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Commission's Recommendation for the Broad Guidelines of the Economic Policies of the Member States and the Community

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Corrected page 12 has been inserted in the main text.

EUROPEAN COMMISSION

Commission's Recommendation for the Broad Guidelines of the Economic Policies of the Member States and the Community

drawn up in conformity with article 103 (2) of the
Treaty establishing the European Community

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I. Broad Economic Policy Guidelines for the Member States and the Community

1. Introduction

Since the Summer of 1994, when the previous Broad Guidelines were adopted, economic growth in the Community has become firmly established. However, as the recent foreign exchange turmoil following the decline of the dollar has highlighted, significant risks and important policy issues remain unresolved. In order to ensure that the growth prospects are fully taken advantage of to increase employment and enhance convergence, economic policies must respond to the challenges and opportunities presented by the emerging economic expansion.

The present set of policy guidelines - prepared and adopted according to article 103(2) of the Treaty establishing the European Community - will constitute the reference for the conduct of economic policies in the Community and the Member States. It re-affirms both the objectives proposed in the earlier versions and the conclusions on fighting unemployment reached by the European Council, notably those of the Essen meeting which recommended five areas where action had to be intensified. Full implementation of these guidelines will make possible a strengthening of convergence and a realisation of the good growth and employment prospects, thus achieving significant reductions in the rate of unemployment.

Two policy concerns should be given prominence in the present environment. First, there is the possibility that the favourable impact of economic growth could give rise to "adjustment neglect". This may take the form of a weakening commitment, induced by the cyclical improvement of the budget deficit, to resolve in a durable manner the structural fiscal imbalances, or, as employment begins to recover, it may be reflected in a reluctance to initiate and implement those measures which are necessary to remove labour market imperfections. It is essential that either type of "adjustment neglect" should be vigorously resisted.

Secondly, recent exchange rate changes have not only contributed to greater risks of inflation dispersion, but they have also contributed to a potential fragmentation of the internal market and to threatening the beneficial achievements of economic integration.

Exchange rate misalignments will have detrimental effects for all the Member States. It is clear that, in order to minimise the occurrence of such episodes, creating the conditions for exchange rate stability within the Community must become a key priority of economic policies.

The present guidelines re-affirm the policy objectives set in the December 1993 and July 1994 guidelines: it is essential for the Community and the Member States to turn the present recovery into a strong, sustainable, non-inflationary medium-term growth and employment creation process, so that the rate of unemployment is substantially reduced and to make possible the achievement of the necessary degree of convergence to facilitate the transition to stage III of EMU. Achievement of these objectives will require a stable, investment-enhancing, short- and medium-term macroeconomic framework characterised by:

- a stability-oriented monetary policy whose task is not undermined by inappropriate budgetary and wage developments;
- sustained efforts to consolidate the public finances in most Member States consistent with the objectives of their convergence programmes;
- nominal wage trends incorporating the price stability objective; at the same time, real wage developments should take into acount the need to strengthen the profitability of employment-creating investment.

An essential complement of this framework are structural reforms aimed at fostering the competitiveness of the economies of the Member States and at improving the functioning of their labour markets. The policies necessary for sustaining long-term growth, increasing employment, and strengthening convergence are mutually consistent.

2. Economic Policy Guidelines

Price and Exchange Rate Stability

Substantial progress in reducing inflation in the Community and in the Member States has been made since the beginning of the decade. Nine Member States (B, DK, D, F, IRL, L, NL, A, UK) are now expected to see a rate of inflation in the range of between 2 and 3 per cent in 1996, consistent with the objective of the 1993 and 1994 guidelines; Finland and Sweden are forecast to experience rates of inflation just above this range next year. Spain, Italy and Portugal, on the other hand, are projected to record rates of inflation of about 4 ½ per cent while inflation in Greece is expected to decline to about 9 per cent.

Further progress towards price stability must be made. This means, above all, enlarging substantially the group of Member States where inflation performance can be considered satisfactory. Those Member States that are currently expected to experience rates of inflation between 2 and 3 per cent should maintain a policy aimed at preventing any resurgence of inflationary pressures and at progressing towards the lower end of this range. Other countries should substantially increase their efforts.

The recent exchange rate changes have important implications for inflation convergence. Thus, in Member States experiencing currency appreciations in nominal effective terms, inflation convergence is expected to strengthen and inflation is projected to remain below 3 per cent this year and next. In these Member States wage trends are expected to develop broadly in line with the objective of price stability too. However, it will be necessary to ensure that wage developments do not lead to reductions in investment profitability, particularly in the export-oriented sectors. On the other hand, in the Member States experiencing currency depreciations, price stability is less secure and the risks of an acceleration of inflation dominate the outlook. In these countries utmost caution is needed. In particular, in the context of strong economic growth, it will be important to prevent increases in import prices from generating a vicious circle of price and wage inflation. Otherwise, the achieved credibility of moving towards a stability oriented policy framework would be lost rapidly.

The combination of the marked depreciation of the dollar and of uncertain fiscal and inflation prospects in some Member States have led to substantial exchange rate instability within the Community. The exchange rate changes which have taken place exceed what would have been warranted by the differentials in the rates of inflation and have resulted in a competitiveness penalty for the countries who have followed sound policies and increased inflationary pressures for those whose currencies have depreciated. Such exchange rate misalignments are detrimental to all Member States; in the ones whose currencies have appreciated short-term growth prospects will deteriorate, while in those whose currencies have depreciated inflation prospects will worsen and the stability-oriented medium-term policy will be in jeopardy. Moreover, the proper functioning of the internal market has been put at risk. Not only is it possible that investment decisions may be made with the view to exploit exchange-rate induced competitiveness gains, but also it is possible that special interest groups supporting devaluation policies will be encouraged.

Therefore, all Member States must pursue policies supporting stable exchange rates within the Community. Exchange rate stability will not only contribute to reaping the full benefits of the internal market and to improving resource allocation within the Community, but it will also make possible the realisation of improved price stability. In this respect a key role will be played by budgetary policy and by the credibility of the fiscal consolidation commitments.

Sound Public Finances

Despite the consolidation of economic growth, prospects for the resolution of the fiscal imbalances remain uncertain and fiscal convergence continues to be elusive. According to current estimates, net borrowing as per cent of GDP is expected to decline by approximately 1 ½ percentage points between 1994 and 1996, about half of which is reflecting the contribution of the automatic stabilisers on the budget balance.

The failure to realise greater progress in budgetary consolidation sustains, in many cases, a situation where fiscal policy is severely constrained by a high and rising burden of interest payments; it also undermines price and exchange rate stability, increases uncertainty about the course of fiscal policy and erodes the credibility of policies, it contributes to an unbalanced policy mix, and it undermines the task of monetary policy. Over the medium term, persistent fiscal imbalances will have adverse implications for economic growth and for employment creation. A sound fiscal position is a positive supply factor as it opens up the possibility for tax reductions and for increases in productive public investment. Indeed the arguments for budgetary consolidation based on growth and employment considerations are at least as important as those based on the need to improve the sustainability of debt positions and nominal convergence. If budget deficits cannot be reduced in a durable manner now, during a period of relatively strong growth, when will they be reduced ?

The clear task confronting virtually all the Member States is to ensure that advantage is taken of all the growth opportunities to promote fiscal consolidation by reducing structural deficits. The Member States should aim to bring their budget deficit below 3 per cent of GDP as soon as possible, as a first step towards the medium term goal, particularly important during Stage III, of reducing it to between 0 and 1 per cent of

GDP as indicated in the 1993 Broad Guidelines. With such a policy it would be possible to have the average budget deficit in the Community below 3 per cent of GDP by 1997.

