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EUROPEAN ECONOMY

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DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

The Community economy at the turn of the decade

Commission of the European Communities

EUROPEAN ECONOMY

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The Community economy at the turn of the decade

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Abbreviations and symbols used

Countries

B	Belgium
DK	Denmark
D	Federal Republic of Germany
GR	Greece
E	Spain
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
P	Portugal
UK	United Kingdom
EUR 9	European Community excluding Greece, Spain and Portugal
EUR 10	European Community excluding Spain and Portugal
EUR 12	European Community, 12 Member States

Currencies

ECU	European currency unit
BFR	Belgian franc
DKR	Danish krone
DM	Deutschmark
DR	Greek drachma
ESC	Portuguese escudo
FF	French franc
HFL	Dutch guilder
IRL	Irish pound (punt)
LFR	Luxembourg franc
LIT	Italian lira
PTA	Spanish peseta
UKL	Pound sterling
USD	US dollar
SFR	Swiss franc
YEN	Japanese yen
CAD	Canadian dollar
ÖS	Austrian schilling

Other abbreviations

ACP	African, Caribbean and Pacific countries having signed the Lomé Convention
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDCs	Less-developed countries
Mio	Million
Mrd	1 000 million
NCI	New Community Instrument
OCTs	Overseas countries and territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PPS	Purchasing power standard
SMEs	Small and medium-sized enterprises
SOEC	Statistical Office of the European Communities
toe	Tonne of oil equivalent
:	Not available

Contents[1]

[1] These documents have been prepared under the sole responsibility of the Commission services.

The Community economy at the turn of the decade

Evaluation by the Commission services

Contents[1]

[1] The forecasts in this document for 1989 and 1990 were finalized by the Commission services on 3 October 1989 and therefore do not take account of economic policy measures taken after that date.

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Part A — The Community economy

1. Short-term outlook

Growth in the Community was exceptionally buoyant in 1988; + 3,8 %, the best performance since 1976. It could be close to 3 ½ % in 1989 and a little above 3 % in 1990. Employment is expected to increase by 1 % in 1990, following on the record increases of 1 ½ % in both 1988 and 1989. The unemployment rate[1] is continuing to fall and could be below 9 % of the labour force in 1990.

These performances confirm the fundamental improvement in the Community economy since the beginning of the decade.[2] Four aspects of the current economic situation, however, deserve special attention: the risk of an uptake in inflation, greater divergences in external balances, the risk of a weakening in investment and possible difficulties arising from the international environment.

From 1988, inflation has once again become a matter of concern. The private consumption deflator for the Community as a whole is expected to increase by almost 5 % in 1989, compared with 3,6 % in 1988 and 3,4 % in 1987.

A succession of factors has contributed to this. By 1987, the inflation rate had already risen somewhat in some countries, such as the Federal Republic of Germany, Belgium and Luxembourg, although from very low or even negative rates. In Denmark, inflation also accelerated in 1987 following a

[1] Unemployed according to the EC labour force survey which provides comparable unemployment rates for the member countries. The corresponding statistics using registered unemployment data which were published in previous Annual Economic Reports would be about 10 %. See also box on the measurement of unemployment in the Community in Chapter 2.

[2] This topic is analysed in more detail in Chapter 2 of this document.

Table 1.1

Key macroeconomic indicators for the Community

	1986	1987	1988	1989	1990
Macroeconomic aggregates at constant prices					
(annual % change)					
GDP	2,6	2,8	3,8	3,4	3,1
Domestic demand	3,9	4,0	4,8	3,8	3,0
of which:					
Private consumption	3,9	3,8	3,8	3,1	3,0
Public consumption	2,5	2,3	2,0	1,6	1,7
GFCF	3,4	4,8	8,4	6,9	4,8
Extra-EC exports	0,7	2,2	4,9	7,3	6,0
Employment and unemployment in the Community					
Employment	0,8	1,2	1,6	1,5	1,1
(annual % change)					
Unemployment rate	10,8	10,4	10,0	9,0	8,7
(% of labour force)					

Table 1.2

Prices and costs in the Community

(annual % change)

	1986	1987	1988	1989	1990
Private consumption deflator	3,8	3,4	3,6	4,8	4,5
GDP deflator	5,5	4,0	4,4	4,9	4,6
Nominal wage per head	6,2	5,5	5,6	6,1	6,2
Nominal unit labour costs	4,3	3,8	3,3	4,2	4,1

Table 1.3

Community external balances

(% of GDP)

	1986	1987	1988	1989	1990
Balance of trade	1,1	0,7	0,4	0,2	0,3
Current account	1,4	0,8	0,3	0,1	0,2

strong surge in nominal wages per head. However, inflation continued to fall in the other Community countries. In 1988, and at the beginning of 1989, external factors, common to all the Community countries, made a very substantial contribution to the acceleration of inflation: the prices of imported raw materials increased sharply and the ecu depreciated against the dollar. These were compounded in some countries by increases in indirect taxes, a certain acceleration in indirect wage costs as well as the effects of growing pressures on productive capacities.

The reaction of the monetary authorities was prompt. Indeed it was essential to react quickly to these inflationary pressures, in order to prevent these price rises from leading to a lasting acceleration of inflation and generating a price-wage spiral. A delayed reaction, which would allow inflationary behaviour to gain in strength, would only increase the cost of unavoidable stabilization in terms of growth and employment. In all Community countries, monetary policy took on a more restrictive stance and short-term interest rates started to rise (see Chapter 6). This shift in monetary policies, which was even further emphasized by the increase in bank rates at the beginning of October, already seems to have had some effect. The average inflation rate in the Community, measured by the 12-month increase in the average of the consumer price indices, has not risen since May 1989. On the basis of current forecasts, the inflation rate has probably peaked in 1989 and should fall slightly in 1990. The short-lived nature of the recent spurt in inflation will not be confirmed, however, unless wage increases remain moderate. The wage negotiations now in progress or scheduled for the coming months will be crucial in this respect.

In 1990, as in 1988 and 1989, the Community as a whole should continue to experience a small external surplus.

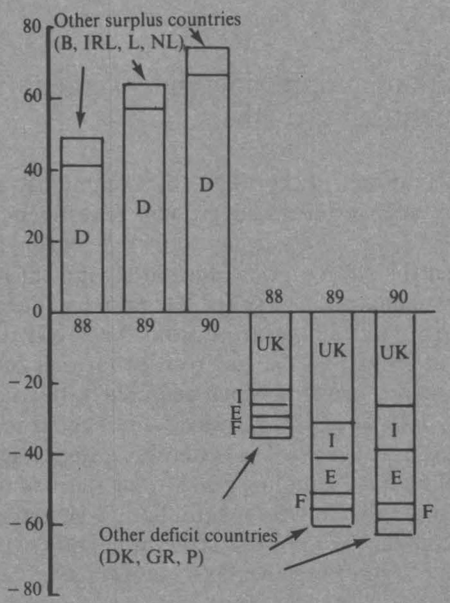
Divergences between the external accounts of Community countries are increasing. The current balances of Spain, Portugal, the United Kingdom and, to a lesser extent Italy, deteriorated rapidly in recent years. The current account surplus in Germany will continue to increase, to reach almost 6 % of GDP in 1990, a level never before seen.

In one aspect the polarization of Community external accounts is linked to the exceptional length and vigour of the economic recovery. The countries which are now in deficit maintained an expansion of domestic demand significantly greater than that of their partners. Greater financial integration, together with the credibility of monetary policies, enabled the deficits to be financed by long- and short-term capital movements. Furthermore, the impetus given by these countries' imports to intra-Community trade was beneficial to their partners, where domestic demand has been less dynamic for some time.

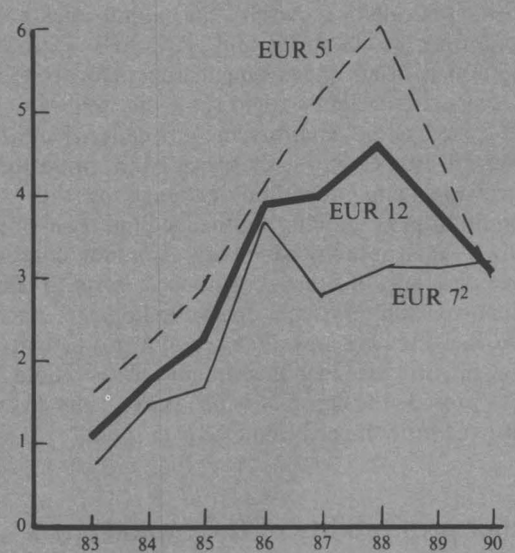
This scenario is now reaching its limits. In reaction to increasing inflationary pressures and to deteriorating external balances, a significantly more restrictive monetary and budgetary policy stance was adopted in the deficit countries. Because of this change in direction, domestic demand in these countries should decelerate sharply. This slowdown is expected to be particularly marked in the United Kingdom (from 7,3 % in 1988 to 0,8 % in 1990). It should also be significant in Spain (from 8,5 % in 1987 to 5,3 % in 1990) and Portugal (from 10,6 % in 1987 to 5 % in 1990). In the other countries domestic demand is expected to continue to grow by little more than 3 % in 1990. In Germany, in particular, domestic demand will benefit from the tax reduction due to take place in 1990.

This turnabout in the relative change in domestic demand between member countries is attenuating somewhat the polarization of external balances. The current account should improve a little in the United Kingdom. The current deficits in Spain and Portugal, however, are expected to continue to rise, to reach 4 % and 3 ½ % of GDP, respectively, in 1990. A further slowdown in domestic demand in these two countries may be necessary to avoid an excessive deterioration in the external accounts. This may also be necessary because inflationary pressures are still very high, albeit to different degrees.

GRAPH 1.1: **Current balances in billion ECU**



GRAPH 1.2: **Domestic demand, real percentage change**



[1] GR, E, I, P, UK.
[2] B, DK, D, F, IRL, L, NL.

In this context it is important that the burden imposed on monetary policy is not too heavy. Already there is a certain slowdown in investment activity in Spain and Portugal. Furthermore, in the United Kingdom where the tightening of monetary policy was particularly marked, total fixed investment which increased by 13,1 % in 1988 is only expected to rise by about 4,6 % in 1989 and by 1 ¾ % in 1990. In the other countries, where the tightening of monetary policies was less severe or where wage pressures are less intense, investment activity should on the whole be sustained.

These experiences underline the importance of a monetary policy reaction to inflationary pressures which is sufficiently quick so as to remain moderate and of an equitable sharing of the stabilization burden between monetary and budgetary policies and wage developments. Policies and behaviour which will allow sustained investment levels to continue are all the more necessary now that there are certain risks pertaining to extra-Community exports.

According to current forecasts for 1990, Community exports to third countries are expected to increase by 6 % (see Table 1.1). It has been assumed that total imports by the rest of the world given the technical assumption of an almost stable dollar exchange rate would also increase by 6 %. The Community's market share is therefore expected to remain unchanged. This latter assumption could turn out to be optimistic, if the stalling of the international adjustment of payments balances provokes a depreciation of the dollar to a level more conforming to long-term fundamental economic variables (see Chapter 4).

In these conditions the Community economy is facing two major challenges:

(i) the first is to strengthen further the internal determinants of growth so as to accelerate the reduction of unemployment, help the poorer countries and regions to catch up and allow the Community to gain the full benefits of the completion of the internal market;

(ii) the second is to ensure that growth does not founder on an accumulation of inflationary pressures and external and budgetary imbalances which, furthermore, would risk calling into question monetary cohesion in the Community. This is all the more necessary now that the progress aimed at during the first stage of economic and monetary union assumes greater convergence towards monetary stability.

2. The fundamental improvement in the Community economy

Higher growth and more stability ...

After recovering from the oil price shock of 1979/80 real GDP growth has steadily accelerated and has now reached a trend rate of increase of more than 3 % per year. Employment, where Europe has lagged behind other major economies, is now on a trend rate of growth of over 1 % per year reversing the poor performance of the 1970s and more than compensating for the job losses of the early part of this decade. Unemployment is also declining, albeit slowly, and is expected to be about 9 % in 1990[1].

Growth has accelerated unevenly in the Community during the 1980s. In the years immediately after the second oil price shock (1981-1984) only Denmark and Luxembourg maintained annual average growth rates above 3 %. Between 1984 and 1987 the strongest growth dynamics became evident in some Member States which were not then members of the exchange rate mechanism (ERM) of the EMS (Portugal, Spain and the United Kingdom); Italy and Luxemburg also exceeded the Community average. Today Spain and Portugal continue their exceptional growth and Ireland has started to catch up. Furthermore several ERM countries (Belgium, Germany, France and, as before, Italy and Luxembourg) have now moved to or above the Community average.

The improvement in the Community's economic performance had already started in the first half of the 1980s, when inflation was reduced by half despite the devaluation of the Community currencies. This resulted from the implementation of stability-oriented monetary policies and a good adjustment of nominal wage increases to declining inflation rates. In 1986 and 1987 the slowdown of inflation was further facilitated by the reduction in oil prices and the appreciation of the Community currencies.

The recovery of the Community economy in the 1980s is the result of many fundamental improvements. These stem from broad reorientation of economic policy involving the implementation of supply-side policies from the beginning of this decade which are now providing a basis for favourable medium-term prospects. Three key elements of the fundamental improvements are: (i) the new dynamics of the investment-led growth process sustained by the positive expectations created by the completion of the internal market; (ii) the higher employment content of growth; and (iii) the renewed catching-up of the less-favoured regions and countries of the Community.

... thanks to supply-side improvements: investment-led growth, ...

In the second half of the 1980s the Community achieved a transition to investment-led growth. Investment in equipment in the Community began to increase strongly in 1985. Since then the strong momentum in equipment investment has been maintained except for a temporary interruption in 1986, when uncertainties arose from the devaluation of the dollar and from the change from export-led to domestic demand driven growth, which required a restructuring of production. By that year, however, investment in construction had also recovered. The result was a steady acceleration in total investment entailing a rise in the share of investment in GDP, which is, however, still about 3 percentage points below the level of the 1960s. Furthermore, public investment has not yet begun to recover as a percentage of GDP.

The higher investment had positive effects both on the supply and on the demand side. These effects were reinforced in recent years by the dynamic expectations and the first adjustments due to the completion of the internal market. Evidence from surveys carried out by the Commission in mid-1989 among industrial firms in the Community (see Chapter 5 and Study No 5) confirms that the private sector is already adapting its strategies and its investment decisions. On the supply side the rate of growth of the capital stock began to accelerate from 2 ¼ % in the mid-1980s to 3 % in 1990. In combination with an improvement in capital productivity, which reversed a declining trend since the 1960s and which was not least due to the improvement in capacity utilization, the faster-growing capital stock provided the opportunity to meet growing demand without endangering the external equilibrium or price stability. In the medium term, however, the growth in capital productivity may not continue at the same pace even if more determined efforts to decouple individual working time from operating hours of machinery could further improve it. Should capital productivity start to fall again, still stronger investment efforts would be required to provide the capacity which is necessary to sustain the improved growth performance.

... higher profitability of the capital stock ...

The impressive investment performance in the second half of the 1980s was made feasible as profitability of the capital

[1] See box on the measurement of unemployment in the Community.

Table 2.1

The recovery of the Community economy in the 1980s

(annual % change, unless otherwise stated)

	1973/1960	1981/1973	1984/1981	1987/1984	1990/1987
Real GDP	4,8	1,9	1,6	2,6	3,4
Employment	0,3	−0,1	−0,5	0,8	1,4
Private consumption deflator	4,6	12,3	8,7	4,4	4,3
Net borrowing/lending of general government[1]	−0,8[3,4]	−3,7[4]	−5,4	−4,8	−3,1
Balance of current account[1]	0,4	−0,3	−0,1	1,0	0,2
	1973	1981	1984	1987	1990
Unemployment[2]	2,8	8,1	10,8	10,4	8,7
Capacity utilization	85,8	77,4	79,0	83,0	86,0[5]

1 As % of GDP, period averages respectively 1961-73; 1974-81; 1982-84; 1985-87; 1988-90.
2 As % of the civilian labour force, based on the EC labour force survey.
3 1970-73.
4 EUR 10: EUR 12 excluding Greece and Portugal.
5 Average of first three quarters of 1989.

Table 2.2

Supply-side developments in the Community

(annual % change, unless otherwise stated)

	1973/1960	1981/1973	1984/1981	1987/1984	1990/1987
Total investment[1]	5,6	−0,4	−0,1	3,6	6,7
of which					
• equipment	5,4[5]	1,2	1,1	7,0	8,6
• construction	3,1[5]	−1,3	−0,4	1,4	4,9
Capital stock	5,2	3,5	2,3	2,3	2,8
Capital intensity	4,9	3,6	2,8	1,4	1,4
Capital productivity	−0,4	−1,5	−0,7	0,3	0,6
Real compensation per employee[2]	4,6	2,4	0,8	1,0	1,2
	1973	1981	1984	1987	1990
Real unit labour costs[3]	94,2	104,1	100,2	97,8	95,7
Profitability[3]	93,0	64,8	71,9	80,5	87,6
Long-term interest rate adjusted for inflation[4]	0,4	3,8	5,2	5,4	5,1

1 Gross fixed capital formation at constant prices.
2 From the point of view of costs: compensation of employees per wage and salary earner deflated by the GDP deflator.
3 1961-73 = 100.
4 Long-term interest rate deflated by the GDP deflator.
5 1970-73.

stock has been recovering steadily since 1981. The moderate increases in real wages compared with productivity growth in the Community have been the major reason for the increasing rate of return on productive capital. The result was lower real unit labour costs, which in 1990 might be about 8 % below their level at the beginning of the 1980s. In addition to moderate wage growth, profitability has been further boosted by higher capital productivity. The terms of trade improvement in 1986/87 also assisted by reducing production costs. Nevertheless, profitability is still below the levels of the 1960s. Given the unacceptably high unemployment in the Community, and thus the need for even more employment-creating investment, further recovery in profitability is desirable. For that reason the moderate growth of real wages witnessed in the Community in this decade ought to continue for some time.

Furthermore, the improvement in investment has been associated with a rise in the national savings ratio in the Community. This permitted investment to accelerate while external equilibrium was maintained. The rise in the national savings ratio has been primarily due to a reduction in government dissaving while the private sector saving ratio has remained stable as an increase in the saving ratio by the enterprise sector, reflecting greater profitability, has been offset by a decline in that of the household sector. In 1989 government saving has become positive again after declining to -1,3 % of GDP in 1981 from +5,0 % in 1970. Further substantial progress in public saving is required, however, to ensure that adequate funds are available to finance the continuing expansion of investment. This remains valid even if improvements in profitability allow the corporate sector to make an even greater contribution to national savings.

... and reinforced export competitiveness, ...

The fundamental improvement of the Community economy can also be seen in the export performance of its manufacturing sector. In the early 1980s, the Community's share of exports to industrialized countries was reduced significantly. Most worrying were the losses of more than 10 % of its export share in sectors with medium and high global demand. Since 1984, however, the loss in market share has virtually come to a halt. In sectors of high demand the Community's share has even regained some lost ground. This occurred in spite of the real appreciation of the Community currencies between 1985 and 1987 and indicates improvements in the structural competitiveness of the Community.

... supported by new demand dynamics

The higher investment activity was itself a key element in the improving demand in the Community economy. The rate of growth of total demand rose steadily between 1981 and 1988. At the same time the relative weights of its components have changed substantially (see Graph 2.1).

Table 2.3

Shares of the Community in OECD exports[1]

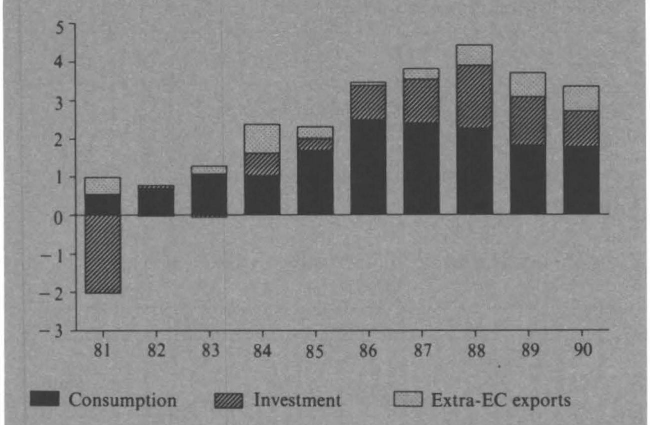
(%)

	Period 1980-84			Period 1984-87		
	1980	1984	Difference	1984	1987	Difference
All products	25,5	23,7	−1,8	23,7	23,7	0
Agriculture	11,9	12,5	+0,6	12,5	13,5	+1,0
Manufactured products	26,7	24,6	−2,1	24,6	24,3	−0,3
• sectors with weak global demand[2]	27,1	28,4	+1,3	28,4	27,1	−1,3
• sectors with medium global demand[3]	27,0	23,6	−3,4	23,6	23,6	0
• sectors with high global demand[4]	25,8	22,9	−2,9	22,9	23,4	+0,5

1 Extra-EC exports as % of total OECD exports.
2 Growth of domestic demand in EC + USA + Japan below the average of total manufactured products; e.g. textiles, steel, metal goods.
3 Growth of domestic demand in EC + USA + Japan at the average of total manufactured products; e.g. industrial machinery, transport equipment.
4 Growth of domestic demand in EC + USA + Japan above the average of total manufactured products; e.g. electrical equipment and electronics, information technology, chemicals. On the methodology see 'Competitiveness of European industry', in *European Economy*, No 25, September 1985.

Especially in 1984 a strong export performance played an important role in overcoming the stagnation of the early 1980s. Subsequently domestic demand began to dominate in accelerating growth. The improvement in the terms of trade in 1986 and 1987 gave a further stimulus to domestic demand growth as it resulted in an unexpected increase in real incomes which in turn boosted private consumption. This acceleration of total demand, together with the improvement in the profitability of the capital stock and the change in expectations due to the completion of the internal market, explains why investment both in equipment and gradually in construction have since become the most dynamic elements of demand.

GRAPH 2.1: **Change in total demand and its components (as % of total demand of the previous year)**



Record employment creation ...

The Community's strong growth performance has been successfully translated into record rates of employment creation. Between 1983 and 1990, 8 million additional jobs will have been created. This more than compensated for the 3,5 million jobs lost in the aftermath of the second oil shock between the previous employment record on Community level in 1980 and the trough in 1983. The average hours worked per person employed have continued to decline as the major part of the new employment created has been part-time; therefore labour volume has grown by less than the total number of jobs.

Table 2.4

Employment in the Member States

(Index 1980 = 100)

	1973	1981	1983	1984	1987	1990
B	101,0	98,0	95,7	95,7	97,8	100,8
DK	97,0	98,7	99,4	101,1	107,1	106,7
D	100,8	99,3	96,1	96,2	98,5	101,9
GR	94,8	104,9	105,2	105,5	106,8	109,5
E	110,5	97,4	96,0	93,7	99,7	108,9
F	98,9	99,4	99,2	98,3	98,2	101,3
IRL	93,6	99,1	97,2	95,4	93,5	96,8
I	96,0	100,0	101,2	101,6	103,6	106,6
L	98,4	100,3	99,7	100,3	107,2	113,7
NL	97,8	98,5	94,3	94,2	98,6	102,4
P	101,0	101,0	98,0	96,5	96,4	101,3
UK	99,3	96,1	93,2	95,0	98,7	104,3
EC	99,8	98,8	97,2	97,3	99,8	104,0

All member countries except Ireland have succeeded in at least regaining 1980 employment levels (see Table 2.4). The strongest performances in terms of employment creation in the 1980s were observed in Luxembourg (+ 13,7 %), Greece (+9,5 %), Denmark (+6,7 %), Spain (+8,9 %) and Italy (+6,6 %). The United Kingdom suffered the heaviest employment losses in the Community between 1980 and 1983; since 1983, however, its employment creation has been nearly twice the Community average. These rates are on a per capita basis and do not take into account the growth of part-time employment which was quite different between member countries. A more detailed picture of employment developments in the Community on the basis of full-time equivalents is presented in the Commission's 1989 report on 'Employment in Europe'.[1]

... facilitated by a higher employment content of growth

The acceleration of job creation throughout the Community went along with the higher economic growth. At the same time the employment content of growth increased significantly. In the 1960s annual GDP growth of 4,8 % barely

[1] COM(89) 399 final.

created 0,3 % of new employment in the Community (see Table 2.1). Today, a GDP growth trend of somewhat above 3 % is accompanied by net annual employment expansion of more than 1 %.

From a macroeconomic viewpoint the increase in the employment content of growth can be related to the profound change in relative factor costs in the Community. In the 1970s the increase in the cost of labour relative to capital produced a situation where a large share of the investment taking place was designed to replace the relatively expensive factor of production. Today capital intensity is growing at less than half the rate of the 1970s. The implication of this development is that investment now has a substantially greater employment content.

These macroeconomic developments were underpinned by important structural changes in the Community economy:

(i) measures to improve the adaptability of labour markets, including the growing number of temporary jobs, have contributed importantly to the recovery of employment;

(ii) the reduction of working time per person employed, in recent years has been due in particular to growing part-time employment: 70 % of all additional employment between 1983 and 1987 was part-time. The share of part-time employment in total employment reached 12,8 % in 1987 in the Community;

(iii) the steady expansion of the service sector in the Community. Since in the service sector the average growth of labour productivity is lower than in the manufacturing sector, its growing weight in the total economy implies an increasing employment content of total growth.

Until 1987 employment expanded only in the service sector. Between 1974 and 1987, 14,2 million additional jobs were created in the service sector (+23 %), which now provides more than 60 % of Community employment (see Table 2.5). Employment in industry recovered slightly in 1988 after 15 years of uninterrupted decline, during which the Community lost nearly 20 % of its industrial employment (more than 9 million jobs). In agriculture employment shrank by 4,6 million, or nearly one-third, in the same period.

Unemployment declines slowly ...

In spite of the favourable development of employment, unemployment has declined only slowly. After it peaked in 1985 at 10,9 %, it will have come down by some 2 percentage points to around 9 % in 1990 (see Table 2.6), which is still one-third above the level of 1980 and three times the level of 1973. Differences among member countries remain vast with Luxembourg at 1,7 % in 1990 and Spain at 16,5 %. These differences have, however, narrowed somewhat since 1985 thanks to the significant reduction of unemployment in Spain. The United Kingdom, Belgium and Portugal have also done better than the Community average.

Table 2.5

Employment by sector in the Community

(%)

	1958 (EUR 5[1])	1974 (EUR 5[1])	1974 (EC)	1987 (EC)
Agriculture	22,8	10,8	11,5	7,8
Industry	39,1	41,0	39,5	32,1
Services	38,1	48,2	49,0	60,1
Total	100	100	100	100

[1] Belgium, Germany, France, Ireland, Italy.

Table 2.6

Rates of unemployment[1] in the Member States

(% of civilian labour force)

	1973	1980	1985	1990
B	2,4	7,9	11,7	8,8
DK	0,9	6,6	7,6	7,6
D	1,0	3,3	7,3	5,4
GR	2,0	2,8	8,7	8,5
E	2,6	11,6	21,9	16,5
F	2,8	6,4	10,3	9,1
IRL	5,7	7,4	18,4	16,2
I	6,4	7,7	9,4	10,6
L	0,0	0,7	3,0	1,7
NL	2,3	6,2	10,4	9,6
P	2,7	7,8	8,5	5,2
UK	2,2	5,7	11,5	6,5
EC	2,8	6,4	10,9	8,7

[1] Annual averages; from 1983 unemployed according to EC labour force survey; before 1983 SOEC estimates.

... but specific problems remain

Youth unemployment has declined much faster than unemployment in general, due to demographic factors and specific youth-oriented labour market programmes. But it is still at a very high level; in Spain, for example, the youth unemployment rate remains above 40 %, and in Italy above 30 % (see Table 2.7). Unemployment of women also remains a specific problem.

As the economy gains momentum the increase in the share of long-term unemployment appears to have come to a halt. It stands, however, well above 50 % of total unemployment (see Table 2.8). Closer examination indicates that among the long-term unemployed the share of those out of work for between one and two years is actually declining whereas the share of the 'very long-term unemployed' (out of work for two years or more) is still increasing. This might indicate that the improvements in the labour market are gradually reaching the more problematic groups of unemployed. But with some 5 million very long-term unemployed in the Community, major efforts at employment creation and specific labour market policies are still required.

The increase in the labour supply partly explains the relatively slow reduction in unemployment. On the one hand, the population of working age is still expanding, although its rate of growth has fallen sharply from its peak in the early 1980s. On the other hand the participation rate has started to recover along with the gradual improvement in labour market conditions. The decline in male participation has come to a halt, whereas female participation has continued its steady expansion.

The Community has wide scope for increasing its participation rate (65 ½ %) which remains significantly lower than in other industrial countries, e.g. USA (76 %), Sweden (82 ½ %) or Japan (72 ½ %). A growing participation rate is *per se* a positive phenomenon. It broadens the base for economic growth. Furthermore it reduces the dependency ratio, i.e. the economically inactive and the unemployed in relation to total employment, which has started to decline to slightly below 1,5. This is, however, still higher than in the 1960s and compares unfavourably with the USA (1,2) or Japan (0,9).

Real convergence goes hand-in-hand with faster growth

Another important element of the economic recovery has been the resumption of the real convergence process in the Community as its least-favoured regions and countries have been catching up since the mid-1980s. A harmonious development within the Community is one of its fundamental economic and social objectives. Measured in terms of real GDP per capita, however, vast differences remain; even today, for example, Greece and Portugal barely exceed 50 % of the Community average. In terms of unemployment Spain and Ireland are far above the Community average (with unemployment rates of 19,6 % and 17,8 % respectively, in 1988, compared with 10 % in the Community on average).

Regional discrepancies are even larger than the differences at the national level. This is true for all Member States; it is of particular importance for Italy where the GDP per capita

Table 2.7

Specific rates of unemployment[1] in the member countries

(% of the respective civilian labour force)

	1985	1988	1985	1988	1985	1988	1985	1988	1985	1988	1985	1988	1985	1988
	B		DK		D		GR		E		F			
Total	11,7	10,4	7,6	6,4	7,3	6,4	8,7	8,5	21,9	19,6	10,3	10,2		
Male	7,6	7,1	6,1	5,4	6,3	5,3	6,3	5,8	20,4	15,3	8,5	7,9		
Female	18,5	15,7	9,3	7,6	8,8	8,1	13,1	13,2	25,3	27,8	12,7	13,1		
Youth (< 25 years)	25,2	20,3	11,2	9,4	10,5	6,4	24,5	27,4	48,4	40,7	26,1	22,9		
	IRL		I		L		NL		P		UK		EC	
Total	18,4	17,8	9,4	10,6	3,0	2,2	10,4	10,3	8,5	5,6	11,5	8,7	10,9	10,0
Male	17,8	17,3	6,2	7,2	2,2	1,6	9,3	7,5	6,3	3,9	11,8	9,1	9,5	8,1
Female	20,0	18,9	15,5	16,8	4,4	3,3	12,5	14,8	11,7	8,0	11,0	8,2	13,0	12,8
Youth (< 25 years)	26,5	25,9	31,6	32,5	6,8	5,4	17,6	17,2	20,2	13,0	18,6	12,3	23,3	19,9

[1] Unemployed based on EC labour force survey.

Table 2.8

Shares of long-term and very long-term unemployment[1] in the member countries

(% of total unemployment)

	1983	1987	1983	1987	1983	1987	1983	1987	1983	1987	1983	1987	1983	1987
	B		DK		D		GR		E		FR			
Long-term unemployment[2]	64,1	73,0	32,2	23,0	38,4	47,2	32,3	43,9	52,5	60,6	39,6	44,6		
Very long-term unemployment[3]	41,8	55,4	12,3	7,8	14,9	30,0	11,7	19,3	:	42,8	17,7	25,1		
	IRL		I		L		NL		P		UK		EC	
Long-term unemployment[2]	35,2	63,8	54,6	65,0	32,7	33,6	46,9	56,4	45,2	53,4	44,8	46,0	46,3	53,1
Very long-term unemployment[3]	19,7	45,2	28,0	42,4	14,4	15,6	22,3	35,7[4]	:	32,6	24,8	32,0	22,3[5]	34,9[6]

1 On the basis of the EC labour force survey, see COM(87) 231 final.
2 Unemployed for one year or more.
3 Unemployed for two years or more.
4 1985.
5 EUR 10: EUR 12 without Spain and Portugal.
6 1985 for the Netherlands.

in the North significantly exceeds the EC average whereas the South lags far behind, and for Spain where the North-East and the region of Madrid come close to the Community average whereas again the South is significantly poorer (see Table 2.9).

In recent years, the less-developed member countries have improved their economic performance. In fact Spain, Portugal and Ireland have achieved impressive results, growing faster than a Community average that has itself risen. As in the 1960s, better economic growth throughout the Community is going hand-in-hand with a gradual decline of economic disparities. The exception is Greece, which continues to fall behind.

In Spain and Portugal the acceleration of growth was led by investment. Strong efforts to increase profitability have manifested themselves in lower real unit labour costs, which declined by more than 10 percentage points in Spain and more than 15 percentage points in Portugal in the first half of the 1980s (see Table 2.10). Furthermore their accession to the European Community in 1986 provided promising demand prospects. Thus the share of investment in total GDP expanded by more than one-fifth to about 26 % in Spain, and even by almost one-third to about 30 % in Portugal. This dramatic increase of the investment share was accompanied, however, by a swing from surplus to deficit in the current accounts of both countries (see Table 2.11) implying that an important part of the additional investment effort was financed by an import of real resources from abroad. To ensure that these countries continue to catch up, domestic saving should be strengthened by further reductions in public dissaving. The investment-led growth also helped both countries to reduce their rates of inflation; in Portugal, however, it remains in double-digits.

Table 2.9

GDP per capita

(Purchasing power standards, EC = 100)

	GR	E		IRL	I		P
1960	38,4	59,2		61,4	91,2		37,6
1973	56,3	77,4		59,9	98,8		54,1
1986	56,0	72,2		63,4	104,0		52,8
		North-East	South		North-West	South	
1986[1]		86,2	57,4		127,4	68,9	
1988	54,4	74,8		64,6	104,8		53,8
1989	54,0	75,7		66,0	105,1		54,5
1990	53,6	76,3		67,3	105,2		55,4

1 Level I regions, of Spain and Italy respectively.

Table 2.10

Investment shares and real unit labour costs in the less-developed countries of the Community

	GR	E	IRL	I	P	EUR 7[1]	EC
Investment[2] shares (as % of GDP)							
1986	18,5	19,2	18,4	20,0	22,4	18,6	19,0
1990	19,2	25,7	18,9	20,0	30,9	20,4	20,9
Real unit labour costs (1981 = 100)							
1986	99,8	88,1	93,4	95,7	83,7	94,5	94,0
1990	99,3	85,8	84,9	95,3	76,6	92,2	91,9

[1] EUR 12 without Greece, Spain, Ireland, Italy, Portugal.
[2] Gross fixed capital formation at current prices.

In Ireland the acceleration of growth was export-led. Budgetary consolidation and moderate wage developments dampened domestic demand and imports. At the same time the competitiveness of the Irish economy improved and enabled its exports to benefit fully from the more favourable economic performance in the rest of the Community, in particular in the United Kingdom. Aided by its membership of the exchange-rate mechanism of the EMS, inflation remained very low. Moreover, with its current account surplus and an improved public deficit Ireland has a sound basis for further catching up. The investment ratio, however, has not yet improved. Efforts are still required to improve supply-side conditions and to complement the better export performance with stronger investment activity.

In Greece real unit labour costs improved much less than in the Community as a whole. The room for manœuvre which could have been gained from the smaller current account deficit has been absorbed by the higher public deficit. Thus investment is still insufficient. Furthermore, despite some improvement, the Greek inflation rate remains by far the highest in the Community. In Greece fundamental adjustments are necessary for the economy to begin catching up again.

Table 2.11

Macroeconomic equilibria in the less-developed countries of the EC

	Inflation rates (private consumption)		Balance of current transactions (% of GDP)		Net lending or net borrowing of general government (% of GDP)	
	1986	1990	1986	1990	1986	1990
GR	22,0	15,0	−5,2	−3,5	−11,6	−20,0
E	8,7	6,3	1,7	−4,0	−6,1	−2,4
IRL	3,9	4,0	−2,9	1,8	−11,0	−1,5
I	5,8	6,0	0,5	−1,4	−11,7	−9,8
P	13,5	11,3	3,9	−3,4	−7,8	−6,1
EUR 7[1]	2,0	3,5	1,5	1,3	−2,5	−0,7
EC	3,8	4,5	1,2	0,2	−4,8	−2,9

[1] EUR 12 without Greece, Spain, Ireland, Italy, Portugal.

Building upon the fundamental improvements for further progress

The Community has regained solid economic ground. The reduction of unemployment and the catching-up process have begun. But to achieve a further substantial reduction of unemployment and a lasting catching-up process of the less-developed countries and regions, the recent favourable performance has to be maintained and even further improved. With regard to the fundamental elements of economic performance this requires:

(i) continued improvements in the structural competitiveness of the Community economy, in particular in the strategic sectors of high global demand and advanced technology. An effective policy to stimulate and coordinate research and development should contribute to this;

(ii) a further increase in the share of investment in the Community which calls for continued moderate wage increases and higher capital productivity, e.g. brought about by a decoupling of working time from operating hours of machinery. At the same time it is essential to ensure that an adequate level of savings is available to support such investment without endangering the external equilibrium. Budgetary policies will have to maintain the trend towards a decline in government dissaving or an increase in government saving;

(iii) further steps to improve the functioning of the labour markets as they were developed in the Commission's 1989 report 'Employment in Europe'. The Community can and must continue to expand its employment so as to reduce its still unacceptably high unemployment and to offer employment to the new labour market entrants who have to be expected either still for demographic reasons or because of growing participation — in particular of women — or because of immigration. Experience shows that the employment content of growth can continue to be improved if appropriate signals from relative factor costs and determined employment-oriented policies are combined.

These tasks have to be tackled throughout the Community. They are, however, particularly important for the regions and countries which need to catch up. For them the fundamental policy approach is the same as for the Community as a whole, but the implementation requires extraordinary efforts. The Community fully supports them in these efforts in particular with its reformed and enlarged structural Funds and its financial instruments (see Chapter 5).

To achieve these tasks the Community has in recent years developed a coherent economic strategy: the completion of the internal market, growth and employment policies along the lines of the 'Cooperative growth strategy for more employment' and policies for economic and social cohesion.

The completion of the internal market will be the engine of growth. It is creating a new dynamism and a large potential for economic growth and employment creation. It thus widens the scope for further solid improvements in the Community's economic performance. Indeed it is generating direct and indirect cost reductions, greater competition as well as incentives for firms to organize more efficiently, for more research and development, new processes and new products. In this context it is remarkable that, according to the already mentioned survey, the completion of the internal market will lead to a reallocation of investment towards the less-developed member countries and will thus provide a positive effect on the catching-up process of these countries (see Chapter 5). Lower costs and higher productivity are enhancing the competitiveness of European enterprises both in domestic and global markets. In addition to its beneficial effects on growth and employment the completion of the internal market will further ease key macroeconomic constraints as it reduces inflation and improves internal and external balances.

To realize fully this potential the internal market programme has to be accompanied by adequate competition, structural and macroeconomic policies. Particularly indispensable are employment and growth-oriented economic policies along the lines developed in the Annual Economic Reports of recent years, adequate regional policies to enable the less-developed regions and countries to catch up fully and the complete implementation of the social dimension of the internal market. In this way the fulfilment of the internal market programme will be an important step towards economic and social integration in the Community and will provide the basis for economic and monetary union.

The measurement of unemployment in the Community

In the Annual Economic Report 1989-90 a new concept to measure unemployment is being used in the Community and its member countries. According to the new concept the unemployment rate for the Community for 1989 is estimated to be 9,0 % as compared to 10,2 % estimated previously.

In the past the Annual Economic Report based its estimates of unemployment mainly on the numbers of persons registered as unemployed at the national employment offices. An attempt was made to adjust these numbers for some major differences in national registration practices (e.g. the treatment of school-leavers). For Spain, Portugal and Greece results of national surveys were used as registration which was not considered adequate in these member countries. With this approach there remained the problem of comparability between member countries. Furthermore as national registration practices were subject to frequent changes (e.g. from 1987 in the Netherlands) it was difficult to get a picture of the 'real' changes in the labour market situation.

To obtain better comparability between countries inside and outside the Community and with other international publications the Annual Economic Report from now on will present unemployment rates based on the EC labour force survey[1] for all member countries and for the Community. These rates have already been used by the Commission for the purposes of the structural Fund allocations. They are regularly published by the Statistical Office of the European Communities (SOEC) in monthly *(Unemployment)* and annual *(Employment and unemployment)* publications.

To measure unemployment the EC labour force survey uses the definition of the International Labour Office (ILO).[2] This definition is based on a wide concept of employment and strict criteria for unemployment. In the survey a person above a certain age (14 years) is considered unemployed, if

(i) he/she is currently not employed (not even for as little as one hour per week),

(ii) he/she is immediately available for work (within the next two weeks), and

(iii) he/she is actively seeking work (in the sense of having taken a specific step to find work within the last month).

[1] The EC labour force survey has been conducted at annual intervals since 1983 and now comprises some 700 000 households; for details see 'Labour force survey-methods and definitions', Eurostat, 1988.

[2] International Labour Organization, 'Resolution concerning statistics of the economically active population, employment, unemployment and underemployment', Resolution I, 13th International Conference of Labour Statisticians (Geneva, 18 to 29 October 1982), published in *Bulletin of labour statistics*, ILO, Geneva, 1983-3, p. 11-15.

The EC labour force survey has provided comparable annual rates of unemployment for the Community as a whole and for the member countries since 1983. As a first estimate of long-time series the most appropriate national indicators (registered unemployment and national surveys) have been used to extrapolate the survey results backwards.

Because of the different criteria used for unemployment in national registration and in the survey, the results differ significantly (see Table).

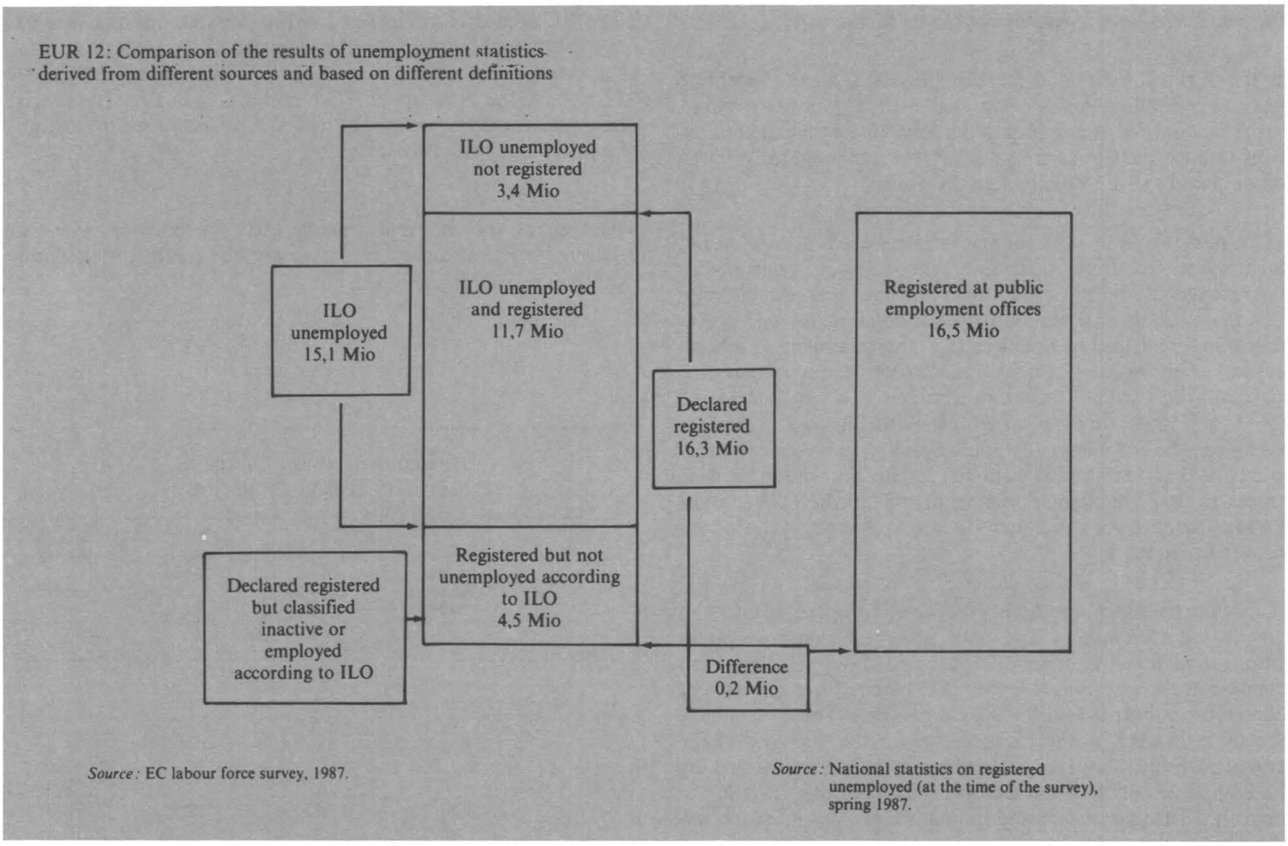
Unemployment rates in the EC
(as % of civilian labour force)

	1983		1987	
	Annual Economic Report 1988/89[1]	EC survey[2]	Annual Economic Report 1988/89[1]	EC survey[2]
B	14,3	12,6	12,3	11,5
DK	10,1	9,5	7,6	5,8
D	8,4	6,9	8,1	6,4
GR	7,8	9,0	7,4	8,0
E	17,7	17,8	20,5	20,5
FR	8,9	8,2	10,8	10,5
IRL	14,9	15,2	19,2	18,0
I	11,0	9,0	14,0	10,1
L	1,6	3,6	1,6	2,7
NL	14,2	12,5	11,5	10,2
P	5,6	7,7	7,2	6,8
UK	11,6	11,2	10,6	10,6
EC	10,6	10,0	11,6	10,4

[1] Registered unemployed for EUR 9, unemployed based on national surveys for Spain, Portugal and Greece.
[2] EC labour force sample survey.

The two concepts overlap to a certain extent. In 1987 there were 16,5 million registered unemployed in the Community as compared to 15,1 million unemployed according to the EC labour force survey using the ILO criteria. 11,7 million were both registered and met the ILO criteria (see Chart).

There were 3,4 million considered unemployed by the survey although they were not registered. This is mainly due to: (i) the lack of appropriate registration procedures and facilities in some countries (Greece, Spain, Portugal); and (ii) the fact that in the



UK only recipients of unemployment benefits are registered. Furthermore the survey captures part of the 'quiet reserve' of job-seekers who are either not entitled to unemployment benefits or who do not use the employment offices to search for work.

Furthermore 4,5 million were registered but were not considered unemployed according to the survey. Main reasons for this are: (i) the person is registered unemployed but considered 'employed' by the survey. This is possible because the employment concept used by the survey is very wide. Even persons working as little as one hour in the reference week are considered 'employed' contrary to some national registration practices, which allow for some small jobs while still keeping people on the unemployment register; (ii) the person is registered unemployed but considered 'inactive' by the survey. This may be because the survey finds that the person is not available for work within the next two weeks or that he/she is not actively seeking work.

These differences illustrate the difficulty in measuring unemployment. The complex problem of 'unemployment' can probably only be adequately treated by using different statistical measurements based on different concepts. The most appropriate measure depends on the purpose for which it is to be used. National registration is basically designed for the needs of the different national social security systems and national labour market policies. The labour force survey approach attempts to measure the actual and the immediately available potential labour input into the production process. To capture the socio-economic problem of unemployment an additional definition might be called for which would focus on the degree of dependence on employment for individual and family subsistence.

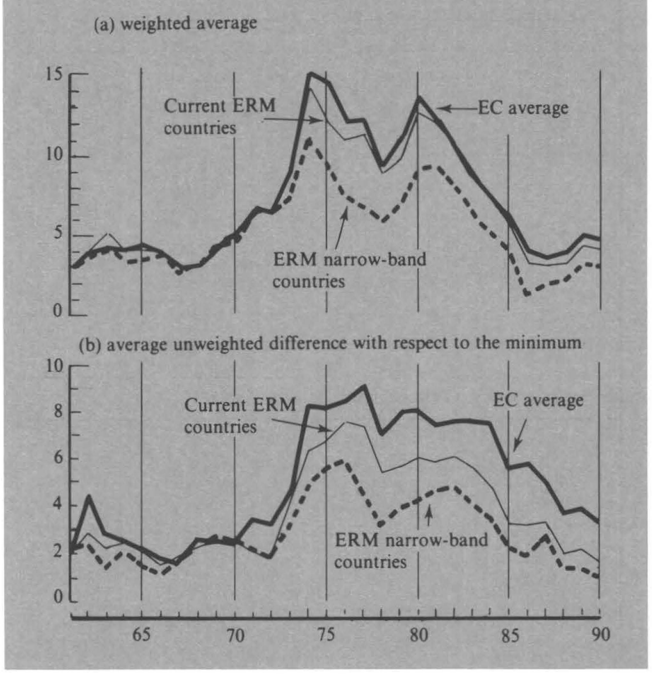
3. Stability and convergence

The convergence of economic performances, which is one of the principal objectives of economic and monetary union, concerns two complementary but distinct domains.

In the economic domain, the strengthening of economic and social cohesion needs to be translated into convergence towards the highest living standards ('real' convergence) through the catching-up of the most disadvantaged countries and regions (see Chapter 2).

In another domain, that of 'nominal' convergence, progress is also needed in order to preserve every opportunity for solid and balanced growth with stability. 'Nominal' convergence implies convergence towards the lowest price increases and to external and budget balances which are compatible with greater stability in exchange rates. The level and development of the current external balances remain a significant indicator of the compatibility of macroeconomic performances with greater exchange-rate stability. The persistence of excessive budget deficits constitutes a potential for monetary instability, first in the countries concerned and in consequence throughout the system. Progress in this area is all the more important as the Community enters into the first stage of economic and monetary union.

GRAPH 3.1: **Private consumption deflator**



Appreciable but insufficient achievements in convergence and stability

Since the start of the 1980s very substantial progress has been made towards the greater convergence of costs and prices. Between 1980 and 1985 the average inflation rate in the Community was cut by more than half, despite inflationary pressures caused by the depreciation of the European currencies against the dollar. Its further decline in 1986 and 1987 was facilitated by the fall in oil and raw material prices and the appreciation of the ecu. Since then, the inflation rate has risen slightly, but has remained below its 1985 level. The dispersion of inflation rates has also narrowed appreciably. For example, the average deviation of the inflation rates from the minimum, which was still 7,5 percentage points in 1980, is 4,3 points in 1989. The progress made by the countries participating in the exchange-rate mechanism within the narrow fluctuation band (ERM narrow-band countries) is even more spectacular. In 1990, average inflation for these countries will probably be 2,8 % with a minimum of 2,3 % (Netherlands) and a maximum of 4,0 % (Ireland). The current degree of convergence is thus in line with that attained during the 1960s (see Graph 3.1).

The group of ERM narrow-band countries thus emerges as providing a benchmark in the field of inflation. All the other Community countries — Greece, Spain, Italy, Portugal and the United Kingdom — at present have rates of inflation which are higher than that group's maximum.

Uneven developments in relative costs

Wage developments are an even more important indicator than price developments for evaluating the sustainability of the disinflation process and the compatibility of performances with greater exchange-rate stability. A slowdown in nominal unit labour costs, which parallels or exceeds that of prices, takes the strain off monetary policy and makes the disinflation process less costly in terms of investment, growth and jobs. Also, the relative cost movements are determinant of competitiveness. Accumulated differences in cost levels are contributing to producing external imbalances which make it increasingly difficult to stabilize exchange rates and necessitate wider and wider interest-rate differentials.

In addition, the emergence of these external imbalances may be accompanied by a growing distortion in the domestic

Table 3.1

Private consumption deflator

(annual % change)

	1980	1985	1986	1987	1988	1989	1990
E	16,5	8,2	8,7	5,4	5,1	6,8	6,3
I	20,2	9,3	5,8	4,8	4,9	6,3	6,0
GR	21,6	18,3	22,0	15,7	13,9	14,3	15,0
P	21,4	19,8	13,5	10,2	9,6	13,0	11,3
UK	16,2	5,3	4,4	3,9	5,0	5,3	5,5
				ERM[1] narrow-band countries			
Maximum	18,6	5,8	3,4	4,1	4,9	4,7	4,0
Average	9,0	3,8	1,1	1,7	1,8	3,2	2,8

[1] Exchange-rate mechanism of the European Monetary System.

Table 3.2

Nominal unit labour costs[1]

(annual % change)

	1980	1985	1986	1987	1988	1989	1990
				(a) ERM[3] narrow-band countries			
Average	9,2	2,8	2,4	1,8	0,5	1,2	1,7
Maximum	18,6	4,5	5,6	10,6	3,7	2,3	3,2
Minimum	5,0	0,4	1,7	−0,8	−0,4	−0,9	1,3
Average deviation from the minimum[2]	4,6	2,3	1,4	3,5	1,3	2,4	0,9
				(b) Other ERM[3] countries			
Spain	12,3	5,6	8,5	6,2	4,3	6,4	5,7
Italy	18,9	8,1	5,4	5,9	6,1	6,4	5,4
				(c) Non-ERM[3] countries			
Greece	15,6	20,8	12,2	12,0	15,1	18,6	14,4
Portugal	19,5	19,1	12,2	11,4	9,2	8,9	8,8
United Kingdom	21,7	4,7	4,5	5,0	6,4	7,9	7,2

[1] Whole economy.
[2] Unweighted.
[3] Exchange-rate mechanism of the European Monetary System.

allocation of resources: in a country where costs are growing more rapidly than in partner countries but where prices are constrained by external competition, profit margins in the sector subject to foreign competition tend to narrow, depressing investment, growth and employment. On the other hand, in a country which year after year gains in cost competitiveness, investment increasingly tends to be allocated to the sectors oriented towards or open to the outside. This allocation of resources is liable to prove inappropriate in the long run and will be expensive to redirect.

For costs, the picture of convergence towards stability in the last few years is similar to that for prices. Within the ERM narrow-band countries, the deceleration of wage costs has contributed very substantially to the attainment of the objective of convergence towards stability.

The average increase in nominal unit labour costs in these countries slowed from 9,2 % per annum in 1980 to 2,8 % per annum in 1985 and they are now increasing at a rate of about 2 %. At the same time, the gap between the least and the most favourable performances has been reduced from over 14 percentage points in 1980 to 4,1 points in 1985 and 1,9 points in 1990. The cumulative variation in nominal unit wage costs since 1986 illustrates the degree of convergence between these countries even more clearly.

On the basis of present forecasts, for the four years between 1986 and 1990, nominal unit wage costs will have increased in total by 3,9 % for the most favourable performance and by 6,9 % for the least favourable, if the two extremes, Denmark (+ 18,2 %) and the Netherlands (+ 1,4 %), are excluded.

The relative movements of unit labour costs, with exchange-rate movements taken into account, make a more precise measurement of changes in cost competitiveness possible. For this indicator, the differences in movements are wider, mainly because of the realignment of parities which took place in 1987. With the exception of Denmark, all the ERM narrow-band countries have gained in cost competitiveness since 1986, to varying degrees, against both their 19 principal industrialized partners and their Community partners.

These changes deserve two comments:

(i) a comparison of the performances of the countries only in this group shows that these movements were generally in the right direction. In particular, the greater depreciation of the real effective exchange rates of France and Ireland enabled these countries to make room for growth while preserving (France) or strongly improving (Ireland) their external position. The same is true of Belgium where the maintenance of an external surplus on current account is welcome to reduce the external indebtedness which built up until the start of the 1980s;

(ii) they nevertheless pose a specific problem in the case of the Federal Republic of Germany, where the depreciation of the real effective exchange rate, even if it was relatively smaller, contributed to the persistence of the external surplus and induced very high profits in the export-oriented sector which could lead to wage increases conflicting with the pursuit of both the stability and employment objectives.

Given the links which join the countries of the exchange-rate mechanism, the movements of prices and costs in each of these should in the future play a predominant role in preventing the appearance of fundamental imbalances or in reducing them. In particular, it is important for the countries whose external position is more fragile to continue to target the best performance in the exchange-rate mechanism since this will help to strengthen their competitiveness and to preserve a low level of inflation in their own and in partner countries. On the other hand, structural adjustments in Germany should take place in order to make its growth less export-oriented.

In the other Community countries, the real effective exchange rate has appreciated, sometimes sharply, in recent years.

In Spain and the United Kingdom, this appreciation of the real effective exchange rate can be explained not only by the positive inflation differential already mentioned, but also by some appreciation of the nominal effective exchange rate (weighted average of bilateral exchange rates *vis-à-vis* the partner countries). In Spain, Italy, the United Kingdom and Portugal, the loss of cost competitiveness, combined with a positive growth differential, led to a deterioration, sometimes severe, in the external position.

In these countries the choice of an appropriate economic policy mix remains very delicate. The appreciation of the real effective exchange rate is a powerful disinflationary instrument. It cannot be used over a long period, however, without an adverse effect on the external accounts and growth, unless at the same time domestic wage adjustment progresses rapidly. The fact that in these countries wage costs are no longer helping to reduce inflation or are even adding to the inflationary pressures may call into question the pursuit of balanced growth and is liable to impede the intended progress towards monetary union.

Table 3.3

Nominal unit labour costs[1] (national currency)

(Cumulative percentage change)

	B	DK	D	F	IRL	NL
			ERM[2] narrow-band countries			
1980-86	30,1	38,4	13,6	54,0	60,5	6,3
1986-90	4,4	18,2	3,9	6,9	4,1	1,4

[1] Whole economy.
[2] Exchange-rate mechanism of the European Monetary System.

Table 3.4

Relative nominal unit labour costs in a common currency[1,2] — ERM[3] narrow-band countries

(Real effective exchange rate; base index: 1980 = 100)

	B/L	DK	D	F	IRL	NL
			(a) Against the Community partners			
1986	90,1	102,2	100,9	98,4	112,6	91,4
1989	85,4	107,6	96,0	90,0	98,0	86,4
			(b) Against 19 principal industrialized partners			
1986	83,9	93,5	90,8	88,6	103,6	85,7
1989	79,7	98,2	87,4	81,8	90,8	81,3

[1] Relative change, adjusted by movements in the effective exchange rate, of the nominal unit labour costs of one country compared with the average of its partners.
[2] Whole economy.
[3] Exchange-rate mechanism of the European Monetary System.

Table 3.5

Relative nominal unit labour costs in a common currency[1,2] — Other Community countries

(Real effective exchange rate; index: 1980 = 100)

	E	I	GR	P	UK
			(a) Against the Community partners		
1986	90,4	125,8	100,5	97,6	91,5
1989	104,1	135,8	108,7	100,4	104,5
			(b) Against 19 principal industrialized partners		
1986	81,0	111,6	90,3	89,9	81,4
1989	93,7	120,8	98,1	92,8	92,1

[1] Relative change, adjusted by movements in the effective exchange rate, of the nominal unit labour costs of one country compared with the average of its partners.
[2] Whole economy.

Polarization of external accounts continues...

These developments are all the more worrying because, within the Community, the tendency for external positions to polarize is becoming more marked.

It is true that no country any longer has a current external deficit that is clearly unsustainable, which was still the case in the first half of the decade. From this point of view the degree of convergence of external positions has improved appreciably. The balance of current transactions in Spain, Portugal and the United Kingdom has deteriorated rapidly in recent years, however, even though the deficit has still not reached an excessive level. On the other hand, Germany's current account surplus is continuing to increase, to almost 6 % of GDP in 1989.

For external positions the objective cannot be the pursuit of convergence towards equilibrium in all countries. It is normal for the relatively less-developed countries or those that are under more severe demographic pressure to have deficits which enable them to finance higher growth and to invest more. In attracting foreign capital on a sound basis, they are creating the conditions for a surplus in the countries where the level of development is higher. This mechanism helps to allocate saving resources to those countries where the development need is greatest and thus contributes to their catching up. The present size of the German surplus cannot, however, be justified by these considerations and it may soon become problematic for Germany itself and for its Community partners.

Firstly, this surplus would represent a potential source of instability within the exchange-rate mechanism if the capital outflows which have counterbalanced it until now were to cease or were to be reversed.

Secondly, in Germany's present situation, which is also characterized by a high rate of capacity utilization, the pressures exerted by the strength of external demand and the insufficient import competition facing domestic production are a potential source of inflation.

Thirdly, the increase in Germany's trade surplus goes hand in hand with an allocation of investment resources which tends to favour the export-oriented industrial sectors. As a result, the imbalances between the production structures of the various Member States are in danger of becoming exacerbated.

The increase in the German current-account surplus reflects a wider divergence of intra-Community trade balances. A more detailed analysis of Germany's bilateral trade balances with its partners confirms what is to be expected from the relative movements of prices and costs within the Community.

Almost half the increase in the German intra-Community trade surplus between 1986 and 1988 derives from only two countries, the United Kingdom and Italy, and almost two-thirds derives from these two countries plus Spain, Portugal and Greece. Furthermore, more than 60 % (DM 6 billion) of the increase in the trade surplus *vis-à-vis* the six ERM

Table 3.6

Balance of current transactions with the rest of the world

(% of GDP)

	1980	1985	1986	1987	1988	1989	1990
				Community			
Average	−1,2	0,8	1,4	0,8	0,3	0,1	0,2
Germany	−1,7	2,6	4,4	3,9	4,1	5,3	5,8
Maximum excluding Germany and Luxembourg	1,6	4,1	3,9	1,8	2,4	2,1	2,1
Minimum	−11,8	−8,2	−5,2	−3,0	−3,2	−4,1	−4,0
				ERM[1] narrow-band countries			
Average	−0,9	1,4	2,3	1,8	1,9	2,4	2,7
Minimum	−11,8	−4,6	−5,2	−3,0	−1,8	−2,0	−1,1

[1] Exchange-rate mechanism of the European Monetary System.

Table 3.7

Trade surplus of Germany

(Billion DM)

	Total	of which					
		Community partners	Six ERM narrow-band partners	NL	E + P + GR	I	UK
1986	112,6	51,4	24,9	−2,3	6,9	4,8	14,8
1988	128,0	80,8	34,6	+3,7	12,3	11,4	22,4
Increase 1986-88	+15,4	+29,4	+9,7	+6,0	+5,4	+6,6	+7,6

Source: Bundesbank.

(narrow band) partners derives from the increase *vis-à-vis* the Netherlands. The main reason for this is the fall in the price of Dutch gas imported by Germany.

The more stable bilateral balances of the ERM narrow-band countries, *vis-à-vis* Germany can be explained by several factors. First, the greater convergence of prices and wage costs with those of Germany plus the effects of the January 1987 realignment have enabled them to preserve their price and cost competitiveness. In addition, the growth differential between these countries and Germany has remained small, if not negative. These conditions did not obtain in the other countries which have generally maintained, in the last few years, distinctly positive inflation differentials in relation to Germany and have had stronger growth than Germany.

Convergence in the public finances is insufficient ...

The strengthening of the Community's monetary cohesion also implies a greater convergence of budget balances. In this area too there is a great difference between the ERM narrow-band countries and the others.

Among the countries in the first group, substantial though still insufficient progress has been made towards the downward convergence of budgetary deficits. As a percentage of GDP, the average deficit as well as the highest deficit have been more than halved between 1981 and 1989. But the level of deficit is expected to remain excessive in Belgium and the

Table 3.8

General government net lending (+) or borrowing (−)[1]

(% of GDP)

	1979	1981	1983	1985	1987	1988	1989	1990
EC	—	−5,3	−5,3	−5,2	−4,2	−3,6	−3,0	−3,2
				(a) ERM[2] narrow-band countries				
Average	−2,4	−4,0	−3,9	−2,7	−2,6	−2,3	−1,3	−1,3
Minimum	−12,7	−13,7	−11,6	−11,1	−9,1	−6,5	−6,0	−6,1
Maximum	+1,2	−1,9	+2,6	+4,5	+2,5	+2,4	+2,3	+2,6
Maximum excluding Luxembourg	−0,8	−1,9	−2,5	−1,1	+1,8	+0,2	+0,1	+0,7
				(b) other countries				
Spain	−1,7	−3,9	−4,8	−7,0	−3,6	−3,2	−2,6	−2,4
Italy	−8,3	−11,5	−10,7	−12,5	−11,2	−10,6	−10,3	−9,8
Greece	—	−11,0	−8,3	−12,3	−14,9	−19,9	−14,5	−20,0
Portugal	—	−9,5	−9,1	−10,1	−6,9	−6,5	−6,0	−6,0
United Kingdom	−3,2	−2,5	−3,4	−2,7	−1,5	+0,8	+1,5	+1,1

[1] ESA definition of general government, which includes social security.
[2] Exchange-rate mechanism of the European Monetary System.

Netherlands (5,7 % and 4,2 % of GDP respectively). In view of economic and monetary union, it is important for these countries to make a further reduction of their deficits a priority (see Chapter 7). This is even more necessary in Greece, Portugal and Italy. In these countries, budgetary policy has, in differing degrees, an essential contribution to make to greater convergence. Unless vigorous action is taken in this area, the burden which monetary policy has to carry in attaining the objective of stability and convergence will still be too heavy.

As a whole, an uneven picture of the degree of convergence achieved in the Community

The ERM narrow-band countries form a group in which the degree of convergence and monetary cohesion is generally on the right track. For this group, the priority during the first stage of economic and monetary union must be jointly to preserve the achievement of stability and convergence. Some of these countries will in addition have to concentrate on completing the process of budgetary consolidation.

In the other countries, the convergence objective is still far from being attained. In these countries substantial domestic imbalances still exist, because of strong wage pressures or excessive budget deficits. The stabilization of exchange rates *vis-à-vis* their other Community partners, either within the exchange-rate mechanism, as is now the case for Spain and Italy or, initially, as a result of the course taken by monetary policy, will increase the credibility of the stability objective and will thus create the conditions for closer convergence. But it is also important for the domestic adjustment mechanisms, in particular wage movements and budgetary policies, to make more of a contribution to the objective of convergence and stability.

Governments and monetary authorities will be able to contribute by continuing to set targets for the progressive reduction of inflation, and by themselves pursuing credible policies in this area. Moreover it seems essential for these countries to give fresh impetus to strengthening the consensus between the two sides of industry on the stability objective. In these circumstances, these countries could be better able both to attain their objective of domestic stability and to contribute to a greater convergence of external positions within the Community.

Even if exchange-rate adjustments are still possible in the period up to economic and monetary union, relative developments in supply conditions will be crucial for the reversal of the polarization of external accounts in the Community. On the one hand, Germany's partners have to pursue policies which improve their competitive position by means of domestic adjustments: this implies that they will maintain or even improve their price and cost competitiveness; and this presupposes that they will go on creating conditions conducive to investment which in the long run will enable them to improve their structural competitiveness. On the other hand, it is important for Germany to go on removing the structural obstacles which prevent production and employment from being switched to sectors which are less export-oriented.

These policies will be slow to take effect. But if they are implemented in a determined and credible fashion, it will be possible to get through the adjustment period without the Community's monetary cohesion being called into question; it may even be possible to strengthen it further because the credibility of stability policies combined with the improvement of supply conditions in countries where the external position is fragile will encourage stabilizing capital movements.

4. The Community in its international environment

The economic size of the Community, about one quarter of world GDP, is such that its growth prospects depend essentially on its own dynamism. Over the last few years, and thanks essentially to the prospects created by the completion of the internal market, the economy of the Community appears indeed to have found within itself the sources of a new vitality. This is shown, *inter alia*, by the behaviour of international investors, who seem to consider that investing in the Community is again a worthwhile proposition.

Table 4.1

Relative weights of the largest economic blocs in 1988

(At current prices and exchange rates, in %)

	EC	USA	Japan
Share of world GDP	22½	23	13½
Share of world exports[1]	19½	14½	12

[1] Excluding intra-Community trade.

Yet, in a world increasingly more integrated, economic developments depend more and more on a healthy international environment. The Community, the largest of the trading blocs with about 20 % of world exports (not counting intra-Community trade), has a special interest in the preservation of a sound international environment and, at the same time, an important role to play in ensuring it.

In 1987 and 1988, world trade expanded strongly thanks to the buoyancy of the industrialized countries and to greater stability of exchange rates brought about by international economic coordination. The most recent forecasts, prepared as usual under the assumption of stable exchange rates, point to a continuation of the expansion of world trade, albeit at a slower pace.

