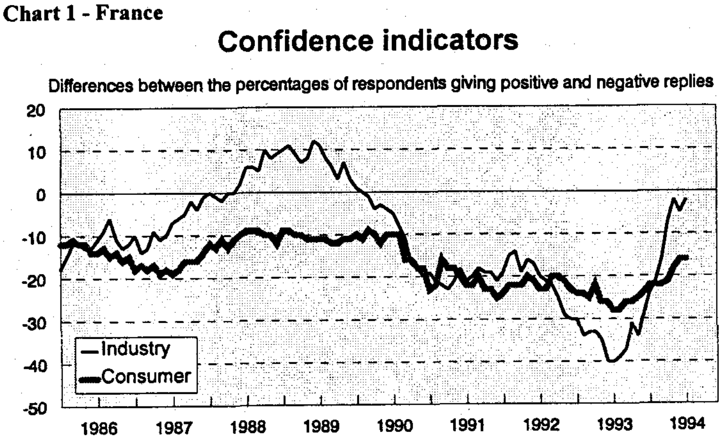
FRANCE

French economy increasingly exposed to external influences, thus behaving more cyclically

The recession of 1992/1993 was the deepest in the post-war period, leading to a 1.0% fall in GDP in 1993. The economy is now more integrated into world trade exchanges and follows the economic cycle common to most economies in continental Europe. While activity was strongly supported by exports, especially to Germany after the unification, they declined when activity in continental Europe began to recede. As European countries are now entering recovery, French exporters should take advantage of the favourable growth prospects of main trading partners. Considerable gains in price competitiveness have been made due to productivity growth and wage moderation. The effect of the appreciation of the franc should, therefore, no longer negatively impact on exports.

The financial situation of companies and households has improved

Chart 1 - France



Source: Commission services

At the end of the eighties, as a result of an increase of credit supply, there had been an excessive rise in indebtedness, which led to a deterioration in the personal and corporate financial situation. As marked cyclical behaviour was unknown in France, the agents' loss of confidence, although a general phenomenon in Europe, was particularly strong and enduring in France and led to a significant adjustment of behaviour.

Firms reduced their investment and ran down stocks in 1992 and 1993; taken together, changes in stocks and gross capital formation contributed negatively around 2.5 percentage points to growth in 1993. These adjustments allowed companies to reduce financing needs and indebtedness, ultimately building up a healthy financing capacity. Households' private consumption slowed markedly in 1993, decelerating more rapidly than real disposable income. The savings ratio increased appreciably in contrast to the normal trend of reduced savings to sustain consumption. The resulting improvement in the financial situation was the basis for the recovery in consumption in 1994.

The recovery follows a classical pattern

Table 1
France: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	1.5	-1.0	2.2	3.2	3.2
Total domestic demand (% change)	1.2	-1.8	2.3	3.4	3.4
Employment (% change)	0.2	-1.6	-0.2	0.7	0.9
Unemployment rate (%)	9.5	10.8	11.3	11.0	10.6
Inflation (% change)	2.8	2.1	1.7	1.9	2.1
Balance of current account (% of GDP)	-0.5	1.0	0.6	0.6	0.5

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

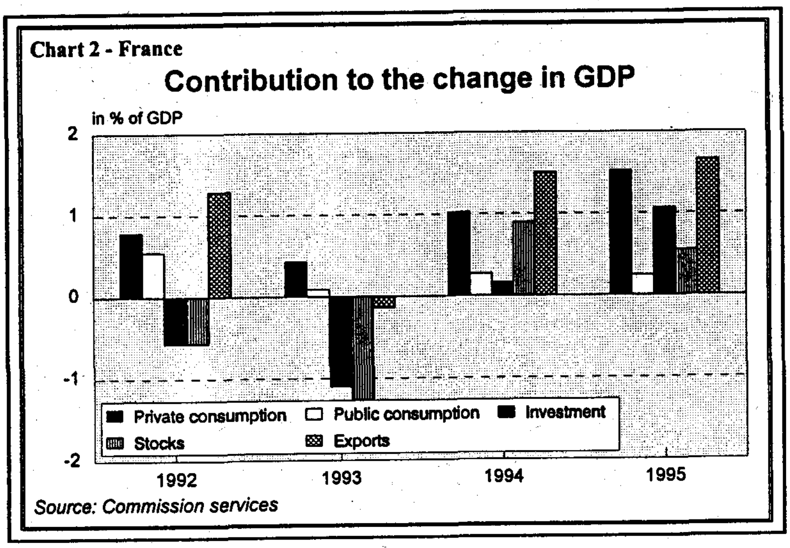
Having reached its floor in the first quarter of 1993, economic activity did not improve significantly in the following quarters. The recovery got underway in the first quarter of 1994 when GDP increased by 0.7%. While in the first quarter stocks contributed to growth, in the second quarter domestic demand rose by nearly 1.0%. Exports rose strongly over the first half of the year and the annual growth rate was close to 3.5%. The business surveys carried out by INSEE, the national statistics office, show that the recovery is broadly based with demand prospects shaping up well. While GDP growth should be less strong in the second half of the year, overall 1994 growth should be around 2.2%.

Table 2
France: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	5.5	-1.7	3.3	3.8	:
Government budget balance (% of GDP)	-2.5	-5.8	-5.6	-4.9	-3.9
Gross government debt (% of GDP)	36.9	45.8	50.4	53.4	55.6
Nominal wages per head (% change)	4.6	2.5	2.4	2.8	3.0
Real wages per head (% change)	1.8	0.4	0.7	0.9	0.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Households' spending has been temporarily supported by fiscal measures, notably the incentives to replace old cars and the maintenance of the triple school expense allowance introduced in 1993. Private consumption will probably continue rising although less buoyantly than in the second and third quarters as households' confidence continues improving. Moreover, employment is growing which will lead to an acceleration of disposable income. An improved outlook for employment - an increase of wage earners and a simultaneous fall in the unemployment rate - should lead to a fall in savings. However, facing uncertainties such as the financing of pensions, private consumption might recover at a somewhat lower pace than in previous periods of growth.



The upswing of external as well as internal demand and the resulting rapid increase in capacity utilisation rates should lead to a strong upturn in investment. Surveys undertaken by the Bank of France show a recovery of productive investment as early as 1994 and an increase in capacity investment prospects for 1995. After a very slight increase in 1994, investment will again become an essential engine of economic growth from 1995 onwards.

High unemployment will remain a major challenge

The number of wage and salary earners began to increase with the upturn in economic activity (up by 0.8% in the first half of the year in the non-agricultural market sector). New jobs, often in the form of fixed-term or temporary contracts, were created mainly in market services. The decline in employment in industry (excluding construction) has been stopped in the second quarter. Taking the average for the year, the number of wage and salary earners might therefore stabilize in 1994.

The increase of employment from 1995 will have a limited impact on the unemployment rate. While the recovery is expected to lead to a 0.7% rise in employment in 1995, an appreciable increase in the active population may limit the fall in the unemployment rate to around 0.3 points. Thus, economic growth will not be sufficient to meet the unemployment challenge in the short term.

As a consequence of the employment situation, the moderation of the rise in wages has paved the way for sustaining low inflation. The fall in prices of raw materials and intermediate goods also contributed to the earlier moderation of prices. As this effect unwinds, consumer prices should increase somewhat more rapidly in 1995 (+1.9%, after +1.7% in 1994, on an annual average basis), but overall inflation will remain subdued.

