ISSN 0379-2056

EUROPEAN ECONOMY

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

Supplement A
Recent economic trends
No 7 – July 1990

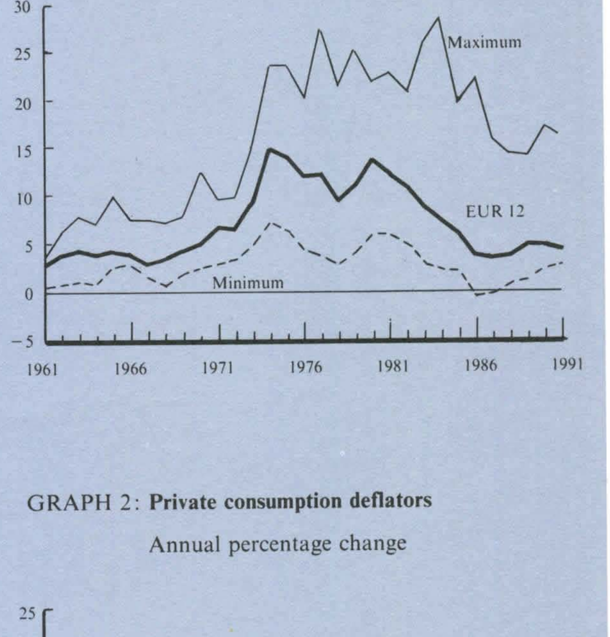
In this number:
Nominal convergence at the beginning of Stage One of EMU.

SUMMARY

- After a disappointing performance in the 1970s, substantial progress towards nominal convergence was made in the Community during the last decade.
- The rate of inflation has converged towards the best results: the average rate has fallen substantially (from 13.5 % per annum in 1980 to 3.6 % in 1988 for the deflator of private consumption) and the dispersion among the individual rates has been reduced significantly.
- Budget deficits have also been reduced. The Community average general government borrowing requirement measured as a percentage of GDP has been reduced from more than 5 points at the beginning of the decade to less than 3 in 1989. The disparities between the positions of the Member States, however, have not been reduced. Indeed, consolidation has been stronger where budget deficits were less serious.
- Progress in reducing the imbalances in the external positions of Member States has also been patchy. Imbalances have come down during the first years of the decade, but have started widening again over the last two/three years. The financing of these imbalances has, however, been much easier than would have been predicted a few years ago.

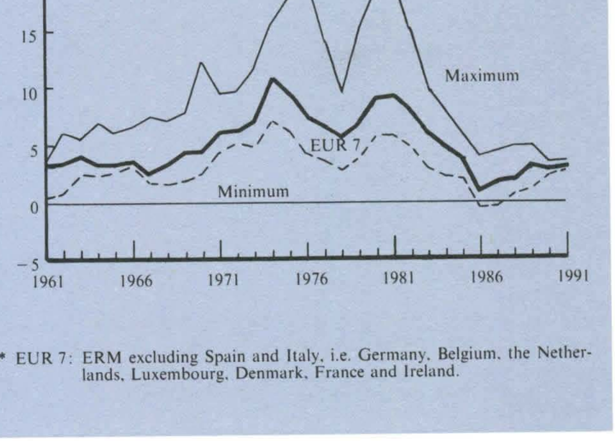
GRAPH 1: **Private consumption deflators**

Annual percentage change



GRAPH 2: **Private consumption deflators**

Annual percentage change



* EUR 7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.

The concept of economic convergence covers two distinct areas. On the one hand, it refers to the long-term process of reduction in the disparities of living standards which is one of the fundamental objectives of the Community. This process is often defined *'real convergence'* and it is usually measured by the changes in the disparities in the levels of GDP per head. More commonly, however, the phrase is employed to describe the convergence, towards the best results, of the economic variables which are more directly responsible for exchange rate stability and the maintenance of a sound economic environment. This process — which involves primarily prices and costs performances, budgetary positions and balances of payments - is commonly referred to as *'nominal convergence'*.

Progress towards 'real convergence' has been reviewed in this series in May and October 1988. The present issue, appearing in July 1990 when the Community enters Stage One of EMU, deals exclusively with 'nominal convergence'.

The transition towards Economic and Monetary Union (EMU) requires that the good results achieved in several Member States be defended and that substantial progress be made in the remainder. Progress towards greater convergence is a complex task. Satisfactory results in those areas that more directly influence exchange rates — such as price and costs developments and current account positions - can be maintained over the medium term only if other variables also move in the right direction. A successful anti-inflationary stance will not affect negatively investment and growth only if cost increases decelerate in line with prices. Similarly, economic policy can offset, to a certain extent, the negative consequences on the current account of cost developments not in line with those of the main trading partners. But this carries a price in terms of GDP and employment growth and only delays the inevitable eventual adjustment.

This issue of the series 'A' of the supplements to European Economy will not discuss these interactions, but will confine itself to a description of progress, or lack of it, in some of the most important areas such as i) price and cost performances, ii) budgetary and iii) current account positions.

Convergence of prices and costs

Convergence of price and cost performances towards the best results is an essential condition for the preservation of a sound economic environment and of exchange rate stability. It is comforting to observe that the Community has achieved the best results precisely in this area.

Convergence of prices — After the very negative performance of the first half of the 1970s, inflation in the Community has shown in the 1980s a favourable and converging trend. Notwithstanding the pressure deriving from the continuous depreciation of the European currencies, the average private consumption deflator in the Community dropped from 13.5 % in 1980 to less than 6 % in 1985 (table 2). The subsequent reversal of the exchange rate movements and the drop in the price of oil allowed a further reduction in the average deflator of private consumption to 3.4 % in 1987: less than the average rate of the 1960s! The reduction in the average deflator of GDP has been slightly less pronounced; nevertheless its average value has been cut from 13 % in 1980 to about 4 % in 1987 (table 1). The convergence of performance between the Member states has also improved considerably (see dispersion measures of tables 1 and 2).