The current estimates suggest that, all the Member States, including those where the forecast deficit for this year will be below the 3 per cent mark (Denmark, Germany, Ireland, and Luxembourg), ought to exploit any room provided by economic growth higher than in budget plans, or by a decline in interest rates, to accelerate the process of budget consolidation. In the event that the exchange rate turbulence lowers economic growth this year, the efforts to achieve the targets of the convergence programmes should not be relaxed.

The forecast for 1996 indicates that, on the basis of the adjustment measures which have been clearly specified so far among those Member States which have set fiscal targets in their convergence programmes, the fiscal objectives will not uniformly met. Adjustment to achieve the deficit target of the convergence programme is required, albeit of different magnitude, in the cases of Belgium, Germany, Greece, Spain, France, and Portugal; in all these cases, the projected deficit is larger than that set in the convergence programme. On the other hand, Denmark, Ireland, the Netherlands, and the UK are expected to meet the deficit objectives by next year.

In many countries, restraining expenditure increases should be the preferred approach since, apart from their impact on employment, there are undoubtedly limits to higher taxation and social charges. But the rationalisation of the public expenditure and taxation systems can also contribute to economic growth and employment creation. In particular, as proposed in the 1994 guidelines, the tax structure should be adjusted in a manner consistent with employment support, while public expenditure should be re-allocated away from consumption and in favour of productivity-enhancing spending; in the latter, strengthening public investment and immaterial investment in human capital should be accorded a priority. In this context as well, taxation on the use of labour should be reduced, especially at the lower end of the wage and productivity scale. It is important, however, that the necessary reduction in budget deficits is not endangered, which implies that compensatory additional revenues should be found.

Fiscal difficulties continue to characterise the public finances of several Member States. In Greece and Italy, the persistence of the fiscal imbalances continues to have wider implications, undermining price and exchange rate stability, contributing to high risk premia on interest rates, and inhibiting progress towards convergence. Decisive measures, in a multi-annual framework, are required in order to restore confidence in the course of economic policies. In the case of Sweden, which is confronted with similar difficulties, a multi-annual adjustment fiscal framework has already been announced; it is necessary that the adjustment path is adhered to. In Belgium, the high indebtedness necessitates that the fiscal component of the Global plan is fully implemented and that further progress in reducing the deficit below the 3 per cent of GDP mark is required in order to also achieve a more significant reduction in the debt ratio.

In Spain and Portugal, greater commitment and more ambitious targets are required in the area of fiscal consolidation; more ambitious fiscal objectives are also necessary in the cases of Austria and France. In Austria and Sweden, further efforts will also be necessary to bring the debt ratio on a downward course. Finally, while Finland has not yet prepared a convergence programme, the forecasts suggest that its fiscal objectives are ambitious; efforts to realise these objectives should be sustained.

Fiscal developments and prospects in Ireland and Luxembourg suggest that they will continue to show no excessive deficit. In the former, the decline in the debt ratio is projected to continue at a healthy pace, while the state of the public finances of the latter continues to be robust.

Competitiveness

Following the proposals of the White Paper on *"Growth, Competitiveness, Employment"*, Member States are implementing reforms aimed at strengthening the forces contributing to endogenous growth and at enhancing the dynamism and competitiveness of the Community economies.

In order to benefit fully from the opportunities offered by the internal market, the transposition of Community directives into national law now stands at 92.4 per cent while the dispersion ranges from 86.3 per cent to 98.6 per cent. Progress is required, however, in the areas of insurance, intellectual and industrial property, public procurement, new technologies and services and freedom of movement. Moreover, progress has been slow in the extension of the single market to telecommunication and energy, while the internal market in transport remains incomplete. Furthermore, additional progress is necessary in reinforcing competition rules, reducing state aids, and reducing the role of the public sector. Privatisation, to the extent that Member States judge it compatible with their objectives, could further the progress already made in this direction.

State of implementation of the internal market White Paper measures (breakdown of situation by Member State, in percent; May 17, 1995)											
DK	L	F	NL	E	UK	P	B	D	IRL	I	GR
98.6	95.9	95.4	95.0	92.7	92.2	90.9	90.4	90.0	89.5	89.0	86.3
EC-12 : 92.4											
Source: European Commission											

Several initiatives have been taken at the Community level. Following the recommendation of the Essen Council, a Competitiveness Advisory Group has been set up and it plans to prepare a report for the Cannes European Council on the state of Community competitiveness and related issues; moreover, the Group for Legislative and Administrative Simplification has been established. In order to enhance overall competitiveness, several issues are being reviewed at the Community level, including improving financing for SMEs, enhancing labour market flexibility, and improving the quality of vocational training.

It is essential for the dynamism of the Community economies that material and immaterial investment be stepped up. This relates in particular to investment in education and training and in the infrastructure of the Community which needs to be developed to match the requirements of the 21st century. The Trans-European Networks should be realised and the Action plan on the Information Society should be carried through. In addition, for the active promotion of research and development initiatives, greater co-ordination between Member States activities is essential. Parallel, co-ordinated, efforts at the level of the Community and of the Member States is an essential building block to realising the potential for job creation and growth.

Employment and the Labour Market

The economic recovery, if it progresses as predicted, will absorb the cyclical component of unemployment by 1997. Nevertheless, to continue to reduce unemployment in a significant and progressive manner, it is necessary to achieve a high rate of economic growth over many years and to increase the capacity of that growth to generate jobs. An essential component of the efforts to achieve these goals is represented by more active and more efficient labour market policies. These must aim at a comprehensive, integrated and coherent effort to bring about structural change in the fields of the educational systems, labour law, work contracts, contractual negotiation systems and the social security system to improve the functioning of the labour market as a whole.

In the context of the White Paper, the Essen European Council identified within the wide array of measures working in the directions outlined presently, the following five priorities:

- Improving the employment opportunities for the labour force by promoting investment in vocational training,
- Increasing the employment intesiveness of growth,
- Reducing non-wage labour costs,
- Improving the effectiveness of labour market policies,
- Improving measures to help groups which are particularly hard hit by unemployment.

Member States were invited to implement measures adapted to their own specific situation and to prepare multi-annual programmes spelling out their policy intentions. Various measures have already been taken, but greater and more determined efforts are needed.

Active and more efficient labour market policies contribute to the goal of increasing employment through three main channels:

i) they ***improve the employment opportunities for the labour force by promoting investment in vocational training***, notably in SMEs, and thus raise the quality of human capital which improves competitiveness, potential output and the flexibility of, and opportunities for, the workforce;

ii) they ***increase the employment intensity of growth***, without affecting negatively the rate of growth itself, by:

   - the Social Partners examining at the appropriate levels whether employment could be promoted without endangering competitiveness through the allocation of productivity gains to contribute to innovative forms of work organisation such as reduction and new patterns of working time and new combinations of work and leisure;

- increasing the incentives to employment by ***reducing non-wage labour costs***, especially at the lower end of the wage and productivity scale, without harming other parts of the labour market; from a macroeconomic point of view this must be achieved in ways which do not compromise the reduction of budgetary deficits nor the competitiveness of enterprises. Reforms including, where appropriate, alternative financing sources of social protection systems are therefore required;
- encouraging the development of new employment opportunities and activities, e.g. those linked to the service society and environmental sustainability.

iii) they promote the employability of people when new jobs become available by:

- ***improving the effectiveness of labour market policy*** through enhancing the flexibility with respect to professional and geographical mobility (particularly for those workers readily employable);
- ***improving measures to help groups which are particularly hard hit by unemployment*** through special retraining schemes which concentrate on target groups hit by exclusion.

Labour market policies contributing to exploiting these three channels constitute not only an indispensable complement to macroeconomic policies and structural policies in the area of competitiveness but they also contribute to maintaining and reinforcing cohesion and the social consensus inside the Union in the long and difficult process of absorbing unemployment.

In order to enhance the effectiveness of the work which is currently under way and to increase the overall consistency of the individual policy actions, the Commission, on 8 March 1995 presented a Communication to the Council in which it suggests the implementation, in the context of Article 103 of the Treaty, of a procedure for the surveillance of employment trends and policies.