Budgetary policy to support employment and to reduce deficits

Besides letting the automatic stabilizers work through during the cyclical downturn, economic policy focused mainly on employment and support to private consumption and housing. With the recovery of activity, the central government budget for 1995 will be targeted to a reduction of the structural component to the deficit. No further personal income tax cuts are planned. Policy measures in favour of employment will be intensified, in particular, with the continued reduction of employers' social contributions.

Priority is being given to the reduction of general government net borrowing. It is planned to cut the central government budget deficit to 4.1% of GDP in 1994 and to 3.6% in 1995. Increases in expenditure will be limited to the forecast GDP price deflator (+1.9%). Tax increases amounting to 0.2% of GDP are planned. The general government deficit is targeted to fall from 5.6% of GDP in 1994 to 4.6% in 1995. These are above the targets in the convergence programme (5.1% in 1994 and 4.2% in 1995) which may mean a lesser than expected effort towards fiscal consolidation given the improved growth prospects. The deviation is due to cancellation of public debt in favour of members of the "zone franc" (0.3% of GDP in 1994) and to the social security deficit which therefore remains paramount. The social security imbalances arise from both short-term factors related to the economic situation and structural factors such as population ageing. In spite of measures already adopted (Veil Law on healthcare, reform of the pension scheme), the social security accounts deficit will amount to 0.75% of GDP in 1994 and to 0.65% of GDP in 1995. Notwithstanding the marked slowdown in healthcare spending, the implementation of long-term policy measures aiming at keeping expenditure in check is required and even an increase in the compulsory levy could become necessary.

Not many choices for monetary policy

As regards monetary policy, the aim remains the franc's internal and external stability. Short-term interest rates have declined, supporting economic activity. High long-term interest rates could, however, pose a risk, particularly to the upswing in the housing sector, notwithstanding the rising debt service requirements of the public sector.

Short-term interest rates declined at the beginning of the year and have stabilized at about 5.6% (three-month rate), with a differential against the DM rates of around 50 basis points. As in other countries, long interest rates also increased in France, reaching 8.15% in mid-November. The long rate differential against the DM had disappeared in the beginning of 1994 but has followed an upward course since the month of March; it stood at about 70 basis points in November. While the slope of the yield curve is positive since March, the main money supply aggregate (M3) has been undershooting the medium-term target (and actually declined through 1994) and real interest rates remain at very high levels, considering the very low current and expected inflation in France.

IRELAND

An impressive economic performance in 1994

Economic developments have evolved very favourably in Ireland in 1994, following the stagnation in domestic demand in 1993, due to the very high interest rates which prevailed in the early part of the year. A wide range of indicators point to a growth outturn of up to 6% of GDP this year. A positive feature of the current outlook is the balanced nature of growth. All the components of domestic demand are buoyant which is in marked contrast to the past few years when growth was led by the export sector. This switch towards the more employment intensive domestic sector is a factor in the impressive rise in total employment in the year to mid-April 1994 of 30 000 (+2.6%). The good growth conditions are also contributing to better than anticipated public finances with the budget deficit outturn likely to remain well below 3% of GDP.

Table 1
Ireland: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	5.5	4.0	6.0	5.6	5.3
Total domestic demand (% change)	1.7	0.2	6.2	4.8	4.0
Employment (% change)	1.5	0.7	2.6	2.9	3.1
Unemployment rate (%)	16.2	18.4	17.7	16.8	15.7
Inflation (% change)	2.2	1.6	2.8	2.7	2.7
Balance of current account (% of GDP)	1.5	6.5	6.0	6.0	6.3

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

There are four principal factors underlying this positive scenario, which can be summarised as follows. Firstly, the confidence engendered by the current price and budgetary stability and the expectation that this stability will be maintained following the moderate wage increases agreed by the social partners for the period between 1994 and 1996. Secondly, the stronger than anticipated recovery in the Community and world economies which has contributed to a further pick-up in business and consumer confidence and improved export prospects. Thirdly, the current low level of nominal interest rates, which is encouraging a rebound in consumer spending and business and housing investment. Finally, the strong rebound in private consumption under the impact of rising employment, lower taxation and continued moderate real wage growth.

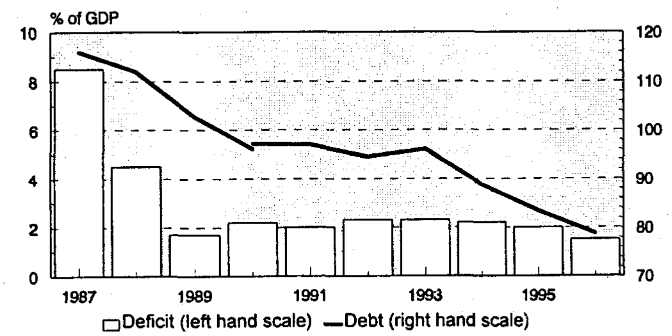
Continued good prospects over the medium term

There are strong indications to suggest that the current buoyant growth conditions will continue in 1995 and 1996. The international environment has improved considerably, which allied to greater inward investment and recent gains in competitiveness points to good export prospects. Domestic factors are also encouraging, with an absence of inflationary pressures and the sound public finances providing a stable environment for both business and consumers. Within this framework buoyant growth can be expected to continue into the medium term. Moreover, it can also be expected to remain well balanced with the recovery in domestic demand likely to be maintained.

Notwithstanding the moderate pay terms agreed by the social partners, real disposable incomes should continue to rise owing to low inflation and the absence of the pressures. Similarly, low short-term interest rates and much improved employment prospects are also expected to lead to improved confidence levels and a fall in the savings ratio. Investment is also responding to lower interest rates, better export prospects and improved business profitability and annual growth of at least 7% to 8% is well within reach. Public consumption is the only component of domestic demand which is expected to slow due to much improved wage moderation in the public sector and the non-repeat of once-off expenditures in 1994 funded from the proceeds of a tax amnesty.

Chart 1 - Ireland

Projected government deficit and debt ratio



Note: in case historical government debt data do not exactly match the debt definition in Regulation (EC) n°3605/93, a break in series is introduced.

Source: Commission services

Inflationary pressures are expected to remain subdued with the authorities' firm commitment to price and exchange rate stability being underpinned by the moderate pay terms agreed by the social partners. Consequently, the change in the private consumption deflator should remain around 2½% to 3% in 1994 and 1995. Given the high growth projections, the moderation of public consumption growth and the sharp fall in interest rates, further falls in the budget deficit to below 2% of GDP in 1995 and 1996 are in prospect. This is conditional, however, on a curtailment of the sharp rise in public spending registered in recent years.

Budget deficit levels of below 2% of GDP or even lower are fully consistent with the favourable cyclical factors and the need to reduce Ireland's continued high debt to GDP ratio.

A much improved employment performance is attainable

Notwithstanding high growth, a sustained improvement in employment performance in Ireland has proved elusive in recent years. This issue is the focus of the Irish convergence programme which aims to complement the continued very satisfactory nominal stability with a programme of structural reforms, leading in turn to higher employment growth. The switch in the composition of growth towards domestic demand evident in both current and expected medium term trends is contributing to the achievement of this objective. The significant rise in employment in the year to mid-April 1994 already points to a welcome change of direction. This process can be aided by intensifying the programme of structural reforms currently underway competitiveness and employment performance. This better performance will be necessary to cater for continued fast labour force growth, as well as to tackle the current very high jobless level.