The performance of the countries participating in the narrow band of the EMS has been particularly impressive, demonstrating the disciplinary force of the exchange rate mechanism. The average private consumption deflator of the countries that have

TABLE 1: **GDP Deflators**

(annual percentage change)

	1961-68	1969-79	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990**	1991**
B	3,2	6,9	3,8	4,7	7,1	5,6	5,2	6,0	3,5	2,1	2,0	3,5	4,0	3,0
DK	6,1	9,5	8,2	10,1	10,6	7,6	5,7	4,3	4,7	5,1	4,9	4,4	2,5	2,6
D	3,1	5,5	4,8	4,0	4,4	3,3	2,0	2,2	3,1	2,0	1,5	2,5	3,3	3,5
GR	3,0	11,5	17,7	19,8	25,1	19,1	20,3	17,7	17,8	14,2	14,5	14,2	17,7	15,7
E	6,5	13,5	14,2	12,0	13,8	11,6	10,9	8,5	10,9	5,9	5,7	6,9	7,0	6,2
F	4,0	9,1	11,6	11,4	12,0	9,6	7,3	5,8	5,2	3,0	3,3	2,9	3,0	2,9
IRL	4,5	12,9	14,7	17,4	15,2	10,7	6,5	5,1	6,1	2,0	2,9	5,0	2,6	3,4
I	4,3	12,6	20,0	18,6	17,1	14,9	11,4	8,9	7,5	6,1	6,0	6,3	6,4	5,2
L	2,6	7,0	7,9	7,2	10,8	6,8	4,4	3,0	1,7	0,9	2,2	3,0	3,3	4,4
NL	5,0	7,6	5,7	5,5	6,1	1,9	1,9	1,8	0,5	−0,4	1,9	1,0	2,6	2,4
P	2,5	13,5	20,9	17,6	20,7	24,6	24,7	21,7	20,5	11,2	11,6	12,5	13,1	10,5
UK	3,6	12,1	19,5	11,4	7,6	5,3	4,6	5,6	3,5	4,8	6,6	6,9	6,3	5,4
Weighted average														
EUR 12	4,0	9,9	13,0	10,9	10,6	8,5	6,9	6,0	5,5	4,1	4,5	4,9	5,1	4,5
EUR 7*	3,7	7,3	7,6	7,3	7,9	5,9	4,3	3,9	3,8	2,3	2,3	2,7	3,1	3,1
Measures of dispersion related to average [1]														
EUR 12	1,0	2,6	5,4	4,6	4,8	5,0	4,8	3,9	4,3	3,1	3,0	2,9	3,3	2,5
EUR 7*	1,0	1,8	3,0	3,5	3,3	2,6	1,8	1,5	1,6	1,2	0,9	1,0	0,4	0,5
Measures of dispersion related to lowest [1]														
EUR 12	1,6	4,7	8,7	7,6	8,2	8,2	6,9	5,7	6,6	5,2	3,8	4,7	3,5	3,1
EUR 7*	1,4	2,9	4,3	4,6	5,1	4,6	2,8	2,2	3,1	2,6	1,2	2,2	0,5	0,8

[1] The dispersion index in an unweighted arithmetic mean of each country's absolute deviation from the respective reference value.
* EUR7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.
** Forecasts, May 1990.

TABLE 2: **Private consumption deflators**

(annual percentage change)

	1961-68	1969-79	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990**	1991**
B	3,2	6,3	6,4	8,6	7,8	7,2	5,7	5,9	0,3	1,8	1,8	3,1	3,2	2,7
DK	5,8	9,5	10,7	12,0	10,2	6,8	6,4	4,3	3,5	4,4	4,9	5,0	2,5	2,7
D	2,8	4,8	5,8	6,0	4,7	3,2	2,5	2,1	−0,2	0,8	1,3	3,1	2,8	3,0
GR	2,3	10,6	21,9	22,7	20,7	18,1	17,9	18,3	22,0	15,6	14,0	13,8	17,0	16,0
E	6,2	13,1	16,5	14,3	14,5	12,3	11,0	8,2	8,7	5,4	5,1	6,6	6,6	6,1
F	3,9	9,0	13,5	13,4	11,8	9,7	7,9	6,0	2,9	3,3	3,0	3,5	2,9	3,0
IRL	3,9	12,8	18,6	19,6	14,9	9,2	7,6	4,7	4,0	2,6	2,5	4,1	3,0	3,4
I	3,8	12,1	20,4	18,2	16,9	15,1	11,9	9,0	5,7	5,0	4,8	6,0	5,5	5,0
L	2,4	5,7	7,6	8,7	10,6	8,5	6,9	4,5	1,2	1,5	2,6	3,4	3,5	3,6
NL	3,8	7,1	6,9	5,8	5,5	2,9	2,2	2,2	0,2	−0,4	0,7	1,1	2,3	2,7
P	2,6	14,4	21,6	20,2	20,3	25,8	28,5	19,4	13,8	10,0	10,0	12,8	11,7	10,0
UK	3,5	11,6	16,2	11,2	8,7	5,0	5,1	5,2	4,4	3,9	5,0	5,8	6,6	5,1
							Weighted average							
EUR 12	3,7	9,4	13,6	12,1	10,7	8,6	7,3	5,9	3,8	3,5	3,7	4,8	4,7	4,3
EUR 7*	3,4	6,9	9,1	9,3	8,0	6,1	4,9	3,9	1,2	1,8	2,0	3,2	2,8	2,9
							Measures of dispersion related to average[1]							
EUR 12	0,9	2,7	5,4	4,7	4,3	4,7	4,7	3,7	4,2	2,9	2,7	2,6	3,1	2,5
EUR 7*	0,8	2,1	3,6	3,6	3,1	2,4	2,2	1,3	1,4	1,2	1,0	0,8	0,3	0,3
							Measures of dispersion related to lowest[1]							
EUR 12	1,3	4,9	8,0	7,6	7,6	7,4	7,3	5,4	5,8	4,9	4,0	4,6	3,4	2,6
EUR 7*	1,3	3,1	4,1	4,8	4,7	3,9	3,4	2,1	1,9	2,4	1,7	2,2	0,6	0,3

[1] The dispersion index in an unweighted arithmetic mean of each country's absolute deviation from the respective reference value.
* EUR7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.
** Forecasts, May 1990.

accepted this discipline from the start* dropped from 9.0 % in 1980 to only 1.7 % in 1988, while over the same period the gap between the highest and lowest figures in this group was reduced from 12.7 to 4.2 points. The dispersion between the rates of inflation of this group of countries is now lower than it was during the 1960s under the Bretton Woods system of fixed exchange rates!