With regard to three main problems of the world economy of recent years, the payments imbalances within the OECD area, the protectionist dangers that arise from the persistence of large trade deficits and the burden of debt on the LDCs, progress has been made. Nevertheless their solution requires continuing efforts and international cooperation.

Maintaining the momentum of international adjustment

The most recent data confirm that the international adjustment process is losing momentum. In 1989, the current account deficit of the USA has been reduced, but no further progress is expected in 1990. The same trend is forecast for the Japanese surplus: after some reduction in 1989, it could increase again in 1990. The Community remains approximately in equilibrium. The German surplus is, however, increasing (see Chapter 3).

Current account imbalances have until now been financed much more easily than would have been expected earlier. Furthermore, international policy coordination has been rather successful in preserving a certain degree of exchange-rate stability.

These are not grounds for complacency. The limited extent of the adjustment implies a rapid accumulation of external assets and liabilities which generate investment income flows that run counter to the reduction of the payments imbalances. The risk that exchange and interest rates may come under intense pressures if policies are judged inappropriate exists.

The challenge is therefore to give new impetus to policies aimed at reducing the international payments imbalances to less worrying levels. The necessary adjustment should not be obtained, however, at the cost of a reduction in the rate of expansion of international trade. Sustained expansion of world trade is important to maintain the confidence of economic agents both in the industrialized and in the developing world, but it is vital to the growth prospects of the indebted LDCs. Policies aimed at modifying the composition of aggregate demand will have to be implemented in both surplus and deficit countries. The adjustment process will in fact imply a sizeable reorientation of trade flows, with possible undesirable negative growth and employment consequences. For instance, the logical implication of the need to reduce the US deficit is that it will be difficult for the Community and Japan to envisage an increase of their world market share in the years to come. On the contrary, they could have to accept a relative reduction.

International coordination must be continued and strengthened to maintain market confidence and thus prevent disorderly conditions. In particular, coordination should aim at policies which will engineer a resumption of the real adjustment process (see Table 4.3).

Surplus countries will have to maintain the present growth momentum and try to increase the share of internal demand being met by foreign production. This is particularly important in the case of the Asian surplus countries, Japan and the NIEs, which are still not very open to foreign manufactured goods. Imports into these countries have increased in 1988 at rates of about 20 % in real terms. Given the gap between

Table 4.2

Current account balances

	1985	1986	1987	1988	1989	1990
			(a) in billion USD			
EC	19,3	47,5	32,6	16,6	5	13
(Germany)	(16,1)	(39,2)	(43,7)	(49,4)	(62)	(72)
USA	−114,4	−142,4	−160,6	−116,9	−99	−102
Japan	49,1	85,2	88,0	80,1	65	72
NIEs[2]	10,2	28,9	28,1	25,0	24	24
		(b) as % of the combined GDP of USA, EC, Japan and the NIEs				
EC	+0,2	+0,5	+0,3	+0,1	0,0	0,1
USA	−1,4	−1,4	−1,3	−0,9	−0,7	−0,7
Japan	+0,6	+0,9	+0,8	+0,6	+0,5	+0,5
NIEs[2]	+0,1	+0,2	+0,2	+0,2	+0,2	+0,2

[1] Hong Kong, South Korea, Singapore, Taiwan.

Table 4.3

Growth of real domestic demand

	1985	1986	1987	1988	1989	1990
		(a) Rate of growth of internal demand relative to rest of the OECD				
EC	−1,6	−0,1	−0,2	−0,5	¼	½
USA	0,7	−0,1	−1,1	−2,3	−1¾	−1¼
Japan	0,7	0,4	1,8	4,0	2½	2
		(b) Rate of growth of internal demand relative to that of GDP				
EC	−0,2	+1,3	+1,2	+1,0	+ ½	0
USA	+0,2	+0,7	−0,6	−1,5	− ¾	− ¼
Japan	−0,7	−1,6	+0,8	+2,0	+ ½	0

the levels of exports and imports (especially in Japan) rates of increase of this order of magnitude will have to be maintained for many years to produce a significant reduction in the surpluses.

The USA, as a deficit country, will have to ensure that its growth continues to be driven by a strong export performance. The improvement in the current account balance experienced in 1988 was achieved thanks to a real increase in exports of goods and services of about 18 %. The most recent forecasts show that this remarkable performance is not being repeated and that in 1990 the increase of US exports will be barely greater than the rate of expansion of world trade.

Progress in reducing the budget deficit would help to contain the inflationary pressure still present in the system and would ease the task of monetary policy. Continued reliance on monetary policy could, via the exchange rate, have adverse effects on the current account. Measures aimed at increasing further the competitiveness of US exports on the world markets would help to offset the effects on activity of the necessary reduction of the budget deficit.

Fresh impetus to a more liberal trading system

The persistence of large trade disequilibria fuels protectionist tendencies which threaten the liberal trading system upon which the industrial world has built its prosperity. There are worrying signs of a movement away from multilateralism towards unilateral measures and managed trade.

The completion of the internal market is further increasing the responsibilities of the Community in the major international negotiations to liberalize markets in goods and services. The Community's position in this area is clear. It is in its own interest for there to be keener and equal competition between its own enterprises and those of third countries, both within and beyond its frontiers.

Completion of the internal market is already giving fresh impetus to the liberalization of international trade. The Community will continue to put its full weight behind further advances in this area, particularly in the context of the Uruguay Round negotiations. The various agreements reached as a result of the examination halfway through these negotiations (Montreal 1988 and Geneva 1989) form a useful set of commitments as well as a multilateral and detailed programme for future work which is heading in the right direction.

Reducing the burden of debt on the LDCs

1988 was also a good year for the economies of the LDCs taken as a whole. But the strong growth, 4,2 % on average, has shown the same differentiation which has characterized the whole of the 1980s. The performance of fast-growing Asian NIEs, China and India, where growth per head has exceeded 8 %, has contrasted with stagnation in the Mediterranean region and with a drop in Latin America and Africa.

The good performance in the Asian countries, particularly in those that export manufactured goods, could slow down in 1990. The NIEs are already feeling the effects of the appreciation of their exchange rates, while other countries (such as China and India) are being forced to tighten budgetary policy. Economic performance in Asia is none the less expected to continue to be strong, contrasting sharply with the performance of other developing regions.

Table 4.4

Performance of the less-developed countries through the 1980s

	Average % change 1981-88	
	Real GDP	Inflation[1]
Asian NIEs	8,6	3
China and India	8,1	6
Latin America	1,5	120
Sub-Saharan Africa	0,7	23
for comparison: OECD	2,8	5

[1] Weighted average of consumer prices.

Per capita output in the Latin American and sub-Saharan countries registered a decline in 1988 which should be only marginally reversed in 1990. The external environment was not favourable to commodity exporting countries. Higher interest rates weigh heavily on countries that are indebted on market terms, and the prices of many commodities (cocoa, coffee, oil, tea) have been declining.

In many debtor countries, moreover, there was a deterioration in the inflation performance and weakness in adjustment policies. An unstable domestic environment has a strong adverse effect on national and foreign private sector confidence and activities, including savings and investment decisions, and does not lead to an efficient allocation of resources. Many developing debtor countries need to implement more firmly and resolutely structural reforms that tackle the distortions and inefficiencies in their economies.

Large debt-servicing burdens can become a deterrent to continuing adjustment and investment. This was increasingly recognized during 1988 and 1989 by all the parties concerned and led to an enhancement of the debt strategy: reduction of debt and debt service are considered necessary in certain cases and may receive the support of the multilateral institutions. Debt alleviation should be directly negotiated between debtor countries and private creditors. Its contribution to a higher growth and development potential in problem debtor countries will still largely depend on their effective implementation of fundamental policy and structural and trade reforms, including trade liberalization.

For many parts of the developing world, the 1980s will be a lost decade. The need to improve their economic situation and to further their integration into the world economy was underlined at the last Summit of the industrialized countries. Only a better growth performance will permit the implementation of policies aimed at protecting the environment and at the same time allowing a significant development in the Third World.

5. 1992 as the lever of generalized structural adjustment

The 1992 process becomes a strategy for comprehensive structural change

The Community's programme for completing the internal market is a wide and deep strategy. In effect, the objective to suppress all frontiers for products and factors of production is integrated with a much more extensive set of policy reforms of a supply-side or structural character at the level of the Member States as well as the Community. At the Community level the Single European Act embodies the political decision to develop the different policy functions (internal market, R&D and technology, social policy, the structural Funds and cohesion, environmental policy etc.) in an integrated manner. The sum of these national and Community actions is now thus conceived as a common effort to secure, ultimately, a lasting improvement in macroeconomic performance.

The present chapter is devoted to reviewing the progress of this ambitious project. This is not easy to do, however, for two reasons. First, the instruments of policy action are numerous and microeconomic in nature: the 279 actions of the White Paper do not even include the accompanying policies at the Community level additionally covered by the Single European Act, let alone the complementary measures of Member States. Secondly, the tracking of the impact of numerous microeconomic measures through the performance of the economy is extremely difficult: there is the danger of describing too much detail and so losing sight of the underlying strategy, and so the causal links between microeconomic actions and macroeconomic results remain rather speculative.

None the less, a number of fundamental principles unify the process, and give it overall logic. These can be considered under three headings:

(i) complementarity of competition and collaboration;

(ii) complementarity of national and Community actions;

(iii) strategic interaction between public and private sectors.

The opening of frontiers is first and foremost a policy to increase competition, and to achieve economic gains through greater efficiency and specialization in production and increases in consumer choice. The Community's competition policy reinforces this process, as do many regulatory reforms undertaken by Member States to improve the functioning of private markets. However, the 1992 process is not exclusively reliant on the paradigm of competition, and complements this with support for several forms of collaboration and solidarity.

Thus, the R&TD instruments aim at inducing collaboration between enterprises in high-technology sectors; the structural Funds aim at increasing the resource endowment of relatively weak regions; the social dimension proposes some minimum rules of social and labour market policies in order to ensure some restraints in competition between national policy regimes in these respects. In general terms, this mix of competition and collaboration reflects the reality that private markets often fall short of perfection, and market failures or imperfections warrant public intervention.

The complementarity between national and Community actions has several important features. There are inevitable technical linkages between the Community's actions under the White Paper and national regulatory policies (for example financial market integration involves not only the passing of Community directives, but a follow-through in terms of many more detailed national regulations). Going deeper, however, it is a well established economic principle that market liberalization which causes flexiblilty and adjustment in one area, will require analogous actions of other types if the full benefits are to be attained (privatization of State-owned enterprises is one example). Broader still, the 1992 process has become more than a process of competition between industries and service sectors within the Community. It has also become a process of competition between virtually the entire economic policy regimes and systems of the Member States: all aspects of efficiency of the national economies are being reconsidered as the Member States 'get fit for 1992'. This is particularly true of the moves to eliminate fiscal barriers between Member States which have implications for government revenues.

The key issues in the process of strategic interaction between public and private sectors concern credibility and expectations. The Commission's research on 'The economics of 1992' showed that the greater part of the potential gains from completing the internal market should come more from changes in the strategic behaviour of the private sector than from the simple removal by the public sector of unnecessary costs (such as frontier controls, disparate technical norms, etc.). In order to trigger such changes in behaviour the essential requirement is that the public sector's plan of action be judged credible in the eyes of the private sector. The Community has in fact taken clear steps in this sense: for example the constitutional commitments of the Single European Act as regards decision-making methods, irreversible financial commitments under the structural Funds, and the accelerated legislative performance of the institutions. This credibility achieved, the private sector is induced to anticipate 1992, and individual firms to hasten to position themselves favourably for the new market environment expected after 1992. With the private sector thus already acting on the assumption that '1992 will happen', the public sector itself has an easier task in overcoming the usual resistances to market liberalizing actions.

In the light of the foregoing principles, the following sections review (briefly and selectively) the policy actions at the Community and national levels, and finally report on first indications of the response of the private sector.

A coherent package of Community measures

The Cecchini Report, which was published in mid-1988, on the potential benefits for the Community of completion of the internal market, has shown that the elimination of all types of obstacles to free trade between Member States should lead to substantial economic benefits. In actual fact, as is shown in the last part of this chapter, firms are already incorporating into their business strategies these market-enlarging horizons and a considerable share of the faster rate of growth of investment may be attributed to their adaptation to an increasingly competitive environment.

Completion of the internal market well under way

At the level of the measures envisaged in the White Paper the balance sheet is, in quantitative terms, very considerable. By the end of 1989, the Commission will have tabled all the proposals provided for in its White Paper of June 1985. In approving finally 133 directives and regulations, partially 7 directives and reaching 6 common positions, the Council has approved more than 50 % of the programme.[1]

The pronounced acceleration in the rate of Council decision-making since the coming into force of the Single European Act is explained by the more general use of the qualified majority rule, as well as a considerable degree of pragmatism on the part of the Community, namely in the technical fields. The approach enshrined in the White Paper and accepted by the Council combines the principle of mutual recognition and that of harmonization and the development of the principal of subsidiarity, but where appropriate its proposals envisage a reduction in the degree of Community regulation in favour of a certain degree of competition between national legislations subjected to the play of market forces.

Obstacles continue to exist where Council decision-making requires unanimity. This is especially the case in the area of the free movement of persons where the only substantial advance made so far concerns the mutual recognition of diplomas of higher education following three years of study. It is also the case regarding taxation of savings and indirect taxes. Moreover difficulties arise with the Member States which are not implementing properly Community directives and Community law in their own legislation or administrative practices. These shortcomings could lead to distortion of competition.

As is also shown in the box, the directives adopted by the Council deal mainly with the elimination of technical barriers to the free circulation of goods, services and capital. It has thus proved easier to achieve a consensus in the Council in cases relating to the suppression of restrictions to market access (public procurement, financial services, etc.) and to greater liberalization of surface or air transport services and telecommunications services. On the contrary there has been a much greater divergence of opinion in relation to decisions which involve fundamental questions of national policy (e.g. fiscal policy) or which appear to involve issues of national sovereignty (controls over frontier entry or rights of residence).

The benefits which are anticipated from the suppression of trade barriers will not be realized in full except in the framework of a Community whose internal frontiers are completely open. The Commission has also confirmed its will to see the Community achieve a greater liberalization of trade in goods and services on the basis of mutual advantage (global reciprocity), according to GATT rules and spirit and taking into account the present Uruguay Round negotiations. For example the Directive on the free movement of capital adopted by the Council envisages the principle of liberalization *erga omnes*. The second banking Directive will allow that a link be made between the establishment within the Community of third-country banks and the effective market access of Community banks in the third country in question.

As regards public procurement, in certain areas such as telecommunications, energy, transport and water presently not covered by the GATT Code, the benefits of their EC liberalization in favour of non-Community companies could be subject to certain conditions. Finally, in the automobile sector, the Commission is advocating a system of progressive liberalization of protected markets, though no formal decision has as yet been taken.

[1] Situation at 8 September 1989.

Appropriate accompanying microeconomic policies

The actual realization of the gains anticipated from the internal market depend also on the development of certain microeconomic policies.

There is a dual logic which underlies the Community measures. On the one hand it is vital to ensure the maximum economic efficiency of the internal market programme; on the other, it is desirable that the distribution of effects minimizes the uneveness of structural development between Member States.

In a large market devoid of obstacles to trade, the strengthening of the competitive process is the fundamental condition for the achievement of general welfare improvement. The translation of productivity gains and reduction of costs into price reductions, and the control of the risks of abuse of dominant positions necessitate the reinforcement of competition policy instruments at the level of the Community.

In this regard the surge in the number of mergers and acquisitions witnessed recently, which also provides evidence of the strategic response of firms to 1992, justifies the pressures on the Council to find a rapid solution to its debates on the Commission proposal to control, according to well-defined criteria, certain mergers between firms whose scale of activities is Community-wide (see box).

While actively implementing policies for control of State regional and sectoral aids the Commission also intends to ensure that the process of deregulation under way in services respects both the rules of competition as well as safeguarding the public interest in matters of security and reliability of service provided.

Another factor of economic efficiency is the stimulation of intra-Community cooperation in the field of research and technological development between the various economic entities (firms, research centres, universities). The achievement of economies of scale as well as the rapid diffusion of technological progress should enhance the current entrenchment of Community competitiveness in high technology products. The Commission has in 1989 presented new proposals for a third R&TD framework programme in this spirit.

In allocating ECU 38,3 billion for the period 1989-93 (in 1989 prices) for the most disadvantaged regions,[1] the Community has provided concrete evidence of its commitment to work in favour of a greater degree of social and economic cohesion (see box). This financial commitment which, in accordance with the new structural Fund regulations, will be additional to national public expenditure, should result in a considerable strengthening of technical infrastructure and human resources, thus allowing these regions to be better prepared for the internal market. The combined participation of the Member States, the regions concerned and of the Commission in defining the priority axes of development, and in the execution of the programmes is aimed at securing the effectiveness of the measures undertaken. Once all the structural Funds have been allocated the total Community financial commitment will reach ECU 60,3 billion for the period 1989-93 (in 1989 prices).

The completion of the internal market has also given rise to some fears on the part of trade unions. Fears have been expressed as to the risks of employment loss as a result of the inevitable restructuring or of the relocation of centres of production towards lower wage cost regions, and about the risks to those standards already achieved in the socially most advanced countries.

The concrete evidence for the present marked strengthening of economic growth to which the internal market programme is making a major contribution, provides the main element of a response to these points. Thus 3 million jobs were created between 1985 and 1987 at a time when the rate of economic growth was 2,5 %; 5 million jobs should be created between 1988 and 1990 with an expected annual growth rate of 3,5 %.

In the social field the Commission is acting on a number of fronts. The starting point is the development of social dialogue at Community level which should enable the social partners to make their contribution to the consolidation of the social dimension of the internal market.

The strengthening of the Community's social cohesion is based on a consensus on fundamental social rights. This consensus should, in the opinion of the Commission, be translated into a charter adopted at the highest political level in the Community. Furthermore the Community possesses a regulatory power in the domain of health and safety at work, where majority decision-making has enabled the Council to adopt important directives.

The aims of the Community-wide labour market policies are to abolish the obstacles to the free movement of persons, to achieve greater mobility of workers while ensuring that when changing jobs they preserve the social security benefits acquired, and to secure the mutual recognition of professional qualifications.

[1] Commission decision of 20 September 1989.

The increasing public concern about environmental problems, particularly as they might concern future generations, underlines the need for the Community to develop its policies for the protection of the environment. It will be necessary to ensure that increased economic growth, resulting in part from the success of the internal market programme, is managed in a way which as far as possible avoids damage to the environment. Moreover, additional resources generated by the growth now taking place should provide the means for solving environmental problems inherited from the past.

Such solutions could be created by the pricing of scarce environmental resources in a way which ensures strong incentives for the full integration of the environmental dimension with the decisions of economic agents. Moreover, a wider application of the 'polluter pays' principle will provide a basis for the use of a range of fiscal and regulatory measures: this should prompt the use of less pollutive production technologies in order to ensure that the restructuring process generated by the internal market is at the same time oriented towards environmental considerations. The Commission has already proposed that the 'polluter pays' principle be applied to those damaging the environment by discharging waste, and is considering a framework for fiscal incentives to favour the purchase of small 'low-polluting' cars.

The approach to environmental policy must also take acount of the international dimension. The Community should ensure that, as far as possible, it is acting in a way consistent with the requirements of sustainable growth and development, that is development which ensures that progress now is not made at the expense of future generations. This theme was given particular emphasis in the Brundtland Report prepared by the United Nations World Commission on Environment and Development. The Community also has to play an active role in setting limits on transfrontier pollution with its neighbours, in particular the Eastern bloc and EFTA countries.

A series of national initiatives

As each Member State has set out from a different starting point, the nature, extent and direction of adaptation that is appropriate to preparing for the internal market varies greatly. The changes implied are probably greatest for the three most recent members of the Community, Greece, Spain and Portugal, which are still in the process of bringing the structures of their economies into line with the existing situation in the Community. The introduction of VAT in Portugal in 1986 and in Greece in 1987, for example, were major reforms. The momentum towards the single market is speeding up the integration of these three countries into the Community. Examples of this acceleration are Spain's decision to bring the peseta into the EMS in June 1989 and Portugal's announcement, in September 1989, of plans to remove controls on purchases of foreign securities by residents.

Even for more longstanding members of the Community some fundamental changes are implied. Italy's liberalization of capital movements has entailed a legal reformulation of its exchange control regulations, which have been switched from a system that forbade transactions that were not expressly permitted, to one that permitted all transactions, with certain exceptions that are now being removed.

By contrast, other Member States had already effected many of the necessary adjustments. Exchange controls were abolished in the United Kingdom, for example, in 1979, and during the past decade the government has undertaken wide-reaching deregulation of markets, taking the lead in the Community in such sectors as telecommunications, air transport and financial services. Other economies, such as Germany and the Netherlands, were also already well placed to participate in a unified internal market. The degree of adaptation required in these countries is clearly less than in others, though none of them can afford to be complacent. In Germany, for example, progress is still needed in deregulating transport, electricity, communications, banking and insurance and in reducing sectoral subsidies.

In the context of tax harmonization the direction as well as the extent of change will vary among countries. For Belgium it entails a reduction in revenue from VAT that will be outweighed by an increase in revenue from excise duties. In Italy the effect, is the opposite: higher VAT receipts partially offset by smaller revenue from excise duties. Ireland's VAT receipts will be largely unaffected, but revenue from excise duties will contract. Harmonization implies higher VAT and excise duties in Spain and Portugal, while both need to be lowered in France, together with tax on investment income.

Few measures, other than those implementing the single market directives, can be attributed solely to the prospect of the unified market, but many policies are being attacked more vigorously because of it. Efforts to improve the competitiveness of national economies have assumed greater urgency. Policies such as privatization, which may not initially have been inspired by the internal market, are now receiving increased attention. Similarly, concern to ensure that labour costs and the skills of the workforce enhance competitiveness in the single market has given a fillip to measures to make labour markets more flexible and to expand opportunities for training. The advent of a fully integrated Community market in financial services, in the wake of the complete freeing of capital movements and the completion of the internal market, is accentuating the need for some Member States to pursue the modernization and liberalization of their financial systems and for others to adapt their regulatory framework and market structures. Infrastructure policy has also been influenced.

The prospect of the internal market has also created much greater awareness among policy-makers of the external implications of policies that traditionally have been seen as essentially domestic, such as tax policy, though here the 1986 tax reform in the United States has exerted influence along with the advance towards 1992.

The measures taken with a view to 1992 present examples both of collaboration and of competition. In the area of taxation Member States are taking steps towards harmonization not only of VAT and excise duties, which they are required to do, but also of corporate taxation. Recent years have seen a marked convergence of rates, and the present or planned rate of corporate income tax now lies within a range of 35 to 39 % in nine countries, while in two others the rate is 43 %.

A more competitive response to the single market is also evident for example in the context of financial markets. The United Kingdom's decision to begin issuing Treasury bills denominated in ecus was prompted partly by a wish to develop London as a centre for ecu transactions.

Throughout the Member States the completion of the internal market is perceived by policy-makers as an irrevocable change that will fundamentally alter the policy environment. This perception is being communicated to the private sector, which in turn is adapting its behaviour.

The reactions of the firms in the light of the achievement of the single market

Surveys carried out by the Commission in mid 1989 among industrial firms in the Community give a first impression of firms' expectations in the light of the completion of the single market. The details of these survey results are given in Study No 5.

Growth of interdependence in a context of greater competition

Industrial firms expect to see a growing interdependence of Member States' economies. They anticipate significant increases in sales within the Community but outside their national markets, a trend which they expect to continue and even strengthen after 1992.

However, firms also expect a growth of competition in their own national markets and those expecting to increase domestic sales are about equal in number to those expecting a fall. The result of these effects will probably lead to a reduction in market share for industrial firms in their domestic markets and an increase in market share in other Member States, a process which means that firms become more 'Europeanized'.

To cope with the prospect of increasing demand in an enlarged market where sales opportunities are mainly located outside their domestic market, firms anticipate an increase in their investment, both at the national level and in other Member States.

A positive contribution to the catching up process

In the less industrialized countries of the Community (Portugal, Ireland, Spain and to some extent Italy), investment expectations tend to favour the domestic market rather than investment in other Member States. On the other hand in countries such as Germany, France or the United Kingdom, investment flows to other Member States are of greater significance. In the long term this process should help the less industrialized countries to catch up with the others and thus contribute to convergence.

Industrialists anticipate little change in employment growth, and any increase in employment is expected to benefit branches established in other Member States.

These views are coherent with those for productivity which is expected to increase substantially before and after 1992. By strengthening competition, helping to eliminate internal inefficiency and monopoly rents, the internal market is a powerful force for substantially increasing productivity.

Changes taking place in internal resource-allocation strategies

As directives come into force, firms have or are making decisions to modify their resource allocation, the location of production plant or distribution networks. In most Member States priority decisions in the light of the internal market concern either the means of production (Germany in particular), or changing products to suit a larger market (Belgium, France, United Kingdom).

In the case of strategies involving the means of production to cope with increased demand, most industrial firms expect to increase capacity in their current plant rather than opening new production units. In the case of some multinationals located in several Member States and producing relatively standard ranges of goods, there is a tendency to reduce the number of production units because of potential economies of size and lower transport costs.

Where the strategy concerns products, firms have two options, either to sell the same product in all Member States, or to modify their product to suit each national market. Most firms believe that the challenge of the internal market will lead them to modify their product to suit the intended market, but it is clear that the various sectors and products will require different marketing policies.

External strategies favour acquisition and mergers

In both industry and services there has been a very significant rise in the number of takeovers and acquisitions of majority shareholdings. The share of international transactions, relative to acquisitions of one firm by another in the same Member State, is increasing. This growing 'internationalization' of firms is occurring both in industry and in the services sector.

This process of internationalization also affects the acquisition of minority shareholdings and the creation of jointly owned subsidiaries. However, to a large extent, the firms asked about the influence of the internal market on their external strategies prefer operations which give them control (takeovers or the acquisition of majority shareholdings) to other transactions (minority shareholdings or jointly owned subsidiaries). These operations can stimulate a more efficient allocation of capital resources and contribute to the efficiency of the internal market, provided that no monopoly situation is created.

The prospects for different sectors

Not all economic sectors are affected in the same way by the internal market directives; structural factors give rise to differences in the strategies adopted in different sectors. Thus for standardized products where economies of scale are important and transport costs are low, the emphasis will be placed on acquiring production plant with a view to greater rationalization. In the case of differentiated products where quality, after-sales service and presentation play an important role, the aim will rather be to acquire a brand name, a distribution network or an image.

Several criteria can be used to distinguish between the effects of the internal market on different sectors: non-tariff barriers, price differences, the present level of intra-Community trade and the existence of economies of scale. Applying such an analytical matrix to industry, it appears that 40 sectors out of 120 will be more affected than the others by the completion of the internal market. These 40 sectors alone represent about 50 % of value-added in industry. Three groups of sectors will be particularly affected by the internal market:

Traditional public procurement: the sectors concerned (electricity generating equipment, railway equipment etc.) are characterized by a small volume of intra-Community trade and very marked price differences. Each national public authority favours its national champions. Important restructuring measures (mergers, concentration, closure of plants) are under way in these sectors as the potential economies of scale are large and the present rates of capacity utilization are low.

Public procurement in high technology fields: in these sectors (telecommunications, data processing, medical equipment etc.), the presence of multinational companies explains both the small price differences and the large flows of intra-Community trade. In terms of productivity, the existing European firms are lagging behind their American and Japanese competitors in markets where demand is growing strongly and R&D expenditure is substantial. Competition in these sectors is on a worldwide scale and Europe needs world-class industrial groups capable of meeting the technological challenges of tomorrow.

Mass consumption products: in these sectors (cars, household electrical appliances, textiles and clothing) the intra-Community trade flows are already large and price dispersion is on average not much greater than the average for industry as a whole. The present non-tariff barriers have encouraged the fragmentation of markets at the level of distribution and marketing while production can be integrated on a European scale. Of course, differences in taste, habits, consumption patterns and history also help to explain this market fragmentation.

Community policies

1. *Progress in achieving the internal market*

The fourth report of the Commission to the Council and to the European Parliament, adopted on 20 June 1989, summarizes progress regarding the completion of the internal market. Already some 133 directives and regulations have been approved by the Council, 7 have been partially adopted and 6 common positions have been agreed.

The majority of the directives adopted by the Council in 1988/89 concern technical harmonization and policies for standardization of industrial products (including food products). Other important decisions cover the opening up of public works and supplies, banking services (agreement in principle on the second banking Directive), insurance services, and the freedom of capital movements which will be in force with effect from 1 July 1990. Important decisions awaited concern veterinary and phytosanitary controls, the opening up of public procurement in excluded sectors, elimination of frontier controls, in particular controls on the movement of persons.

2. *Taxation*

For the harmonization of indirect taxes, in 1987 the Commission presented proposals (COM(87) 320 to 328) for the dismantling of fiscal barriers. Modifications to those proposals were outlined in a new Commission communication (COM(89) 260) of 14 June 1989.

On excise duties, the modified approach envisages minimum rates for alcohol and tobacco, applicable from 1 January 1993.

For VAT, the Commission proposes a standard rate, subject to a minimum to be decided, and a reduced rate within the range of 4 to 9 %. Member States that currently apply a zero rate may maintain it for a limited number of goods. With regard to intra-Community trade, on 9 October 1989 the Council, while adhering to the abolition of frontiers by the end of 1992, disagreed with the Commission's proposal that VAT should be levied on exports in the country of origin from 1 January 1993. Consequently, the Council has decided, as a transitional arrangement, to maintain the present system of taxation in the country of destination. An appropriate control system will have to be put into place.

For the harmonization of taxes on interest income, the Commission put forward two Directives in proposal COM(89) 60 of 8 February 1989. In the first Directive, a minimum withholding tax of 15 % levied in interest income paid to Community residents is proposed. This proposal, requiring unanimity, has encountered opposition from certain countries. The second Directive proposed is designed to step up cooperation between tax administrations by removing the justification that administrative practices do not permit Member States to obtain the information requested.

3. *The liberalization of capital movements*

Numerous restrictions still remain in force hindering the free flow of capital throughout the Community. To remove them the Council adopted Directive 88/361/EEC on 24 June 1988. This Directive requires the liberalization of all remaining capital movements between residents in Member States by mid-1990, with postponed implementation allowed for Greece, Ireland, Portugal and Spain.

In banking services, the Commission is proposing that there should be a single banking licence, valid throughout the Community. This will be achieved with 10 Directives and Recommendations, of which the most important is the second Council banking Directive. Agreement in principle on this Directive has already been reached in the Council.

As regards insurance, full freedom of establishment and trade will be mainly achieved via two Directives; for non-life insurance (second Council Directive 88/357/EEC adopted on 22 June 1988) and for life insurance.

4. *Competition policy*

The prospect of achieving the internal market has led to a boom in the number of mergers between firms and, to maintain competition within the Community, the Commission has proposed a Regulation allowing it to exercise legal control over the mergers and acquisitions among firms operating at Community level. This proposal makes it necessary to define Community operations and concentration levels.

The definition of Community operations is based on turnover thresholds above which the Regulation would apply: first, total global turnover of the firms concerned now fixed at ECU 5 billion in the Commission proposals; second, the two-thirds rule, meaning that firms must have a Community dimension, and third, the *de minimis* threshold eliminating operations in which small firms are involved, and how these thresholds should be revised after a transitional period. To assess the level of concentration some Member States prefer using criteria based on measures of internal Community competition. Others wish to take into account factors relating to worldwide competition, the special situation of backward regions and the beneficial economic effects expected from the mergers.

5. *Research, technology and innovation*

The Single European Act (SEA) states that 'the Community's aim shall be to strengthen the scientific and technological basis of European industry and to encourage it to become more competitive at an international level'. Given this objective, the Commission has presented to the Council a third framework programme for research and technological development (R&TD) covering the period 1990-94. The framework programme (COM(89) 379) encourages a greater degree of joint cross-border R&TD cooperation between industrial companies including small and medium-sized firms, research centres and universities.

6. *Structural Funds*

Implementation of the reform of the Community structural Funds began in 1989. Together with a new regulatory framework, the financial means allocated to the structural Funds were significantly increased. The interventions of the Community structural Funds, of the EIB and other financial instruments will be concentrated in five objectives: (1) promoting the development and structural adjustment of regions whose development is lagging behind; (2) converting regions seriously affected by industrial decline; (3) combating long-term unemployment; (4) facilitating the occupational integration of young people; and (5) (a) speeding up the adjustment of agriculture, and (b) promoting the development of rural areas. Interventions will take place within a Community support framework (CSF) agreed between the Commission and the Member States.

Objective (1) regions are the less-favoured regions of the Community, and the corresponding CSFs were established in September 1989 with a total contribution of the structural Funds amounting to ECU 36,2 billion. In addition, ECU 2,1 billion will be disbursed in these regions through programmes to be established under Community initiatives. The transfers from the Funds are additional to the national development effort and not a substitute for national expenditure.

As regards the other objectives, the process of establishing the CSFs is still under way, but the global allocations of structural Funds are already decided: ECU 7,2 billion for objective (2) regions, ECU 7,5 billion for objectives (3) and (4), ECU 3,4 billion for objective (5) (a) and ECU 2,8 billion for objective (5) (b) (figures in 1989 prices).

7. *The social dimension*

In December 1989 the Council will examine the Community Charter on Social Rights. Moreover, the Commission intends to adopt, before the European Council, an action programme whose objective is to enforce certain principles as regards the free circulation of workers, conditions of employment and remuneration, working hours, worker participation, equality of the sexes, and the protection of children and the handicapped.

8. *Important recent developments in environmental policy*

In response to the phenomenon of global warming and the destruction of the ozone layer, the Council of Environment Ministers adopted (on 8 and 9 June 1989) a resolution on the 'greenhouse' effect, confirming the Community's willingness to contribute to an international agreement on dealing with climatic changes. The Council also agreed to Community participation in the revision of the Montreal protocol on chlorofluorocarbons (CFCs) and committed the Community to reducing the production and consumption of CFCs to 85 % of their present level as quickly as possible, and to eliminate their production and consumption entirely by the end of the century.

The Council has also agreed to stricter controls regarding the quality of exhaust emissions from small cars (with a capacity less than 1,4 litres). These controls will apply to new models from 1 July 1992 and for all new cars from 1 January 1993. Equivalent requirements will be proposed for medium-sized and large cars.

The Council is now considering a number of other Commission proposals:

(i) proposal for a Directive on liability for damage caused by waste (COM(89) 282);

(ii) the proposal for a European Environmental Agency (COM(89) 303);

(iii) the Community strategy for the conservation of the tropical forests (COM(89) 410).

6. The EMS and monetary policies

The EMS: policy convergence has strengthened stability

It is more than two and a half years since the last EMS realignment, the longest period of stability since the inception of the EMS in 1979. A further currency, the Spanish peseta, entered the exchange rate mechanism in June 1989, though with a wide band (± 6 %) for the time being. Although there have been occasional minor tensions in the system (for example, during the autumn of 1988) these have been countered in an effective and timely way by adjustments in monetary and other economic policies. In the spirit of the Basle/Nyborg agreements of September 1987, currencies have been allowed to fluctuate within their intervention limits to a greater extent than in the past. Tensions, when they have arisen, have been dealt with by adjusting interest rate differentials appropriately (which has often involved interest-rate moves for both strong and weak currencies), without resorting to extended periods of intramarginal interventions. Further steps in capital liberalization and continuing financial innovation have been accompanied by increasing confidence in the present parity grid. In its more than 10 years of existence, the EMS has helped create an area of monetary stability in Europe that has in turn promoted further economic integration.

The stability of the EMS in recent years owes much to the convergence of economic developments already achieved (see Chapter 3). In turn, this convergence of performance reflects the convergence of monetary policies among the ERM countries evident since 1983 or thereabouts. Thus to a significant extent, the EMS has been self-stabilizing, and the present degree of stability in the system is the reward of participating States' firm commitment to it. In addition, the Basle/Nyborg agreements have proved to be a valuable systemic improvement, guarding the system from speculative pressures unrelated to fundamentals. Further, the increased integration of capital markets worldwide, combined with ongoing financial innovation, has expanded the possibilities for financing current account movements without creating exchange-market disturbances.

As well as reaping the benefit of systemic improvements, EMS stability has been helped, at least so far, by the impact of the internal market programme. Anticipation of its effects (combined with capital liberalization that is leading to a more economically efficient allocation of resources) has had a powerful effect on supply-side expectations in some participating countries, notably Italy and Spain, leading to strong growth of domestic demand and to substantial capital inflows in such countries. Finally, the dollar has been strong since the beginning of 1988. The strength of this factor — traditionally favourable for EMS stability — has no doubt recently been reduced somewhat by the better integration and greater deregulation of financial markets within the Community, but probably retains some importance.

These conjunctural factors, however, while contributing to EMS stability, have had as their counterpart the accentuated current account imbalances within the Community referred to in Chapter 3. The imbalances have presented no financing problems and to a substantial degree represent an optimal allocation of financial resources to the countries where prospective returns on capital have been perceived to be highest and where in consequence the investment-led boom has outstripped current supply.

In the longer term, however, demand growth will tend to slow down in the countries that are currently growing fastest, supply capacity will respond to the strength of investment and current account imbalances will begin to narrow. Within the EMS, monetary policy will not be able to cope alone with significantly changing degrees of balance between supply and demand in some Member States. Maintaining EMS stability — while at the same time fostering convergence of productivity levels and living standards — will require improved convergence of policies and performance, especially in respect of public finance and domestic costs. Without this, the convergence of monetary policies which is the proximate determinant of EMS stability cannot be guaranteed.

The monetary aggregates: growth still strong

After the summer of 1988, fears of a possible financial crisis as a consequence of the October 1987 crash gave way to greater concern about accelerating inflationary pressures. Money and credit market conditions tightened, although money growth has in general remained rapid if decelerating, and interest rates began to increase. In spite of some moderation in late 1988, money and credit aggregates continued to overshoot targets in most EC countries during the first quarter of 1989. This rapid monetary growth was mainly fuelled by the strong expansion of credit to the private sector (especially in Spain, Italy, Portugal and the United Kingdom) supported by domestic demand. In some countries — Germany, Denmark and Spain — the rapid monetary growth also resulted from shifts, determined by yield and tax considerations, in money demand towards more liquid assets. During the early summer of 1989, after several rounds of monetary tightening, some deceleration took place in Germany and the United Kingdom and money growth there came more in line with targets. But there are indications of a reacceleration in these countries in the latest figures. In contrast, France represents the main exception where the monetary aggregate has fluctuated within the limits of the target range.

Table 6.1

Monetary and credit targets

(% increase)

		1988		1989	
		Target	Outcome (annual rate)	Target	Outcome (annual rate)
D:	M3	3- 6	6,9	±5	5,3 (Aug.)
F:	M2	4- 6	3,9	4 - 6	3,3 (July)
E:	ALP	8-11	11,1	6,5- 9,5	14,6 (Aug.)
I:	PSCE[1]	6-10	15,7	7 -10	14,7 (July)
	M2	6- 9	8,5	6 - 9	9,7 (July)
UK:	MO	1- 5[2]	8,5 (Dec.)	1 - 5[2]	6,0 (Aug.)

1 Domestic credit to the private sector.
2 Fiscal year, not seasonally adjusted.

The stance of monetary policy: higher short-term rates but flatter yield curves

Partly in response to strong growth in the monetary aggregates, short-term rates have risen since last summer in all member countries. During the period under review, four rounds of interest rate increases — in January, April, June and October — took place, led by the Bundesbank. The key discount and Lombard rates in Germany were raised in several steps from their historically low levels of 2,5 % and 4,5 % respectively last summer to 6 % and 8 % in October 1989 as a result of above-target money stock growth, a deterioration in the domestic price climate and concern about the DM exchange rate. Within the ERM group, these moves in official rates were followed closely in the Netherlands, where the authorities were concerned about fast rates of money growth. In some other ERM countries, however, the first two of these moves in official rates were followed only partly or with a lag or were not fully reflected in market rates. In the first half of the period under review, for instance, market interest-rate differentials *vis-à-vis* German rates fell quite sharply in Belgium and France. Markets were increasingly impressed by the authorities' commitment to the hard-currency option within the EMS evidenced in concrete terms by a close convergence of inflation rates with Germany. In the case of France, confidence in the parity improved to such an extent that the French authorities could abstain from following the rise in German official rates in April 1989. The June increase in German rates was, however, followed in France, and short-term interest rate differentials have stabilized, as the French authorities shared German concern that the pace of activity was producing a potential risk of inflationary pressure. Similarly, the October increase was followed by all narrow-band participants and by the United Kingdom.

In Italy, Spain and Ireland, short-term rates have risen steadily during the period under review. Monetary policy in Italy and Spain has had to reconcile exchange rate stability and the control of the monetary aggregates in the face of greater-than-expected growth of credit to the private sector and strong foreign capital inflows. The authorities took a more restrictive monetary stance during most of the period, introducing measures to discourage capital inflows and allowing some appreciation of their currencies. However, these two countries did not follow the October round of interest-rate increases, thereby accepting some depreciation of their currencies within the wide bands. In Ireland, short-term rates have risen by about 200 basis points in one year, reflecting the authorities' determination to restore differentials and their concern about a rapid expansion in private sector credit.

In the United Kingdom, short-term rates rose from 10,5 % to about 15 % between July 1988 and October 1989 as the authorities attempted to slow down an economy which had clearly been overheating and in which inflation was accelerating. During most of this year, the exchange-rate effect of interest rates has been accompanied by an exchange rate under some downward pressure after the pound had risen sharply between early 1988 and early 1989.

Monetary policy in Portugal was tightened in the first half of 1989 to combat inflationary pressure. The measures included a rise in the official discount rate and a significant increase in banks' reserve requirements.

These generalized increases in short-term interest rates have not been fully reflected in long-term yields: indeed the response of long yields has been very muted, and yield curves have flattened. The yield curve is strongly inverted in the United Kingdom and Spain, countries where monetary policy has had to react particularly severely in the face of obvious overheating. It has also become inverted in Ireland, where the bond market has benefited from a major budgetary adjustment and, at least in the earlier part of the period, from the strength of sterling. The curve is almost completely flat in most of the other Member States with significant bond markets, with the exception of Italy, where the threat of potential public debt unsustainability continues to impose some risk premium on long rates. Even in Italy, however, the curve is now significantly flatter than a year ago.

Table 6.2

Nominal short-term interest rates

(Monthly averages)

	B	DK	D	GR	E	F	IRL	I	NL	P	UK	EC
September 1988	7,35	7,81	4,96	11,30	11,14	7,99	7,76	11,51	5,63	12,91	12,15	9,06
December 1988	7,50	7,96	5,33	20,86	13,51	8,47	8,17	12,22	5,70	12,50	13,14	9,93
March 1989	8,20	8,00	6,62	19,72	15,12	9,16	8,25	13,12	6,98	12,49	13,05	10,71
June 1989	8,50	9,04	6,96	21,00	14,88	9,00	9,38	12,60	7,22	10,00	14,16	10,86
August 1989	8,50	9,13	7,02	18,70	15,31	9,10	10,15	12,77	7,25	12,90	13,86	10,78
September 1989	8,58	—	7,21	—	15,05	9,28	10,47	12,65	7,56	—	14,01	—

Table 6.3

Nominal short-term interest differentials *vis-à-vis* Germany

(Monthly averages)

	B	DK	GR	E	F	IRL	I	NL	P	UK
September 1988	2,39	2,85	6,34	6,18	3,03	2,80	6,55	0,67	7,95	7,19
December 1988	2,17	2,63	15,57	8,18	3,14	2,84	6,89	0,37	7,17	7,81
March 1989	1,58	1,38	13,10	8,50	2,54	1,63	6,50	0,36	5,87	6,43
June 1989	1,54	2,08	14,04	7,92	2,04	2,42	5,64	0,26	3,04	7,20
August 1989	1,48	2,11	—	8,29	2,08	3,13	5,75	0,23	5,88	6,84
September 1989	1,37	—	—	7,86	2,06	3,26	5,44	0,35	—	6,80

While this picture of flat or inverted yield curves is generally reassuring with respect to longer-term inflationary expectations, there has none the less been some — though far from dramatic — rise in nominal long-term interest rates in Germany and the Netherlands in the past year. Since there are no obviously compelling reasons for thinking that expected real long-term rates have increased over this period, at least in Germany, the suspicion must be that inflationary expectations have increased there somewhat despite the monetary policy tightening.

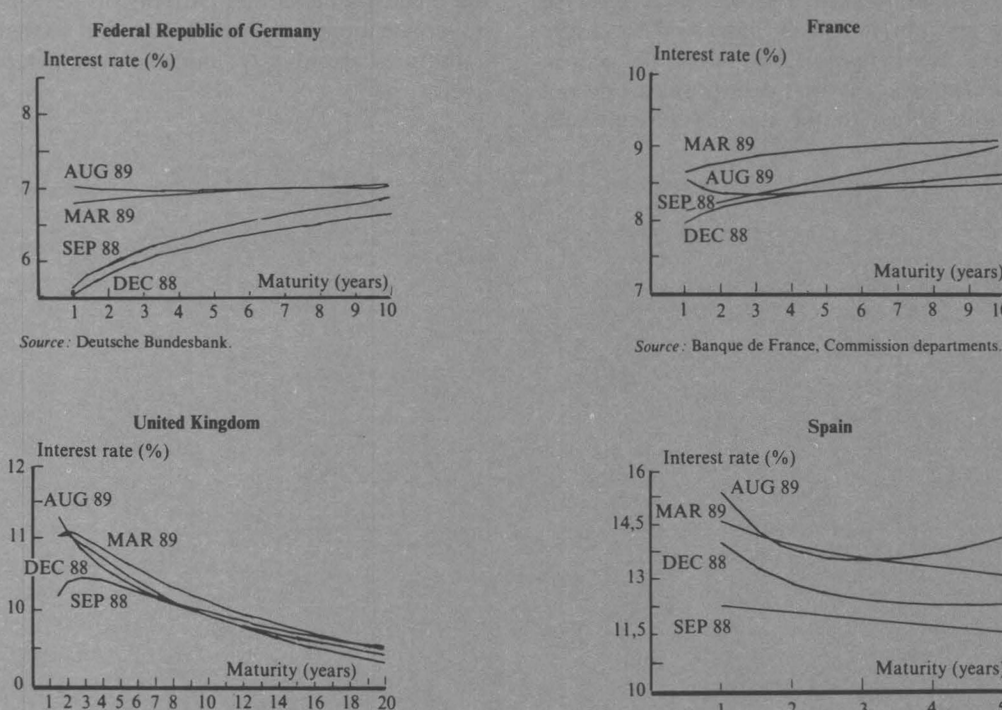
All in all, indicators such as the general strength of activity, above-target growth of the monetary aggregates in many countries and the evident acceleration in price increases, suggest that a tightening of monetary policy — including that in October — in the Community was necessary. The sharp increases in short-term rates and the movement of the yield curve suggest that the monetary policy response has been vigorous and — in many countries — probably successful in restraining, but not yet reducing, long-term inflation expectations.

Stage one of EMU: implications for monetary policy

Stage one of economic and monetary union in the Community will be marked by the total liberalization of capital movements. Furthermore, it would be important that all Member States participate in the narrow band of the EMS exchange-rate mechanism. Stage one will also coincide with the implementation and operation of the unified internal market, including the market in financial services, of the Community. These three phenomena will have important implications for monetary policy management.

Capital liberalization has already made very substantial progress and will be completed — for those major countries that have not totally abolished restrictions already — by July 1990. The impact of the liberalization that has already taken place can be seen in the convergence of deflated long-term interest rates among the original ERM participants as

GRAPH 6.1: **Yield curves in major markets**



Source: Deutsche Bundesbank.

Source: Banque de France, Commission departments.

Source: Bank of England, Commission departments.

Source: Commission departments.

restrictions on capital movements have been progressively relaxed in countries such as France, Italy and Ireland. The presumed underlying rationale for capital restrictions was the manipulation of real interest rates in an attempt to offset, at least temporarily, the impact on the economy of a lack of budgetary or wage adjustment. With this option, to the extent that it was ever a real one, no longer available, governments will be subject to greater pressure to remedy budgetary and labour market distortions. As long as governments react positively to this pressure, the effect of capital liberalization in improving the allocation of resources will be considerably reinforced.

The inflationary and current account impact of certain monetary consequences of disturbances within the EMS will be considerably reduced in the absence of capital controls. Under a regime of capital controls, an excessive expansion of domestic credit will tend initially to produce a faster growth of money supply, an increase in spending and a higher rate of inflation. It may take some considerable time before the increase in spending is reflected in a current account deterioration that ultimately brings the money supply back to its original level. Without capital controls the excessive monetary expansion immediately provokes capital outflows that prevent any significant impact on the money supply, spending, inflation and the current account. In other words, if domestic credit expansion becomes excessive, the monetary authorities receive immediate signals in the form of pressure on the external reserves and can react far more quickly. Again, however, there is a proviso: financial markets must be sufficiently developed to allow the monetary authorities to operate policy without creating unnecessary distortions in the interest-rate structure. Deregulating and encouraging the development of domestic financial markets is thus the counterpart of liberalizing external capital flows, as member governments have not failed to recognize.

In this context, there must first be agreement that the objective of price stability is a prerequisite for the attainment of other desirable economic aims. Further, there must be agreement on the appropriate policy mix. And to ensure that the right policy mix is feasible, the public finances in must be managed in such a way that debt problems do not constitute a potential threat to the stability objective. In addition, the development of financial market structures must proceed so that in all the Member States changes in the financing needs and patterns of the various sectors do not create monetary disturbances and so that the monetary authorities are able to implement monetary policy effectively.

7. Budgetary policies

Significant progress has been achieved since the middle of the decade in consolidating public finances in the Community. There are fears, however, that the movement is tending to weaken. On the basis of the current forecasts, which take into account the measures which have so far been announced, the net borrowing requirement of general government, after falling from 5,2 % to 3,6 % of GDP between 1985 and 1988, is only expected to fall slightly in 1989 and to stabilize at around 3 % of GDP in 1990. Government saving is only expected to be marginally positive in 1989 (0,5 % of GDP) and in 1990 (0,4 %). Gross public debt as a percentage of GDP is only expected to fall slowly. Above all very significant disparities are expected to remain between the budgetary consolidation programmes of member countries.

A better contribution of budgetary policies to Community objectives

These insufficiencies are all the more regrettable now that budgetary policies will have to play a greater role in two principal directions in the coming years:

(i) The contribution of budgetary policies to the creation of conditions which are favourable to strong and sustainable growth will have to continue and in several Member States be significantly strengthened. This orientation is particularly needed in the less prosperous countries in order to permit further progress towards greater economic and social cohesion and to derive all the gains from the support given to this end by the Community. In these countries, supplementary resources will have to be released in order to comply with the additionality rule governing the structural Funds. More generally, over and above the Community measures concerning the approximation of fiscal systems, the completion of the internal market, by increasing competition among the member countries, will impose additional constraints on national public finances. In several countries, measures to adapt the fiscal system have already been taken to prepare for this deadline.

(ii) Budgetary policies will have to provide a more important support to monetary policies in the pursuit of the stability objective and of greater convergence, essential prerequisites for sound and harmonious growth in the Community and for the success of the first stage towards economic and monetary union. In those countries where budget deficits remain very high, the exclusive recourse to monetary policy to achieve this stability objective risks crowding out private investment and, eventually, causing slower growth and employment. On the other hand, the slowdown of inflation obtained in this way is likely to lead, through an increase in interest charges and lower growth, to an unsustainable evolution of public finances.

In order for these objectives to be realized, a certain consensus has now been established in the Community on the necessity to pursue medium-term budgetary policies based on sound financial management principles. A better coordination of budgetary policies does not mean a systematic convergence towards a Community average; it implies, on the contrary, taking into account the specific situation of each Member State (for instance, the level of national saving, the external balance position, the need to curb inflation), their structural differences and the uneven results achieved so far in the consolidation of public finances.

Table 7.1

Principal budgetary trends in the Community[1]

	1980	1985	1988	1989	1990	Change 1988/1985	Change 1990/1988
Gross saving	0,3	−1,2	−0,2	0,5	0,4	+1,0	+0,6
Net borrowing/lending	−3,8	−5,2	−3,6	−2,9	−2,9	+1,6	+0,7
Expenditure	45,1	49,0	47,0	46,3	45,8	−2,0	−1,2
Receipts	41,3	43,8	43,4	43,4	42,9	−0,4	−0,5
Gross public debt	41,1	56,8	59,1	58,3	57,7	+2,3	−1,4

[1] EC, general government, % of GDP.

The implementation of these principles has, in addition, to be complemented by an assessment of the possible contribution of budgetary policy, according to the specific situation of each country and the broader framework of the general economic policy-mix, to preventing or reducing fundamental disequilibria which eventually lead to exchange-rate adjustments. Such an assessment will also have to be seen in a medium-term rather than a 'fine-tuning' perspective. Periodic multilateral surveillance, based on both horizontal and country-by-country examinations, in the course of the first stage of EMU, should allow the criteria and methods of strengthened coordination in this field to be progressively refined.

With respect to sound medium-term management of public finances, the consensus which is tending to be established in the Community rests on four guiding principles.

Avoiding monetary financing of deficits

Respecting this principle involves giving the monetary authorities the necessary autonomy in the pursuit of the stability objective. This at least should signify that:

(i) the budgetary authorities should not have automatic access to credit from the central bank, unless it is for cash advances of limited amounts and repayable within a very short period of time. Currently the exchequer benefits from an automatic credit line in only four countries — Belgium, Greece, Spain and Italy — and even then subject to fixed ceilings either in absolute values, as is the case of Belgium, or, in the three other Member States, as a percentage of the public expenditure of the current year;

(ii) there should be no obligation on banks to invest in government paper. The banking system is still subject to such an obligation in four member countries (Greece, Spain, Ireland and Portugal).

It is necessary that in the countries concerned the borrowing conditions for the State should be progressively aligned with market conditions; this process should accompany the development and decompartmentalization of the national monetary and financial systems which in any case is being made necessary by greater exposure to the outside world.

Reducing budgetary disequilibria

The development of budget balances in the medium term should be kept within the limits so as to control the debt/GDP ratio or even to reduce it where it is highest while at the same time aiming at a downward convergence of inflation rates. In any event, public finances should not be the original cause of an absorption of private saving by the financing of current expenditure. On these points, despite a sharp improvement at Community level, the favourable impact of the more sustained growth of recent years has been very unevenly used for reducing budgetary imbalances and the disparities are even widening between two groups of member countries.

In the first group of countries, the budgetary situation can be regarded as consolidated. In three of the countries of this group (Denmark, Luxembourg and the United Kingdom) the general government budgets are in surplus and the debt ratio is falling sharply. In these countries, the mechanical effects of the recovery in economic growth are being fully utilized to improve the budget balances. In this same group, the budget deficits in Germany, France and Spain should remain moderate, permitting an almost stable debt/GDP ratio. In addition to a reduction in the budget deficit, the favourable impact of the uptake in activity in these three countries has been beneficially used to reduce receipts in the case of France, and particularly in Germany, and to strengthen public investment expenditure in the case of Spain.

In this first group of countries, general government saving will reach 2,5 % of their GDP in 1989 and 1990 which is equivalent to 8 % of the Community's gross saving. The contribution which the public finances of these countries will make to savings in the Community is still significantly below where it was at the beginning of the 1970s (5 % of their GDP and 15 % of total Community saving on average over the period 1970-73).

In the second group of Member States — Belgium, Ireland, the Netherlands, Portugal and especially Greece and Italy — budget deficits remain at very high levels. Public saving in these countries is expected to continue to be significantly negative in 1990 (more than 5 % of their GDP on average, or more than 7 % of total Community saving). Important efforts were made in most of these countries, and in particular in Ireland, between 1985 and 1988 to reduce the budget deficits over and above the effects directly resulting from economic growth. However, the maintenance of a favourable economic environment will in the majority of these countries not result, according to forecasts, in an equivalent improvement of actual budget balances in 1989 and 1990. The budgetary balances should even slightly deteriorate on average. In these conditions, the ratio of public debt to GDP should continue to increase with the exception of Ireland and Belgium. In particular, the primary balance (net government lending/borrowing requirement excluding interest payments)

GRAPH 7.1: **Trends in gross public debt (as % of GDP)**

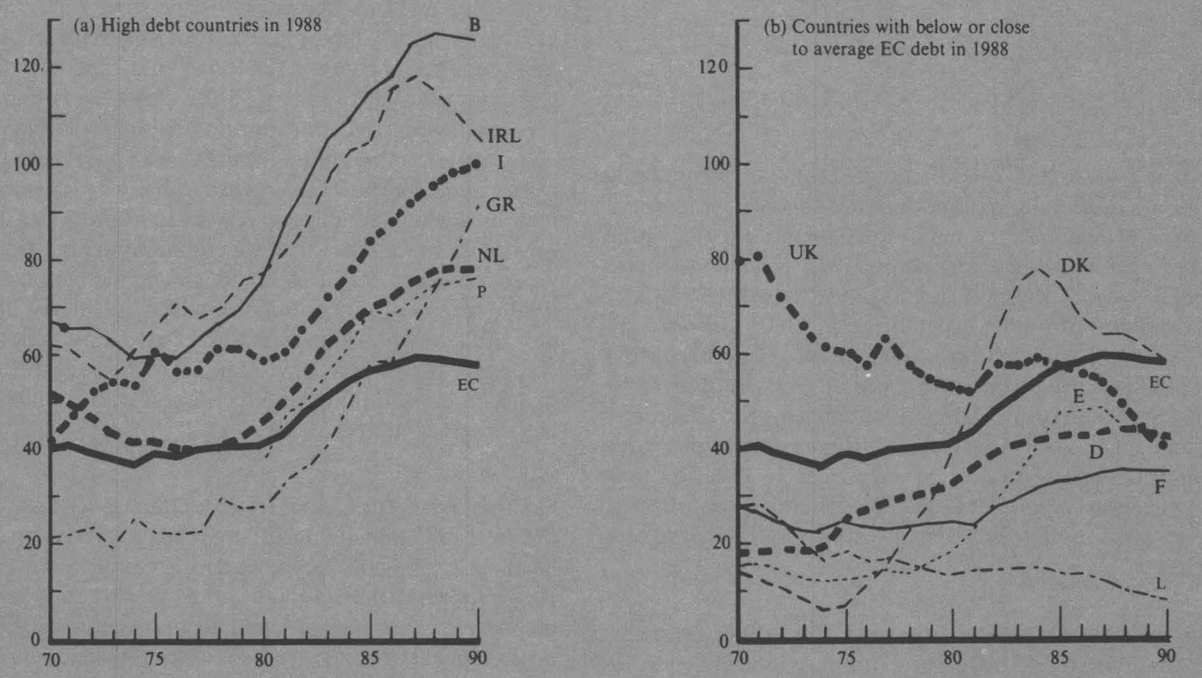


Table 7.2

Changes in budget balances[1] and the mechanical impact[2] of the changes in economic activity

(% of GDP)

	Cumulative changes over each period			
	1985-88		1988-90	
	Actual balance	Impact of economic activity	Actual balance	Impact of economic activity
Community	+1,6	+1,9	+0,7	+1,5
Countries with a budget surplus[3]	+3,4	+2,9	+0,3	+0,3
Countries with a budget deficit below or close to the Community average[4]	+0,8	+1,9	+1,0	+2,0
Countries with a budget deficit above the Community average[5]	+1,7	+1,3	−0,5	+1,4

1 A + sign signifies an increase in the surplus or a fall in the deficit.
2 Estimates of the net incidence on receipts and expenditure of the change in economic activity in comparison with its medium-term trend.
3 Denmark, Luxembourg, United Kingdom.
4 Germany, France, Spain.
5 Belgium, Greece, Ireland, Italy, Netherlands, Portugal.

in Italy and Greece is expected to deviate by 6 to 7 percentage points of GDP from the level necessary to stabilize the debt/GDP ratio on the basis of current interest rates and nominal growth projected in the medium term.

Controlling the share of public finances in GDP

Even if the share and role of the government in economic activity are essentially national political choices, it is in the interest of Member States and of the Community as a whole to guard against the negative effects of an excessive increase in public expenditure and direct taxes. Between 1970 and 1985 the share of public expenditure in GDP increased by 14 percentage points, following an increase of 6 points during the 1960s. This expansion introduced an element of growing rigidity into the resource allocation mechanism. The corresponding increase in direct taxes heightened the pressures on wage costs and prices; as subsequently inflation was progressively contained, this development adversely affected company profitability and thus investment, growth and employment.

It was possible to reverse the trend from 1985 onwards. From that date to 1988 the reduction in public expenditure (2 percentage points of GDP on average in the Community) was sufficient to allow a simultaneous significant reduction in budget deficits and a slight fall in the share of receipts in several Member States (Belgium, Germany, France, Luxembourg, the Netherlands and United Kingdom). Even though, according to forecasts, there should be a slow-down in the reduction of deficits between now and 1990, the tendency for government receipts to fall as a proportion of GDP should increase and affect almost all Member States.

Improving supply conditions by restructuring public receipts and expenditure

It is important that the budgetary authorities, within the limits imposed by the demands of consolidating public finances, should proceed to a restructuring of expenditure and receipts to enable economic productivity and growth to be strengthened. These adjustments are generally carried out across a diverse set of particular measures which affect the economy mainly at the microeconomic level, the budgetary implications of which are difficult to measure at the level of the broad expenditure and receipts categories.

When looking at the broad budgetary aggregates one nevertheless observes that on the receipts side many differences remain between Member States in the share and particularly the structure of taxes and social security charges. In 1988, the share of public receipts in GDP in the Community ranged from a minimum of 35,8 % in Portugal to a maximum of more than 60 % in Denmark. At the same time, the largest gap between the Community countries in the level of indirect taxes as a proportion of GDP was in a ratio of 1 to 2; this gap attained a ratio of 1 to 5 for direct taxes and 1 to 10 for social security contributions. It is probable that the completion of the internal market will, by right, gradually result in a certain convergence, following harmonization measures which are directly related to it, or in fact following greater competition between fiscal systems. In general, greater balance ought to be sought, as far as possible, between taxes and contributions which adversely affect the cost of factors of production (direct taxes and social security contributions), which have seen a rapid increase, and those based on consumption (indirect taxes) whose share in GDP has remained almost stable.

On the expenditure side, its reduction as a share of GDP between 1985 and 1990 will have been achieved by a decline in all categories of expenditure, including interest charges. It is important that in maintaining this trend, training and reconversion programmes and economically profitable public investment are preserved, even strengthened, in particular in those countries engaged in the catching-up process where the co-financing of the Community's structural programmes must be ensured.

Implications for the Member States

Because of the disparities in the current positions of Member States, the implementation of these guidelines would demand different efforts from the different Member States.

In Greece and Italy, the lack to date of a significant improvement in the position of the public finances makes the resolute application of a consolidation programme very urgent. In the absence of a rapid reduction in the public finance imbalances, the maintenance or uptake in growth in these countries will be seriously compromised, as will the search for more stability and greater cohesion in the Community.

In a second group of countries — Belgium, Ireland and Portugal — significant progress has already been made in improving the public finances and the favourable economic environment should be used to complete the actions already undertaken.

Table 7.3

General government receipts in the Community

(% of GDP)

	1970[1]	1985	1988	1990
Indirect taxes	13,1	12,9	13,2	13,2
Direct taxes	9,4	12,3	12,3	12,2
Social security contributions	10,2	14,6	14,5	14,2
Current transfers	3,0	4,0	3,4	3,3
Total	35,6	43,8	43,4	42,9

1 Excluding Portugal.

Table 7.4

General government expenditure in the Community

(% of GDP)

	1970[1]	1985	1988	1990
Current transfers	14,6	21,4	20,6	20,0
• to enterprises	1,7	2,5	2,1	1,9
• to households	12,4	17,7	17,2	16,9
• to the rest of the world	0,5	1,2	1,3	1,2
Interest payments	1,9	5,0	4,7	4,8
Public consumption	14,3	18,6	18,2	17,7
Fixed capital formation	4,0	2,9	2,6	2,7
Net capital transfers	0,8	1,1	0,7	0,6
Total	35,5	49,0	47,0	45,8

1 Excluding Greece and Portugal.

In the other Member States, even if a sustainable budgetary position has been once again achieved, the room for manoeuvre in this area remains constrained in most of them by an external position which is in deficit (United Kingdom and Denmark), or fragile (France and Spain). The growth in public debt in the Netherlands, even though it is slowing down, could become worrying in the medium term. In Germany the significant room for manoeuvre will be used to pursue the tax reform programme.

Conclusions

The prospects for the forthcoming decade are good. The policies which have been pursued since the beginning of the 1980s have allowed the fundamental factors for sound and employment-creating growth to improve significantly. The completion of the internal market, the catching-up process of the less favoured regions and countries, the liberalization of capital movements and the necessary advancement towards economic and monetary union will be the source of new progress and still greater dynamism. They, simultaneously, pose a challenge to firms, governments and central banks who, in a situation involving greater competition, must adapt their behaviour and policies to this new frame of reference.

In order to gain the full benefits from these achievements and opportunities, economic policy efforts need to be pursued in two principal directions:

(i) To further improve the fundamental determinants of growth in the medium term. This is necessary so that all Community countries regain a high level of employment. It is particularly necessary in those countries which need to catch up and will be first to benefit from the structural Funds.

(ii) To further improve the convergence towards monetary stability and the compatibility of macroeconomic performances with sustained and balanced growth. This is necessary so that the recovery of the last seven years does not founder on a resurgence of inflation or unsustainable external or budgetary imbalances. Furthermore, greater convergence is necessary to achieve greater stability of exchange rates which is also a condition for successful completion of the first stage of the EMU.

Three principles for better coordination

The economic policy challenges facing the Community require determined action from individual Member States and more effective coordination between them. Coordination of economic policies within the Community has never been an easy task and has not been very successful in the past. Since the early 1980s, however, progress has been made in this area as well and coordination has become much more effective. At the outset of the first stage of economic and monetary union the Community must strengthen it further, drawing on the experience accumulated over the years.

Better coordination should rest on three principles:

(i) consensus on the way to attain the common economic policy objectives;

(ii) subsidiarity;

(iii) learning-by-doing, in a dynamic process.

Consensus on the way to attain the common economic policy objectives

In the industrialized countries, the unsatisfactory experience of the 1970s led in the 1980s to a reorientation of the prevailing economic policy approach towards a greater awareness of the importance of stability and supply conditions. In the Community this trend has been accompanied by a growing recognition of the importance of policy interdependence and the development of a practice of looking for common answers to common problems. Years of cooperation have led to a broad consensus between Member States on the fundamental economic policy approach.

The setting up of the EMS represented a quantum leap in this process. The economic policy discussions which went with the relatively frequent realignments of the beginning of the 1980s have been important steps in the development of a common approach to economic policy problems. The progressive implementation of the internal market project, with the additional constraints that greater integration and stronger interdependence bring, has also marked an important step in this direction. Since 1985, the Commission, especially in the Annual Economic Reports, has played a more active role in trying to consolidate and develop this consensus not only between Member States, but also with and between the Social Partners.

Member States agree now not only on the main objectives of economic policy indicated in the Treaty such as growth, stability and a high level of employment, but they also share, to a large extent, a common view on how best to attain them. They agree on the objective of job-creating and non-inflationary growth with stability; on the framing of policy in the medium term; and on the need to accompany good macroeconomic management with structural reforms, taking into consideration the economic and social cohesion in the Community. On several occasions, since 1986, the Social Partners have expressed, in the framework of the social dialogue at Community level, their agreement on the basic principles of economic policy defined in the Annual Economic Reports.[1]

[1] In particular, joint opinion on the Annual Economic Report 1986-87 of 6 November 1986 and joint opinion on the Annual Economic Report 1987-88 of 26 November 1987, published in *European Economy*, No 30 and No 34.

During the 1980s, progress has been made in this direction throughout the Community, but with different degrees of success. The differences reflect the diversity in the starting points, the specific social situations and the different degrees of commitment to the achievement of this goal.

The success of the first stage of EMU will depend to a large extent on the consolidation and development of this consensus. This is a necessary, but insufficient condition; other principles are required.

Subsidiarity and mutual engagements

The principle that the Community should only seek to act where a national government cannot be expected to do so satisfactorily is already widely reflected in areas of internal market and microeconomic policies. It should also be applied to the macroeconomic area as the Community progresses towards economic and monetary union.

The creation of the internal market is increasing the economic interdependence between the Member States and progressively reducing the scope for independent policy action. The liberalization of capital movements and the approximation of indirect taxes, to mention just two of the internal market measures, will exert a profound influence on policy-making at the national level. In fact, there are already signs that individual governments are responding to these influences or anticipating them by voluntarily taking steps in the direction of the common objectives.