Table 2
Ireland: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	9.2	23.3	10.5	8.5	:
Government budget balance (% of GDP)	-2.2	-2.5	-2.4	-2.0	-1.5
Gross government debt (% of GDP)	95.5	96.1	89.0	83.7	79.1
Nominal wages per head (% change)	5.3	5.9	3.5	3.0	4.0
Real wages per head (% change)	3.0	4.2	0.7	0.3	1.2

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

ITALY

In 1994 the economic upswing gained momentum

In 1994 the Italian economy went through a consolidation of the recovery which had already begun in the last months of 1993. The initial impulse to growth came from a buoyant export performance, but by the first months of 1994 domestic demand also began to pick up.

The recession-induced restructuring of large parts of both the industrial and services sectors, accompanied by an unprecedented labour shedding, boosted productivity across the board. The depressed conditions of the labour market together with the preservation of the income policy framework defined in 1992 and 1993, determined a very low dynamism of contractual wages. The resulting fall of unit labour costs allowed a large increase in profit margins, which markedly contrasted with the squeeze recorded during the preceding cyclical phase. As a consequence of the increased profitability, the downward trend in industrial investment reversed by the end of 1993 and switched to a sustained growth already in the first semester of 1994. The recovery in construction investment, however, lagged behind due to the persisting stagnation of public works and the depressed conditions of the private building sector.

Table 1
Italy: Macroeconomic performance

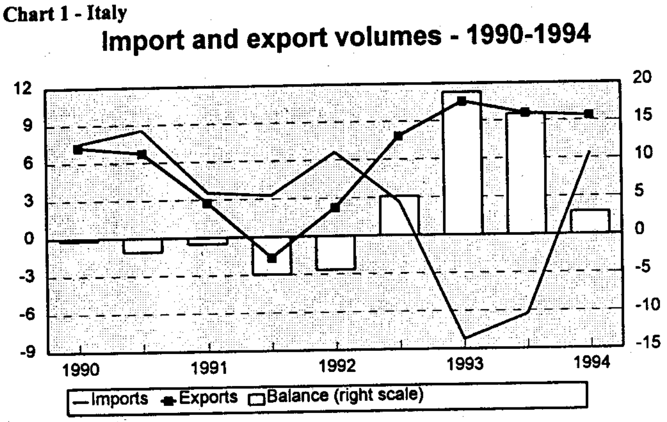
	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	1.4	-0.7	2.4	3.0	3.2
Total domestic demand (% change)	1.9	-5.6	1.7	2.8	3.3
Employment (% change)	0.5	-2.8	-1.7	0.8	1.1
Unemployment rate (%)	10.1	11.1	11.5	10.8	10.1
Inflation (% change)	6.0	5.1	4.0	3.5	3.5
Balance of current account (% of GDP)	-1.8	1.1	2.0	2.6	2.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

With some delay with respect to the cyclical upturn in total output also private consumption resumed, backed by a significant improvement in consumer confidence and a marginal recovery in real disposable income. The two latter circumstances are to be partially credited to the fiscal stance which in 1994 became relatively less strict than in the previous two years.

As a typical pattern of a recovery, the contribution to growth of the external side was reduced progressively throughout the year, due to a significant rise in import volumes from the exceptionally low levels of 1993. However, the export dynamics remained sustained, and still exceeded the growth of imports. After the export boom recorded in 1993, largely due to competitiveness gains arising from the lira devaluation, a new impulse was given in 1994 by the recovery in international trade (chart 1). The trade balance surplus showed a further widening with respect to 1993, and caused the current account surplus to improve in spite of some deterioration in invisible items. Thus, the external constraint appears to be less binding than in previous expansionary phases.

Chart 1 - Italy



Source: ISTAT, National Accounts

In 1994 a further, although limited, progress on inflation was accomplished. Consumer price increases fell below 4% for the first time in over twenty years. The main factors behind this result were the already mentioned slowdown in labour cost and the persistence of a significant output gap in the non-export oriented sectors during the first stages of the recovery. These factors allowed production prices to renew their descent after the upsurge in the first semester of 1993 due to the lagged effects of the devaluation. The breakdown in the prices of goods and services shows a still declining trend for the latter, thanks to a more competitive environment due to the structural changes intervened during the recession, whereas goods prices are either stable or on the rise depending on different categories. The outlook for inflation is one in which the impact of the weakening of the lira seems to become less relevant, but there are signals that some internal pressure due to the recovery might gradually build up and delay the pace of further decline in 1995.

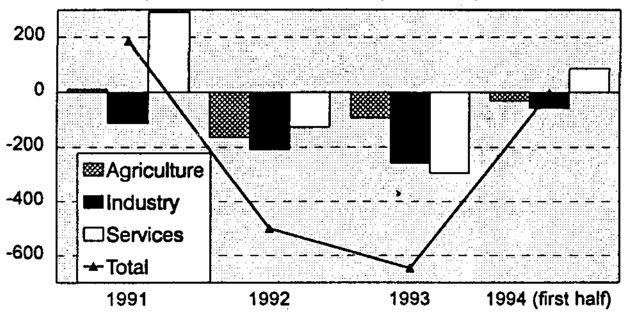
A sluggish recovery in the labour market

The recessionary phase had a dramatic and unprecedented impact on employment. More than one million jobs were lost in 1992 and 1993, 40% of which in industry, 23% in agriculture and 37% in services (chart 2). The downward trend in employment stabilised in the first half of 1994 and presumably reversed in the following months, but the extent of the crisis has been such that a complete recovery of the labour market will require a prolonged period of growth. Provisional data on employment trends show a mixed picture according to different sectors. Employment in agriculture and industry continued to decline in the first semester of 1994. Largely responsible for the decline in industry was the crisis in the construction sector, whereas the manufacturing sector did not record further losses. The still negative trends in agriculture and industry were compensated by the improvement in the services sector. A large part of the recent job creation is in the area of self-employment, thus confirming the important contribution in terms of flexibility that the one-person enterprises provide to the Italian economic system. The unemployment rate has peaked at 11.6% in April 1993 and subsequently declined to 11%. This figure would be higher had a significant reduction in the labour force due to a discouragement effect not taken place. The latter circumstance, suggesting a likely rebound in the labour supply during the recovery, is an additional factor that should prevent unemployment from falling rapidly from today's levels.

Chart 2 - Italy

Employment (*) - 1991/1994

(Absolute variations on end-period data)



(*) Expressed as man-years according to national accounts definition

Source: ISTAT, National Accounts

No progress in the fiscal consolidation process was recorded in 1994

In 1994 the Italian authorities adopted a softer approach to budget consolidation than in the previous two years, officially justified with the desire not to hinder the infant recovery. In the medium term economic and financial plan for the years 1994-96 the key objective of stabilising the debt to GDP ratio was postponed from 1995 to 1996. Along these lines the 1994 fiscal package was centred on expenditure cutting and only minor revenue enhancing measures were enacted. Some relevant one-off measures operating in 1993 on the revenue side were not replaced, allowing a decrease in the fiscal pressure of 1.2 percentage points. The action on the expenditure side was essentially made of three components: i) some piecemeal intervention aimed at reducing the social security outlays; ii) a contraction in capital accounts transfers and contributions; iii) a structural reform of the public administration. The first component targeted some sensitive areas of the budget, but did not represent a comprehensive reform of either the health care or the pension system. As for the reform of the public administration, up to now only a fraction of its provision have been carried on as intended.

