

EUROPEAN ECONOMY

COMMISSION OF THE EUROPEAN COMMUNITIES • DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Supplement A — No 12 — December 1988

Recent economic trends

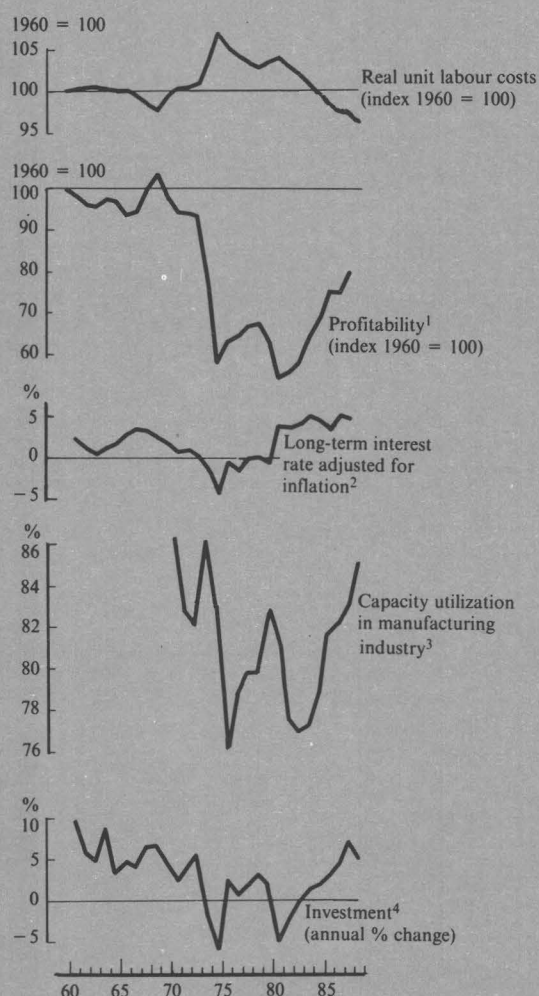
*In this number:
Preparing for 1992.
Summary and conclusions of
Annual Economic Report 1988-89*

MAIN POINTS IN BRIEF

The main features of the Commission services Annual Economic Report 1988-89 are as follows:

- Generally speaking, the current economic situation in the Community is very satisfactory: the Community economy is expected to grow at rates of 3 1/2 and about 3 % in 1988 and 1989 respectively; the increase of 7 % in investment is the highest for two decades; in 1988 employment is expected to grow at a historically high level of more than 1 %, the inflation rate of 3 1/2 should be about that of the 1960s and there is an impressive downward convergence of inflationary performance in the Member countries.
- Despite these satisfactory trends, there remain four areas of concern: the unemployment rate remains unacceptably high at about 11 %; there is a risk of renewed inflation; budgetary deficits and public debt in some countries remain excessively high and the gap in the current balances between the surplus and deficit countries in the Community tends to grow further.
- At present, the Community reaps the fruit of the efforts undertaken since 1985 as part of the Cooperative Growth Strategy for more Employment. In order to tackle pending economic policy issues continued and intensified efforts along these lines are required in the years ahead.

GRAPH 1: Real unit labour costs, profitability, real long-term interest rate, capacity utilization and investment, EUR 12



¹ Databank Compact

² Long-term interest rates deflated by the GDP deflator

³ Business surveys

⁴ Gross fixed capital formation at constant 1980 prices

Source: Commission services.

PREPARING FOR 1992

Annual Economic Report 1988-1989

(Commission annual report on the economic situation in the Community in accordance with article 4 of the Council decision of 18 February 1974)

SUMMARY AND CONCLUSIONS

I. Favourable economic prospects for the Community and the world economy

1. *The economic prospects for the Community have significantly improved in recent months. In 1988 the Community benefited from an unexpected dynamism of its own, in the whole OECD area and from world trade. In the Community, growth (1988: 3 1/2 % on*

average) is likely to be the strongest since the end of the 1970s; the increase in investment (7 %) the highest for over two decades; the inflation rate (3 1/2 %) should be about that of the 1960s. Despite a mild deterioration in the international environment, growth is likely to be strong in 1989 (about 2 3/4 %). The inflation trend should only increase slightly. The rate of unemployment has started to decrease but it is still at too high a level.