It is sometimes argued that these independent steps taken under market pressure are all that is needed to ensure that Member States and the Community as a whole achieve the common goals. Yet, experience shows that the effectiveness of these responses varies widely and insufficient and/or belated adjustment can be costly. A self-enforced policy coordination based on mutual engagements ensures the attainment of common goals more rapidly at lower adjustment costs. In the first stage of economic and monetary union, an equilibrium, which cannot be defined *a priori*, will have to be sought in a pragmatic way between market-enforced adjustment and voluntary coordination.

Learning-by-doing in a dynamic process

Over the last decade the Community has accumulated a rich experience in dealing with economic policy problems. It can now draw on it to define the actual policies to be implemented and to develop further a common approach. Three examples will give a more concrete idea of the scope of this experience.

Firstly, during the 1980s, the Community and the industrialized countries as a whole, have fought a hard disinflationary battle which has yielded remarkably positive results. The rate of inflation in the Community, in spite of a small acceleration over the last year, is now less than half of what it was in 1980.

The most impressive results have been reached in countries which had previously experienced very high rates of inflation rather than in countries such as Germany where a national consensus on the need to maintain price stability had existed for years. In France and Ireland, the present rates of inflation are between a quarter and a third of what they were at the beginning of the decade and are comparable to those recorded by the best performers.

This result has been obtained through a combination of:

(i) a broadly-based national consensus on the need to reduce inflation as part of the efforts aimed at improving growth conditions and eventually reduce unemployment which was at an extremely high level, and

(ii) a coordinated policy effort which has drawn on all instruments of policy: a stability-oriented monetary policy, a firm exchange rate (both countries have submitted themselves to the discipline of the narrow band of the exchange rate mechanism of the EMS), budgetary and wage developments consistent with the stability objective.

The experience of these countries now constitutes a useful precedent for the rest of the Member States.

Secondly, visible progress has also been made in the budgetary field. In the Community as a whole, the general government borrowing requirement is now half of what it was at the beginning of the 1980s. Three countries are even running a surplus and are therefore reducing the amount of outstanding public debt.

In this area, however, some Member States have until now found it difficult to draw on the experience of others and many worrying positions still persist. Progress in this area is objectively difficult. Budgetary consolidation, especially if starting from extremely deteriorated conditions, is a painful and politically difficult process. Failure to act does not result in immediately visible negative consequences, but rather permeates the whole economic system and results in a continuous deterioration of structural conditions. The temptation to delay action is difficult to resist. Besides, the external constraint represented by the exchange rate discipline takes more time to feed through. It is possible to counter with other means — in particular, with a very restrictive monetary policy — the negative effects of a lax budgetary policy for many years. This however takes its toll on investment and growth.

Reliance on totally independent policy action could be costly and policy coordination would bring welcome positive results. There are also Community-wide reasons for such coordination. Stability of exchange rates, which is a 'common good' for the Community, is eventually undermined by untenable budgetary positions. In addition, in an integrated financial system the financing of large budget deficits is not without influence on monetary conditions in other Member States.

Member States can especially draw on the experience of Ireland and Denmark where the budgetary positions were very precarious and where the burden of public debt represented a serious burden on economic policy. These countries have successfully managed to turn around their budgetary position in a relatively short period and without affecting growth. In Denmark, a general government borrowing requirement exceeding 9 % of GDP in 1982 was turned into a surplus equal to 3 % of GDP by 1986 while maintaining an average growth rate of more than 3 %. In Ireland, the general government borrowing requirement was reduced from 11 % of GDP in 1985-86 to around 4 % in 1988-89 while the rate of growth has progressively accelerated to reach over 5 % this year.

Thirdly, the large and growing imbalances in the external positions of Member States show that more effort has to go into the search for a better approach to this policy problem.

In this area, as in that of budgetary policy, other means — essentially monetary policy — can successfully offset the adverse effects of unsound cost, price and demand developments for many years before eventually giving way to exchange rate adjustments or policy adjustment. If adjustment is delayed, the structures of production adapt in reaction to incorrect signals and the eventual correction will be all the more painful.

Current account imbalances are often the result of medium-term processes which need several years to be corrected. The timely detection of worrying trends is not easy. By the time symptoms appear, the underlying trend has often acquired a momentum of its own that will be maintained long after the introduction of corrective action. The difficulty of agreeing on a current account balances pattern compatible with all Community objectives, including the strengthening of its cohesion, complicates the problem further.

For the success of the first stage of economic and monetary union, it will be necessary to inject a new spirit into Community macroeconomic coordination on the basis of the principles just outlined.

Part B — The national economies

Introduction

Most of the 12 national economies have recently experienced strong growth which should be maintained, albeit at a slightly slower pace, for the next year. The exceptions are Denmark, which is recovering only slowly from recession, and the United Kingdom, where overheating has necessitated restraints on growth.

Faster growth has assisted the efforts of the less-prosperous countries, particularly Portugal, to narrow the gap with the rest of the Community. For Greece and Portugal, however, further progress may be impeded by constraints arising from the high public debt, while in Spain some overheating is evident which may result in growth being curbed.

Strong growth is having positive effects on employment, especially in Germany, Spain and Portugal, and until recently in the United Kingdom. None the less, unemployment remains high in several countries, notably in Denmark, France and Italy, and above all in Spain and Ireland, reflecting the intractability of long-term unemployment.

Widespread wage restraint has helped to ensure that inflation has picked up only slightly in the wake of faster growth. Among the participants in the exchange-rate mechanism there is increasing convergence, though the average has risen. Elsewhere, however, the situation is less satisfactory.

Although almost everywhere increased investment has contributed importantly to growth, capacity constraints have emerged in several economies, particularly in Germany, Spain, France, Italy, the Netherlands and the United Kingdom. For some, the additional investment required may have a high import content, which can be expected to cause a deterioration in the external balance. By contrast, German exports of investment goods have expanded rapidly to meet the current booming demand in other Community countries. This is further contributing to Germany's excessively large external surplus, which gives ground for concern in the medium term, since the longer a correction is delayed the more severe will be the likely consequences.

An emerging constraint in several countries is the ageing of the population. This affects Germany, Spain, France and Luxembourg. Such demographic change carries substantial implications for welfare and health provision since it entails a combination of rapidly expanding expenditure and a declining number of contributors, as well as a shorter contribution period where education is being extended or retirement brought forward.

Demographic shifts account too for some of the structural differences among countries, for instance in saving and investment patterns. In this respect, increased financial integration of the Community may help by facilitating autonomous capital flows from countries with an ageing population and excess savings to faster-growing, less-industrialized economies.

Besides continuing efforts towards nominal and real convergence and overcoming medium-term constraints, national policy has to adapt to the changes resulting from capital liberalization, prepare for the greater competition in goods and factor markets that will result from the completion of the internal market in 1992, and embark on economic and monetary union. Both public authorities and private agents have begun to adjust to the developments of the coming years.

Complete capital mobility will remove the capacity to shelter domestic financial markets from external developments. In countries that participate in the EMS exchange-rate mechanism, monetary policy will have to take into account the objective of stabilizing the exchange rate. Since policymakers will no longer be able to pursue independent monetary policies, other policies will assume a greater role.

The importance of fiscal policy will increase for correcting imbalances in the medium term. In some countries, however, notably Belgium, Greece, Ireland, Italy, the Netherlands and Portugal, fiscal policy is constrained by a high public debt.

Tax reform is an area where, despite the substantial power of national authorities, the market is exerting significant pressure. Several governments have already taken steps to position their economies better for the single market, and further action is planned. Measures focus on alleviating the tax burden of firms to help them to become more competitive and bringing VAT and excise duties into line with those of other Member States.

The increased attention given to structural policy in recent years will expand further in view of the limits on some other policy instruments and the nature of the problems. The persistence of high unemployment in several countries, despite strong growth, and the pressure to improve competitiveness in advance of the completion of the internal market have renewed concern with the labour market. The problems of mismatch and long-term unemployment point to the need for improved training and other measures to increase geographical and occupational mobility.

A more detailed analysis of the current situation and recent policy measures in each of the 12 national economies is presented in the following sections.

Belgium

Domestic developments allow full participation in an expanding environment

The policies introduced since 1982 to restructure the economy have undoubtedly enabled Belgium to rejoin the group of mature EC countries with low inflation, a significant trade surplus, a stable exchange rate, high growth and falling unemployment.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,3	1,6	4,0	4,2	3,3
Total domestic demand (% change)	0,3	2,3	4,0	4,5	3,3
Employment (% change)	−0,8	0,7	1,4	1,1	0,6
Unemployment rate (%)	12,4	11,7	10,4	9,4	8,8
Inflation (%)	6,7	2,7	1,2	3,2	3,5
Balance of current account (% of GDP)	−1,5	1,2	1,0	0,8	0,8

The performance of the Belgian economy has exceeded expectations for the second consecutive year, with real GDP growth of 4,2 % likely this year. This development, although supported by a sound evolution of private consumption, has mainly been based on buoyant investment and expanding demand for exports and as such reflects the return of confidence. Furthermore, the buoyancy of demand has not led to inflationary pressures nor to excessive imports. Clearly, supply conditions have strongly improved to be able to respond to these changes in demand. Meanwhile, the expansion of output has led to a substantial reduction in unemployment, pushing the rate below the EC average. Prospects for 1990 remain very favourable from a domestic point of view, on the assumption that no fundamental changes occur in the dynamism of the international environment.

The present government has taken a number of important measures during the last year to consolidate these achievements. Among other things, the authorities and the social partners have reached a consensus with respect to the major policy objective of external equilibrium. If competitiveness relative to the country's main trading partners is threatened, the government can, after consultation, take effective measures to control domestic cost developments. An ambitious reform of personal income taxation has also been accomplished, whereby the government has reduced the tax wedge on labour income and has substantially eased the previously heavy taxation of the incomes of married couples.

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	16,8	17,1	18,9	20,3	20,8
• % change	−1,3	4,1	12,9	12,3	5,8
of which:					
Equipment (% change)	5,3	6,7	14,0	16,0	8,0
Construction (% change)	−5,9	2,4	12,0	9,0	3,8

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	6,9	9,1	7,6	7,5	7,0
Short-term interest rate	12,0	8,2	6,7	8,4	8,0
Long-term interest rate	12,4	8,8	7,9	8,5	8,5
Competitiveness [1]	73,4	77,3	79,1	78,2	78,7
Budget balance (% of GDP)	−10,4	−8,1	−6,5	−6,0	−5,7
Gross public debt (% of GDP)	103,1	119,9	127,5	126,6	126,0
Nominal wages per head (% change)	6,9	3,1	2,4	5,4	5,8
Real wages per head (% change)	0,2	0,3	1,2	2,1	2,2

[1] BLEU, 1980 = 100.

Inflation: consumer price deflator.
Money growth: broad money expansion (M2/M3).
Competitiveness: Nominal unit wage costs, manufacturing industry or branches relative to 19 industrial countries, double weighting of exports; 1980 = 100.
Budget balance: net borrowing of general government.
Gross public debt: general government.
Nominal wages: compensation per head.
Real wages: compensation per head deflated by consumer prices.

The public finance situation calls for greater efforts in the context of the single market

In the medium term, a major threat which might jeopardize future growth stems from the fiscal-policy stance. Although it is likely that the central government target deficit of 7 % of GNP for 1989 will be achieved, this can hardly be considered to be a very substantial reduction, particularly as a number of savings intended to bring the deficit down consisted of rescheduling operations and off-budget financing. With respect to fiscal policy for 1990 and beyond, the adherence of the Belgian authorities to their dual-target strategy, i.e. no increase in non-interest expenditure above the rate of inflation and no rise in the central government deficit in nominal terms, should be sufficient to stop the automatic increase in the public debt/GDP ratio caused by the continuing rapid expansion of interest payments. Of course, the recent devolution of powers to the autonomous regions and communities will have major implications for fiscal policy, since the dual-target strategy applies strictly to central government. Consequently, it is important to ensure that the process of fiscal consolidation — which should be assessed at general government level — is not hampered by this devolution process.

Fiscal consolidation is a necessary condition for Belgium to take full advantage of the benefits of the 1992 programme and the liberalization of financial markets. The completion of the internal market will constitute a new challenge for this small open economy, which already has a long tradition of non-restrictive external policies. The abolition of the dual-exchange market system, necessary to achieve unification of financial markets within the Community, will force domestic monetary and fiscal policies to become even more integrated with those of the other Member States. In this respect, a number of policy measures which have already been taken to meet this challenge are welcome. The central bank has been allowed the power to institute compulsory reserves for financial intermediaries; furthermore, a new system of central bank credits to financial institutions has been established, allowing an extension of the bank's sphere of influence to very short-term interest rates. Apart from this, the opening of frontiers in several sectors which up to now have been sheltered from competition implies an active restructuring policy in order to anticipate these developments. Policy action is particularly recommended in the financial sector, where markets and institutions should be reformed to bring their structure closer to those of other European financial centres, allowing them to compete after 1990. Furthermore, corporate taxation should be made more transparent to foreign investors by reducing the number of tax deductions and lowering marginal rates.

Nevertheless, assessment of the future performance of the domestic economy will largely depend on the evolution of unemployment. Despite the substantial reduction achieved in recent years, it cannot be denied that the absolute level of unemployment remains too high. An additional problem in this respect is the existence of an unsatisfied demand for skilled labour. This points to maladjustments in the labour supply and thus underlines the need for more readily available training opportunities. A more fundamental absorption of surplus labour will have to be generated through developments in the private sector, because of the very limited scope for action within the public sector.

Denmark

External situation steadily improving but unemployment remains high

After years of persistent external deficits resulting in mounting external debt and constraints on economic policy, the improvement of the current account was given the highest priority. The necessary adjustment process was assisted notably by a tight budgetary policy and, recently, by measures to curb private consumption. However, the development of international competitiveness was not sufficient to facilitate a rapid shift of resources from domestic sectors to export sectors. Therefore, output fell followed by a rise in unemployment.

Positive achievements in the process of macroeconomic convergence

In 1989, the Danish economy has begun to recover from one of its longest post-war recessions. The fall in domestic demand has bottomed out and the growth of exports has been high. Thus, real GDP should grow by some 1,6 % in 1989 compared with a minor fall in 1988. In 1990, the growth of GDP should accelerate slightly to a rate of about 2,0 %.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	3,3	2,2	−0,4	1,6	2,0
Total domestic demand (% change)	3,3	2,6	−2,2	0,7	1,1
Employment (% change)	0,8	1,9	−0,3	−0,6	0,5
Unemployment rate (%)	9,9	6,4	6,4	7,4	7,6
Inflation (%)	7,8	4,1	4,9	4,7	3,0
Balance of current account (% of GDP)	−3,3	−4,3	−1,8	−2,0	−1,1

In recent years, relatively sluggish domestic demand combined with strong growth in world trade has helped to narrow the current account deficit. Following substantial improvements in the past two years (a fall in the external deficit from 5,5 % of GDP in 1986 to 1,7 % in 1988) 1989 is seeing a minor set-back which is due to a deterioration in the terms of trade and a one-off decline in net exports of ships, prompted by the establishment of the Danish International Ship Register. The more fundamental underlying current account balance, however, is likely to remain on the positive trend path which it has followed during most of the 1980s, and in 1990 the current account deficit should narrow somewhat further.

In 1987, international competitiveness was seriously eroded by generous two-year wage settlements. Cost-reducing fiscal measures, which were adopted subsequently, compensated exporters to some extent. Thanks to recent wage moderation combined with a fall in the effective exchange rate, the pre-1987 level of international competitiveness has now been restored. Despite very buoyant world demand, however, overall economic growth has been too low to foster employment creation. The number of unemployed has risen for the second consecutive year.

The two-year wage settlement of 1989 provided for a significant slowdown in hourly wage increases. Hence, even though import prices soared from 1988 to 1989, inflation tapered off slightly and is now below the average for the Community. In 1990, import prices may rise only moderately and inflation could fall to 3 % — the lowest rate for decades.

Low gross capital formation and weak competitiveness

Although the narrowing of the current account deficit is encouraging, a shadow is cast by the fact that recently the main counterpart of this improvement has been a decline in private investment, notably during the period 1986 to 1988. Relative to GDP, gross capital formation has fallen steadily since the mid-1980s; it is now lower than for most other member countries. A two-handed strategy is needed in order to continue the external adjustment process while improving the capacity of the economy to pursue employment-creating growth. On the one hand, continued efforts are required to increase private saving while maintaining a high level of

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	16,4	19,5	18,0	17,9	17,8
• % change	7,2	7,4	−6,5	0,0	2,2
of which:					
Construction (% change)	3,0	8,2	−6,1	−3,0	1,5
Equipment (% change)	13,0	4,6	−7,0	4,0	3,0

public saving. On the other hand, incentives to invest, notably in the exporting sectors, should be strengthened. The latter may be impossible to achieve without an improvement in international competitiveness. A return to employment-creating growth, therefore, will require a fall in wage costs relative to competitors.

Room for demand management remains narrow—micro-policies are called for

While fiscal policy is assigned to the external balance, monetary policy is restricted by the ERM commitment. It is, therefore, necessary to rely on other policies to ensure a balanced adjustment of the economy.

A consequence of the ongoing process of international monetary and economic integration is that the labour market will increasingly bear the brunt of adjustments following adverse movements in international competitiveness. Policies designed to assist wage moderation, therefore, are more necessary than ever. Measures to ensure that the economic burden of unemployment is shared and more directly felt by the whole labour force are desirable. Greater flexibility in the utilization of the existing capital stock should also be considered.

Major plans for reform of the tax system have been launched in 1989. The idea is to broaden the tax base and to reduce the tax imposed on interest payments. Reductions in marginal tax rates and excise duties are also proposed. Although these measures are welcome and in line with other major international tax reforms, some words of caution are appropriate. Firstly, the overall stance of fiscal policy should not

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	18,1	9,4	2,0	4,1	4,3
Short-term interest rate	14,3	12,9	8,3	8,7	8,5
Long-term interest rate	16,3	11,3	10,6	10,0	9,5
Competitiveness (1980 = 100)	91,2	106,7	122,2	123,6	111,5
Budget balance (% of GDP)	−6,8	1,1	0,2	0,1	0,7
Gross public debt (% of GDP)	72,3	68,5	64,0	61,6	58,1
Nominal wages per head (% change)	10,5	5,0	4,3	3,6	3,3
Real wages per head (% change)	0,7	1,8	−0,6	−1,1	0,3
Hourly wage costs in industry (% change)	8,4	7,2	6,9	4,5	3,5

For definitions, see table for Belgium, p. 60.

be eased by the reform, since this might jeopardize the external adjustment process. Secondly, the measures should meet the requirements of the internal market, thus significantly reducing excise duties on a wide range of commodities. Within a neutral fiscal policy framework the room for lowering the tax burden on personal incomes may be limited, even though public expenditure is being reduced. Nevertheless, marginal tax rates should be lowered substantially in order to assist wage moderation and, at the same time, the tax base should be broadened.

Federal Republic of Germany

The recent upswing has been fuelled by a recovery of investment and exports

The German economy is booming as in the late 1970s. In 1988 and 1989, the seventh and eighth consecutive years of the recent upswing, the economy has moved onto a growth path of more than 3 %. Very buoyant investment in equipment, a strong recovery in construction investment and a favourable external trade performance dominate the growth pattern, with overall economic growth in 1989 likely to attain some 4 % (GDP). Next year will see a significant acceleration of private consumption too, fuelled by the third step of the 1986-90 tax reform. Meanwhile, the investment performance will moderate somewhat. The external balance will contribute less to growth due to the assumed slowdown of world demand. Nevertheless, GDP growth will once again exceed 3 %.

The excellent growth performance in Germany is, however, resulting in two imbalances: the German current account balance is exhibiting a rapidly increasing surplus of 5 to 6 % of GDP, not least as a result of the investment boom in Europe, and increasing demand pressure is leading to rising inflation rates.

Buoyant internal and external demand has brought about a significant improvement in employment. Employment creation is being assisted by very moderate wage demands on the part of the trade unions. Because of immigration, however, unemployment figures do not completely mirror the excellent employment performance.

Recent settlements indicate that wage moderation will continue, so that German export industry's competitiveness will not be threatened by labour costs. The recovery of international competitiveness, due to a real Deutschmark depreciation, has fuelled the widening external surplus. With rates of return abroad better than expected at home and in the absence of expectations of a Deutschmark revaluation, net long-term capital outflows rose to record levels in 1988, offsetting the current account surplus on the balance of payments. Since early 1989, the abolition of the coupon tax, the narrowing interest rate differentials *vis-à-vis* EMS and non-EMS currencies and an implied change in exchange rate expectations, particularly against the dollar, have led to a reversal of long-term capital flows.

Inflation picked up after 3 years of accommodating monetary policy, a jump in import prices and consumer tax increases. Monetary policy, therefore, was tightened between mid-1988 and mid-1989, mainly affecting short-term interest rates. Long-term interest rates have remained relatively stable, the consequent flattening of the yield-curve suggesting that monetary policy has so far succeeded in subduing inflation expectations. At the same time the expansion of M3 was brought down to 5 % compared to the fourth quarter of 1988, implying a slight reduction of the monetary overhang.

Tighter monetary policy was accompanied by a somewhat tighter fiscal policy. In 1990, however, reflecting the tax reform, fiscal policy will become quite expansionary and perhaps even procyclical. The change of the fiscal policy stance of the Federal Government mainly reflects the elections of 1990. This may have also affected the great reluctance to do away with sectoral subsidies.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,2	2,0	3,7	3,8	3,5
Total domestic demand (% change)	0,8	2,4	3,8	2,7	3,1
Employment (% change)	−1,0	0,8	0,6	1,4	1,3
Unemployment rate (%)	6,9	6,7	6,4	5,6	5,4
Inflation (%)	3,5	0,7	1,2	3,1	2,8
Balance of current account (% of GDP)	0,5	3,6	4,1	5,3	5,8

Table 2

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	5,7	5,8	6,9	5,1	4,9
Short-term interest rate	6,9	4,7	4,3	6,7	6,8
Long-term interest rate	8,2	6,1	6,1	7,0	7,0
Competitiveness (1980 = 100)	92,2	100,6	107,8	102,7	101,0
Nominal wages per head (% change)	3,8	3,3	3,1	3,1	3,4
Real wages per head (% change)	0,3	2,6	2,0	0,0	0,7

For definitions, see table for Belgium, p. 60.

As far as monetary policy is concerned, Germany remains the anchor of the EMS. In microeconomic areas, however, neither 1989 nor 1990 will record progress in the field of deregulation and subsidy reduction. On the contrary, with respect to the internal market programme, deregulation projects (e.g. in the transport sector) have come to a standstill.

Table 3

Public finance data

(% of GDP)

	1970	1980	1985	1988	1989	1990
Current receipts	38,9	45,4	46,4	44,5	45,1	43,6
Current expenditure	32,6	43,0	43,7	43,1	41,6	40,8
Gross fixed capital formation	4,6	3,6	2,4	2,4	2,3	2,3
Budget balance	−0,2	−2,9	−1,1	−2,1	0,0	−0,5
• Federal Government	−0,7	−1,7	−0,9	−1,7	−0,7	−0,8
Gross public debt	18,6	32,7	42,5	44,5	42,0	40,8
• Federal Government	8,0	15,7	21,4	22,5	22,5	22,8

Excessive external imbalances call for new measures

An excessive widening in the external imbalances *vis-à-vis* other Community countries is increasingly a problem in both the national and international context. The likely continuation of these imbalances will intensify pressure for a process of adjustment. The later this comes, the more painful it will be for the German economy. Recent exchange rates allow German enterprises to make high profits from exports, leading to an allocation of resources to export-oriented sectors. A late and consequently sharp change in relative prices would seriously reduce profitability in the export industries with significantly negative implications. This would lead, perhaps, to a strong cyclical slowdown, coinciding with a substantial deficit in the public sector and still quite high unemployment figures. Moreover, a slowdown of internal demand in Germany might negatively affect the total economic performance in Europe.

Prospects for reducing external imbalances in the shorter term are quite poor, since the appropriate instruments do not appear to be available. Stimulating fiscal measures in addition to those already planned for 1990 would increase the danger of overheating. In the European context, a reduction of investment demand in deficit countries would perhaps not be welcomed in view of the catching-up strategy. Furthermore, there is no guarantee that a slowdown in those countries would be focused on German investment goods given Germany's favourable competitiveness. Nevertheless, the large and rising current account surplus will have important structural implications for the German economy.

Deregulation in sheltered domestic sectors, such as electricity, transport and communications, would lead to a welcome shift of demand to imported goods. Reducing subsidies in agriculture or coal would reinforce such a move.

Growth is becoming more employment intensive

The growth of the capital stock remains in line with output. The capital coefficient (capital stock/GDP) has stabilized at 5 for the whole economy and 2,3 for the manufacturing sector. Yet capital intensity (capital stock/employed person) is edging up by less than 2 % per year compared to around 5 % in the early 1980s or more than 6 % during earlier upswings, making growth more employment-intensive. Thanks to the greater flexibility in the use of the capital stock and the still high labour market reserves, no overall constraints on real output are emerging from this source. Some sectors, however, already fear output constraints stemming from labour shortages, e.g. in the construction sector.

Table 4

Investment and capital stock

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	20,7	20,3	20,8	21,6	21,9
• % change	−0,5	2,0	5,9	7,7	5,1
of which:					
Construction (% change)	−0,3	−0,9	4,7	4,8	3,2
Equipment (% change)	−0,5	6,4	7,5	11,3	7,4
Capital stock (% change)	2,8	2,5	2,6	:	:
Capital coefficient (% change)	1,6	0,5	−0,9	:	:
Capital intensity (% change)	3,9	1,7	2,0	:	:

In this respect, economic integration would help by reducing regional imbalances in the demand for and supply of labour. To the extent that an important medium-term labour supply shortage can be expected in Germany, economic integration with the possibility of immigration should be of interest. Recently immigration from the East is offsetting the endogenous demographic decline of labour supply. Indeed, between 1988 and 1990 about 1 million immigrants will push up the labour force by 2 ½ %.

Deregulation as the internal market approaches

Germany is the biggest exporter and importer in the Community. Furthermore, its stability record has been the best of all member countries. So it looks as if Germany is well prepared to face the challenge of the single market and to defend its position in the European Community, and the Federal Government sees no need for action beyond appropriate national legislative changes to accompany the decisions and directives of the Council. Deregulation plans (e.g. for transport, banking and insurance sectors, etc.) seem to have been postponed.

However, to improve the competitiveness of enterprises the government now plans to reduce the overall tax burden by a reform of corporate taxation. A simultaneous reduction of sheltering and subsidizing sectors, which could partly finance such tax cuts or make them more significant, is not planned for the time being. On the other hand the government has adopted some changes in indirect taxation (excise duties) which match the Commission's proposals in this field.

Greece

Little progress on macroeconomic stability and poor medium-term growth performance

Whereas in 1986 and 1987 economic policy pursued a stabilization programme aimed at reducing the current account deficit and inflation, since the beginning of 1988 more emphasis has been put on output growth. The relaxation of wage policy boosted private consumption; the upturn in private investment — to a large extent a reaction to improved profitability — and the expansion of public current and capital expenditure have also contributed to the increase in domestic demand. Growth in output has covered most of this increase, while pressures on the external balance from the real economy have so far remained moderate and for the most part have been offset by invisible receipts and spontaneous capital inflows. The slowing in inflation observed since the beginning of 1986 came to an end in mid-1988; since then it has persisted at around 13-14 %. However, the upturn in activity has been achieved at the expense of widening public deficits and a fast rising public debt/GDP ratio which now put at risk the progress achieved on the inflation and external fronts.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,2	1,3	4,0	2,5	2,3
Total domestic demand (% change)	1,3	2,0	3,5	3,5	2,7
Employment (% change)	0,2	0,3	1,1	0,7	0,7
Unemployment rate (%)	8,0	8,3	8,5	8,5	8,5
Inflation (%)	19,2	18,9	13,9	14,3	15,0
Balance of current account (% of GDP)	−4,5	−5,7	−1,5	−3,4	−3,5

Relative to the Community average, Greece fell back in the 1980s in terms of GDP per capita: the catching-up process observed in the 1960s and 1970s not only stopped but indeed went into reverse. The catching-up process can only be expected to resume in the medium term if economic policy is radically changed with a view to enhancing the prospects for balanced growth.

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross fixed capital formation					
• % of GDP	19,6	18,4	17,8	18,7	19,2
• % change	−3,0	−1,1	9,0	6,6	6,4
of which:					
Construction (% change)	−5,2	−1,9	7,7	7,5	6,0
Equipment (% change)	0,0	−0,1	10,7	5,5	7,0

Control of public deficits: the priority task

In the coming years, there is an urgent need to reduce rapidly public deficits, which in 1989 are by far the largest in the Community. High public deficits for several consecutive years have led to a rapid increase in the general government debt/GDP ratio which in 1988 reached 73,9 % (as against 27,7 % in 1980). The restructuring of the public debt towards bond financing together with a monetary policy aiming at higher real interest rates resulted in a sizeable increase in the effective financing cost of public debt, thus giving rise to a vicious circle. The public finance situation deteriorated substantially in 1989 for the second year in a row. The shortfall in tax revenue — which was the main reason for the overshooting of public deficits in 1988 — continued in 1989; in addition, expenditure this year is expected to grow faster than projected. As a consequence, the PSBR (covering both general government and public enterprises) is likely to exceed 21 % of GDP for the year as a whole (compared with 16 % in 1988).

Clearly, the public debt is on an unsustainable trajectory. Not only has it now reached a level at which deficits become self-generating, but its direct repercussions on the real economy and the building-up of negative expectations could undermine any attempts to restructure the productive capacity and could aggravate the internal and external constraints on the growth of the economy. Monetary and exchange rate policies will continue to bear a heavy burden in the policy mix. The financing of the ever-higher public deficits will lead to a further increase in interest rates from an already high level. But the implied monetary tightening will inevitably make the necessary investment for modernization and capacity expansion more costly. Combined with the loss in competitiveness brought about by an anti-inflationary exchange rate policy, this could affect the upturn in business

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	26,2	23,5	24,8	24,1	24,1
Short-term interest rate	17,1	17,5	15,9	19,0	20,0
Long-term interest rate	17,4	16,3	16,6	18,0	19,0
Competitiveness	119,8	105,5	104,2	111,6	113,7
Budget balance (% of GDP)	−8,7	−11,3	−14,9	−19,9	−20,0
Gross public debt (% of GDP)	42,3	60,9	73,9	82,1	91,8
Nominal wages per head (% change)	23,8	16,0	18,4	20,6	16,2
Real wages per head (% change)	4,1	−2,3	4,0	5,5	1,0

For definitions, see table for Belgium, p. 60.

investment observed in 1988 and 1989. The lack of a programme of fiscal consolidation could create inflationary expectations and thus lead to a flight into real estate and hasty purchases of goods. Besides pushing up product prices, such a development would result in higher imports and a wider trade deficit, while the fading confidence in the drachma would reduce the capital and quasi-capital inflows, leading to a weakening of the balance of payments. There are already some signs indicating that such a negative scenario is not pure fiction but a worrying possibility.

Since mid-1988, the annual inflation rate has remained within the 13-15 % range, which is almost three times the average for the Community. Such a discrepancy clearly does not leave any room for Greece to participate in the moves towards EMU. Given the interrelation between fiscal and monetary policies, progress on fiscal consolidation would lead to more nominal convergence with the EMS countries and is, therefore, a precondition for a possible participation in the ERM. On the other hand, the credibility gains to be obtained from this participation would in turn help the domestic stabilization process.

In search of a comprehensive development strategy

The scale of the necessary correction in public finances and the seriousness of the economic prospects now seem to be widely recognized in Greece. But persisting political uncertainty has not yet provided the necessary conditions for corrective measures to be taken. Quick and determined action by the Greek authorities is needed to counter the build-up of negative expectations and to establish the conditions which will encourage the balanced expansion of activity, especially in the private sector. The structural adjustment of the Greek economy with a view both to integration in the internal market and to real convergence with the rest of the Community requires a medium-term development strategy containing a combination of structural measures, together with the appropriate macroeconomic (monetary, exchange rate and incomes) policies. Among the structural measures priority should be given to a fiscal adjustment plan aimed at reducing deficits by tight control of current spending and action to increase tax revenues. The liberalization of the financial system - already under way for several years — should continue so as to allow it to adapt smoothly to a fully integrated European market for financial services. A third element concerns the deregulation of the goods and labour markets. Incomes policy will play an important role in this development strategy. The wage indexation scheme, while it has helped to restrain wage increases and so contributed to the disinflation process, on the other hand — by reducing wage differentials — tends to diminish the incentives for productive work. This aspect will become more important in the medium term and should, therefore, be taken into account in the design of incomes policy. Finally, the increased spending of the Community's structural Funds should be used to finance the formation of physical and human capital so as to facilitate the necessary adjustment and development of the Greek economy.

Spain

An excellent economic performance but one which is increasingly difficult to sustain

Continuing a remarkable phase of expansion since the second half of 1985, the Spanish economy will achieve a growth rate of 4,7 % in 1989, which is higher than initially forecast. A recovery in the gross operating surplus, an improvement in the financial situation of firms and the favourable prospects opened up by accession to the Community have led to a sharp increase in investment and consequently in employment. Gross fixed capital formation has risen by an average of 13,1 % per year over the period 1986-89. Greater labour market flexibility associated with a moderate trend in wage costs has resulted in very high levels of employment creation since 1986 (+3,5 % in 1989 and an annual average of +2,9 % over the last four years). Nevertheless, the unemployment rate remains very high relative to the Community average although it has fallen from 19,6 % in 1988 to 17,6 % in 1989.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,6	3,7	5,0	4,7	4,0
Total domestic demand (% change)	0,4	5,7	6,7	6,7	5,3
Employment (% change)	−1,4	1,3	2,9	3,5	2,5
Unemployment (%)	18,2	21,2	19,6	17,6	16,5
Inflation (%)	12,7	7,6	5,1	6,8	6,3
Balance of current account (% GDP)	−0,9	1,1	−1,1	−2,9	−4,0

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation:					
• % of GDP	20,2	19,6	22,5	24,4	25,7
• % change	−2,6	9,5	14,0	13,9	9,9
of which:					
Equipment (% change)	−3,1	15,0	14,7	12,8	8,7
Construction (% change)	−2,4	6,1	13,5	14,6	10,9
Capital stock (% change)	3,3	3,4	4,4	4,2	3,4

The sharp growth in the components of domestic demand has been reflected in a widening of the foreign trade deficit (6,2 % of GDP in 1989). The current account balance, in surplus until 1987, has deteriorated sharply and a deficit probably approaching 3 % of GDP is now likely in 1989. Although this deficit and its rapid deterioration in particular threatens to constrain economic growth, financing of the deficit has so far not caused problems because of high levels of long-term foreign investment.

The gradual overheating of the economy is reflected in the inflation rate, which has been climbing again since the summer of 1988. The private consumption deflator was following a downward trend until 1988 (5,1 %) but this has now been reversed and it will reach 6,8 % in 1989. The social dialogue, which had moderated growth in nominal wages, broke down at the end of last year, resulting in an acceleration of wage rates in 1989. In consequence, inflationary expectations are now higher and have not been dampened by the measures adopted in the first half of this year.

A more active supply-side policy should favour the convergence process

The continuation of sounder investment-based growth is essential to keep the Spanish economy on the path of convergence with the other Community countries. In 1989, per capita GDP in Spain remains only 76 % of the Community average, so that the country has a long way to go in the catching-up process.

The damping down of inflationary expectations, as part of a strategy of controlling domestic demand and strengthening supply, is becoming essential. The resumption of the social dialogue providing for relatively moderate wage growth is a fundamental condition to prepare the Spanish economy to meet imminent challenges in the area of competitiveness. It is necessary to reduce rigidities, improve supply conditions, and enhance competition. Otherwise one of the main achievements of recent years will be put in jeopardy.

In this area, it will be necessary to continue to place the emphasis on certain supply-side policies. The labour market still suffers from a variety of rigidities as well as a mismatch between supply and demand. The financial system will have to be liberalized by 1992, the object being greater transparency and efficiency, so that the Spanish economy can meet the challenge represented by the liberalization of capital movements. As regards the need for infrastructural improvement, continued public investment in this area, supported by contributions from the structural Funds, should allow more balanced growth at the regional level, increasing benefits from the completion of the single market.

In this regard, the role of budgetary policy has become even more important as a means both to regulate short-term demand and to eliminate medium-term imbalances. While the government has had much success in consolidating the budget in recent years, this progress should not be allowed to conceal the difficulties which remain in this area.

Social security expenditure, which increased in 1989 following a reorganization of the central government budget, is still too low and there is some scope for improving the benefits provided by certain social services. The future prospects for financing social security expenditure remain uncertain in view of the ageing population and the average level of pensions. In order to create some margin for social security financing, subsidies to enterprises should be reduced. It would also be desirable to continue with the privatization policy.

As far as revenue is concerned, the updating of legislation now under way and the harmonization of tax rates imply, in fact, major changes in almost all taxes and an improvement in administration. In any event, the likely increase in the pressure of indirect taxation, while reducing tax evasion, should certainly make it easier to reduce taxes on households and employers' social security contributions.

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	15,3	12,9	10,3	15,6	9,8
Short-term interest rate	17,1	13,2	11,6	14,8	14,5
Long-term interest rate	16,5	12,5	11,8	13,6	13,2
Competitiveness (1980 = 100)	82,0	80,5	88,0	95,1	97,5
Budget balance (% of GDP)	−5,3	−5,6	−3,2	−2,6	−2,4
Gross public debt (% of GDP)	35,2	47,8	44,1	43,8	42,0
Nominal wages (% change)	13,0	8,4	6,4	7,6	7,1
Real wages per head (% change)	0,3	0,8	1,2	0,7	0,8
Productivity (% change)	3,1	2,4	2,0	1,1	1,4
Real unit labour costs (% change)	−2,2	−2,3	−1,3	−0,8	−0,8

For definitions, see table for Belgium, p. 60.

In this new situation the management of the budget must facilitate an increase in the savings ratio which, at present, is insufficient to support the needs of the economy, requiring increasing recourse to foreign borrowing.

Meeting the challenge of integration by means of a more effective macroeconomic policy

Because of the breakdown in the social dialogue at the end of last year, and some delay with regard to taxation policy, the authorities have placed too much reliance on monetary policy in order to contain domestic demand and inflation. The possibilities here are already limited by a significant increase in the external reserves and an appreciation in the exchange rate. The decision to take the peseta into the EMS exchange rate mechanism determines the limits of the role of monetary policy. EMS entry will strengthen the role of fiscal policy and the credibility of the anti-inflationary policy while guaranteeing that balanced growth will be maintained as a result of the discipline observed.

Confirmation of the strong currency option against the background of the forthcoming liberalization of capital movements encourages the interest rate to decline towards those of other ERM countries. After an initial appreciation, the peseta should tend to depreciate in the medium term, because of the narrowing of interest rate differentials and the widening of the balance of payments current account deficit. In any event, action is necessary to ensure that the impact of central bank intervention rates is passed through more efficiently to lending rates in order to ease the pressures on the exchange rate and reduce the Treasury's financing costs.

The strong currency option will also require a more rapid consolidation of the budget and the limitation of inflationary expectations. In consequence, financing of the public sector should become less difficult and could be achieved by long-term instruments. This would reduce the pressure which the Treasury exerts on the markets and end its need for direct access to the Bank of Spain.

The challenge represented by the completion of the internal market in 1992 is encouraging the modernization of the Spanish economy. The problems of employment and the trade balance will improve only in line with the strengthening of the factors governing competitiveness. Economic policy must take account of the relatively short time available before the establishment of the single market; for Spain this deadline coincides with the end of the transitional period following its accession to the Community. Thus, the process of convergence and of gearing up to a new framework of keener competition must be accelerated.

France

Investment-led growth

In 1988 France achieved the highest GDP growth rate (+3,4 %) since 1976, and activity remains very buoyant in 1989. This is partly due to an extremely favourable international economic situation and to the process of reforming the French economy which was begun in 1982. Investment by companies in the industrial and tertiary sector is continuing to rise, and it is significant that the expansion of production capacity is now a priority objective. The improvement in profit margins, which are now back to the highest levels achieved before the first oil shock, demonstrates the recovery in the economic situation of companies. The improvement in employment and the rise in take-home pay are contributing to the increase in the purchasing power of households and the recovery of their savings ratio.

This quite impressive picture nevertheless conceals two causes for concern: unemployment, although reduced, is still extremely high (between 9 and 10 % of the labour force), and the external balance remains in deficit. The very strong expansion of exports due to rapidly rising world demand is accompanied by a significant growth of imports which has been supported by strong internal demand. The investment drive is sucking in a growing volume of plant and machinery imports, but this is sustainable and in the long run should enable external equilibrium to be re-established as a result of the expansion and renewal of productive potential.

The factors which gave rise to growth in 1988 and 1989 should continue to do so in 1990. The monetary authorities' determination to control inflation, the improvement in company competitiveness and the reduction of the budget deficit have certainly helped to increase confidence in the French economy.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,5	2,0	3,4	3,3	3,2
Total domestic demand	1,1	3,2	3,8	3,2	3,3
Employment (% change)	−0,4	0	0,6	1,4	1,2
Unemployment rate (%)	8,8	10,4	10,2	9,5	9,1
Inflation (%)	9,6	3,9	2,7	3,5	2,7
Balance of current account (% of GDP)	−1,1	0	−0,4	−0,5	−0,5

Continuation of a tight budgetary stance and confirmation of a strong currency policy

Budgetary policy should aim to continue the reduction in the central government deficit and to cut taxation. Nevertheless, the fact that expenditure has accelerated in 1989 threatens to limit the government's choices, especially as far as tax cuts are concerned. In addition to the tighter financial constraints, which are the result of new commitments (expenditure on research and education, measures to be taken with regard to the internal market), the government has to cope with the effects of the 1988 public-sector wage settlements, which have substantially inflated the wage bill, and the higher-than-expected level of short-term interest rates, which have increased the debt burden.

Table 2

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	10,8	6,8	7,3	7,0	6,9
Short-term interest rate	12,9	8,6	7,9	8,5	7,8
Long-term interest rate	13,9	9,6	9,0	8,7	8,2
Competitiveness	89,9	92,3	87,8	83,3	81,2
Budget balance (% of GDP)	−2,9	−2,5	−1,4	−1,2	−1,1
Gross public debt (% of GDP)	29,7	34,0	35,7	35,4	35,2
Nominal wages per head (% change)	10,8	4,8	3,8	4,0	4,0
Real wages per head (% change)	1,1	0,9	1,1	0,5	1,3

For definitions, see table for Belgium, p. 60.

Monetary policy, which has been managed according to new rules since January 1987, has set itself the objectives of controlling the monetary aggregates and keeping the French franc stable within the EMS so that price movements can be brought under better control. Interest rates are managed so as to prevent any strain on the exchange rate, even if this choice could well have an adverse effect on economic activity, since real interest rates are fairly high.

An economic policy based on a strong franc compels firms to be more competitive in pricing their products. Their costs must therefore continue to be controlled by further cuts in company taxation, which is penalizing firms, and by wage moderation. The incomes policy pursued by the authorities should therefore be based on a moderate rise in the statutory minimum wage (SMIC) and in public-sector wages.

Growth is being slowed by insufficient productive capacity

The French economy's current problems (foreign trade, employment) are partly connected with the inability of the productive system to cope with the rise in domestic and export demand. Although industrial investment started to recover in 1985, there has until now been no significant increase in the capital stock, if the large-scale withdrawal of obsolete plant and machinery is deducted from gross investment. This is why investment and employment must continue to be the prime beneficiaries from growth, with purchasing power taking second place.

Substantial finance is required for the investment still needed to increase productive capacity. The improvement in companies' profit margins should enable them to set aside internal resources for investment; if investment is to be financed it is also necessary for the personal savings ratio to rise in the long term through the introduction of appropriate tax measures.

Table 3

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	20,5	20,3	21,3	21,8	22,3
• % change	−2,5	3,4	7,3	5,6	5,5
of which:					
Construction (% change)	−3,0	1,8	4,3	3,8	3,4
Equipment (% change)	−2,1	4,8	9,7	7,0	7,0
Capital stock (% change)	2,5	2,3	2,8		

If the French productive system is to grow, employment is to continue increasing and unemployment is to fall, it is essential for the financial health of companies to improve further and for sufficient finance to become available. Moreover, the structure of unemployment is deteriorating. The average period of inactivity is becoming longer and the proportion of long-term unemployed is rising. Considerable resources also need to be devoted to vocational training, so that this section of the labour force can be brought back into employment; otherwise it is in danger of being consigned to the margins of society, excluded from the benefits of growth and employment.

The 1992 deadline is speeding up reforms

In order to avoid situations of tax competition arising in trade between Community partners, the 1992 deadline has led the French authorities to make appreciable adjustments to the existing tax system, which is based largely on indirect taxation. The number of different VAT rates has been reduced and, mainly due to the reduction of the top rate, from 33,3 to 28 % and to 25 % in September 1989, the average rate of taxation has been cut. As a result of the present buoyancy in economic activity, these measures of tax harmonization are so far not being translated into high revenue losses for the public finances and so do not conflict with the objective of reducing the public deficit. As the cut in indirect taxation has lowered the prices of the products concerned, demand for them has increased and the larger volume of sales has partly offset the lower tax rates in determining the tax yield. France has therefore appreciably narrowed the gap with those Community countries which impose lower indirect taxation and, other things being equal, seems well placed to implement the final phase of tax harmonization.

France has also almost fully prepared for the more imminent deadline of the liberalization of capital movements. The phasing out of exchange controls, which began in 1985, has led to the removal of almost all the obstacles to unrestricted foreign transactions.The full liberalization of capital movements in the Community will have the effect of taking the French franc from the system of external convertibility to a system of internal convertibility, with individuals no longer prohibited from holding assets in foreign currencies. Given the level of taxation of saving in France, which on average is higher than in its European partner countries, and the strictness observed in enforcing taxation, some measures are planned to reduce the danger that savings will be moved out of the country. Nevertheless, the increased confidence in the French economy and the authorities' declared determination to keep the franc stable should help to mitigate the effects of completing the European capital market.

Ireland

Macroeconomic stabilization proceeding well

In contrast to the earlier part of this decade, the Irish economy is now in a phase of strong growth. Over the period 1987-89, real GDP has increased by an average of 4,2 % per annum compared to an average growth rate of about 2,0 % between 1980 and 1986. The main contributory factors to economic recovery have resulted from fundamental policy reorientations in important areas and include:

(i) a favourable supply-side response to significant improvements in the public finances;

(ii) wage moderation based on social consensus, which has boosted competitiveness, profitability and employment creation; and

(iii) buoyancy in the international economy which has facilitated a major expansion of exports.

Initially, economic recovery was exclusively export-led as internal demand was weakened by the tight fiscal stance and low levels of consumer and business confidence. This year a more balanced pattern in economic performance has emerged. While the external sector remains strong with the current balance remaining in substantial surplus, the main contribution to growth is now coming from private consumption and investment in response to the growing confidence in the overall economic environment. As the relatively labour-intensive domestic sector begins to grow more rapidly, employment creation has accelerated but unemployment remains a major problem.

Closer convergence with inflation in other ERM countries, the beneficial effect of budgetary consolidation on price expectations and the general improvement in economic performance have led to a hardening of the Irish currency within the EMS. The Irish pound has been decoupled from sterling (to which it was formally linked until 1979) and the interest-rate differential with the Deutschmark has narrowed to around 200 basis points. Reduced interest rates, low inflation and modest increases in unit labour costs have helped to boost competitiveness in the economy. Profitability has greatly improved, resulting in growing rates of investment in plant and machinery. However, the heavy interest burden (about 10 % of GDP) related to the national debt and the dependence on the external environment for growth continue to highlight the vulnerability of the Irish economy.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate					
(% change)	2,0	2,0	3,7	5,1	4,6
Total domestic demand					
(% change)	−0,6	1,0	0,2	5,0	4,3
Employment (% change)	−1,3	0,3	1,0	1,2	1,3
Unemployment (%)	14,6	18,3	17,8	16,7	16,2
Inflation (%)	11,9	4,2	2,5	4,1	4,0
Balance of current					
account (% of GDP)	−7,3	−2,0	2,0	2,0	1,8

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	23,9	20,4	16,8	17,3	18,3
• % change	−5,3	−2,0	−1,7	8,6	10,0
of which:					
Construction (% change)	−9,8	−4,9	−6,8	6,1	10,2
Equipment (% change)	−0,3	0,8	2,8	10,5	9,9

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth					
(% change)	9,5	5,0	6,3	7,4	7,8
Short-term interest rate	14,9	11,8	8,1	9,0	9,7
Long-term interest rate	15,2	11,7	9,4	9,0	9,2
Competitiveness					
(1980 = 100)	90,9	80,2	70,0	63,4	59,9
Budget balance[1]					
(% of GDP)	−11,	10,3	−3,7	−3,7	−1,5
Gross public debt					
(% of GDP)	95,5	113,0	115,4	110,9	105,3
Nominal wages per head					
(% change)	12,8	5,8	2,3	4,8	5,0
Real wages per head					
(% change)	0,8	1,5	−0,2	0,7	1,0

[1] Net borrowing by general government.
For definitions, see table for Belgium, p. 60.

Structural reform to generate additional growth and employment now top of the policy agenda

The strides towards a sustainable macroeconomic stance in recent years have not been fully matched by structural reform. Imbalances in the public finances and rigidities elsewhere in the economic system have tended to hinder growth and aggravate the mismatch of supply and demand for labour. Some of these issues are addressed in the medium-term National Development Plan (1989-93), which was published in March 1989. The Plan acknowledges the success of current policies and commits the authorities to a continuation of budgetary reform and wage moderation based on social consensus. Investment in the economy is to be further boosted, with an emphasis on export-oriented activity, while the supply side of the economy will benefit from structural reforms. The employment potential of growth is to be significantly enhanced.

In the context of structural reforms, the recent competitiveness gains in the Irish economy have reflected very high growth rates in labour productivity. Otherwise, the value of the Irish pound would have come under increasing downward pressure. This would have been in conflict with government policy, which is to maintain the value of the currency following the unpleasant experience of devaluation in 1986.[1] The current productivity performance may not be sustainable in the medium term, so microeconomic improvements in the operation of the economy are further justified by exchange-rate considerations.

As 1992 approaches and Community assistance through the structural Funds is intensified, it is particularly important that impediments to more accelerated rates of growth and employment creation in the economy are removed. Two main targets for reform can be identified:

(i) the taxation system, which is heavily weighted in favour of capital and against labour; a strong case can be made for a tax reform which would widen the incidence of taxation on capital and property and reduce the burden on payroll taxes;

(ii) the operation of the labour market; while regulation is a less important feature in the Irish labour market than elsewhere in the Community, measures to encourage more flexible working patterns supported by improved quality of vocational training would seem desirable.

Gearing up for the internal market

The removal of the remaining barriers to trade will present many challenges to the Irish economy. In consequence, the government has launched an information campaign to heighten awareness of the likely changes in the Community's trading environment. Meanwhile, increased assistance from the structural Funds is designed to compensate for physical disadvantages affecting regions like Ireland. However, the eventual impact of the internal market on the Irish economy will be largely determined by the response of the various private economic agents.

Recent high investment rates linked to improved profitability suggest that Irish industry is already gearing up for increased competition after 1992. Much scope remains for further increases in investment and for the extension of investment into new activities. This would be facilitated by continued moderation in wage costs to boost profitability and appropriate fiscal measures by government to encourage investment and domestic savings.

The traded services sector has been relatively sheltered in the past and will face a more uncertain prospect after 1992. In particular, the insurance sector, the distribution sector and financial services sector may be exposed. While an appropriate response from these sectors to new market structures will be most important, government again has a complementary role to play in providing a more appropriate regulatory framework and a more efficient fiscal regime in many of these areas of the economy.

[1] An 8 % devaluation of the Irish pound within the EMS in 1986 resulted in a serious loss of confidence in the economy; large capital outflows emerged and real short-term interest rates rose above 10 %.

Italy

The contradiction between tight money and fiscal laxity

The performance of the Italian economy in 1988 and in the first part of 1989 has been mixed. On the one hand, real GDP increased by 3,9 % in 1988 and is expected to grow by about 3,5 % in 1989 and 3,0 % in 1990. This is resulting in a rise in employment (270 000 new jobs in 1988 and 400 000 expected for the period 1989-90) which should allow a small reduction in unemployment this year. On the other hand, the determination of government to tackle the structural disequilibria of the Italian economy came up against unexpected difficulties which weakened its action. Therefore the opportunities created by the high growth in 1988 and 1989 to cut the budget deficit and to reduce the North-South gap have been missed. A new government was formed in July, with a renewed commitment to fiscal consolidation and structural reform.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,5	2,7	3,9	3,5	3,0
Total domestic demand (% change)	1,5	3,4	4,3	4,1	3,7
Employment (% change)	0,6	0,7	1,3	0,9	0,6
Unemployement rate (%)	9,1	10,0	10,6	10,5	10,6
Inflation (%)	14,6	6,7	4,9	6,3	6,0
Balance of current account (% of GDP)	−0,6	−0,1	−0,1	−1,3	−1,4

The full liberalization of capital flows in July 1990 occurs in a year when about one-third of the public-sector debt (the level of which is now roughly 100 % of GDP) has to be rescheduled. At the same time, a further small deterioration is likely in the current account balance (to a deficit of over 1 % of GDP) and, owing to the triennial industrial wage round starting at the end of this year, there is a danger of a slight rise in the inflation differential relative to other EMS countries, which ceased to narrow in 1988.

The experience of 1988 and 1989 shows the increasing contradiction between a restrictive monetary policy and a structurally unbalanced fiscal policy, as the system moves towards the implementation of the first phase of the EMU project.

In the presence of persistent fiscal deficits, monetary policy alone has borne the burden of short-term adjustment by reducing the rate of money creation and enhancing the flexibility of nominal interest rates. This has led to massive inflows of short-term capital during 1989 which has caused an appreciation of the lira exchange rate within the EMS band. Such a mechanism, though it has helped to contain inflationary pressure, cannot be pursued indefinitely: the necessary consequence of the high interest rates is a rise in the interest burden on public debt and a further incentive for capital inflows which complicate the attainment of monetary targets and, by pushing up the exchange rate, will lead to a deterioration in the external balance.

Table 2

Public finance and monetary indicators

	1982-84	1985-87	1988	1989	1990
Money growth, M2 (% change)	14,1	9,6	8,4	10,0	9,0
Short-term interest rate	18,5	13,1	11,3	13,2	12,7
Long-term interest rate	18,0	12,4	12,1	13,0	13,0
General government budget balance (% of GDP)	−11,1	−11,5	−10,6	−10,3	−9,8
State-sector borrowing requirement (% of GDP)	−13,5	−13,0	−11,5	−11,1	−10,6
Gross public debt (% of GDP)	71,9	88,5	96,1	98,5	100,5

High budget deficits, external and regional imbalances

The experience of the last two years shows that the structural disequilibrium of public finances cannot be cured spontaneously through a 'high growth' therapy. The very small reduction in the borrowing requirement relative to GDP in a period of rapid growth implies that the effect of the automatic stabilizers has been offset by a continuous uncontrolled rise in spending. The agreement on the automatic indexation of personal income tax brackets is likely to add to these budgetary difficulties, although it may be helpful in moderating wage settlements. Moreover, the financing of the public debt could be constrained by the observed trend reduction in households' propensity to save. As a consequence, the full liberalization of capital flows would imply a shift from internally to externally financed deficits. Under these circumstances, the risk of capital flight, which would imply a further rise in the risk premium on public debt or an exchange-rate crisis, cannot be ruled out if, for lack of substantial correction, the prospects of an unsustainable public debt heighten.

The external constraint is likely to become of major concern in the medium-term perspective. The very slow growth in productive capacity in the 1980s (with the notable exception of 1988) and the appreciation of the real exchange rate, combined with low non-price competitiveness, have led to some decrease in market shares. In particular, Italy's industrial structure and export performance are weak in those sectors which will benefit more from the completion of the internal market. The industrial restructuring of the first part of the 1980s strengthened the productive system inherited from the 1960s based on traditional sectors, rather than changing it qualitatively. The weaknesses in high-technology sectors and scale-intensive sectors, in mature industries dominated by public procurement and standards, and in high-employment sectors (e.g. cars) will be sharpened by the removal of trade barriers. The progressive decrease in the surplus on tourism adds to the worsening of the external imbalance.

Table 3

Investment and competitiveness

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	21,8	21,7	22,4	22,8	23,0
• % change	−1,0	3,2	4,9	5,2	4,0
of which:					
Equipment (% change)	−1,0	3,2	6,0	6,2	4,8
Construction (% change)	−1,7	0,1	3,7	4,0	3,0
Nominal wages per head (% change)	14,5	8,9	8,8	9,2	8,0
Real wages per head (% change)	−0,1	2,1	3,9	2,9	2,0
Competitiveness	98,8	100,9	103,3	109,0	113,1

For definitions, see table for Belgium, p. 60.

Most of the problems which face the Italian economy cannot be fully understood without exploring their regional dimension. The average rate of unemployment (11,9 % in 1989 according to the labour force survey) results from 'almost full' employment in the North (5,8 %), where there are shortages of qualified labour, and massive unemployment in the South (21,3 %); similarly, almost half of the trade deficit in 1988 was due to the Mezzogiorno. It is therefore clear that any strategy of sustainable growth has to face the question of the dualism of the Italian economy, by taking into account the effective comparative advantages of the regions.

Need for a strategy to consolidate public finances and a new industrial policy

The objective of stabilizing the public debt/GDP ratio, set in the medium-term public finance programme, is an important but only an intermediate step in the process of public finance consolidation. The elimination of the primary deficit cannot be expected to affect market sentiment substantially in a situation in which the interest burden on public debt already represents 9 % of GDP. A sustained reduction of the total budget deficit requires a rise in the fiscal pressure (especially in indirect taxation) and substantial changes in the mechanisms for controlling current expenditure. Furthermore, an innovative policy aimed at reducing the outstanding stock of debt (i.e. through the sale of public assets) would help lessen the interest burden. Only the consistent implementation of a credible consolidation programme will produce a fall in the risk premium on public debt which, by reducing the interest rate/growth rate differential, will lead to a stabilization and then to a progressive fall in the public debt/GDP ratio.

The international competitiveness of Italian industry requires an innovative industrial policy which would encourage R&D expenditure and cooperation amongst firms, and enhance education to improve skills. On the other hand, the improvement of price competitiveness requires consistent behaviour of wages and salaries, which have to grow in line with those in the other European countries. In this context, the spread of profit-sharing and agreements which would facilitate employment (e.g. part-time contracts) is to be encouraged in the next round of wage negotiations.

A more flexible labour market is an essential element in the new approach to dealing with regional imbalances. A centralized wage formation system contributes to the maintenance of the disequilibrium between demand and supply of labour in the Mezzogiorno. A renewed labour market flexibility needs to be supplemented by a radical reform of 'extraordinary' intervention. The system of incentives has to be revised, by cutting grants to obsolete sectors, reducing the uncertainty associated with State transfers, stimulating investment in labour-intensive sectors, promoting training and education programmes. It is also necessary to select public investment in infrastructure (e.g. more in telecommunications, less in roads) so as to promote a new development model, based on small and medium-sized industrial enterprises, services and tourism. In this new approach, the structural Funds of the Community can play an important role by setting a new standard for public intervention in less-developed regions.

Luxembourg

The policy of diversifying the economy has yielded satisfactory results but they need to be consolidated

The policy of adjusting the productive system has reduced the importance of the steel industry in the economy as a whole; the arrival of new industrial firms and the expansion of the financial sector have helped to diversify the structure of the economy.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	3,5	3,5	5,2	3,7	3,3
Total domestic demand (% change)	1,7	3,6	4,6	3,3	2,9
Employment (% change)	0	2,2	2,9	1,7	1,3
Unemployment rate (%)	2,6	2,8	2,2	1,8	1,7
Inflation (%)	8,4	2,4	1,5	3,3	3,1
Balance of current account (% of GDP)	16,3	19,0	16,4	14,9	14,5

As a result of this policy, the general economic performance has been satisfactory: the budgetary position is positive, the external surplus is high, unemployment is extremely low and, even though inflation has accelerated slightly, it is still below the Community average. GDP growth in 1989-90 is slightly higher than that of the Community as a whole.

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	22,1	20,2	21,2	21,3	21,4
• % change	−4,1	5,9	4,5	4,3	4,0
of which:					
Equipment (% change)	−0,9	9,6	3,0	4,5	5,0
Construction (% change)	−5,6	4,7	5,4	4,1	3,4

The diversification effort has been supported by the creation of a favourable economic environment, in particular by cuts in company taxation. The financial situation of the social security fund is liable to become worrying very soon. The approach of 1992 should encourage prudence, especially in the areas (pensions, sickness) where demographic trends could eventually lead to increases in company costs. Although the central government budget surplus suggests that cuts in personal taxation may be possible in 1990, it will nevertheless be advisable to increase the budget reserve with a view to creating more room for manœuvre.

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Budget balance (% of GDP)	1,5	3,6	2,5	2,4	2,8
Gross public debt (% of GDP)	14,8	13,2	10,1	9,1	7,9
Nominal wages per head (% change)	7,0	4,2	4,0	6,4	6,1
Real wages per head (% changes)	−1,3	1,7	2,5	3,0	2,9

For definitions, see table for Belgium, p. 60.

The maintenance of business competitiveness calls for control over costs and a skilled workforce

In the medium term, it is important to maintain a competitive industrial sector, to attract new, high-technology firms, and to prevent the economy from becoming too dependent on the financial sector.

Because of the heavy dependence on exports, not only in the steel industry but also for newly established industries, Luxembourg companies need to remain conscious of their competitive position. Increases in wage costs must remain moderate since, in the single market, the choice of location will to a large extent be determined by the level of costs. Furthermore, since most Luxembourg firms are small or of moderate size, economies of scale will remain limited, and they will have to specialize in order to survive in the single market. This industrial specialization will call for an appropriately trained workforce. The technical training of young people will therefore have to be improved in order to satisfy the needs of the newly established industries.

Progressive adjustment of the economy to the implementation of the single market: some major problems

For most new firms the decision-making centre will be outside the country, so that the choice of Luxembourg as a location will depend on the quality of the economic environment and the labour situation. The methods of attracting firms in the 1992 environment will be, in particular, taxation the flexibility of the labour market and vocational training.

The government has cut company taxation in several stages, mainly in order to create a climate more conducive to the establishment of new industries. Although the rate of tax on profits has been cut from 40 to 34%, the retention of a number of other taxes payable by firms still places them in a position less favourable than their competitors. In view of the budgetary leeway which exists, a reduction in these taxes could be envisaged.

With regard to the organization of the labour market, consensus should be sought between the two sides of industry in order to guarantee a flexible application of the new legislation, as impediments in this area will influence the choice of location.

The Luxembourg authorities will be faced with a difficult problem when they implement the present proposals to harmonize indirect taxation. The proposals will lead to a very sharp rise in consumer prices and, through wage costs, to a deterioration in the competitive position of firms.

Netherlands

More rapid growth underpinned by investment

Economic acivity has accelerated in 1989, underpinned by a continued growth of business investment; the inflation rate remains among the lowest in the Community and policy followed since 1982 aims at a significant reduction in the budget deficit.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	1,1	1,9	2,8	3,8	3,0
Total domestic demand (% change)	0,8	2,6	2,3	4,3	2,9
Employment (% change)	− 1,5	1,6	1,3	1,6	1,0
Unemployment rate (%)	12,2	10,3	10,3	9,9	9,6
Inflation rate (%)	3,3	0,8	0,8	1,4	2,3
Balance of current account (% of GDP)	3,5	2,7	2,4	2,1	2,1

In 1989 the expansion in exports has been accompanied by an increase in internal demand; household consumption has grown due to an improvement in purchasing power, while investment in plant and machinery has expanded markedly. This dynamism results from a high level of capacity utilization and an improvement in the financial situation of enterprises due to a moderate wages policy. Employment creation has been significant but the reduction in unemployment remains limited. Real GDP growth at 3,8% should be slightly higher than the Community average. Despite some moderation in the investment trend, growth should be 3% in 1990.

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	18,7	20,5	22,1	22,7	22,4
• % change	1,1	5,0	9,7	6,7	1,4
of which:					
Equipment (% change)	6,1	8,6	6,3	9,8	2,7
Construction (% change)	− 1,8	2,3	12,6	4,3	0,4

Consumer prices remain low, having been moderated by a reduction in the higher rate of value-added tax. The increase in output prices, due to rising import prices since the beginning of this year, may have repercussions for the level of consumption prices in 1990.

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth % change)	8,5	7,4	10,6	11,4	6,5
Short-term interest rate	6,7	5,8	4,8	7,1	6,8
Long-term interest rate	9,3	6,7	6,3	7,1	7,1
Competitiveness	89,6	88,4	91,6	86,9	85,0
Budget balance (% of GDP)	− 6,6	− 5,8	− 4,9	− 4,4	− 4,2
Gross public debt (% of GDP)	61,2	72,2	77,4	78,3	78,5
Nominal wages per head (% change)	3,1	1,5	1,4	1,3	3,4
Real wages per head (% change)	− 0,3	0,7	0,6	− 0,1	1,0

For definitions, see table for Belgium, p. 60.

Due to a favourable trend in receipts, the central government budget deficit should be below the intermediate objective for 1989. A similar outcome is likely in 1990, despite a reduction in direct taxes as part of the process of tax reform.

Action must continue to put the public finances in order and to create jobs

From 1983 to 1989 progress was made in restoring sound public finances, with the central government borrowing requirement falling by 2,5% of GDP. This result is due not only to the effects of expenditure savings but, more recently, to tax revenues which were far higher than expected. In order to halt the increase in the ratio of public debt to national product and to reduce the budget's sensitivity to interest-rate movements, action to reduce the budget deficit will have to continue during the next legislative period. This action is especially necessary because the general government borrowing requirement is well above the Community average, as a percentage of GDP.

The reduction in the number of unemployed has been slow due to an increase in activity rates. Despite the recent sharp rise in employment, the high proportion of long-term unemployed illustrates the structural nature of unemployment. Action must continue to reduce unemployment by a policy of wage moderation and by reducing the overall tax burden so as to improve company competitiveness and create an economic climate more conducive to recruitment. Expenditure on vocational training and on the retraining of the long-term unemployed is also necessary.

Preparing the economic environment for the single market

In recent years, the authorities have taken certain measures to help firms to become integrated into the single market. Although the reduction of taxes on company profits (and the reduction of employers' social security contributions) was primarily intended to offset the withdrawal of aids to investment, the main objective of the cut in the top rate of VAT was to moderate price rises, and also to bring the Dutch rate closer to the average rate for the Community. Moreover, a further reduction in this rate of VAT, in order to avoid an excessive expansion of cross-frontier trade, could be envisaged.

After the restoration of company profitability, investment did not pick up immediately. At present, strong export demand is causing problems for production capacities, but the necessity of renewing products and production processes in order to cope with the keener competition in 1992 has become an important factor in the investment decision.

Lastly, measures to liberalize the capital market, giving foreign banks easier access to the Dutch market and authorizing various forms of investment, are improving the starting position of Amsterdam as a financial centre.

Monetary policy and exchange-rate stability

The priority objective of monetary policy is to maintain a stable guilder/Deutschmark exchange rate and the central bank is also pursuing a policy for short-term interest rates which shadows that of the Bundesbank. Against this background, the bank is very worried by the rapid expansion of liquidity which, it fears, will boost inflation. For this reason, the bank has concluded an agreement with the financial intermediaries which aims to curb the rise in the net amount of overall credit outstanding, at present the main source of liquidity creation.

The objective of this agreement is to encourage the banks to finance a greater proportion of lending by long-term capital. The central bank has also introduced a new instrument intended to guide long-term interest rates by itself building up a portfolio of central government bonds but, given the limited size of the portfolio, these buying and selling operations can give no more than an indication of the course desired by the monetary authorities.

Portugal

Continued strong growth but no weakening of inflationary pressures

Domestic-demand-led growth in the Portuguese economy continues at a fast pace and is once again well above the Community average. In line with the buoyancy in the economy, employment continues to increase. In fact, the unemployment rate is at its lowest level this decade (5,2 % in 1989). Contrary to the national authorities' expectations, however, no progress has been made on the inflation front.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP growth rate (% change)	0,0	3,8	3,9	4,7	4,6
Total domestic demand (% change)	−3,2	6,4	8,3	5,6	5,0
Employment (% change)	—	0,8	2,6	1,6	0,8
Unemployment rate (%)	7,9	7,9	5,6	5,2	5,2
Inflation (%)	24,7	14,5	9,6	13,0	11,3
Balance of current account (% of GDP)	−7,9	2,3	−1,4	−2,8	−3,4

The evolution of investment has been particularly impressive, even after allowing for the 'catching-up' effect deriving from a sharp fall in investment during the 1983/85 recession. Fuelled by a marked improvement in corporate profitability, generous incentives and the economic outlook emerging within the framework of entry into the Community, gross fixed capital formation rose by 15,5 % per year between 1986 and 1988 and is expected to increase by 11,6 % in the current year. Accompanied by a progressive weakening of the economy's heavy regulatory framework and efforts to improve the quality of the labour force, the investment surge is leading to a substantial improvement in the supply side of the economy.