It is now important that Member States adopt rapidly their multi-annual programmes which will constitute the benchmark in the continuous monitoring of the policies aimed for job creation. These programmes should be mutually consistent with the macroeconomic framework defined by the Broad Economic Policy Guidelines.

II. Explanatory document

This explanatory document reviews the economic situation and outlook, the progress made in implementing the previous Broad Guidelines and the current stance of economic policy. In accordance with what was announced in the Communication to the Council on the Follow-up to the Essen European Council on Employment[1], employment trends and policies are given greater prominence.

On the basis of the analysis outlined in this explanatory document, the Commission is recommending a new set of guidelines for the economic policies of the Member States and of the Community which are firmly oriented towards achieving economic convergence and fostering job creation. These guidelines confirm the thrust of those adopted in December 1993 and July 1994, but take into account the fact that the economies of the Community are now at a much more advanced stage of the recovery and that a number of risks are appearing on the way to transforming the current recovery into strong medium-term growth.

1. Introduction

The economic outlook for the Community continues to be favourable. The recovery, which had just become visible a year ago when the 1994 Broad Guidelines were adopted, has gathered strength and its pattern - exports and investment continue to be the most dynamic components - remains conducive to sustained medium-term growth. Notwithstanding the negative effects of the recent foreign exchange turmoil, growth is expected to remain satisfactory also in 1996. The recent episode of exchange rate instability has certainly affected business confidence negatively, but the fundamental factors determining growth remain favourable.

Progress has taken place in achieving the degree of nominal convergence necessary for the transition to EMU. But more needs to be done and, in certain cases, progress has been disappointing relative to what could have been achieved in the current favourable economic environment. The recent instability of foreign exchange markets, even if its origin lays to a great extent outside the Community, highlights the lack of convergence which still characterises the economic performance of several Member States, and especially the lack of credibility of their budgetary consolidation plans.

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1 "Follow-up to the Essen European Council on Employment" Com (95) 74 final of 8 March 1995

Given that employment always responds with a lag to a recovery in economic activity, the improvement in the economic situation is not yet contemporaneously reflected in a similar upturn in labour market conditions, even though the reduction of unemployment in this cycle is expected to be much more pronounced than that seen in the early 1980s. Employment, which declined again in 1994, is now projected to increase this year and in 1996 by about one per cent a year, with the rate of unemployment also starting to decline.

Under these circumstances, economic policy must be resolutely oriented towards the twin objectives achieving economic convergence and fostering job creation. This means achieving strong, non-inflationary and more employment-creating rates of growth.

2. The economic situation and outlook

2.1 Growth prospects

Economic growth in the Community is projected to average 3.1 per cent in 1995 and 2.9 per cent in 1996, up from an estimated 2.7 per cent last year. Thus, the recovery which commenced towards the second half of 1993, is now being transformed into robust economic growth so that, by 1996, real output in the Community will be almost 10 per cent above the 1991 level.

The economic expansion has been, and is expected to continue to be, sustained by strong exports, investment spending and, to a lesser extent, private consumption growth. Buoyant world trade conditions are expected to sustain Community exports which should increase, in real terms, by 7.5 and 6.5 per cent, respectively, during this year and next. Investment spending, which is estimated to have grown by 2.4 per cent in 1994, is projected to increase by 6.3 per cent this year and by just below 6 per cent in 1996. Finally, private consumption, is projected to expand by 2.1 per cent this year and by 2.5 per cent in 1996. This pattern of growth - with investment growing at a brisk pace - corresponds closely to what is necessary to create the conditions for a long period of strong growth.

The recent weakening of the dollar in the foreign exchange markets and the substantial depreciations experienced by some European currencies are having a twofold effect on

Table 1				
Economic growth in the Community (percentage change in real GDP)				
	1993	**1994**	**1995**	**1996**
B	-1.7	2.3	2.7	2.6
DK	1.5	4.4	3.3	2.9
D	-1.1	2.9	3.0	2.6
GR	-0.5	1.2	1.6	1.8
E	-1.1	2.0	3.1	3.4
F	-1.5	2.7	3.1	2.9
IRL	4.0	6.3	6.9	5.5
I	-0.7	2.2	3.3	3.4
L	2.1	3.0	3.3	2.9
NL	0.3	2.5	3.2	2.8
A	-0.1	2.7	2.7	2.5
P	-1.2	1.1	3.0	3.2
FIN	-1.6	3.9	5.3	4.2
S	-2.6	2.2	2.8	3.0
UK	2.0	3.8	3.1	2.8
EC	-0.5	2.7	3.1	2.9

Source: Commission Spring 1995 economic forecasts

Community growth prospects. On the one hand, overall growth is slowed down as Community exports become, on average, more expensive on world markets and as business confidence is negatively affected by the uncertainty induced by exchange rate instability. On the other hand, the exchange rate movements within the Community may result in short-term differential effects on the growth prospects of countries whose currencies have depreciated compared with those which appreciated.

The fundamental factors which shape economic growth in the Community, however, remain favourable. World trade is expected to continue expanding strongly while labour productivity and investment profitability trends within the Community are encouraging. As a result, most Member States are expected to show satisfactory rates of economic growth (see Table 1), with Ireland projected to post remarkably fast rates of output and employment growth throughout the period.

2.2 Employment trends

Following three years of net job losses, employment in the Community is projected to expand again in 1995 and 1996. Employment in the Community declined by a cumulative 3.9 percent over the period 1992-1994: 5.8 million jobs were lost. 1995-96 should see an increase in employment of about one per cent a year which implies the net creation, over the two years, of about 3 million jobs. Given that in 1995-96 the active population will increase by about 1.4 million persons, the expected job creation will allow a net reduction of unemployment by approximately 1.6 million.

This year and next employment is expected to rise in all the Member States, with particularly strong rates of increase in Denmark, Spain, the Netherlands, Sweden, the United Kingdom, and especially so in Luxembourg, Finland and Ireland (see table 2).

In recent years, labour productivity growth evolved in a way similar to that of all previous cyclical episodes: it decelerated substantially during the recession (see table 3) and accelerated at the beginning of the recovery (3.2 per cent in 1994). For 1995 and 1996, however, the forecasts suggest a return to the trend of the last twenty years (about 2 per cent). In the present forecast the Community economy is therefore expected to show an employment content of growth which is not inferior, but also not greater, than that of the last twenty years.

Table 2

Employment and Unemployment

(percentage change and per cent of the labour force)

	Employment growth			Unemployment rates		
	1994	1995	1996	1994	1995	1996
B	-0.7	0.7	1.0	10.0	9.6	9.1
DK	-0.1	2.3	1.1	10.2	8.6	8.0
D	-0.9	0.7	0.9	8.4	7.8	7.3
GR	1.3	1.0	1.0	9.6	9.6	9.5
E	-0.9	1.5	2.0	24.1	23.7	22.8
F	0.1	1.1	1.0	12.5	12.1	11.5
IRL	2.6	2.7	2.6	15.1	14.1	13.1
I	-1.6	0.3	0.8	11.4	11.4	10.9
L	2.6	2.8	2.7	3.5	3.6	3.4
NL	-0.0	1.3	1.9	7.7	7.6	7.2
A	0.2	0.5	0.4	4.0	3.9	3.8
P	-0.1	0.4	0.7	6.9	6.7	6.3
FIN	-0.8	3.0	2.5	18.5	16.3	14.6
S	-0.9	2.0	1.8	7.8	7.2	6.5
UK	0.3	1.2	1.1	9.4	8.3	7.8
EC	-0.5	1.0	1.1	11.2	10.7	10.1

Source: Commission Spring 1995 economic forecasts
N.B. At the beginning of 1995 Eurostat has significantly revised its unemployment figures

Employment in the manufacturing sector, where productivity increases are particularly strong, declined by about 2.5 per cent last year, but is now expected to recover to a projected growth of 0.5 per cent in 1995 and 1.1 per cent in 1996. The expansion in employment in this sector as well suggests that the recovery has given way to a sustained growth process.