2. *The international framework for the conduct of monetary policy in the Community has changed significantly. With an improvement in the US trade deficit early in the year and an increase in interest rates in spring the dollar had by autumn almost reached its level of January 1987, just before the Louvre accord. Partly to control the rise in the dollar and partly in response to the exigencies of internal stability European Central Banks were led, to different degrees, to tighten conditions on their own money markets.*

3. *International co-operation allowed significant progress to be made towards greater stability in the world economy. But it needs to be pursued with determination because important risks remain:*

TABLE 1: Main economic aggregates 1961-89^(a), EUR 12

	Annual percentage change unless otherwise stated									
	1961-1973	1974-1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Gross domestic product										
— At current prices	10,2	14,4	11,2	10,1	9,1	8,7	8,3	6,9	7,4	6,7
— At constant prices	4,8	2,0	0,8	1,4	2,4	2,5	2,6	2,9	3,5	2,8
— Price deflator	5,1	12,1	10,3	8,5	6,6	6,1	5,5	3,9	3,8	3,7
2. Gross fixed capital formation (b)										
— Total	5,6	-0,3	-2,0	-0,1	1,3	2,1	3,1	4,6	7,1	5,2
— Construction (c)	:	-1,2	-2,4	0,6	1,2	-2,4	2,4	2,2	6,2	3,8
— Equipment (c)	:	1,8	-1,9	0,1	6,6	9,1	3,3	7,2	8,1	6,7
3. Share of gross fixed capital formation in GDP (d)										
— Total	23,3	22,1	20,2	19,7	19,3	19,2	18,9	19,1	19,7	20,1
— General government	:	3,3	3,0	2,9	2,8	2,9	2,8	2,7	2,8	2,8
— Other sectors	:	18,8	17,3	16,8	16,5	16,3	16,1	16,3	16,9	17,3
4. Final national uses incl. stocks (b)										
— EUR 12	4,9	1,6	0,8	1,1	1,9	2,3	3,8	3,8	4,1	3,0
— EUR 12 against 9 other OECD countries	-0,5	-0,7	1,0	-2,0	-3,4	-1,4	-0,1	-0,2	0,0	0,3
5. Inflation (price deflator private consumption)	4,6	12,3	10,5	8,5	7,1	5,9	3,6	3,3	3,5	3,7
6. Compensation per employee										
— Nominal	10,0	14,9	11,0	9,7	7,4	6,9	6,1	5,5	5,3	5,2
— Real, deflator private consumption	5,1	2,3	0,4	1,1	0,3	0,9	2,3	2,1	1,8	1,5
— Real, deflator GDP	4,6	2,4	0,6	1,1	0,8	0,8	0,5	1,6	1,4	1,4
7. Productivity (e)	4,5	2,1	1,6	2,0	2,3	1,8	1,8	2,0	2,4	2,0
8. Real unit labour costs (f)										
— Index: 1961-73 = 100	100,0	104,3	103,1	102,2	100,7	99,7	98,4	98,0	97,2	96,7
— Annual percentage change	0,1	0,4	-1,0	-0,9	-1,4	-1,0	-1,3	-0,3	-0,9	-0,5
9. Profitability (index: 1961-73 = 100)	100,0	65,7	59,0	61,1	68,2	72,5	77,6	78,7	82,1	83,0
10. Relative unit labour costs in common currency against 9 other OECD countries										
— Index: 1961-73 = 100	100,0	107,6	98,2	92,8	85,9	85,4	93,8	100,8	98,0	:
— Annual percentage change	1,0	-0,2	-6,1	-5,6	-7,4	-0,6	9,7	7,5	-2,8	:
11. Employment	0,3	-0,1	-0,8	-0,5	0,1	0,6	0,8	0,9	1,1	0,9
12. Unemployment rate (g)	2,2	5,1	9,4	10,6	11,4	11,8	11,9	11,6	11,3	10,9
13. Current balance (h)	0,4	-0,6	-0,9	-0,1	0,3	0,7	1,3	0,8	0,3	0,1
14. Net lending of general government (h)(i)	:	-3,7	-5,5	-5,3	-5,3	-5,2	-4,8	-4,2	-3,8	-3,5
15. Gross debt of general government (h)(i)	:	39,4	47,6	50,8	54,0	56,6	57,8	59,2	60,0	60,7
16. Interest payments by general government (h)(i)	:	2,8	4,1	4,4	4,7	5,0	5,1	4,9	4,8	4,8
17. Money supply (end of year) (j)	11,9	13,4	11,9	10,7	9,9	9,9	10,4	11,0	:	:
18. Long-term interest rate (k)	7,1	11,7	14,3	12,7	11,8	10,9	9,2	9,3	9,3	:

(a) 1961-86: Eurostat and Commission services.
1987-89: Economic forecasts September-October 1988.

(b) At constant prices.

(c) Until 1986: EUR 12 without Spain and Portugal.

(d) At current prices.

(e) GDP at constant market prices per person employed.

(f) Deflator GDP.

(g) Percent of civilian labour force.

1961-73: EUR 12 without Greece, Spain and Portugal.

(h) Percent of GDP.

(i) 1974-81: EUR 12 without Greece and Portugal.

(j) Broad money supply M2 or M3 according to country.

1961-73: EUR 12 without Spain and Portugal.

(k) Levels: 1988: January-August average.

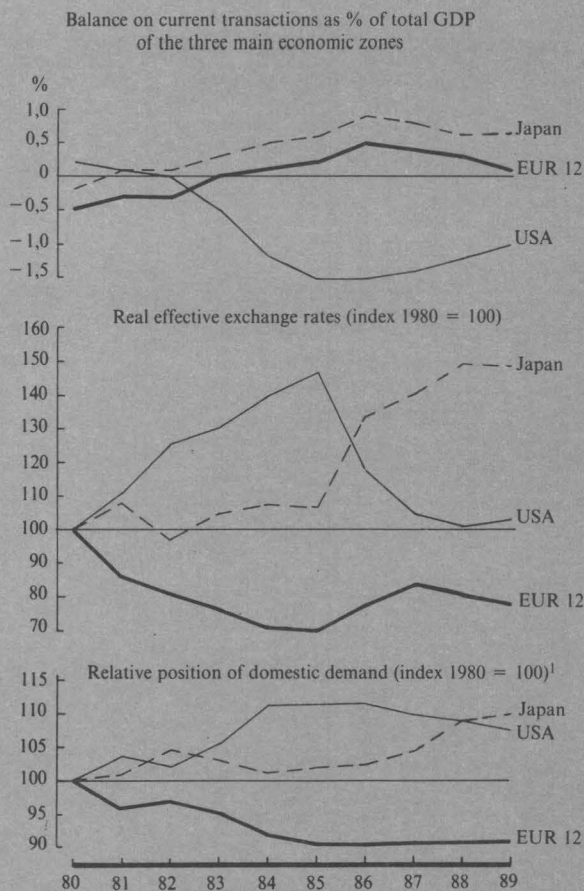
Source: Eurostat and Commission services.

- a) in 1989, the reduction in balances of payments disequilibria is likely to loose some of its vigour at a time when the accumulation of United States foreign debt is continuing;
- b) the persistence of the disequilibria continues to create risks for the stability of the international monetary system;
- c) the situation in developing countries is not improving and is affected by the recent rise in interest rates.