Table 2

Investment performance

	1982-84	1985-87	1988	1989	1990
Gross capital formation					
• % of GDP	28,0	23,1	28,3	30,1	31,7
• % change	−7,7	8,6	15,8	11,6	10,0
of which:					
Equipment (% change)	−13,0	14,3	19,5	11,7	9,0
Housing (% change)	−3,2	4,1	12,3	11,5	11,0

Reflecting the pressure of internal demand and, to a lesser extent, the progressive reduction of trade barriers, import volumes have been growing at impressive rates. Consequently, despite a good export performance, there has been a very large deterioration in the real balance of goods and services since 1985. The impact on the current account has been lessened by favourable exogenous developments, above all large and uninterrupted terms of trade gains. Nonetheless, after recording sizeable surpluses between 1985 and 1987, which allowed the external debt to be reduced from 80 to 49 % of GDP, the current account recorded a deficit (1,4 % of GDP) in 1988.

Thanks to the buoyancy of tax revenues and to some restraint on non-interest current expenditure, a marked reduction in the general government deficit has been achieved since 1985. However, gross public debt increased at a much faster rate than was implied by budget deficits. As a consequence of large debt takeovers by the Treasury, related to past public-sector financial imbalances, the debt ratio jumped from 61,5 % of GDP in 1984 to 74,6 % in 1988.

Budgetary consolidation remains the priority

Despite improvements in the past few years, public finance imbalances remain a serious structural problem in the economy. In the absence of a significant reduction in the currently high general government deficits, both nominal and real convergence with the rest of the Community will be much more difficult to achieve. And with the exception of the privatization process, where receipts will be used mainly to reduce public debt, other foreseeable developments (rise in public debt interest rates induced by the replacement of credit ceilings with indirect instruments of monetary control, and the deteriorating trend in the social security accounts) will have a significantly adverse budgetary impact. In such a context, and without the implementation of a vigorous fiscal adjustment strategy, it might be impossible to stabilize the debt/GDP ratio even at its present very high level.

The recent evolution of the current account and its medium-term prospects suggest that the external constraint can no longer be ignored. However, in the absence of any major adverse change in the international environment, the current account deficit should not prove to be unsustainable, given the size of spontaneous private capital inflows and the impressive stock of external reserves.

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth (% change)	21,8	23,8	14,8	11,0	10,0
Short-term interest rate	20,1	16,8	13,0	14,0	13,5
Long-term interest rate	—	19,6	14,2	14,8	14,5
Competitiveness [1]	93,5	90,1	91,2	92,8	93,5
Budget balance (% of GDP)	−10,5	−8,1	−6,5	−6,0	−6,1
Gross public debt (% of GDP)	55,8	69,8	74,5	75,3	76,3
Nominal wages per head (% change)	21,5	19,2	10,6	12,3	12,9
Real wages per head (% change)	−2,5	4,1	0,9	−0,7	1,4

[1] Total economy.
For definitions, see table for Belgium, p. 60.

The inflation differential from the EC average has not narrowed since the middle of 1988 and needs to be greatly reduced before a successful entry into the European Monetary System can take place. Progress on the inflation front is one of the national authorities' prime objectives and both the exchange rate and monetary policy have been geared to it. Inevitably, the efficiency of monetary policy is bound to decrease with the progressive relaxation of controls on capital movements, making even more pressing the need for a restrictive budgetary policy. The resumption of an active incomes policy, based on prudent and credible targets, could play a useful role.

Catching up with the Community: the need for a vigorous effort

Assisted by a favourable set of external conditions, the Portuguese economy has been successfully converging with the rest of the Community since 1985. As regards per capita income, the key to convergence is a successful long-term investment effort. The increase in structural Funds agreed upon last year will particularly benefit Portugal and represents a unique opportunity to underpin the dynamism of gross fixed capital formation. However, as past experience shows quite well, the correct allocation of investment is at least as important as its volume. Given the tendency towards a deterioration of the current account, economic policy should ensure that the investment effort is mainly allocated to the export sector or indirectly improves its competitiveness.

A successful modernization of the Portuguese economy depends on its adaptation to the challenge of the almost simultaneous completion of the internal market and the end of the transition period. This will require a strong emphasis on policies geared to improving the supply side of the economy. In this respect and given the number of publicly owned enterprises, the importance of the privatization process, which has recorded a very promising start, can hardly be overstated. Further progress on the modernization and liberalization of financial markets and in reducing the rigidities and bottlenecks in the labour market will also play a role. An important step towards liberalizing capital markets was taken recently with the announcement that from January 1991 residents will be allowed to buy foreign securities.

United Kingdom

Slower growth after serious overheating

1988 marked the end of a seven-year period of strong growth in the UK economy averaging over 3 % per annum. Growth of domestic demand in 1988, fuelled by high real earnings growth, credit expansion and a residential and business investment boom, far exceeded most expectations, at about 7 % (this figure, like other recent UK data, needs to be interpreted with caution given the very serious discrepancies displayed by official economic statistics). Overheating in the economy was evident in a swift deterioration of the current external deficit, to over 3 % of GDP for the year, and an acceleration in inflation to an annual rate in the second half of about 6 % (private consumption deflator). To dampen demand, short-term interest rates were raised progressively, from a low of 7 ½ % in May 1988 to 13 % by November. To support the exchange rate, interest rates were raised by a further 1 % in May 1989. The March 1989 Budget was conspicuously cautious. Despite the very large public-sector surplus that emerged during the 1988-89 financial year (UKL 14,3 billion, some 3 % of GDP), the tax burden was projected to remain unchanged relative to GDP and public expenditure on the same basis to decline somewhat, implying a more restrictive stance overall.

A period of below potential growth has become inevitable to control and reduce inflationary pressures. Developments in the first half of 1989 indicated a distinct slowing of demand growth, particularly private consumption and residential investment, and some slowing of activity. Whether this is sufficient to achieve a rapid improvement in inflation and the external deficit remains uncertain. More recent developments have indicated a worsening of wage tension, while the current deficit is likely to be larger in 1989 than in 1988.

Table 1

Macroeconomic performance

	1982-84	1985-87	1988	1989	1990
GDP[1] (% change)	2,5	4,0	4,2	2,2	2,1
Total domestic demand (% change)	3,3	4,1	7,3	3,7	0,8
Employment (% change)	−0,4	1,3	3,1	1,7	0,7
Unemployment rate[2] (%)	11,0	11,2	8,7	6,8	6,5
Inflation[3] (%)	6,2	4,5	5,0	5,3	5,5
Current account balance (% of GDP)	1,2	0,0	−3,2	−4,1	−3,3

[1] Average measure at market prices.
[2] SOEC definition, % of civilian labour force.
[3] Private consumption deflator.

Unemployment has fallen rapidly since 1986, increasing labour market pressures, but the outlook for activity indicates that the pace of this decline will probably slow if not reverse shortly. Prospects for 1990 suggest that domestic demand will continue to be depressed, with slower growth of private fixed investment accompanying the slowdown in private consumption expenditure. A positive net trade contribution and a recovery in energy output, depressed in 1988 and 1989 by serious accidents in the North Sea, may help prevent too abrupt a slowdown in total output. The acceleration in wage settlements during 1989 suggests that only a gradual easing in wage growth and underlying price inflation is likely next year.

Better balanced, low-inflation growth is necessary

In a medium-term perspective there are both positive and negative aspects in the development of the economy. On the positive side, the structural adjustment policies pursued during the 1980s have borne fruit in faster growth of productive potential, now estimated by the authorities at about 2 ¾ % per annum, or some 3 % per annum for the non-oil economy. This compares favourably with actual growth of just over 2 % per annum for the years 1979 to 1988. Annual growth of non-residential investment accelerated sharply

Table 2

Investment, production potential and productivity

	1982-84	1985-87	1988	1989	1990
Gross fixed capital formation					
• % of GDP	16,4	17,2	18,9	19,3	19,2
• % change	6,3	4,8	13,1	4,6	1,7
of which:					
Non-residential	6,1	5,2	14,7	7,4	2,9
• Business	5,2	5,6	18,4	7,2	3,1
manufacturing	5,9	5,2	11,0	8,9	3,7
other	5,1	5,6	20,2	6,8	2,9
• General government[1]	13,5	2,8	−20,9	29,6	4,1
Residential	7,1	3,5	7,1	−7,0	−4,3
Productive potential	2,0	2,2	:	:	:
Labour productivity growth					
• whole economy	3,5	2,9	1,0	0,4	1,3
• manufacturing	7,2	4,6	5,4	4,9	5,2
• non-manufacturing	2,2	2,3	−0,1	−0,7	0,4

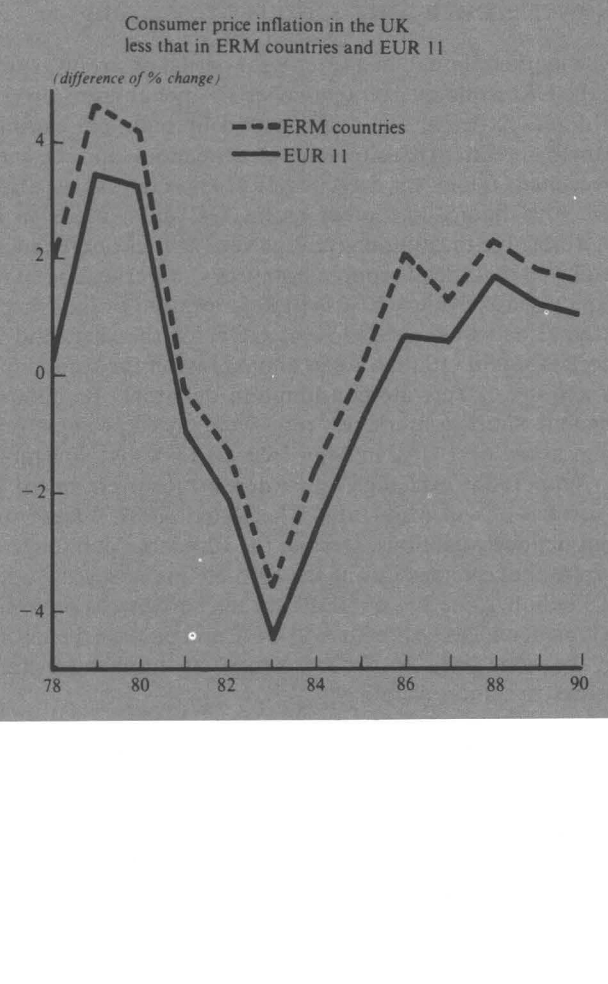
[1] Including sales of existing dwellings.

in 1987 and 1988, helped considerably by sharply rising profitability. Although shortages of capacity became evident in 1988, total fixed investment relative to GDP has risen from 16,4 % in 1982-84 to about 19 % in 1988. Moreover, productivity improvements in manufacturing have resulted from better use of available capacity as well as a deepening of the capital stock: total factor productivity growth rose to 4 ½ % per annum in the four years to 1988 and capital productivity to 3 ¼ % per annum. Labour productivity in manufacturing increased by 4 ¾ % per annum in the same period, a consequence of strong output growth as the decline in employment stabilized. However, outside of manufacturing, labour productivity has risen more slowly, given the expansion of employment, and appears to have halted in 1988.

On the other hand, some long-standing weaknesses in the economy have not been resolved. The chief problem is the failure to continue progress towards price stability. The government's framework for securing price stability, the Medium-term Financial Strategy (MTFS), has been in place for 10 years, with successive revisions. After early success in the years to 1983, the UK's relative inflation performance has since deteriorated (Graph 1), and there have been recurrent difficulties during a period of deregulation in establishing a reliable regime of monetary policy. During this time, the labour market has improved significantly in terms of flexibility and employment generation, but wage growth has not decelerated, suggesting that the fundamental causes of high inflation lie more with the failure to achieve a macroeconomic policy framework convincingly oriented towards price stability. Nevertheless, specific ways of encouraging more moderate wage development should be further explored: by encouraging more consensual attitudes in favour of this objective and by continuing with efforts to improve geographical and occupational labour mobility.

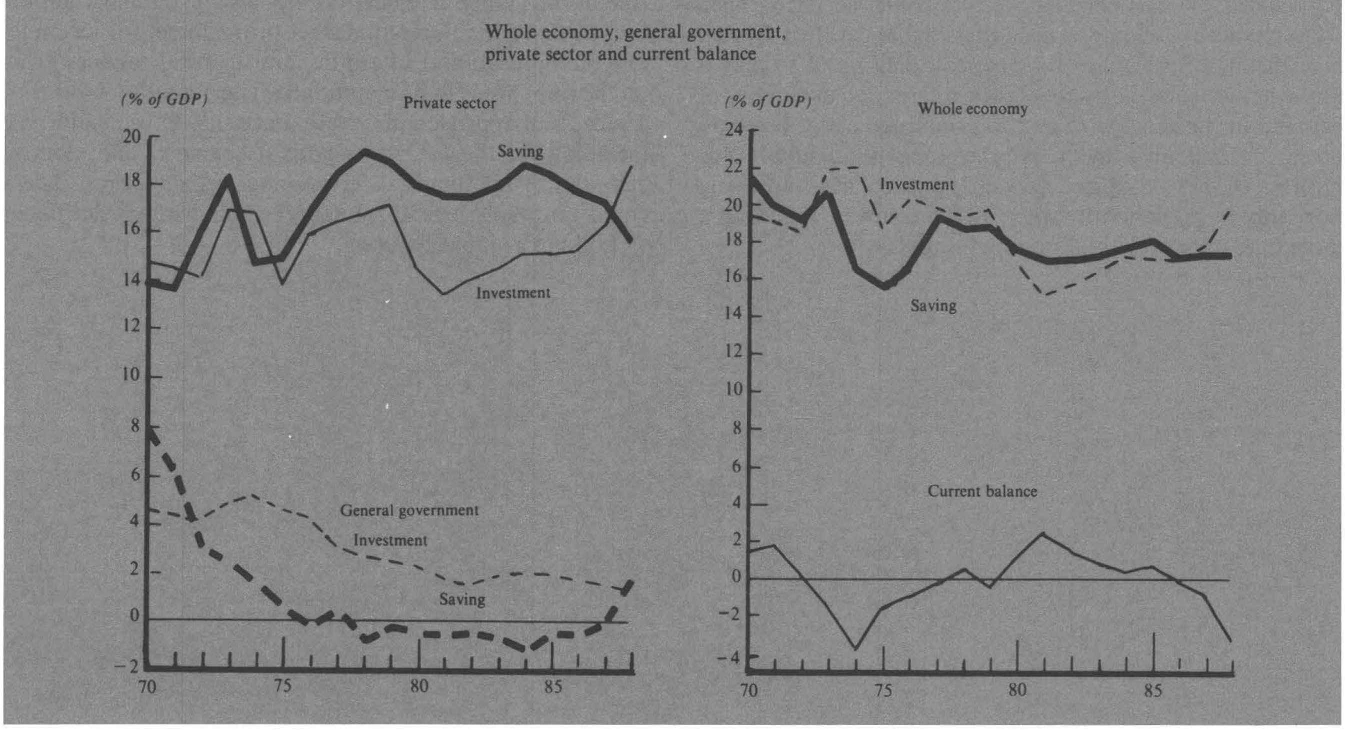
Other weaknesses are also apparent. The recovery in private investment relative to GDP since its trough in 1980 has not been accompanied by higher private-sector saving (Graph 2). Indeed, there has been a sharp fall since 1984, led by the personal sector (encouraged, *inter alia*, by increasing wealth stemming from the steep rise in residential property prices). By contrast, general government saving has risen sharply and net public investment has declined relative to GDP from already low levels. For the whole economy saving relative to GDP has changed little since the early 1980s; investment has recovered from its slump in 1979 and 1980, but to levels which by international standards remain low. The consequences in terms of sectoral financial balances (although such estimates are subject to large residual errors) look undesirable. Particularly, the current account deficit is financed largely by short-term net inflows which are highly dependent on maintaining market confidence.

GRAPH 1: **UK comparative inflation performance**



The current account deficit is of such a size that adjustment must inevitably be achieved over the medium term. It might be argued that the deficit owes something to a deliberate intertemporal choice by the private sector to consume or invest, accepting the implied reduction in assets or increase in liabilities, which will be naturally self-correcting. It would nevertheless be unwise to count on this, and the difficulties of continuing to finance the deficit may impose a more urgent response by the authorities. Moreover, although the expansion of the deficit in 1988 obviously owed most to excessive demand growth, performance assessed over a longer period suggests more deep-seated weaknesses, the correction of which becomes more necessary as the cushion provided by the oil surplus dwindles. Assistance from greater price competitiveness is likely to be limited, given the policy of a firm exchange rate and the likelihood of wage rises failing to decelerate markedly; a further strengthening of industrial performance as well as a restrained evolution of domestic demand seem necessary.

GRAPH 2: **Saving and investment**



The need for a cautious policy stance to continue

In spite of the undoubtedly better performance in the 1980s, the economy faces a difficult period ahead, a product of a cyclical slowdown, the need to correct the excesses of recent fast growth, and the need also to counter more long-standing underlying weaknesses. Current policy is to bear down on inflation through high interest rates, accompanied by a prudent fiscal stance in which the public-sector surplus is reduced only over the medium term and by further measures to improve the supply side.

However, a wider range of options seems to be needed if a significant and lasting reduction in inflation is to be achieved, including greater consideration of the role of fiscal policy, the monetary/exchange-rate framework (early participation in the exchange-rate mechanism of the EMS) and the nature of wage determination. Saving, especially in the private sector, appears too low for the current level of investment,

Table 3

Economic policy indicators

	1982-84	1985-87	1988	1989	1990
Money growth, M4 (% change)	9,8	18,2	17,0	16,7	10,3
Short-term interest rate	10,8	10,9	10,3	13,7	13,0
Long-term interest rate	11,4	10,0	9,3	9,5	9,2
Competitiveness	87,9	79,7	81,7	81,5	81,3
Budget balance[1] (% of GDP)	−3,2	−2,2	0,8	1,5	1,1
Gross public debt (% of GDP)	58,4	56,0	49,1	43,5	40,4
Compensation of employees (% change)	7,4	7,0	7,4	8,3	8,7
Real wages per head (% change)	1,2	2,4	2,3	2,8	3,0

[1] General government.
For definitions, see table for Belgium, p. 60.

which is not high. Public investment has fallen to very low levels. Thought needs to be given to how higher saving, particularly by the personal sector, could be encouraged so as to accommodate a desirably higher level of overall investment. Fiscal policy thus seems called upon to play a more active role, both to ensure a gradual evolution of demand in the short term and to encourage better balances of saving and investment. At the same time, supply-side reforms should be carried forward, particularly improving flexibility in the labour market with the aim of achieving a more moderate growth of nominal wages.

In the Community context, preparing for the internal market is of prime importance. The UK has so far played a leading role in furthering deregulation in many of the most important areas of the internal market programme, for example, telecommunications, air traffic and financial services. This momentum needs to be maintained. The potential rewards of a successful approach in certain areas should be significant, including for the City as regards its banking and security activities or for financial services in a broader sense. These could profitably extend a European role without detriment to London's global standing.

Key macroeconomic indicators for the Community and the Member States

Contents[1]

[1] The forecasts in this document for 1989 and 1990 were finalized by the Commission services on 3 October 1989 and therefore do not take account of economic policy measures taken after that date.

Table 1

Gross domestic product

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	4,9	2,0	1,5	0,2	2,3	0,9	1,9	2,0	4,0	4,2	3,3
DK	(b)	4,3	1,2	3,0	2,5	4,4	4,2	3,3	−1,0	−0,4	1,6	2,0
D	(b)	4,4	1,9	−0,6	1,5	2,8	2,0	2,3	1,9	3,7	3,8	3,5
GR	(a)	7,7	3,0	0,4	0,4	2,8	3,1	1,2	−0,4	4,0	2,5	2,3
E	(b)	7,2	1,8	1,2	1,8	1,8	2,3	3,3	5,5	5,0	4,7	4,0
F	(b)	5,4	2,5	2,5	0,7	1,3	1,7	2,1	2,2	3,4	3,3	3,2
IRL	(c)	4,4	4,3	2,3	−0,2	4,2	1,6	−0,4	4,1	3,7	5,1	4,6
I	(b)	5,3	2,6	0,2	1,1	3,2	2,9	2,9	3,1	3,9	3,5	3,0
L	(b)	4,2	1,2	1,5	2,9	6,2	3,7	4,7	2,5	5,2	3,7	3,3
NL	(b)	4,8	2,0	−1,4	1,4	3,2	2,6	2,1	1,3	2,8	3,8	3,0
P	(d)	6,9	3,0	2,2	−0,0	−1,4	2,8	4,3	4,7	3,9	4,7	4,6
UK	(c)	3,2	0,7	1,2	3,8	1,8	3,6	3,1	3,8	4,2	2,2	2,1
EC	(b)	4,8	1,9	0,8	1,6	2,3	2,5	2,6	2,8	3,8	3,4	3,1

(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 2

Domestic demand

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	4,8	1,7	0,8	−2,2	2,3	0,6	3,0	3,4	4,0	4,5	3,3
DK	(b)	4,6	0,0	3,5	1,4	5,1	5,7	5,4	−3,2	−2,2	0,7	1,1
D	(b)	4,5	1,7	−2,0	2,3	2,0	0,8	3,5	3,2	3,8	2,7	3,1
GR	(a)	8,1	1,7	1,5	0,4	0,9	4,2	−1,8	−1,8	3,5	3,5	2,7
E	(b)	7,7	1,4	1,1	−0,1	−0,7	2,9	6,1	8,5	6,7	6,7	5,3
F	(b)	5,5	2,0	3,5	−0,7	0,4	2,2	3,9	3,3	3,8	3,2	3,3
IRL	(c)	5,3	3,5	−2,1	−2,6	1,1	−0,4	1,4	−1,5	0,2	5,0	4,3
I	(b)	5,3	1,5	0,3	0,1	4,1	3,1	3,6	4,8	4,3	4,1	3,7
L	(b)	4,3	1,8	0,9	0,1	4,3	1,4	2,3	2,5	4,6	3,3	2,9
NL	(b)	4,9	1,5	−0,9	1,5	1,7	3,2	3,5	2,1	2,3	4,3	2,9
P	(d)	7,3	2,3	2,1	−5,3	−6,2	0,9	8,4	10,6	8,3	5,6	5,0
UK	(c)	3,2	0,1	2,3	4,9	2,7	2,7	3,8	4,3	7,3	3,7	0,8
EC	(b)	4,9	1,4	0,9	1,1	1,8	2,3	3,9	4,0	4,8	3,8	3,0

(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 3

Private consumption

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	4,3	2,3	1,5	−1,4	1,2	2,1	3,4	1,6	2,5	3,2	3,3
DK	(b)	3,8	0,7	1,4	2,6	3,4	5,5	3,8	−1,0	−1,1	0,0	1,0
D	(b)	5,0	2,7	−1,3	1,6	1,9	1,6	3,4	3,4	2,7	1,7	3,0
GR	(a)	6,7	3,2	3,9	0,3	1,7	3,9	−0,0	0,5	3,2	2,7	2,0
E	(b)	7,2	2,0	0,2	0,3	−0,4	2,4	3,6	5,5	4,2	4,6	4,0
F	(b)	5,3	2,7	3,5	0,9	1,1	2,3	3,4	2,5	2,8	2,6	2,8
IRL	(c)	4,1	3,0	−7,1	0,9	1,1	2,9	3,1	0,1	3,2	4,9	4,5
I	(b)	5,9	2,5	1,0	0,5	2,6	3,1	4,2	4,6	3,8	3,7	3,8
L	(b)	4,6	3,2	0,2	−0,1	2,4	1,7	4,2	1,4	3,5	3,3	2,8
NL	(b)	5,6	2,7	−1,2	0,9	1,0	2,4	2,9	2,9	1,2	3,2	3,3
P	(d)	6,0	2,3	2,4	−1,5	−3,1	0,4	7,0	6,8	6,6	3,5	3,5
UK	(c)	2,9	0,9	0,9	4,5	1,8	3,5	5,4	5,1	6,9	4,0	2,1
EC	(b)	4,9	2,2	0,8	1,4	1,5	2,6	3,9	3,8	3,8	3,1	3,0

(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 4

Gross fixed capital formation (a)

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(c)	5,1	−0,6	−1,7	−4,2	2,1	1,0	3,7	7,6	12,9	12,3	5,8
DK	(c)	6,5	−5,3	7,1	1,9	12,9	11,8	17,3	−9,0	−6,5	−0,0	2,2
D	(c)	4,0	0,1	−5,3	3,2	0,8	0,1	3,3	1,8	5,9	7,7	5,1
GR	(b)	10,0	−1,9	−1,9	−1,3	−5,7	5,2	−5,7	−3,2	9,0	6,6	6,4
E	(c)	10,4	−1,3	0,5	−2,5	−5,8	4,1	10,0	14,6	14,0	13,9	9,9
F	(c)	7,7	0,2	−1,4	−3,6	−2,6	2,8	2,9	3,7	7,3	5,6	5,5
IRL	(d)	10,0	4,6	−3,4	−9,3	−2,0	−6,6	−0,3	0,0	−1,7	8,6	10,0
I	(c)	4,3	0,5	−5,7	−0,1	5,3	2,5	1,4	5,2	4,9	5,2	4,0
L	(c)	5,1	−1,1	−0,4	−11,6	−0,4	−3,3	15,8	5,3	4,5	4,3	4,0
NL	(c)	5,3	−1,6	−4,1	2,1	5,4	6,8	8,2	1,6	9,7	6,7	1,4
P	(e)	7,9	1,6	3,4	−7,6	−17,2	−3,4	9,5	19,5	15,8	11,6	10,0
UK	(d)	4,6	−1,8	5,4	5,0	8,6	3,8	0,9	5,5	13,1	4,6	1,7
EC	(c)	5,6	−0,4	−2,0	0,1	1,5	2,5	3,4	4,8	8,4	6,9	4,8

(a) Gross fixed capital formation in construction and equipment does not necessarily add up to the total.
(b) 1970 prices. (c) 1980 prices. (d) 1985 prices. (e) 1986 prices.

Table 5

Gross fixed capital formation — Construction

(Annual % change)

		1971-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	2,4	−1,6	−5,6	−6,2	−5,9	−0,4	2,0	5,5	12,0	9,0	3,8
DK	(b)	5,1	−7,2	−1,3	1,9	8,8	8,9	17,5	−0,9	−6,1	−3,0	1,5
D	(b)	3,9	−0,9	−4,3	1,7	1,6	−5,6	2,7	0,2	4,7	4,8	3,2
GR	(a)	12,6	−3,1	−13,2	5,3	−6,9	3,1	0,2	−4,9	7,7	7,5	6,0
E	(b)	7,3	−1,6	0,1	−2,0	−5,2	2,0	6,5	10,0	13,5	14,6	10,9
F	(b)	5,6	−0,2	−2,5	−3,6	−2,9	0,6	2,5	3,3	4,3	3,8	3,4
IRL	(c)	8,0	3,9	1,3	−14,3	−4,4	−9,7	−3,6	−6,5	−6,8	6,1	10,2
I	(b)	−1,3	−0,4	−6,6	1,1	−0,0	−0,6	0,7	−1,3	3,7	4,0	3,0
L	(b)	11,7	−1,5	−2,4	−12,7	−4,6	4,7	6,0	4,6	5,4	4,1	3,4
NL	(b)	−0,1	−2,0	−6,6	−3,4	4,0	0,2	4,8	2,8	12,6	4,3	0,4
P	(d)	—	—	1,8	−3,3	−9,2	−6,0	8,7	10,5	12,3	11,5	11,0
UK	(c)	1,7	−3,3	8,8	5,0	6,1	−2,2	3,7	3,9	6,5	−1,4	−1,0
EC	(b)	3,2	−1,4	−2,5	−0,2	−0,1	−1,5	3,2	2,4	6,3	4,7	3,6

Note: EUR without Portugal up to 1981, EUR 12 from 1982 onwards.
(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 6

Gross fixed capital formation — Equipment

(Annual % change)

		1971-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	3,1	2,6	5,5	−2,3	13,8	2,7	4,8	8,6	14,0	16,0	8,0
DK	(b)	3,8	−1,3	19,9	2,2	17,9	16,2	15,4	−14,5	−7,0	4,0	3,0
D	(b)	0,3	2,1	−7,0	5,6	−0,2	9,9	4,3	4,1	7,5	11,3	7,4
GR	(a)	11,8	0,1	14,1	−8,5	−4,2	7,7	−12,6	−1,0	10,7	5,5	7,0
E	(b)	10,9	−0,5	2,2	−4,8	−7,3	9,1	15,8	24,2	14,7	12,8	8,7
F	(b)	9,0	0,7	1,6	−3,5	−0,9	6,7	2,5	4,7	9,7	7,0	7,0
IRL	(c)	13,7	5,1	−8,0	−3,4	1,9	−2,7	5,3	3,6	2,8	10,5	9,9
I	(b)	5,9	1,9	−4,4	−4,2	9,3	8,2	2,0	15,0	6,0	6,2	4,8
L	(b)	5,4	−0,5	0,8	−7,2	3,7	−16,5	39,1	6,1	3,0	4,5	5,0
NL	(b)	2,2	−0,6	−0,0	10,0	9,5	16,1	11,3	1,1	6,3	9,8	2,7
P	(d)	—	—	6,4	−12,2	−30,3	−4,9	13,7	31,0	19,5	11,7	9,0
UK	(c)	3,5	−0,1	1,3	4,8	11,4	10,1	−1,8	7,2	20,4	10,3	4,0
EC	(b)	5,4	1,0	−1,2	−0,1	3,6	8,7	3,5	8,5	10,6	9,2	6,1

Note: EUR without Portugal up to 1981, EUR 12 from 1982 onwards.
(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 7

Exports of goods

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	10,2	2,2	2,0	2,4	6,5	1,0	5,7	5,5	9,2	8,3	6,1
DK	(b)	6,8	4,7	2,1	7,7	5,5	4,5	0,1	3,0	6,0	5,5	5,3
D	(b)	8,0	4,7	3,2	−1,0	8,5	7,8	−0,3	1,2	6,2	11,2	7,2
GR	(a)	11,9	5,5	0,2	14,2	21,4	−0,1	16,9	1,9	6,1	4,2	4,0
E	(b)	—	8,9	6,3	10,2	13,6	3,0	−3,5	5,8	8,0	6,6	5,4
F	(b)	10,0	5,2	−2,8	3,6	7,0	2,0	−0,3	3,4	7,9	9,0	7,0
IRL	(c)	8,1	7,9	5,3	12,0	17,6	6,7	4,2	13,5	8,9	12,9	9,3
I	(b)	11,8	7,3	−1,6	4,0	7,7	2,9	4,9	3,0	5,9	6,3	5,0
L	(b)	5,5	−0,8	−1,2	4,1	21,9	11,7	4,2	6,1	9,0	7,0	5,5
NL	(b)	10,3	2,7	−0,4	4,6	7,6	6,0	2,2	3,8	8,2	6,4	5,9
P	(d)	—	—	—	—	—	—	—	11,1	7,8	17,5	11,0
UK	(c)	5,0	3,5	2,8	2,3	8,1	5,5	3,6	5,2	1,4	4,0	8,2
EC	(b)	8,8	4,8	1,2	3,1	8,4	4,7	2,1	3,8	6,2	8,0	6,7

Note: EUR 10 up to 1973, EUR 11 (without Portugal) from 1974 to 1986, EUR 12 from 1987 onwards.
(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 8

Imports of goods

(Annual % change)

		1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	(b)	9,3	1,9	1,5	−0,9	6,2	0,1	8,0	8,4	9,2	8,5	6,2
DK	(b)	7,9	−0,2	2,4	3,2	7,1	8,5	5,4	−3,0	−0,1	3,9	3,4
D	(b)	8,8	4,0	−1,2	2,5	6,6	5,0	4,1	5,4	6,5	8,0	6,7
GR	(a)	12,7	0,4	9,1	9,4	−0,1	28,8	4,2	10,8	6,2	7,4	5,1
E	(b)	—	1,7	3,9	−0,1	−1,0	5,8	16,9	22,1	14,5	14,8	10,5
F	(b)	11,3	2,4	2,9	−2,7	2,6	4,4	7,7	7,5	9,2	8,5	6,8
IRL	(c)	9,2	4,5	−3,4	4,5	10,5	3,3	5,4	3,9	3,2	14,0	9,5
I	(b)	10,4	3,9	−1,4	−1,9	10,8	4,4	6,0	10,0	7,2	8,0	7,0
L	(b)	6,1	1,1	−1,6	1,8	16,8	7,5	4,1	7,0	7,0	6,2	4,8
NL	(b)	9,4	1,3	1,0	4,5	5,4	7,3	3,5	5,9	7,4	7,0	5,7
P	(d)	—	—	—	—	—	—	—	28,3	17,7	14,0	9,0
UK	(c)	5,2	0,3	5,5	9,0	11,3	3,1	6,9	6,9	13,0	9,4	2,4
EC	(b)	9,0	2,3	1,6	2,1	6,8	5,0	6,6	8,7	9,1	9,0	6,2

Note: EUR 10 up to 1973, EUR 11 (without Portugal) from 1974 to 1986, EUR 12 from 1987 onwards.
(a) 1970 prices. (b) 1980 prices. (c) 1985 prices. (d) 1986 prices.

Table 9

Deflator of GDP

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	4,1	7,1	7,2	5,8	5,0	5,9	3,4	2,0	1,5	3,1	3,6
DK	7,0	10,0	10,6	7,6	5,7	5,2	4,2	5,0	4,9	3,8	2,8
D	4,3	4,7	4,4	3,3	2,0	2,2	3,1	2,0	1,4	2,4	2,7
GR	4,5	16,3	25,1	19,1	20,3	17,7	18,6	15,7	14,6	15,0	15,2
E	7,1	17,0	13,8	11,6	10,9	8,5	10,9	5,9	5,7	7,3	6,6
F	5,0	11,0	11,7	9,7	7,5	5,9	5,1	2,8	3,2	3,3	2,7
IRL	7,1	14,8	15,2	10,8	7,0	5,2	5,6	2,5	2,9	4,4	4,1
I	5,4	17,7	16,2	15,0	11,3	8,9	7,5	5,6	6,0	6,3	6,6
L	4,3	6,7	10,4	6,9	4,4	3,3	1,5	−1,1	3,4	3,2	3,5
NL	6,0	6,9	6,0	1,9	1,8	1,8	0,7	−0,9	1,8	1,4	2,3
P	3,9	19,6	20,6	24,4	24,1	21,7	19,8	12,1	11,7	12,4	12,0
UK	5,1	15,9	7,6	5,2	4,7	5,6	3,6	4,9	6,6	6,7	5,3
EC	5,2	12,2	10,4	8,5	6,9	6,1	5,5	4,0	4,4	4,9	4,6

Table 10

Deflator of private consumption

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	3,7	7,8	7,7	6,7	5,7	5,8	0,4	2,2	1,2	3,2	3,5
DK	6,6	11,0	10,2	6,8	6,4	4,7	3,4	4,1	4,9	4,7	3,0
D	3,6	5,0	4,7	3,2	2,4	2,1	−0,2	0,7	1,1	3,1	2,7
GR	3,5	16,8	20,7	18,1	17,9	18,3	22,0	15,7	13,9	14,3	15,0
E	6,6	17,5	14,5	12,3	11,0	8,2	8,7	5,4	5,1	6,8	6,3
F	4,8	11,5	11,5	9,7	7,7	5,8	2,7	3,1	2,7	3,5	2,7
IRL	6,0	16,6	15,3	9,2	8,1	4,5	3,9	3,1	2,5	4,1	4,0
I	4,8	17,6	15,9	15,0	11,7	9,3	5,8	4,8	4,9	6,3	6,0
L	3,0	7,5	10,8	8,9	5,5	5,2	0,8	2,9	1,5	3,3	3,1
NL	5,0	7,1	5,3	2,7	2,0	2,1	0,6	−0,3	0,8	1,4	2,3
P	3,9	21,6	20,2	25,9	28,7	19,8	13,5	10,2	9,6	13,0	11,3
UK	4,8	15,1	8,8	4,8	5,1	5,3	4,4	3,9	5,0	5,3	5,5
EC	4,6	12,3	10,5	8,5	7,2	5,9	3,8	3,4	3,6	4,8	4,5

Table 11

Compensation of employees per head

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	8,9	10,9	7,7	6,3	6,7	4,4	4,1	0,9	2,4	5,4	5,8
DK	10,7	11,4	11,9	8,2	5,5	4,9	4,7	8,2	4,3	3,6	3,3
D	9,2	7,1	4,2	3,7	3,5	3,1	3,9	2,9	3,1	3,1	3,4
GR	10,2	21,2	27,8	21,3	22,3	23,3	13,2	11,7	18,4	20,6	16,2
E	14,6	21,2	13,7	13,8	10,0	9,4	9,5	6,4	6,4	7,6	7,1
F	9,9	14,9	14,1	10,1	8,2	6,6	4,1	3,7	3,8	4,0	4,0
IRL	11,3	19,3	14,4	12,6	11,3	7,4	5,0	6,0	2,3	4,8	5,0
I	11,6	20,5	16,2	15,9	11,8	10,3	7,4	9,0	8,8	9,2	8,0
L	7,4	10,7	6,9	6,9	7,1	3,5	5,2	3,9	4,0	6,4	6,1
NL	11,4	8,7	5,8	3,2	0,2	1,4	1,9	1,3	1,4	1,3	3,4
P	12,0	25,4	21,6	21,8	21,2	22,5	20,3	13,6	10,6	12,3	12,9
UK	8,3	17,1	8,4	8,6	5,3	6,7	7,4	6,9	7,4	8,3	8,7
EUR	10,0	14,9	11,0	9,8	7,5	6,9	6,2	5,5	5,6	6,1	6,2

Table 12

Real compensation of employees per head (a)

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	5,1	2,9	0,0	−0,3	0,9	−1,3	3,7	−1,3	1,2	2,1	2,2
DK	3,8	0,4	1,5	1,3	−0,8	0,2	1,2	4,0	−0,6	−1,1	0,3
D	5,4	2,0	−0,5	0,5	1,0	1,0	4,1	2,2	2,0	0,0	0,7
GR	6,5	3,7	5,9	2,7	3,8	4,2	−7,2	−3,4	4,0	5,6	1,1
E	7,5	3,2	−0,7	1,3	−0,9	1,1	0,7	0,9	1,2	0,7	0,8
F	4,8	3,0	2,3	0,4	0,5	0,8	1,4	0,6	1,1	0,5	1,3
IRL	5,0	2,3	−0,8	3,2	2,9	2,7	1,1	2,8	−0,2	0,6	0,9
I	6,5	2,5	0,2	0,8	0,0	1,0	1,6	4,0	3,8	2,7	1,9
L	4,2	2,9	−3,5	−1,9	1,5	−1,7	4,4	0,9	2,5	3,0	2,9
NL	6,0	1,6	0,5	0,4	−1,7	−0,7	1,3	1,6	0,6	−0,1	1,1
P	7,8	3,1	1,1	−3,3	−5,8	2,2	6,0	3,1	0,9	−0,7	1,4
UK	3,3	1,7	−0,3	3,6	0,2	1,4	2,8	3,0	2,3	2,9	3,0
EC	5,1	2,3	0,5	1,2	0,2	0,9	2,3	2,0	1,9	1,3	1,6

(a) Deflated by the price deflator of private consumption.

Table 13

Unit labour costs

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	4,5	8,5	4,7	5,0	4,3	4,2	3,1	−0,8	−0,2	2,3	3,2
DK	7,3	10,2	9,1	5,8	2,8	3,6	3,6	10,6	3,7	1,2	1,8
D	4,8	4,7	3,1	0,6	0,7	1,7	2,5	1,7	−0,0	0,7	1,3
GR	1,9	19,2	26,3	22,1	19,4	20,8	12,2	12,0	15,0	18,4	14,3
E	7,7	17,3	11,3	11,2	5,5	5,6	8,5	6,2	4,3	6,4	5,7
F	4,9	12,4	11,4	8,9	5,8	4,5	2,1	1,6	1,1	2,1	2,0
IRL	6,7	15,4	11,8	10,8	4,8	3,4	5,6	1,9	−0,4	0,9	1,7
I	5,6	18,3	16,5	15,5	8,8	8,1	5,4	5,9	6,1	6,5	5,4
L	4,1	10,1	5,1	3,6	1,5	1,2	3,1	4,1	1,5	4,1	3,8
NL	7,1	6,7	4,6	−0,2	−2,9	0,4	1,7	1,1	−0,1	−0,9	1,4
P	4,2	21,6	16,7	20,4	21,1	19,1	12,2	11,4	9,2	8,9	8,8
UK	5,3	15,8	5,2	3,3	5,4	4,7	4,5	5,0	6,4	7,9	7,2
EC	5,2	12,6	9,2	7,3	5,1	4,9	4,3	3,8	3,3	4,2	4,1

Table 14

Real unit labour costs (a)

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	0,3	1,3	−2,3	−0,8	−0,7	−1,5	−0,3	−2,7	−1,6	−0,7	−0,4
DK	0,2	0,3	−1,3	−1,7	−2,7	−1,5	−0,5	5,3	−1,1	−2,5	−1,0
D	0,5	0,0	−1,2	−2,5	−1,2	−0,5	−0,6	−0,3	−1,4	−1,7	−1,4
GR	−2,5	2,5	1,0	2,5	−0,7	2,7	−5,5	−3,2	0,4	3,0	−0,8
E	0,6	0,3	−2,2	−0,3	−4,9	−2,8	−2,2	0,3	−1,3	−0,8	−0,8
F	−0,1	1,2	−0,3	−0,7	−1,5	−1,3	−2,8	−1,2	−2,1	−1,1	−0,6
IRL	−0,4	0,6	−2,9	−0,0	−2,0	−1,7	−0,0	−0,6	−3,2	−3,4	−2,3
I	0,2	0,5	0,3	0,4	−2,3	−0,7	−2,0	0,3	0,2	0,1	−1,1
L	−0,2	3,1	−4,8	−3,1	−2,8	−2,1	1,5	5,3	−1,8	0,9	0,3
NL	1,0	−0,2	−1,3	−2,0	−4,6	−1,4	1,0	2,0	−1,9	−2,3	−0,9
P	0,3	1,6	−3,3	−3,2	−2,4	−2,2	−6,3	−0,6	−2,2	−3,1	−2,9
UK	0,1	−0,1	−2,2	−1,7	0,7	−0,9	0,9	0,1	−0,2	1,1	1,9
EC	0,1	0,4	−1,1	−1,1	−1,7	−1,1	−1,2	−0,2	−1,1	−0,7	−0,5

(a) Real compensation of employees per head (deflated by GDP deflator), divided by labour productivity per head.

Table 15

Balance on current transactions with rest of world

(% of GDP)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	1,1	-1,6	-3,6	-0,6	-0,4	0,5	2,0	1,2	1,0	0,8	0,8
DK	-2,0	-3,5	-4,2	-2,6	-3,3	-4,6	-5,2	-3,0	-1,8	-2,0	-1,1
D	0,7	0,5	0,5	0,7	1,3	2,6	4,4	3,9	4,1	5,3	5,8
GR	-2,9	-1,7	-4,4	-5,0	-4,0	-8,2	-5,2	-2,5	-1,5	-3,4	-3,5
E	-0,2	-2,0	-2,5	-1,5	1,4	1,6	1,7	0,1	-1,1	-2,9	-4,0
F	0,4	-0,1	-2,1	-0,8	-0,0	0,1	0,5	-0,4	-0,4	-0,5	-0,5
IRL	-2,5	-8,6	-10,6	-6,9	-5,8	-4,0	-2,9	1,4	2,0	2,0	1,8
I	1,5	-0,7	-1,6	0,3	-0,7	-0,9	0,5	-0,1	-0,6	-1,3	-1,4
L	6,8	20,8	34,7	39,6	39,2	43,8	39,4	33,0	16,4	14,9	14,5
NL	0,5	1,0	3,2	3,1	4,2	4,1	2,8	1,6	2,4	2,1	2,1
P	0,4	-6,8	-13,5	-8,3	-3,4	0,4	3,9	1,8	-1,4	-2,8	-3,4
UK	-0,1	-0,4	1,5	0,9	-0,2	0,7	-0,9	-1,6	-3,2	-4,1	-3,3
EC	0,4	-0,3	-0,7	0,1	0,3	0,8	1,4	0,8	0,3	0,1	0,2

Table 16

General government lending and borrowing

(% of GDP)

	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	-6,6	-10,9	-11,2	-9,1	-8,6	-8,8	-7,0	-6,5	-6,0	-5,7
DK	-1,4	-9,1	-7,2	-4,1	-2,0	3,5	1,8	0,2	0,1	0,7
D	-3,0	-3,3	-2,5	-1,9	-1,1	-1,3	-1,8	-2,1	-0,0	-0,4
GR	—	-7,7	-8,3	-10,0	-13,8	-11,6	-9,9	-14,9	-19,9	-20,0
E	-1,3	-5,6	-4,8	-5,5	-7,0	-6,1	-3,6	-3,2	-2,6	-2,2
F	-1,0	-2,8	-3,2	-2,8	-2,8	-2,9	-2,5	-1,4	-1,2	-1,1
IRL	-10,5	-13,7	-11,6	-9,6	-11,1	-11,0	-8,9	-3,7	-3,7	-1,5
I	-8,4	-11,3	-10,6	-11,6	-12,5	-11,7	-11,2	-10,6	-10,3	-9,8
L	1,8	-0,5	2,6	3,4	4,5	2,5	2,7	2,5	2,4	2,8
NL	-2,9	-7,1	-6,4	-6,3	-4,8	-5,9	-6,2	-4,9	-4,4	-4,2
P	—	-10,4	-9,1	-12,0	-10,1	-7,8	-7,0	-6,5	-6,0	-6,1
UK	-3,8	-2,5	-3,3	-3,9	-2,7	-2,4	-1,5	0,8	1,5	1,1
EC (a)	-3,7	-5,5	-5,3	-5,3	-5,2	-4,8	-4,3	-3,6	-2,9	-2,9

(a) EUR without Greece and Portugal up to 1981, EUR 12 from 1982 onwards.

Table 17

Total employment (a)

(Annual % change)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	0,6	−0,2	−1,3	−1,1	0,0	0,8	1,0	0,4	1,4	1,1	0,6
DK	1,1	0,2	0,4	0,3	1,7	2,9	2,3	1,1	−0,3	−0,6	0,5
D	0,2	−0,4	−1,7	−1,5	0,1	0,7	1,0	0,7	0,6	1,4	1,3
GR	−0,5	1,3	−0,8	1,0	0,3	1,0	0,3	−0,1	1,1	0,7	0,7
E	0,7	−1,5	−0,9	−0,5	−2,4	−1,3	2,3	5,4	2,9	3,5	2,5
F	0,7	0,2	0,2	−0,4	−0,9	−0,3	0,2	0,1	0,6	1,4	1,2
IRL	0,1	0,9	0,0	−1,9	−1,9	−2,2	0,2	0,0	1,0	1,2	1,3
I	−0,4	0,7	0,6	0,6	0,4	0,8	0,9	0,2	1,3	0,9	0,6
L	1,1	0,6	−0,3	−0,3	0,6	1,4	2,6	2,7	2,9	1,7	1,3
NL	0,9	0,1	−2,5	−1,9	−0,1	1,5	1,9	1,2	1,3	1,6	1,0
P	−0,5	−0,1	−1,9	−1,1	−1,5	−0,0	−2,7	2,7	2,6	1,6	0,8
UK	0,3	−0,4	−1,8	−1,2	1,9	1,6	0,4	1,9	3,1	1,7	0,7
EC	0,3	−0,1	−0,9	−0,7	0,1	0,6	0,8	1,2	1,6	1,5	1,1

(a) National accounts definition.

Table 18

Number of unemployed as percentage of the civilian labour force (a)

(Annual average)

	1961-73	1974-81	1982	1983	1984	1985	1986	1987	1988	1989	1990
B	2,2	6,6	11,9	12,6	12,6	11,7	11,9	11,5	10,4	9,4	8,8
DK	1,1	6,7	11,1	9,5	9,1	7,6	5,8	5,8	6,4	7,4	7,6
D	0,9	3,7	6,8	6,9	7,1	7,3	6,5	6,4	6,4	5,6	5,4
GR	4,2	2,3	5,8	9,0	9,3	8,7	8,2	8,0	8,5	8,5	8,5
E	2,8	7,5	16,3	17,8	20,6	21,9	21,2	20,5	19,6	17,6	16,5
F	2,3	5,2	8,3	8,2	9,9	10,3	10,4	10,5	10,2	9,5	9,1
IRL	5,3	8,0	11,6	15,2	17,0	18,4	18,3	18,0	17,8	16,7	16,2
I	5,6	7,0	8,7	9,0	9,5	9,4	10,6	10,1	10,6	10,5	10,6
L	0,0	0,5	1,3	3,6	3,0	3,0	2,7	2,7	2,2	1,8	1,7
NL	1,3	5,6	11,6	12,5	12,5	10,4	10,3	10,2	10,3	9,9	9,6
P	2,6	6,5	7,5	7,7	8,4	8,5	8,3	6,8	5,6	5,2	5,2
UK	2,0	5,0	10,5	11,2	11,4	11,5	11,5	10,6	8,7	6,8	6,5
EC	2,6	5,5	9,5	10,0	10,8	10,9	10,8	10,4	10,0	9,0	8,7

(a) SOEC definition.

Analytical studies[1]

List of studies

[1] These studies have been prepared under the sole responsibility of the Commission services.

Study No 1

The recovery of growth in the 1980s and its main macroeconomic determinants

The recovery of growth in the 1980s and its main macroeconomic determinants

Tables

Graphs

Summary

Growth and employment in the Community have substantially improved since the middle of the 1980s. Forecasts for the Community confirm that growth is now on a trend rate of increase of over 3% per annum. Employment is rising faster than at any time over the last 30 years (over 1% annually). The unemployment rate (9% in 1989) is falling, but only slowly. This overall economic improvement is a consequence of the reorientation of economic policies since the beginning of the decade. By 1985, however, the prospects for growth and reducing unemployment were still poor. Against this background the cooperative growth strategy for more employment was adopted for the Community. It reflected the growing consensus on the necessity for a better balance between demand management and supply-side policies. This blueprint for higher sustainable employment-creating growth with stability in the Community was subsequently complemented by the decision to complete the internal market and to implement policies to accelerate the catching-up of the poorer Community countries and regions. Four main aspects of the recovery reflect the fundamental improvement in the Community economy: higher profitability has largely contributed to boosting investment; a better balance between labour productivity and real wage costs has slowed down the rate of substitution of labour by capital and thus increased the employment content of growth; the progress made in consolidating the public finances, but which is still insufficient, has released resources for private investment; the better investment performance has resulted in a faster growing capital stock which has lowered the risk of capacity constraints and simultaneously sustained domestic demand, thus making the Community less dependent on external factors. Prospects for the 1990s are favourable. If growth, for instance, stays on a trend of 3% and the growth-employment relationship remains unchanged, employment can be expected to rise by 1% a year in the medium term and the unemployment rate could stand at 6% in 1995. This would, however, be just below the rate of 1980 but more than twice that of the early 1970s. A better performance, reducing the unemployment rate to 4% in 1995, could be achieved if employment growth were to accelerate to 1 ½%. A continued improvement in the growth conditions is therefore still necessary and could be achieved if the policies and behaviour along the lines defined in recent Annual Economic Reports are continued.

1. Overview

1.1. The improved performance

Forecasts for the Community confirm that growth is now on a trend rate of increase of over 3 % per annum. Employment is rising faster than at any time over the last 30 years (over 1 % annually). Unemployment is also declining, albeit slowly, and is expected to fall to less than 9 %[1] of the labour force by 1990. Although there has been a rise in inflationary pressures during 1989, inflation rates on the whole are now comparable with the relatively low rates experienced during the 1960s.

This contrasts sharply with the extremely poor performance from the middle of the 1970s to the early 1980s when the Community economy was characterized by slow growth

1 Unemployment according to the EC labour force survey which provides comparable rates for the member countries. The corresponding figure using the registered unemployment data which were used in previous annual economic reports would be about 10 %.

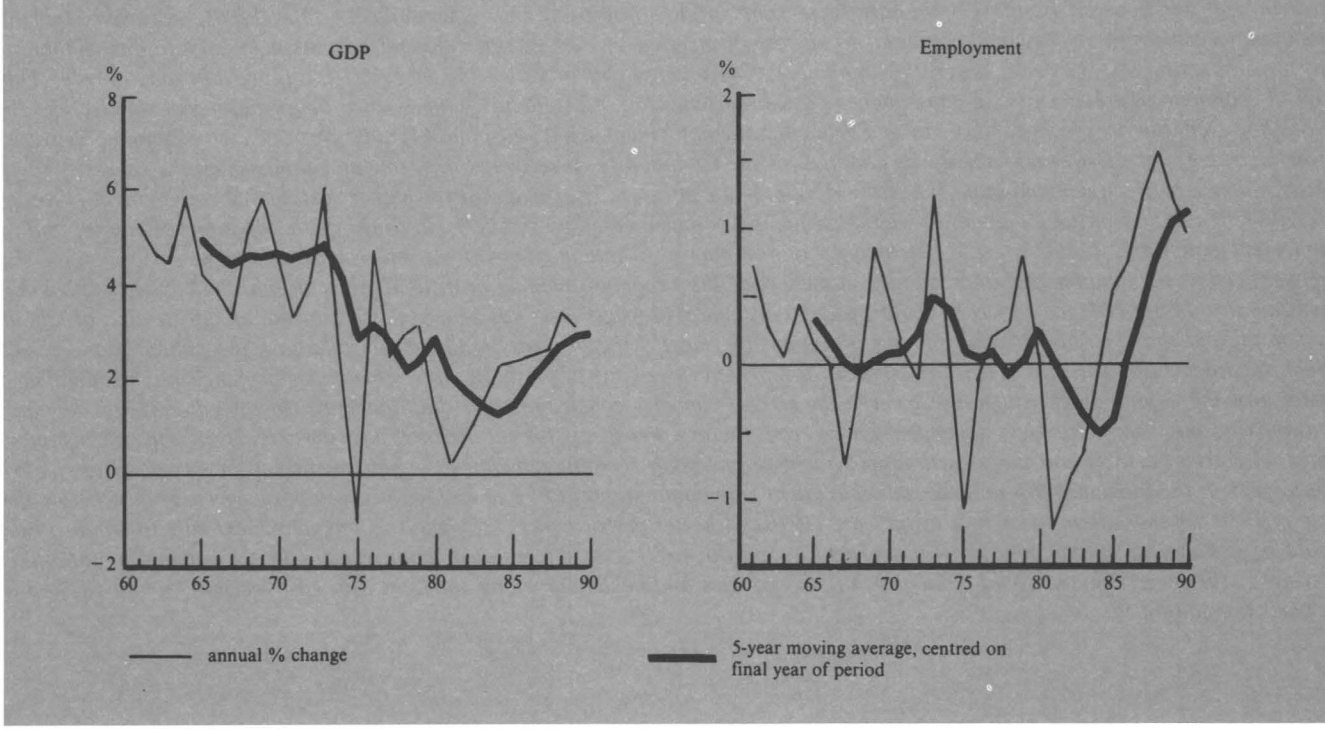
Table 1

Key indicators of economic performance in the Community

	1973/1960	1980/1973	1985/1980	1990[4]/1985
Annual % change				
Real GDP	4,8	2,2	1,5	3,1
Employment	0,3	0,1	−0,4	1,2
Investment[1]	5,6	0,3	−0,6	5,7
Private consumption deflator	4,6	12,4	8,8	4,1
Annual average (% of GDP)				
Current account balance	0,5	−0,5	−0,2	0,6
Net borrowing/lending of general government	−0,6[2]	−3,5[3]	−5,3	−3,7

1 Gross fixed capital formation at constant prices.
2 1970-73 EUR 10: EUR 12 excluding Greece and Portugal.
3 EUR 10: EUR 12 excluding Greece and Portugal.
4 Provisional forecasts, September/October 1989.
Source: Commission services.

GRAPH 1: **Real GDP and employment in the Community**



accompanied by chronic disequilibria in the form of persistently high inflation rates, rising unemployment and large public deficits. The years 1979 to 1984 were the most unfavourable five-year period for growth and employment since the early 1950s (see Graph 1). During that period the average annual increase in real GDP in the Community was only 1,2 %, compared to an average of 4,8 % achieved throughout the 1960s. Total employment fell by over 2,5 % in the same period, at a time when the labour force was rising, to leave the unemployment rate standing at 10,8 % in 1984.

1.2. Policy reorientation

From the early 1980s a consensus had begun to emerge regarding the need to change the direction of economic policy in order to lift the Community economy out of the slow growth trap into which it had fallen. It came to be recognized that a better balance between supply-side and demand management policies was required to eliminate the persistent disequilibria that had characterized the latter half of the 1970s. The first steps towards restoring stability to the European economies were taken. More stability-oriented monetary policies and a good adjustment of nominal wage increases helped to bring about a remarkable reduction in the inflation rate, from 13,5 % in 1980 to 5,9 % in 1985. This was achieved despite the difficult international environment and the depreciation of European currencies *vis-à-vis* the dollar. The continuing deterioration in budgetary positions experienced from the mid-1970s was halted in 1983 and thereafter budget deficits began to improve somewhat.

Despite this progress the overall outlook in 1985 was far from satisfactory with the Community facing the prospect of a low rate of growth which was totally inadequate to deal with its serious unemployment problem. The investment ratio was almost 3 points lower than at the beginning of the 1980s and almost 5 points lower than in 1974. The medium-term projections available at the time forecast growth averaging only some 2 ½ % a year up to 1990, with little hope of significantly reducing unemployment.

Against this background the 'Cooperative growth strategy for more employment' was adopted in the Annual Economic Report of 1985-86.[1] The strategy, whose central objective is to reduce unemployment significantly, reflected and articulated the growing consensus on the need to reorient economic policy. The implementation of its proposals would allow a return to stronger and more lasting growth, with a greater employment content, against a background of stability. Its basic guidelines won the support of the social partners within the framework of the Community's social dialogue.[2]

It was recognized in the strategy that growth was insufficient and that its employment content was too low. The structure of the economy had become biased too much in favour of capital-deepening and labour-saving investment, so that there has been insufficient employment-creating investment. This was largely due to the development of relative factor costs throughout the 1970s which was inappropriate for the labour market conditions at that time, a development supported by mis-directed budgetary and monetary policies.[3] While it is true that moderation in wage increases had allowed profitability to begin to recover somewhat from 1981 onwards, at the time the strategy was adopted it was clear that substantial further progress was required to achieve adequate investment and employment growth.

At the macroeconomic level the strategy called for moderate real wage increases to be accompanied by an adequate level of aggregate demand. This combination would ensure that profitability could continue to rise sufficiently to bring about the necessary increase in job-creating investment. At the microeconomic level action was to be taken to improve the flexibility of markets in goods, services, capital and labour. The objective behind the efforts to increase labour market flexibility was not to destroy achievements on the social front but to create more jobs.

In addition, monetary and budgetary policies were called on to provide a framework supportive of the objectives of the strategy. Monetary policy was to be used to create and maintain a stable monetary framework so that relative price movements and in particular interest rates could effectively perform their correct allocative function in the economy.

Budgetary policy was directed towards a qualitative and quantitative consolidation of public finances in order to improve both supply and demand conditions. The control of public expenditure would enable budget deficits to be reduced, where necessary, and allow taxes and social security contributions to fall where that became possible as a result of stronger growth. Public expenditure was to be restructured to favour greater productivity, in particular by engaging in economically profitable infrastructural projects and vocational training.

2. The growth process

2.1. The sustainability of growth

The second half of the 1980s has seen a significant turn around in the Community's economic and employment prospects. As proposed in the cooperative strategy, growth is accelerating and investment and employment are rising. Indeed the strong investment performance suggests that the faster growth can continue in the medium term, as the demand for capital goods remains buoyant. The estimated average increase in the volume of total investment between 1987 and 1990 of 6,7 % is more than twice the rate of increase in GDP. In addition, the improved profitability levels, coupled with the current high rates of capacity utilization, suggest that strong investment growth could be maintained. The share of GDP devoted to investment is now on a rising trend and in 1990 is forecast to be 2 % points above the minimum reached in 1986 but still about 3 % points below that of the first few years of the 1970s. The rate of growth of the capital stock has once again begun to increase, from 2,2 % in 1984 to almost 3 % in 1989.

Table 2

Investment, consumption and the balance of goods and services in the Community

(% of GDP)[1]

	1973[2]	1981	1986	1990[4]
Gross investment[3]	25,9	20,9	19,4	21,9
Consumption	74,8	79,6	78,8	78,1
of which:				
private	60,3	62,3	61,7	60,2
government	14,5	17,3	17,1	17,9
Balance of goods and services	−0,1	−0,4	1,8	0,0

[1] Figures are subject to statistical discrepancies.
[2] EUR 11: EUR 12 excluding Portugal.
[3] Gross capital formation including stocks.
[4] Provisional forecasts, September/October 1989.
Source: Commission services.

[1] Annual Economic Report 1985-86, Chapter 2, *European Economy*, No 26, November 1985.
[2] See joint opinions of the social partners on the cooperative growth strategy for more employment published in *European Economy*, No 30, November 1986 and No 34, November 1987.
[3] See Chapter 2, Section 2.3 of this study.

Even more impressive than the capital investment performance is that of employment which is now increasing at record rates (1,6 % in 1988 and an annual average of 1,2 % in the five years to 1990). This more than compensates for the loss of 3,5 million jobs between 1980 and 1983 in the aftermath of the second oil price shock. However, the current uptake in employment creation in the Community is only slowly affecting unemployment. This is due to a continuing, but slower, increase in the population of working age and participation rates which are responding positively to the improved growth and employment prospects. The decline in the male participation rate has come to a halt and the female participation rate has continued to rise. Further increases in participation rates may also be expected considering the significantly higher rates in the United States, Japan and Scandinavian countries.

2.2. Main changes in the fundamentals of growth

2.2.1. Profitability of fixed capital

A major factor in the expansion of investment in the Community has been the increase in the rate of return on productive capital since 1981. This increase in profitability has largely been due to the moderation in real wage increases with respect to labour productivity[1] which has been a particular feature of the Community economy in the 1980s. Prior to the first oil price shock the trend increase in real wages (GDP deflator) was more than 4,5 % per annum. This declined throughout the second half of the 1970s and even more so in the 1980s. Thus the average annual rate of increase in real wages in the five years up to 1990 is forecast to be just over 1 %. With labour productivity continuing to rise, although more slowly than in the 1960s and 1970s, real unit labour costs will have fallen by over 8 % between 1981 and 1990.

A further factor contributing to the strengthening of profitability has been the rise in capital productivity seen in the last few years. This represents a reversal of a declining trend which was seen throughout the 1960s and 1970s. Capital productivity at first stabilized in 1984 and thereafter began to rise. A notable contributor to this increase is the current very high rates of capacity utilization.

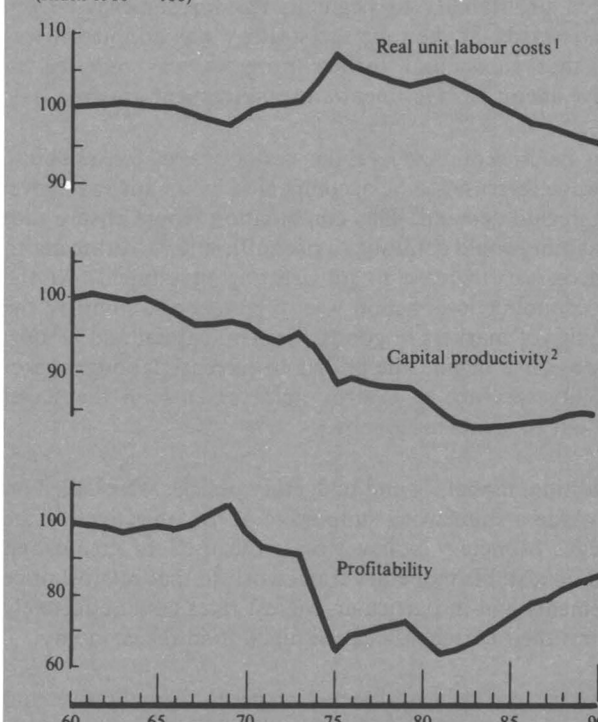
The rise in profitability was also assisted by the terms of trade gains arising from the fall in oil prices, which began at the end of 1985, and the decline of the dollar in 1986 and 1987. Profitability benefited directly from the reduction in energy and raw material prices and the ensuing fall in inflation assisted the trend towards continued moderate increases in real wages.

2.2.2. Substitution and factor productivity

Not only has wage moderation improved employment prospects through its beneficial effects on profitability and investment but the simultaneous change in relative factor costs together with policies designed to achieve greater flexibility in the labour market have significantly contributed to making growth and investment more employment-creating. This has been particularly noticeable in the second half of the 1980s.

GRAPH 2: **Real unit labour costs, capital productivity and profitability**

(Index 1960 = 100)



[1] See footnote 9 to Table 3.
[2] Real GDP per unit of capital.

During the 1960s and up to 1973, while real wages and labour productivity (GDP per person employed) tended to grow at similar rates, a considerable gap developed between

[1] GDP per person employed.

Table 3

Development of main supply-side factors in the Community, 1960-93

(% change per annum unless otherwise stated)

	1973/1960	1981/1973	1986/1981	1990[11]/1986	1984	1985	1986	1987	1988	1989[11]	1990[11]	1993[11]	1993[12]/1988
1. Real GDP	4,8	2,0	2,0	3,1	2,3	2,5	2,6	2,8	3,8	3,4	3,1	3,5	3,2
2. Employment	0,3	−0,1	0,0	1,2	0,1	0,6	0,8	1,2	1,6	1,5	1,1	1,2	1,2
3. Capital stock[1]	5,2	3,5	2,3	2,7	2,2	2,2	2,2	2,3	2,7	2,9	3,1	3,5	3,2
4. Real gross fixed capital formation	5,6	−0,3	1,1	6,1	1,5	2,5	3,4	4,8	8,4	7,0	4,8	5,9	5,6
5. Real investment[2] in equipment	5,4	1,2	2,9	8,4	4,2	8,3	3,1	9,3	10,6	10,0	5,9	—	—
6. Degree of capacity utilization (%)	85,5[3]	82,7[4]	82,1[5]	86,2[6]	79,0	81,5	82,1	83,0	84,4	86,2	—	—	—
7. Labour productivity	4,5	2,1	2,0	1,9	2,2	1,9	1,8	1,6	2,2	1,8	2,0	2,2	2,0
8. Capital productivity	−0,4	−1,5	−0,3	0,4	0,1	0,2	0,4	0,4	1,1	0,5	0,0	0,0	0,0
9. Total factor[7] productivity	2,8	0,9	1,2	1,3	1,5	1,3	1,3	1,2	1,7	1,3	1,2	1,2	1,2
10. Real compensation per employee[8]	4,6	2,5	0,8	1,2	0,6	0,8	0,6	1,4	1,1	1,2	1,4	1,7	1,5
11. Capital/labour substitution[7]	1,7	1,1	0,8	0,6	0,7	0,6	0,5	0,5	0,5	0,5	0,8	0,9	0,8
12. Capital intensity	4,9	3,6	2,3	1,4	2,2	1,6	1,5	1,1	1,0	1,6	2,0	2,3	2,1
13. Real unit labour costs[9] (1961-73 = 100)	100	104,3	100,5	96,7	100,2	99,2	98,0	97,8	96,7	96,1	95,7	95,2	94,9
14. Profitability (1961-73 = 100)	100	69,8	71,4	84,0	71,5	74,5	78,8	80,4	83,0	85,2	86,6	90,3	87,0
15. Long-term interest rate adjusted for inflation[10]	2,0	−0,4	4,4	5,2	5,2	4,8	3,7	5,4	5,5	4,9	4,8	4,7	4,8

1 Methodologically it is difficult to measure the capital stock in the economy. The estimates provided here are based on the Commission's Compact model.
2 Excludes Portugal up to and including 1986; EUR 12 from 1987 onwards.
3 Peak level of the period attained in 1973.
4 Peak level of the period attained in 1979.
5 Peak level of the period attained in 1986.
6 Peak level of the period attained in 1989 (1990 not available).
7 The rate of growth of factor productivity can be computed approximately as follows: $g = y - ak$, where g is the rate of growth of total factor productivity, y the rate of growth of output per person employed, k the rate of growth of the capital stock per person employed and a the share of profits in gross domestic product. Thus technical progress is a residual item and includes factor inputs other than capital and labour. Given this division of output growth, capital/labour substitution equals the difference between labour productivity and total factor productivity.
8 From the point of view of costs: compensation of employees per wage and salary earner deflated by the GDP deflator.
9 Compensation of employees per wage and salary earner deflated by the GDP deflator and divided by real GDP per head of occupied population.
10 Long-term interest rate deflated by the GDP deflator.
11 Provisional forecasts, September/October 1989.
12 Medium-term projection, assuming no significant policy change, based on Compact model.