In Denmark and France, where inflation was still at 12 and 13 % respectively in 1981, governments took a clear anti-inflationary stance and tried influencing the process of wage formation. These efforts are now paying dividends and the French and Danish annual inflation rates in May 1990 were down to 3 and 2 ½ percent respectively. The most spectacular result has been achieved, however, in Ireland where the deflator of private consumption has been reduced from 19.6 % in 1981 to 2.5 % in 1988. This is all the more remarkable when considering the substantially less favourable price performance of the United Kingdom which remains by far Ireland's most important trading partner.

In Italy, Spain and the UK, the rates of inflation have also been reduced significantly since the beginning of the decade. Their best performance, however, was still almost more than double that of the initial narrow-band countries. In 1987, the UK experienced its lowest rate of inflation of the last decade, but its performance (the deflator of private consumption rose by 3.9 %) was still more than twice the average performance of the initial members of the narrow band of the EMS, 1.7 %. Italy and Spain experienced their best inflation results of the last decade, 4.8 % and 5.1 % respectively, in 1988 when the narrow-band club was still below 2 percent.

* Italy joined in January 1990 the original group consisting of Belgium, Denmark, Germany, France, Ireland, Luxembourg and the Netherlands.

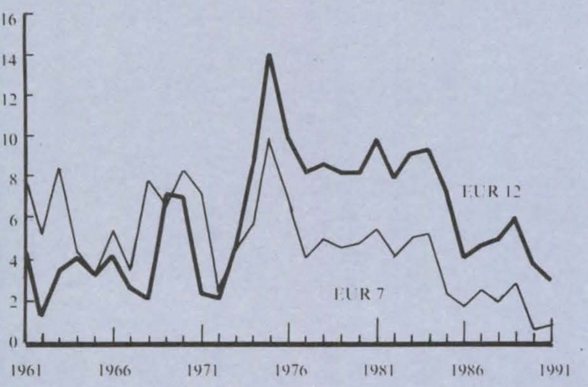
The development of inflation rates in Portugal and Greece was less favourable. While in the rest of the Community inflation rates declined steadily since the beginning of the 1980s, in these two countries the movement started only in 1984 and 1986 respectively. The results, however, have been remarkable. Portugal reduced its inflation rate from 28.5 % in 1984 to 10 percent in 1987, while Greece cut its inflation rate from 22 percent in 1984 to 14 percent in 1988.

Since 1988/89, the inflation performance of the Community has deteriorated somewhat. Rates of inflation have started to accelerate again in most countries, although the widespread character of the movement does not influence the dispersion measures much. The deterioration is more evident in terms of consumer prices rather than GDP deflators. Falling import prices pushed the increases of consumer prices down to historically low levels in 1987/88, but in 1989 this trend was reversed. In addition, factors of an exceptional nature such as steep increases in indirect taxes and administered prices added to inflationary pressures in some countries.

The expected stability of import prices in 1990 and the occasional nature of some of the factors behind the acceleration of inflation in 1989 had led forecasters to expect a significant deceleration of inflation this year. This would have turned the acceleration of inflation in 1989 into an unfortunate 'blip' in a continuously descending trend. This projection is being proved wrong. High degrees of capacity utilization, the expectation of demand remaining strong and some tensions on the labour markets, notwithstanding the still high rates of unemployment, have facilitated passing higher unit labour costs onto prices.

In 1990 and 1991, the performance of the group of narrow-band countries is expected to remain far better than that of the rest of the Community, but the rates of inflation will remain above the best levels reached in 1986/87: the average rate of inflation in these countries is forecast to edge up marginally to about 3 %

GRAPH 3: **Divergence of the nominal unit labour costs**
Annual percentage change



* The dispersion index is an unweighted arithmetic mean of each country's absolute divergence from the minimum.
* EUR 7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.

in 1991. The rates of inflation in the other countries, on the other hand, should come down somewhat thus improving overall convergence. Private consumption deflators are forecast to slow down next year by between half a point and a full point in Italy, Spain and the United Kingdom*. The inflation rates in Greece and Portugal, which are by far the highest in the Community, are expected to decline between 1990 and 1991 by 1 and almost 2 points respectively. In Greece, the expected reduction must be viewed in the context of an acceleration of inflation between 1989 and 1990 of 3.2 points which was due to the abandonment of the anti-inflationary policy pursued until 1989.

Convergence of labour costs — Progress in improving the convergence of the rates of inflation has been helped by success in the achievement of convergence of wage costs. Since productivity increases averaged between 1 and 2.3 percent over the last decade, the reduction in the rates of increase of unit labour costs and in their dispersion is essentially explained by trends in nominal wages per employee. The success achieved was brought about by significant policy changes in many countries, notably in the area of monetary policy. Although free collective bargaining was maintained, specific measures were taken to influence wage trends. For instance, in some countries, wage indexation schemes have been partially, temporarily or entirely suspended.