II. Encouraging elements and some matters of concern

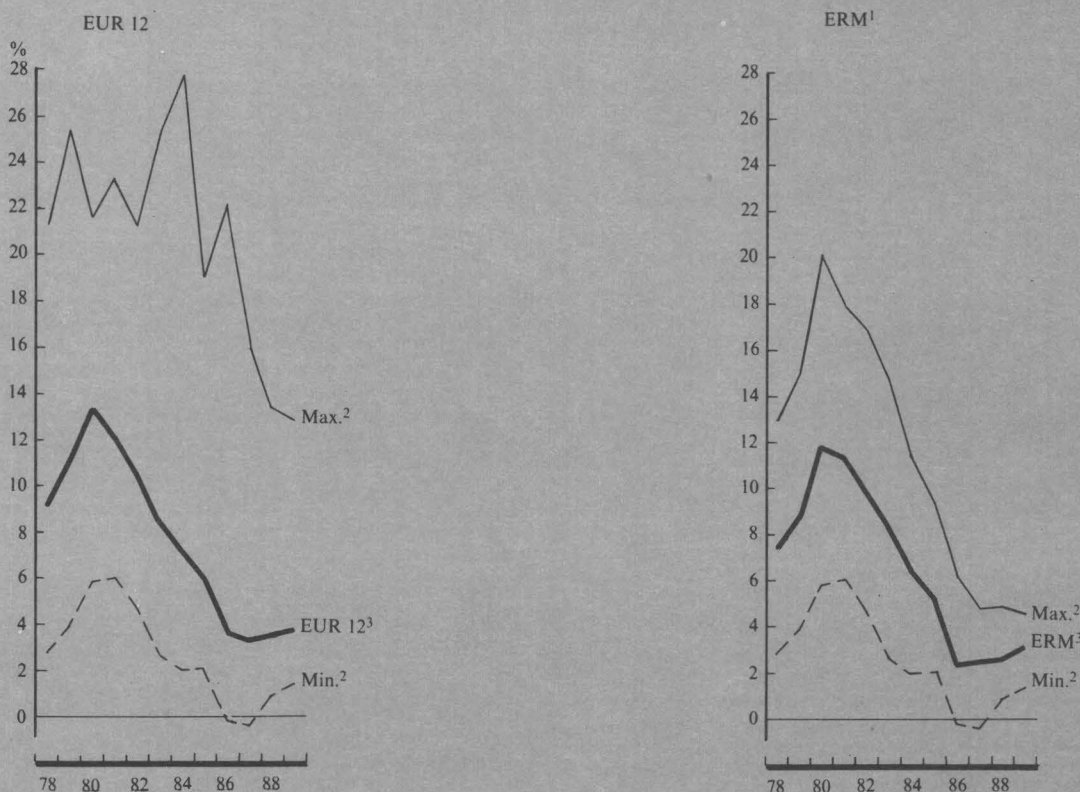
- 4. Three aspects of the economic situation are encouraging:
 - The dynamism of the economies of Spain, Portugal, Italy and the United Kingdom is now spreading to their partners whose exports, and also investment, are more buoyant. Thus, for example, in France and Germany growth should be about 3 % in 1988 and should only dip slightly in 1989 (compared with 2 % in 1987).
 - Growth is more and more being led by investment. Many factors are contributing to this: greater profitability, a historically high level of capacity utilization, a favourable international environment and preparation by private firms for 1992.
 - The Community has achieved a degree of stability and convergence of inflation rates unequalled since the 1960s. However, progress is still necessary, especially in Portugal and Greece.
- 5. Despite these satisfactory trends there are four areas of concern:
 - a) the risk of renewed inflation;
 - b) excessive budgetary deficits in some countries;
 - c) an increase in the intra-Community disequilibria in external balances;
 - d) an unemployment rate that is still on average in the Community more than 11 % of the active population.
- 6. The strengthening of potential growth must remain a priority for all Member States. However, the consolidation of the current good growth performances may require, over the coming months, different actions in different Member States. As growth in the more dynamic countries is expected to slow down as a result of