The projected increases in employment will produce a decline in the unemployment rate from a peak of 11.2 per cent of the labour force in 1994 to 10.1 per cent in 1996. Large declines in unemployment in the period 1994-1996 are projected to take place in Finland (3.9 percentage points), Denmark (2.2 points) and Ireland (2 points).

High unemployment, however, is projected to continue to mark the labour market experience of Spain, Ireland, Finland; in Italy and France unemployment is expected to remain between 10.5 and 11.5 per cent in 1996; in Belgium and Greece unemployment is projected to remain between 9 an 9 ½ per cent; finally, with regard to the remaining eight Member States, the rate of unemployment is expected to range from a low of 3 ¼ per cent in the case of Luxembourg to a high of 8 per cent in the case of Denmark.

Table 3

Labour Productivity Growth

(annual percentage changes)

	1961-73	1974-90	'91	'92	'93	'94	'95	'96	1991-96
B	4.3	2.0	2.1	2.3	-0.3	3.1	1.9	1.6	1.8
DK	3.2	1.4	2.9	1.2	2.2	4.5	1.0	1.8	2.2
D *	4.0	1.9	2.5	3.9	0.7	3.8	2.3	1.8	1.7
GR	8.1	1.4	5.6	-0.6	-1.5	-0.1	0.6	0.7	0.8
E	6.5	2.7	1.8	1.9	3.3	2.9	1.6	1.4	2.1
F	4.7	2.2	0.7	2.2	-0.3	2.6	1.9	1.8	1.5
IRL	4.3	3.8	2.9	4.5	3.3	3.6	4.1	2.9	3.6
I	5.5	2.0	0.4	1.8	2.2	3.8	3.0	2.6	2.3
L	3.0	1.3	-1.0	0.0	0.0	0.4	0.4	0.1	0
NL	3.9	1.7	0.9	0.4	0.5	2.5	1.9	0.9	1.2
A	5.0	1.5	0.9	0.0	0.4	2.5	2.2	2.1	1.4
P	6.6	3.4	1.3	1.7	0.8	1.3	2.5	2.5	2.8
FIN	4.5	2.6	-2.0	3.7	5.0	4.7	2.3	1.6	2.5
S	3.5	1.1	0.4	3.2	3.2	3.1	0.9	1.2	2.0
UK	2.9	1.6	1.1	1.6	3.7	3.4	1.8	1.7	2.2
EC *	4.4	2.0	1.5	2.3	1.5	3.2	2.1	1.8	2.1

Source: Commission Spring 1995 economic forecasts * For the averages until 1991 Germany = West Germany

While employment trends and the pace of the reduction of unemployment correspond closely to expectations, unemployment continues to be a major policy concern. Current and projected trends suggest the need to ensure that the rate of economic growth remains strong over many more years so as to make possible the recovery of the ground lost during the recession and to set in train reductions in unemployment below the level achieved at the peak of the previous cycle.

2.3 The Outlook for Inflation and Budgetary Convergence

Of all areas of convergence in the Community, most progress has taken place with regard to ***inflation.*** Measured by the private consumption deflator, the Community average rate of inflation declined to 3.2 per cent in 1994, from a peak of 5.6 per cent in 1991, and is expected to remain at its 1994 level during this year and in 1996. The guidelines goal of the Community achieving a rate of inflation of between 2 and 3 per cent by 1996, as a first step towards price stability, will therefore not be fully met.

In 1994, ten Member States had inflation at or below 3 per cent while the remaining had inflation in excess of 3 per cent. Changes in the country composition of these groups are projected to take place in 1995 and in 1996, with Ireland's and Austria's inflation falling below 3 per cent this year and easing to 2.7 per cent in 1996 in Ireland while stabilising at somewhat below 3 per cent in Austria; Sweden's and Finland's inflation accelerating to around 3.3 per cent next year; and the UK's staying flat at 3 per cent this year and next.

Price convergence appears secure in the group of Member States which are seeing effective exchange rate appreciations. Inflation in eight Member States (Belgium, Denmark, Germany, France, Ireland, Luxembourg, the Netherlands, Austria) is expected to be below 3 per cent this year and next.

In Portugal and Finland, which have also seen recently effective exchange appreciations, inflation prospects are less encouraging. In Portugal, after a significant decline from the level of 1993 and a smaller one from last year, inflation is expected to stabilise at 4.5 per cent this year and next. In Finland, on the other hand, inflation is forecast to accelerate markedly next year.

Table 4

Inflation

(percentage change, private consumption deflator)

	1993	1994	1995	1996
B	2.6	2.4	1.9	2.4
DK	1.0	1.7	2.3	2.7
D	3.8	2.7	2.3	2.5
GR	13.6	10.9	9.6	8.9
E	5.6	5.1	4.9	4.5
F	2.2	1.8	1.9	2.1
IRL	1.6	3.0	2.9	2.7
I	5.1	4.7	5.2	4.5
L	3.6	2.2	2.3	2.5
NL	2.1	2.2	1.8	2.2
A	3.5	3.3	2.8	2.9
P	7.9	5.1	4.5	4.5
FIN	3.9	1.6	1.7	3.3
S	5.8	3.0	3.2	3.2
UK	3.4	2.5	3.0	3.0
EC	4.0	3.2	3.2	3.2

Source: Commission services Spring 1995 forecasts

The inflation outlook remains uncertain in the Member States which have experienced currency depreciations in recent months (Italy, Greece, Sweden, Spain and the UK). While, it may be argued, the inflationary consequences of the depreciation would not emerge until actual output rises above potential, uncertainty about the exact level of the output gap, and the possibility that potential output may have declined during the recession, would suggest that the risk for an acceleration of inflation dominates the outlook.

Greece, Spain, Italy and Portugal are recording and are expected to record, a less satisfying, albeit to different degrees, price convergence in the Community, and Sweden's inflation is not expected to post any deceleration over the forecast period.

Inflation in the UK is projected to remain stable at 3 per cent in 1995 and 1996. However, there is considerable uncertainty about the inflation outlook in view of the fact that, in addition to recent exchange rate developments, the UK will have had four years of strong economic growth by 1996 and the level of excess capacity will have narrowed substantially. In the UK, but also in Finland and Sweden where monetary policy pursues an inflation target, vigilance is an essential ingredient of the policy stance.

Table 5

Nominal effective exchange rate changes

(relative to 19 industrial partners)

Annual percentage changes					Cumulative changes since 1991				
	1992	1993	1994	1995*		1992	1993	1994	1995*
B	2.3	0.8	1.6	5.3	B	2.3	3.1	4.8	10.3
DK	2.8	2.1	0.1	5.3	DK	2.8	4.9	5.0	10.5
D	3.3	2.7	0.1	6.8	D	3.3	6.1	6.3	13.4
GR	-7.7	-9.6	-7.1	-3.3	GR	-7.7	-16.6	-22.5	-25.0
E	-1.8	-13.1	-6.7	-2.1	E	-1.8	-14.7	-20.4	-22.1
F	3.6	1.9	0.6	4.0	F	3.6	5.5	6.1	10.4
IRL	2.8	-5.9	0.3	-0.4	IRL	2.8	-3.3	-3	-3.5
I	-2.7	-16.9	-4.6	-14.3	I	-2.7	-19.2	-22.9	-33.9
NL	2.4	3.0	0.4	5.2	NL	2.4	5.5	6.0	11.4
A	2.6	2.4	0.0	4.9	A	2.6	5.1	5.0	10.1
P	3.6	-7.6	-4.7	2.8	P	3.6	-4.3	-8.7	-6.2
FIN	-12.7	-14.8	7.5	9.3	FIN	-12.7	-25.7	-20.1	-12.6
S	1.3	-19.3	-1.2	-4.7	S	1.3	-18.2	-19.1	-22.8
UK	-3.6	-9.0	0.2	-4.0	UK	-3.6	-12.3	-12.1	-15.6
EC	2.2	-13.1	-2.2	1.4	EC	2.2	-11.2	-13.2	-12.0

Source: Commission Services * on the assumption that exchange rates will remain constant at their April 1995 level

A notable feature of the inflation performance since 1993 is that, despite the severity of the recession, the average rate of inflation in the Community has remained at over 3 per cent. Certainly a large number of countries are currently experiencing a satisfactory price performance, but in about a third of the Member States, inflation still gives cause for concern. In addition, no further progress in lowering inflation is projected for this year and next.