Table 2
Italy: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	7.2	7.8	6.0	7.0	:
Government budget balance (% of GDP)	-10.2	-9.5	-9.6	-8.6	-7.9
Gross government debt (% of GDP)	102.5	118.6	123.7	126.8	128.6
Nominal wages per head (% change)	8.3	3.7	3.8	4.4	4.3
Real wages per head (% change)	2.2	-1.3	-0.2	0.9	0.8

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The overall result of the 1994 fiscal package came short of its original targets. The general government net borrowing grew in absolute terms and its ratio to GDP remained close to the 9.5% level of the previous two years. The debt ratio further increased. Thus in 1994 no progress in the process of fiscal consolidation was recorded, a circumstance which undermined investors' confidence, weakening the lira and lifting interest rates.

The draft budget law for 1995 aims at reducing the State sector borrowing requirement from 9.4% in 1994 to 8.0% in 1995 and 6.6% in 1996. The budget law for 1995 aims at reducing the State sector borrowing requirement from 9.4% in 1994 to 8.0% in 1995 and 6.6% in 1996. The government decided to leave unchanged the fiscal pressure at the level of 1994 and to carry on structural changes on the pension system in a separate reform project to be designed and approved by June 1995. This circumstance negatively affects the fiscal package by seriously limiting the extent of measures with permanent effect on the budget.

In 1994 the general economic conditions improved beyond expectations, and the outlook for the next year remains optimistic. This favourable cyclical phase should provide an opportunity to pursue budget consolidation with greater determination, as it reduces the costs of adjustment and eliminates the dilemma between fiscal consolidation and anti-cyclical policy. On the other hand a weak action on the fiscal side would lead to a more inflationary growth with the already experienced negative repercussions on the lira and a likely tightening of the monetary conditions. The Bank of Italy has repeatedly warned that monetary policy is anti-inflation oriented. In August 1994 a hike in the official rates was effected in response to growing inflationary expectations. Financial markets are also likely to react negatively to a looser fiscal stance, with adverse effects on government's interest expenditure and on investment. This was indeed the case in the second half of 1994 when the long term interest rates displayed a sharp rise in the differential vis à vis their German and French counterparts.

In conclusion the major policy challenge for 1995 remains a decisive correction of the fiscal imbalances. This objective would also be coherent with a more sustainable pattern of economic growth.

LUXEMBOURG

External demand adds additional strength to growth

As a small open economy, Luxembourg was able to take advantage of the faster than expected recovery in its neighbouring countries. Starting from the favourable situation in 1993, when due to the strong internal demand a recession was avoided, the Luxembourg economy is expected to grow by approximately 2¼% in 1994, while growth might run up to 3% next year.

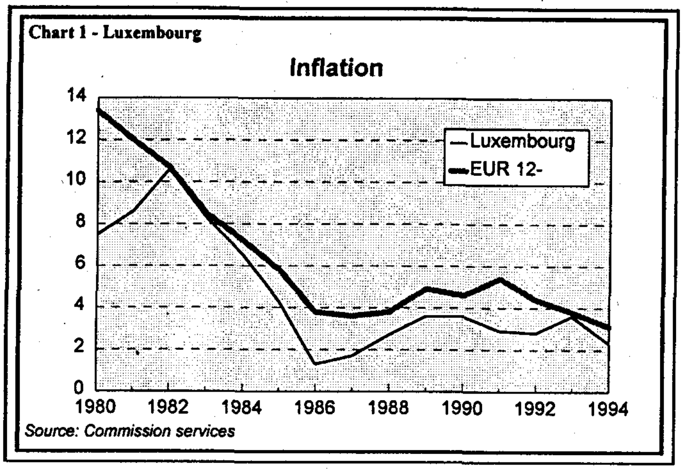
The principal contribution to growth in 1994 still came from private and public consumption. Private consumption probably grew by 1¾%, supported by a relatively high real wage growth and the improving economic climate. The healthy public finance situation allowed the government to extend real expenditures by almost 1%. The growth contribution of investment has fallen back slightly from last year's high level, which was brought about by some major projects in the steel and telecommunication sectors. Although firm data on the evolution of external trade is currently unavailable, it can be expected that the merchandise trade deficit shrank somewhat this year as a result of the strong external demand. As usual, this deficit was compensated by a surplus on the balance of services and by a net inflow of factor income, creating a healthy surplus on the current account.

Table 1
Luxembourg: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	2.7	0.6	2.3	3.0	3.2
Total domestic demand (% change)	4.5	1.6	1.5	2.1	2.4
Employment (% change)	3.4	1.7	1.7	1.9	2.1
Unemployment rate (%)	1.7	2.6	3.3	3.2	3.1
Inflation (% change)	3.1	3.6	2.3	2.5	2.7
Balance of current account (% of GDP)	30.7	28.8	28.8	28.7	28.3

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Domestic employment continued to grow rapidly, resulting from a further contraction in the industrial sector, more than compensated for by increasing employment in the services sector (mainly in the financial sector). However, since most of the new jobs were filled by foreign workers, the average unemployment rate was higher this year than last year. Still, at 3% (Eurostat definition), unemployment remained by far the lowest in the Community.



After the pronounced acceleration of inflation to 3.6% last year, the consumption price index fell rapidly back to a level of just over 2% in the third quarter of this year. This favourable evolution is due to the disappearance of the effects of higher excise duties and increases in administered prices. The government is currently evaluating the introduction of a number of ecological taxes, which could increase inflation by approximately 0.5 percentage point in 1995.

In the coming years, domestic demand will probably continue to sustain economic growth, due to continued real wage growth and the improving economic climate. As in the past, important investment projects in the steel and telecommunications sectors will push up investment. Given the improvement of the economic situation in the neighbouring countries in 1995, the positive growth contribution from external trade will probably be maintained. These better growth prospects should permit a further expansion of employment. However, the current stock of low skilled, long-term unemployed will continue to have problems to re-enter the labour market and foreigners will probably have to be engaged again to fill high skill jobs.

Public finance situation remains healthy

General government accounts for Luxembourg are only partially available, but current information shows that net lending of global government remains in surplus. This surplus is the net result of a small deficit for the central and local governments, compensated by a significant surplus of the social security sector. Still, general government gross debt is rising slightly (because of reserve build-up by local authorities and the social security funds) to reach a meagre 9.2% of GDP. Consequently, Luxembourg continues to comply to all EMU convergence criteria.

Table 2
Luxembourg: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	:	:	:	:	:
Government budget balance (% of GDP)	2.8	1.1	1.3	1.6	2.0
Gross government debt (% of GDP)	5.4	7.8	9.2	9.8	9.9
Nominal wages per head (% change)	5.6	4.9	4.1	4.2	4.6
Real wages per head (% change)	2.4	1.3	1.8	1.6	1.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

In 1995, the new government will maintain the prudent fiscal policy of the past. Although central government expenditures will rise by 6.3%, receipts are expected to increase even slightly faster (6.8%). To promote employment and improve the economic structure of Luxembourg, expenditures will be directed more towards public investment; the share of investment in total central government expenditures should run up to around 10%. The measures that were agreed with the social partners to promote employment, price stability and competitiveness will also be further implemented. For 1995 this implies that the employers' contributions for family allowances will be suppressed and paid by the central government.

In the second half of 1995, the government plans to introduce a number of ecological taxes on waste, packaging and CO2 emission. The implementation of the taxes could be postponed if the negotiations on the CO2 tax on the Community level are not concluded by then. In order to avoid negative effects on competitiveness, possible inflationary effects through the automatic wage indexation mechanism will be partly or totally neutralised.

THE NETHERLANDS

Recovery faster than expected

After a relatively mild economic slowdown in 1993, the recovery in the Netherlands clearly gained force at a faster pace than previously expected. Supported by the surprisingly strong improvement in the neighbouring countries, the Dutch economy might grow by as much as 2¼% in 1994. For the following years, it is expected that the leading role in the recovery will be taken over first by investment (from the second half of 1994 onwards) and gradually by private consumption when employment starts growing again. This could intensify growth in 1995 to around 3¼%.