GRAPH 2: Current balances and determinants



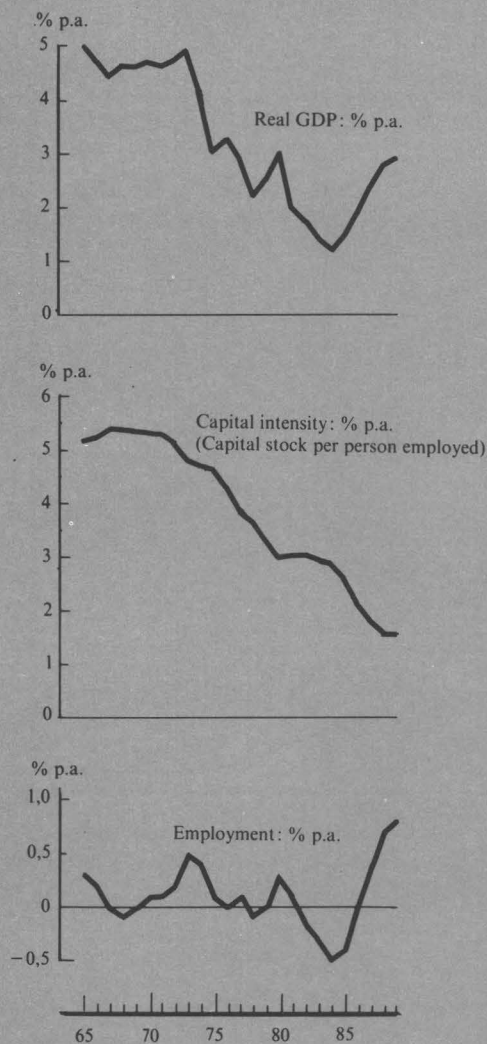
¹ Index of domestic demand of the country or economic zone concerned in relation to those of its trading partners
 Source: Commission services.

GRAPH 3: Convergence of inflation rates in the Community and in the ERM-countries¹ (private consumption deflator)



¹ Countries participating in the exchange rate mechanism of the EMS
² Maximum/Minimum rate of inflation in the Community/ERM-countries
³ Weighted average rate of inflation in the Community/ERM-countries
 Source: Commission services.

GRAPH 4: Real GDP, capital intensity and employment, EUR 12
— 5 year moving average of annual growth rates¹



¹ 5 year period ending in indicated year
Source: Commission services.

inflationary pressures and/or a deterioration of external accounts, economic policies in the other countries should accentuate the shift to domestic growth by a strengthening of supply and demand conditions.

III. Realizing the medium-term objectives

7. Faster growth is now giving the Community the chance to realize in the best conditions its major objectives: *to benefit from the completion of the internal market, strengthen economic and social cohesion and reduce unemployment.*

8. *The irreversible character of the completion of the internal market in 1992* was confirmed by the Council of Hanover. Significant progress has already been realized. In recent months, public opinion and enterprises have become more and more aware of the opportunities offered by this project. It is essential that these hopes are not disappointed when the decisions implementing the important measures of the White Paper are taken during the coming years.

9. To produce its full effects, the completion of the internal market needs to be accompanied by structural policies, especially an effective competition policy, also necessary in their own right.

10. The success of the internal market will also have significant macro-economic effects. Studies by the Commission services show that the completion of the internal market will in the medium term improve significantly growth, budgetary and external positions and will have favourable effects on inflation. So that the productivity gains which will be realized are rapidly transformed into higher growth and employment, it will be important to fully benefit from the alleviation of constraints by reducing domestic disequilibria and actively strengthening the conditions of supply and demand.

11. With the reform and the increase of the Structural Funds, already under way, and the increased activity of the Community financial instruments, the Community has acquired the means to *strengthen economic and social cohesion*. A new model of 'partnership' between the Community and the beneficiary countries must be created. Not only is the efficient utilization and additionality of these resources at programme level essential but economic policies in the countries concerned must ensure that the overall supply conditions improve and especially that the efficiency and the share of productive investment relative to GDP are increased.