The apparent stickiness of inflation could reflect the influence of several, reinforcing, factors. On the one hand, the amount of spare capacity created during the recession may be smaller than currently estimated. This could be the result of measurement errors or of an acceleration in the scrapping of obsolete capacities. On the other hand, the credibility of announced monetary and, above all, fiscal policies may still be too low and unable to affect significantly expectations about future inflation. In addition, in some Member States currency depreciations have contributed to sustaining inflation. Finally, it is possible that non-competitive conditions continue to prevail in several Community countries despite the efforts to implement the internal market.

An implication of these considerations is that further reductions in inflation will require measures which foster the credibility of policies, which improve the adaptability of workers in a changing economic environment, and which also foster competition. In particular, it is important to strengthen the credibility of the low inflation targets, so that they can be incorporated into pay trends, and of the budgetary consolidation programmes.

Budgetary convergence in the Community continues to be elusive. Table 6 shows that, for the Community as a whole, the net borrowing of the general government, which peaked at 6.3 per cent of GDP in the recession year 1993, is currently estimated to decline gradually to 4.5 per cent of GDP in 1995 and to 3.9 per cent by 1996.

Between 1994 and 1996, the largest reduction in the deficit is projected to take place in Finland and Sweden (4.6 and 4.5 percentage points in terms of GDP, respectively), followed by the UK (4 points), Denmark (2.8 points), and Greece (2.3 points). In addition to these five countries, five more, Belgium, Spain, France, Italy and Portugal, are expected to register deficit reductions ranging between one and two percentage points of GDP, with Spain and France envisaged to make the greatest degree of progress amongst this group. No significant change is expected in relation to the five remaining Member States which, with the Netherlands and Austria, includes the three countries which were below the reference value of 3 per cent of GDP in 1994, namely Germany, Ireland and Luxembourg. On the basis of the present forecasts seven Member States will have a general government deficit at or below the reference value of 3 per cent of GDP by 1996.

The forecasts are based on the assumption of unchanged policies; however, not all Member States have announced their concrete budgetary intentions for 1996. An implication of this assumption for the projected fiscal adjustment is provided by the decomposition of the change in net borrowing into a cyclical and a discretionary part. Table 7 shows that over a three-year period of strong economic growth (1994-96) only small reductions in the structural deficits are expected to take place. The 1.6 point in terms of GDP cumulative decline in Community net borrowing between 1994 and 1996 reflects only 0.8 of one per cent of GDP discretionary deficit reduction.

Table 6

General government deficit
(per cent of GDP)

	1993	1994	1995	1996
B	6.6	5.3	4.2	3.9
DK	4.5	4.0	1.9	1.2
D	3.3	2.5	2.1	2.4
GR	13.2	12.5	11.3	10.2
E	7.5	6.6	6.0	4.8
F	6.1	6.0	4.9	3.9
IRL	2.4	2.3	2.8	2.6
I	9.6	9.0	7.9	8.1
L	-2.1	-2.3	-1.4	-1.5
NL	3.3	3.1	3.2	2.5
A	4.1	4.0	4.6	3.9
P	7.0	5.8	5.6	4.7
FIN	7.8	5.6	5.0	1.1
S	13.4	10.4	9.1	5.8
UK	7.8	6.9	4.8	2.9
EC	6.3	5.5	4.5	3.9

Source: Commission Spring 1995 economic forecasts; (-) indicates a surplus

The persistence of fiscal disequilibrium has contributed significantly to the growth in the general government indebtedness in the Community. At the beginning of the present decade the ratio of general government debt to GDP in the Community was 55.8 per cent; as can be seen in table 8, it grew to 66.2 per cent in 1993, and it is currently expected to grow to 70.4 per cent of GDP by 1996. In 1996, four Member States (Germany, France, Luxembourg, and the UK) are projected to have a debt ratio below the 60 per cent of GDP mark. Of the remaining Member States, the debt ratio is projected to increase in six (Greece, Spain, Austria, Portugal, Finland, Sweden), while in another five (Belgium, Denmark, Ireland, Italy, the Netherlands) it is projected to decline. Despite the good growth prospects, these trends suggest that substantially more ambitious fiscal plans than those currently contemplated are necessary in order, in several cases, to stabilise the debt ratio and to place it unambiguously on a downward path.

From a medium-term perspective, covering the period 1993-1996, in four Member States (Belgium, Denmark, Ireland, the Netherlands) the debt ratio is projected to decline, with the largest decline projected to take place in Ireland (16.2 percentage points in terms of GDP), followed by Belgium and Denmark (4.9 points) and by the Netherlands (4.3 points).

Table 7

Changes in the actual and cyclically adjusted general government deficit

(per cent of GDP)

	Changes in the actual deficit				Changes in the cyclically-adjusted deficit				
	1993	1994	1995	1996	1993	1994	1995	1996	
B	-0.1	-1.3	-1.1	-0.3	-2.4	-1.0	-0.8	0.1	B
DK	1.6	-0.5	-2.1	-0.7	1.2	0.8	-1.3	-0.4	DK
D	0.4	-0.8	-0.4	0.3	-1.4	-0.7	-0.3	0.3	D
GR	0.9	-0.7	-1.2	-1.1	0.2	-0.8	-1.1	-0.9	GR
E	3.3	-0.9	-0.6	-1.2	0.9	-1.3	-0.2	-0.7	E
F	2.2	-0.1	-1.1	-1.0	0.5	0.1	-0.7	-0.5	F
IRL	0.0	-0.1	0.5	-0.2	-0.8	0.5	1.2	-0.2	IRL
I	0.1	-0.6	-1.1	0.2	-1.2	-0.4	-0.6	0.8	I
L*	-1.3	-0.2	0.9	-0.1	-2.0	-0.4	1.1	-0.3	L
NL	-0.6	-0.2	0.1	-0.7	-2.2	-0.2	0.7	-0.4	NL
A	2.1	-0.1	0.6	-0.7	0.9	0.1	0.7	-0.6	A
P	3.7	-1.2	-0.2	-0.9	2.1	-1.7	0.1	-0.4	P
FIN	1.9	-2.2	-0.6	-3.9	0.1	-0.6	1.9	-2.4	FIN
S	5.6	-3.0	-1.3	-3.3	2.4	-2.0	0.0	-1.9	S
UK	1.7	-0.9	-2.1	-1.9	1.4	-0.1	-1.6	-1.6	UK
EC	1.2	-0.8	-1.0	-0.6	-0.4	-0.5	-0.5	-0.3	EC

Source: Commission Spring 1995 economic forecasts; (-) indicates a reduction, (+) indicates an increase in the respective deficits
* Luxembourg has a surplus, thus a (-) indicates an increase, (+) a reduction in its surplus.

In France the debt ratio is projected to increase to 52.8 per cent of GDP by 1996, while in the UK it is projected to stabilise at 51.5 per cent of GDP this year and next. In Germany, the sharp rise in the debt ratio this year is a reflection of the take-over by the general government of off-budget liabilities related to unification.