Again, the results achieved by the initial narrow-band countries are the most impressive. Nominal unit labour costs had risen in 1980 by 12.2 % in the Community as a whole and by 9.2 % in the narrow-band countries (increases in national currencies). The corresponding figures for 1989 were 4.3 % for the whole Community and 1.4 % for the initial narrow-band countries (table 3). The performance of France was most impressive: over the 1986/1989 period, nominal unit labour costs rose on average by less than 2 % a year compared to more than 10 % at the beginning of the decade.

The dispersion measures used in table 3 show the same remarkable improvement as for prices. The difference between the highest and lowest rates of increase in the Community, however, increased from 17.1 points in 1980 to 20.3 points in 1989. This surprising result is explained by Greece's recent very poor cost performance. If Greece is excluded, the gap has been reduced to about 10 points. Among the initial narrow band countries, the difference between the highest and the lowest rate of increase has been reduced from 13.6 points to just 4.2.

* To avoid a discontinuity in the series the Commission services treat the Community charge as an indirect tax as it was the case with the previous 'rates' system. The United Kingdom's Central Statistical Office, on the other hand, treats the Community charge as a separate type of tax which implies that the suppression of the 'rates' system amounts to a substantial decrease of indirect taxes in 1990 and 1991. This depresses substantially the deflator of private consumption.

TABLE 3: **Nominal unit labour costs**

(annual percentage change)

	1961-68	1969-79	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990**	1991**
B	3,4	8,0	5,0	5,2	4,5	4,5	4,4	4,2	3,8	0,7	−0,9	1,9	3,0	3,3
DK	6,8	9,3	10,0	8,8	9,1	5,8	2,8	2,9	4,5	9,9	4,5	1,9	2,0	1,9
D	3,2	5,8	6,6	4,3	3,1	0,6	0,7	1,7	2,5	2,1	0,1	0,8	2,2	2,6
GR	1,0	11,3	15,6	27,3	26,3	22,2	19,4	22,6	12,3	11,2	16,1	19,0	17,5	14,7
E	7,5	13,8	12,3	12,6	11,3	11,2	5,5	5,6	8,5	6,2	4,5	5,0	6,4	5,4
F	4,1	9,5	13,8	12,3	11,7	8,8	5,7	4,4	2,3	1,9	1,3	2,5	2,7	2,6
IRL	4,2	13,1	18,6	13,3	11,8	10,8	4,3	3,3	5,2	2,0	0,5	−0,1	1,9	2,7
I	3,9	13,1	18,8	21,4	16,4	15,5	8,9	8,2	5,5	6,8	6,1	6,0	6,1	5,0
L	3,1	8,6	8,9	9,4	5,5	3,5	1,5	1,9	3,4	3,7	1,9	3,0	3,5	4,0
NL	6,2	8,1	5,3	2,6	4,6	−0,2	−2,9	0,4	1,6	1,8	−0,1	−1,2	2,2	2,2
P	1,4	16,0	19,7	20,3	16,8	20,6	21,7	19,1	13,6	13,1	8,4	9,1	10,9	9,6
UK	3,5	12,1	22,1	11,1	4,7	3,7	5,9	4,7	4,3	3,9	6,3	8,9	9,0	4,4
Weighted average														
EUR 12	3,8	10,2	13,9	11,6	9,1	7,3	5,2	5,0	4,3	4,0	3,4	4,3	5,0	3,9
EUR 7*	4,0	7,8	9,3	7,4	6,9	4,2	2,5	2,8	2,5	2,2	0,6	1,4	2,4	2,6
Measures of dispersion related to average[1]														
EUR 12	1,4	2,5	5,0	5,5	5,2	5,9	4,7	4,3	2,6	3,3	3,6	4,0	3,5	2,3
EUR 7*	1,1	1,7	3,7	3,5	3,1	3,1	2,2	1,1	1,1	1,7	1,2	1,2	0,5	0,5
Measures of dispersion related to lowest[1]														
EUR 12	3,1	4,9	8,1	9,8	7,4	9,1	9,3	6,2	4,0	4,6	4,9	5,9	3,7	2,9
EUR 7*	1,3	3,1	4,7	5,4	4,1	5,0	5,2	2,3	1,7	2,5	1,9	2,4	0,6	0,8

[1] The dispersion index in an unweighted arithmetic mean of each country's absolute deviation from the respective reference value.
* EUR7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.
** Forecasts, May 1990.

TABLE 4: **Net lending (+) or borrowing (−); general government**

(percent of GDP)

	1970-79	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990**	1991**
B	−4,5	−9,2	−12,8	−11,0	−11,2	−9,2	−8,5	−9,0	−7,1	−6,7	−6,3	−6,1	−6,3
DK	1,6	−3,3	−6,9	−9,1	−7,2	−4,2	−2,2	3,1	2,2	−0,1	−0,7	−0,5	0,5
D [2]	−1,7	−2,9	−3,7	−3,3	−2,5	−1,9	−1,1	−1,3	−1,9	−2,1	0,2	−1,4	−1,0
GR	:	:	−11,0	−7,7	−8,3	−10,0	−13,8	−12,7	−12,0	−14,7	−17,6	−17,7	−16,8
E	0,3	−2,6	−3,9	−5,6	−4,8	−5,5	−7,0	−6,1	−3,2	−3,1	−2,1	−2,0	−1,1
F	−0,2	0,0	−1,9	−2,8	−3,2	−2,8	−2,9	−2,7	−2,0	−1,4	−1,3	−1,3	−1,3
IRL	−7,5	−12,7	−13,4	−13,8	−11,8	−9,8	−11,3	−11,1	−9,1	−3,9	−3,1	−2,8	−3,2
I	−7,1	−8,6	−11,4	−11,3	−10,6	−11,6	−12,5	−11,7	−11,1	−10,9	−10,2	−10,3	−10,0
L	2,8	−0,4	−3,4	−1,0	2,0	3,4	5,3	3,3	1,3	2,3	3,3	4,0	3,1
NL	−1,6	−4,0	−5,5	−7,1	−6,4	−6,3	−4,8	−6,0	−6,5	−5,0	−5,1	−5,3	−5,1
P	:	:	−9,3	−10,4	−9,0	−12,0	−10,1	−7,2	−6,8	−6,5	−5,0	−7,4	−6,9
UK	−2,4	−3,4	−2,6	−2,5	−3,3	−3,9	−2,7	−2,4	−1,5	1,0	1,6	0,2	0,9
	Weighted average												
EUR 12	:	:	−5,3	−5,5	−5,3	−5,3	−5,2	−4,8	−4,2	−3,6	−2,8	−3,5	−3,1
EUR 7*	−1,3	−2,5	−4,0	−4,3	−3,9	−3,2	−2,7	−2,7	−2,6	−2,3	−1,3	−2,0	−1,8
	Measures of dispersion related to average [1]												
EUR 12	:	:	3,7	3,7	3,5	3,7	4,6	4,5	4,0	3,7	4,0	4,2	4,1
EUR 7*	2,6	3,5	3,7	4,2	4,1	3,5	3,8	4,5	3,6	2,4	2,5	2,4	2,5