12. Even if the completion of the internal market in the last analysis results in significant gains in welfare and employment, the restructuring which it will imply during the transition phase gives rise to certain anxieties. The *social dimension* of the internal market needs to be given attention, in particular: (i) the implementation of policies to facilitate re-employment; (ii) the convergence towards the higher social standards, for instance, by minimum security and health regulations at the work place; (iii) the strengthening of the social dialogue at Community level.

13. *The reduction in unemployment* remains the priority task common to all Member States. Already employment is increasing at a historically high rate. This trend needs to be reinforced. In many countries there are signs of greater labour market adaptability, especially in the form of part-time work. The direction of the Cooperative Growth Strategy for more Employment remains valid: it involves, at the macroeconomic level further improvement in the profitability of capacity increasing and employment creating investment. An increase in wage costs, which should remain moderate, in conjunction with the new favourable demand prospects would contribute to this. It also involves concentrating attention on the elimination of unnecessary administrative obstacles which hinder employment creation and on greater mobility and skill improvements, particularly by sustained training efforts.

IV. The narrow path towards a consolidation of growth

14. The potential for non-inflationary growth can be strengthened by making *European economies even more adaptable*. Greater flexibility of markets and their positive effect on the behaviour and initiative of entrepreneurs is in itself a source of progress. In a situation where on the one hand it is necessary to avoid excessive pressures on productive capacity and on the other to further improve employment performances, structural policies are still very important.

15. The stabilization, and then the appreciation of the dollar on the foreign exchanges, led the *monetary authorities* to give more attention to the objectives of domestic stability. Recent increase in money market interest rates in the Community has strengthened the credibility of monetary authorities. To the extent that longer-term expectations of inflation and/or depreciation of the currencies have been reduced, long-term interest rates could be stabilized or decrease on a sound basis; some evidence of this emerged in some countries in early autumn. In the countries participating in the Exchange Rate Mechanism domestic inflationary pressures generally remain under control and further tightening of monetary policy does not seem necessary in the immediate future. Yet, the risk and main challenge to monetary policy could arise from renewed instability of the dollar.

16. *For budgetary policies*, medium-term objectives continue to be of primary importance. In the context of the achievement of the internal market discussions concerning the approximation of indirect taxes and taxation of capital income must be pursued so as to reach rapid agreement on these subjects. Other medium-term objectives include the convergence of general government balances, still excessive in some Member States, and the need to use budgetary policy to strengthen the conditions of supply and demand.

17. The increasing interdependence between Member States makes greater co-ordination of *economic policy* essential. Furthermore, an

TABLE 2: Main economic indicators 1985-89
Community countries, USA and Japan

(1) GDP^(a) at constant prices
(% change on previous year)

	1985	1986	1987	1988(*)	1989(*)
B	1,4	2,3	1,8	3	2½
DK	4,2	3,4	-1,0	0	1¾
D	2,1	2,6	1,9	3¼	2½
GR	3,0	1,3	-0,4	2¾	2
E	2,3	3,3	5,2	4¾	4
F	1,7	2,1	2,3	3	2¾
IRL	1,1	-0,3	4,1	3	3¼
I	2,7	2,7	3,1	4	3½
L	3,8	2,9	2,4	2¾	2½
NL	2,3	2,4	1,5	2¼	2¼
P	3,3	4,3	4,6	4	3½
UK	3,7	2,9	4,3	3¾	2½
EUR 12	2,5	2,6	2,9	3½	2¾
USA	3,1	3,0	3,4	4	2¼
JAP	4,5	2,4	4,2	5½	3¾

(2) Deflator of private consumption
(% change on previous year)