In Greece and Italy a rise in the debt ratio by 1 and 5 points, respectively, is projected between the period 1993-1996. In Italy the debt ratio is expected to have peaked in 1994 and relative to this mark a modest adjustment is projected for this year and next. In Greece, where the debt ratio is also already very high, debt convergence will be worsening this year and next.

Finally, worsening convergence on the basis of the debt criterion is also expected to take place in Spain and Portugal, where the debt ratio is projected to rise by 5.3 and by 4.1 points, respectively, between 1993 and 1996 and to reach 65.2 and 70.7 per cent of GDP, respectively, in 1996.

Table 8

General government gross debt
(per cent of GDP)

	1993	1994	1995	1996
B	137.2	136.1	134.3	132.3
DK 1)	80.3	75.6	76.1	75.4
D	48.2	50.1	58.2	58.1
GR	115.2	114.1	115.3	116.2
E	59.9	62.3	64.6	65.2
F	45.8	48.5	51.2	52.8
IRL	97.0	89.8	84.6	80.8
I	119.4	125.4	124.9	124.4
L	6.9	7.2	7.6	7.8
NL	81.4	78.1	78.1	77.1
A	62.8	64.5	66.2	67.4
P	66.6	69.2	70.5	70.7
FIN	57.1	60.1	64.4	64.6
S	76.2	79.1	84.6	85.7
UK	48.5	50.1	51.5	51.5
EC	66.2	68.1	70.3	70.4

Source: Commission Spring 1995 economic forecasts
1) Government deposits with the central bank, government holdings of non-governmental bonds and public enterprises related debt amounted to 23.4 % 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"

Worrying trends have also emerged in the debt ratio in the three new Member States. While the large increases occurring over the period 1993-1996 reflect to a considerable extent the impact of the recession, it is also clear that adjustment plans of greater ambition are necessary in order to halt the rise, and to ultimately reverse direction, in the path of the debt ratio. In May 1995 Austria presented a convergence programme and Sweden is expected to do so in June.

It is possible that the persistence of fiscal imbalances in the Community countries, and the failure to decisively advance fiscal consolidation in periods of strong economic growth, reflect also the importance of budget institutions and procedures in the determination of fiscal deficits as well as the nature of political discourse. In several Community countries the rules according to which budgetary policy is approved and amendments to budget plans are admissible, play a key role in fiscal outcomes. It is also possible that the form the commitment to fiscal consolidation takes may not be conducive to fiscal discipline; for example, it may be appropriate to combine improved budget procedures with numerical fiscal targets in order to enhance the probability that fiscal programmes are actually implemented as planned.

The importance of these considerations has now become more pronounced, both because it is necessary to explore all avenues to strengthen fiscal discipline in the Member States and in order to increase the probability that fiscal convergence criteria are met by the largest possible group of countries prior to the move to stage III of EMU.

The forecast for 1996 indicates that, on the basis of the adjustment measures which have been clearly specified so far among those Member States which have set fiscal targets in their convergence programmes, the fiscal objectives will not be uniformly respected. Adjustment to achieve the deficit target of the convergence programme is required, albeit of different magnitude, in the cases of Belgium, Germany, Greece, Spain, France, and Portugal; in all these cases, the projected deficit is larger than that set in the convergence programme. On the other hand, Denmark, Ireland, the Netherlands, and the UK are expected to meet the deficit objectives by next year. Of the new Member States, Austria has recently submitted a convergence programme and Sweden is expected to do so in June. In both cases more ambitious targets would be required to ensure that fiscal convergence is secure. Finally, in Finland where a substantial fiscal consolidation effort is under way, policies should ensure that the projected reduction of the deficit in 1996 is in fact realised.

3. The policy objectives and risks

The Broad Guidelines of December 1993 and July 1994 have laid out the broad thrust of the policies needed to achieve economic convergence and to foster job creation. The 1995 Broad Guidelines should confirm these objectives. In addition, the recommended policies should take account of the risks and concerns characterising the current economic outlook.

The Community economy is still broadly expanding at the pace forecast a few months ago, even if growth prospects have become somewhat less favourable. The improvement in the consumer and business confidence indicators stalled at the beginning of this year, even before the recent period of exchange rate instability. In addition, a new period of weakness of the US dollar vis-à-vis the European currencies would create an atmosphere of greater uncertainty that might jeopardise the projected positive growth. On the other hand, it should be stressed that, as already noted, the main factors affecting growth prospects - notably world trade and investment profitability - remain good and that a rate of growth stronger than the one now projected cannot be ruled out. Economic policy must therefore act to prevent developments that might jeopardise the continuation of the growth process.

The first risk to be considered is that of a renewed resurgence of inflation. As regards the consequences of the recent currency movements for inflation two different groups of countries may be identified: on the one hand the countries whose currencies appreciated in effective terms and who are therefore likely to "import" price stability and on the other hand the ones whose currencies devalued (especially Italy) and whose inflation, all other things held equal, will tend to increase. Overall, this risks making inflation performances more divergent than prior to the recent exchange market episodes.

Inflationary pressures may appear due to the fact that the economy's actual rate of growth may approach to or exceed the potential rate of growth, especially in 1996, which would cause capacity constraints leading to inflationary tensions. This risk will be less apparent if business investment in the Community increases significantly over the next few years. Furthermore, there may be a danger that wage settlements will be higher than currently forecast and put upward pressure on prices and/or lead to reduced investment profitability. This danger could also arise from a desire to compensate, too rapidly and at the expense of growth and employment, for the low increases or, in some cases, actual declines in real wages during the 1993-94 period of sluggish economic growth and of rising unemployment. Some countries are already expected to record inappropriately high wage increases in 1995-96.

The second, and more worrying, concern is that budgetary positions in several Member States remain unsatisfactory. Increased consolidation efforts are therefore necessary and the elimination of structural budgetary deficits must be tackled now, during the recovery, when the Member States can also take advantage of the functioning of automatic stabilisers. In addition, with the still high levels of public debt, several Member States continue to be very vulnerable to interest rate shocks that are possibly associated with uncertainties about fiscal, exchange rate and price developments and could in those countries effectively eliminate the budgetary gains likely to occur during the recovery.

Finally, as already put forward in the Commission's 1995 Annual Economic Report, the favourable economic conditions created by the recovery may give rise to "adjustment neglect". This could take the form of a less determined commitment by the public authorities to tackle the structural causes of the high budget deficits as the recovery makes a positive cyclical contribution to tax receipts and to the budget balance. Furthermore, the efforts aimed at the removal of labour market rigidities may seem less urgent in the short term when employment is starting to rise again and unemployment is falling. Such a relaxation in consolidation and reform efforts would seriously put at risk the successful transformation of the recovery into a sustained and job-creating growth process, would contribute to an unbalanced policy mix and would increase the risk of a new recession.

Strengthening convergence and sustaining economic growth will require that the opportunities emerging in the present recovery are wisely taken advantage of. It is clear that an important contribution to inflation convergence will be made by wage developments.

If nominal wage increases begin to accelerate with the consolidation of economic growth, especially before unemployment declines substantially, also giving rise to an acceleration of inflation, the Member States may have to undergo another deflationary cycle; at current levels of unemployment, such an episode they can ill afford. Moderate wage growth will also contribute to fostering investment. The recent recovery of private investment is a reflection of the propitious economic prospects and of a wage growth inferior to labour productivity increases. The strength of investment expenditure, if sustained, will contribute to raising potential output and to fostering job creation.

A wise use of the recovery will require that the Member States, first and foremost, consolidate their public finances. Sustainable fiscal positions are a necessary condition to support economic growth and durable employment creation. It is evident that the policies which are required to sustain long-term economic growth, foster job creation and reduce unemployment, and strengthen convergence are mutually consistent.