[1] The dispersion index in an unweighted arithmetic mean of each country's absolute deviation from the respective reference value.
[2] The figures for 1990 and 1991 include borrowing under the 'German unity' fund.
* EUR7: ERM excluding Spain and Italy, i.e. Germany, Belgium, the Netherlands, Luxembourg, Denmark, France and Ireland.
** Forecasts, May 1990.

The convergence of budgetary positions

In the field of budgetary policies, progress has been distinctly less remarkable than for prices and costs. The average general government borrowing requirement in the Community declined from 5.3 % of GDP at the beginning of the 1980s to 2.8 % of GDP in 1989 whereas inflation, measured by the deflator of private consumption, fell from 13 % to 4.9 % over the same period. The improvements in convergence between the individual budgetary positions of Member States have been small.

This can be explained, first, by the extreme inertia always displayed by budget volumes (cumbersome decision making processes, action of the automatic stabilizers, etc.) and second, by the fact that the exchange rate constraint does not affect budgetary policy so directly as it does costs and prices. The latter point is clearly illustrated by the observation that in the budgetary area the disparity between the progress made by the initial ERM narrow-band countries and that made by the other countries is not as clear-cut as it is for prices and costs.

In the area of public finances, the 1980s witnessed a fundamental change of policy stance in the direction of consolidation. However, efforts at consolidation produced visible results only when the upturn in economic activity and the growth of employment made their contribution. The Community's average borrowing requirement did not start to fall significantly until 1986/1987. A certain correlation exists between respect for the discipline of the EMS and the extent of the progress made, but the link is somewhat tenuous. Admittedly, the most remarkable progress has been made in Denmark and Ireland, countries which respect the narrow fluctuation band, and the least satisfactory situations are to be found in Greece and Italy. But significant progress has also been made in Spain, Portugal and the United Kingdom which either do not belong to the exchange rate mechanism or have just joined it in the case of Spain.

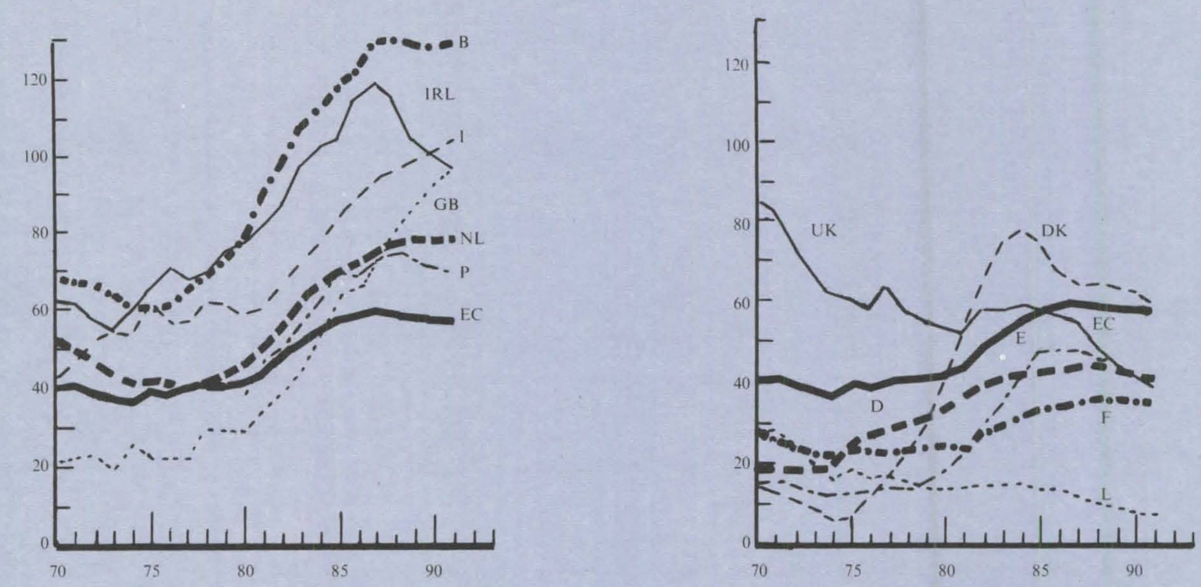
As a result of a remarkable consolidation effort and while maintaining sustained economic growth, Denmark has turned its budgetary position around in the space of a few years, moving from a deficit equivalent to 9.1 % of GDP in 1982 to a surplus of 3.1 % of GDP in 1986. Since then, the slowdown in growth has caused some deterioration in the budgetary position but it is nevertheless close to equilibrium. Comparable progress has also been made in Ireland. At the beginning of the 1980s, Ireland's general government borrowing requirement was the highest in the Community (averaging over 13 % of GDP for the years 1980-82) and its reduction has always been a priority objective of government economic policy. After some years of mixed success, this deficit started to be reduced very considerably in 1986/87 and is now at a level equivalent to some 3 % of gross domestic product.