	1985	1986	1987	1988(*)	1989(*)
B	5,2	0,8	1,6	1¼	2½
DK	4,9	3,6	4,1	4¾	3¾
D	2,1	-0,2	0,5	1¼	2½
GR	18,7	22,2	15,8	13¾	12¾
E	8,3	8,7	5,3	4¾	4¼
F	5,7	2,5	3,2	2¾	2¾
IRL	4,5	3,6	3,1	2	2¾
I	9,3	6,1	4,8	5	4½
L	5,2	0,6	0,6	1½	2¼
NL	2,5	0,2	-0,4	¾	1¼
P	19,0	12,0	10,2	9½	7
UK	5,2	3,6	3,8	4½	4¾
EUR 12	5,9	3,6	3,3	3½	3¾
USA	3,1	2,1	4,5	4¼	5
JAP	2,1	0,6	-0,2	1	2

(3) Balance on current transactions
(as a % of GDP^(a))

	1985	1986	1987	1988(*)	1989(*)
B	0,7	2,6	1,9	1¾	1¾
DK	-4,7	-5,1	-3,0	-2½	-2¼
D	2,4	4,2	4,0	4	4¼
GR	-8,2	-5,4	-3,4	-2¾	-3½
E	1,6	1,7	0,1	-¾	-2
F	0,1	0,6	-0,3	0	¼
IRL	-3,8	-2,4	1,3	2½	3½
I	-0,9	0,8	-0,1	-½	-½
L	43,3	46,1	38,0	38½	36½
NL	4,3	2,8	1,7	1½	1¾
P	1,7	3,9	1,8	0	-1¾
UK	0,5	-0,8	-0,6	-3	-3¾
EUR 12	0,7	1,3	0,8	½	¼
USA	-2,9	-3,4	-3,6	-2¾	-2½
JAP	3,7	4,3	3,6	2¾	3

(4) Number of unemployed as % of the civilian labour force^(b)

	1985	1986	1987	1988(*)	1989(*)
B	13,6	12,6	12,3	11½	11
DK	8,7	7,4	7,6	8½	9
D	8,4	8,1	8,1	8	8½
GR	7,8	7,4	7,4	7½	7½
E	21,4	21,0	20,5	20	19½
F	10,5	10,7	10,8	10¾	10¾
IRL	17,9	18,2	19,2	18¾	18¼
I	12,9	13,7	14,0	15	14½
L	1,7	1,4	1,6	1½	1¼
NL	13,3	12,1	11,5	11¼	11
P	8,7	8,7	7,2	6½	6½
UK	12,0	12,0	10,6	8½	7¼
EUR 12	11,8	11,9	11,6	11¼	11
USA	7,2	7,0	6,2	5½	5½
JAP	2,6	2,8	2,8	2½	2½

(*) Forecasts September-October 1988.

(a) GNP for USA and Japan from 1987 onwards.

(b) EUR 9: Registered unemployed; GR, E, P: labour force sample survey.

Source: Commission services.

increasingly high degree of stability in exchange rates related to converging underlying economic fundamentals would improve the functioning of the internal market. The strengthening of monetary cohesion could be realized by an enlargement of the exchange rate mechanism to those countries not yet participating, management of monetary policies in greater co-operation and strengthening the role of the ecu. However monetary cohesion in the Community cannot be permanently ensured unless Member States follow compatible policies in other areas, particularly budgetary policy. In this

context it is important to strengthen the consensus on the principal economic policy objectives: a) stable prices and convergence of inflation rates; b) medium-term compatibility of payments balances and c) the contribution of internal and external stability to the growth and employment objectives of the Community and its Member States.

22 December 1988

Principal economic policy measures - November 1988

Community (EUR 12)

None

Belgium (B)

17.11 The central bank cuts the discount rate from 7,50 % to 7,25 % and the rate for current account advances from 7,75 % to 7,50 %.

Denmark (DK)

None.

Federal Republic of Germany (D)

25.11 The Federal budget for 1989 passes legislation exhibiting an expenditure increase of 5,4 %. Expenditures of DM 290,3 billion (about 13 % of GDP) and revenues of DM 262,4 billion will lead to a net borrowing requirement of DM 27,9 billion (or 1,3 % of GDP).