Recent developments in the foreign exchanges indicate how important stability of exchange rates within the Community is for furthering economic integration and completing the single market. Exchange rate changes can lead to resource misallocation when investment decisions, made on the expectation of depreciation-induced competitiveness gains, prove ultimately obsolete when competitiveness is eroded either as a result of nominal exchange appreciation or because of higher inflation. Furthermore, the possibility of exchange depreciation undermines wage and price discipline since losses in competitiveness can be, temporarily at least, recovered through exchange devaluations; as a result, reductions in inflation and price stability become difficult to achieve. Finally, as devaluations offer a prospect of temporarily improving competitiveness, they raise the possibility of practising beggar-thy-neighbor policies, which are not compatible with the completion of the internal market.

4. The Policies

The principal task of economic policy at this stage of the cycle is to ensure that the on-going recovery translates into non-inflationary, employment-creating, growth. In view of the risks impinging upon the economic outlook, and the progress yet to be accomplished in convergence, macroeconomic and structural policies should be directed towards securing price stability, fostering fiscal consolidation, and strengthening the dynamism and competitiveness of the Community.

4.1 Macroeconomic policies

The main task of macro-economic policies will be to maintain a stable framework which will prevent the appearance of the tensions which have contributed to the recession of 1992-93 and which will foster a continued steady increase in potential output. As the previous sections have underlined, key developments give cause for concern on both counts. At the same time, with the consolidation of economic growth and the approach to stage III of EMU, the challenges confronting the Member States have become more pronounced, while the diverging trends which have emerged as a result of exchange rate changes have also raised important questions about the appropriate economic policies.

Securing and furthering the progress made on inflation, and sustaining economic growth is a crucial challenge for ***monetary and exchange rate policy*** in the current cycle. A necessary contribution to the task of defending price stability in this context will have to be provided by fiscal consolidation policies. While in virtually all Member

States such policies are required, these are especially urgent in those Member States where fiscal deficits and rising debt burdens, and the associated inflation and exchange market developments, place the greatest burdens on the conduct of monetary policy and where the risks of a substantial acceleration of inflation are greatest. Equally necessary will be policies encouraging non-inflationary wage developments and, over a longer-term horizon, increased competition in product markets.

Stability of exchange rates within the Community is essential for the proper functioning of the internal market. In Member States where fiscal positions are diverging and which have experienced exchange depreciations (Greece, Spain, Italy, and Sweden) it is essential that a bold and credible efforts are undertaken to foster fiscal consolidation. More generally, credible fiscal consolidation measures will contribute to reducing exchange rate instability. This will contribute not only to resolving concerns about competitive disruptions of the internal market, but it will also create the conditions for reductions in interest rates, and it will ultimately facilitate the implementation of the fiscal adjustment programme.

Budgetary policy directed towards consolidation will play a crucial role in reducing the risks of an acceleration of inflation, of exchange rate instability, and of further worsening fiscal imbalances.

Fiscal consolidation is necessary not only in order to foster stable inflationary expectations but also to sustain the progress made in reducing inflation. This is particularly important in Member States with persistent fiscal imbalances and persistent inflation (Greece, Italy, Spain). Failure to make decisive progress in redressing the fiscal imbalances, especially in an environment of strong economic growth, will increase uncertainty about the intentions of the fiscal authority. This uncertainty has been contributing to raising real interest rates and to, in turn, making fiscal consolidation more difficult to achieve in several Member States.

Incomplete credibility of the fiscal consolidation plans may also be reflected in exchange rate instability, higher real interest rates and increases in interest rate differentials vis-à-vis other countries. Domestic and international investors holding government debt require an increase in the rate of return, or a strong exchange rate, to compensate for the increased risk, a combination of circumstances which is inimical to both economic growth and to fiscal adjustment. The instability characterising exchange rates in Greece, Spain, Italy and Sweden is partly a reflection of the continuing lack of resolution of the fiscal difficulties.

Over the medium term, fiscal consolidation will contribute to raising the level of national saving and will, through this channel, contribute to increasing the level of potential output.

Respecting the fiscal convergence criteria remains an area where sustained efforts will have to be expended. According to the Spring 1995 forecast, seven Member States are expected to have deficits below the 3 per cent of GDP mark in 1996 (Denmark, Germany, Ireland, the Netherlands, Finland, and the UK; Luxembourg is expected to have a surplus). In these Member States the efforts to consolidate the public finances must be pursued with determination. In Belgium, France, and Austria, attaining the reference value for the deficit in 1996 would be within reach, provided that the adjustment effort gains renewed momentum. While no forecasts exist for the outer years, it is clear that for the remaining Member States the objective to respect the fiscal convergence criteria by 1999 must, even more than today, become a principal policy objective.

The ***policy mix*** required in the individual Member States reflects the uneven distribution of policy risks. The Member States whose currencies have experienced depreciations over the recent months will likely see an increase in the inflationary pressures while the interest rate implications of the exchange rate instability will undoubtedly make budgetary consolidation more difficult. In general, these countries had already unsatisfactory starting positions. The depreciations will lead to higher import costs and, through the effects on export growth and economic activity in general, will contribute to narrowing the output gap.

In these Member States the policy mix must be resolutely oriented towards containing the inflation risks and towards stepping up the efforts to consolidate budgetary positions. In these countries it will be particularly important to prevent, through the instruments available in each country, that the increase in imports costs may lead to a price and wage inflation spiral.

In the Member States whose currencies have experienced appreciations, inflationary risks will be generally contained. However, given that the success of these countries in containing inflation owes much to the external constraint, it will be important to make sure that pay trends do not lead to reductions in investment profitability. There are indications that this may be happening in Germany.

Investment profitability must still increase substantially in most countries if investment is to expand to the extent necessary to ensure sustained growth in the medium term. In some cases, the stability of exchange rates could only be maintained at the cost of increases in the interest rate differentials with Germany. This suggests that markets still perceive some risks in the budgetary positions of these countries. Determined corrective action could bring substantial benefits through the reduction, or the total elimination, of these differentials.

4.2. Policies for greater competitiveness

Structural measures aimed at promoting the competitiveness, dynamism and overall productivity of the Member States' economies are essential to the achievement of the Community's twin policy objectives of strong, employment-creating growth and enhanced nominal convergence. Such measures are particularly important at the present time to strengthen economic growth, but also given the renewed anxiety about inflation especially in those Member States which have witnessed substantial depreciations of their currencies.

The 1993 White Paper advocated reforms directed towards increasing the endogenous growth forces of the Community's economy as the means to securing the basis for its long-term prosperity. A variety of proposals aimed at making the Community economies more dynamic were subsequently incorporated in the 1993 and 1994 Guidelines exercises. Such proposals, which were to be carried out at both the Community and individual Member State levels, were essential to the quest to promote the productivity and competitiveness necessary to underpin stronger growth and employment creation.

Efforts at enhancing productivity and employment growth can only be successful if carried out in the context of a flexibly functioning economy which is capable of exploiting the opportunities generated by a rapidly changing technological and social environment. In this regard efforts are being undertaken to:

- exploit the opportunities associated with the internal market, an open world trading system and to safeguard the Community's competitiveness;
- accelerate the realisation of the Trans-European networks;

- push through rapidly the Action Plan concerning the development of the information society;
- exploit the growth and employment potential offered by SMEs;
- and actively promote Community initiatives in Research and Development (R & D) and call for a greater degree of co-ordination of Member States' R & D policies.

In relation to the internal market, strong efforts have been undertaken to transpose the relevant directives into Member States' legislation. However, transposition has been slow in the key sectors of insurance, company law, intellectual and industrial property, public procurement, new technologies and services, financial services, and freedom of movement.