The robust export evolution is the main contributor to the stronger than expected recovery of the Dutch economy. The improvement of exports started already in the second half of 1993, which was remarkable given the deep recession in Germany, the major Dutch trading partner that accounts for approximately one third of total exports. The export specialisation in agricultural products and their derivatives, which are less sensitive to cyclical variations, and the small share of the hard-hit manufacturing sector explain why the Dutch exports remained relatively unaffected. In 1994, export markets grew vividly, especially outside the European Community, and exports remained the single most important impulse for economic growth in 1994. However, because of the unfavourable composition of the Dutch export package for the recovery phase of the economic cycle, and since exporters will probably try to restore profit margins, it can be expected that the growth contribution of exports will gradually diminish.

Table 1
Netherlands: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	2.5	0.3	2.3	3.2	3.3
Total domestic demand (% change)	2.2	-0.5	1.7	2.8	2.8
Employment (% change)	2.2	-0.1	0.0	1.3	1.8
Unemployment rate (%)	7.3	8.8	10.0	9.8	9.4
Inflation (% change)	2.8	2.1	2.3	2.4	2.5
Balance of current account (% of GDP)	3.4	3.7	4.0	4.3	4.6

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Higher exports lead to higher capacity utilisation and higher profits, which are both beneficial for the evolution of corporate investment. Investment in housing by households was increasing because of lower government rent-subsidies; the perception that long-term interest rates have passed their lowest point also accelerated housing construction. However, the completion of some major investment programmes in the energy sector had a temporary negative effect on investment in 1994. In the coming years, gross capital formation and economic growth will be pushed up by cyclically induced investment, renewed investment in the energy sector and the start-up of some major public investment projects in railway infrastructure.

The recovery had an almost immediate positive effect on employment, but unemployment figures followed a more erratic pattern. Although it can be expected that the continued recovery will reduce unemployment further in the coming years, structural measures are still needed to bring down unemployment to an acceptable level. Surveys show that consumers do not expect that their financial situation will ameliorate considerably in the short run, which can be explained by the moderate wage evolution in the Netherlands. Therefore, private consumption will probably remain subdued until employment starts growing at a faster pace again. This restrained evolution of costs and domestic demand and the solid exchange rate will all contribute to keep inflation at a modest level.

Economic policy focuses on employment, lower tax burden and fiscal consolidation

General government net borrowing is higher in 1994 than in the previous year (around 3.8% of GDP compared to 3.3%), partly because of some unrealised savings and unbudgeted expenditures, and partly because of cuts in taxes and social security contributions to promote employment. However, mainly due to privatisation receipts, general government gross debt could decline from 81.4% of GDP in 1993 to 78.9% in 1994.

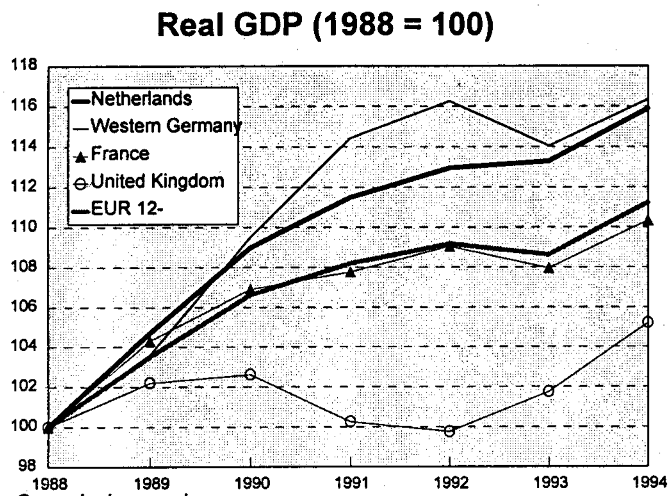
Table 2
Netherlands: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	6.4	7.7	4.0	5.0	:
Government budget balance (% of GDP)	-4.0	-3.3	-3.8	-3.5	-2.7
Gross government debt (% of GDP)	79.2	81.4	78.9	78.8	78.0
Nominal wages per head (% change)	4.2	3.3	2.0	1.8	2.4
Real wages per head (% change)	1.3	1.2	-0.3	-0.6	0.0

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The new convergence programme for the period 1995-98, which is based on the coalition agreement of the new government (formed last August) and the 1995 budget, puts the emphasis on creating employment by reducing the burden of taxes and social security contributions and promoting private initiative and competition. Based on strict expenditure control (real government expenditures should decrease by 0.7% yearly on average), the government deficit would simultaneously be reduced from the current level of almost 4% of GDP to a level significantly below 3% from 1996 onwards, to allow a continued reduction of the gross debt ratio.

Chart 1 - Netherlands



Source: Commission services

Since the coalition agreement is based on a rather cautious medium-term growth scenario, it can be expected that revenues might turn out to be higher than expected. The government intends to use this additional budgetary room in the first place to further reduce the general government deficit to around 2%, which would have a beneficial effect on the debt ratio. For the use of possible further growth windfalls, a choice will be made between further reducing the budget deficit and easing the total tax burden.

The measures the government plans to take to increase employment and labour market participation, especially at the lower end of the labour market, include reducing labour costs by lowering the burden of taxes and social security contributions and deregulation of the product and labour markets. Furthermore, a higher investment share in government expenditures will be realised. The planned reform of the social security system, which includes a privatisation of the disability and sickness benefit schemes, tighter criteria for calls on the system and smaller yearly adjustments of social benefits, should help to realise both the reduction of labour market inactivity and fiscal consolidation. The Dutch government estimates that between 350 000 and 450 000 additional jobs will be created in the next four years, 120 000 of which will be the result of the measures of the Coalition Agreement. The favourable but hard-to-quantify effects of market deregulation are not yet included in this estimate.

PORTUGAL

Moderate recovery in 1994 under the impulse of strong export performance

After a decline in 1993, real growth recovered at a moderate pace in 1994. The main positive factor sustaining economic activity was a clearly positive performance of exports recorded since the beginning of the year, the small open Portuguese economy benefiting fully of expanding external demand.

In contrast, internal demand remained weak, mainly delayed by low consumer expenditure. However, in the course of the year, the internal components of demand were showing signs of improvement. At the end of the first half of the year private consumption was recovering progressively despite falling real wages and a still depressed labour market situation; consumer demand was partly sustained by a fall of about one percentage point in the saving rate and larger indebtedness of households reflecting positive expectations for the coming months. Despite strong export expansion and an improvement in business confidence in export-oriented sectors, recovery in investment was weak due to still cautious expectations related to domestic demand, the need for financial consolidation of enterprises and availability of production capacities, particularly in capital goods sectors. Investments in constructions were lacking dynamism namely because public investment programmes related to EC Structural funds financing started later than expected.

As imports were contained by the still sluggish internal demand, the trade balance improved in 1994; however, despite a sharp increase in tourism receipts, the improvement of the current account balance was limited reflecting falling emigrants remittances and delayed net transfers of EC Funds.