25.11 Parliament agrees upon consumer tax increases from 1989 onwards. The change in taxation of fuel, heating oil and tobacco and the implementation of a time-limited tax on gas will lead to revenue increases of about DM 7 billion in 1989. At the same time, Parliament also agrees upon an increase of the registration tax for diesel cars and the registration tax for insurance policies.

25.11 In relation to health insurance reform legislation was passed which will lead to expenditure reductions of about DM 7,4 billion in 1989, rising to DM 13,5 billion in 1992, while additional expenditures stemming from the new implemented insurance for home-based nursing of handicapped and elderly people will increase to DM 7 billion in 1992.

Greece (GR)

31.10 Government tables before Parliament the draft tax law which is to take effect on 1 January 1989 and will be applicable to 1988 income. The following are the most important provisions in the field of personal taxation:

- the tax scales have been amended and will now consist of nine bands with a top tax rate of 50 % (previously 19 and 63 % respectively);
- the system of tax allowances has been simplified and replaced by limits on taxation;
- a new method is used to calculate the tax payable;
- the exemption from tax on national income calculated on the basis of an owner's use of his residence is extended;
- the system for estimating income by means of objective signs of presumed expenditure is reformed.

The following points concern the taxation of legal persons:

- the rate of tax on undistributed profits is reduced from 49 % to 46 % (lower rates apply to specific categories of firms);
 - a proportion of profits are exempt from tax provided that they are reinvested.
- The draft tax law also states that part of the central government's tax revenue should be set aside to finance the local authorities.

28.11 The Government tables before Parliament the draft central government budget for 1989. Central government revenue is projected to be DRA 2 660 billion, an increase of 18,4 %, while expenditure will be DRA 4 052 billion, an increase of 18,7 %. The budget deficit will be DRA 1 392 billion or 16,2 % of GDP, compared with DRA 1 167,5 billion or 15,6 % of GDP in 1988.

Spain (E)

10.11 The Treasury raises the interest rate on one-year public debt from 11,54 % to 11,78 %.

15.11 The Treasury raises the interest rate on three-month debt by 0,25 % to 11,75 %.

24.11 The interest rates on one-year public debt are raised from 11,78 % to 12,06 % to maintain the existing differential between one-year and three-month interest rates. These measures are in line with the authorities' decision to increase the share of the public deficit financed by the issue of securities on the market.

France (F)

23.11 The Minister for the Civil Service presents the Government with a decree which, with effect from 1 October 1988, grants an increase of 2 index points to staff of the central government, regional or local authorities and public hospitals.

Ireland (IRL)

None.

Italy (I)

None.

Luxembourg (L)

None.

Netherlands (NL)

None.

Portugal (P)

8.11 The Government decides to make a partial start on the process of privatizing two public enterprises dealing with insurance (up to 49 % of their capital), because of the delays in revising the constitution.

22.11 The Government decrees that retirement and invalidity pensions paid by the social security scheme are to be increased from December 1988. The additional cost to the budget will be 0,6 % of GDP.

United Kingdom (UK)

1.11 Public expenditure plans for the next three years and revised economic forecasts for 1988 and 1989 are published. In the current financial year public spending is now expected to be UKL 3,2 billion (or 2 %) below the March budget forecast. The total planned for next year, 1989-90, remains unchanged at UKL 167,1 billion. For 1990-91, the planning total has been revised upwards by UKL 3,3 billion to UKL 179,4 billion and a new total of UKL 191,6 billion has been set for 1991-92. These plans imply a continued further reduction in general government expenditure as a proportion of GDP from 39,7 % in 1988-1989 to 38,8 % in 1991-92.

24.11 The Government announces that selective additional rises in pensions for poorer pensioners over 75 years old will take effect from October 1989, costing UKL 195 million of public expenditure in a full year, UKL 95 million in the 1989-90 financial year.

25.11 Immediately following announcement of record trade and current account deficits, the Bank of England prompted commercial banks to raise base rates by 1 % to 13 %.

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