The Essen European Council stressed the intention of the Council to pay particular attention in the future to the competitiveness of the European economy. In this connection the Commission has established a high-level group to deal with competitiveness and to submit appropriate reports on these matters[2]. This the Commission duly followed through on with the formation of the Competitiveness Advisory Group at the beginning of 1995. The high-level Legislative Administrative Simplification Group ("Deregulation Group") has begun its work. It has stressed the need to monitor Community and national law for over-regulation and it requested the "Deregulation Group" to submit a report by June 1995.

Initiatives in the area of the Trans-European networks in the transport, energy and environmental spheres have also been receiving a lot of attention. The Group of Personal Representatives of Heads of State or Government (the Christophersen group) submitted their report to the December 1994 European Council. It confirmed that the eleven priority projects decided upon at the Corfu European Council in June 1994 and the three new projects concerning the Nordic Member States and Ireland had already been started or were in a position to commence shortly.

In relation to the establishment of the information society, this has been the object of an Action Plan adopted by the Commission in July 1994, which encompassed all

2 See also "An Industrial Competitiveness Policy for the European Union", Communication from the Commission to the Council, COM(94) 319 final, September 14, 1994 and two companion documents: "Report on the Implementation of the Council Resolutions and Conclusions on Industrial Policy", SEC(95) 437 final, March 22, 1995 and "Action Programme and Timetable for Implementation of the Action Announced in the Communication on an Industrial Competitiveness Policy for the European Union", COM(95) 87 final, March 30, 1995.

aspects addressed in the report of the Bangemann group. In its November 1994 meeting this Council discussed the Commission's liberalisation timetable. The December European Council emphasised that the Commission's Action Plan and the conclusions of the Ministers for Industry and Telecommunications had set the agenda for the development of an information society. With regard to developments in 1995, as a follow-up to the G-7 ministerial meeting of February 1995, the Group of Commissioners on the Information Society was established.

Raising the productivity of the Community's economy using these initiatives has the potential to contribute to strengthening employment creation. There is no necessary contradiction between productivity growth and employment creation.

However three conditions must be met to ensure that the relative price mechanism makes possible a redistribution of productivity gains between sectors, enabling sectors with low productivity growth to create new jobs and to maintain similar wages for similar work:

- relative prices must continue to change without artificial rigidities, and the increased competition and flexibility on all markets should help this;
- sectoral changes need to be socially acceptable, with market mechanisms being complemented by forward looking active policies and social dialogue;
- the overall macroeconomic rate of growth must be strong enough to allow for a positive balance between job creation and job destruction across sectors.

4.3 Employment and labour market policies

The economic recovery, if it progresses as predicted, could absorb by 1997 the cyclical component of unemployment. This component is estimated at about 3 million unemployed or only 2 percentage points of the present eleven per cent rate of unemployment in the Community. To absorb 3 million unemployed is indeed a first important step and an essential one towards the achievement of the White Paper objectives. Nevertheless, in order to reduce, in a significant and progressive manner, the remaining 9 per cent of unemployment, it is necessary not only to achieve a strong and sustainable medium-term growth process, brought about by investment in order to create the necessary working posts, but it is also necessary to implement more active and more efficient labour market policies which may need to bring about significant changes in the areas of educational systems, labour law, work contracts, wage settlement arrangements and the social security systems.

To this end, the Essen European Council, identified the following five priorities:

1) Improving the employment opportunities for the labour force by promoting investment in vocational training,
2) Increasing the employment intesiveness of growth,
3) Reducing non-wage labour costs,
4) Improving the effectiveness of labour market policies,
5) Improving measures to help groups which are particularly hard hit by unemployment.

Active and more efficient labour market policies contribute to the goal of increasing employment through three main channels:

i) reinforce the growth potential itself by an improvement in the quality of human capital;

ii) make growth more employment-creating without, however, negatively affecting the growth process itself; and finally

iii) facilitate, to the extent that the new jobs will become available, the absorption of those unemployed who are still easily employable as well as to help the long-term unemployed and particular disadvantaged groups who cannot easily occupy the available working posts and who risk being affected by social exclusion.

Labour market policies in the above three areas constitute not only an indispensable complement to macroeconomic policies and to structural policies in the area of competitiveness but they also contribute to maintaining and reinforcing cohesion and social consensus inside the Union in the long and difficult process of absorbing unemployment.

i) As regards the improvement of the quality of human capital, it is a matter of strengthening the systems of professional training, in particular that of the young, and to promote continuous training of the workforce in order to prepare and adapt the latter to social and technological change in a world of free trade and in a process of strong structural adjustment. These policies will improve the flexibility of the labourforce, individual opportunities, and the comparative advantage of the European economy in comparison with other geographical regions of the world *[Essen priority n° 1]*.

These policies will increase the growth potential of the European economy and, like the policies for competitiveness, will generate their full benefit from the point of view of both their costs and their creation of employment, if simultaneously the effective rate of economic growth can develop without encountering the obstacles of inflation and of capacity constraints.

ii) The contribution of the medium-term growth process to the reduction of unemployment is indispensable, but it must be complemented by a large effort, targeted and concrete, to increase the employment content of growth *[Essen priority n° 2]*. Actions in three areas, which must not hold back the growth process itself, are necessary in this regard:

- the examination, by the social partners, of whether a reorganisation, a reduction and/or new patterns of working time could lead to increases in the employment content of growth without reducing the competitiveness of firms. In particular, the de-coupling of the working time of individuals from that of the enterprise may open promising opportunities: the existing capital stock - equipment, premises, etc. - could be better exploited with significant productivity gains which may be used to encourage different working patterns among the employees. Development of part-time and other atypical forms of employment may also help. Progress in this area might also require a revision of existing regulations *[Essen priority n° 2]*.
- increasing the incentives to employment by reducing non-wage labour costs, especially at the lower end of the wage and productivity scale, without harming other parts of the labour market; from a macroeconomic point of view this must be achieved in ways which do not compromise the reduction of budgetary deficits nor the competitiveness of enterprises. Reforms, including where appropriate alternative financing sources for social protection systems, are therefore required *[Essen priority n° 3]*;
- easing the development of new employment opportunities and activities, e.g. those linked to the service society and environmental sustainability *[Essen priority n° 2]*.

iii) The task of facilitating the absorption without tensions of the unemployed and the new entrants to the labour market, when the economy makes available the new working posts, concerns firstly the efficiency of labour and manpower offices and the promotion of flexibility in the areas of professional and geographical mobility

[Essen priority n°4]. An important part of the non-cyclical component of unemployment could be progressively integrated into working life by reasonable efforts in these areas provided that the recovery can be transformed into the medium-term growth and employment creation process described by the White Paper and aimed at by the present economic policy guidelines.

Nevertheless, to significantly reduce the hard core of structural unemployment - which could represent about half of the 9 per cent of non-cyclical unemployment - different and much greater efforts will be necessary. It is a matter not only of strengthening the link between the granting of social allowances and the availability of the unemployed to accept work, but especially of reinforcing active labour market policies aimed at improving the "employability" of long-term unemployed workers by giving access to specific training and of concentrating the latter on particularly disadvantaged groups i.e. women, young people and older citizens who risk to being affected by social exclusion *[Essen priority n°5]*.

These relatively expensive policies also only achieve their full benefit if labour, which in this way is rendered employable, has the opportunity in practice to find a job. Nevertheless, these policies must not only be evaluated in terms of their immediate economic benefit; taking into account the inevitable and necessary time to significantly reduce the hard core of structural unemployment, these policies must also act to safeguard the existing human capital of the unemployed in order to prevent social exclusion and to maintain social cohesion.

In order to better organise the implementation of the priorities identified by the Essen European Council, the Commission, on 8 March 1995, presented a Communication to the Council in which it suggests the implementation, in the context of Article 103 of the Treaty, of a surveillance procedure with regard to employment trends and policies.

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Bearing these considerations in mind, the Commission is proposing the present broad economic policy guidelines for the Community and the Member States which confirm the medium-term framework of those of June 1994, and assert the policy priority of reducing unemployment.

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