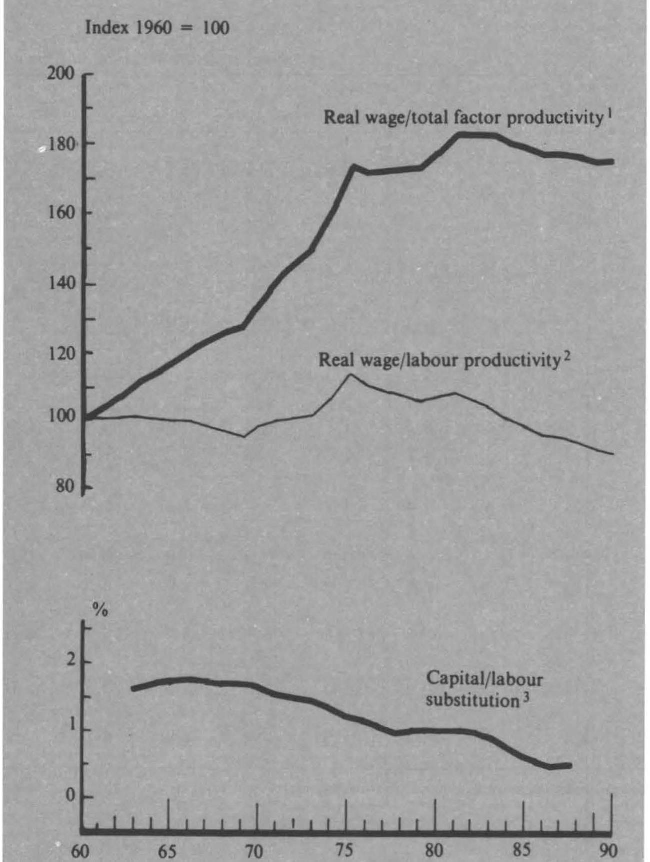
Source: Commission services.

labour productivity and total factor productivity (see Graph 3). This difference is a measure of the productivity gains attributable to the increase in capital intensity, which implies more capital per person employed, and can be thought of as representing capital labour substitution. However, given the slow increase in the labour force in this period a high degree of capital labour substitution was compatible with equilibrium in the labour market and unemployment remained below 3 %.

Until the end of the 1960s the degree of substitution was also compatible with maintaining a high level of profitability of fixed capital. After this time, however, the decline in capital productivity meant that profitability could no longer be sustained in the light of the increase in real wages.

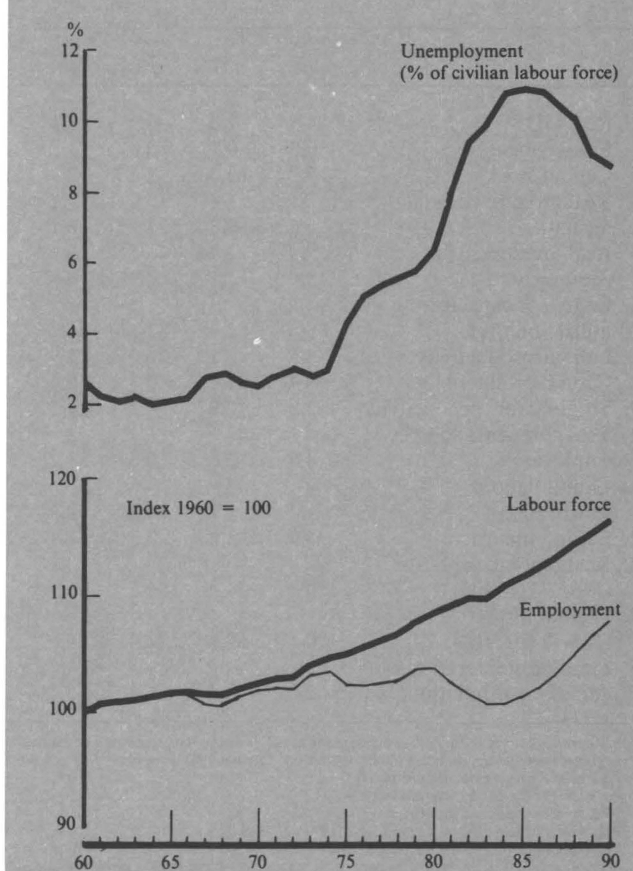
Due to the slowdown in output and productivity growth, the period 1973 to 1981 was characterized by a rise in real unit labour costs and a further widening of the gap between real wage increases and total factor productivity growth and low profitability. Thus the investment ratio declined and as capital labour substitution continued, albeit at a slower pace than in the previous period, the employment performance remained poor.

GRAPH 3: **Real wages, factor productivity and substitution**



1 Index of real wages (GDP deflator) divided by index of total factor productivity: see footnote 7 to Table 3.
2 Index of real wages divided by index of output per person employed.
3 See footnote 7 to Table 3; 5-year centred moving average.

GRAPH 4: **Employment and unemployment in the Community**[1]



1 On the basis of labour force surveys.

The substitution trend was also exacerbated by low or even negative 'real' interest rates (nominal interest rate deflated by the GDP deflator) which further reduced the real cost of financing capital expenditure. In contrast with the 1960s, however, the labour force had begun to grow rapidly from the first years of the 1970s, with the arrival of the post-war baby boom generation, so that the rate of unemployment increased almost threefold between 1973 and 1981 (see Graph 4). Equilibrium in the labour market could not therefore be maintained during this period.

Furthermore, partially because of labour market rigidities and partially due to labour hoarding by firms, the employment adjustment appears to have been somewhat delayed, a fact which negatively affected labour productivity. Given the rate of increase in real wages, this contributed to the very slow recovery in profitability of fixed capital from the low levels reached in the wake of the first oil price shock. As a result of all these factors the level of investment was in itself inadequate and furthermore each unit of investment was not sufficiently employment-creating.

With the slowdown in the rate of increase in real wages after 1981 real unit labour costs began to fall and profitability of fixed capital to rise. However, as total employment declined against a background of slow GDP growth and with the labour force continuing to expand rapidly, unemployment continued to rise, reaching 10,0 % in 1983. Thus the first years of the decade saw profitability beginning to recover but the imbalance in the labour market worsening considerably.

However, as the accumulated gap between real wage increases and total factor productivity continued to decline, by 1985 the rate of substitution had begun to fall significantly. From this point onwards the real wage and total factor productivity configuration was such as to enable profitability to rise and the labour market to move, albeit very slowly, in the direction of equilibrium. Employment in the Community began to increase significantly from 1985 onwards, the year in which unemployment peaked.

2.2.3. Budgetary policy[1]

Budgetary policies have also had a role to play in the redirection of general economic policies in the 1980s. This reorientation was seen as necessary in the light of the failure and unsustainability of the policies that had been followed throughout the 1970s and the first years of the 1980s mainly in response to the oil price shocks. While expenditure increased sharply in the 1970s in order to maintain economic activity and social benefits, particularly the benefits of the unemployed, its partial financing through higher direct taxes and social security contributions, notably as a result of fiscal drag, exerted additional inflationary pressures on wages and salaries. This in turn contributed to the fall in profitability and investment and therefore to the slowdown in economic growth, particularly when inflation was contained and eventually reduced. Thus a vicious circle had developed whereby the extra tax burden, by slowing down growth, created additional demands on the governments' finances in the long-run. An accommodating monetary policy, made necessary by the rising deficits and unwillingness or inability to increase tax receipts, exacerbated the problems. It added to inflationary expectations and pressures and in allowing real interest rates to fall, further contributed to a distortion of relative factor costs, a misallocation of scarce resources and consequently to slow growth. When monetary policies were tightened the resulting rise in interest rates had a negative impact on investment and added to the problems of financing the continuing budget deficits.

From the beginning of the 1980s it became clear that the direction of budgetary policies would have to change if they were to make a significant contribution to growth and employment creation in the Community. It was felt necessary to reduce the financial pressures caused by the crowding-out effect of high budget deficits and rising debt, to control the expansion of the share of government expenditure and receipts in GDP and to reform the tax and expenditure systems to ensure their contribution to economic growth. Tax systems have in some cases been simplified and marginal tax rates reduced and public expenditure made more selective in order to improve productivity.

[1] See the study 'Public finances and fiscal policies in the Community' for a more in-depth analysis of this topic.

Table 4

Main public finance trends in the Community

(% of GDP)

	1970[1]	1982	1985	1990[2]
Total expenditure	35,5	48,2	49,0	45,7
of which:				
Public consumption	14,3	18,8	18,6	17,8
Current transfers	14,6	21,3	21,4	19,9
Interest payments	1,9	4,1	5,0	4,7
Public investment	4,0	3,0	2,9	2,7
Receipts	35,8	42,7	43,8	43,0
of which:				
Indirect taxes	13,1	12,7	12,9	13,2
Direct taxes	9,5	11,8	12,4	12,2
Social security contributions	10,2	14,4	14,6	14,3
Net lending (+) or net borrowing (−)	0,2	−5,5	−5,2	−2,8
Gross public debt	38,9	47,8	56,8	59,2

[1] EUR 10: EUR 12 excluding Greece and Portugal.
[2] Provisional forecasts, September/October 1989.
Source: Commission services.

It wasn't until the growth momentum got under way in the second half of the 1980s that significant results in this area were achieved. Current receipts in the Community continued to rise, from 41,8 % of GDP in 1981 to 43,8 % in 1985, but since then the trend has been downwards and in some countries fiscal reforms have been introduced. Current receipts are expected to reach 43,0 % of GDP in 1990. The total expenditure pattern has been similar rising to 49,0 % in 1985 but forecast to fall to 45,7 % in 1990. Net borrowing peaked at 5,5 % of GDP in 1982 and is now also on a declining trend and gross public debt should stabilize at around 60 % of GDP.

The counterpart of the increase in the share of investment in GDP since 1986 is to be found in the significant fall in government dissaving and to a somewhat smaller extent in a decline in the Community's exports of capital to the rest of the world. This represents a reversal of the trends of the first half of the 1980s. Private sector saving has remained relatively stable in recent years as an increase in saving by the enterprise sector, reflecting greater profitability, has been offset by a decline in the household sector.

2.2.4. The change in the structure of demand

Higher investment on the one hand is contributing to an expansion of potential output and on the other to the main-

Table 5

Saving, investment and current balance in the Community[1]

(% of GDP at current market prices)

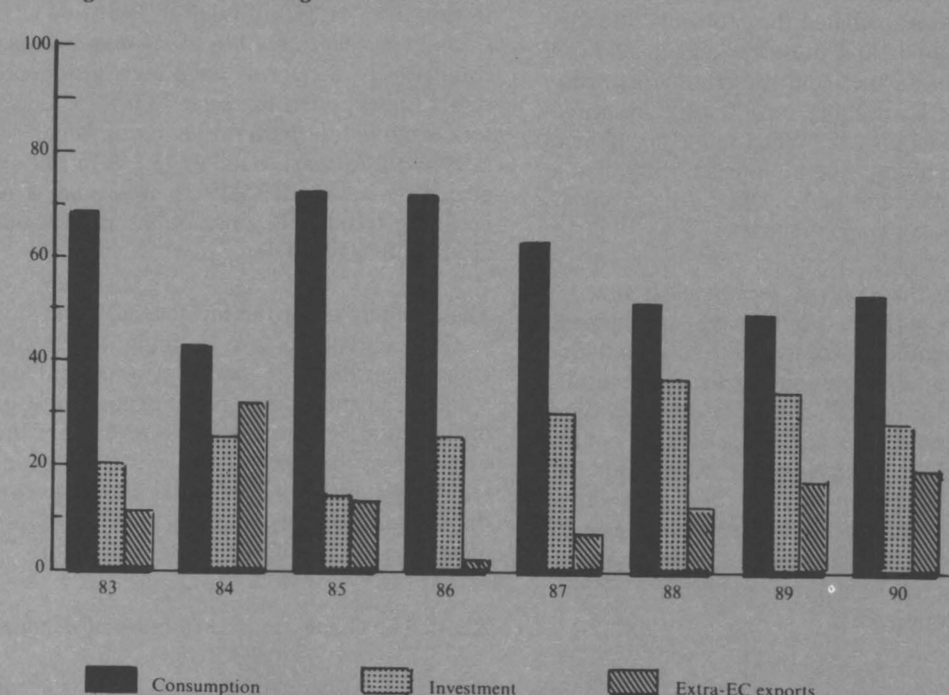
	1970[2]	1979[2]	1982	1986	1990[3]
Gross national saving	25,8	22,6	19,5	20,6	22,2
of which:					
Private	20,8	22,2	21,1	21,7	21,7
General government	5,0	0,4	−1,6	−1,1	0,5
Gross capital formation	25,7	23,0	20,4	19,4	21,9
of which:					
Private	21,7	20,1	17,4	16,7	19,2
General government	4,0	2,9	3,0	2,7	2,7
Current balance	0,7	0,1	−0,9	1,2	0,3

[1] Due to statistical discrepancies the difference between gross national saving and gross capital formation does not equal the current balance in each year.
[2] EUR 10: EUR 12 excluding Greece and Portugal.
[3] Provisional forecasts, September/October 1989.

tenance of demand. The change in the structure of demand in the 1980s means that growth has become less reliant on volatile external factors. Now that demand is mainly being led by investment the Community is closer to an ideal growth configuration.

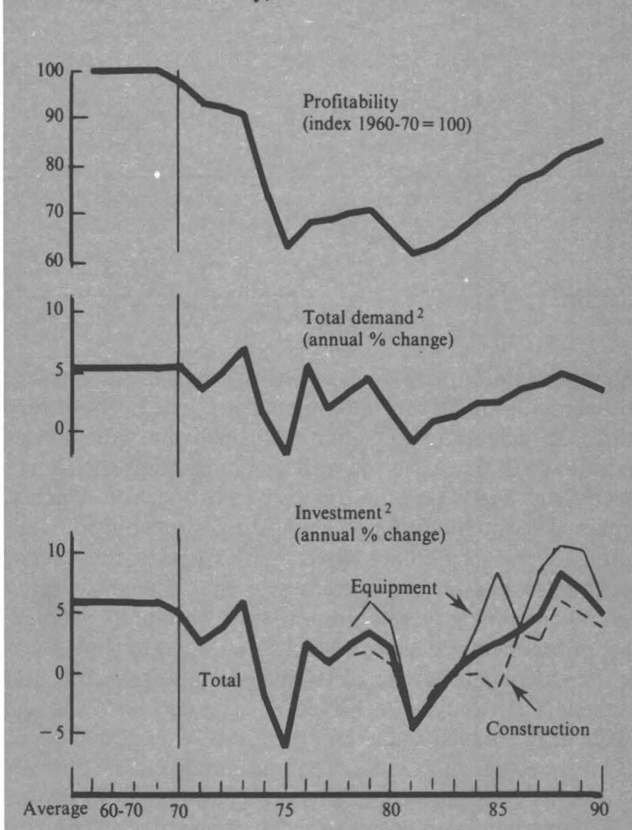
Investment in equipment, which had begun a modest recovery in 1984 and had increased by 8,5 % in 1985, faltered as a result of the uncertainties created by the changing external circumstances of 1986. The change in the composition of aggregate demand, with relatively fewer exports and more domestic demand, caused the rate of growth in investment in equipment to fall to less than 3 %. However, by 1986 investment in construction was already recovering so as to maintain a steady but modest increase in total investment. Subsequently investment has been a key element in the increase in total demand with equipment investment rising by almost 9 % in real terms in each of the three years up to 1989 (see Graph 5).

GRAPH 5: **Percentage contribution to change in total demand**



During the 1980s demand in the Community was given a significant boost on two occasions by external factors. The boom in the United States in 1984 saw exports making a substantial contribution to the increase in final demand in that year. On the second occasion, the significant improvement in the terms of trade in 1986, resulting from the fall in oil prices which had begun towards the end of 1985 and the decline in the value of the dollar, gave a stimulus to domestic demand growth through its effects on real incomes. The unexpected fall in inflation and rise in real incomes was reflected in an acceleration in private consumption to almost 4 % in 1986.

GRAPH 6: **Profitability, demand and investment** [1]



[1] EUR 12.
[2] Constant prices.

Private demand has also been boosted by internal factors. The success of supply-side measures, by stimulating growth, has in itself given a further impetus to demand and the additional growth has, in some countries, allowed room for supply-oriented tax reductions thus stimulating investment and consumption even more.

3. Conclusions

The efforts made and the policies implemented since the beginning of the decade are now bearing fruit. Not only have growth rates improved, but growth itself has become more employment-creating. Between 1960 and 1973, for example, while the annual rate of growth of GDP averaged 4,8 %, employment in the Community rose by only 0,3 % annually. An average annual growth rate of 2,4 % in GDP between 1973 and 1979 had almost no effect on employment. Recent studies suggest that employment now begins to increase with a rate of growth of 2 % and every one percentage point of growth above this threshold yields an increase of one percentage point in employment.

If growth, for instance, stays on a trend of 3 % and the growth-employment relationship remains unchanged, employment can be expected to rise by 1 % a year in the medium term. The consequences of such an increase in employment are illustrated in Table 6 (assumption a). Here it is assumed that the labour force will rise by 0,4 % a year. Of this increase, 0,1 percentage point is due to demographic factors and 0,3 percentage point to a continuation of the present trend in participation rates. Taking all these assumptions together yields an unemployment rate of 6 % in 1995; just below the rate of 1980 but more than twice that of the early 1970s.

A more favourable employment scenario is illustrated in Table 6 (assumption b). In this instance employment increases by about 1 ½ % annually but the labour force itself is also assumed to expand more rapidly (+ 0,6 % p.a.), due to a faster increase in participation rates. Previous experience has indeed shown that activity rates respond positively to improvements in employment prospects. In this case the unemployment rate would fall to about 4 % in 1995.

Furthermore, it is interesting to note that, according to this scenario, the dependency ratio (ratio of inactive persons of all ages and unemployed to total employment) would revert to its level in the early 1960s, something which would reduce the burden on the working population. The share of older people in total population and part-time employment in total employment, however, should certainly be greater than in the 1960s and this should reduce somewhat the beneficial effects of the fall in the dependency ratio.

Assuming again that the growth/employment relationship remains unchanged, the 1 ½ % annual increase in employment would require an annual increase in GDP of 3 ½ %. But in this context two questions must be answered. Firstly, does the Community economy have the capacity to grow at such a rate and, secondly, will the GDP-employment ratio remain stable?

Table 6

Population, active population and employment in the Community

Average annual % change	1970/1960	1980/1970	84/80	88/84	90/88	1990/1980	1995/1990 Scenario (a)	1995/1990 Scenario (b)
Population	0,8	0,5	0,3	0,3	0,3	0,3	0,2	0,2
Active population	0,2	0,6	0,8	0,8	0,6	0,8	0,4	0,6
• due to the increase in the population of working age	0,5	0,7	1,1	0,5	0,3	0,7	0,1	0,1
• due to the change in the participation rate	−0,3	−0,1	−0,3	0,3	0,3	0,1	0,3	0,5
Employment	0,2	0,2	−0,6	0,9	1,2	0,3	1,0	1,6
	1960	1970	1980	1984	1988	1990	1995 (a)	1995 (b)
Unemployment rate[1]	2,0[2]	2,5	6,4	10,8	10,0	8,7	6,0	4,1
Dependency ratio[3]	1,32	1,46	1,50	1,58	1,52	1,51	1,41	1,34

Assumptions: (a) +0,4% per annum increase in active population (1990-95); employment (1990-95) +1,0% p.a.
(b) +0,6% per annum increase in active population (1990-95); employment (1990-95) +1,6% p.a.

[1] Based on labour force surveys.
[2] 1964.
[3] Ratio of inactive persons of all ages and unemployed to total employment.

In the medium term the growth potential is fundamentally determined by the change in factor inputs, labour and capital. From the point of view of labour, the numbers of unemployed indicate the existence of a significant potential. In order to facilitate the use of this potential and to improve its quality, continued improvements in labour market flexibility and better professional and vocational training are necessary. On the capital stock side the outlook is also promising. The favourable investment performance of recent years is now showing in its effects on the growth of the capital stock, accelerating from 2 ¼ % annually in the middle of the 1980s to a forecast 3 % in 1990. If this favourable investment scenario continues, the capital stock could be growing annually by about 3 % in the middle of the 1990s. Equivalent GDP growth rates are therefore attainable in the medium term, assuming capital productivity remains stable. It is, in particular, necessary that profitability improves further and that the impetus given by the prospects opened up by the internal market are maintained.

The growth/employment relationship, however, is subject to many opposing influences which are more difficult to assess. On the one hand the improvement in the economic fundamentals which is at the heart of the current investment-led expansion will lead to productivity gains (more output per person employed) through the incorporation of technical progress in the capital stock via strong investment activity. The completion of the internal market will be a further source of increased productivity, through the reduction in the administrative costs of trade, greater competition between firms and economies of scale in production which it implies. The catching-up process of the poorer countries and regions of the Community envisages large-scale investment and greater productivity increases to enable them to bring their incomes in real terms closer to the Community average. In contrast there are factors which could tend to slow down the increase of output per employed person. Environmental protection can only be achieved at a certain cost and the effects of this increasingly important factor on global productivity, measured as GDP per person employed, are difficult to quantify. The sectoral changes in employment in favour of the more labour-intensive services sector will also contribute to a reduction in the measure of GDP per person employed. This is also true of the trend towards a reduction in the average number of hours worked.

Taking all factors into account it is now possible and necessary to make substantial progress in reducing unemployment. In order to achieve this it is essential that the policies and behaviour which have contributed to the improved economic environment of recent years are continued in the medium term.

Study No 2

Monetary policy indicators in an evolving monetary environment

Monetary policy indicators in an evolving monetary environment

Graph

Summary

In the perspective of a free market for financial services, fundamental changes in the competitive structure of the banking sector would lead to increased competition between financial intermediaries on the money market. In turn, this might imply a reduced ability to predict what rate of growth of money would be consistent with the preferred path of nominal incomes, even in the absence of supply shocks or aggregate demand shocks. In such circumstances, the significance of the aggregates as an indicator would be substantially reduced. As a result, a monetary policy which relied too heavily on monetary aggregates as indicators of the monetary stance, would be faced with increasing difficulties, capable of limiting the effectiveness of monetary policy, whether or not a rule for the growth of the monetary aggregates is applied. In part, the problem of instability of money demand is a technical, econometric one; it is reviewed in an annex to this study. But a more fundamental difficulty is structural in nature. The process of financial innovation seems to be causing a breakdown of the conventional relationships between monetary aggregates on the one hand and economic activity and prices on the other. In this study, an overview is presented of the experience of this problem in the EC countries which target one or other measure of the money supply. It appears that the problem is most severe in the United Kingdom, which has progressed further than the other countries on the road to deregulation and increased competition in the financial sector. But while the problem is not yet acute in continental Europe, it could become so when these countries, at least to some extent, follow the example of the UK, notably within the framework of 1992. The question of which other indicators could be used to supplement monetary aggregates in analysing the monetary stance is then addressed. The advantages and disadvantages of exchange rates, interest rates and yield curve movements, and commodity prices as additional indicators are assessed. It is concluded that the analysis of the stance of monetary policy, and in particular its impact on inflation expectations, has to be based on several indicators which should be interpreted interdependently. The judgmental element in monetary policy - already important in many countries - will inevitably have a continuing or even an increasing role to play.

1. Introduction

This study addresses the difficulties currently faced - or likely to be faced in the perspective of a free market for financial services - in relying exclusively on monetary aggregates as indicators of the monetary stance. These problems are potentially serious for a monetary policy based on rules, but are also relevant wherever monetary aggregates are used as indicators.

The conduct of monetary policy based on a monetary rule depends largely on the existence of a stable relationship between the targeted monetary aggregate and a limited number of key macroeconomic variables. Only if this requirement is met will targeting the money stock be successful in guiding expectations and controlling inflation. Several factors seem however to be significantly complicating the task of the monetary authorities in the use of monetary targeting. The monetary authorities' ability to identify and control a monetary aggregate that is related in a sufficiently stable way to economic activity and prices appears to have weakened in several countries.

Increasing definitional problems are making it more and more difficult to identify and measure a meaningful monetary aggregate. The significance of monetary aggregates is being increasingly undermined in some countries by changes in the currency to deposit ratio, by the shift of funds between various categories of deposits and by the instability of the demand for money.

But even where it is possible to measure and control the money stock in a satisfactory way, it is increasingly suggested that its usefulness for the conduct of monetary policy has decreased since the early or mid-1970s, when explicit monetary targeting became commonplace in the major industrial countries. First, the frequency and amplitude of shocks has increased. For Community countries these shocks have included external shocks such as disturbances to commodity prices and the dollar exchange rate, and internal shocks such as periods of budgetary indiscipline in some countries, sometimes later followed by budgetary retrenchment.

More recently, improved supply expectations, linked both to improvements in market functioning and to anticipation of the completion of the internal market, have had a powerful influence on domestic demand in several Member States. This experience has re-opened the old debate about the relative merits of rules versus discretion in monetary policy. On the one hand, the expectations-anchoring function of monetary targets may be reduced both by repeated departures from targeting, or of out-turns from targets, as a result of attempts to stabilize the economy in the short term in the face of shocks. On the other hand, there may be costs imposed by short-term fluctuations, in either direction, in activity and the inflation rate that cannot be offset in a policy regime of non-contingent adherence to monetary targets.

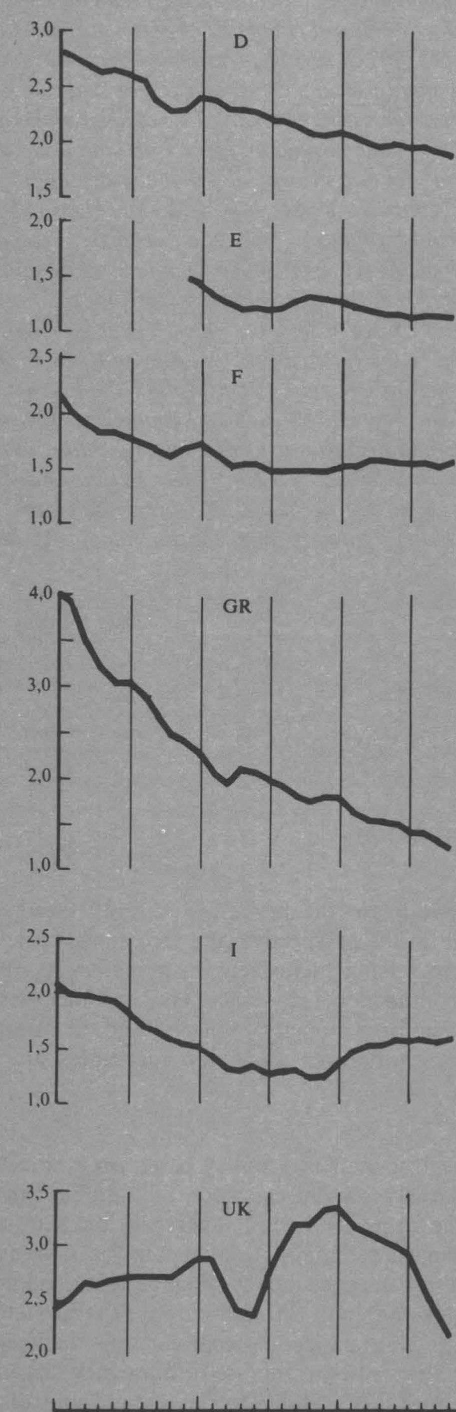
This study makes no attempt to address this issue directly. Instead, it confines itself to a second problem capable of limiting the effectiveness of monetary policy, whether or not a rule for the growth of the monetary aggregates is applied. An inability to predict what rate of growth of money would be consistent with the preferred path of nominal incomes, even in the absence of supply shocks or aggregate demand shocks, would substantially reduce the significance of the aggregates as an an indicator.

Problems of two kinds have emerged. First there is the technical problem of the specification of the variables thought to determine money demand. In Annex 1, a brief overview is given of the theoretical issues involved here and the remedies proposed to deal with it.

But a more fundamental difficulty is structural in nature. The process of financial innovation seems to be causing a weakening of the conventional relationships between monetary aggregates on the one hand and economic activity and prices on the other. The nature of this weakening differs among countries. In most countries the problem of instability of money demand seems to be more severe for narrow definitions of the money stock than for broader ones; in such countries the monetary authorities have turned to a broader concept of money (United States of America, Germany, France, Spain). In these countries, the downward shift of narrow money demand is mainly attributed to more frequent transfers from non-interest-bearing assets to higher yielding alternatives. In turn, this is the result of the introduction of new technologies (new means of payments), increased sophistication in the banking sector, and in some instances reactions to new monetary control methods.

The situation is, however, different in the United Kingdom, where it is the broader aggregate that has been less stable. This is seen to be the consequence of the fundamental changes in the competitive structure of the banking industry which have occurred in the UK financial sector over the last few years, as a result of which competition between financial

GRAPH 1: Velocity of M3



intermediaries on the money market has very much increased. This has induced transfers from non-monetary to monetary assets, now also offering attractive yields. It could be argued that this still-ongoing process of deregulation and increasing competition will become more and more important also in the other EC countries, especially as a result of the liberalization of financial services in a 1992 framework. As a consequence, in these countries too the instability of broader monetary aggregates could become a problem in the near future. Whereas in most continental European countries there still seem to exist stable money-demand relationships, say since 1979 onwards, there is a consensus in the UK that the demand for money function for sterling M3 broke down in 1972/73, and has remained unstable ever since (this is illustrated in Graph 1, which shows the velocity of M3 for a number of countries). The question arises, therefore, whether a development similar to that in the UK will eventually take place in the other European countries after 1992. If so, this could imply, for an indeterminate period of time, a weakening in the indicator function of the monetary aggregates.

In the next section of this study, an overview is presented of the particular experiences with the abovementioned problems in certain EC Member States (the countries studied are those that target one or other measure of the money supply, but as already noted, these questions are also of interest to countries that do not — whether because they rely on an exchange-rate rule or for other reasons — target the monetary aggregates). Section 3 examines the possibility of supplementing or even replacing the monetary aggregates as indicators by the analysis of alternative indicators. Finally, in Section 4 some conclusions are drawn, based on the difficulty of interpretation of all the indicators studied.

2. Structural changes in the monetary aggregates in some European countries

In the Federal Republic of Germany, the demand for broad money is generally considered to be adequately stable. However, some measurement problems have arisen at times in recent years. The calculation of the money stock M3 was somewhat distorted in the beginning of 1986 by the strong growth of short-term bank bonds and Euro-deposits of domestic enterprises,which played a greater role as substitutes for deposits since they were free from minimum reserve requirements and, therefore, yielded relatively high interest rates. In 1988-89 a similar distortion was recorded when residents' Euro-deposits became even more attractive when the introduction of a withholding tax, to be applied to time deposits placed in the FR of Germany, was announced.

These shifts in asset demand led the authorities to calculate a new monetary aggregate, the so-called 'extended M3', which included both short-term bank bonds and Euro-deposits of non-bank residents. Since the abovementioned movements in money demand are considered small and transitory, the Bundesbank gives no public figure for 'extended M3' and the intermediate target is set in terms of the traditional M3 definition, which does not include assets of residents held abroad. The liberalization of financial services within the framework of 1992 will both increase the amount and reinforce the permanent character of shifts in German money demand, suggesting a possible need for a wider definition of money stock.

In France, the significance of the monetary aggregates has been affected by the substantial liberalization of exchange controls that has already taken place, permitting French firms to maintain transaction balances abroad. Furthermore, the suppression of the *devise-titre* regime allows residents to hold monetary assets abroad. The full liberalization of capital markets in July 1990 is expected to lead to some further displacement of savings, although it is not clear to what extent such shifts will involve assets included in the targeted money variable.

Given the reinforcement of economic and financial integration expected in stage one of the European monetary union (EMU), the range of monetary aggregates to be monitored should be enlarged, including, in addition to the present ones, other broader aggregates which would take into account the assets of residents abroad as well as foreign monetary assets.

In Spain, the traditional approach to monetary policy by means of indirect control of the monetary aggregates has been increasingly affected by financial innovations and financial market integration and by changes in the financial behaviour of the public and the banks. In view of the uncertain and complex financial environment, the authorities have had increasing recourse to flexibility, discretionality and judgement in implementing monetary policy.

A first element of uncertainty arises from the reduced capacity of ALP (the broad monetary aggregate, which includes holdings of liquid money-market instruments as well as the traditional components of M3) to give information about the evolution of nominal income and prices. It has become more difficult to distinguish between two alternative interpretations of an overshooting in ALP: an undesired evolution of nominal expenditure - that should, therefore, be corrected - or as changes in the relative yields of ALP and non-ALP assets, which should be accommodated. The development of ALP has been increasingly influenced by changes in financial markets. First, the share of ALP composed of very liquid and profitable non-money assets has increased. Second, the distinction between means of settlements and assets held for financial investment purposes has become blurred as a result of financial innovation and a growing degree of substitutability among a large number of financial assets.

The stability of the relation between the intermediate target (ALP) and the instrumental variable (bank liquidity) has also weakened. Instability of the money multiplier has resulted from the more frequent shifts in the portfolio of the public in reaction to changes in the yield and fiscal attributes of certain assets and also from the increasing capacity of bank operators to transform liabilities which are subject to the minimum reserve requirement into those which are excluded from that coefficient.

Finally, there is a definition problem with ALP since it includes money market assets, such as Treasury bills, which in principle cannot be held by non-residents. However, as substantial capital liberalization is progressing there is the suspicion that non-residents have invested in such assets, thus leading to distortions in ALP.

In Italy, a set of new financial products - such as Treasury bills, Treasury credit certificates at floating rates, certificates of deposit, etc. - has emerged in the recent past. These have shown a growing degree of competition and substitution with money since they are liquid yet offer high yields, muddying the traditional definition of 'money'. The fact that most of the new financial instruments are not submitted to the reserve requirements contributes to magnifying the substitution process and affects the stability of money multipliers. Moreover, the traditional banking sector is no longer the only source of finance for the corporate sector since it can be financed directly in the international loan market or through non-bank intermediaries — for example special credit institutions — which are not subject to reserve requirements.

As a result, the efficiency of the transmission of monetary impulses (from bank liquidity to money stock) by the monetary authorities has been reduced. Moreover, the relation between M2 and CNSS (credit to non-state sector) on the one hand, and nominal income, on the other hand, has lost some significance. This creates new doubts about the reliability of the present approach to monetary policy, one based on the announcement of targets for monetary and credit aggregates, especially in a situation where the central bank is following a nominal exchange rate target.

In the United Kingdom, structural shifts related to financial market change and in particular to the deregulation of credit have affected the indicator role of the monetary aggregates throughout the 1980s. Moreover, changes in interest rates have affected the relationship among the aggregates, producing shifts between interest-bearing and non-interest-bearing components. Over this period the authorities have therefore focused on a range of monetary aggregates.

At the beginning of the 1980s the sterling M3 target was substantially overshot, despite the fact that other indicators (the exchange rate, real interest rates, house prices) pointed to very tight monetary conditions and that the economy was in recession. Broad money growth remained high, and velocity continued to decline, throughout the 1980s. Most notably, broad money growth accelerated again in 1986 and has been above 15% a year, often more than that, ever since.

The main distorting factor early in the 1980s was the return of deposits to the banking system following the abolition of the supplementary special deposit scheme. However, throughout the period, the response has gone 'far beyond a simple stock adjustment but to an entirely new dynamic in competition between financial intermediaries'.[1] Major factors contributing to this dynamic have been the development of an increasing array of attractive and competitive financial instruments and much-increased competition between banks and building societies in personal sector lending (from the side of the banks, a reaction to squeezed margins on wholesale lending; from the side of the building societies, a reaction to a change in their statutory position allowing them to expand the range of their activities). The increasingly bank-like behaviour of building societies has led the authorities to install M4 (including deposits with building societies) as the preferred measure of broad money. But competitive forces in the banking industry are still being felt in the spread of ever-more-attractive interest payments on current accounts, and the significance of broad money growth is still open to interpretation. It is believed that an increased proportion of broad money balances are now savings media rather than transactions balances. As a result, the authorities have since 1986 expressed monetary targets in terms of a narrow money aggregate (MO), composed of currency in circulation and bank reserves with the central bank. This aggregate is believed by the authorities to have an acceptably stable relationship with nominal incomes.

However, MO is essentially a coincident indicator. The question of whether or not fast growth of broad money in 1986 and 1987 presaged the acceleration of MO in 1988 and ultimately of inflation in 1988/89 cannot be answered with any great confidence. More generally, it must be expected that at some undetermined time in the future a new equilibrium will be reached in the banking industry and that the

1 *Bank of England Quarterly Bulletin*, December 1986.

attractiveness of deposits will cease to change, or at least will cease to change as rapidly as over the last decade. When this happens, broad money growth will have to slow down very considerably if money balances are to be willingly held. The policy problem will be that of judging exactly when an inflexion in broad money growth is required. It is also possible that a spread of debit card payments could affect the stability of narrow money demand in the future, possibly at the same time that demand for broad money may be stabilizing. Thus while in the long run narrow and broad money aggregates could retain and regain, respectively, significance, the next few years are likely to prove difficult ones for the interpretation of the aggregates. Reliance on a whole range of indicators, including the exchange rate, asset prices, the yield curve and coincident indicators of activity as well as monetary aggregates, will continue to be necessary.

Money demand in Greece has been influenced by the relatively underdeveloped nature of its financial system. The ratio of financial wealth to total wealth and to incomes has shown a trend increase with the process of development. But, at least until recently, almost the only financial assets available to the Greek public were components of broad money. Thus there has been a trend fall in the velocity of broad money (M3).

This could be taken account of fairly readily in monetary management. However, the progressive liberalization of the financial system in recent years and the attempt by the government to fund at least part of its borrowing requirement through the issue of non-monetary domestic debt has increased the range of financial assets available to the public. These structural changes can in principle be expected to produce changes in broad money demand very different from those experienced in the UK. In the latter country, financial change has increased the attractiveness of deposits, inducing shifts from non-money assets to components of broad money and thereby making broad money correspond less and less with the concept of transactions balances. In Greece, where savings deposits have always bulked large in M3, structural change is likely to induce shifts from broad money into non-money financial assets. Such change is likely to accelerate when capital movements in Greece are completely liberalized (by mid-1992 at the latest) and the range of non-money financial assets available to the Greek public will be dramatically widened.

3. Alternative monetary policy indicators

3.1. Exchange rates

Monetary aggregates alone can never make it clear whether monetary conditions exert a restraining or accommodating influence on the growth of nominal income. However, the path of the exchange rate (or, in a fixed-exchange-rate regime, the path of official reserves) often provides valuable additional information since exchange rates react more quickly than nominal income to disequilibria between money supply and demand. Thus, for instance, an appreciating exchange rate will tend to indicate a shortage of money balances even if the monetary aggregates are accelerating; similarly, a depreciating exchange rate may indicate an excess of money balances even if the aggregates are decelerating. However, these movements shed light only on what monetary conditions are, not on what they should be. Thus, for example, a shortage of money balances and an appreciating exchange rate may be caused by excessive strength of activity provoked by increased spending propensities. If the authorities are concerned to stabilize activity in the short run, a tightening of monetary policy could be called for in such circumstances.

Care also needs to be taken in interpreting exchange-rate movements even in the absence of aggregate demand shocks because it is not always clear to what extent the forces behind the movement originate in the domestic economy rather than abroad. For instance, an exchange-rate depreciation provoked by monetary tightening abroad may have very different implications from one originating in monetary expansion at home.

3.2. Interest rates and yield curve movements

The yield curve is a market-based indicator which has received an increasing amount of attention. It has long been an important tool for analysis for market participants in well-developed markets such as those in the USA, the United Kingdom and Germany. As financial liberalization proceeds in a number of other countries, the analysis of yield curves is becoming increasingly important there as well. But in addition it can, if used carefully, be a useful monetary indicator.

A monetary-policy tightening, for instance, acting through increased short-term rates, will generally flatten the yield curve. Long-term nominal rates will rise by less than short rates or may even fall, if longer-term inflation expectations are reduced, since monetary policy is generally thought to have little impact on expected real long rates. As a general rule, the greater the impact of monetary policy on inflation expectations, the greater will be the change in the slope of the yield curve, which thus becomes an important indicator.

However, factors other than current monetary policy can also affect the yield curve. For instance, budgetary policy or perceptions of the future rate of return on capital can in certain circumstances have such an effect. Moreover, expectations of future changes in monetary policy - related to electoral expectations, perhaps, or to increasing or diminishing fears of future monetization of public debt - can affect longer-term inflation expectations. In consequence, there is a variety of ways in which the yield curve can steepen or flatten without there having been any change in the current stance of monetary policy. Thus while the yield curve can undoubtedly supply valuable additional information both on the stance of monetary policy and on longer-term inflation expectations, it nevertheless has to be interpreted with care.

3.3. Commodity prices

The upward movement of commodity prices can be an early indicator of excess demand for commodities and can in certain circumstances indicate that demand is growing too fast. Moreover, commodity prices are available in an extremely timely fashion. However, the timeliness of data is balanced by their very great volatility, which makes it difficult to establish trends. Moreover, since commodity prices are much more flexible than the prices of industrial goods, they tend to overshoot in response to shocks. Thus, for instance, after a monetary tightening commodity prices may fall sharply while there is initially little response in other prices. As general inflation eventually subsides, and monetary conditions ease endogenously, commodity prices tend to recover from their depressed levels, moving back up to new equilibrium levels consistent with lower general inflation. A monetary policy reaction to commodity prices - in either phase - would clearly be inappropriate. Finally, commodity prices are particularly subject to supply factors. All in all, then, while commodity prices do provide additional information, it might be unwise to use them as the primary monetary indicator.

4. Conclusion

The structural changes in the financial system seem to be creating at least the potential for significant problems for any monetary policy strategy that focused exclusively on the monetary aggregates as indicators. The primary rationale of such a strategy - the monetary authority's ability to identify and control a monetary aggregate that is related in a reasonably stable way to economic activity and prices - is in question in several countries. Definitional problems are making it difficult to identify and measure a meaningful monetary aggregate and the indicator function of monetary aggregates is being additionally undermined by the instability of the demand for money in some countries. In Germany, which plays a particularly important role as the anchor in the ERM, the problem is not yet acute. But following the liberalization of financial services within the framework of 1992, increased competition, especially in retail banking, might possibly lead to an emergence of such problems.

Other indicators can contain useful information, but they also need to be interpreted with care. In consequence, the analysis of the stance of monetary policy, and in particular its impact on inflation expectations, has to be based upon several indicators which should be interpreted interdependently. Exclusive reliance on one indicator can, in certain circumstances, lead to misleading interpretation of monetary developments and to incorrect policy conclusions. The judgemental element in monetary policy - already important in many countries - will inevitably have a continuing or even an increasing role to play.

Annex 1

The instability of money demand functions: some theoretical considerations

By the early 1970s, the debate about the theory of the demand for money was regarded as closed, especially on the basis of the conclusions of Goldfeld's almost encyclopaedic study (Goldfeld (1973)) and of Laidler's works (1977, 1982). Agreement was reached upon a formulation in which, just as in Keynes' General Theory, the demand for real balances was assumed to depend negatively on a short-term interest rate, representing a proxy for the opportunity cost of holding money, and positively on a transactions measure such as real GNP. The specification usually proceeds by postulating the desired or long-term demand for money as a function of the abovementioned explanatory variables, with a partial adjustment mechanism with which real money balances adjust to the gap between the long-run demand for money and the previous period's holdings. This partial adjustment mechanism was justified by an appeal to portfolio adjustment costs.

Prior to 1973, research was concentrated on four empirical issues. The first involved the definition of money: should it be narrowly defined to include only actual means of payment, or should it be broadened to include substitutes such as savings deposits?

The second and third issues had to do with the arguments in the money demand function. What is the appropriate 'scale' variable? Is it some measure of transactions or is wealth to be preferred? What is the correct measure of the opportunity cost of holding money? Could this also involve yields on longer-term financial assets?

The fourth empirical issue concerned whether lagged values of money should be included to serve as a proxy for incomplete adjustment of money demand in the short run, or more generally, the dynamics of the relationship.

The evidence that had accumulated from the large body of research done over the post-war period was interpreted as showing that a stable demand function for money did, in fact, exist. The result was that by the early 1970s money was given a significant role in the conduct of economic policy in many countries.

With 'The case of the missing money', however, Goldfeld (1976) sounded the alarm concerning the stability of the money-demand function. Since then, the study of the money-demand function and its stability has become one of the most discussed topics of the macro-monetary profession. For the USA, Judd and Scadding (1982) came to the tentative conclusion that financial innovations were at the heart of the problem, a statement which found fairly general response and approval. For the other industrialized countries, financial innovations and deregulation of the financial markets are also very frequently cited as the main cause of breaks and/or instabilities in the money-demand relation (see for example Blundell-Wignall, Rondoni and Ziegelschmidt (1984) for the USA, Japan, Germany, France, the UK, Italy and Canada). Other authors (e.g. Boughton (1981)) associate the misbehaving money demand observed in different countries with modifications in the methods of monetary policy.

Observing unstable behaviour is one thing: trying to remedy the problem is another. The hypothesis that disturbances have been created by the wave of innovations and deregulation seems to be rather generally accepted, and a great deal of research aims at finding a solution along these lines. In this respect several authors have tried to better specify the theoretical money demand model by explicitly adding to the conventional equation some variable which is deemed to reflect the innovation effect. The following approaches can be mentioned:

(i) Making explicit allowance for new cash-management techniques, which are viewed as reducing the variance of cash flow, thereby allowing firms to reduce their precautionary balances;

(ii) taking transaction costs explicitly into account in determining the demand for money. Lower costs of converting other assets into money allow money-holders to keep smaller money balances, meeting transactions needs by more frequent transfers of funds from higher yielding alternatives;

(iii) the redefining of the dependent variable to be able to take into account the changing money character of several (old and new) types of financial assets. Several investigators have found a broader definition of money to show less instability than M1 (for example Laidler (1980)). The relative stability of broader aggregates is, however, attributed to spurious correlation by other authors.

As a result of the weak performance of money-demand equations over the last decade, several authors have in addition re-examined the pre-1973 issues. In empirical versions of money-demand models, GNP is typically used as a proxy for transactions. The potential problems with this variable are well-known:

(i) GNP ignores transactions in financial assets and existing goods,

(ii) it includes imputations that may involve no transactions, and

(iii) it nets out intermediate transactions.

Several authors have found permanent income or wealth to outperform measured income in producing a stable demand function for money. The results indicate that these modifications may improve the performance of the money-demand equation marginally, but that the solution probably does not reside in this area.

Because of collinearity of interest rates, an important empirical simplification in money-demand functions has been the introduction of only one interest rate to represent the opportunity costs of holding money. Tests of equations including more interest rates — up to the entire term structure of interest rates — however, do not always provide convincing evidence that this is the adequate solution in solving the instability problem (see Judd and Scadding, 1982).

What seems to be a more promising line of inquiry focuses on the specification of short-run adjustment dynamics in the money market. The traditionally-used partial adjustment mechanism has been motivated by a vague appeal to portfolio adjustment costs (Goldfeld, 1973). Darby (1972) argues that money balances serve as a shock absorber or buffer-stock which temporarily absorbs unexpected variations in income until a portfolio of securities and consumer durables can be conveniently adjusted. It has been shown that neither proposition rationalizes partial adjustment in the demand for money (see, for example, Goodfriend, 1985). It is still widely used however, because (Laidler, 1984, p. 28) '... a lagged dependent variable in the aggregate demand for money function is hard to justify; but everyone knows, this variable is, as a matter of fact, much utilized and apparently badly needed (...) so as to achieve satisfactory econometric results'.

Without a partial adjustment specification, the standard money-demand regression would include only current income and interest rate variables as regressors. In other words, standard theoretical models of money demand would predict lagged real money balances to be irrelevant to money demand. Yet, in general, the coefficient on lagged real money balances in the conventional money-demand regression is positive and highly significant, and accounts for much of the explanatory power of the regression.

A second problem for the standard interpretation of the coefficient on lagged money along partial adjustment lines is that, to quote Goldfeld (1973, p. 599) 'the lags that result statistically for money adjustment appear too long to be explained on grounds of adjustment costs'.

Finally, a third problem with the standard partial adjustment interpretation of the conventional money-demand regression concerns residual autocorrelation. The standard specification coupled with partial adjustment should not exhibit autocorrelation. Yet, residuals from conventional money-demand regressions generally exhibit highly significant positive serial correlation. Goodfriend (1985) suggests that the importance of the lagged dependent variable in the standard money-demand equation is the result, not of any adjustment problem, but of measurement errors in the regression variables. This also accounts for the serial correlation problem.

Koskela and Viren (1986) compare alternative dynamic specifications; they find an error-correlation mechanism to outperform other specifications. Heri (1985) tests a so-called absorber version of the partial adjustment mechanism, where money supply shocks are incorporated into the adjustment process. This approach, when applied to German money demand, however, cannot account for the 'missing money puzzle' after 1973.

Judd and Scadding (1982) argue that the correct dynamic specification is not independent of the direction of causation between the quantity of money on the one hand, and the arguments of the money-demand function on the other. This raises the question of the exogeneity of the regressor variables. The conventional money-demand specification only makes sense as long as the supply of money more or less passively accommodates itself to changes in its demand. But if a central bank pursues, for example, an interest-rate stabilization policy, then the changes in the money supply will trace out the desired short-run money-demand function. Judd and Scadding (1982) present an overview of several empirical studies on whether money is exogenous with respect to income and interest rates. The results are, however, ambiguous and appear to be sensitive to the particular technique used to test for exogeneity. They conclude that it is still useful to examine alternative specifications which take into account the simultaneity problem. One way to do this (see, for example Goldfeld (1973)) is to chose an appropriate set of instrumental variables and to estimate the money-demand function by two-stage least squares. But perhaps the most obvious way is to simultaneously estimate a demand-for-money function and some sort of monetary policy reaction function in terms of the interest rate to represent the money supply (see, for example, Blundell-Wignall, Rondoni, Ziegelschmidt and Morgan, 1984).

The general problem with all the abovementioned approaches is, however, that they only tackle the short-term instability of money demand, while at the same time incorporating an assumption of a stable long-run equilibrium relationship between the money stock and nominal income. Engle and Granger (1987) have, however, demonstrated that, at least for the United States of America, the various monetary aggregates have not been co-integrated with nominal income. If this finding proved to be more general, all the efforts to remedy the instability of money-demand functions would be in vain.

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Study No 3

Public finances and fiscal policy in the Community

Public finances and fiscal policy in the Community[1]

[1] This study is a slightly modified and updated version of a document prepared by officials of the Directorate-General for Economic and Financial Affairs for the Economic Policy Committee and discussed by its members in May 1989.

Tables

Graphs

Summary

The post-war expansion of the public sector in Europe has had a considerable impact on economic developments. Starting from the lessons that can be drawn from these developments, the paper highlights the adjustments to be made in fiscal policy in order to sustain the recovery of economic growth and to allow a better coordination of policies with a view to achieving the Community objectives. After recalling briefly the evolution of public finances during the 30 years of the Community's history in Section 1, the study proceeds in Section 2 with an examination of the direction and the magnitude of the required adjustments over the next few years. The present situation shows that, as a matter of priority, fiscal policy action has to be pursued in two main directions: to assure a sustainable development of public debt levels and to define, at the Community level and in the framework of an overall economic policy, a fiscal policy that would result in budget deficits compatible with sustained growth and a stable external position of member countries. While for certain countries the maintenance of the ratio of public debt to GDP at its present level may be considered acceptable, for others, where interest charges absorb an important share of total expenditure, a reduction of this ratio seems warranted to create more room for manœuvre. The savings/investment balance is another frame of reference by which guidelines for the conduct of fiscal policy can be developed. If the current strong pace of investment growth in the Community is to be maintained or even to accelerate further, while preserving a sustainable external balance, higher savings will be required in the Community on average. Fiscal policy should contribute to this process by an increase in the savings capacity of general government. This would at the same time relieve pressure on interest rates and on the conduct of monetary policy. The execution at the national level of these guidelines has to be adapted to the size of the required macroeconomic adjustment and the specific internal and external allocation of resources (fiscal balance, external balance, level of private saving and investment). Section 3 deals with the contribution fiscal policy can provide to the realization of the Community objectives. The strengthening of the coordination of fiscal policies should aim at achieving a sustainable and employment-creating growth. In this way it would allow the benefits of the internal market to be fully reaped. Higher growth rates are particularly needed to support the catching-up process of the less prosperous countries. Finally, by achieving a better balance in public finances and by progressively reducing unsustainable debt levels, fiscal policy should contribute to progress towards economic and monetary union.

1. Long-term trend in public finances and new thrust of fiscal policies in the Community

1.1. General trends

Developments in public finance over the first 30 years in the Community's existence can be divided into three fairly distinct periods (see Graph 1):

(i) From 1960 until the beginning of the 1970s, the growth of the share of public finance in economic activity was relatively rapid but did not give rise to any major or sustained budgetary disequilibria (phase of balanced budget expansion).

(ii) The following decade saw a sharp expansion in public expenditure and, despite a substantial increase in the relative share of taxes and social security contributions, the emergence of budget deficits which rose to very high levels (establishment of a vicious circle between budget trends and the deceleration of growth).

(iii) From 1982 onwards, the pace of growth of public expenditure tended to slow down and was even reversed during the past three years. This shift has been accompanied by a reduction in budget imbalances and a stabilization — and in certain cases an actual reduction — of the relative burden of taxes and social security contributions which, according to current forecasts, are likely to continue until 1990 (a corrective first step towards a more satisfactory allocation of resources in the economy).

The broad tendencies discernible for the Community as a whole can be observed in each member country, with differences in intensity and relatively limited differences in timing. This parallelism in performance reveals the existence of powerful underlying factors that are at work simultaneously in the various economies.

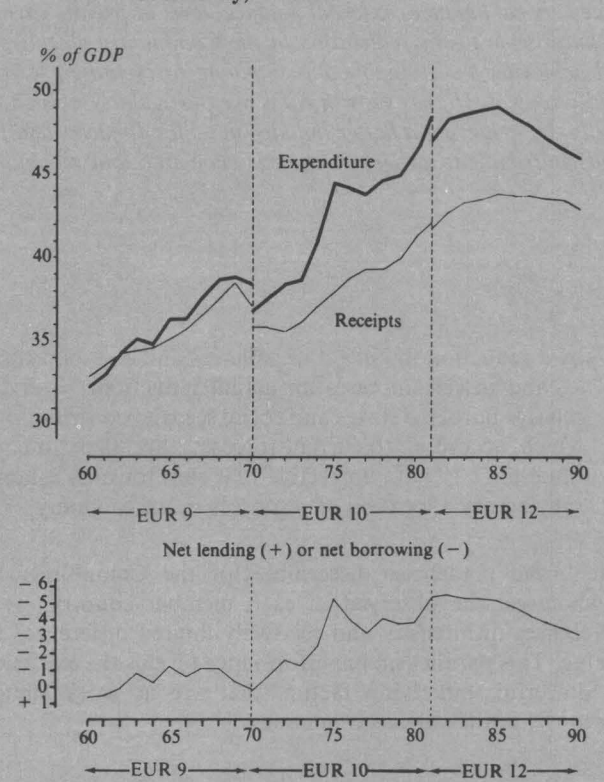
1.2. 1960-70: rapid but balanced expansion of public finances

Taking the Community average (EUR 9), total general government expenditure as a proportion of GDP rose by some six percentage points (from 32 to 38 %) over the period 1960-70. This increase is mainly due to the growth in welfare benefits; expenditure on public consumption and capital expenditure remained broadly unchanged as a proportion of GDP.[1]

General government revenue expanded at the same pace as expenditure so that, taking the average for the Community, swings in balances were fairly small, being largely contained within a band of 1 % (surplus or deficit) of GDP. The share of indirect taxes contracted a little and some two-thirds of the increase in revenue came from social security contributions, while the increase in direct taxes was more moderate on average.

The trend over this period seems to have been determined mainly by the expansion of social protection schemes reflecting an increase in individual benefits but also an extension of coverage to include new sections of the population. The corresponding increase in expenditure could be financed without excessive constraint by the spontaneous buoyancy of revenue resulting from a high level of employment and strong real incomes growth.

GRAPH 1: **Trend in general government expenditure, receipts and net lending (+) or net borrowing (−) in the Community, 1960-90**[1]



[1] The break recorded in 1970 is due not only to the change in geographical coverage but mainly to a switch to a different statistical source and methodology (OECD prior to 1970, Commission services after that date).
Source: Commission services.

At that time, the balanced expansion of the public sector was not thought to be incompatible with the pursuit of sustained growth. On the contrary, the existence of a positive multiplier on demand of an expansion of public expenditure financed by higher taxes, was largely recognized. However, higher social security payments and the increase in direct taxation, notably as a result of fiscal drag, encouraged potential increases in wage costs — wage-earners seeking to maintain the level of earnings net of tax and social security contributions — and hence an acceleration of inflation, or to the extent that the latter could be curbed, a change in the allocation of incomes to the detriment of company profitability. These risks materialized during the subsequent period.

1.3. 1970-82: sharp acceleration in the growth of public expenditure and emergence of large deficits

From the beginning of the 1970s until about 1982, budget trends in combination with the economic policies pursued in response to the oil price shocks led to a radical change in the allocation of resources in the economy.

Over that period (see Table 1) the public expenditure ratio in the Community increased on average by nearly 13 percentage points of GDP, an annual rate that was almost double the already high rate recorded in the preceding decade.

The level of taxes plus social security contributions also rose sharply (by nearly 6,5 percentage points of GDP). The increase in social security contributions and the rise in direct taxes added considerably to the upward pressure, first emerging at the end of the 1960s, on gross wage and salary incomes which in turn strengthened inflationary pressures. To the extent that inflation is gradually contained, these wage increases entailed a growing squeeze on company profits. In this way, profitability of capital was progressively eroded and affected in turn investment and then growth and employment. Under these conditions, as the subsequent experience showed, the expansion of the public sector has had an adverse effect on economic growth in the long run. An accommodating monetary policy, aimed at maintaining the investment propensity by means of zero or negative real interest rates, could only accentuate the vicious circle by new distortions of relative factor costs and entail a worsening of inflation.

[1] For this period, sufficiently comparable figures are only available for total public expenditure and revenue. Because of the difference in sources, these figures cannot be compared with those for the period after 1970.

Table 1

Main public finance trends in the period 1970-90 in the Community as a whole [1]

(% of GDP)

	1970	1973	1978	1982	1985	1988 [2]	1990 [2]	Change 1970-82	Change 1982-88
Total expenditure	35,5	37,2	43,3	48,2	49,0	47,1	46,0	12,7	−1,1
of which: Public consumption	14,3	15,2	17,3	18,8	18,6	18,3	17,7	4,5	−0,5
Current transfers	14,6	15,8	19,2	21,3	21,4	20,7	20,2	6,7	−0,6
Interest payments	1,9	1,9	2,8	4,1	5,0	4,8	4,8	2,2	0,7
Public investment	4,0	3,6	3,0	3,0	2,9	2,7	2,7	−1,0	−0,3
Receipts	35,7	36,1	39,4	42,7	43,8	43,5	42,8	7,0	0,8
of which: Indirect taxes	13,1	12,2	11,9	12,7	12,9	13,2	13,0	−0,4	0,5
Direct taxes	9,4	9,7	11,1	11,8	12,4	12,4	12,2	2,4	0,6
Social security contributions	10,2	11,2	13,0	14,4	14,6	14,5	14,3	4,2	0,1
Net lending (+) or net borrowing (−)	0,2	−1,1	−3,9	−5,5	−5,2	−3,6	−3,2	−5,7	1,9
Gross public debt	40,2	37,7	40,2	47,9	56,8	59,6	59,2	7,7	11,7

[1] EUR 10: EC excluding Greece and Portugal up to 1978.
[2] Economic forecasts, May/June 1989.
Source: Commission services.

The increase in revenue, fuelled by high inflation, financed only little more than half of the extra expenditure. The general government balance, which was close to equilibrium in 1970, had thus on average shifted to a net borrowing of 5,5 % of GDP by 1982.

The explosion in public expenditure and the widening of budget deficits occurred in two stages, linked to the two oil shocks: in 1974-75, when economic activity dropped sharply, and again, towards the end of the period, from 1979 onwards, when the slowdown in growth became more and more sustained and had a growing impact on the deterioration in budget equilibrium. Because of the inadequate economic policy response to the problems of the reallocation of resources thrown up by the two oil price shocks, a perverse reciprocal link was established between the budgetary developments and the slowdown of growth. The sharp increase in labour costs, encouraged by an accommodating monetary policy, produced a deterioration in profitability, growing underemployment and the development of increasingly strong inflationary pressures:

(i) Higher unemployment contributed to the increase in public expenditure: consumption expenditure went up because of an increase in the number of public employees and current transfers rose as a direct result of the fight against underemployment (this category of expenditure expanded by two percentage points of GDP from less than 0,5 % in 1970), while old-age and sickness benefits maintained their own momentum.

(ii) Despite fiscal drag due to the high rate of inflation, the increase in taxation and social security contributions remained insufficient. Public capital expenditure tends to be hit first by budgetary constraints. The emergence of large-scale budget deficits is reflected in a growing burden of interest payments; the only choice is then between an increasingly heavy financial burden on the private sector or an increasingly accommodating monetary policy, setting up renewed inflationary pressures which in turn sharpen the conflict over shares in national income.

The latter aspect is illustrated by the changes in the gross public debt/GDP ratio which, following a decline between 1970 and 1975, rose sharply after that period. The increase in this ratio tended to feed off itself through the rapid increase in the burden of interest payments. Inflation acts on the trend of the rate of indebtedness in two ways:

(i) First, the high level of inflation contributes to a 'snowball effect' by pushing up the nominal component of interest rates; the doubling of the effective interest rate on the public debt recorded between 1970 and 1982 was probably almost entirely due to this effect as real interest rates fell slightly over the period, for the Community on average.

(ii) Second, inflation leads to a depreciation of the stock of existing debt in relation to GDP at current prices, and this was by far the strongest effect during the period under review.

1.4. 1982-88: reorientation towards stabilization and consolidation of public finances

The period 1982-88 was characterized by a fundamental reorientation of fiscal policy. The results of this reorientation show, however, that in comparison with the objectives, important adjustments have still to be carried out.

1.4.1. The rationale behind the new fiscal policy stance: an emerging consensus on a few rules of conduct

To break the perverse chain of causation which developed in the period 1970-82, a change was needed in the general direction of economic policies. The new course of fiscal policy thus fits into a broader economic policy strategy. The action taken in the fiscal policy field had three main objectives on which a certain consensus had been established in the Community, notably through discussions in the Economic Policy Committee.

(a) Containing the growth of the public debt

The negative effects of the rapid increase in the public debt became increasingly clear: budgetary inflexibility as a result of the fixed and increasingly heavy debt-servicing burden, greater vulnerability to changes in interest rates, an upward pressure on interest rates and in the end a reduction in investment and in the rate of growth.

Progress in the convergence of monetary policies towards price and exchange-rate stability did much to demonstrate the limits to growth in the public debt. From the broad indicators given in Table 2 it can be seen that monetary policy, which had been relatively accommodating between 1974 and 1978 in relation to the trend of budget balances, subsequently switched to a much more restrictive stance in most member countries. In the countries with the largest budget deficits, this resulted in an appreciable increase in the financial pressure exerted by general government, which in particular was forced to have much greater recourse to funding through the issue of bonds (see Table 3) and became the largest borrower on the national markets for long-term securities.

For these reasons, improving the fiscal balance to the level needed for stabilization of the public debt in relation to GDP, or even for its reduction in the countries where it is highest, had thus to be made a priority objective of fiscal policy. In addition it was generally accepted that, even once this objective had been achieved, the need for the medium term would have to be to maintain positive net saving, or at the very minimum zero saving, by general government. In other words, public indebtedness should correspond to an increase in the capital stock and should not serve to finance current expenditure.

(b) Reducing the share of public finances

Following the accelerated expansion since 1960, it was also realized that there was a need in most countries to reduce, or at least to first stabilize, the percentage of GDP absorbed by public expenditure.

Such a course meets a twofold concern. First of all, it is aimed at encouraging a wage trend that is capable of restoring the profitability of supply to a sufficient level while easing the upward pressures on the level of earnings exerted by taxes and social security contributions. Secondly, a reduction in the public expenditure ratio and hence in the public sector's claim on real resources leaves the room needed for an expansion of private investment without a deterioration in the external position.

This policy posture means that, in those member countries where trimming the budget deficits is a priority objective in view of the trend of public indebtedness, disequilibria must be eliminated, preferably in most of these countries through a cut in the level of expenditure as a proportion of GDP. In those member countries which have some new-found room for manœuvre in terms of their budget balance, moderate real wage growth could be accompanied by a reduction in the tax burden. To the extent that profitability recovers, this type of action should not lead to any serious deterioration in the budget balance as a stronger growth rate will generate extra revenue.

(c) Changing the structure of public expenditure and revenue

In the recent past, the public authorities have been paying growing attention to changes in the structure of expenditure and revenue that serve to boost the productivity of the economy and growth.

So far, the measures taken along those lines have focused mainly on systems of direct taxation. Their main aim has been to simplify the way tax liability is established (definition of the tax base, reducing the number of tax rates), to lower marginal tax rates and to widen the base (reducing the number of exemptions), with an effort generally made to ensure that these measures are broadly neutral in their impact on tax revenue. On the expenditure side, there has been

Table 2

Budget balances and monetary aggregates, 1974-88

(annual averages)

	B	DK	D	GR	E	F	IRL	I	NL	P	UK
						1974-78					
D/ΔM	−0,6	0,0	−0,7	:	0,0	−0,1	−0,9	−0,5	−0,7	:	−1,2
D/Y (%)	−5,1	0,0	−3,0	:	−0,7	−1,1	−9,2	−7,9	−2,1	:	−4,1
M/Y	0,8	0,4	0,5	:	0,9	0,7	0,6	0,9	0,3	:	0,4
ΔM/M (%)	11,1	10,8	8,8	:	16,2	12,5	17,0	17,5	9,3	:	9,5
						1979-83					
D/ΔM	−1,7	−1,2	−1,0	:	−0,3	−0,3	−1,9	−1,1	−2,5	:	−0,8
D/Y (%)	−10,5	−6,0	−3,0	:	−4,0	−1,9	−12,6	−10,3	−5,4	:	−3,0
M/Y	0,8	0,4	0,5	:	0,9	0,7	0,6	0,8	0,3	:	0,3
ΔM/M (%)	7,3	12,0	5,6	:	14,4	10,3	11,9	12,6	6,6	:	11,1
						1984-88					
D/ΔM	−1,2	0,0	−0,5	−0,8	−0,5	−0,3	−3,0	−1,9	−1,8	−0,5	−0,3
D/Y (%)	−8,1	0,1	−1,6	−12,1	−4,9	−1,4	−8,6	−11,4	−5,6	−8,2	−1,8
M/Y	0,9	0,5	0,5	0,8	0,9	0,7	0,5	0,7	0,4	0,9	0,4
ΔM/M (%)	7,5	8,3	5,6	19,3	11,0	6,9	5,9	8,8	7,7	17,3	15,1

Note:
D = net lending (+) or net borrowing (−) of general government;
Y = nominal GDP;
M = broad money supply: B: M2N, DK: M2, D: M3, GR: M3, E: ALP, F: M3, IRL: M3, I:M2N, NL: M2N, P: L⁻, UK: M3;
ΔM = change in broad money supply.

Methodological note:
The ratio of the budget balance to the variation in broad money supply (D/ΔM) over a given period may be considered as a summary indicator of financial pressures exerted by general government. A coefficient lower than −1 tends to indicate high financial pressures. It implies in fact that, even under the assumption that the expansion of the money stock is entirely allocated to cover the budget deficit, general government has to compete with the private sector on capital markets in order to finance its budget deficit. A coefficient between −1 and 0, on the contrary, indicates either a low level of budget deficit or monetary accommodation of the fiscal deficit.