Consolidation efforts in the other countries have achieved less remarkable results. Nevertheless, Belgium has succeeded in holding the primary budget balance (budget balance net of interest payments) at a level which permitted stabilization of the public debt/GDP ratio in 1988, a year when the ratio reached 130 %, the highest level in the Community. Portugal and Spain have been successful in exploiting the period of strong growth which they have enjoyed since the mid-1980s to bring down their borrowing requirement sharply, in the case of Portugal from a level equivalent to some 10 % of GDP in 1985 to 5 % in 1989, and in Spain from 7 % to 2 %.

These favourable developments exist side by side with a striking lack of progress in Greece and in Italy, where moreover, no significant improvement is forecast for the next two years. In Italy, the general government borrowing requirement fell slightly between 1985 and 1988, but now stands at a level equivalent to some 10 % of GDP and is therefore still close to the levels reached at the beginning of the decade. In Greece, after two years in which the budget deficit worsened, it has reached a very high level of some 17 % of GDP. In these two countries, the persistence of high budget deficits leads to a worrying continuation of the increase in the public debt/GDP ratio which is already very high.

The progressive reduction of the Community's average borrowing requirement during the 1980s is, however, primarily explained by the progressive improvement in budgetary positions in Germany, France and the United Kingdom. In the latter country, general government in 1989 achieved a net

GRAPH 4: **Trends in gross public debt (% of GDP)**



lending position equivalent to 1.6 % of GDP. The tendency for the average general government borrowing requirement to fall is, however, in the process of coming to a halt. Chiefly because of the budgetary costs which the FRG will have to sustain to bring about economic unification with the GDR, the average borrowing requirement for 1990 and 1991 is forecast to rise again. But, even if the FRG is disregarded, the forecasts show a slight deterioration in budget balances during these two years mainly because of the deterioration forecast in Portugal and the expected erosion of the United Kingdom's surplus.

In 1990 and 1991 the general government borrowing requirement in the FRG should be equivalent to 1.4 % and 1 % respectively of GDP, compared with a surplus of 0.2 % of GDP in 1989. If the two German economies were taken into account, the deterioration would probably be even more significant: the combined deficits of the GDR and the FRG could be equivalent to some 2 % of the Federal Republic's GDP in 1990 and 1 ¾ % in 1991.

The external imbalances

Since the 1960s, the current balance of the Community as a whole has always been close to equilibrium and it has been dislodged from this position solely as a result of the oil shocks and the reverse oil shocks in 1973-74, 1979-80 and 1986. But this turmoil produced no dramatic effects since the extreme values of the Community's current balance have ranged from deficits equivalent to 1 point and 1.2 points of Community GDP in 1974 and in 1980 to a surplus equivalent to 1.4 points in 1986.

However, imbalances within the Community have sometimes been very sizeable and are at present at a fairly high level. The stormiest periods have clearly been those associated with the oil shocks of 1973 and 1979 (see Graph 6). Since 1986, there is evidence of a renewed worsening of Member States' current payments imbalances.

In this area, the economic policy objective should not be the equilibrium of all countries. The less favoured countries must have recourse to capital from abroad in order to finance their investment and their growth and it is therefore normal for them to have a current account deficit. To the extent that this deficit is funded by long-term capital inflows which finance investment, the situation is healthy and acceptable from the point of view of economic policy. Conversely, it is quite normal for countries at an advanced stage of development to have a current account surplus which corresponds to the transfer of real resources which they make to countries lagging behind in development. However, the present degree of external imbalances is greater than can be justified by these considerations.

GRAPH 5: **Current balances in billions of ecus**

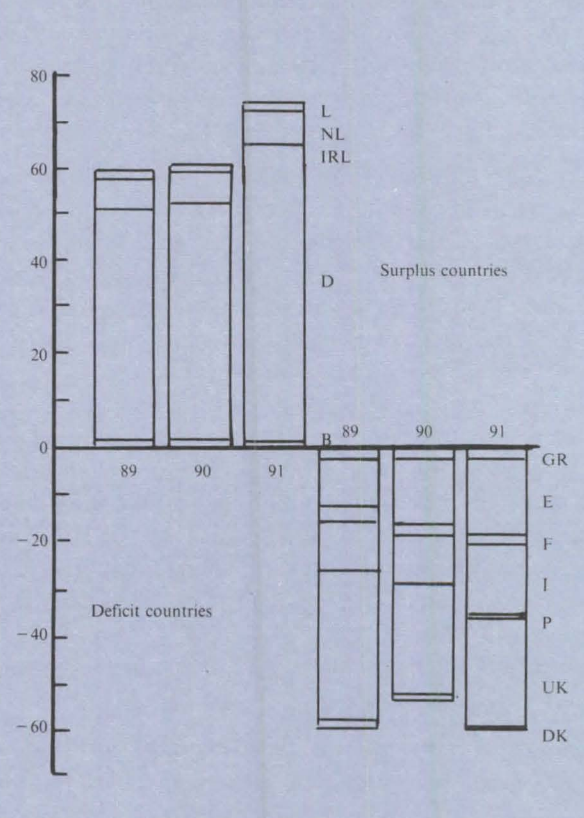


TABLE 5: **Balance on current transactions with the rest of the world**

(Percent of GDP)