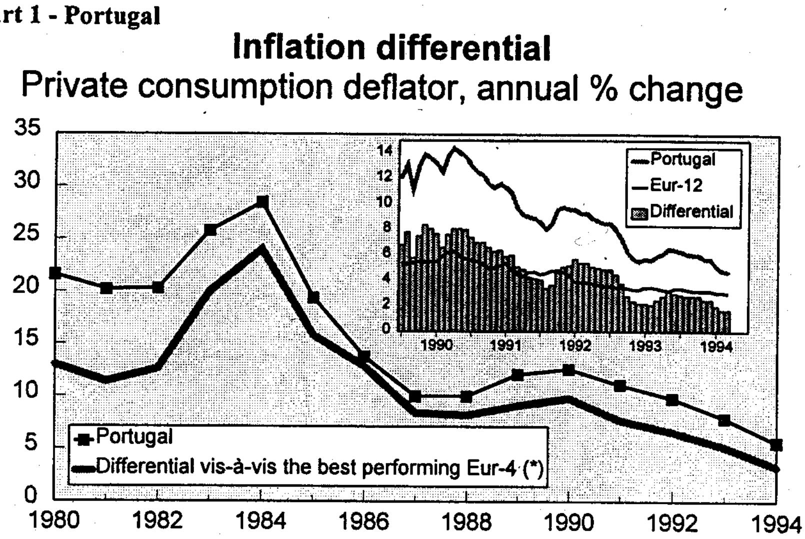
Table 1
Portugal: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	2.5	-1.2	1.1	3.0	3.2
Total domestic demand (% change)	4.7	-0.8	-0.1	2.6	3.2
Employment (% change)	1.4	-2.0	-0.4	0.1	0.4
Unemployment rate (%)	4.2	5.1	6.1	6.0	5.6
Inflation (% change)	11.1	7.9	5.5	4.6	4.4
Balance of current account (% of GDP)	-1.0	-0.7	-0.4	1.1	1.9

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The unemployment rate which had increased from 3.9% in the first quarter of 1992 to 6.8% in the first quarter of 1994 declined marginally to 6.7% in the second quarter of the year. This increase in unemployment and a diffused but clear increase of underemployment were transmitted to wage developments, giving evidence of flexibility in the labour market. Wages implicit in collective bargaining settlements were increasing at 5.2% in the first half of the year, decelerating from 7.1% in the whole of 1993. However, the reduction of the coverage of enterprises involved in these settlements was reflected in a slower effective increase in wages in the whole private sector, implying some reduction in real terms.

Chart 1 - Portugal



(*) Eur4 = B WD F NL

Source : Commission services

The declining trend of inflation which was resumed in 1991 continued steadily in 1994 reflecting the contraction of internal demand and the adjustment of domestic costs, offsetting the inflationary effects of the 1992-1993 depreciation of the escudo. However, rising import prices of raw materials and agricultural goods led to slight increases of prices of tradable goods during the summer. In October the year-on-year increase of the consumer price index reached 5.6%.

Table 2
Portugal: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	14.2	6.6	7.0	6.0	:
Government budget balance (% of GDP)	-5.2	-7.2	-6.2	-5.8	-4.8
Gross government debt (% of GDP)	66.2	66.9	70.4	71.7	72.3
Nominal wages per head (% change)	17.3	7.4	5.3	5.9	4.8
Real wages per head (% change)	5.5	-0.4	-0.2	1.3	0.4

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

After a period of instability in the second quarter of 1994 during which the markets tested the orientation of economic policy, the escudo started a movement of gentle appreciation and interest rates eased supported by increased confidence.

After a sharp deterioration of the general government deficit in 1993 - resulting from the negative impact of cyclical factors, particularly on tax revenues, and from structural factors - the public finance situation improved in 1994; the deficit was lowered from 7.1% in 1993 to 6.3% in 1994. Tax collection improved and fiscal revenues, particularly from VAT, increased markedly; current expenditures were kept within the predetermined ceilings at central government level. However, the deficit of social security continued to rise, fuelled by increasing unemployment transfers and weaker growth of social contributions. Although interest payments were declining significantly, the primary balance of general government in 1994 (total deficit net of interest payments) remained slightly negative at the level recorded in 1993. The government gross debt ratio to GDP, which had increased in 1993, rose again in 1994 to 70.4%

Expansion of internal demand will intensify activity growth in 1995

Real GDP growth will accelerate to 3% in 1995, under the impulse of resuming internal demand. Real gross disposable income starting to rise moderately within a context of greater confidence should boost consumer spending. Positive investment incentives, already under way in 1994 in exporting sectors, should spread throughout all productive sectors: the fall in stock levels, progressive decrease in idle capacity and larger order-books, combined to steadily improving expectations related to internal demand should fuel private capital formation. Public investment will expand, sustained by increased EC structural funds inflows. Moreover, the completion of a large, export-oriented, foreign investment project will strongly increase exports. Inflation is expected to moderate further but at a slower pace than in 1994; although in the wake of recovering activity some acceleration in wages is to be expected, their increase will remain moderate as improvement in total employment will be only progressive.

The achievement of further progress in fiscal consolidation should continue to be a priority for economic policy in 1995. The general government deficit is targeted to fall to 5.8% of GDP which does not seem very ambitious in the light of the improved growth prospects. According to the budget, the budgetary policy stance is to maintain current expenditure firmly under the compulsory ceilings for central government, while interest payments should decrease further although less than in 1994. Moderation of current outlays is designed in order to accommodate a marked increase in capital expenditure. The budget plans a broadening of the tax base; while some taxes will be reduced, the main rate of the value added tax will rise to 17% from the current 16% rate in order to finance a 0.75% decline in the rate of employers contributions to social security to reduce indirect labour costs. Indeed, the social security sector is currently the major source of the general government imbalances. The government plans to reduce further the general government deficit in the coming years towards the 3% of GDP target in 1997.

UNITED KINGDOM

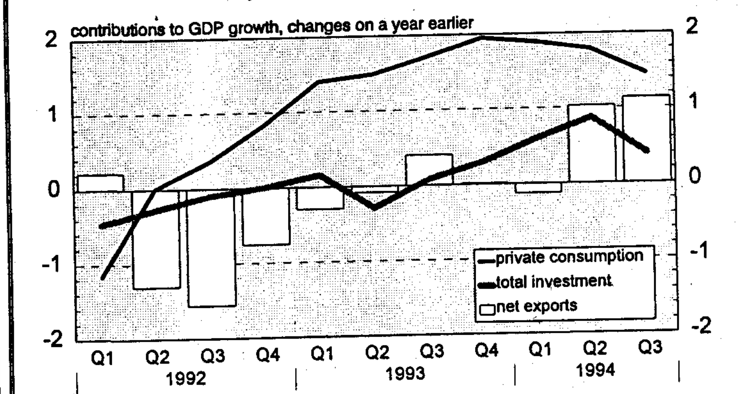
The recovery progresses

Recovery in the United Kingdom economy began more than a year earlier than in the rest of the Community. From its low point in the first quarter of 1992 the output of the economy has expanded by about 7% to the third quarter of 1994 and has more than recovered the fall in output during the preceeding recession of 1990/1991. In 1994 it is expected that GDP growth will average just less than 4%.

Oil production has been extremely strong and has contributed to the strong rise in overall output. Thus while total GDP has grown by 6% in the seven quarters up to the third quarter of 1994 non oil and gas GDP has risen by 5.4%. Manufacturing output lagged somewhat but began to pick up sharply in 1994 particularly as exports began to respond strongly to the recovery in the rest of the Community. On the demand side the upswing has until recently been led by private sector consumption which accelerated to a peak growth rate of 3.8% (annualised) by the second half of 1993. Consumption growth took place against a background of high levels of borrowing in the household sector, by historical standards, and restrained income growth. Furthermore the growth in consumption was not associated with a strong housing market - the housing market remains weak with broadly stable prices and declining turnover growth. Thus the rise in consumption has been mainly financed through a fall in the savings ratio which, with the exception of the first quarter of 1993, has fallen continuously from its peak of 13.3% at mid 1992 to 9.3% in the second quarter of 1994.