The ratio D/ΔM can be broken down into three components as follows:

$$\frac{D}{\Delta M} = \frac{D/Y}{\Delta M/M} \times \frac{Y}{M}$$

For a given level of velocity of money (or inversely liquidity ratio), the coefficient of financial pressure evolves positively with the level of budget deficit (as % of GDP) and adversely with money supply growth. It should be noted that coefficients are not comparable across countries given differences in the definition of the chosen monetary aggregate and structural differences in the liquidity ratio.

Source: Commission services.

a drive for greater selectivity through a reduction in subsidies to non-profitable activities and a shift to expenditure on manpower training and economic conversion.

Given the natural inertia of public finances, these policies necessarily form part of a medium-term approach. It seems to be increasingly widely accepted that public finance management must be geared to such a time-scale instead of focusing on the fine tuning of the economy. This has two types of consequence: firstly, for the budgetary programmes launched to be credible, the public authorities must formulate the objectives pursued in a precise and demanding manner; secondly, great caution is required in the implementation of counter-cyclical budgetary measures that go beyond the simple operation of the built-in stabilizers.

Table 3

Budget balances and capital markets, 1974-87

(annual averages in %)

	B	DK	D	GR	E	F	I	NL	P	UK
					Government securities issues/GDP					
1974-78	5,6	3,4	1,1	:	0,1	0,5	3,6	0,7	5,4	4,3
1979-83	4,9	10,1	0,7	0,0[2]	0,7	1,0	3,4	2,7	7,2	3,6
1984-87	11,2	1,8	2,3	0,6	1,9	2,0	8,7	3,3	6,5	2,1
					Government securities issues/total issues on domestic market					
1974-78	51,9	21,9	26,4	:	2,3	18,6	42,6	35,7	79,5	88,6
1979-83	42,9	55,3	16,1	−2,5	20,7	27,3	48,9	74,9	80,8	81,2
1984-87	62,3[1]	13,4	46,8	43,3	35,6	28,6	74,6	76,0	68,8[1]	49,5
					Total issues on domestic market/GDP					
1974-78	10,8	15,5	4,3	:	4,1	2,6	8,5	2,0	6,8	4,9
1979-83	11,5	18,3	4,4	0,6	3,6	3,8	6,9	3,6	8,9	4,4
1984-87	17,9[1]	13,4	5,0	1,4	5,3	6,9	11,6	4,3	9,5	4,3

[1] 1984-86.
[2] 1981-83.
Source: OECD financial statistics, calculations of Commission services.

1.4.2. Trends across the Community and results still uneven among member countries

Throughout the Community, the six most recent years saw a slowdown and then a reversal of the growth of public expenditure as a proportion of GDP which had been in progress with virtually no interruption since 1960, and showed the reorientation of fiscal policy mentioned above.

On the side of government receipts the reorientation was less clear-cut: indeed receipts continued to rise as a proportion of GDP until 1985 and then fell slightly. Overall, this led to a clear improvement in budget balances. According to forecasts now available, the reduction in budgetary imbalances is likely to continue until 1990, linked to a fall in the role of the public sector in economic activity. This recent tendency towards a relative decline is apparent in all main categories of expenditure. Owing to the improvement in net positions and the fall in nominal interest rates (see Table 4), even the burden of interest payments diminished very slightly as a proportion of GDP between 1985 and 1988.

The ratio of public debt to GDP, on the other hand, still increased sharply until 1985, but subsequently the movement tended to slow down appreciably.

The results achieved in implementing these policies are stil uneven, depending on the member country.

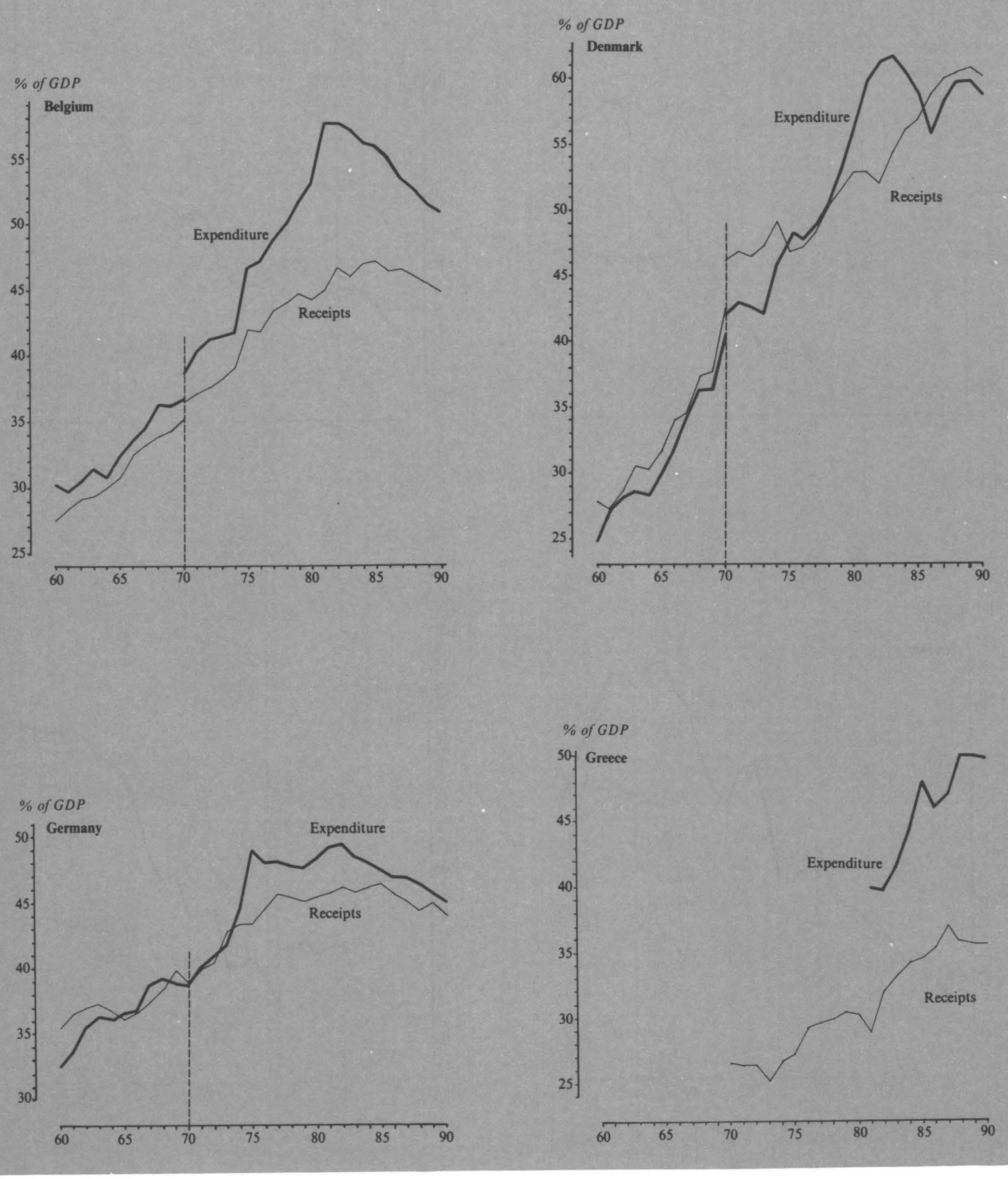
(a) Controlling the development of public debt

Two groups of member country can be distinguished here which have experienced diverging trends over the recent past (see Graph 3 and Table 5).

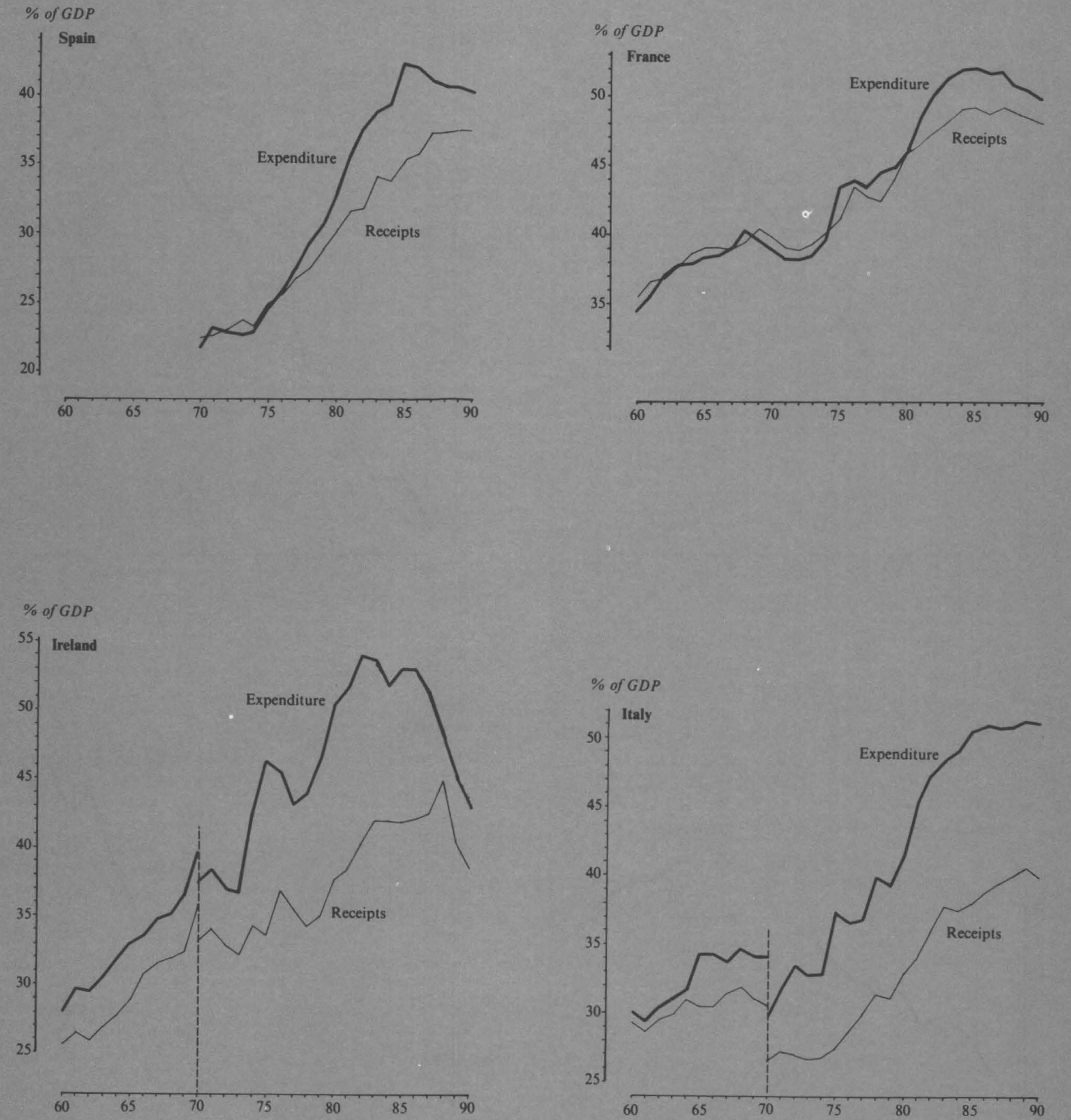
In those member countries where the ratio of public debt to GDP is lower than the Community average, this ratio rose only relatively moderately between 1985 and 1988 (Germany, Spain, France) or fell (United Kingdom, Luxembourg). In Denmark, the public debt ratio was first soaring but then contracted sharply and was broadly down to the Community average by 1988.

By contrast, in those member countries where the public debt ratio is relatively high, it maintained its sharp increase over the recent past. In Belgium, Ireland, the Netherlands and, to a lesser extent, Portugal, the primary deficit ceased to be an aggravating factor in this trend, the increase in the debt resulting primarily from a self-feeding process caused by interest payments (see Table 6). Greece and Italy, how-

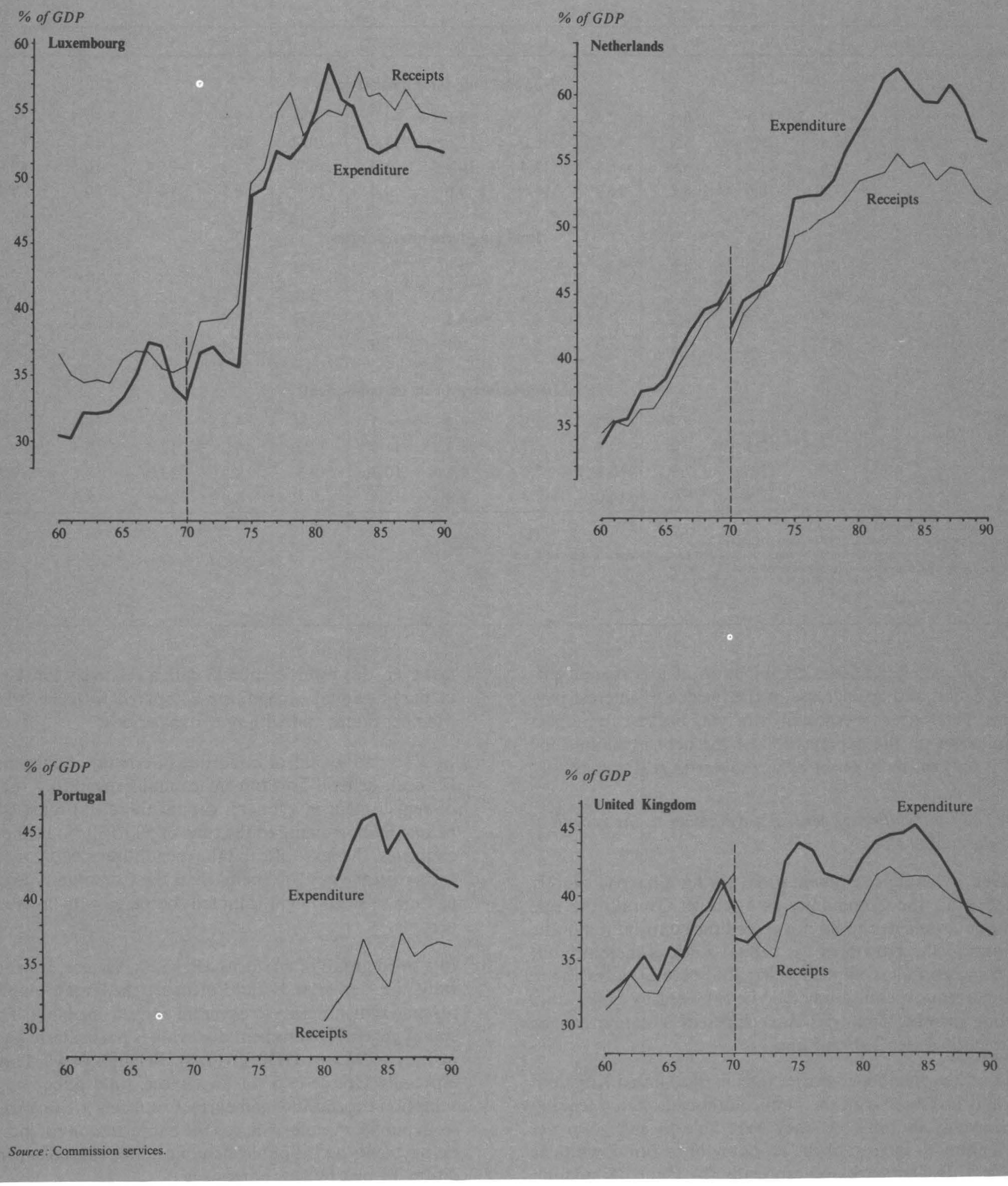
GRAPH 2: **Trend in general government expenditure and receipts in the member countries, 1960-90**



GRAPH 2: *(continued)*



GRAPH 2: *(continued)*



Source: Commission services.

Table 4

Nominal and real long-term interest rates and effective interest rates on public debt, 1970-88

(%)

	B	DK	D	GR	E	F	IRL	I	NL	P	UK	EC[1]
						Nominal long-term interest rates[2]						
1970	7,8	11,1	8,3	:	:	8,6	:	9,0	7,8	:	9,3	8,7
1982	13,4	20,5	8,9	15,4	16,0	15,6	17,0	20,9	10,5	:	12,7	14,3
1985	10,6	11,6	6,9	15,8	13,4	10,9	12,7	14,3	7,3	25,4	10,6	10,9
1988	7,9	10,6	6,1	16,9	11,8	9,0	9,4	12,1	6,3	14,1	9,3	9,3
						Real long-term interest rates[3]						
1970	3,8	4,4	4,7	:	:	2,5	:	3,9	4,0	:	2,7	3,5
1982	4,4	9,4	3,5	−4,6	1,4	3,5	−0,3	3,8	4,5	:	3,7	3,1
1985	5,5	6,6	4,6	−2,8	4,2	4,8	6,9	4,6	5,0	4,8	4,2	4,5
1988	6,7	5,8	4,8	3,0	6,7	6,1	7,0	6,7	5,4	4,1	4,2	5,5
						Effective interest rate on public debt[4]						
1970	5,0	10,6	5,4	4,2	3,9	3,9	6,3	3,6	5,6	:	5,3	4,9
1982	10,4	10,9	7,4	8,3	4,1	8,3	11,5	12,0	10,0	12,4	9,5	9,5
1985	9,7	13,5	7,3	10,8	7,6	9,1	10,3	10,5	9,4	13,3	8,8	9,3
1988	8,3	12,9	6,6	14,0	7,3	8,0	8,4	9,1	8,0	11,3	8,0	8,3

1 EC excluding Greece and Portugal in 1970.
2 Nominal yield on public sector bonds (yearly average).
3 Nominal yield on public sector bonds (yearly average) adjusted by changes in consumer prices.
4 Actual interest payments as percentage of gross debt $\frac{t+(t-1)}{2}$.

Source: Commission services.

ever, still experienced the combination of a persistent primary deficit and an increase in the burden of interest payments. This pattern is especially worrying because the impact of inflation on the depreciation of the debt is diminishing and is only partially offset by a recovery in real growth.

(b) The contribution of general government to the growth of the capital stock

In 1988, general government gross saving remained slightly negative for the Community as a whole. Overall, the rule that public deficits should not exceed the contribution of the budgets to the growth of the capital stock is therefore not yet being entirely complied with, after several years where even current expenditure had to be financed by borrowing. Among member countries three types of situation can be distinguished (see Tables 5 and 7):

(i) In three member countries (Denmark, United Kingdom and Luxembourg), the public authorities had a lending capacity in 1988, i.e. they were able to engage in net lending to the rest of the economy or to run down their debt. In Denmark and especially the United Kingdom, however, this result combines with a relatively low level of public capital expenditure compared with the other Member States and with previous periods.

(ii) In a second group of countries (Germany, Spain and France), general government capital expenditure (new or replacement investment, capital transfers) must still be met by borrowing to the tune of 50 to 60 %. In these countries, the level of capital expenditure is equal to or higher (in the case of Spain) than the Community average and shows no significant fall compared with previous periods.

(iii) In a third group of countries (Belgium, Greece, Ireland, Italy, the Netherlands and Portugal), the level of public revenue is insufficient to cover all current spending. The size of general government dissaving is particularly high in Italy (5,9 % of GDP in 1988), Belgium (4,4 %) and especially Greece (9,6 %). In Greece, only public consumption expenditure and current transfers are financed from public revenue, whereas the entire amount of interest payments on the public debt must, like capital expenditure, be met by new borrowing.

Table 5

Gross saving, primary balance, net lending/borrowing of general government[1] and gross public debt, 1970-88

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
							Gross saving						
1970	2,4	10,0	6,3	4,4	4,1	5,1	1,8	0,5	7,1	4,4	:	7,9	5,0
1982	−6,9	−5,4	1,1	−4,7	−0,5	0,9	−7,6	−7,0	7,5	−1,7	−5,2	−0,4	−1,6
1985	−5,7	0,9	2,7	−9,1	−1,4	0,5	−6,8	−6,9	11,5	0,2	−6,3	−0,5	−1,2
1988[5]	−4,4	3,0	1,5	−9,6	1,8	1,8	−1,0	−5,9	9,1	−0,5	−2,7	1,8	−0,2
							Primary balance[3]						
1970	1,2	5,4	1,2	:	1,3	2,1	−0,3	−1,5	3,8	1,7	:	6,9	2,1
1982	−1,8	−3,1	−0,5	−5,2	−4,6	−0,7	−4,7	−4,2	0,6	−1,9	−4,9	2,6	−1,4
1985	2,0	7,8	1,9	−8,5	−3,9	0,1	−0,8	−4,5	5,6	1,5	−2,2	2,2	−0,2
1988[5]	3,7	8,4	0,9	−5,5	0,1	1,2	6,3	−2,3	3,7	1,0	1,1	4,8	1,2
							Net lending (+) or borrowing (−)						
1970	−2,2	4,1	0,2	:	0,7	0,9	−4,3	−3,1	2,7	−1,2	:	3,0	0,2
1982	−10,9	−9,1	−3,3	−7,7	−5,6	−2,8	−13,7	−11,3	−0,5	−7,1	−10,4	−2,5	−5,5
1985	−8,6	−2,0	−1,1	−13,8	−7,0	−2,8	−11,1	−12,5	4,5	−4,8	−10,1	−2,7	−5,2
1988[5]	−6,5	0,4	−2,0	−14,3	−3,2	−1,6	−3,4	−10,6	2,6	−5,0	−6,6	0,8	−3,6
							Gross public debt[4]						
1970	67,5	14,8	18,4	21,3	15,5	28,0	62,1	41,6	28,1	52,2	:	79,8	40,2
1982	95,3	64,5	39,3	36,1	27,9	27,9	87,2	66,4	14,5	55,6	50,0	58,2	47,9
1985	115,4	74,5	42,5	57,9	46,5	33,4	105,0	84,0	14,0	69,6	69,5	57,6	56,8
1988[5]	127,5	62,8	44,6	71,4	47,5	36,4	118,0	96,1	10,4	78,5	74,4	49,2	59,6

[1] ESA definition of general government, which includes social security funds.
[2] EC excluding Greece and Portugal in the case of 1970.
[3] Net lending/borrowing excluding actual interest payments.
[4] General government, except: for Belgium and the Netherlands, excluding social security funds; for Greece and Ireland, central government only.
[5] Economic forecasts, May/June 1989.

Source: Commission services.

(c) Stabilization of the share of public finance and reduction of budget deficits

Graph 4 shows to what extent Member States have succeeded in recent years in reducing budget imbalances and stabilizing or even reducing the role of public finance in economic activity.

It can be seen that progress was made in these two areas in virtually all member countries; performance in reducing the deficits has generally been significantly better than performance in reducing public spending.

In other words, only a few Member States (Belgium, Germany, Luxembourg and the United Kingdom) managed at that stage to combine a reduction of deficits with a cut in public revenue as a proportion of GDP. In Denmark and Ireland, much of the improvement in the budget balance is due to a further rise in revenue. In Spain and Italy and, to a lesser extent France, revenue as a proportion of GDP had to be increased to reduce the deficit and to meet extra expenditure.

As can be seen from Table 8, this improvement in budget balances was helped, under the overall economic policy pursued, by a recovery in economic growth. Only Ireland and Greece did not benefit from this positive impact. Greece is the only Community country where the deficit worsened and where public expenditure and revenue expanded rapidly as a proportion of GDP. In Italy, too, very little progress was made given a budget position that was initially marked by a heavy deficit.

Table 6

Impact of budget deficits, interest payments, real growth and inflation on the development of gross public debt,[1] 1974-88

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
							1974-78						
a. Change in gross public debt[3]	3,6	14,8	11,4	9,9	1,4	0,5	14,9	7,6	−5,0	−2,5	:	−9,1	2,5
b. Accumulated primary balance	5,0	−8,6	7,6	:	0,0	−1,0	21,7	20,0	−20,4	−4,9	:	0,0	5,0
c. Accum. interest payments	19,3	7,9	7,5	7,4	2,5	6,0	24,8	19,4	4,3	15,2	:	20,7	12,4
d. Real growth effect	−7,2	−0,7	−2,6	−4,2	−1,7	−3,7	−15,2	−6,0	−1,1	−5,4	:	−3,6	−4,0
e. Inflation effect	−24,3	−4,6	−5,3	−14,3	−10,3	−11,1	−40,2	−41,7	−5,8	−15,5	:	−43,6	−21,1
f. Stock-flow adjustment[4]	10,8	20,8	4,2	:	10,9	10,3	23,8	15,9	18,0	8,1	:	17,4	10,2
							1979-83						
a. Change in gross public debt[3]	38,1	50,7	10,9	11,8	20,3	6,3	27,7	10,2	−0,6	21,0	:	0,7	11,0
b. Accumulated primary balance	13,5	1,4	3,2	:	14,2	−0,7	24,4	18,9	−5,2	4,4	:	−8,8	4,6
c. Accum. interest payments	37,3	26,8	11,7	14,0	4,4	9,4	38,4	31,2	4,7	22,2	:	23,8	18,4
d. Real growth effect	−4,8	−3,5	−2,0	−1,7	−0,9	−2,2	−8,3	−6,8	−1,2	−1,0	:	−2,2	−2,7
e. Inflation effect	−20,1	−17,0	−6,6	−24,1	−11,7	−12,1	−48,7	−45,2	−5,0	−10,1	:	−28,3	−20,5
f. Stock-flow adjustment[4]	12,2	43,0	4,6	:	14,3	11,9	21,9	12,1	6,1	5,5	:	16,2	11,2
							1984-88						
a. Change in gross[3] public debt	22,6	−11,5	3,7	30,2	13,0	6,9	20,7	24,1	−4,4	16,6	18,4	−8,7	8,4
b. Accumulated primary balance	−12,2	−44,1	−6,6	28,1	9,7	−1,5	−5,0	16,6	−21,1	−2,5	3,6	−12,9	−1,1
c. Accum. interest payments	52,2	44,6	14,7	31,6	15,8	14,0	49,2	40,9	5,5	30,6	39,8	22,6	24,3
d. Real growth effect	−12,5	−7,8	−5,2	−5,2	−7,8	−3,4	−13,9	−13,0	−3,1	−7,9	−9,7	−8,3	−7,6
e. Inflation effect	−19,0	−17,0	−4,5	−38,8	−16,4	−7,4	−21,8	−29,4	−1,5	−3,3	−48,2	−13,8	−14,1
f. Stock-flow adjustment[4]	14,1	12,8	5,3	14,5	11,7	5,2	12,2	9,0	15,8	−0,3	32,9	3,7	6,9

[1] General government, except: for Belgium and the Netherlands, excluding social security funds; for Greece and Ireland, central government only.
[2] 1974-78 and 1979-83: EC excluding Greece and Portugal.
[3] a = b + c + d + e + f.
[4] Allows for the difference between the national accounts basis for budget deficits and the Exchequer basis for public debt; f is calculated as residual.
Source: Commission services.

(d) The structure of total taxation (including social security contributions)

The measures taken to modify the budget structure did not produce any significant changes in the composition by main categories of expenditure and revenue.

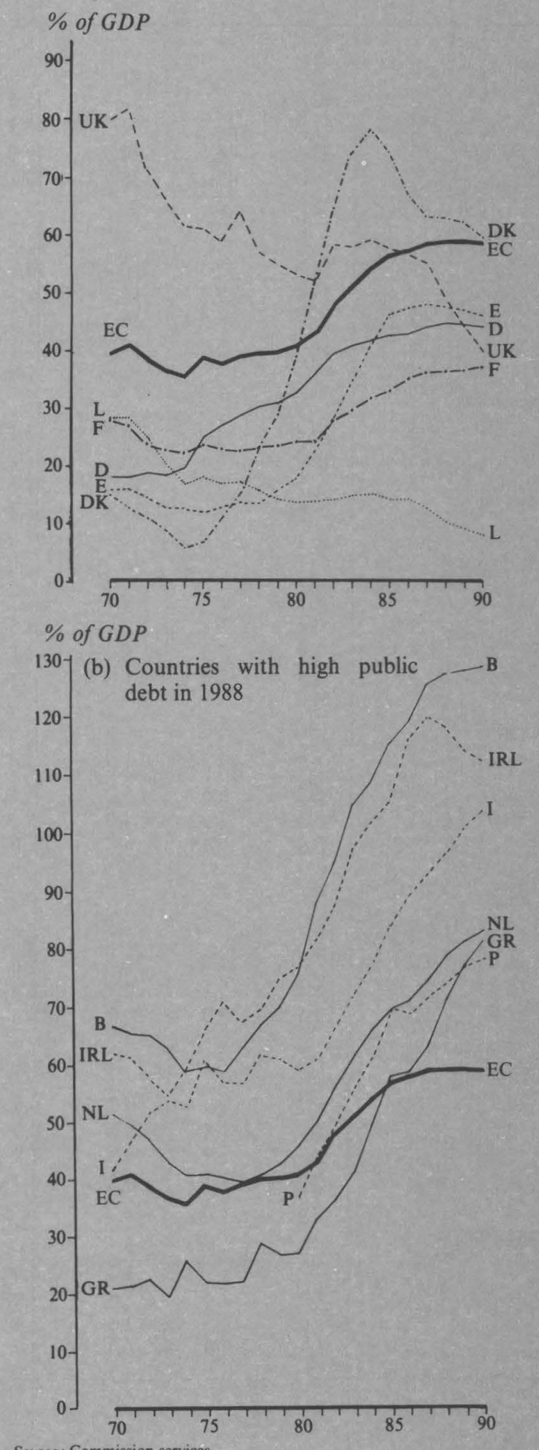
Taking the average for the Community, current and capital transfers to enterprises tended to decline from 1985 onwards (see Table 7). On the revenue side, the primary tendency (see Table 9) was towards a stabilization of direct taxes and social security contributions as a proportion of GDP at the expense of a slight increase in indirect taxes. These recent trends represent the first reversal in the tendencies observed since the 1960s. But they are still no more than marginal, and the structure of total taxation continues to vary sharply between Member States, as can be seen from Graph 5.

The share of social security contributions in total taxation reflects major differences in the way the social security systems are funded, quite apart from the level of development of these systems. Three groups of countries can be distinguished. In the United Kingdom, Ireland, and especially Denmark, the share of funding through social security contributions is relatively low (ranging from 4 to 20 % of total taxation); at the other extreme, it is substantial in Germany, the Netherlands and France (ranging from 42 to 47 % of total taxation); in the other Member States, the share is close to the Community average (28 to 37 %).

The split of tax revenue proper between direct and indirect taxes also varies considerably. In Belgium, Luxembourg, Denmark and, to a lesser extent, in Italy, direct taxes provide the largest share. The pattern is reversed in Greece, Portugal

GRAPH 3: **Trends in gross public debt, 1970-90**

(a) Countries with public debt below or very close to EC average in 1988



Source: Commission services.

and, to a lesser extent, France and the United Kingdom. The respective receipts from direct taxes and indirect taxes are broadly equivalent in Germany, Spain, Ireland and the Netherlands.

2. The direction and scale of the desired budget adjustments

The current situation produced by the trends described in the first part makes it necessary for budgetary action to have two primary aims: ensuring a sustainable trend of public debt and devising, at Community level and as part of an overall economic policy, a public finance policy that leads to a pattern of budget balances that is consistent with sustained growth and a stable external position in the Member States.

2.1. Sustainable trend of public debt

In view of the special situations in each member country and the variety of factors at work, any assessment of whether public indebtedness is sustainable or not can only be made in an indicative and largely arbitrary way by reference to predetermined thresholds. Such an assessment must be made in dynamic rather than static terms and be based principally, as is done by markets, on the budgetary authorities' likely capacity to keep the medium-term trend of the public debt under control and ensure that the debt is serviced.

A simple criterion here is the size of the required budget balance (before payment of interest) to ensure, against the background of a specified growth and interest-rate performance, the long-term stability of the current ratio of public debt to GDP. Comparison of the required balance with the actual balance provides an indication of the room for manœuvre available to the budgetary authorities in order to change the trend of the public debt[1] where necessary.

Table 10 shows the level of the required primary balances in comparison with the balances actually achieved in 1988 and those projected, assuming an unchanged fiscal policy, for 1993; it also gives the assumptions made for interest

[1] The primary balance (before interest payments) required to stabilize the future rate of indebtedness at its present level can be simply calculated on the basis of the relationship

$$s = (i-g) \times d$$

where s is the required primary balance, d the desired debt-GDP ratio (in this case, the current rate of indebtedness), and g and i respectively the nominal growth rate of GDP and the nominal interest rates used by way of assumption as exogenous data for the period ahead. For this methodology, see also *European Economy* No 22, November 1984.

Table 7

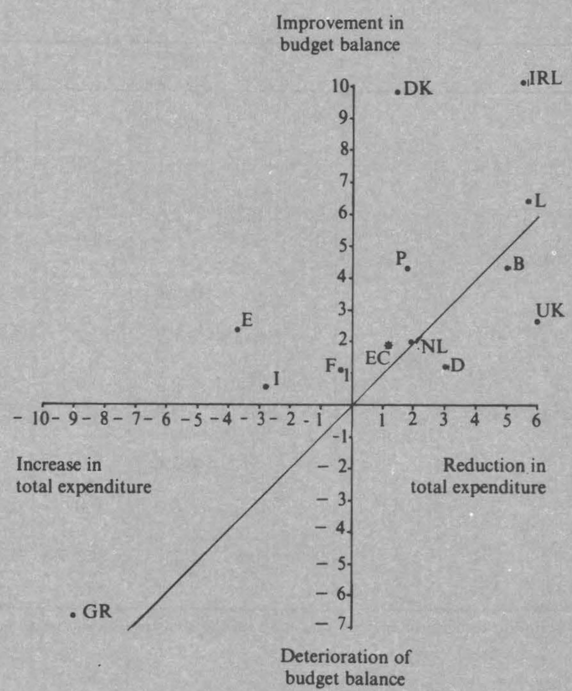
Share of selected categories of general government expenditure,[1] 1970-88

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
						Total expenditure							
1970	38,6	42,1	38,7	:	21,7	38,9	37,5	29,7	33,1	42,3	:	36,7	35,5
1982	57,6	61,2	49,4	39,7	37,5	50,3	54,0	47,4	55,8	61,3	43,8	44,7	48,2
1985	55,8	59,3	47,5	48,1	42,1	52,1	53,0	50,8	51,8	59,6	43,5	44,3	49,0
1988[3]	52,4	59,9	46,5	50,0	40,5	50,7	48,1	50,8	52,2	59,3	42,1	38,7	47,1
						Current transfers: total							
1970	17,0	14,9	15,9	8,5	9,3	20,1	13,5	12,7	17,0	18,4	:	10,4	14,6
1982	25,9	23,2	21,9	15,7	18,1	25,2	19,4	20,0	30,3	33,1	18,2	15,9	21,3
1985	24,8	21,3	20,7	17,6	19,3	26,5	20,0	20,8	28,2	32,2	16,2	16,2	21,4
1988[3]	23,9	23,4	20,8	15,8	17,8	25,6	18,9	20,7	28,3	33,2	15,4	13,8	20,7
						Current transfers to households							
1970	14,1	11,4	13,0	7,6	7,4	16,9	8,7	10,7	15,1	16,8	:	8,4	12,1
1982	22,3	18,2	18,2	12,7	14,0	21,2	15,4	16,4	25,5	28,9	:	13,2	17,7
1985	21,8	16,4	16,7	14,5	14,9	22,1	16,4	17,3	23,6	27,3	:	13,2	17,7
1988[3]	20,9	17,8	16,5	13,9	14,3	21,9	16,3	17,5	24,3	26,8	:	11,8	17,2
						Current transfers to enterprises							
1970	2,4	2,9	2,0	0,8	0,9	2,0	4,7	1,3	1,3	1,3	:	1,7	1,7
1982	2,6	3,2	2,1	2,9	2,5	2,3	3,7	3,1	4,6	2,5	5,6	2,1	2,5
1985	2,5	3,0	2,3	3,0	2,6	2,5	3,3	2,8	4,3	3,0	4,3	2,0	2,5
1988[3]	2,0	3,3	2,5	1,9	1,8	2,0	2,4	2,5	3,8	3,8	2,0	1,3	2,2
						Actual interest payments							
1970	3,4	1,3	1,0	0,9	0,6	1,1	3,9	1,5	1,1	2,9	:	3,9	1,9
1982	9,1	6,0	2,8	2,6	1,0	2,0	9,0	7,1	1,0	5,2	5,5	5,0	4,1
1985	10,6	9,9	3,0	5,4	3,2	2,9	10,4	8,0	1,1	6,3	7,9	4,9	5,0
1988[3]	10,2	8,0	2,8	8,8	3,3	2,8	9,7	8,2	1,2	6,0	7,7	4,0	4,8
						Government consumption							
1970	13,7	20,0	15,8	12,6	8,4	13,4	14,0	12,0	10,5	15,4	:	17,5	14,3
1982	18,6	28,2	20,4	18,3	13,4	19,3	19,6	16,0	16,4	17,7	14,9	21,7	18,8
1985	17,6	25,3	20,0	20,4	14,0	19,4	18,3	16,4	15,6	16,2	15,5	20,9	18,6
1988[3]	16,1	25,9	19,4	20,6	14,3	18,8	17,0	17,2	16,2	15,5	15,0	20,0	18,3
						Net capital transfers							
1970	0,3	1,0	1,5	:	0,9	0,3	1,8	0,8	0,8	1,0	:	0,2	0,8
1982	0,6	0,9	1,6	0,2	2,0	0,3	1,0	0,5	1,3	2,5	1,8	0,5	0,9
1985	0,6	0,7	1,5	0,4	1,9	0,1	0,4	1,9	1,7	2,3	1,3	0,3	1,1
1988[3]	0,4	0,4	1,1	1,3	1,3	0,1	0,2	1,3	1,0	2,2	1,1	−0,3	0,7
						Gross fixed capital formation							
1970	4,2	5,0	4,6	:	2,5	3,9	4,3	2,7	3,6	4,7	:	4,7	4,0
1982	3,4	2,8	2,8	2,9	3,1	3,4	5,1	3,7	6,7	2,9	3,4	1,6	3,0
1985	2,2	2,2	2,3	4,4	3,7	3,2	4,0	3,7	5,2	2,6	2,5	2,0	2,9
1988[3]	1,8	2,2	2,4	3,4	3,8	3,3	2,2	3,5	5,6	2,3	2,9	1,2	2,7

[1] ESA definition of general government, which includes social security funds.
[2] EC excluding Greece and Portugal in the case of 1970.
[3] Economic forecasts, May/June 1989.
Source: Commission services.

GRAPH 4: **Changes in budget balances and total general government expenditure, 1982-88 (as % of GDP[1])**



[1] The diagonal indicates a constant share of government receipts in GDP. Positions above this line correspond to an increase in government receipts as a percentage of GDP (and inversely).

Source: Commission services.

rates (long-term interest rates maintained at their 1988 level) and the growth rates (medium-term projections for 1988-93). The calculation is based on *gross* public debt, the view being taken that public sector claims on the rest of the economy can to a large extent be equated with capital transfers (low likelihood of reimbursement, return generally lower than market rates). To maintain consistency, the primary balance to be used must be that of the general government net borrowing requirement which, unlike net lending/net borrowing for national accounts purposes, includes loans, advances and equities for the benefit of the rest of the economy. In the absence of harmonized data, an estimate of these balances (including stock/flow adjustments) has been made for 1988 and a projection produced for 1993.

On the basis of these criteria, the member countries can be divided into three groups:

(i) In Denmark, Ireland and the United Kingdom the primary balance to be financed in 1988 is higher than the balance required to stabilize the level of debt. It is very close to this threshold in Germany and France. According to the projections, this situation is likely to continue until 1993. In this group of countries, the trend of the public debt can be considered to be under control, although the ratio of public debt to GDP is undoubtedly still at a too high level in the case of Ireland.

(ii) In Belgium, Spain and Portugal, the condition of stability of the public debt/GDP ratio is not yet completely met. But the stance of fiscal policy is such that the objective might be achieved by 1993. Improving the budget balances is a priority task in Belgium, as in Ireland, where the high level of the public debt places a substantial interest burden on the budget (some 10 % of GDP) and deprives economic policy of all room for manœuvre on the budgetary front.

(iii) In the other member countries (Greece, Italy and the Netherlands) neither the level of the present balance nor that of the balance projected for 1993 holds out hope of a stabilization of the public debt/GDP ratio. In these

Table 8

Components of change[1] in budget deficits in the Community, 1974-88

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
							1974-78						
Actual change in budget deficits	−2,7	−5,6	−3,6	:	−2,9	−3,0	−5,1	−2,4	2,0	−3,5	:	−1,7	−2,8
Effect of change in economic activity	−0,3	−1,1	−0,9	:	0,1	0,2	2,6	−1,5	−4,4	1,9	:	−1,0	−0,6
Residual change	−2,4	−4,5	−2,7	:	−3,0	−3,2	−7,7	−0,9	6,4	−5,4	:	−0,7	−2,2
							1979-83						
Actual change in budget deficits	−5,3	−6,9	−0,1	:	−3,1	−1,1	−1,9	−2,2	−2,7	−3,6	:	1,0	−1,3
Effect of change in economic activity	−1,4	−1,4	−1,7	:	−2,1	−0,4	−2,3	−0,3	−3,0	−3,7	:	−2,6	−1,5
Residual change	−3,9	−5,5	1,6	:	−1,0	−0,7	0,4	−1,9	0,3	0,1	:	3,6	0,2
							1984-88						
Actual change in budget deficits	4,7	7,6	0,5	−6,0	1,6	1,5	8,2	0,0	0,0	1,4	2,4	4,2	1,7
Effect of change in economic activity	2,0	0,9	2,4	−1,1	4,9	0,3	−1,7	2,5	7,2	3,2	0,2	4,5	2,5
Residual change	2,7	6,7	−1,9	−4,9	−3,3	1,2	9,9	−2,5	−7,2	−1,8	2,2	−0,3	−0,8

[1] A plus sign indicates a reduction in the general government borrowing requirement or an increase in net lending, a minus sign indicates an increase in the borrowing requirement or a decrease in net lending.
[2] 1974-78 and 1979-83: EC excluding Greece and Portugal.
Source: Commission services.

countries, this ratio, while not reaching the extremely high level recorded in Belgium and Ireland, is still a good deal higher than the Community average. Given the danger of a loss of control over the trend of the debt and of an increasingly tight constraint on the economy, there is a need to bring the deficit down rapidly to a more sustainable level.

2.2. Budget balances consistent with satisfactory equilibrium of saving and investment and with stable external positions

The effects of the perverse process that has developed, as a result of the economic cause and effect sequence described above, between budget trends and the slowdown of the trend of growth after the first oil price shock can be gauged from the fundamental changes that have occurred in the saving/investment equilibrium. The present position as regards budget balances and current external balances and the point of equilibrium for private sector saving/investment indicate the various economic policy means to be employed to restore the conditions for sustained growth.

2.2.1. Fundamental changes that have occurred in the conditions for achieving saving/investment equilibrium

Table 11 shows the scale of the changes that have occurred since 1970 in the saving/investment equilibrium in the Community.

While it was generally possible to maintain a balanced external position for the Community on the average, the equilibrium between saving and investment changed substantially during the period. Between 1970 and 1983, the economic policies pursued have attempted to maintain or restore a reasonable external position in response to the external shocks. In this way the drop in public saving was reflected in a simultaneous fall of about six percentage points of GDP in investment (public and private) and national saving (exclusively because of the decline in general government saving). From 1983, by contrast, the situation was reversed and a recovery in public saving was accompanied by a modest upturn in investment.

The same type of trend was observed, though with different degrees of intensity, in most member countries taken individually; this shows that in the context of the economic

Table 9

Share of selected categories of general government receipts,[1] 1970-88

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
Total current receipts													
1970	36,5	46,2	38,9	26,5	22,5	39,8	33,2	26,7	35,8	41,1	:	39,7	35,7
1982	46,7	52,0	46,1	32,0	31,9	47,6	40,3	36,1	55,4	54,2	33,4	42,3	42,7
1985	47,2	57,3	46,4	34,3	35,1	49,3	41,9	38,2	56,3	54,9	33,4	41,5	43,8
1988[3]	45,8	60,4	44,5	35,7	37,3	49,0	44,7	40,2	54,7	54,3	35,5	39,5	43,5
Indirect taxes													
1970	12,9	18,4	13,2	14,5	7,8	15,2	18,8	9,7	9,1	10,8	:	16,1	13,1
1982	12,0	17,7	12,6	14,2	7,8	14,6	16,9	8,6	14,2	11,4	14,2	16,7	12,7
1985	11,5	18,4	12,6	15,3	9,6	14,9	17,1	8,9	15,8	11,9	14,1	16,0	12,9
1988[3]	11,5	19,4	12,2	16,5	10,2	14,7	17,9	10,1	16,0	13,0	16,0	16,4	13,2
Direct taxes													
1970	11,0	22,6	10,8	3,5	3,4	7,2	8,5	4,7	12,1	13,0	:	14,3	9,4
1982	19,3	25,4	12,1	5,9	6,8	8,8	13,2	11,8	18,2	14,7	7,7	14,5	11,8
1985	19,0	28,6	12,5	5,6	8,5	9,2	14,5	13,0	20,0	12,6	8,3	14,6	12,4
1988[3]	17,9	31,2	12,1	6,2	10,3	9,3	17,1	13,4	18,4	14,5	6,5	13,3	12,4
Social security contributions													
1970	10,3	2,5	12,6	6,6	6,4	14,6	2,5	10,4	9,9	13,8	:	5,1	10,2
1982	12,7	2,4	17,8	10,2	13,3	20,2	5,5	13,7	15,2	19,7	9,6	6,5	14,4
1985	14,4	2,9	17,5	11,3	13,1	21,1	5,7	13,6	14,1	20,6	9,1	6,8	14,6
1988[3]	14,5	1,9	17,4	11,2	12,8	20,8	5,6	13,9	14,6	20,5	10,7	6,9	14,5
Other current receipts													
1970	2,2	2,6	2,4	1,9	4,7	2,9	3,4	1,9	4,6	3,5	:	4,1	3,0
1982	2,7	6,6	3,6	1,7	4,0	4,0	4,7	2,0	7,8	8,5	2,0	4,5	3,8
1985	2,2	7,5	3,8	2,0	3,8	4,1	4,7	2,8	6,4	9,8	1,8	4,1	4,0
1988[3]	1,8	7,8	2,9	1,7	3,9	4,2	4,0	2,8	5,8	6,4	2,3	2,9	3,4

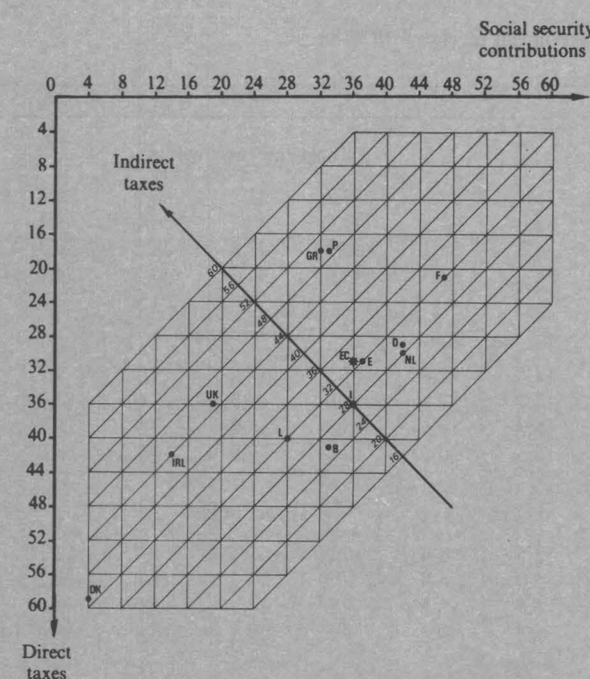
[1] ESA definition of general government, which includes social security funds.
[2] EC excluding Greece and Portugal in the case of 1970.
[3] Economic forecasts, May/June 1989.
Source: Commission services.

policies pursued in those countries the same perverse process tended to develop. In particular, the data presented in Table 12 reveal three dominant features of the changes that have occurred: (a) a close parallel between changes in the budget deficit and changes in private investment, (b) the absence of a clear relationship between the trend of private saving and the trend of budget balances, and (c) the fact that the burden of the external constraint showed up in relatively limited swings in current balances in response to fluctuations in budget deficits. These shifts have to be analysed in detail by country in a general economic framework. On the basis of this analysis, it should be possible to identify guidelines on the appropriate policy mix for the future.

2.2.2. Guidelines for economic policy and fiscal policy

If sustained growth is to be restored in the Community, the upturn in investment which started in the past few years must continue and gather momentum. In the medium term, private and public investment should, as a proportion of GDP, again reach a level close to that recorded at the end of the 1960s (which would mean an increase in the investment

GRAPH 5: **Structure of general government fiscal receipts in 1988 (as % of total fiscal receipts)**



Source: Commission services.

ratio of some 4 to 5 percentage points of GDP) or even more, in view of the downward tendency in capital productivity recorded between 1960 and the mid-1980s. For this objective to be achieved, profitability must be given an extra boost through the continuation of a moderate real wage trend against the background of monetary stability. Fiscal policy can contribute in two ways: by a reduction in the resources claimed from the economy so as to ease the pressure on wages and salaries and free the resources needed to secure higher growth without external disequilibrium; and by an increase in general government saving so as to reduce pressures on interest rates and on the conduct of monetary policy.

In implementing these guidelines at the national level, account must be taken of the scale of the adjustments required and the room for manœuvre available in each Member State. According to their external position and the internal pattern of allocation of resources (budget balance, level of investment and private saving), the Member States fall into three groups:

(i) Among the member countries which earned a current external surplus in 1988, Belgium, Germany and the Netherlands probably have structural features (capacity to save, level of incomes, potential growth rate, etc.), which induce them to be net exporters of capital.

In Germany the size of the current surplus looks difficult to reconcile with Community and domestic objectives. An expansion of domestic demand, especially through higher investment, would enable this surplus to be reduced to a more normal level. The room for manœuvre in fiscal policy could be used along these lines (reduction in expenditure on subsidies and a consequent easing of taxation and an increase in productive public investment). This kind of budgetary action, together with a drive to obtain greater labour market flexibility, especially in the service sector, should go hand in hand with a moderate wage trend and a monetary policy geared to stability, given the exchange rate options adopted.

In Belgium and the Netherlands, maintenance of an external surplus of the approximate size of the one

Table 10

Primary balances needed to stabilize gross public debt

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	NL	P	UK	EC
Debt/GDP ratio in 1988	127,5	62,8	44,6	71,4	47,5	36,4	118,0	96,1	78,5	74,4	49,2	59,6
Primary balance to be financed in 1988 (a + b + c)	1,7	7,9	0,1	−5,5	0,1	1,1	3,9	−3,3	−1,0	−1,5	6,5	1,2
a. Net lending/borrowing	−6,5	0,4	−2,0	−14,3	−3,2	−1,6	−3,4	−10,6	−5,0	−6,6	0,8	−3,6
b. Actual interest payments	10,2	8,0	2,8	8,8	3,3	2,8	9,7	8,2	6,0	7,7	4,0	4,8
c. Loans, advances, equities and adjustments	−2,0	−0,5	−0,7	:	:	−0,1	−2,4	−0,9	−2,0	−2,6	1,7	:
Primary balance to stabilize debt/GDP ratio at 1988 level[1]	2,4	3,7	0,3	0,1	0,8	1,2	3,1	3,0	1,5	0,1	0,6	1,2
Projected primary balance to be financed in 1993[2]	5,0	9,1	1,9	−2,5	1,3	1,6	3,4	−3,0	0,1	0,6	7,4	2,3
Memorandum items:												
Growth of nominal GDP 1989-93[2]	6,0	4,7	5,4	16,4	10,2	5,7	6,8	9,0	4,4	14,0	8,0	7,3
Nominal long-term interest rate in 1988	7,9	10,6	6,1	16,6	11,8	9,0	9,4	12,1	6,3	14,1	9,3	9,3

[1] The primary balance required to stabilize the public debt/GDP ratio at its 1988 level is calculated on the basis of the relationship $s = (i - g) \times d$, where s denotes the required primary balance, d the debt/GDP ratio and i and g the nominal long-term interest rate and the nominal growth of GDP, respectively. For this methodology, see also *European Economy* No 22, November 1984.
[2] Medium-term projections 1989-93, June 1989.
Source: Commission services.

recorded now should be accompanied, at domestic level, by a continuation of budget adjustment (reduction of the rate of indebtedness and return to positive public saving). This reduction of budget imbalances should be achieved without an increase in taxes and social security contributions, since the burden on gross wages is already heavy. It is necessary, especially in Belgium, to encourage the growth of private investment and step up action to maintain a strictly controlled wage trend.

Ireland's position among the Member States with the largest current surplus should be only temporary, because it is linked to the implementation of a severe domestic and external adjustment programme. Once this consolidation has been achieved, the prime objective of economic policy, backed up by Community structural measures, should be to bring about a clear upturn in the investment ratio. Portugal's situation resembles that of Ireland in some respects but the fiscal consolidation process is less advanced.

(ii) Among the member countries with no more than a moderate current external deficit in 1988, the budget situation in France and Spain looks sustainable. Because of the relative vulnerability of the external position, however, there is a need for a continued rigorous stance in all fields of economic policy. In fiscal policy, the emphasis should be on improving supply conditions and the formation of private saving.

In Italy, the near equilibrium achieved on the current external account masks the handicap for the buoyancy of the economy of that country and hence the Community[1] that lies in the persistence of a large budget deficit. It is essential that a thoroughgoing consolidation programme be implemented in the public finance field; this would reduce the current burden on monetary policy and would, even if it is reflected in a reduction in the saving ratio, ensure a sustained upturn in investment. The need for such a budgetary recovery programme, together with a much more tightly controlled real wage trend, is even stronger in Greece.

(iii) The situation in Denmark and the United Kingdom is marked by the combination of a high external deficit and a slight budget surplus that offsets a savings deficit in relation to private sector investment. This pattern

[1] Italy's budget deficit absorbs over 8 % of the Community's total gross savings.

cannot be regarded as normal given the average income levels achieved in the two countries. It can hardly be sustained in the medium term because it requires a high level of domestic interest rates and carries the risk, in the case of Denmark, of a cumulative process of external debt growth which places an increasingly high cost on any subsequent adjustment through the exchange rate. Reducing the external deficit through a substantial increase in the budget surplus (forced saving) is only a 'second best' solution. Moreover, this approach is likely to come up rapidly against its limits. It could lead to a new slackening in the private saving ratio and, in the absence of an extra improvement in profitability, does not guarantee the required upturn in investment. In these circumstances, optimal adjustment should be achieved through a stricter wage trend and systematic measures to encourage personal saving. In the present circumstances, however, such a wage trend appears to be hardly achievable. This type of country-by-country analysis should be refined and could lead to medium-term public finance guidelines in the general framework of the economic policy mix.

Table 11

Saving and investment in the Community, 1970-88

(% of GDP)

	Saving			Investment[1]		
	Public	Private	Total	Public	Private	Total
1970	5,0	20,8	25,8	4,0	21,8	25,8
1983	−1,5	21,2	19,7	2,9	16,8	19,7
1970-83	−6,5	0,4	−6,1	−1,1	−5,0	−6,1
1988	−0,2	21,1	20,9	2,7	18,0	20,7
1983-88	1,4	−0,2	1,2	−0,2	1,2	1,0

[1] Including changes in stocks.
Source: Commission services.

Table 12

Change in budget balances, gross private saving and investment and current account, 1974-88[1]

(% of GDP)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EC[2]
1974-78													
Net lending or net borrowing of general government	−2,7	−5,6	−3,6	:	−2,9	−3,0	−5,1	−2,4	2,0	−3,5	:	−1,7	−2,8
Gross private saving	−0,7	0,0	0,0	:	−1,1	0,0	3,8	1,6	−1,6	−3,0	:	3,3	0,7
Gross private investment	0,8	−2,9	−2,7	:	−3,4	−2,6	2,3	−2,9	−3,6	−1,2	:	0,7	−1,8
Current account balance	−3,2	−1,0	0,1	2,5	0,2	0,8	−3,3	4,1	3,1	−4,7	−8,8	2,4	0,7
1979-83													
Net lending or net borrowing of general government	−5,3	−6,9	−0,1	:	−3,1	−1,1	−1,9	−2,2	−2,7	−3,6	:	1,0	−1,3
Gross private saving	0,1	2,5	−0,3	:	−4,0	−4,6	−2,8	−0,1	20,9	3,2	:	−2,6	−1,5
Gross private investment	−4,9	−4,4	0,7	:	−2,9	−2,3	−4,3	−2,6	−2,7	−2,5	:	−1,6	−1,7
Current account balance	0,6	0,2	−0,8	−3,7	−2,5	−2,2	−0,1	−2,1	20,3	4,0	−2,6	0,5	−0,8
1984-88													
Net lending or net borrowing of general government	4,7	7,6	0,5	−6,0	1,6	1,5	8,2	0,0	0,0	1,4	2,4	4,2	1,7
Gross private saving	0,8	−4,7	3,6	2,8	2,5	−0,5	−3,9	−1,6	−7,1	1,0	5,2	−4,2	−0,2
Gross private investment	2,9	1,6	−0,6	−2,3	1,0	−0,3	−3,5	−1,2	1,6	3,3	−1,7	3,1	0,5
Current account balance	1,6	0,9	3,4	3,1	0,4	0,5	9,0	−0,9	−8,0	−0,7	6,8	−4,1	0,3

[1] Net lending of general government + gross private saving — gross private investment = balance on current account. The difference between the total of the three first terms and the external current account is due to changes in stock building and net capital transfers from the government.
[2] 1974-78 and 1979-83: EC excluding Greece and Portugal.
Source: Commission services.

3. The contribution of fiscal policy to the achievement of Community objectives

Four priority objectives at Community level can be identified for an increased coordination of fiscal policies.

3.1. Ensuring stable and employment-creating growth

In this area, fiscal policy is only one component of a much wider strategy that draws on all instruments of economic policy. The task here is to strengthen the consensus on the policy mix that is best tailored, at Community and national level, to achieving this objective.

The specific contribution to be made by fiscal policy must fit into a medium-term perspective. It consists in the public authorities keeping control of the trend of the public finances and of budget balances so that resources that are necessary for private sector and investment growth are provided. It means that the structure of revenue and expenditure must be more systematically geared to the growth of productive activity and the improvement of supply conditions. The virtuous circle that seems to have been set up in the recent past between the stabilization of taxation and social security contributions and the reduction of budget deficits on the one hand and an upturn in growth and investment on the other needs to be maintained and strengthened.

In operational terms, fiscal policy could be fitted more closely into implementation of a Community growth strategy, notably through establishing medium-term 'target zones' for the budget balances of the various Member States. Under such an approach it would be possible to specify, together with the other means of economic policy action, the objectives of fiscal policy in terms of the level and structure of revenue and expenditure that would be consistent with internal and external equilibrium.

3.2. Participating in the completion of the internal market

For full advantage to be taken of the productivity gains expected from completion of the internal market, conditions must be restored that ensure sustained growth. Also, there will be more direct competition between national public finances as a result of completion of the internal market. It is important that each Member State should have the necessary room for manœuvre in fiscal policy to adjust to the new requirements. More specifically, Community moves to harmonize taxation in connection with the establishment of the large internal market will have a direct impact on national budgets:

(i) The strongest impact will come from the closer alignment of rates of VAT and excise duties. Without prejudging the decisions which will eventually be taken, it is possible, on the basis of the Commission's current proposals, to make an estimate of the budgetary impact of this alignment. This estimate is confined to the primary effects of the change in tax rates and makes no allowance for economic mechanisms or for budget decisions which might be taken to limit this impact (response of demand to price changes, operation of the built-in budget stabilizers, compensatory tax reforms). It is also assumed that each member country will choose those tax rates within the bands established which minimize the initial impact on revenue.

On this basis, the budgetary impact of harmonization would be relatively weak in Belgium, Italy, the Netherlands and France. It would be very strong, in opposing directions, in Denmark (a revenue loss of the order of 4 to 5 % of GDP) and Luxembourg (extra revenue of the order of 7 % of GDP). This would pose a major problem in these countries as regards the compensatory tax measures that might be applied. In the other countries, the impact of harmonization would be reflected in an increase in revenue: this would be moderate in Germany, the United Kingdom and Greece (between 0,5 and 1 % of GDP) and higher in Portugal and Spain (between 2 and 3 % of GDP). Indirect tax revenue would fall in Ireland (by 1 to 2 % of GDP).

(ii) Making similar assessments is more difficult in the case of the possible tax revenue effects of the harmonization measures proposed for the taxation of interest income. The main objective of this harmonization is to limit the scope for tax evasion that might result from complete freedom of movement of capital and which, by definition, is difficult to measure. However, in view of the relatively low level of the revenue involved and a foreseeable offsetting effect between an increase in tax revenue collected from non-residents and a decrease in revenue from residents, these measures would have a broadly neutral impact on the budget in virtually all Member States (leaving aside possible effects on the location of savings and financial activities).

3.3. Strengthening economic and social cohesion

If the less prosperous countries of the Community are to catch up, the first need is for a sustained recovery in growth. By easing the external constraint, the Community measures initiated to assist these countries, through the structural Funds and financial instruments, will provide substantial support for the catching-up process. These measures primarily affect the Community budget. Care must, however, be taken to establish a proper link in these fields between the Community budget and the national budgets. Given the additionality rule governing these transfers and the way loans of Community origin are allocated, particular attention must be paid to ensuring that the necessary fiscal consolidation efforts are not undermined.

3.4. Facilitating progress towards monetary integration

The burden of the adjustments required to ensure increasingly greater stability in exchange rate relationships must not be carried by monetary policy alone. However, there are still wide differences between budget balances: in 1988, net borrowing exceeded 10 % of GDP in Italy and Greece whereas the United Kingdom had a net lending capacity of 0.8 % of GDP. The size of the public debt relative to GDP in Belgium for example is three times that in France. On unchanged fiscal policies, the projections available for 1993 show that these gaps will for the most part be maintained.

Despite the structural differences between Member States regarding saving ratios and investment ratios, continued existence of these gaps feeds internal and external disequilibria that are difficult to sustain and represent a major potential source of exchange rate instability. Closer monetary integration and the liberalization of capital movements therefore make it essential that medium-term fiscal consolidation programmes be maintained and intensified in those Member States where the situation in this field still diverges from that in the rest of the Community (especially Italy and Greece but also Belgium, Ireland, the Netherlands and Portugal).

In the light of the conclusions reached by the Committee on Economic and Monetary Union and the follow-up action taken, strengthening monetary cooperation will probably require a redefinition or clearer description of the existing framework for fiscal policy coordination. Consideration will therefore have to be given to this area so as to identify the type of rules capable of reducing the potential conflict between an increasingly unified monetary policy and a largely decentralized management of public finances.

Study No 4

Saving, investment and international financial markets: an overview

Saving, investment and international financial markets: an overview

Tables

Graphs

Summary

This study aims at giving a broad overview over trends in saving, investment and international financial intermediation. Without attempting an in-depth analysis, it discusses the main issues involved. The starting point is a brief review of the development in saving ratios over the past few decades (Section 1), a development that is characterized by a considerable fall in gross national saving as a percentage of GDP. Declining and even negative general government saving can be identified as the main factor behind this trend. Section 2 then asks whether there is an insufficiency of saving in the Community. Two points of view are distinguished in this context: the domestic and the external one. With respect to the former the question is whether there are enough savings to finance the desired level of investment. Concerning the latter, the question is whether a country's national saving/investment deficit (or surplus) is sustainable or not. It is concluded in this study that national saving ratios in the Community will have to rise in order to finance the lasting recovery in investment that is required to solve the unemployment problem, if unsustainable external deficits are to be avoided. However, such a rise can be considered to be feasible if the appropriate policies are implemented. In Section 3, the external aspect of saving/investment imbalances is analysed from the point of view of the world economy. Overall, the picture is characterized by a shift in the aggregate position of the industrialized countries from surplus to deficit, on the one hand, and by growing disparities within the group of industrial countries as well as within the Community. Section 4 then discusses the relationship between the observed current account imbalances and international capital flows, the counterpart of any national saving/investment imbalance. It is argued that these imbalances explain part of the fast growth of international financial markets. At the same time, the growth and improved functioning of these markets have allowed the international current account imbalances to persist. However, while structural changes in the institutional as well as in the technical field have improved the capacity of financial markets to allocate savings internationally, these developments have also increased both the volatility in exchange markets and the risk of instability. It can be noted that to a certain extent the risk has been extended from the individual to the global financial and monetary system. Section 5, finally, tries to draw some general policy conclusions, namely the need to increase public sector saving, to improve the conditions for private investment, to stabilize expectations and to reduce uncertainty.

1. Observed trends in saving rates

Gross national saving as a percentage of GDP fell considerably on a national account basis between the early 1970s and the early 1980s in almost all industrialized countries (see Table 1). For the Community as a whole, for example, national saving decreased by around 6 percentage points of GDP in the period 1970-83. In recent years, however, there has been a modest recovery in national saving rates on average in the Community. In the United States and Japan the picture is broadly similar to that in the Community although the rise in national saving has only been small in the USA over the past few years.

It has to be noted that these developments occurred in a context of levels of saving ratios that differ markedly between countries. In Japan, for example, national saving ratios have been more than twice as high as in the United States in the past few years (over 32 % of GDP compared to around 15 %, respectively), the Community's average saving ratio lying between these two extremes (around 20 % of GDP).

Concerning sectoral saving patterns, declining and even negative general government saving can be identified as the main factor behind the trend of falling national saving rates (see Graph 1). In fact in both the Community and the United States, public saving (in percent of GDP) fell by more than national saving during the period 1970-83. On average in the Community some progress has been made in reversing this trend since 1983, so that this year for the first time since 1980 government saving is likely to move back into surplus. However, progress in reducing government dissaving has been uneven among Community countries. Progress has been largest in those countries where attempts to consolidate public finances have been the most determined and where sound and dynamic growth has therefore set in motion a virtuous circle.

Private saving rates, on the other hand, remained broadly stable on average in the Community, concealing, though, some degree of offsetting movement in household and business saving rates, respectively. In the past few years, for example, the observed significant recovery in business saving was in some Member States (e.g. France, United Kingdom) accompanied by a significant fall in private household saving. It should be noted, however, that household saving ratios have been particularly high during the 1970s (in response to high inflation rates and uncertainty) and that the present situation of higher business saving than personal saving could also be observed in the 1960s.