	1961-68	1969-79	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
B	0,3	0,6	−4,3	−3,8	−3,7	−0,8	−0,6	0,3	2,0	1,2	1,0	1,0	1,0	0,7
DK	−1,8	−2,9	−3,7	−3,0	−4,2	−2,6	−3,3	−4,6	−5,5	−3,0	−1,8	−1,8	−1,3	−0,8
D	0,6	1,0	−1,7	−0,7	0,5	0,7	1,3	2,6	4,4	4,1	4,1	4,5	3,7	4,4
GR	−3,0	−2,5	0,5	−0,7	−4,4	−5,0	−4,0	−8,2	−5,3	−3,1	−1,7	−4,9	−4,6	−4,6
E	−0,8	−0,6	−2,4	−2,7	−2,5	−1,5	1,4	1,6	1,7	0,1	−1,1	−2,9	−3,6	−3,9
F	0,3	0,3	−0,6	−0,8	−2,1	−0,8	0,0	0,1	0,5	−0,3	−0,4	−0,4	−0,3	−0,2
IRL	−1,7	−5,5	−11,8	−14,7	−10,6	−6,9	−5,8	−4,0	−2,9	1,3	1,8	1,6	1,2	0,7
I	1,7	0,4	−2,2	−2,2	−1,6	0,3	−0,6	−0,9	0,5	−0,2	−0,6	−1,3	−1,1	−1,5
L	3,3	17,0	18,7	21,2	34,4	39,3	38,9	43,5	39,4	31,6	34,3	32,1	30,0	28,0
NL	0,2	1,1	−1,5	−2,2	3,2	3,1	4,2	4,1	2,7	1,4	2,4	3,2	3,0	3,1
P	−1,4	−1,8	−5,9	−12,2	−13,5	−8,3	−3,4	0,4	2,4	−0,4	−4,4	−1,2	−1,2	−1,8
UK	−0,3	−0,5	1,5	2,4	1,4	0,9	−0,2	0,6	−0,8	−1,9	−4,1	−4,1	−3,0	−2,8
EC	0,3	0,2	−1,2	−0,7	−0,7	0,1	0,3	0,7	1,4	0,7	0,2	0,0	0,0	0,1

Anxieties are, however, moderated by the observation that even though the combined scale of deficits and surpluses is now very high, no country any longer has current account deficits as high as during the first half of the decade. In 1989, Greece, the United Kingdom and Spain had deficits of the order of 3 to 5 points of GDP. At the beginning of the decade, several countries had large deficits and in Portugal and Ireland they were well above 10 % of GDP. From this point of view, the degree of convergence of external balances has improved.

The most remarkable development of recent years, however, has been the exceptional increase in Germany's current account surplus which reached a level equivalent to 4.5 % of GDP in 1989 and which during the last two or three years has concentrated the minds of economic policy-makers. Because of the large transfers from the FRG to the GDR as part of the process of unifying the two economies, an appreciable fall in the West German surplus, expressed as a percentage of GDP, is taking place.

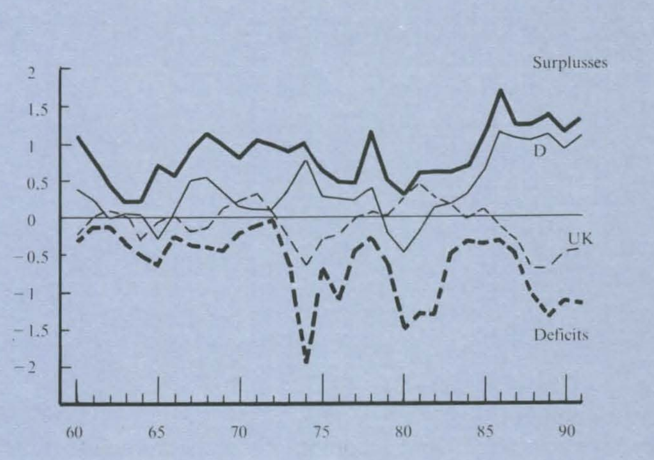
Ireland has succeeded in reversing its external position which previously had been one of the most worrying in the Community. It has moved from a deficit equivalent to 14.7 % of GDP in 1981 to a surplus of 1.6 % of GDP in 1989. Past imports of capital and of investment goods are now producing the goods which enable debts to be repaid. Denmark, by contrast, still has a deficit on its current account even though it has a trade surplus. This situation is due to the high cost of servicing the foreign debt.

Spain has seen a sharp deterioration in its external position, which has moved from a surplus of 1.7 % of GDP in 1986 to a deficit of 2.9 % in 1989. Even if this deterioration is chiefly the mirror image of inflows of capital to finance productive investment, the speed of the deterioration, which should continue in 1990 and 1991, gives cause for concern. In 1985, Greece introduced a stabilization programme aimed at reducing its current account deficit which at the time stood at over 8 % of GDP. As a result of this programme, supported by a large Community loan, the deficit was brought down to under 2 % of GDP in 1988. Thereafter, efforts were interrupted and the external position has again deteriorated sharply, recording a deficit equivalent to almost 5 points of GDP in 1989.

The forecasts for 1990 and 1991 show a slight increase in external imbalances in the Community resulting from an increase in the aggregated surpluses. However, if these figures are adjusted for the amount of the surplus which the FRG is achieving in relation to the GDR, the picture which emerges is if anything that of stabilization at current levels.

17 July 1990

GRAPH 6: **Current Account Surplusses and Deficits of EC Member States as % of Community GDP**



Principal economic policy measures — June 1990

Community (EUR 12)

11.6 The ECOFIN Council conducts the first 'Multilateral Surveillance' exercise envisaged under the new convergence decision. This involves an assessment of the economic situation in the Community and the consistency of economic policies.

11.6 The Committee of central bank Governors accomplishes the reorganisation of its structures and working procedures with the objective of the first phase of the EMU. The Committee of Governors will be assisted by the Committee of Alternates, three Sub-Committees and an enlarged Secretariat.

11.6 The Council of Governors of the European Investment Bank (EIB) decides to double the capital of the EIB.

25.6 The European Council decides to convene an intergovernmental Conference on Economic and Monetary Union for December 13 in Rome.

Belgium (B)

15.6 The Government officially announces that it will follow a policy of pegging the Belgian franc more closely to the German mark. The Government's objective is to increase foreign investors' confidence in the Belgian currency. The result should be lower interest rates which, and foremost, should bring down interest charges on the public debt.