Chart 1 - United Kingdom

Private consumption, investment and net exports



Source: Commission services

More recently consumption growth has slowed as the tax increases announced in the two budgets of 1993 began to take effect and real personal disposable income growth slowed. However as consumption growth slowed in the first half of 1994 net exports picked up sharply and contributed to a further acceleration of growth. The sharp rise in UK net exports was partly due to strong oil exports and falling oil imports while non-oil exports accelerated driven by the good competitiveness position of the UK and by the upsurge in world trade.

So far the upswing has showed no signs of emerging inflationary pressures. Indeed retail price inflation has continued to slow through to the third quarter of 1994. Strong competitive conditions in the domestic market and the absence of wage and other cost pressures (rising commodity input prices have been absorbed) appear to have kept inflationary pressures under control.

Table 1
United Kingdom: Macroeconomic performance

	1990-92	1993	1994	1995	1996
GDP growth rate (% change)	-0.8	2.1	3.8	2.7	2.8
Total domestic demand (% change)	-1.2	2.1	2.9	2.3	2.5
Employment (% change)	-1.6	-1.0	0.0	0.7	1.1
Unemployment rate (%)	8.7	10.4	9.4	8.5	7.6
Inflation (% change)	5.9	3.5	2.5	2.9	3.3
Balance of current account (% of GDP)	-3.1	-1.6	-0.4	-0.4	-0.3

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The employment response to the recovery remains unclear. The employer based survey suggests that employment continued to fall through to the third quarter of 1994 (except for a rise in the third quarter of 1993) while the household based survey indicates rising employment from the second half of 1993 through to mid 1994. The continued fall in employment as recorded in the employer based survey is somewhat unusual given that the UK is more than two years into recovery. It is possible that the employer based survey is not adequately recording jobs in new businesses or rising employment in the construction sector. It may also be the case that the employment response to the recovery is taking longer to emerge as a result of productivity gains due to restructuring during the recession. Furthermore the number of full time jobs continues to decline while part time employment is expanding. Both sources indicate falling levels of unemployment.

While the outlook is for more modest but better balanced growth

The outlook for growth in the UK is for a slowdown to a more modest growth rate than that expected for 1994. Two factors lie behind the expected slowdown. Firstly, the surge in oil production, witnessed in 1993 and 1994, is assumed to level off so that the contribution of oil output and net oil exports to growth diminishes. Secondly with a further increase in the tax burden in 1995/96 in addition to that of 1994/95 private consumption growth is expected to decline before picking up somewhat in 1996 as real income growth begins to recover and as consumers adapt to the higher tax burden. However the slowdown in growth will be moderated by rising investment and a strong export performance.

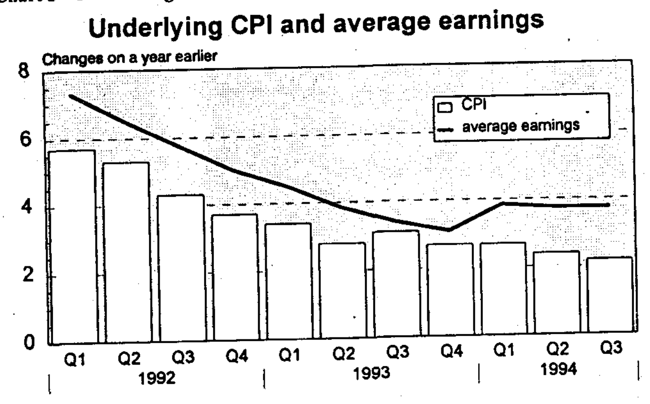
Table 2
United Kingdom: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	7.1	5.8	6.2	6.5	:
Government budget balance (% of GDP)	-3.4	-7.8	-6.3	-4.6	-3.4
Gross government debt (% of GDP)	:	48.3	50.3	52.3	52.9
Nominal wages per head (% change)	7.7	4.1	4.1	4.6	5.0
Real wages per head (% change)	1.6	0.6	1.5	1.7	1.6

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

Prospects for inflation depend on the extent to which the economy slows down over the course of 1994/1995 and on the behaviour of wages. In response to the relatively strong growth in the economy the authorities raised interest rates in the autumn of 1994 for the first time in five years. While the half point rise in official interest rates will in itself have little impact on economic activity, it represented a signal of the authorities' firm commitment to their inflation target (to keep inflation, as measured by the underlying retail price index, within a 1-4% band and to reduce it to the lower half of the band by late 1996 or early 1997).

Chart 2 - United Kingdom



Source: Commission services

Despite a continuing unexpectedly good inflation performance with underlying retail price inflation falling to 2% in September 1994, average earnings bottomed out at 3% in the third quarter of 1994 and subsequently rose to 3¾% in 1994 indicating that wage disinflation may have ceased before price inflation has bottomed out thus allowing real wages to rise. With unemployment continuing to fall and assuming that employment will respond to the recovery the labour market is expected to tighten somewhat and to lead to some upward drift in wages and earnings. Consequently inflation will tend to rise, albeit modestly, as the economy continues to grow into 1996.

The UK government presented an updated convergence programme in February 1994 in which a faster rate of reduction in the general government deficit was foreseen as a result of further budgetary measures announced in November 1993. Combined with continuing growth these measures should confirm the downward trend in the deficit. The programme of fiscal deficit reduction also involves ambitious expenditure plans which would need to be vigorously enforced. Lower than expected inflation would offer scope for even further expenditure reduction. Finally the UK external deficit is not expected to worsen despite the recovery and the earlier cycle in the UK than in the rest of the Community.

The main policy challenge in the UK is to maintain the anti inflationary stance in the face of a recovery which has not fully impacted on all sectors of the economy. Confidence has not yet fully recovered possibly because the housing market continues to remain weak. Despite uncertainty about how much spare capacity exists the UK economy will have to slow down at some point to a growth rate closer to the potential output growth rate if inflationary pressures are to be avoided. It is possible that this may require further policy action by the authorities.

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1995 Annual Economic Report

(presented by the Commission)

remained practically stable for the third year running at the very high level of 9 ½ per cent of GDP. Spain and France achieved small reductions in their deficits, which, however, remain too high (7.0 and 5.6 per cent of GDP respectively in 1994).

According to the November 1994 Commission forecasts, the outlook for next year and for 1996 suggests that, under current policies, fiscal consolidation will not fully exploit the opportunities offered by the emergence of a stronger growth performance, even though the projected deficits will be on a downward path.

Table 9

	General government net borrowing (-) or lending (+)			General government gross debt		
	percentages of GDP					
	1994	1995	1996	1994	1995	1996
B	-5.5	-4.7	-4.0	140.1	138.7	136.0
DK 1)	-4.3	-3.0	-2.2	78.0	78.0	78.2
D	-2.9	-2.4	-2.0	51.0	2) 59.4	58.9
GR 3)	-14.1	-13.3	-12.9	121.3	125.4	128.1
E	-7.0	-6.0	-4.7	63.5	65.8	66.1
F	-5.6	-4.9	-3.9	50.4	53.4	55.6
IRL	-2.4	-2.0	-1.5	89.0	83.7	79.1
I	-9.6	-8.6	-7.9	123.7	126.8	128.6
L	1.3	1.6	2.0	9.2	9.8	9.9
NL	-3.8	-3.5	-2.7	78.9	78.8	78.0
P	-6.2	-5.8	-4.8	70.4	71.7	72.3
UK	-6.3	-4.6	-3.4	50.4	52.4	53.1
EC	-5.6	-4.7	-3.9	68.8	72.7	73.2

European Commission estimates of November 1994

1) Government deposits with the central bank, government holdings of non-government bonds and public enterprises related debt are expected to amount to 24.4% of GDP in 1994.
2) The sharp increase in the German debt ratio in 1995 is mainly caused by the take-over by the government of off-budget unification-related liabilities, the most important of which is the debt of the "Treuhandanstalt".
3) The Commission forecast for Greece is based on the revised national accounts presented by the Greek authorities to the Commission; subsequent information would appear to indicate that the public sector accounts in the revised national accounts yields a larger deficit than should be the case. Taking account of this factor the Commission forecast for the general government deficit in 1994 would be 12.7 % of GDP rather than the actual forecast of 14.1 % of GDP.