Table 1

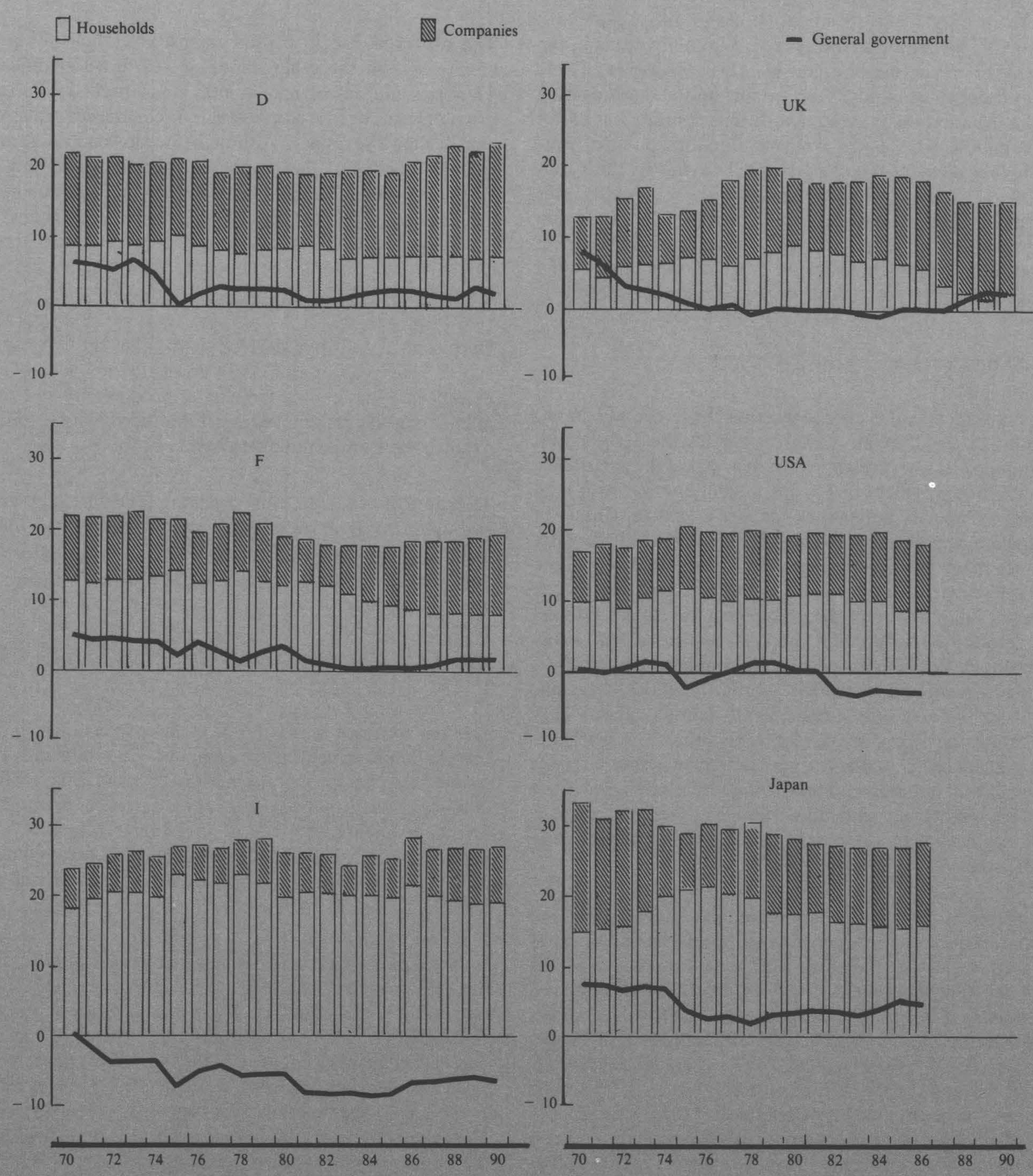
Gross capital formation, gross saving and current account balance

(% of GDP)

	Gross capital formation				Balance on current account	Stat. discrep.	Gross national saving		
	Fixed capital		Change in stocks	Total			Total	Private	Public
	Private	Public							
					EC				
1960	17,4[1]	4,4[1]	2,3	24,1	0,9	0,7	24,3	18,4[1]	5,9[1]
1970	20,0	4,0	1,8	25,8	0,7	0,7	25,8	20,8	5,0
1983	16,7	2,9	0,0	19,7	0,0	0,0	19,7	21,2	−1,5
1988	17,2	2,7	0,8	20,7	0,1	−0,1	20,9	21,1	−0,2
1990[2]	18,3	2,7	0,8	21,8	−0,2	−0,2	21,8	21,7	0,1
					USA				
1960	15,5	2,5	0,7	18,7	0,6	0,0	19,3	16,0	3,3
1970	15,1	2,6	0,1	17,8	0,4	0,0	18,2	17,5	0,7
1983	15,8	1,5	−0,3	17,0	−1,0	0,0	16,0	19,6	−3,6
1988	17,1		0,7	17,8	−2,8	0,0	15,0	:	:
1990[2]	16,9		0,5	17,4	−2,1	0,1	15,2	:	:
					Japan				
1960	29,0		3,9	32,9	0,5	0,0	33,4	:	:
1970	30,5	5,0	3,5	39,0	1,0	0,0	40,0	32,9	7,1
1983	21,8	6,5	0,1	28,3	1,8	−0,1	30,2	27,2	3,0
1988	31,2		0,0	31,2	2,8	0,7	33,3	:	:
1990[2]	32,1		0,0	32,1	2,7	1,2	33,6	:	:

[1] Estimates.
[2] Economic forecasts, May/June 1989.
Source: Commission services, Yearna and Finpub databanks.

GRAPH 1: **Saving ratios by institutional sector (% of GDP)**



Source: Eurostat, Commission services (Economic forecasts, May/June 1989) and OECD.

2. Is there an insufficiency of saving?

In order to judge whether present saving ratios can be considered to be satisfactory or not, the criteria for the evaluation have to be specified. While in an *ex post* view total saving by definition always equals total investment, the *ex ante* difference may be considerable. Moreover, in the case of an open economy, even *ex post* national saving may diverge from national investment. In this context, it is useful to distinguish two aspects: from the domestic point of view it is highly relevant whether national saving in the Community can grow sufficiently to finance the simultaneous increase in the level of domestic investment that is required in order to create the desired amount of additional employment opportunities; from the external point of view this should go together with a sustainable saving/investment balance.

2.1. The domestic point of view

Seen domestically, it is crucial whether the level and composition of national saving is appropriate for the desired level and composition of investment. In this respect the persistence of high unemployment in Europe in combination with high degrees of capacity utilization indicates a relative scarcity of productive capital: existing productive capital is apparently insufficient to provide employment for all those who seek work. The extent to which this is the case depends on the degree of adaptability of the existing capital stock to different factor input ratios (e.g. putty-putty versus putty-clay technology). While in a situation of complete adaptability a change in relative factor prices would theoretically be sufficient to achieve full employment, limited adaptability necessitates new productive capital in order to absorb the unemployment. This new capital can serve either as a replacement for existing capital (in the same industry or in a different sector) but embedding different factor input proportions, or it can serve as an extension of the existing capital stock.

The present situation in the Community suggests that the solution should not only consist of a shift in technology and sectoral output patterns, but also of an extension of the stock of productive capital. The exact amount of the required additional capital is difficult to determine as it depends on the future development of capital productivity and capital intensity. In both respects, developments have been favourable in recent years (see Graph 2 and Table 2): after having declined, on average in the Community, for over two decades, capital productivity (output per unit of capital) started to increase by the mid-1980s, mainly reflecting rising degrees of capacity utilization. The creation of the internal market is likely to support this trend. In addition, a decoupling of machine operating hours and individual working hours would increase apparent capital productivity further. These factors may, however, to a certain extent be compensated by the negative influence on apparent capital productivity of rising needs for environmental protection.

The observed rise in capital intensity (capital per person employed), on the other hand, slowed down significantly. Thus the amount of new capital stock needed to create a given amount of new employment opportunities grows more slowly than previously. Although the slower growth in the ratio of capital to the number of persons employed is to some extent due to the increase in part-time employment, it is also likely to reflect the growing importance of the services sector and a slow-down in the substitution of labour through capital in response to the moderate real wage increases of the recent past.

Despite these positive developments, the 'full employment capital stock gap' is still considerable. Moreover, it cannot be expected that changes in capital productivity and capital intensity in the coming years will on their own be sufficient to solve the European unemployment problem.

The share of productive investment in GDP should therefore rise significantly in order to allow not only for the replacement and modernization of the existing capital stock, but also for the desired increase in productive capacity and employment opportunities. The question then arises of how such a level of investment could be achieved and whether it could be financed by a corresponding level of national saving.

The key to a rise in private productive investment lies in a further improvement in profitability and demand expectations. At the same time, national saving ratios will undoubtedly have to rise, on average in the Community, to finance a lasting recovery in investment ratios of several percentage points of GDP, if unsustainable external deficits are to be avoided. Such a rise can be considered to be feasible, however, if appropriate policies are implemented.

It is therefore necessary for the consolidation of public finances to continue so as to increase public saving also from that point of view. This is in line with the policy of budgetary consolidation that is — with different degrees of success — pursued in member countries. It is important, however, that this consolidation process is not achieved at the expense of economically viable public investment. As a general rule the most pressing need is to stop government dissaving. Public current expenditure should not be credit financed. The available evidence overwhelmingly suggests that an increase in public saving will not (or at least not fully) be offset by a corresponding decrease in personal saving as claimed by the

Table 2

Capital formation — main aggregates (EC)

	Average 1961-73	Average 1974-81	1982	1983	1984	1985	1986	1987	1988	1989[1]	1990[1]
Gross fixed capital formation (annual % change)											
Total	5,6	−0,4	−2,0	0,1	1,5	2,5	3,4	4,8	7,8	6,8	5,0
• Equipment[2]	:	1,2	−1,3	0,3	4,3	8,6	2,9	9,0	9,1	8,8	5,9
• Construction[2]	:	−1,2	−2,7	0,1	0,3	−1,9	2,7	2,4	6,2	4,6	3,8
Capital stock (annual % change)	5,2	3,5	2,4	2,3	2,2	2,2	2,2	2,3	2,6	2,8	3,0
Capital productivity[3] (annual % change)	−0,4	−1,5	−1,6	−0,6	0,1	0,2	0,4	0,4	1,0	0,3	−0,0
Capital intensity[4] (annual % change)	4,9	3,6	3,3	3,0	2,2	1,6	1,5	1,1	1,0	1,6	2,0
Profitability of capital stock[5] (index 1961-73 = 100)	100,0	69,9	64,8	67,4	71,6	74,6	78,9	80,5	83,4	85,5	87,2

[1] Forecasts, May/June 1989.
[2] Excluding Ireland, Luxembourg and Portugal.
[3] Real GDP over capital stock.
[4] Capital stock per person employed.
[5] Net operating surplus over net capital stock.
Source: Commission services, Yearna databank.

Ricardian equivalence proposition. Higher public saving will therefore lead to higher national saving.

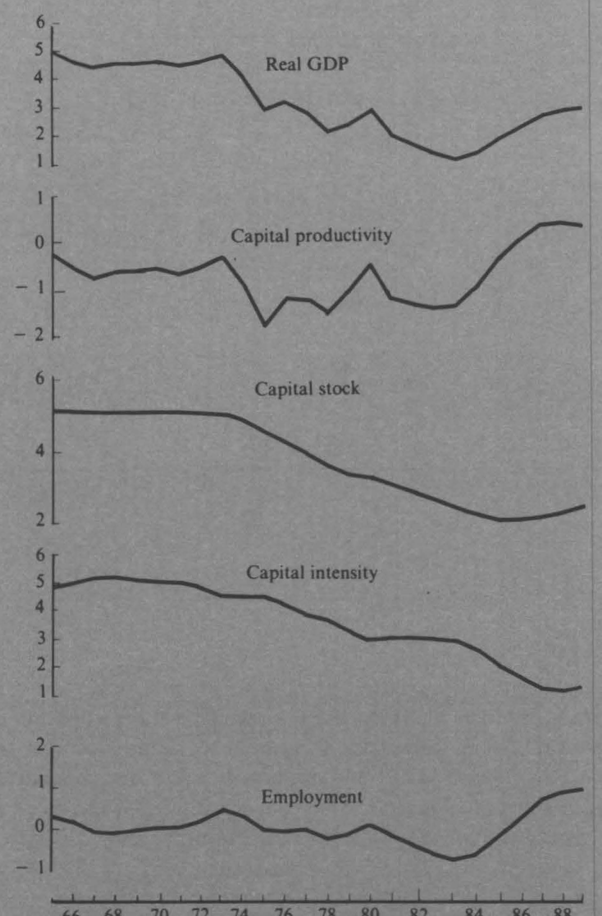
Concerning private saving, business saving will to some extent increase automatically in parallel with an improvement in profitability. Although the precise determinants of personal saving are difficult to discern, it is possible that part of the additional business saving might be counterbalanced by lower household saving ratios. This could either be due to the fact that households see business saving as a close substitute for household saving since they are the ultimate owners of companies or due to an income redistribution effect on primary incomes in different stages of the business cycle. Both theoretical arguments and empirical observations indicate, however, that any rise in business saving will only partly be counterbalanced by a fall in household saving. Moreover, household saving rates are influenced by a number of other factors, the most prominent of which are the following:

inflation rates: while the relatively high inflation rates experienced in the 1970s can be seen as having contributed to the high personal saving ratios observed during this period (due to a real wealth effect and precautionary saving in response to increased uncertainty), the disinflation process of recent years is in turn likely to explain part of the recent fall in personal saving ratios in a number of countries. As the disinflation process in the Community has come to a standstill, no further negative effect on personal saving rates can be expected from this side for the coming years;

demography: the important role assigned by most theories (e.g. the life cycle model) to demographic factors in explaining saving ratios has generally been confirmed by most empirical studies. From this point of view it is to be expected that household saving ratios in the Community will be rising in the medium term along with a fall in dependency ratios and an increase of the share of those in the prime saving age (45-64) in total population;

interest rates: although the effect of interest rates on saving rates is theoretically ambiguous as income effect and substitution effect work in opposite directions, it is widely held that interest rates have a positive, though moderate, influence on personal saving. On the basis of the currently available interest rate forecasts no major change in saving ratios can be envisaged for the near future. However, while a possible rise in interest rates might increase saving, it risks at the same time having an undesirable negative effect on investment;

GRAPH 2: **GDP, capital stock, employment, capital productivity and capital intensity (EC, 5-year moving average of percentage changes [1])**



[1] Five-year period ending in the indicated year.
Source: Commission services.

financial integration and deregulation: one of the important developments of the 1980s has been an acceleration in the process of international financial integration and deregulation. This process tends to ease liquidity constraints that both households and companies may face in smaller and more regulated financial markets, thereby reducing the net supply of (or increasing the net demand for) savings. The crucial question in assessing the prospects for the coming years is, whether the effect of financial integration and deregulation on saving is only transitory (while economic agents adjust to their new optimum), or whether it has to be considered as permanent as is sometimes argued.

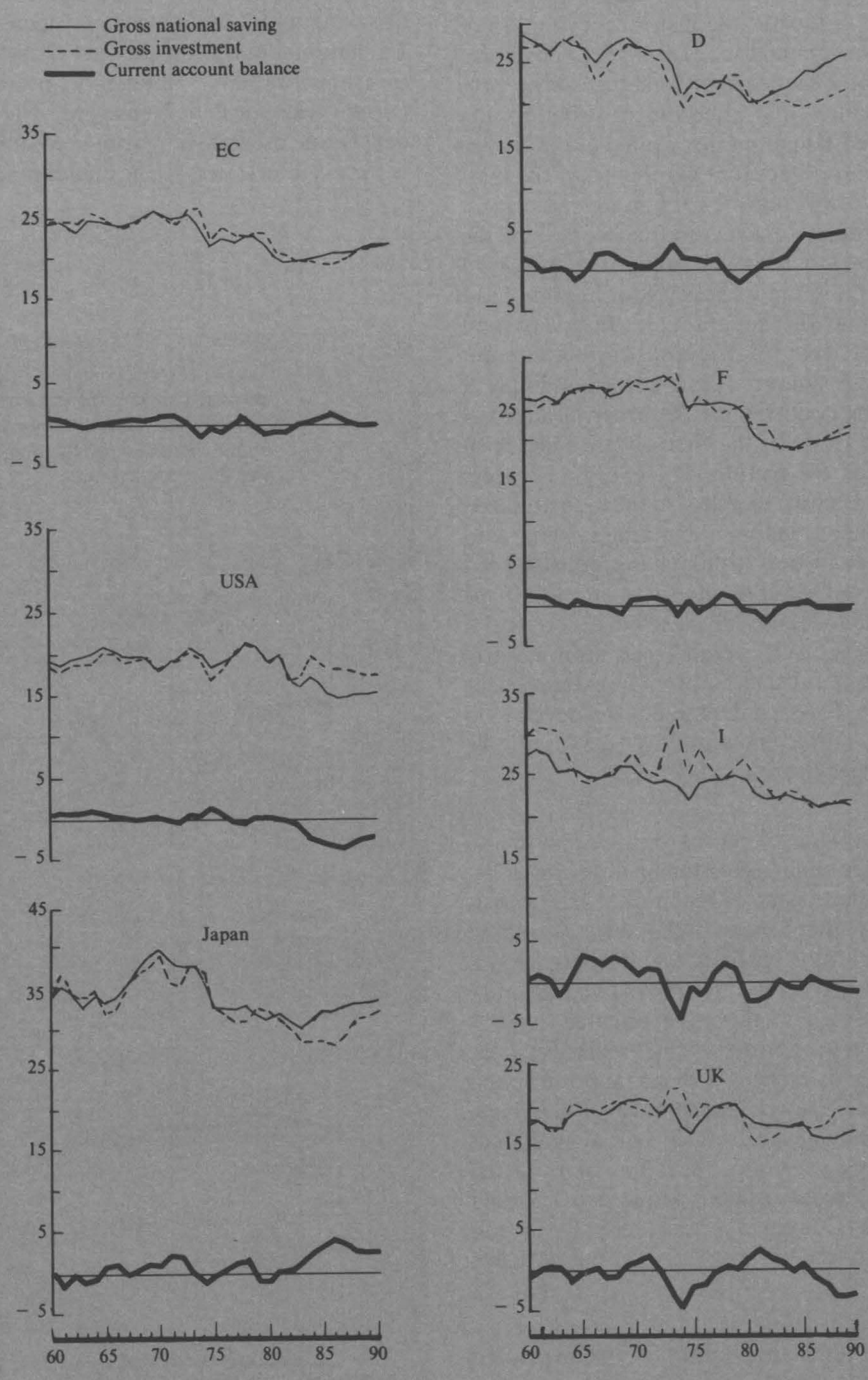
Overall, therefore, the evolution of private saving in the next few years is difficult to forecast. Some rise in gross private saving ratios should be possible, but by no means certain. This only underlines the important role to be played by the public sector in raising national saving ratios in the Community (and, even more so, the United States).

2.2. The external point of view

The relation of saving to investment can also be seen from an external point of view, with the evolution of external indebtedness being the decisive criterion. If a country's national saving falls short of the amount required to finance the level of domestic investment, this is reflected in a current account deficit (or capital account surplus): foreign saving is filling the gap (see Graph 3). Theoretically, there is little reason to object to one country's excess saving financing another country's excess investment, if international capital markets are efficient. It is indeed the role of financial capital in an integrated world economy to maximize total welfare by flowing to those countries where expected rates of return on investment are highest. Attempting to obtain balanced current accounts in a context of different time preferences, stages of economic development and investment opportunities would thus be economically sub-optimal.

The crucial question is, however, whether the current account imbalances that result from the divergence of a country's gross national saving from gross domestic investment are sustainable or not. Although an answer to this question has to take into account the specific situation of the country concerned, a general remark can be made. A sustained current account deficit results in a continuous build-up of external debt. Any country's — as well as any individual's — capacity to indebt itself is, however, limited. From a certain debt ratio onwards markets will be reluctant to lend and will add a risk premium to interest rates. This risk premium can reflect either a risk of exchange rate depreciation or a risk of insolvency. A vicious circle of external debt and interest charges can therefore only be avoided if the foreign capital is used for productive investment (e.g. in the export industry) that provides a rate of return that is higher than the rate of interest that has to be paid on the foreign capital. Only under these circumstances can a country increase its level of external debt over a prolonged period of time without raising its debt/income ratio to a level that is unsustainable and necessitates painful adjustment policies. Moreover, if the investment projects financed by foreign capital are located in the export industry the exchange rate risk of foreign exchange exposure is limited. These considerations have to be taken into account by those countries engaged in the catching-up process.

GRAPH 3: **Gross capital formation, gross national saving and current account balance (% of GDP)**



Source: Commission services.

3. The regional distribution of saving and investment in the world economy

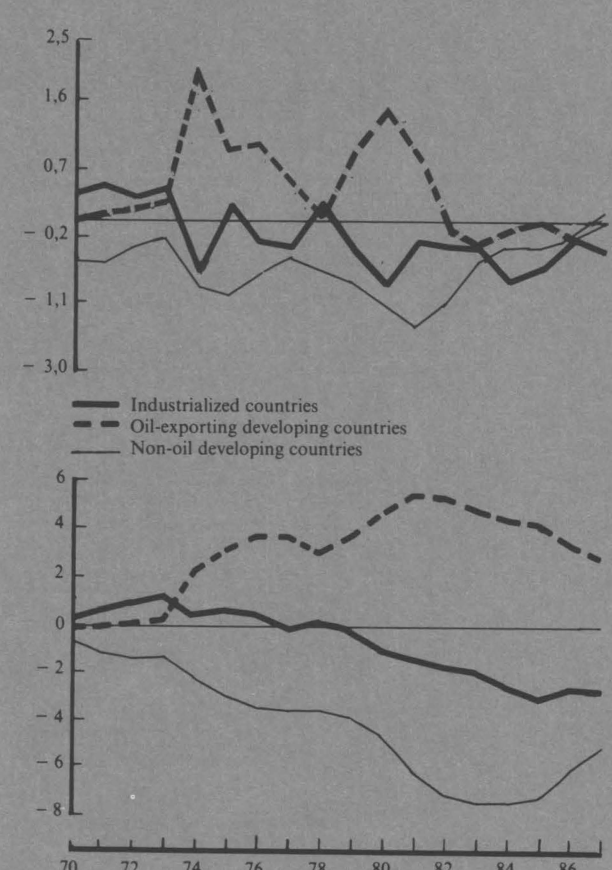
In order to assess the global aspect of saving/investment imbalances it is useful to look at the historical evolution of current account imbalances and the resulting debt positions. This history consists of a sequence of sometimes even prolonged regional imbalances that often reflect structural developments. The United Kingdom, for example, ran a continuous and sizeable current account surplus from the mid-19th century up to World War I. In the more recent past of this century, in addition to structural developments the consequences of inappropriate policies (e.g. in response to the oil price shocks) or absence of policy coordination have become apparent. While the situation of the 1960s and early 1970s was characterized by an overall current account surplus of industrialized countries and correspondingly a deficit of the developing countries (of the order of approximately 0,5 % of OECD GDP), the first oil price shock in 1973 somewhat changed the picture. The enormous excess saving by OPEC countries was 'recycled' to the industrialized countries and — via the international banking system — to the non-oil developing countries. Although the industrialized countries became overall capital importers in the 1970s (which, according to the — admittedly unreliable — statistics they still are today), they could overall — up until recently (see below) — avoid an important build-up of external debt as a percentage of GDP. External debt in non-oil developing countries, on the other hand, grew rapidly (see Graph 4), the consequences of which are felt today.

By the mid-1980s a new development occurred with the appearance of very large saving/investment imbalances between the industrial countries (see Graph 5). These imbalances have been the consequence of the then prevailing policy-mix (notably expansionary fiscal and restrictive monetary policies in the United States and restrictive monetary policies in combination with fiscal policies oriented towards budgetary consolidation in Europe) and are reflected in current account deficits or surpluses of an unprecedented size. Two main reasons for the appearance of the huge imbalances in recent years can be singled out: a significant excess of national saving over investment in Japan on the one hand and a high saving/investment deficit in the United States on the other, the Community being broadly in balance. This situation is likely to persist also in the next few years.

The emergence of these imbalances can partly be explained by a sharp fall in the Japanese investment ratio between 1973 (a year with a balanced current account) and 1986 of the order of approximately 10 percentage points of GDP. National saving, on the other hand, fell by less than 6 percentage points, thereby opening-up a large current account surplus.

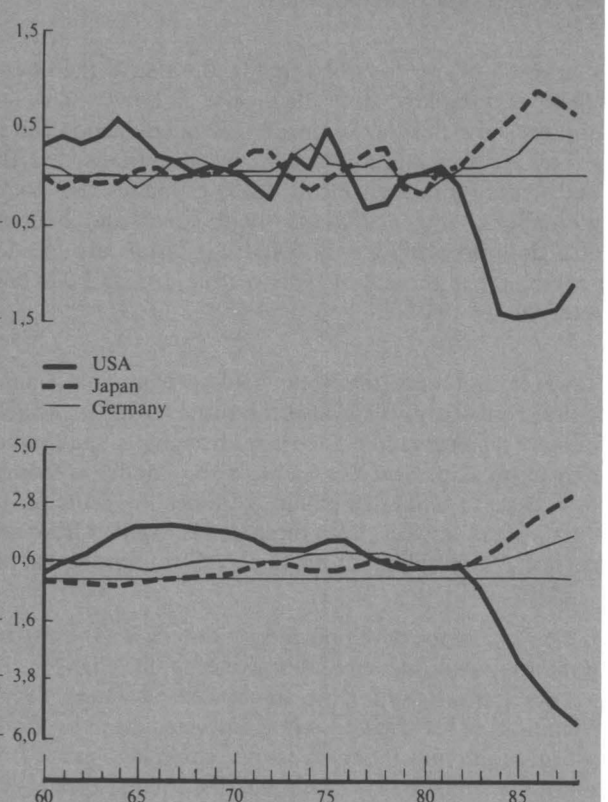
In the United States, in contrast, high general government dissaving and lower household saving led to a sharp fall in US national saving in the first half of the 1980s. With the investment ratio remaining more or less stable, an enormous current account deficit emerged. The consequence of these developments, the shift from a creditor to a debtor nation, is clearly illustrated when cumulating the current account

GRAPH 4: **Current account balances[1] and cumulated current account balances for industrialized countries, oil-exporting developing countries and non-oil developing countries (in % of the combined GDP of EC, USA and Japan)**



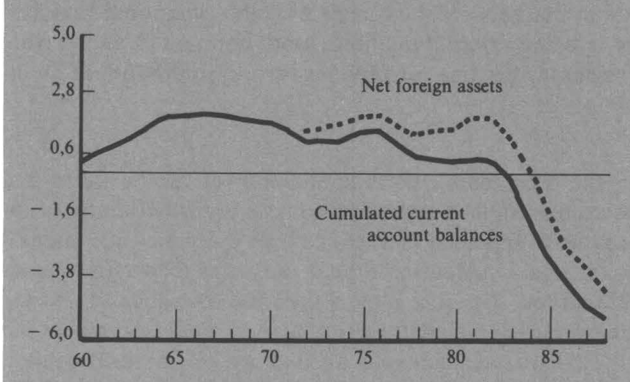
[1] Excluding exceptional financing.
Source: IMF and Commission services.

GRAPH 5: **Current account balances[1] and cumulated current account balances for the United States, Japan and Germany (in % of the combined GDP of EC, USA and Japan)**



[1] Excluding exceptional financing.
Source: IMF and Commission services.

GRAPH 6: **Cumulated US current account balances and US net foreign assets**



Source: IMF and US Department of Commerce (SCB).

balances. Even when taking into account the problems of accurately measuring the US international investment position, this picture is not fundamentally altered, although the exact moment of the transition from a creditor to a debtor position might be different (see Graph 6). According to official statistics, the USA became a net debtor in 1985 for the first time since 1914.

Although the Community's current account is currently broadly balanced, this conceals rising disparities also within the Community. On the one hand there is a German current account surplus in excess of 4 % of GDP, going hand in hand with comparatively low domestic fixed investment rates despite still relatively high unemployment. On the other hand there are rising deficits by a number of Community countries (United Kingdom, Portugal, Spain and Italy).

4. International financial markets

The described trends in current account imbalances and the resulting build-up of financial debt and asset positions explain part of the rapid growth in international financial markets. This phenomenon could already be observed in the 1970s, following the first oil price shock. The growth has, however, also been fuelled by a significant increase in public sector financial liabilities due to the fact that continued high government deficits have increasingly been financed in the capital markets. High interest rates on government debt (partly reflecting a capital shortage in the world) in the context of low degrees of capacity utilization and low rates of return on productive capital led, on the other hand, to the phenomenon that companies were attracted to temporarily invest in financial rather than in real assets. Although this shift has only been a small percentage of total company assets (see Table 3), it represents a high absolute amount of financial capital (the stock of marketable securities in the hands of German companies belonging to manufacturing industry, for example, reached almost DM 40 billion in 1985). Only in 1985 did investment in equipment start to pick up in the Community and only since 1988 has the rise in companies' profits been accompanied by a corresponding increase in productive investment. The increased openness of individual countries and the progressing liberalization of capital markets resulted in part of these national financial assets being internationalized. Both companies and private households became directly engaged in international financial markets.

On the other hand, the liberalization of capital flows and the accompanying growth and improved functioning of international financial markets have at the same time allowed international current account imbalances to persist. Financial markets therefore played their role of allocating saving internationally. That these imbalances could persist is not only due to the increased availability of financial capital, but also to the fact that the amount of financial capital has stimulated both the size and the functioning of the financial services sector.

Institutional as well as technical developments have led to important structural changes. On the institutional side, financial innovation has pushed towards financial deregulation (or at least towards more market oriented regulations). Deregulation and increased competition in turn, created new financial innovation (e.g. financial futures). In addition, the world-wide trend towards a liberalization of capital movements and the implied decompartmentalization of national capital markets has led to a globalization of the adjustment process between saving and investment. On the technical side, improved telecommunications facilities and information technology have not only supported this trend, but have also increased the speed of international transmission mechanisms. Information has become more rapid and exhaustive and operations have become faster (on 'black Monday' 19 October 1987 alone, Wall Street carried out 2,5 billion operations!) and cheaper.

As a result of the described trends, the size of the financial sphere grew rapidly: Both the growth of bond and of stock markets show this development. The phenomenon can also be observed on international financial markets: the Bank for International Settlements (BIS) estimates the stock of international financial assets (bank loans and bonds) to have doubled within only four years from around USD 1 600 billion at the end of 1984 to around USD 3 200 billion at the end of 1988.

However, not only the volume of international financial capital rose sharply, but also the turnover in financial and foreign exchange markets. To give an example, the combined daily turnover of New York, Tokyo and London is estimated to be close to USD 250 billion, 25 times the value of flows of goods and services. Both these trends together have raised fears of a 'decoupling' of the financial from the real sphere.

In the wake of the developments set out above, the character of international financial intermediation has changed. During the 1980s a noticeable trend towards 'bank disintermediation' or securitization (e.g. intermediation by markets instead of intermediation by banks) could be observed. This can be explained by two main factors. Firstly, the collective management of individual savings (e.g. by pension funds)

Table 3

Companies' investments in marketable securities as % of total assets (manufacturing industry)

	1981	1982	1983	1984	1985	1986	1987
FR of Germany	1,63	2,03	2,93	3,44	3,87	3,57	:
France	0,25	0,28	0,57	0,97	1,40	2,36	3,12
Italy	1,13	1,12	1,73	2,94	2,87	3,78	4,32
United Kingdom	4,79	5,27	5,94	7,01	7,69	6,06	:
Belgium	1,65	1,90	2,40	3,84	4,26	5,22	6,39
Portugal	0,72	0,57	1,23	1,00	1,26	1,57	3,44
Netherlands	0,16	0,29	0,55	0,65	:	:	:
Spain	:	0,25	0,28	0,33	0,37	0,56	1,05
United States	:	:	3,58	3,49	3,32	3,29	3,08
Japan	3,08	3,31	3,68	3,83	3,66	4,22	4,36

Source: Commission services, BACH databank.

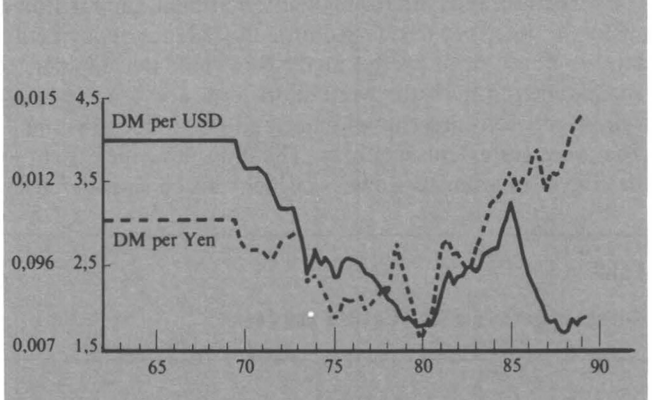
has to some extent grown at the expense of banks. Secondly, banks themselves seem to have become more risk averse and have, to a larger extent than previously, attempted to 'securitize' both their assets and their liabilities (a development that has also to be seen in the context of the LDC debt crisis). This is clearly reflected in the structure of borrowing on international markets. While the amount of new bank loans only increased from USD 67 billion in 1983 to 76 billion in 1988, the amount of securities more than doubled from USD 87 billion to 234 billion. For new forms of securitization like note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) the increase is even more pronounced. Thus, although banks still play a major role in international financial markets, their role as financial intermediaries seems to have somewhat diminished.

Although on the level of the individual economic agent the ability to distribute risks more evenly has generally increased, the reduced constraints for the individual as well as international integration have raised the more systemic risks of the financial community. In a sense, therefore, the risk has been extended from the individual to the global financial and monetary system. The increased risk of instability evokes the question of the security for the individual investor and consequently the issue of new prudential rules.

At the same time, the increased volatility in exchange markets observed since the beginning of the 1970s has added a new aspect to the picture (see Graphs 7 and 8). While a higher flexibility (not volatility) of exchange and interest rates is only normal and may even be desirable in a system of open economies without a high degree of policy coordination, the behaviour of exchange rates in the last two decades has raised a number of questions. On the one hand, there is the problem of short-term fluctuations. The amount of these fluctuations has led some observers to conclude that markets have a tendency to be myopic and that exchange rates are to an important extent determined by speculative capital flows. On the other hand, there is the phenomenon of 'overshooting' and exchange rate misalignments, a phenomenon that reflects at the same time the behaviour of economic agents in financial markets as well as the fact that international financial integration has strengthened the spillover effects of fiscal policies onto exchange rates.

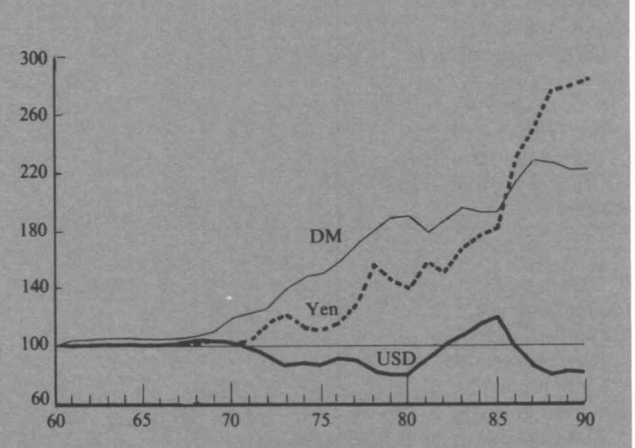
While the increased volume of short-term capital flows may have improved the efficiency of capital markets in a narrow sense by exploiting arbitrage opportunities and thereby guaranteeing international interest rate parity, they do not correspond to the most obvious source of gains from capital movements, namely the long-term transfer of resources. In contrast to capital flows based on short-term considerations, these capital flows with long-term aim are rather based on

GRAPH 7: **Nominal bilateral DM/USD and DM/Yen exchange rates (quarterly averages)**



Source: Commission services.

GRAPH 8: **Nominal effective USD, Yen and DM exchange rates[1] (1960 = 100)**



[1] Against the main 19 trading partners (double export weighting).
Source: Commission services.

economic 'fundamentals'. This distinction between the two-way trade in financial assets and the long-run resource transfer is, incidentally, analogous to the distinction between intra-industry and inter-industry trade as distinguished in trade theory.

The structure and variation of international capital flows reflect the described trends. Admittedly, balance of payments data do not allow a precise analysis of these developments. The distinction made between short-term and long-term as well as between direct investment and portfolio investment is to a certain extent arbitrary. The data nevertheless show that direct investment flows — which can be considered to come closest to capital flows moving to the 'real' economy and to be based on factor endowment considerations — only explain a very limited part of international capital flows (see Table 4). Even if there is a clear overall trend towards higher direct investment flows, reflecting the growing integration of the world economy, net direct investment inflows to the United States covered only one fifth of the required total capital inflow in 1988. At the same time these data also illustrate the role of Japanese banks as financial intermediaries (illustrated by net inflows of short-term capital and net outflows of long-term capital) and the role of the Japanese economy as a supplier of savings to the world economy (overall deficit of the capital account).

Table 4

Balance of payments for EC, USA and Japan[1]

(billion ecus)

	1981	1985	1986	1987	1988[3]
			EC		
Current balance	−18,2	25,0	51,9	32,5	15,1
Capital balance	6,4	−29,7	−54,3	9,5	−25,9
Direct investment, net	−9,9	−14,7	−22,5	−24,0	−19,0
• to abroad	−23,6	−31,8	−40,8	−53,7	:
• from abroad	13,8	17,1	18,3	29,8	:
Portfolio investment	−9,5	−8,5	−5,3	22,0	−32,0
Other long-term flows	17,8	−1,7	−7,0	11,8	15,5
Other short-term flows	7,9	−4,8	−19,6	−0,4	9,8
Reserves[2]	13,9	0,6	−12,0	−57,8	−3,3
			USA		
Current balance	6,0	−151,2	−140,9	−133,7	−114,7
Capital balance	−20,0	131,7	124,4	110,5	103,5
Direct investment, net	14,2	1,9	5,5	−1,9	18,4
• to abroad	−8,5	−23,3	−28,7	−38,3	−17,3
• from abroad	22,8	25,2	34,3	36,4	35,7
Portfolio investment	13,7	88,8	83,2	54,9	56,4
Other long-term flows	−17,3	10,1	−5,4	−0,9	10,8
Other short-term flows	−30,7	30,8	41,1	58,3	17,9
Reserves[2]	−2,6	−4,8	0,3	7,8	−3,6
			Japan		
Current balance	4,6	64,1	86,7	75,3	49,2
Capital balance	−1,7	−69,9	−74,4	−39,4	−39,5
Direct investment, net	−4,2	−7,6	−14,3	−15,8	:
• to abroad	−4,4	−8,5	−14,6	−16,8	:
• from abroad	0,2	0,8	0,2	1,0	:
Portfolio investment	6,8	−54,5	−103,1	−79,4	−45,1
Other long-term flows	−8,5	−20,6	−16,0	−21,2	:
Other short-term flows	4,2	12,9	59,0	77,0	43,6
Reserves[2]	−3,0	−0,2	−15,1	−32,9	−13,9

[1] Due to errors and omissions the sum of the components is not equal to zero.
[2] A minus sign for the balance of the reserves indicates a net increase in assets or a decrease in liabilities.
[3] Partly estimates.
Source: Eurostat, Cronos databank GBOP.

5. Conclusions

What can be the conclusions of the diverse trends described above? Although one cannot say that there presently is an overall shortage of saving in the Community, the aim for the future must be to increase national saving in line with the increase in investment that is required to create the internal market, to absorb the current unemployment and to promote the catching-up of the less prosperous member countries. Only in this case can the emergence of a current account deficit for the Community be avoided. Part of the additional saving is likely to be the result of policies directed at improving the conditions for private investment, but governments will also have to make an additional effort to increase public sector saving.

On the international level, higher savings in the OECD area would facilitate the catching-up process of the less developed countries. Moreover, increased coordination of economic policies and a better equilibrated international monetary system — not least resulting from the growing monetary identity of the Community — would defuse some of the risks with respect to the international economic and financial system.

Both on the national and the international level there is the need to stabilize expectations and to reduce uncertainty. On the national level, investors have to be confident that they will be able to obtain a satisfactory rate of return on their investment in physical capital. Uncertainty with respect to future demand, factor prices and exchange rates increase the risk premium for investors. On the international level, a stabilization of exchange rate expectations would reduce the amount of short-term fluctuation and thereby contribute to the stability of financial markets and to the growth of world trade. In the Community, the EMS has already contributed to such a stabilization. The establishment of an economic and monetary union would strengthen the Community's position in line with its increased weight in the world economy. In all these areas governments and monetary authorities have an important role to play by acting predictably and by making the necessary structural, institutional and regulatory adjustments.

Study No 5

The effects of the internal market — Sensitive sectors

The effects of the internal market — Sensitive sectors

Tables

Graphs

Summary

This study aims to provide a first overview of the way in which firms are reacting to the completion of the internal market. After an initial economic evaluation of the internal market programme had been made in the Cecchini Report, it was important, on one hand, to assess the actual reactions of firms to the structural changes occurring in their environment as the Directives were implemented and, on the other hand, to see how far these reactions correspond to those foreseen in the 'cost of non-Europe' study. The first part of the study presents the results of a survey of industrial firms carried out by the Commission in mid-1989. This survey throws light on the expectations of firms with respect to the impact of 1992 on their turnover, investment and employment. A box gives a quantitative assessment of the extra growth in the investment due to 1992. The second part, more microeconomic in focus, examines firstly the way in which firms are changing the allocation of internal resources: location of production plant, distribution networks, research and development. Secondly, it analyses the external strategies of firms (cooperation, creation of jointly-owned subsidiaries, acquisitions) in the light of trends since the beginning of the 1980s. These trends are compared with the results of the survey in order to assess the impact of 1992 on external strategies. Finally, in the third part, more sectoral detail is introduced, highlighting the differences in the impact of the internal market by sector. In the case of industry, it is possible to distinguish four broad groups of sectors on the basis of the size and nature of the impact of the White Paper measures.

1. The prospects opened up by the internal market

Following publication in June 1985 of its work programme for the elimination of all obstacles to freedom of movement in the Community, the Commission regularly reviews the state of implementation of the White Paper.[1] The introduction of qualified majority voting following the entry into force of the Single European Act, has increased pressure to arrive at a consensus. In addition to the 130 measures now finally adopted by the Council, seven have been partially adopted and eight common positions have been agreed: this accounts for over half the 279 measures in the programme.

For its part, the Commission has undertaken a detailed analysis of the economic consequences of completion of the internal market.[2] Using a microeconomic approach based on a partial equilibrium model, welfare gains ranging from 4,25 to 6,5 % of Community GNP, were obtained. A macroeconomic approach using the Commission's Hermes model and the OECD's Interlink produced a comparable series of medium-term results: 4,5 % of additional growth in GNP, a 6 % reduction in price inflation and growth in employment equivalent to 1,5 %.

The gradual completion of the internal market already appears as one of the basic factors which are contributing to the favourable economic climate which the Community is enjoying. Since 1988, the trend of the Community's economy has been essentially upwards and the most dynamic component of demand is investment. Surveys of investment by industry show that industrialists are sticking by their intention to invest even more in 1989 than in 1988 with increases by volume of 8 % in 1988 and 10 % in 1989 expected (see box for the effect of 1992 on private investment).

From this point of view, the Commission's survey of Community firms shows that the 'internal market' is having a not inconsiderable effect on the expectations of firms and, in particular, on their investments. The last survey of industrial firms in the 12 Member States carried out in mid-1989 provided a means of analysing more precisely how firms saw the prospects opened up by completion of the internal market.

[1] Commission of the European Communities: 'Fourth report from the Commission to the Council and the European Parliament' (COM(89) 311), 1989.

[2] Commission of the European Communities: 'The economics of 1992', *European Economy*, No 35, March 1988.

Perceived effects on sales volumes

The perception by firms of the effects of completion of the internal market depends to a large extent on where sales are made.

In general, firms expect comparatively minor changes in their national markets: overall, 66 % of Community firms expect no change, 16 % a change for the better and 10 % one for the worse. However, these figures vary considerably from one country to another. A majority of Spanish industrialists expect their net sales on the domestic market to fall, a result which contrasts with those of the first survey, carried out in 1987.[1] It appears that a trend has developed in Spain and that those fearful of the effect of completion of the internal market on sales on the domestic market are now in the majority. In other countries (Belgium, Germany, France and the United Kingdom), those expecting an improvement are only slightly more numerous than those expecting a deterioration.

By contrast, the effect on sales in the other Community Member States is expected to be considerable. Taking an average across the Community, the net balance between those firms expecting their sales in other Community countries to increase and those expecting them to decrease is 33 %. This very positive view of the prospects for increased sales outside national markets is common to all the Member States and accounts, to a great extent, for the feeling that the total volume of sales is likely to increase substantially. Hence the net effect on the total increase in sales across the Community is put at 27 %, less than the net effect on sales in other Community countries (33 %) but considerably more than the net effect on volume within the country (6 %) or in non-member countries (7 %).

A comparison of the results obtained for the same question before and after 1992 is most instructive. To take the period after 1992 first, across the Community the same percentage (18 %) of firms expect domestic sales to rise as expect them to fall. This means that the increased effects of competition between national producers on their own markets will be felt to an ever greater extent. In most countries the net effect for the period 1992-96 is less than that for the period before 1992. On the other hand, in Belgium, Germany, Ireland, Italy, Spain and the United Kingdom, penetration of Community markets other than the domestic market is expected to continue and grow as the measures in the White Paper are implemented.

Overall, the net effects on the total volumes of sales for these two periods are comparable. After 1992 the greater optimism concerning sales on Community markets other than the domestic market offsets the greater pessimism concerning the trend of sales on national markets.

The reasons for expectations of increased sales on Community markets were analysed in the Commission's earlier survey in 1987.[3] The abolition of customs formalities and lower transport costs in particular will greatly help producers to export within the Community and this greater price competitiveness will then help them to secure market shares in the other Member States. In addition, improved non-price competitiveness (a wider range of products) and increased competition should result in manufacturers reducing their cost-price margin.

Perceived effects on the volume of investment

In general, the percentage of firms expecting to increase investment in their national markets is much larger (33 % against 3 % giving a balance of 28 %) than that expecting such investment to fall.

These results are considerably more positive than those for the net effect on sales and show that even now Community firms are investing in production plants within their home territory to serve an enlarged market where the opportunities for increasing sales lie mainly outside the national market. The net balances for all the Member States are substantial: 41 % in Italy, 38 % in Portugal and Ireland and 22 % even in France, the country with the lowest figure.

The effect on the volume of investment, by firms, in other Community countries is also positive. Investments by firms in the other Member States should therefore lead to an increase in the flow of direct investment between Community countries amounting on average to 19 %. This compares with an increase of 28 % in domestic investment. It is important to note here that the least industrialized countries in the Community (Portugal, Ireland and Spain) and to a lesser extent Italy, are also the countries which will, obviously, be the first to benefit from an increase in investment on their own territory as compared with investment elsewhere.

By contrast, in certain countries the extent of the extra investment due to the completion of the internal market should be similar within the country and in the other Member States. This is particularly true of Germany (net positive balance of 25 % and 24 %), France (net positive balance of 22 % and 19 %) and, to a lesser extent, the United Kingdom (net positive balance of 23 % and 18 %). In the case of the

[1] Commission of the European Communities: 'The completion of the internal market — A survey of European industry's perception of the likely effects', *Research on the 'cost of non-Europe'*, Vol. 3, 1988.

Table 1

Up to 1992 — Influence of the completion of the internal market on the volume of industrial sales

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on volume of domestic sales										
Net effect[1]	3	5	−18	1	19	22	11	15	5	6
Don't know/no answer	7	1	15	16	3	0	6	27	9	7
Influence on volume of sales in other EEC countries										
Net effect[1]	36	34	27	28	50	41	24	26	35	33
Don't know/no answer	15	4	23	20	7	0	3	35	11	10
Influence on volume of sales in non-member countries										
Net effect[1]	11	7	4	3	19	14	−8	5	9	7
Don't know/no answer	26	6	26	26	20	0	12	43	14	13
Influence on total sales volume										
Net effect[1]	29	28	10	18	55	38	22	24	29	26
Don't know/no answer	18	0	23	25	11	0	10	37	22	12

[1] Net effect: difference between the percentage of firms foreseeing increased sales and those expecting a reduction.
Source: Commission departments.

Table 2

From 1993 to 1996 — Influence of the completion of the internal market on the volume of industrial sales

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on volume of domestic sales										
Net effect[1]	12	1	−18	−9	14	11	7	−1	−1	0
Don't know/no answer	17	2	43	40	10	0	11	44	23	17
Influence on volume of sales in other EEC countries										
Net effect[1]	45	40	29	27	51	44	3	12	44	37
Don't know/no answer	26	4	42	40	14	0	10	61	17	17
Influence of volume of sales in non-member countries										
Net effect[1]	18	11	4	2	21	22	7	5	5	10
Don't know/no answer	33	6	46	45	27	0	17	61	23	20
Influence on total sales volume										
Net effect[1]	36	30	9	17	51	36	25	10	34	27
Don't know/no answer	30	0	46	43	17	0	14	64	31	20

[1] Net effect: difference between the percentage of firms foreseeing increased sales and those expecting a reduction.
Source: Commission departments.

Table 3

Up to 1992 — Influence of the completion of the internal market on the volume of industrial investment

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on volume of domestic investment										
Net effect[1]	29	25	26	22	38	41	26	38	23	28
Don't know/no answer	7	1	25	16	7	0	4	26	11	8
Influence on volume of investment in other EEC countries										
Net effect[1]	16	24	10	19	16	22	9	9	18	19
Don't know/no answer	28	11	39	29	27	0	13	38	23	18
Influence on volume of investment in non-member countries										
Net effect[1]	4	7	0	3	4	8	2	0	3	5
Don't know/no answer	31	13	40	33	33	0	22	42	24	20
Influence on total volume of investment										
Net effect[1]	23	30	25	20	40	38	30	22	23	28
Don't know/no answer	24	1	31	30	17	0	3	38	28	15

[1] Net effect: difference between the percentage of firms foreseeing increased investment and those expecting a reduction.
Source: Commission departments.

large industrialized countries of the Community, where the large multinationals are already well established, investment should therefore take place both at home and abroad. As a result of these trends in the various Member States the less industrialized countries should catch the others up; and this should favour the process of convergence.

Answers to the same question with reference to the period 1993-96 demonstrate two points.

The first is that in general the net positive effect on investment at home should be felt more forcefully before 1992 than after, with a net balance of 28 % for the Community average before 1992 as against 23 % after 1992. The second concerns the net positive effect on investments in other Community countries (flow of direct investment) which will be as large before as after 1992 with a net balance across the Community of 19 % in both cases. In the case of Germany, the net balance is 24 % as against 18 % for investments in Germany.

Table 4

From 1993 to 1996 — Influence of the completion of the internal market on the volume of industrial investment

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on volume of domestic investment										
Net effect[1]	31	18	22	19	31	42	19	22	20	23
Don't know/no answer	18	2	47	39	17	0	10	49	23	17
Influence on volume of investment in other EEC countries										
Net effect[1]	17	24	9	17	15	26	10	10	17	19
Don't know/no answer	38	10	45	49	37	0	20	58	32	25
Influence on volume of investment in non-member countries										
Net effect[1]	11	9	0	4	4	12	5	1	4	7
Don't know/no answer	40	12	58	53	41	0	24	61	34	27
Influence on total volume of investment										
Net effect[1]	28	27	21	19	36	41	23	12	21	26
Don't know/no answer	35	1	51	46	27	0	11	58	35	22

[1] Net effect: difference between the percentage of firms foreseeing increased investment and those expecting a reduction.
Source: Commission departments.

Perceived effects on employment and productivity

In general, firms expect the effects on employment to be less substantial: a net balance of 13 %, as against 26 % for total sales and 27 % for investment.

Expectations concerning the trend in employment are, however, in line with those concerning productivity. The expected effect on productivity is particularly substantial at 38 %, with no difference between the pre-1992 and post 1992 figures. This figure is the result of very positive views on the growth in overall sales combined with a less optimistic outlook on employment.

To sum up, the dominant feeling is that the internal market will increase competition and so help eliminate internal inefficiencies (x-inefficiency) and monopoly profits. Furthermore, market integration will generate economies of scale through increased production in existing plants, or the restructuring of production to eliminate the less efficient plant.

Table 5

Up to 1992 — Influence of the completion of the internal market on total employment and productivity in industry

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on level of domestic employment										
Net balance	8	8	1	1	14	17	17	29	9	9
Don't know/no answer	8	2	22	16	4	0	3	26	9	8
Influence on level of employment in other EEC countries										
Net balance	9	14	5	8	14	13	7	4	21	13
Don't know/no answer	27	13	39	32	33	0	18	45	22	20
Influence on level of employment in non-member countries										
Net balance	2	3	0	2	2	3	1	−2	5	3
Don't know/no answer	31	15	40	35	41	0	0	49	24	21
Influence on total employment level										
Net balance	9	14	4	5	17	17	19	14	15	13
Don't know/no answer	26	1	35	34	21	0	3	40	28	17
Influence on productivity										
Net balance	42	29	21	42	66	46	33	42	45	38
Don't know/no answer	7	3	29	18	9	0	7	27	11	10

Source: Commission departments.

Table 6

From 1993 to 1996 — Influence of the completion of the internal market on total employment and productivity in industry

	B	D	E	F	IRL	I	NL	P	UK	EUR
Influence on level of domestic employment										
Net balance	13	1	1	4	15	19	13	15	10	7
Don't know/no answer	20	2	46	42	13	0	9	47	22	18
Influence on level of employment in other EEC countries										
Net balance	12	17	5	9	11	19	11	5	20	15
Don't know/no answer	37	11	55	54	40	0	20	45	32	27
Influence of level of employment in non-member countries										
Net balance	8	5	0	3	0	7	3	−1	4	4
Don't know/no answer	43	13	56	58	46	0	24	62	34	30
Influence on total employment level										
Net balance	19	12	4	8	16	19	20	7	16	13
Don't know/no answer	39	2	52	52	29	0	10	57	37	25
Influence on productivity										
Net balance	47	34	19	36	60	51	29	32	45	38
Don't know/no answer	19	3	47	39	17	0	10	46	17	17

Source: Commission departments.

The combined effect of these mechanisms will be a considerable increase in productivity. An improvement in conditions of supply within the Community in terms of efficiency and productivity is a necessary precondition for improvements on the labour market.

Looking beyond 1992, in many countries, firms are a little more optimistic about the prospects which the internal market will open up for the level of employment in their subsidiaries in other Community countries. For example, after 1993 the net balance of firms expecting to increase their labour force in other Community countries is 17 % in Germany, 19 % in Italy and 20 % in the United Kingdom.

2. Strategic redeployment in progress in firms

The survey, the results of which were set out in the previous section, also provided some information about the strategic behaviour which firms intend to adopt in preparation for the single market. This, together with information from other sources, provides an initial picture of the strategic redeployment being undertaken by Community firms. Changes in strategic behaviour can be seen at two levels:

(i) within firms, decisions have been or are being taken, to alter the allocation of resources, the location of production units or the structure of distribution networks. Some internal strategy decisions are therefore related to the impact of completion of the internal market on the various stages of the process of adding value: research and development, logistic supply, production, marketing and distribution. We shall look in the first part at the nature of these developments and the changes in the behaviour of firms as they can be seen at present;

(ii) as a result of enlarged markets, firms are altering their strategy regarding working together, cooperation or acquisition as it relates to other firms. These external strategies may be explained in part by each firm's desire to reach as soon as possible a critical size through the acquisition of competing firms, or through joint ventures, so making it possible to share research and development costs. The second part will be devoted to these external strategies.

2.1. Internal strategies

From the point of view of the firm, the impact of removing non-tariff barriers will be felt at all stages in the process of adding value although each of these will be affected in a different way by changes in the strategic environment in which firms operate.

Table 7

Impact of the internal market on the value-added chain within the firm

Component of value-added	Nature of the impact
1. Research and development	• Growth in the number of joint projects • More homogeneous environment at European level
2. Supplies	• Wider range of suppliers • Lower prices
3. Logistics	• Lower transport costs • Relocation of storage facilities (better adapted to an integrated market)
4. Production	• Increased production at each plant • Creation of new plants in markets to be targeted or reduction in the number of production plants
5. Marketing and distribution	• Centralization of product management at European level • Shorter delivery times due to absence of customs control • Community-wide marketing campaigns
6. Consumers	• Availability of a wider range of products • Lower prices • Increased demand (growth effect)

Source: Commission departments.

The 1989 survey provided preliminary indications of the effect of completion of the internal market on the internal strategies of industrial firms.

First of all the internal market's effect is clearest in the area of product adaptation and in the restructuring of production plants. Over the Community as a whole 63 % of firms surveyed thought that the internal market would influence production decisions and 61 % believed this to be true of products. However, there was also a clear effect on distribution decisions (56 %) and those concerning research and development (55 %). The considerable differences between answers from one Member State to another should also be noted. German industry put the greatest weight on decisions concerning production plant (82 %) and displayed greater scepticism about the effect of the internal market on research and development decisions (50 %). This was true also of Portuguese industrialists, who expected the internal market to influence production strategies (52 %) but had reservations about the influence on decisions concerning products, distribution networks and R&D. By contrast, Belgian, French and United Kingdom industrialists expected the main strategic decisions to concern the adaptation of products to the internal market. French industrialists expected most changes to affect strategic decisions on research and development.

A glance at the main changes expected shows that certain structural alterations were already under way; in such cases the internal market is acting as an accelerator.

Research and development strategy

Here it is to be expected that the internal market will exert its influence in the form of greater dynamism in the face of increased competition. In addition, Community policy on technical standards (Community harmonization or mutual recognition) will create a more uniform technological environment and so encourage cooperation between Community firms.

Answers to the survey about the effect of the single market on R&D policy decisions stressed equally greater cooperation (net balance of 42 %) and greater utilization of the firm's resources (net balance of 44 %). Of course, those two answers are not mutually exclusive and firms could give a positive reply to both options proposed. In most Member States the net balance for each of the two options were similar except in the case of German firms, which gave greater weight to internal R&D efforts, and Spanish firms, which in contrast felt a greater need for more cooperation between firms.

Production strategy

Decisions on production will depend on the economies of scale in the sector in question and the extent to which transport costs contribute to total costs. In some sectors, where economies of scale are considerable and transport costs low, industrialists may increase the production of their existing factories by adding extra capacity.

There was a clearly positive net balance (24 % over the Community as a whole) in favour of increasing the size of the production unit; this was most marked in Germany, Ireland and Italy.

There are, however, two ways of dealing with the increase in sales which completion of the internal market is expected to generate: either firms increase the production capacity of their existing factories, as described above, or they increase the number of production sites. Far fewer firms expect to increase the number of production units. In most countries the firms surveyed expected as a rule that the number of production units would remain more or less stable or even fall (Belgium, France, Ireland, Spain and the United Kingdom).

If we take the case of certain multinationals already established in a number of European countries, the choice as regards rationalization of production in certain cases involves either a reduction in the number of production sites or an increase in production on each site.

Five years ago, for example, Kodak in Europe had two production units in France, two in the United Kingdom and one in Germany. Today it has only one in France and one in the United Kingdom. This is also true of Unilever, which in 1973 had nine units producing detergents in nine different Member States of the European Community. By 1989 it had only four in four different Member States (Italy, Portugal, Germany and the United Kingdom). Volume of production has not increased but productivity has shot up (by more than 200 % over the nine years from 1978 to 1987). Finally the Swiss Jacob Suchard group has also just completely restructured its European production network by closing or disposing of 11 small production units and transferring 1 500 workers. Supplies to each country are now sourced from six factories which specialize intensively in a different type of chocolate. Other multinational European groups are also considering the concentration of production on a reduced number of sites.

Product strategy

Firms may adopt one of two policies to cope with expectation of a considerable increase in sales on the Community

Table 8

Influence of the completion of the internal market on the strategies of industrial firms [1]

	B[1]	D	E[1]	F	I[2]	NL	P[2]	UK	EUR
Production plant									
Effect	50	82	25	73	62	36	52	43	61
No answer	1	3	6	14	—	3	—	10	6
Products									
Effect	70	64	61	77	55	45	18	66	63
No answer	1	3	8	—	—	5	—	7	3
Distribution									
Effect	57	64	53	58	53	42	28	53	56
No answer	3	0	10	—	—	6	—	10	5
Research and development									
Effect	53	50	56	73	49	36	18	61	55
No answer	5	6	9	—	—	3	—	7	4

[1] As the questions were not worded in exactly the same way in Belgium and Spain, the results for these two countries cannot easily be compared with the others.
[2] In the case of Italy and Portugal, the non-respondents were eliminated from the sample and the percentages were calculated on the basis of the firms which replied only.
Source: Commission departments.

Table 9

Influence of the completion of the internal market on the strategies of industrial firms (net balance between positive and negative impacts)

	B	D	E	F	IRL	I	NL	P	UK	EUR
Research and development										
Greater cooperation	26	30	39	44	63	47	20	18	66	42
Greater use of the firm's resources	27	46	15	43	59	43	27	16	66	44
Production of plant										
Increase in size of production units	13	30	8	17	37	38	—	22	17	24
Increase in number of production units	2	14	0	−2	−4	17	—	10	1	7
Products										
More standardized products	19	21	9	29	34	33	16	14	28	24
More specialized products (adapted to each market)	39	36	38	40	64	49	31	14	32	38

Source: Commission departments.

market: either they sell identical products on an enlarged market or they take into account the varying tastes of consumers and introduce individual products adapted to each national market. In practice, as a result of the features of the sector, the firms are often confronted with a number of possibilities. Certain standardized basic products may be marketed in identical fashion in all markets. If in addition economies of scale are considerable, it is possible to consider concentrating production on a limited number of sites. There are not, however, many products of this kind. In most cases the differences between products are well developed and numerous (quality, time, presentation, after-sales service). In such circumstances a very large number of specialized slots exist, each of which is filled by a particular product. To reach other customers, the firms must adapt their products to meet the tastes of their new target consumers.

Overall, most of the firms surveyed expected the influence of 1992 to result in the need to adapt products to suit each new national target market. A net balance of 38 % of firms expected it would be necessary to adapt their products within the context of the internal market, while 24 % expected demand for standardized products to increase. These results must be considered in the light of the type of economic activity concerned; more detailed results, disaggregated by industry, would undoubtedly show some variation but unfortunately they are not available.

In addition to deciding whether to adapt the product, there is the question of the approach to consumers. Some European manufacturers already practice global marketing throughout Europe. One example is the Italian confectionery firm Ferrero, which sells its products in all European countries using the same commercial approach. Oréal also sells certain hairdressing products throughout the Community in the same way. However, the brand images of a single product may differ markedly from one Member State to another so that advertising campaigns and the approach to the consumer have to be adapted to suit each market.

2.2. External strategies

After having described the changes in the internal organization and strategy of businesses prompted by completion of the internal market, attention is now focused on their external strategies. Analysis of recent trends in takeovers, the acquisition of minority holdings and the launching of joint ventures is based on data published in the specialized press relating to the thousand largest firms in the Community (Reports on Competition Policy, Commission of the European Communities).

As highlighted by the Eighteenth Competition Report, internal market pressures loom large among the reasons given by firms for making purchases or entering into joint ventures.

In the case of acquisitions, a firm's decision to strengthen its market position is largely prompted by the desire to

Table 10

Main motives given for mergers and joint ventures in 1987-88

Mergers, including takeovers and acquisitions of majority holdings		Joint ventures	
Improvement of market position	70	R&D, production, marketing	27
Expansion	54	Production	19
Complementarity	49	Restructuring	13
Restructuring	41	Expansion	5
Diversification	23	Complementarity	5
Integration	6	Marketing	3
Synergism	5	Improvement of market position	3
Specialization	5	Cooperation	2
Production and marketing	2	Diversification	2
R&D	2	Production and sales	2
Others	19	Others	13
Not specified	107	Not specified	17
Total operations	383	Total operations	111

Source: Eighteenth Report on Competition Policy, EC Commission.

attain a critical mass on an integrated internal market. The argument, is moreover, often used in the public pronouncement of company directors making takeovers.

(i) Industry

The total number of acquisitions made and majority holdings taken by the largest European industrial firms doubled in the three-year period from 1983-84 to 1986-87, rising from 155 to 303, and increased by a further 34 % between 1986-87 and 1987-88 to reach the figure of 383. There has therefore been a proliferation in the number of company purchases among the largest European groups.

Operations at the national level dominated the scene between 1983 and 1985, since nearly two-thirds of purchases were made by firms in the same Member State. Nevertheless, the slowdown in the growth of operations at national level (55,9 % in 1987-88 as against 69,6 % in 1986-87) shows that the focus in acquisitions is shifting towards international operations. If the trend were to continue it would clearly demonstrate the importance large firms attach to internationalizing their activities.

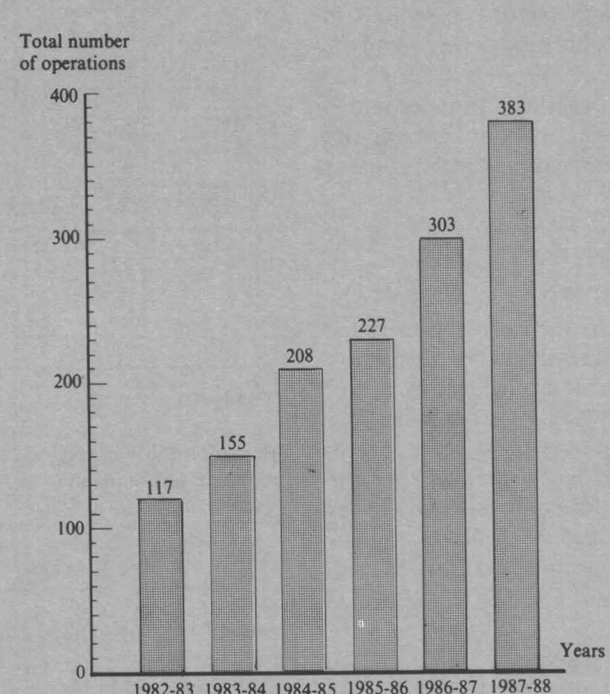
As far as international operations are concerned, the proportion of acquisitions at the Community level is appreciably larger than those with non-Community partners and has been increasing in relative importance since 1983-84.

Such a trend towards increased concentration among the major industrial groups could in the long run give rise to competition policy problems, since monopolistic situations could arise and hinder the free play of competition. This is the case in particular where the sector concerned is relatively sheltered from international competition.[1] In some sectors where the impact of the internal market will be particularly marked, company acquisitions are in response to the need to achieve a particular size and will be justified for the firms concerned on the grounds of the economies of scale they can bring about.

Acquisitions of minority holdings have also increased considerably: their number more than trebled, rising from 54 to 181, between 1983-84 and 1987-88.

[1] Commission of the European Communities: 'Horizontal mergers and competition policy in the European Community', *European Economy*, No 40, May 1989.

GRAPH 1: **Growth in the total number of mergers/takeovers carried out by the 1 000 biggest European industrial firms**



Source: Reports on Competition Policy.

Table 11

Breakdown of mergers/takeovers and acquisitions of majority holdings by type of operation (industry)

Year	Domestic operations	Community operations	International operations	Total
1983-84	101 (65,2)	29 (18,7)	25 (16,1)	155 (100)
1984-85	146 (70,2)	44 (21,2)	18 (8,7)	208 (100)
1985-86	145 (63,9)	52 (22,9)	30 (13,2)	227 (100)
1986-87	211 (69,6)	75 (24,8)	17 (5,6)	303 (100)
1987-88	214 (55,9)	112 (29,2)	57 (14,9)	383 (100)

NB: Figures in parentheses show the percentage of the total number of operations surveyed.
Source: Reports on Competition Policy (EC Commission, 1988 and 1989).

As in the case of takeovers, the proportion of international operations is increasing, which provides ample demonstration of the fact that an internationalization process is currently under way among European firms.

Creations of joint subsidiaries have not enjoyed such rapid growth over the period under consideration. Between 1983-84 and 1987-88, their number increased more modestly from 69 to 111 operations.

Nevertheless, more than with purchases or acquisitions of minority holdings, transfrontier operations predominate here, since most joint subsidiaries are set up at Community or international level. In 1987-88, American firms accounted for 16 of the 35 creations of international joint subsidiaries observed, as against 5 cases of joint ventures with Japanese firms.

(ii) Services

The total number of acquisitions by the largest firms in the services sector also increased considerably. Over the period 1984-85 to 1987-88, the total number of mergers by acquisition, and acquisitions of majority holdings in services rose from 67 to 175: a 160 % increase over three years, nearly double the figure for industry (an 85 % increase over the same period). Sectors directly affected by the Directives mentioned in the White Paper, such as banking and insurance, are currently undergoing fundamental restructuring.

Operations within the same Member State account for between 60 and 70 % of the total number of acquisitions recorded, a figure which remains relatively stable. As far as international operations are concerned, in all the service sectors observed (distribution, banking and insurance), ac-

Table 12

Breakdown of acquisitions of minority shareholdings by type of operation (industry)

Year	Domestic operations	Community operations	International operations	Total
1983-84	37	8	9	54
1984-85	45	10	12	67
1985-86	88	20	22	130
1986-87	84	21	12	117
1987-88	115	37	29	181

Source: Reports on Competition Policy (EC Commission, 1988 and 1989).

Table 13

Breakdown of new jointly-owned subsidiaries by type of operation (industry)

Year	Domestic operations	Community operations	International operations.	Total
1983-84	32	11	26	69
1984-85	40	15	27	82
1985-86	34	20	27	81
1986-87	29	16	45	90
1987-88	45	31	35	111

Source: Reports on Competition Policy (EC Commission, 1988 and 1989).