27.6 In five stages, the central bank cuts the rates for one-, two- and three-month Treasury bills by 0,45 of a percentage point. This takes the rate for three-month bills, considered to be the main instrument for guiding monetary policy, to 9,40 %.

Denmark (DK)

15.5 To revitalize the market for owner-occupied dwellings, the stamp duty on sales is suspended during the period from 15 May to 1 September.

22.6 National bank key interest rates reduced by 0,5 % for the third time this year.

Federal Republic of Germany (D)

18.5 German-German state treaty adopted by the Federal Cabinet, giving legal regulations for the path to German unification. The main features of this treaty are that the DM will become the only legal tender in the GDR and that the GDR will copy West German tax laws and other laws regulating economic activities. GDR monetary sovereignty will be transferred to the Bundesbank, GDR fiscal policy sovereignty has to be shared with the West German Ministry of Finance, and GDR economic policy sovereignty has to be shared with the West German Ministry of Economics. The FRG will partly finance the public sector deficit in the GDR.

18.5 Second supplementary budget for 1990 adopted by the Federal Cabinet, fixing additional expenditures of DM 4,76 billion and additional tax revenues of DM 6,75 billion. Consequently, the borrowing requirement will be reduced by DM 2 billion to DM 30,9 billion.

21.6 German-German state treaty adopted by all houses of parliament in the Federal Republic of Germany and in the German Democratic Republic, allowing for German Economic, Monetary and Social Union (GEMSU) as from 1 July 1990.

Greece (GR)

31.5 The Treasury issues a new series of drachma bills and bonds. Interest rates were raised by up to 1 percentage point and range from 18 % (3 months) to 23,5 % (3 years).

31.5 May 1990 budget provides for increases in indirect taxes, tighter control of tax administration, reduction in tax evasion, increases in income tax liabilities, and promises to restructure the public finances. In 1990, revenues are projected to increase by 39,9 %, and expenditures by 29,8 % over the previous year. The government deficit is estimated to decline from 20,4 % of GDP in 1989 to 19,6 % in 1990; the central government borrowing requirement is projected at 16 % of GDP in 1990, down from 18 % in 1989.

25.6 The Government introduces into Parliament a bill containing a number of measures aimed at modernizing, restructuring and strengthening the development of the economy. The bill mainly reflects the Government's philosophy on economic policy outlined when it took office. The provisions of the bill, scheduled for adoption in July, cover the following areas:

— investment incentives
— banking system and capital markets
— privatization
— labour issues

26.6 The Bank of Greece issues a Yen 60 billion bond series on the Japanese capital market. The duration is 7 years, the interest rate is fixed at 7,4 % and the issue price at 101 %.

29.6 The Treasury issues two series of 18-month foreign currency bonds. The interest rate on the Ecu bonds is 11 %, while the interest rate on the USD-linked bonds is 9,2 %.

30.6 The Treasury issues a new series of drachma bills and bonds. Interest rates were again raised by 1 percentage point and range from 19 % (3 months) to 24,5 % (3 years).

Spain (E)

None.

France (F)

None.

Ireland (IRL)

1.6 Central bank reduces short-term facility from 12 % to 11,5 %.

Italy (I)

21.6 Parliament finally approves, in its third version, the decree law containing the measures accompanying the 1990 Finance Law, which had first been presented in December 1989. The amendments made to it could involve a reduction in the previously projected tax revenue (LIT 5 300 billion).

21.6 Parliament approves a resolution accepting the contents of the medium term fiscal adjustment programme presented by the Government in May.

Luxembourg (L)

22.6 The Government adopts a draft Grand Ducal Regulation concerning the establishment of the consumer price index which will come into force at the beginning of next year. The main changes are an increase in the number of items chosen, and in particular the increase in the range of items representing the health services, the removal of tobacco and cigarettes from the list of reference items and a heavier weighting for 'rent'.

Netherlands (NL)

8.6 The Government decides on a number of measures to reduce the 1990 budget deficit. In order to offset the overruns on appropriations earmarked for aid to investment it will introduce a 35 % tax on the subsidy received by firms and will increase the special employers' health insurance contribution. To compensate for overspending by the national education department, the Government decides to increase, over the next five years, the university registration fee, to limit the duration of higher professional studies and to restrict the number of first scholarships granted and their value.

Portugal (P)

1.6 The Prime Minister announces that persons covered by the pension insurance scheme will be paid the equivalent of a fourteenth month's pension. This payment will be made for the first time in July and will cost the budget an additional ESC 50 billion, or 0,5 % of GDP. Almost 2,8 million people will benefit from this measure.

21.6 The Government approves the new statute for the Bank of Portugal which substantially increases the central bank's independence, in particular in relation to Ministry of Finance guidelines and the financing of the budget deficit.

26.6 The Bank of Portugal announces the suspension, for 90 days, of all capital swap operations by non-residents on the escudo foreign exchange market. This measure is necessary in order to limit the massive capital inflows which the Portuguese economy has been experiencing for several months.

29.6 The Bank of Portugal decides that 40 % of the value of any capital raised abroad by Portuguese companies must be deposited with the central bank. No interest will be paid on the deposits.

United Kingdom (UK)

None.

Prices (excluding VAT) in Luxembourg

		Ecu	
'European Economy' (4 issues per year)		58	The annual subscription runs from 1 January to 31 December of each year.
Supplements			
Series A	'Economic trends' (11 issues per year)	23,50	Payments to be made only to the agents in the countries listed on page 3 of the cover of European Economy.
Series B	'Business and consumer survey results' (11 issues per year)	23,50	These are surface mail rates; for air subscription rates please apply to the agents.
Complete series of supplements		37	
Combined subscription	'European Economy' and supplements	84	

OFFICE FOR OFFICIAL PUBLICATIONS
OF THE EUROPEAN COMMUNITIES

L-2985 — Luxembourg

CB-AS-90-007-EN-C