For the Community as a whole, net borrowing as a percent of GDP is expected to narrow to 4.7 per cent next year and to 3.9 per cent in 1996. In five Member States (Denmark, Germany, Ireland, the Netherlands and the UK) the projected reductions in general government net borrowing are consistent with the objectives set in the national convergence programmes. On the other hand, the projections for Belgium, Spain, France, Italy, and Portugal indicate that continued efforts or additional measures are

November 1990 to 10.2% in March 1994. However, this downward trend in inflation seems to have been interrupted since then given that CPI inflation subsequently rose to 11% in October. This development in inflation performance might reflect the ending of recession, the rise in real wages and the continued large scale fiscal deficits.

Table 2
Greece: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	14.0	15.2	:	:	:
Government budget balance (% of GDP)	-12.9	-13.3	-14.1	-13.3	-12.9
Gross government debt (% of GDP)	87.0	115.2	121.3	125.4	128.1
Nominal wages per head (% change)	13.6	8.6	12.4	10.1	10.5
Real wages per head (% change)	-3.4	-4.4	1.5	0.5	1.3

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

The Commission forecast for Greece is based on the revised national accounts presented by the Greek authorities to the Commission; subsequent information would appear to indicate that the public sector accounts in the revised national accounts yields a larger deficit than should be the case. Taking account of this factor, the Commission forecast for the general government deficit in 1994 would be 12.7% of GDP rather than the actual forecast of 14.1% of GDP.

Efforts to tackle the public sector deficits have been insufficient in the face of rising real interest rates and growing debt. Thus while the primary deficit has been reduced from 7.9% of GDP in 1989 to a surplus in 1994 the general government deficit remains at over 13% of GDP. The interest cost of the debt has been rising sharply from 6.7% of GDP in 1989 to an estimated 15% in 1994. Apart from the continued costs of the deficits two other factors have played a significant role in increasing debt servicing costs; firstly, the central government has taken over substantial debts from both the wider public sector and from the private sector thus increasing the general government debt level and secondly, partly because of EC pressures and developments (conditions associated with the 1991 balance of payments loan and Community Treaty provisions) the use of administrative devices to lower interest costs have been eliminated and the deficits are now financed mostly at market interest rates. Reflecting the insufficient fiscal adjustment and the consequent high levels of inflation Greece has the highest levels of nominal and real interest rates in the Community.

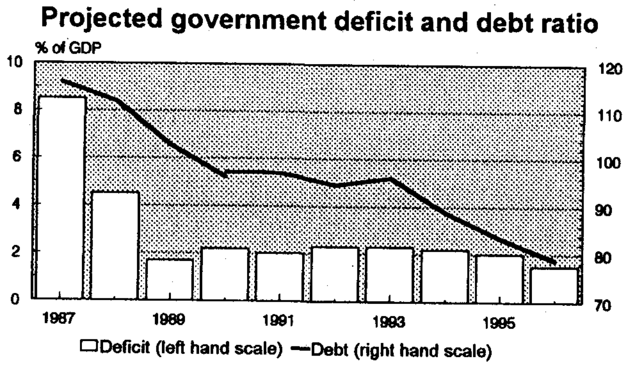
The prospects are for a continuation of the modest upswing evident in 1994. The recovery will be led by domestic demand and in particular by public sector investment driven by the Community Support Framework. Private investment, however, will continue to be restrained by high real and nominal interest rates. Exports will gain from the recovery in the rest of the Community but because of the wide absolute gap between exports and imports the balance of trade will deteriorate. Domestic demand will be

Continued good prospects over the medium term

There are strong indications to suggest that the current buoyant growth conditions will continue in 1995 and 1996. The international environment has improved considerably, which allied to greater inward investment and recent gains in competitiveness points to good export prospects. Domestic factors are also encouraging, with an absence of inflationary pressures and the sound public finances providing a stable environment for both business and consumers. Within this framework buoyant growth can be expected to continue into the medium term. Moreover, it can also be expected to remain well balanced with the recovery in domestic demand likely to be maintained.

Notwithstanding the moderate pay terms agreed by the social partners, real disposable incomes should continue to rise owing to low inflation and the absence of tax pressures. Similarly, low short-term interest rates and much improved employment prospects are also expected to lead to improved confidence levels and a fall in the savings ratio. Investment is also responding to lower interest rates, better export prospects and improved business profitability and annual growth of at least 7% to 8% is well within reach. Public consumption is the only component of domestic demand which is expected to slow due to much improved wage moderation in the public sector and the non-repeat of once-off expenditures in 1994 funded from the proceeds of a tax amnesty.

Chart 1 - Ireland



Note: in case historical government debt data do not exactly match the debt definition in Regulation (EC) n°3605/93, a break in series is introduced.
Source: Commission services

Inflationary pressures are expected to remain subdued with the authorities' firm commitment to price and exchange rate stability being underpinned by the moderate pay terms agreed by the social partners. Consequently, the change in the private consumption deflator should remain around 2½% to 3% in 1994 and 1995. Given the high growth projections, the moderation of public consumption growth and the sharp fall in interest rates, further falls in the budget deficit to below 2% of GDP in 1995 and 1996 are in prospect. This is conditional, however, on a curtailment of the sharp rise in public spending registered in recent years.

Budget deficit levels of below 2% of GDP or even lower are fully consistent with the favourable cyclical factors and the need to reduce Ireland's continued high debt to GDP ratio.

A much improved employment performance is attainable

Notwithstanding high growth, a sustained improvement in employment performance in Ireland has proved elusive in recent years. This issue is the focus of the Irish convergence programme which aims to complement the continued very satisfactory nominal stability with a programme of structural reforms, leading in turn to higher employment growth. The switch in the composition of growth towards domestic demand evident in both current and expected medium term trends is contributing to the achievement of this objective. The significant rise in employment in the year to mid-April 1994 already points to a welcome change of direction. This process can be aided by intensifying the programme of structural reforms currently underway to improve competitiveness and employment performance. This better performance will be necessary to cater for continued fast labour force growth, as well as to tackle the current very high jobless level.

Table 2
Ireland: Economic policy indicators

	1990-92	1993	1994	1995	1996
Money Growth (% change)	9.2	23.3	10.5	8.5	:
Government budget balance (% of GDP)	-2.2	-2.5	-2.4	-2.0	-1.5
Gross government debt (% of GDP)	95.5	96.1	89.0	83.7	79.1
Nominal wages per head (% change)	5.3	5.9	3.5	3.0	4.0
Real wages per head (% change)	3.0	4.2	0.7	0.3	1.2

For defintions, see Table 2 for Belgium
Source: Commission services, economic forecasts, Autumn 1994

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