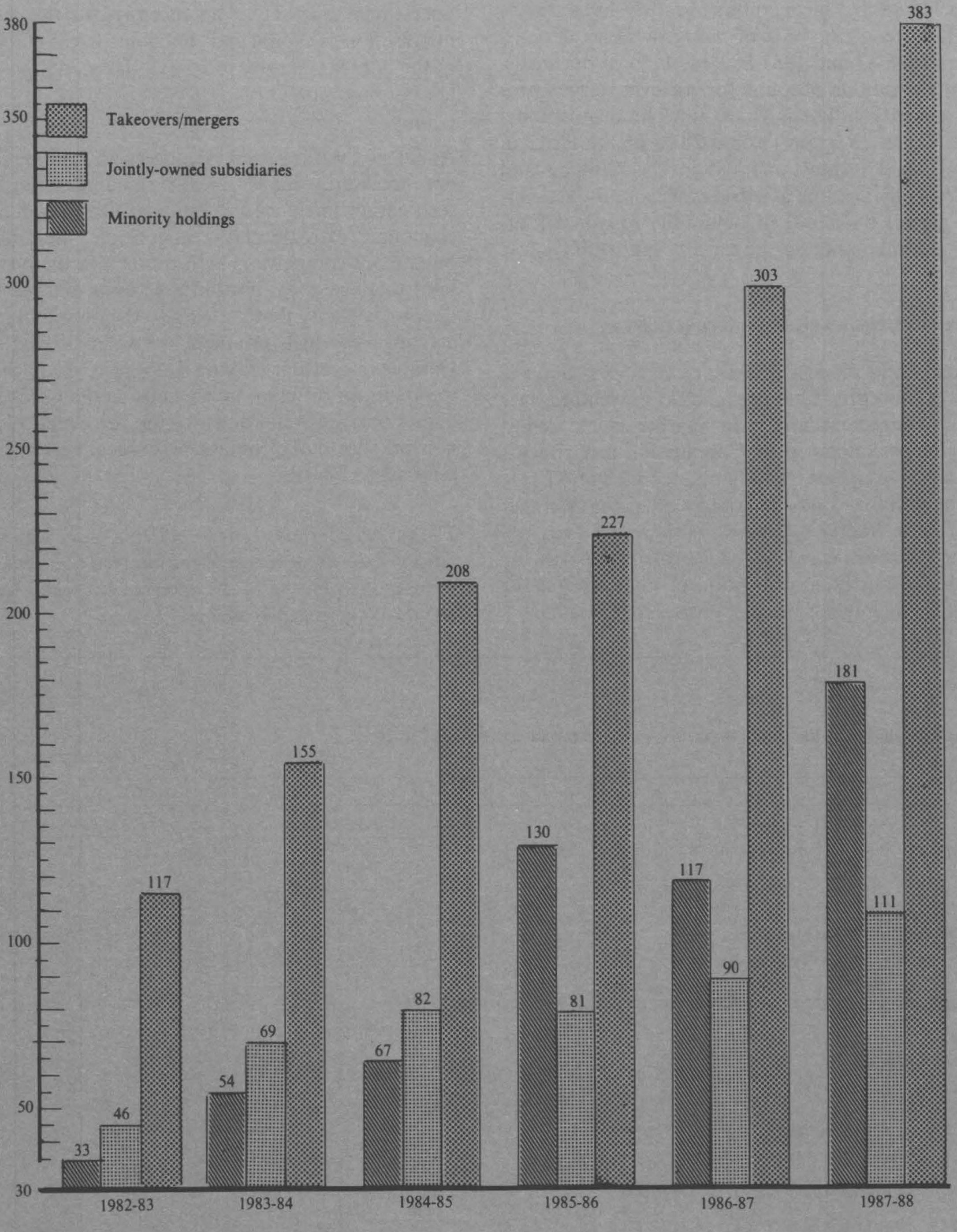
Table 14

Breakdown of mergers/takeovers and acquisitions of majority holdings by type of operation (services)

Year	Domestic operations	Community operations	International operations	Total
1984-85	47	16	4	67
1985-86	44	13	13	70
1986-87	79	15	18	112
1987-88	107	34	34	175

Source: Reports on Competition Policy (EC Commission, 1988 and 1989).

GRAPH 2: **Number of takeovers, acquisitions of minority holdings and new jointly-owned subsidiaries involving the 1 000 biggest European industrial firms**



Source: Reports on Competition Policy.

quisitions are divided roughly equally between operations within the Community and those in which one of the two parties is based outside Europe.

Acquisitions of minority holdings in the services sector rose from 38 in 1984-85 to 134 operations in 1987-88, a 250 % increase in three years, the bulk of that growth being registered between 1986-87 and 1987-88 (+ 145 % in one year). International operations account for an even larger proportion of minority holdings than outright acquisitions: 41 % of the former as against some 20 % of the latter in 1987-88. The trend is most marked in the banking and insurance sectors and can be ascribed *inter alia* to the determination of groups outside the Community to gain a foothold on the internal market at the earliest opportunity.

(iii) External strategies and the internal market

In both industry and services operations such as takeovers, acquisitions of minority holdings and joint ventures are therefore increasing considerably in number. Such trends, reported in studies conducted by Commission departments (Competition Reports), are given ample confirmation in a wide range of national studies carried out in the Member States. A major restructuring process is therefore currently under way in Europe, which can be explained partly by international factors (the globalization of markets and the emergence of newly industrialized countries in particular).

The creation of a European internal market on which goods and persons can move freely is also playing a part in the changes observed: takeovers, joint ventures and minority holdings can facilitate a more efficient use of economies of scale and better coverage of the common market. Such operations thus act as an incentive to the more efficient distribution of capital and contribute to the efficient working of the internal market, provided that monopolistic positions are not built up.

As far as the firm itself is concerned, such acquisitions are not necessarily made for the same reasons. As we have seen earlier in the case of standardized products, in which economies of scale play a major role, the aim pursued in buying out competitors is to rationalize the production system: to close down unprofitable units and set up new production capacity that is closer to the optimum size. In other activities in which products are differentiated and the key variable in decision-making is not price, acquisitions may be in pursuit of different goals, such as the purchase of brand names that are well-known to the consumer, of distribution networks, to make contacts with local customers or a well-established image.

The survey conducted in mid-1989 of European firms' expectations from completion of the internal market also provides some indications as to the external strategies to which they should be giving precedence.

Table 15

Influence of the completion of the internal market on the external strategies of firms [1]

(%)

	B	D	E	F	I	NL	P	UK	EUR
Increase in number of mergers and acquisitions of majority shareholdings									
In the country	40	54	21	51	75	29	43	29	48
In the European Community	63	54	15	56	67	46	45	51	52
In the world	46	33	17	27	47	15	23	18	30
Increase in acquisitions of minority shareholdings									
In the country	3	14	0	11	15	16	12	8	11
In the European Community	5	20	2	20	24	25	13	23	19
In the world	4	12	0	6	17	9	4	10	10
Increase in jointly-owned subsidiaries									
In the country	5	20	1	18	12	13	—	13	14
In the European Community	9	33	3	32	25	42	—	32	28
In the world	8	20	4	13	12	8	—	9	13

[1] The firms questioned could tick more than one box; the sum of the percentages is therefore greater than 100.
Source: Commission departments.

First, the results of the questionnaire clearly confirm that mergers and majority holdings are generally preferred to minority holdings or joint subsidiaries. In Europe as a whole, on average nearly 50 % of firms questioned expect there to be an increase in take-overs, as against less than 20 % for minority holdings and less than 30 % for joint subsidiaries.

The increase in takeovers is expected to take place first and foremost at Community level (52 % of respondents). Nevertheless, industrialists in certain countries place emphasis above all on takeovers within the same country (Italy), others on international, and more particularly Community operations (United Kingdom, Belgium and the Netherlands). These results clearly confirm the stance already taken by industrialists in the UK and the Netherlands, who are at the forefront in transfrontier acquisitions in Europe.

Minority holdings are envisaged above all at Community level. In many cases, they are the first step in making the acquaintance of a partner located in another Member State and may subsequently lead to a takeover. Between one-fifth and one-quarter of the firms surveyed in the Federal Republic of Germany, France, Italy, the Netherlands and the United Kingdom anticipate an increase in acquisitions of minority holdings at Community level.

Lastly, creations of joint subsidiaries are also very clearly geared to the Community market. Over a third of firms surveyed in the Federal Republic of Germany, France, the Netherlands and the United Kingdom anticipate that completion of the internal market will lead to the creation of more joint subsidiaries.

All the analyses so far have presented the impact of the internal market in highly aggregate terms. Nevertheless, not all sectors are affected in the same way by the Directives proposed by the Commission, and the dates on which they are adopted by the Council and then implemented by the Member States depend on the difficulties encountered and the possibilities for reaching agreement between Member States. It is therefore necessary also to conduct a more detailed analysis of the challenges offered by the internal market at the sectoral level.

3. The sectoral challenges of the internal market

While all sectors will be concerned by the internal market, some will undoubtedly be more affected than others, either directly through the measures set out in the White Paper, or indirectly through keener competition. An initial exercise aimed at identifying the most sensitive sectors has been carried out at the Community level for industry; it is based on the application of several criteria taken together.

The first criterion considered will be the scale of the non-tariff barriers that currently hinder trade between Member States: public procurement, standards, taxation and the lack of harmonization in external trading policies. The second criterion, the disparities between prices for identical goods in different Member States, is an additional indicator of market fragmentation. The third criterion, namely the degree of penetration (the proportion of demand met by imports), shows the importance of trade in the economic life of the sector. The potential for achieving economies of scale, which is the fourth and last criterion, gives an indication of the potential cost reductions that can result from an increase in size.

In the case of industry, some 40 out of 120 sectors, representing approximately 50 % of industrial value-added, will be most affected by completion of the internal market. The sectors concerned can be classified into four major categories according to the extent to which they are open to intra-Community trade and the degree to which prices for the same products vary between all the Member States.

Traditional or tightly regulated public procurement sectors

Most of the sectors belonging to this first category are traditional industries involved in public procurement (railway rolling stock and energy production plant, for instance) or strictly regulated sectors (pharmaceuticals).

These sectors have so far been protected, each Member State favouring its national 'champion'. Intra-Community trade is consequently highly underdeveloped in these cases (the degree of intra-Community penetration is 8 %, against an average of 18 % for industry as a whole), there are too many European manufacturers for the size of the market and price disparities are considerable: 25 % against an average of 15 % and a maximum of 33 % in the pharmaceuticals industry, as a result of certification procedures and price controls.

In this group of sectors, the internal market effect should be extremely pronounced. In the short and medium term, the opening-up of public procurement will favour the most competitive suppliers at Community level and thus boost intra-Community trade and push prices down. Such a change in the behaviour of public buyers should lead to major restructuring operations (mergers and plant closures) in order to facilitate the emergence of production units of optimum size with respect to the integrated Community market.

GRAPH 3: **The industrial sectors most affected by the internal market**

INTENSITY OF COMMERCIAL TRADE	PRICE DIFFERENCES BETWEEN MEMBER STATES: Small	PRICE DIFFERENCES BETWEEN MEMBER STATES: Large
Weak	**Industries in competition with NICs** *Characteristics* • Sectors subject to competition from NICs *Strategy of firms* • Relocation of production, mergers, concentration *examples:* electrical and electronic goods, shipbuilding	**Traditional public procurement or highly regulated sectors** *Characteristics* • Fragmented sectors where international competition is weak • Restructuring probable as a result of 1992 *Strategy of firms* • To move from being national champions to being European leaders *examples:* electricity generating equipment, railway equipment, pharmaceuticals
Strong	**High technology public procurement** *Characteristics* • Sectors already partially open to competition • Restructuring already under way *Strategy of firms* • Firms already starting to operate on a worldwide scale, mergers, concentration *examples:* telecommunications, data processing	**Mass consumption products** *Characteristics* • Sectors fragmented at distribution and/or marketing level • Highly differentiated products *Strategy of firms* • Europeanization of distribution and marketing, cooperation *examples:* cars, textiles/clothing, shoes, household electrical goods, television, video, toys

Sectors Characteristics	Traditional public procurement	High-tech public procurement	Mass consumption goods	Industries in competition with NICs
Share of industrial value-added (in %)	6,4	6,1	30,8	5,6
Price dispersion (in %)	25,3	8,9	13,8	9,7
Intra-Community penetration rate (in %)	7,9	31,9	35,4	11,2

This is, for example, the case in the electricity power plant industry, in which two European giants have been created. Asea-Brown Boveri (200 000 employees) is the result of a merger between the Swedish firm Asea and the Swiss company Brown Boveri and is today the European leader in the construction of plants for electricity transmission and distribution and No 2 in electrical power plant construction. Since the merger, the ABB group has been unceasingly expanding its basic activities by buying into the different Member States: in Italy (acquisition of Marelli, a holding in Franco Tosi and discussions with the public authorities concerning the restructuring of Italy's publicly owned electricity generating industry), in the Federal Republic of Germany (purchase of AEG's turbine operations) and in France (creation of a joint subsidiary with Jeumont Schneider). Opposite ABB, another European giant was recently formed through the joint venture between GEC (United Kingdom) and Alsthom (France), which is No 1 in Europe for electricity generation equipment and No 2 (behind ABB) in equipment for transmission and distribution. Here too, the strategy is the same: to gain a foothold in basic activities in as many Member States as possible; thus the purchase of ACEC in Belgium and acquisition of a 45 % holding in MAN's electricity production division in the Federal Republic of Germany.

Public procurement of high-technology products

The second group includes such sectors as information technology, office equipment, telecommunications and medical equipment. Like the previous group, these sectors are involved in public procurement; however, they are areas in which demand is rising steeply and the technology content of products is high. Moreover, the presence of American multinationals on the Community market and the openness of the sectors to imports (intra-Community penetration: 32 %) explain why price disparities between Member States are small.

In these sectors, Japanese or American firms have today a major productivity advantage over their European counterparts. The activities concerned lend themselves to considerable economies of scale, which are not always properly exploited at the Community level.

Clearly, the market is globalized here, both by the uniformity of consumers' needs in all the industrialized countries, and by the nature of the competitors and the technological challenges. Enlargement of the market could therefore lead to cost reductions for European firms through more intensive utilization of economies of scale. The Commission wishes to promote cooperation between European firms with that end in view.

In the electronic components sector, the three European leaders (Siemens, Philips and SGS Thomson) are not yet large enough in global terms and have decided to cooperate under the Jessi programme, which has a budget of nearly ECU 4 000 million over eight years.

Mass-consumption products

The third group alone accounts for 30,8 % of value-added by industry, i.e. more than the three other groups combined. It encompasses a large number of ordinary consumer goods (radios, television sets, household electrical appliances, clothing, footwear and toys) and a few intermediate and capital goods (motor vehicles, machinery and glass).

This group should in theory be less affected by the abolition of non-tariff barriers: the sectors are already engaged in extensive intra-Community trade (intra-Community penetration: 35,5 %), and in many areas, there are already large firms operating on an extended market. A number of technical, administrative or tax barriers nevertheless continue to hinder intra-Community trade and enable fairly wide price disparities to exist (nearly 14 %).

In these sectors the impact of completion of the internal market should, initially, be felt chiefly downstream, in the distribution channels, rather than upstream, at the production stage. As far as distribution is concerned, two trends are emerging: on the one hand, the central purchasing departments of the major distributors are modifying their sources of supply and seeking the most competitive supplier at Community level; on the other hand, in certain sectors producing intermediate or capital goods, customer integration is prompting firms to centralize their distribution channels and sales forces.

Sectors exposed to competition from newly industrialized countries

The last group comprises sectors such as shipbuilding, electrical plant and some branches of the agri-foodstuffs industry. These are industrial activities in which intra-Community trade is limited (intra-Community penetration is only 11,2 %) and price disparities are also relatively small (9,7 %).

In some of the sectors in the group (shipbuilding and electrical plant), a large volume of trade is conducted with non-member countries, and competition from newly industrialized countries is keen. Such factors also explain why price disparities are small, despite the low level of intra-Community trade, and so most of the restructuring has already taken place in these sectors independently of the large internal market. Admittedly, gains in technical efficiency are still possible, but should be smaller here than those expected in the other groups.

4. Conclusions

The implementation of the measures relating to the internal market is now well under way. Confronted with the prospect of a unified market, firms have anticipated a number of ways of how the development of their businesses will be affected. New strategies have been implemented in order to cope with these changes. Firstly, in the context of a growing interdependence of the Member States' economies there should be a more rapid growth of intra-Community trade, since firms expect to increase their sales outside their domestic markets.

Secondly, firms in the most industrialized countries expect to increase their direct investments outside their national borders, while in the least industrialized countries there should be a growth in direct investment at the national level. This process should, therefore, in the long term, help the least industrialized countries to catch up with the others and contribute to economic convergence.

Thirdly, firms are in the process of restructuring. In the case of standardized products, where economies of scale are important, the number of takeovers is growing as firms try to reach the optimum size to take advantage of enlarged markets. In the case of differentiated products, where quality and after-sales service play an important role, takeovers are aimed rather at acquiring a brand name, a distribution network or an image. These external operations can stimulate a more effective allocation of capital resources and contribute to the efficiency of the internal market, provided that no monopoly situation is created.

Finally, not all sectors are equally affected by the Directives; for structural reasons, the strategies adopted can vary between sectors. Using several criteria to assess the fragmentation of markets (level of non-tariff barriers, importance of intra-Community trade and price differences), it is possible to identify the sectors most affected by the internal market. In the case of industry, these account for 50 % of industrial value-added, and it is here that the adjustment processes have already begun.

The '1992 effect' on private investment

The impact of 1992 on investment can be analysed at two levels:

(i) short-term effects associated with the anticipatory reactions of firms that have become aware of the opportunities offered by 1992;

(ii) medium-term effects resulting from the favourable influence of the implementation of the White Paper programme on the determinants of investment and the mechanisms generated by the implementation of the programme (effects of scale and competition).

Short-term impact associated with firms' anticipatory reactions

The most recent survey of firms in all 12 Member States, which was carried out in mid-1989 and the results of which are analysed in Study No 5 on the effects of the internal market shows that 31% of industrial firms surveyed expect completion of the internal market to exert a favourable effect on the investments made in the domestic market. The question thus arises whether the steep rise in investment registered in the Community in 1988 can already be partly ascribed to a '1992 effect', or whether it is merely the result of increased demand and the improved return on capital. Given the time lags between investment decisions and putting these decisions into effect, then if there was an internal market effect in 1988, businesses would need to have become aware of the prospects offered by 1992 shortly after publication of the White Paper, namely in 1986-87.

Such an assumption does not look unrealistic in the light of trends in mergers by acquisition observed between 1985-86 and 1986-87: 303 operations in 1986-87 in industry as against 227 one year before, and 112 operations in 1986-87 in services as against 70 a year earlier.

Company acquisitions are one of the alternatives open to firms anticipating the opportunities offered by enlarged markets, the other being to invest in greater capacity.

Another factor that confirms the above assumption is the downward bias in investment forecasts for 1988 when the latter are based on well-tested econometric equations, using equations data from the past. This suggests that the underestimation measures the impact of not taking into account the '1992 effect'.

Thus, the observed trend in investment in 1988 was compared with a forecast based on an equation incorporating the values of the explanatory variables observed in 1988. This exercise, which was conducted using the investment function of the Compact model, suggests that anticipation of 1992 by businesses boosted investment growth by an additional 1,5 points in 1988. The '1992 effect' is thus considered to have accounted for some 17% of the growth in private investment.[1]

[1] Some of the difference could be ascribed to forecasting errors due to the stochastic nature of the model underlying the estimated equation.

Medium-term impact

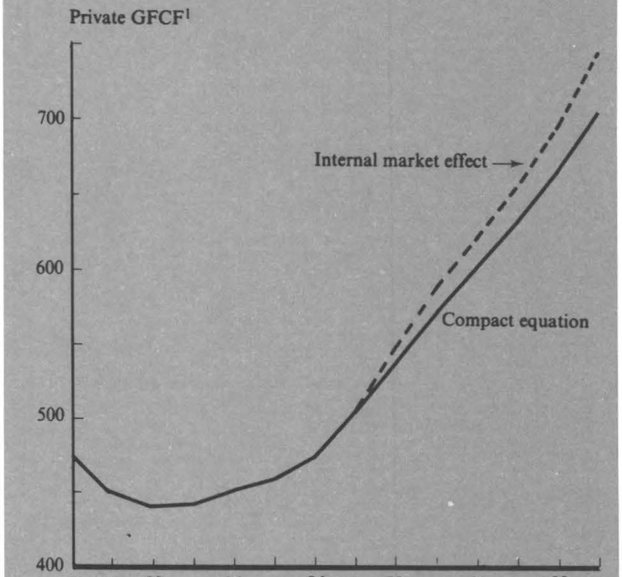
The simulations carried out for the Cecchini report measured the medium-term impact of implementing all the measures envisaged in the White Paper, assuming that they were all introduced at the same time. A more precise timetable for implementation of the 1992 programme now exists which makes it possible to devise a scenario on the basis of progress made in removing non-tariff barriers. The latter are far from negligible, since over 50% of the planned measures have now been adopted by the Council.

This new scenario, which makes it possible to refine the time profile of the macroeconomic effects of the internal market, is based on the following assumptions:

1. The effects of abolition of frontier controls and the opening-up of public procurement will not begin to be felt before 1993, given the difficulties encountered in these areas.

2. The liberalization of financial services will have an impact from the end of 1990 onwards, since the proposals for Directives organizing the liberalization of banking and insurance services have been transmitted to the Council and in some cases already adopted, and the liberalization of capital movements should enter into force from July 1990 onwards.

GRAPH 4: **Total private investment — EUR 12 — Internal market effects**



[1] At constant 1980 prices (billion PPS).

3. Lastly, supply-side effects, i.e. the consequences of the reactions of firms to their new competitive environment, are assumed to come into play from 1988 onwards. Scrutiny of the strategic redeployments in progress in European firms clearly demonstrates that the latter are anticipating the effects of 1992 and have already modified their behaviour accordingly.[1]

The Commissions' Compact model has been used to evaluate, over the period 1989-93, the macroeconomic effects of the internal market scenario, which is based on relatively cautious assumptions, particularly as far as the opening-up of public procurement and supply-side effects are concerned.

[1] This is also the reason why it is assumed that some of the supply-side effects have already affected macroeconomic performance in 1988 and that only 50% of those effects come into play from 1989 onwards. Furthermore, the effects are spread over 10 years instead of the six years allowed for in the Cecchini Report simulations.

In order to estimate the impact of 1992 on private investment, the results of the internal market scenario are compared with those of a simulation excluding all 1992-related effects. The private investment flows obtained in both simulations are presented in Graph 4.

The gap between the two curves provides an estimate of the '1992 effect' on private investment. According to these results, completion of the internal market should boost private investment by 5,6% in 1993. The average annual growth of private investment during the period 1988-93 would be 6,3% in the internal market scenario as against 5,2% in the alternative one. It can therefore be concluded on the basis of such simulations that implementation of the 1992 programme and the resulting effects could bring about a one-point increase in the annual growth of private investment over the coming five years.

Study No 6

The Community as world trade partner

The Community as world trade partner

Tables

Summary

World imports and exports increased by a remarkable rate of 6 % per annum on average over the period 1982-88. In this dynamic world environment, the Community continues to be an active trading partner: its import increases were close to the world average. In the aggregate, this trend can be largely explained by increased final demand and lower increases in prices for imports than for domestic production. However, the Community is falling behind in terms of exports: extra-Community exports increased much less than world trade. A major explanatory factor for this is the decrease in imports of OPEC countries, of which the Community has been a major supplier. The Community is also losing export market shares. This can be largely explained by the loss of price competitiveness. Helped by the accession of Spain and Portugal, intra-Community trade expanded faster than world trade. Intra-EC exports have grown much more rapidly than extra-EC exports, raising the intra-EC-share of Community exports to more than 60 % in 1988. There are two major factors at play here. First, intra-EC exports of high-tech products increased strongly over the whole period and boomed in 1988. Secondly, there was a striking accession effect for Spain and Portugal.

1. Highlights

In a dynamic world environment, the Community continues to be an active trading partner but it is falling behind in terms of exports to third countries. Helped by the accession of Spain and Portugal, intra-Community trade expanded faster than world trade. These are the main findings of this study which analyses Community trade for the period 1982-88.[1]

A dynamic world environment. World imports and exports increased by a remarkable rate of 6 % per annum on average over the whole period; 1988 was an exceptional year with the strongest growth in world trade since 1976. Growth in imports and exports has been somewhat faster in the United States of America and Japan than in the EC. OPEC countries cut their imports back substantially; suffering from its debt, Latin America had a very low import growth. The trade of South-East Asian NICs expanded fastest; this is no surprise for exports, but it also holds true for imports. These trends in world trade are dealt with in Section 2.

The Community continues to be an active trading partner. The Community's import increases were close to the world average. In the aggregate, this trend can be largely explained by increased final demand and lower increases in prices for imports than for domestic production. On a disaggregated level, two specific growth factors emerge. The Community's trade in high-tech products was particularly dunamic; increases significantly above the average for all products can be observed. The growth of extra-Community imports of high-tech products was not matched by similar increases in extra-EC exports, a worrying development since it has halved the high-tech surplus of the Community with the rest of the world. The enlargement of the Community has also contributed to the high growth in imports; Spain and Portugal's extra-EC import increases were about twice as big as the Community average. Section 4 provides a fuller analysis of the Community as an importer; Member States' trade performance is dealt with in Section 5.

The Community is falling behind in terms of exports. Extra-Community exports increased much less than world trade. A major explanatory factor for this is the decrease in imports of OPEC countries of which the Community has been a major supplier. The Community is also losing export market shares. This trend can be largely explained by the loss of price competitiveness. However, for the year 1988, the particularly pronounced loss in export market shares cannot solely be caused by the change in price competitiveness: a reorientation of exports from the world towards the internal market would seem to have occurred. No conclusive answer can be given to the question of how this might be related to the completion of the internal market or to cyclical capacity constraints. The Community export performance is more fully analysed in Section 3.

Helped by the accession of Spain and Portugal, intra-Community trade expanded faster than world trade. Intra-EC

[1] A general methodological disclaimer is necessary. International trade data, though abundantly available generally speaking, contain significant inconsistencies when drawn from different statistical sources. This is especially the case for data concerning price (unit value) and volume developments. The analysis which follows is based on different sources. This implies that the conclusions based on them should only be taken as a broad description of trends.

exports have grown much more rapidly than extra-EC exports, raising the intra-EC share of Community exports to more than 60 % in 1988. There are two major factors at play here. First, intra-EC exports of high-tech products increased strongly over the whole period and boomed in 1988. Secondly, there was a striking accession effect for Spain and Portugal. Their intra-Community exports increased by about twice the Community average. Their intra-EC imports grew even faster, by about five times the Community average, thus making a significant contribution to the Community's rate of growth in intra-EC imports.

2. Trends in world trade

During the period 1982-88, the export volume of goods increased on average by 5,6 % per annum for the whole world; the corresponding figure for the import volume is 6,2 % (see Tables 1 and 2). For the years 1984 and 1988 these increases are considerably higher. Both in 1984 and in 1988 world imports grew by around 9 % in volume terms. In 1984, the main driving force behind world trade was the import surge in the United States of some 25 % in volume, stimulated by buoyant domestic demand and the high value of the dollar. The 1988 increase in world trade was more equally spread, with stimuli to trade originating mainly outside the United States.

While the Community's export[1] growth (4,5 % per annum on average over the period) has been 1,1 % lower than the world average, its imports (6,1 % increase) have risen in line with this average. Major winners in terms of export growth are the South-East Asian NICs (14 %) and Canada (7,8 %), whereas the OPEC countries' exports (3,4 %) increased much more slowly than the average. For imports, there is a dramatic decline for the OPEC (− 10 %). The South-East Asian NICs, Canada and the USA, on the other hand, experienced increases of more than 10 %.

For 1988, the export surge in the USA (20,5 %), and the fast rise in imports in the Pacific (Japan 16,6 %, South-East Asian NICs, 23 %) are noteworthy.

3. The Community's export performance

There are a number of factors determining the evolution of Community exports during the period 1982-88: the geographical composition, the commodity composition, export-price competitiveness or other factors such as supply effects or market integration effects. In the following analysis of exports, these factors are considered in order to obtain a broad picture of the structure of Community exports.

3.1. Main trends

There are remarkable differences between the trends of intra- and extra-Community export volumes over the 1980s (see Table 3). From 1982 to 1988, intra-EC export volumes increased on average by more than 5 % per annum, while extra-EC export volumes remained virtually stagnant.

Two factors play a role in this development: first, the evolution of domestic demand inside the Community was a stable one. Moreover, it was accompanied by smaller changes in relative price positions, reflecting the exchange-rate stability provided by the European Monetary System.

The relative stability inside the Community is in sharp contrast with the position of its exports to third countries. After decreasing in 1982 and 1983, the export volume to third countries followed the increase of world trade in 1984. The decline of the dollar almost halved this export growth in 1985, whereas it turned sharply negative (− 6 %) in 1986 and also declined, but to a lesser extent, in 1987. Only in 1988 have extra-Community exports picked up again, by 2 %, but this falls short of the growth in world trade of 9 % by a considerable amount.

As a consequence of the different movements in intra- and extra-Community exports, the intra-Community share of Community export volume, which stood at about 55 % in 1982, increased to approximately 62 % in 1988. The corresponding value share experienced a similar increase.

3.2. Analysis of extra-Community exports

Constant market share analysis

Europe remains a major world trading partner, but it is losing ground. Extra-Community exports of goods as a percentage of GDP at current prices, fell from 10,6 % in 1982, to 9,1 % in 1988. This compares, in 1988, to 6,6 % for the United States, and 9,0 % for Japan. Changes in exports may be broken down by means of a so-called constant market share analysis (CMSA) into four effects: a world

[1] The expression 'Community exports' is used to denote average (intra- plus extra-EC) exports of Community countries, and similarly for imports. In all other cases the distinction between intra- and extra-EC trade is made explicitly.

Table 1

Export volume of goods, 1982-88

(% average annual growth rates)

	1988/1982	1982	1983	1984	1985	1986	1987	1988[1]
BLEU	6,1	1,6	3,9	4,9	4,6	7,7	6,6	9,2
Denmark	4,6	-0,1	10,3	4,7	5,9	-1,9	2,8	6,0
FR of Germany	4,2	3,2	-0,3	9,0	6,9	0,9	2,8	6,2
Greece	9,8	1,7	12,6	21,0	0,9	17,3	2,6	6,1
Spain	5,9	6,3	7,2	16,7	2,4	-5,9	8,6	8,0
France	3,6	-3,7	3,4	5,5	2,2	-0,4	3,5	7,9
Ireland	11,0	7,3	11,9	18,6	7,1	3,5	14,6	10,8
Italy	4,5	-1,3	3,3	8,0	3,4	4,2	2,5	5,9
Netherlands	5,3	-1,0	5,0	6,6	5,0	2,6	4,4	8,2
Portugal	11,5	13,3	21,8	13,6	10,5	7,3	8,5	7,8
United Kingdom	3,0	1,8	0,8	8,1	6,3	-3,2	5,3	1,4
EC	4,5	0,8	2,7	8,0	5,0	1,0	4,2	6,3
OECD excl. EC	5,8	-4,5	1,7	11,8	3,4	1,8	5,2	11,3
United States	5,2	-10,3	-5,9	7,4	-1,5	2,9	10,1	20,5
Canada	7,8	-0,1	7,5	18,1	4,5	4,5	3,1	10,0
Japan	5,5	-2,0	8,5	15,7	5,7	-0,7	0,3	4,4
Australia	5,9	7,8	-4,7	21,9	10,0	2,6	7,3	0,5
Austria	5,8	1,3	4,1	9,0	11,7	-1,1	2,1	9,3
Finland	3,7	-1,4	3,3	9,6	1,2	-0,0	4,0	4,3
Norway	8,4	1,7	12,2	7,0	6,9	4,1	11,1	9,5
Sweden	5,4	3,7	12,5	8,1	3,7	1,9	3,9	2,8
Switzerland	4,2	-3,8	0,1	7,7	12,6	1,9	-3,2	6,8
Rest of OECD	9,1	13,5	8,4	14,2	10,5	0,0	14,7	7,4
Total OECD	5,2	-1,9	2,2	9,8	4,2	1,4	4,7	8,8
OPEC	3,4	-15,5	-8,6	-3,3	-3,9	3,7	29,6	7,0
Other developing	8,8	-6,4	11,1	9,3	6,4	0,8	14,8	10,7
— NICs	10,8	-2,5	6,1	13,5	5,5	9,4	17,4	13,3
— South-East Asian NICs	14,0	-0,2	7,2	15,7	4,8	16,7	24,4	16,3
— Other NICs	5,5	-5,4	4,6	10,4	6,6	-1,1	5,4	7,4
— Other LDCs	5,2	-12,1	19,1	3,5	7,8	-12,1	10,1	5,4
CPEs	5,4	4,6	15,3	3,4	-0,6	7,3	3,6	4,0
World	5,6	-3,7	3,5	7,9	3,4	2,0	8,3	8,5

[1] Provisional.
Source: Quest model.

Table 2

Import volume of goods, 1982-88

(% average annual growth rates)

	1988/1982	1982	1983	1984	1985	1986	1987	1988[1]
BLEU	5,8	0,7	−0,6	5,2	3,4	10,1	8,0	9,2
Denmark	3,9	0,1	3,9	7,3	9,8	5,4	−2,3	−0,1
FR of Germany	5,2	1,2	3,9	5,4	4,4	5,7	5,4	6,5
Greece	7,4	10,0	8,0	2,1	13,8	0,7	12,7	7,9
Spain	9,9	3,5	0,3	−0,9	6,6	17,4	23,5	14,5
France	5,0	3,4	−1,5	2,4	4,5	8,6	7,3	9,2
Ireland	4,9	−3,4	3,1	10,1	3,7	2,5	6,2	3,9
Italy	6,3	−2,0	−2,1	10,9	4,1	7,6	10,9	7,2
Netherlands	5,7	−0,2	2,9	6,9	7,8	3,5	5,7	7,4
Portugal	2,0	7,3	−7,5	−0,2	−10,8	−1,0	17,6	17,7
United Kingdom	8,1	3,4	6,4	9,0	3,9	9,8	6,9	13,0
EC	6,1	1,5	1,8	6,0	4,7	7,6	7,9	8,8
OECD excl. EC	8,8	−4,0	5,8	18,7	3,4	10,7	5,4	9,2
United States	10,2	−5,2	10,4	26,1	4,4	12,3	3,5	6,1
Canada	10,4	−17,7	10,8	18,9	5,9	8,8	4,0	14,5
Japan	7,8	−0,4	1,0	10,6	−4,3	14,5	10,0	16,6
Australia	3,5	7,9	−16,6	20,9	5,8	−3,6	1,2	18,1
Austria	6,2	−0,8	5,8	8,4	6,9	3,2	4,9	7,7
Finland	6,2	1,2	3,1	−0,1	6,5	6,3	13,4	8,4
Norway	3,4	6,5	−6,4	13,3	10,9	12,5	−1,2	−6,7
Sweden	5,4	4,9	2,7	5,3	9,1	3,2	8,0	4,5
Switzerland	6,8	−1,5	4,6	8,1	5,0	8,7	6,0	8,1
Rest of OECD	10,3	2,2	6,4	24,4	4,7	8,4	16,0	3,3
Total OECD	7,4	−1,2	3,7	12,3	4,0	9,2	6,6	9,0
OPEC	−10,0	8,7	−8,6	−11,0	−14,7	−19,1	−4,5	−1,0
Other developing	7,7	−10,3	3,9	7,6	11,4	2,0	8,3	13,5
— NICs	7,8	−4,8	−3,0	4,9	−0,1	12,8	17,3	17,0
— South-East Asian NICs	11,4	−1,9	−0,1	9,5	2,3	12,5	23,7	23,0
— Other NICs	2,2	−8,2	−6,8	−1,3	−3,8	13,3	7,1	5,9
— Other LDCs	7,5	−17,0	13,4	10,7	24,3	−7,7	−1,6	9,0
CPEs	4,5	2,0	12,7	3,1	4,2	−0,6	0,0	8,0
World	6,2	−1,9	3,4	8,8	4,1	5,6	5,9	9,4

[1] Provisional.

Source: Quest model.

Table 3

Export volume of goods by Member State (SITC 0-8), 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
BLEU	Intra	4,8	2,2	2,8	3,4	2,5	5,6	7,0	7,5	10,7	76,0
	Extra	4,4	0,0	4,7	10,8	4,3	−0,7	1,8	6,1	5,0	24,0
	World	4,4	0,6	3,4	5,4	2,7	3,4	5,6	5,9	8,4	100,0
Denmark	Intra	4,2	5,5	9,8	−4,8	6,2	3,4	4,6	6,7	2,2	48,3
	Extra	5,0	−3,6	10,5	13,6	4,3	−1,8	−1,0	5,1	3,4	51,7
	World	4,6	0,8	10,6	5,3	5,1	−0,1	1,3	5,9	2,7	100,0
FR of Germany	Intra	4,6	5,2	−0,9	8,1	5,4	3,3	4,9	7,1	27,9	53,0
	Extra	1,0	−0,7	−2,8	9,3	7,5	−3,9	−3,4	0,4	36,3	47,0
	World	2,9	1,6	−2,0	8,6	6,2	−0,8	1,1	4,6	31,3	100,0
Greece	Intra	12,6[2]	:	28,2	17,5	−4,1	31,6	−4,8	:	0,8	67,5
	Extra	0,3[2]	:	7,3	12,3	2,2	−3,7	−14,2	:	0,6	32,5
	World	6,8[2]	:	17,0	15,3	−1,0	13,9	−8,6	:	0,7	100,0
Spain	Intra	9,1[3]	:	:	:	:	7,3	7,1	13,1	4,0	59,9
	Extra	−6,9[3]	:	:	:	:	−18,0	−4,5	2,9	3,9	40,1
	World	2,7[3]	:	:	:	:	−3,7	3,1	9,1	4,0	100,0
France	Intra	6,9	−3,9	4,0	6,1	5,7	1,7	7,0	17,5	15,4	60,5
	Extra	0,4	−4,1	1,6	6,2	1,2	−12,2	−2,6	9,9	14,8	39,5
	World	4,0	−4,1	2,9	6,2	3,5	−5,0	2,9	14,4	15,2	100,0
Ireland	Intra	9,4	5,0	9,2	14,1	2,1	5,3	14,8	11,1	2,1	74,3
	Extra	7,5	6,0	16,3	15,6	12,0	−5,0	8,5	−0,2	1,1	25,7
	World	9,0	4,7	11,2	14,9	4,7	1,6	12,8	9,2	1,7	100,0
Italy	Intra	4,2	6,6	1,6	2,5	5,8	6,0	4,5	5,0	12,0	56,4
	Extra	−0,6	−7,0	1,2	7,3	5,3	−8,8	−4,7	−2,7	13,6	43,6
	World	1,8	−0,9	0,9	4,9	5,4	−1,9	0,1	1,7	12,6	100,0
Netherlands	Intra	6,1	−0,2	4,6	7,1	6,8	5,5	4,8	7,7	12,8	77,3
	Extra	3,8	−0,5	5,7	5,0	2,6	−4,2	2,8	11,7	5,5	22,7
	World	5,4	−1,5	5,1	6,5	5,6	3,8	4,4	7,2	9,8	100,0
Portugal	Intra	12,4[3]	:	:	:	:	15,2	12,9	9,1	1,2	71,9
	Extra	−0,4[3]	:	:	:	:	−6,9	1,5	4,4	0,7	28,1
	World	8,6[3]	:	:	:	:	7,6	9,7	8,5	1,0	100,0
United Kingdom	Intra	6,0	1,0	2,9	10,5	8,2	5,6	6,5	2,4	10,9	51,2
	Extra	−0,8	−0,3	−9,2	4,2	1,2	−0,9	0,7	−0,2	15,2	48,8
	World	2,6	0,9	−3,6	6,6	2,9	3,7	4,1	2,3	12,6	100,0
EC	Intra	5,5	2,2	2,5	6,6	5,6	4,7	5,8	7,9	100,0	59,5
	Extra	0,7	−2,0	−1,2	7,5	4,4	−5,9	−2,1	2,0	100,0	40,5
	World	3,4	−0,2	0,9	6,9	4,6	0,1	2,6	5,6	100,0	100,0

Source: Eurostat Trend, Comext. EC: until 1985: EUR 10.
The 1987 structure is with respect to the EC (first column) or world (second column).

[1] Provisional.
[2] 1987/1982.
[3] 1988/1985.

Note: Due to the statistical techniques used to derive the volume indices, the growth rates for trade with the world may lie outside the interval determined by the intra-EC and extra-EC growth rates.

trade effect, a product composition effect, a geographical distribution effect and a remainder which contains the effects of such diverse factors as price competitiveness or supply effects.

Table 4 contains such a breakdown for the export volumes of the Community (extra-EC trade), the United States and Japan over the period 1963-87. This table provides a global view of the structural factors explaining export volume growth of these three entities, leaving the content of residual factors to be explained.

It appears from the table that the Community has, except for the period 1973-81 and in 1985,[1] not been able to match the growth of world trade. Until 1973, this was due in small part to the geographical distribution of Community exports to third countries, but mainly explained by residual factors, while product composition exerted a small positive influence. After 1973, the latter factor became less positive and had a small negative influence from 1982 onwards. From 1973 to 1981, the geographical composition turned out to be slightly beneficial, whereas the negative effect of the remainder, though still present, was reduced compared to the decade before. Throughout the 1980s, these trends seem to have been reversed. The geographical spread of Community exports to third countries exerted a fairly strong negative influence, for instance in 1985-86 when Community exports were affected by the decrease in imports of OPEC and least developed countries. The effect of the remainder was positive until 1986, but became strongly negative in 1987. In what follows, the composition effects (product composition and geographical composition) and the effects of the remainder are further analysed.

Geographical structure and product specialization

The geographical structure of the value of extra-Community exports over the period 1973-87 shows considerable variation for manufactured products (see Table 5). Over the period 1982-87, the importance of the OECD as an export market for the Community increased by 15 percentage points, nearly matched (13 percentage points) by the reduced weight of the OPEC countries. The combined share of Japan and South-East Asian countries rose from 5,7 % in 1982 to 7,9 % in 1987; the export share of the USA increased from 13,7 to 20,1 %. Due to the small share of its exports to South-East Asian countries, the Community has not benefited much from their import surge (more than 20 % per annum) in 1987-88.

[1] It should be noted that for any other than year-to-year changes, the breakdown in growth rates does not add up to the total due to the use of average annual growth rates.

As regards product specialization, until 1985, the Community continued to specialize in products for which world demand was generally weak over the recent past[2] (see Table 6). Since 1986, this trend seems to have been reversed: the Community's specialization in products with strong or moderate demand growth now almost equals the average of the OECD countries. This favourable reorientation of the Community's export industry is, for instance, fairly pronounced in the car industry and even more for ships and aircraft.

Export volume market shares and price competitiveness

The shortfall of extra-Community exports with respect to the development of world trade can thus be explained in some part by composition effects. The effects of others variables, however, have been of equal importance. Table 7 compares an indicator of export market volume shares to one for price competitiveness for the Community, the United States and Japan. The market share indicator is defined, on the basis of aggregate trade data, as the difference between annual (extra-EC) export volume growth and the growth of weighted world demand. The competitiveness variable is defined as the difference between the growth rate of double-weighted export prices of competitors and the growth rate of the own export price. The two variables are therefore expected to be positively related: an improvement in price competitiveness should improve export volume market shares.

The table points to a continued loss of export volume market shares for the Community on third markets through the 1980s, with an average differential of more than 6 % between the annual growth of extra-Community export volumes and weighted market growth. From 1982 to 1984, this loss seems

[2] On the basis of a breakdown of industry into 14 branches, it is possible to compare and classify the branches in question according to the rate of growth of domestic demand. By considering the evolution of domestic demand in the OECD countries those branches can then be regrouped into three categories: strong, moderate, and weak demand sectors. Office machines, data-processing equipment, electrical and electronic equipment, chemicals and pharmaceuticals belong to the strong demand sectors (average annual increase higher than 5 %). The moderate demand group (average growth rate around 3 %) includes rubber, plastics, transport equipment, foodstuffs, paper, printing, industrial and agricultural machinery. Finally, the weak demand group (average growth below 2 %) includes metal products, miscellaneous industrial products, ferrous and non-ferrous metals, textiles, leather, non-metallic minerals. The definition of demand used is the following: domestic demand = domestic production intended for national markets + imports. This definition of domestic demand, or apparent consumption, is a far wider concept than final demand, since it also includes intermediate consumption. The period considered to establish the classification of branches was 1972-85. (For more detailed information see *European Economy* No 39, March 1989, Chapter 3).

Table 4

Constant market share analysis of export volume growth, 1963-87

(% average annual growth rates)

	1973/1963	1981/1973	1982	1983	1984	1985	1986	1987	1987/1982
Community									
World trade effect	9,5	3,9	−1,6	3,4	9,8	2,5	0,5	4,0	4,0
Product composition effect	0,7	0,1	−0,2	−0,7	−0,4	0,2	−0,1	−0,1	−0,2
Geographical distribution effect	−0,8	1,5	−1,7	−0,8	−0,7	−1,3	−4,5	−2,0	−1,9
Other effects (competitivity etc.)	−4,0	−1,2	1,6	0,3	0,1	3,4	1,9	−1,9	0,7
Total change in exports	7,8	4,3	−1,9	2,2	8,9	4,8	−2,3	−0,1	2,6
United States									
World trade effect	9,5	3,9	−1,6	3,4	9,8	2,5	0,5	4,0	4,0
Product composition effect	−0,1	0,4	0,0	−0,4	0,3	−1,0	0,0	0,6	−0,1
Geographical distribution effect	−2,5	0,4	−3,2	−2,0	0,8	−2,2	−0,3	1,9	−0,4
Other effects (competitivity etc.)	−0,4	1,1	−3,2	−7,6	−0,4	−10,5	2,2	6,8	−2,1
Total change in exports	8,2	5,3	−8,1	−6,5	10,5	−11,2	2,3	13,3	1,2
Japan									
World trade effect	9,2	3,9	−1,6	3,4	9,8	2,5	0,5	4,0	4,0
Product composition effect	0,6	0,1	0,0	−0,5	2,5	−0,3	−0,7	−0,4	0,1
Geographical distribution effect	−2,3	1,3	0,5	2,7	3,3	−0,3	−2,4	−2,4	0,2
Other effects (competitivity etc.)	8,0	4,3	−1,9	1,5	−1,0	2,0	0,2	−2,8	0,0
Total change in exports	13,3	8,2	−3,0	7,1	14,6	4,0	−2,4	−1,6	4,2

Source: Volimex databank.
Note: World trade effect is with respect to OECD trade.

Table 5

Geographical distribution of the Community's industrial exports (extra-EC)

(%)

	1973	1979	1982	1983	1984	1985	1986	1987
OECD	57,1	48,0	42,5	45,4	49,6	52,4	55,9	57,3
USA	17,6	13,3	13,7	15,7	19,5	21,0	20,8	20,1
Japan	3,2	2,6	2,3	2,6	2,7	2,7	3,2	3,9
EFTA	24,9	22,8	20,0	20,6	20,3	20,9	24,1	25,6
Rest of OECD	11,4	9,2	6,4	6,5	7,2	7,9	7,7	7,7
East-European countries	8,7	8,1	6,2	6,6	5,8	5,7	5,5	5,4
Developing countries	28,6	38,3	43,7	39,8	37,0	34,0	30,1	27,9
of which: Latin America	6,2	6,3	5,4	4,4	4,3	4,2	4,4	4,4
South-East Asia	3,1	3,8	3,4	3,6	3,6	3,5	3,5	4,0
Africa (excluding OPEC)	4,9	4,2	6,2	5,4	5,5	4,9	4,5	4,5
OPEC	8,9	16,8	21,6	19,0	16,3	13,7	10,6	8,7
Rest of the world	5,6	5,6	7,6	8,3	7,7	7,9	8,5	9,5
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: Volimex databank.

Table 6

Export specialization indices, 1973-87

(manufacturing products = 1)

	1973	1979	1980	1981	1982	1983	1984	1985	1986	1987
Community (extra-EC)										
Agriculture	0,38	0,40	0,45	0,48	0,46	0,47	0,51	0,59	0,58	0,55
Energy	0,83	0,84	0,83	0,94	0,91	0,86	0,81	0,79	0,78	0,85
Manufacturing	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00
— Strong demand	1,01	0,98	0,97	0,94	0,94	0,95	0,93	0,96	0,97	0,96
— Moderate demand	1,01	0,99	1,01	0,99	0,99	0,97	0,96	0,94	0,95	0,97
— Weak demand	0,98	1,04	1,02	1,07	1,09	1,12	1,16	1,16	1,14	1,11
Total	0,94	0,95	0,96	0,97	0,97	0,97	0,96	0,97	0,98	0,98
United States										
Agriculture	2,96	2,91	2,83	2,59	2,61	2,61	2,67	2,32	2,10	2,09
Energy	0,90	0,73	0,66	0,66	0,81	0,69	0,65	0,69	0,89	0,82
Manufacturing	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00
— Strong demand	1,13	1,19	1,18	1,16	1,22	1,23	1,26	1,22	1,24	1,24
— Moderate demand	1,21	1,16	1,12	1,14	1,11	1,11	1,09	1,12	1,09	1,07
— Weak demand	0,58	0,57	0,65	0,57	0,54	0,53	0,50	0,48	0,49	0,52
Total	1,17	1,11	1,09	1,08	1,08	1,07	1,09	1,06	1,07	1,10
Japan										
Agriculture	0,12	0,05	0,05	0,04	0,05	0,05	0,04	0,05	0,05	0,05
Energy	0,06	0,05	0,05	0,04	0,03	0,03	0,03	0,03	0,04	0,06
Manufacturing	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00
— Strong demand	1,17	1,15	1,14	1,15	1,14	1,20	1,23	1,22	1,25	1,27
— Moderate demand	0,88	0,96	0,99	0,98	0,96	0,97	0,97	0,99	1,00	1,00
— Weak demand	1,04	0,92	0,88	0,87	0,92	0,81	0,75	0,72	0,64	0,60
Total	0,90	0,88	0,87	0,86	0,86	0,86	0,86	0,87	0,90	0,90

Source: Volimex databank; export share in OECD exports (including intra-EC trade) by product divided by average for manufactured products.

Table 7

Gains in export volume market shares and price competitiveness, 1960-88

(% average annual growth rates)

	1973/1960	1981/1973	1982	1983	1984	1985	1986	1987	1988[1]	1988/1982
Community										
Gain in market shares	−2,2[2]	0,2	−3,0	−5,7	−8,8	−0,6	−9,9	−3,9	−11,2	−6,1
Gain in price competitiveness	−0,4[2]	2,8	−0,6	−1,2	2,5	−5,3	−20,9	−11,9	−1,3	−5,3
United States										
Gain in market shares	−1,5	−0,0	−4,9	−7,3	−0,6	−8,1	−0,2	6,1	6,2	−0,8
Gain in price competitiveness	0,5	1,0	−6,1	−7,1	−4,1	−2,1	5,7	6,4	0,2	−0,1
Japan										
Gain in market shares	8,4	3,0	1,3	0,4	−7,1	−3,2	−8,2	−1,6	−2,4	−3,7
Gain in price competitiveness	1,5	2,4	3,4	−2,4	−1,8	−1,6	−15,9	−2,0	−5,7	−4,8

Sources: Eurostat Trend, Volimex databank and Quest model.
[1] Provisional.
[2] 1973/1963.
Note: Gains in export volume market shares are defined as the difference between the average annual growth of export volume (for the Community: extra-EC) and weighted world import volume (for the Community: extra-EC). Gains in price competitiveness are defined as the difference between the average annual growth of double-weighted competitors' export prices (for the Community: extra-EC) and the export price (for the Community: extra-EC).

to have hardly any relationship with the price competitiveness of the Community, which improved on average. This implies that other factors must have played a dominant role. The loss of price competitiveness in the wake of the fall of the dollar seems to have had some (lagged) influence on volume market shares, however. The 1988 loss of volume market shares of more than 11 %, on the other hand, can only be partly explained by the Community's export price position, implying that other, possibly supply-related, factors could have exterted some influence. In this context one could think of a European version of a phenomenon well-known in the United States and some European countries, whereby a high degree of utilization of production capacities (as presently observed) trends to have a negative effect on exports. Transposed to the Community, this might imply a two-tier system where high degrees of capacity utilization would affect intra-Community exports less than extra-Community exports, since the Community market is more integrated than the world market.

For the United States and Japan, the relationship between export volume shares and price competitiveness seems to be more stable than that for the Community, thus highlighting the possibility of structural changes inside the Community.

3.3. Export trends for high-tech and other products

Product categories

The present decade has not only been characterized by considerable differences in the growth of intra- and extra-Community export volumes, but also by equally diverse trends among product categories (see Table 8). Quite remarkably, intra-Community export volume growth rates have been consistently positive for each category of manufactured products from 1984 onwards, contrary to the developments for extra-Community exports, which mostly declined in 1986 and 1987. The table also shows how the 1984 export boom for each product category excluding fuels was led by extra-Community exports. This is in sharp contrast to the export volume surge in 1988, when intra-Community exports in manufactured goods, for instance, increased by 10 % compared to 2 % for extra-Community exports.

High-tech

Export volume trends for high-tech products show that for the whole period 1982-88 the dynamic development of their intra-Community exports (8,3 % annual average) was remarkable (see Table 9); their extra-Community exports, on the other hand, increased by a much lower 1,9 %.

Moreover, the 1988 intra-Community trade expansion was clearly fuelled by trade in high-tech products, for which intra-Community exports increased by more than 20 %. Among the chemical high-tech products, both pharmaceuticals and plastics expanded strongly inside the Community in 1988, by 13 % and 27 % respectively, with the extra-Community trade for plastics also increasing significantly, by 18 %. Among machinery and equipment goods, intra-Community exports of power equipment,[1] specialized machinery and electrical machinery all expanded by around 17 %, ships and aircraft even increasing by almost 100 %. For computers, telecommunication equipment and consumer electronics, the 1988 increase in intra-Community exports, though still sizeable with rates of growth of 7,5 and 9 %, fell short of the growth of the other categories. As will be seen below, intra-Community exports of these products were faced with strongly expanding extra-Community imports in 1988. Moreover, the extra-Community export growth of these products, together with specialized machinery, was virtually zero in 1988 or decreased markedly, as for telecommunication and consumer electronics products, which decreased by 14 %. For professional/scientific and photo/optical equipment, intra-Community exports increased in line with the average for equipment goods in 1988. For these categories, extra-Community exports, with increases of 8 to 9 %, moved along with average world trade. The conclusion seems to emerge that for sensitive high-tech sectors such as computers, telecommunication and consumer electronics, the Community, firstly, seems to be concentrating on its own market, but, secondly, even in its own market is losing part of its market shares. In the markets of third countries, the loss of volume shares seems even more pronounced for these products. Given the possible presence of supply constraints, this may be a temporary phenomenon, which nevertheless deserves attention as the completion of the internal market proceeds.

4. The Community as an importer

4.1. Main trends

During the period 1982-88, the Community's final demand has grown at an annual average rate of 2,9 %, compared to 1,4 % during the 1974-81 period. In fact, since 1982 the

[1] As may be seen from Table 15, the 1988 growth rate of the intra-EC import volume of power generating equipment is negative. This points to statistical uncertainties concerning this particular category.

Table 8

Community export volume by SITC groupings, 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988 [1]	Structure (1987)	
SITC 0+1	Intra	4,2	4,1	2,1	7,1	4,8	5,8	3,5	2,2	12,3	71,6
Food, beverages	Extra	0,8	−5,7	1,0	8,6	3,4	−9,3	2,5	−0,4	7,1	28,4
and tobacco	World	3,1	0,1	1,6	7,8	4,3	0,5	2,8	1,6	10,2	100,0
SITC 2+4	Intra	5,9	−0,8	8,8	4,0	7,6	−0,5	8,4	7,4	3,8	71,1
Raw	Extra	4,6	−6,9	7,9	9,8	5,1	−7,1	9,7	3,1	2,3	28,9
materials	World	5,3	−2,9	9,4	6,0	6,7	−2,9	8,1	5,0	3,2	100,0
SITC 3	Intra	0,6	−1,9	10,4	7,3	5,8	−1,7	−4,9	−11,8	4,9	71,6
Fuels	Extra	−1,6	6,6	−2,3	−2,4	0,4	4,8	−7,2	−2,7	2,8	28,4
	World	0,0	0,2	4,8	3,6	3,8	−1,6	−4,1	−6,0	4,1	100,0
SITC 5-8	Intra	5,7	2,7	0,9	6,6	5,5	5,0	6,9	9,8	73,4	56,7
Manufactured	Extra	0,4	−2,4	−1,7	8,1	4,5	−7,0	−2,8	2,2	81,5	43,3
products	World	3,2	−0,1	−0,4	7,4	4,5	−0,9	2,6	6,5	72,7	100,0
SITC 5	Intra	6,5	5,6	5,4	8,8	6,2	3,6	6,5	8,7	10,8	58,2
Chemicals	Extra	3,2	0,2	8,2	8,2	4,9	−6,6	0,9	4,5	11,2	41,8
	World	5,4	1,2	7,3	9,0	5,7	−0,5	4,3	6,6	10,9	100,0
SITC 6	Intra	4,6	−0,8	1,7	6,9	3,3	4,1	4,3	7,7	18,6	60,2
Basic	Extra	0,1	−6,1	−0,4	8,2	0,7	−9,3	−0,7	2,8	17,9	39,8
manufacturing	World	2,6	−3,6	0,9	7,3	2,1	−2,4	2,3	5,9	18,3	100,0
SITC 7	Intra	5,7	4,1	−1,7	5,6	6,4	4,3	8,0	12,3	32,4	54,8
Machinery and	Extra	−1,5	−2,5	−6,4	6,0	4,2	−7,5	5,6	1,3	39,0	45,2
equipment	World	1,9	0,5	−4,5	5,6	4,2	−2,0	1,5	7,0	35,1	100,0
SITC 8	Intra	6,3	2,4	1,7	6,2	5,9	9,2	8,6	6,3	11,7	55,8
Other	Extra	4,4	3,0	3,6	16,1	10,8	−4,5	−1,0	2,6	13,4	44,2
manufacturing	World	5,6	2,6	2,7	11,0	8,3	2,5	4,1	5,0	12,4	100,0
SITC 0-8	Intra	5,5	2,2	2,5	6,6	5,6	4,7	5,8	7,9	94,5	59,5
Total excluding	Extra	0,7	−2,0	−1,2	7,5	4,4	−5,9	−2,1	2,0	93,7	40,5
products n.e.s.	World	3,4	−0,2	0,9	6,9	4,6	0,1	2,6	5,6	94,2	100,0
SITC 0-9	Intra									100,0	59,3
Total	Extra									100,0	40,7
	World									100,0	100,0

Source: Eurostat Trend, Comext. Until 1985: EUR 10. Classification used: SITC Rev. 2. The 1987 structure is with respect to SITC 0-9 (first column) or with respect to world (second column).
[1] Provisional.
Note: See Table 3.

Table 9

Community export volume of high-technology categories, 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
SITC 54	Intra	5,9	5,5	3,0	6,7	8,1	3,3	1,5	13,3	4,6	43,0
(Medicine and	Extra	1,3	1,1	0,8	7,1	3,3	−2,5	−3,7	2,8	7,1	57,0
pharmaceuticals)	World	3,4	2,2	1,6	7,4	5,1	−0,5	−1,4	8,3	5,6	100,0
SITC 58	Intra	11,6	6,5	10,7	7,9	8,9	7,8	8,6	27,0	14,3	67,1
(Plastics	Extra	6,0	−1,4	11,7	8,0	3,4	−4,4	1,0	17,8	8,2	32,9
etc.)	World	10,0	1,3	11,0	8,0	6,9	3,2	6,0	26,1	11,3	100,0
SITC 71	Intra	1,7	−3,9	−8,2	1,5	5,1	−3,0	−0,5	16,9	7,8	44,3
(Power	Extra	−2,0	−4,6	−10,8	−0,9	1,5	−8,1	−4,2	9,9	11,4	55,7
equipment)	World	−0,9	−4,4	−9,8	0,8	2,6	−6,6	−3,0	12,5	9,1	100,0
SITC 72	Intra	4,4	0,1	−5,3	4,5	5,4	0,3	5,1	17,5	14,1	42,9
(Specialized	Extra	−3,4	−10,3	−14,1	3,2	5,9	−5,2	−10,2	0,5	21,9	57,1
machinery)	World	−0,4	−7,2	−11,5	3,7	5,7	−3,2	−4,4	8,9	17,0	100,0
SITC 75	Intra	14,1	9,7	15,9	26,9	11,7	5,3	19,1	7,4	17,6	70,3
(Computers	Extra	12,4	11,8	17,1	35,6	19,0	−0,2	5,0	1,6	8,6	29,7
etc.)	World	13,7	10,6	16,0	30,3	14,2	3,0	14,8	5,9	12,9	100,0
SITC 76	Intra	8,0	0,5	0,3	4,3	9,3	14,5	11,4	9,1	6,6	53,2
(Telecom and	Extra	−3,2	4,4	−9,8	6,0	6,2	−8,4	2,5	−13,6	6,7	46,8
cons. elect.)	World	1,8	2,2	−4,6	3,1	6,9	1,9	6,4	−2,1	6,7	100,0
SITC 77	Intra	8,9	6,8	2,1	11,2	8,8	6,9	6,4	18,7	19,2	57,3
(Electrical	Extra	4,4	5,9	0,2	7,6	6,6	−0,8	−0,5	13,9	16,6	42,7
machinery)	World	6,2	6,2	0,9	9,6	7,5	2,8	3,2	13,8	18,4	100,0
SITC 79	Intra	2,3	22,9	−27,7	13,3	−14,1	−19,9	3,6	96,3	5,5	47,6
(Ships,	Extra	−0,9	1,0	3,9	11,5	−25,3	−24,1	−3,8	49,5	7,0	52,4
aircraft)	World	−1,3	10,6	−8,9	14,5	−23,4	−21,2	1,6	44,1	8,1	100,0
SITC 87	Intra	8,8	4,2	2,4	10,9	13,0	8,3	6,7	11,7	6,3	46,2
(Professional and	Extra	7,7	3,3	3,1	19,1	20,4	−3,4	0,2	8,8	8,6	53,8
scientific equipment)	World	8,3	3,5	2,7	16,0	17,2	1,1	3,0	10,7	7,1	100,0
SITC 88	Intra	6,0	1,4	1,1	6,9	6,7	1,2	9,7	11,0	3,9	53,9
(Photo and	Extra	5,4	5,2	4,2	15,6	9,1	−6,2	2,9	7,7	3,9	46,1
optical equipment)	World	6,2	3,0	2,3	11,8	7,6	0,0	6,2	9,6	3,9	100,0
Total	Intra	8,3	5,5	2,2	11,0	7,5	3,8	8,3	20,2	100,0	53,7
High-	Extra	1,9	0,0	−1,8	9,7	5,4	−5,5	−2,5	9,0	100,0	46,3
technology	World	4,9	2,5	0,0	10,6	5,5	−1,4	3,1	13,9	100,0	100,0

Source: Eurostat Trend, Comext. Until 1985: EUR 10. Classification used: SITC Rev. 2. The 1987 structure is with respect to the total for high-tech products (first column) or world (second column).

[1] Provisional.

Note: See Table 3.

Table 10

Comparison of Community imports and final demand, 1960-88

(% average annual growth rates)

	1973/1960	1981/1973	1982	1983	1984	1985	1986	1987	1988	1988/1982
Volumes										
Final demand (including stocks)	4,9	1,4	0,9	1,1	1,8	2,3	3,9	4,0	4,4	2,9
Imports of goods (intra + extra)	9,0	2,3	1,6	2,1	6,8	5,0	6,6	8,1	9,1	6,3
Imports of goods (SITC 0-8)[1]										
— Intra-EC	:	:	2,0	3,4	6,1	6,5	4,4	6,3	7,3	5,7
— Extra-EC	:	:	−2,5	0,8	4,7	2,4	6,2	6,7	10,5	4,9
Deflators										
Final demand (including stocks)	5,1	12,8	9,9	8,2	7,0	5,7	3,7	3,5	3,8	5,3
Imports of goods (intra + extra)	2,7	13,7	6,7	3,1	7,6	2,8	−13,8	−3,1	1,8	−0,5

Source: Commission services.
[1] Source: Eurostat Trend, until 1985: EUR 10.

Community's final demand has progressively accelerated, recording, in 1988, an annual rate of growth of 4,4 %. As shown in Table 10, the increase in Community imports (intra plus extra) was considerably bigger than the rate of increase in final demand: during the period 1982-88 the former rose, on average, twice as fast the latter (6,3 % against 2,9 %). After a major slowdown in the early 1980s, Community imports (in volume terms) have recovered well, and in 1988 they rose by 9,1 %.

A country's final demand is met either by domestic production or by imports. The choice of the economic agents between Community-produced and foreign products is largely based on criteria such as price, quality, capacity constraints and technological content. With regard to relative prices, it can be seen (Table 10) that after the 1974-81 period, during which the price of final demand (i.e. domestic plus imported goods) increased on average less rapidly than for imported goods (12,8 % against 13,7 %), the price differential between imported and domestic goods widened substantially over the following period (1982-88) in favour of imports (whose average price decreased annually by −0,5 % against an increase of 5,3 % for final demand). The price gap became larger in 1986 and 1987 as a consequence of the oil-price fall and the dollar depreciation. Although in 1988 the price differential narrowed, import volumes continued to accelerate, suggesting that non-price factors are also playing an important role in determining the relative competitiveness of imports.

Although the largest share (some 59 % in 1987) is still represented by intra-EC imports, during the last three years extra-EC imports have been increasing more rapidly than those from within the Community. Thus, it would appear that, prima facie, the implementation of the internal market programme has not penalized extra-EC imports but has instead contributed actively to the growth of world trade.

4.2. Rising penetration rates

The competitive situation on the home market is illustrated by the long-term evolution of import penetration in the Community, the United States and Japan (see Table 11). Whereas, in the former two, import penetration has increased since the early 1960s (from 8,8 and 2,8 % of GDP in 1963 in the Community and the USA, respectively, to 9,6 and 9,5 % in 1988), in the case of Japan it has considerably decreased (from 9,6 to 5,7 %). Moreover, the EC and the USA tend to import a larger share of manufactured goods compared to Japan. The integration of the former two economies into the world economy, therefore, has progressed much more rapidly than in the case of Japan, whose economy appears to be relatively less open than 25 years ago. The fall in oil prices combined with the dollar depreciation are the main factors behind the halt observed in 1986-87 in the import penetration rate for the Community. In fact this result appears to be mainly due to price changes, since the Community import volumes have continued to increase at a sustained rate (see Table 10).

Table 11

Imports as a percentage of GDP

(% current prices)

	Community[1]		USA		Japan	
	Manufacturing	Total goods	Manufacturing	Total goods	Manufacturing	Total goods
1963	4,9	8,8	1,9	2,8	4,7	9,6
1964	5,2	8,9	2,0	2,9	4,9	9,6
1965	5,2	8,8	2,2	3,0	4,2	8,9
1966	5,2	8,6	2,5	3,3	4,3	9,0
1967	4,9	8,2	2,5	3,3	4,8	9,4
1968	5,3	8,5	2,9	3,7	4,4	8,8
1969	5,6	8,8	3,0	3,8	4,5	8,7
1970	5,8	8,8	3,2	4,0	5,0	9,3
1971	5,2	8,4	3,4	4,2	4,3	8,5
1972	5,1	8,0	3,7	4,6	3,9	7,7
1973	5,7	8,9	4,0	5,2	4,8	9,2
1974	6,4	12,1	4,7	6,9	5,5	13,5
1975	5,5	10,3	4,0	6,1	4,3	11,6
1976	6,0	11,5	4,4	6,9	4,2	11,5
1977	6,0	11,2	4,6	7,5	3,7	10,2
1978	5,9	10,4	5,6	8,2	3,3	8,1
1979	6,3	11,2	5,6	8,8	4,3	10,9
1980	6,7	12,5	5,7	9,3	4,6	13,2
1981	6,5	12,9	5,6	9,0	4,1	12,0
1982	6,4	12,5	5,4	8,1	4,2	12,0
1983	6,6	12,0	5,7	8,0	4,0	10,6
1984	7,2	12,8	6,8	9,1	4,2	10,7
1985	7,2	12,5	7,1	9,1	3,9	9,5
1986	6,7	9,7	7,5	9,1	3,1	6,1
1987	6,7	9,3	7,7	9,4	3,4	6,1
1988[2]	:	9,6	:	9,5	:	5,7

Source: BDS, Commission services.
[1] Extra-EC imports.
[2] Estimates.

By looking at the developments of import penetration rates in the three major blocs, according to the product demand pattern,[1] their relative performance can be further highlighted (Table 12). Whereas import penetration has increased in all product categories — namely strong, moderate and weak demand sectors — in the Community and the United States, the opposite occurred in Japan where a decline was observed in all product groups. The Community's increased dependency on imports of industrial products as a whole hides a wide range of situations, according to the sector of activity concerned: relative stagnation of the penetration rate in weak and moderate demand sectors, and a sharp increase in the penetration rate in strong demand sectors. The slowdown observed in 1986 is likely to be related to relative price movements (dollar depreciation), rather than to any structural inversion in the underlying trend. Thus, the Community shows a growing propensity to import products, often characterized by a high technological content, for which there is strong demand (between 1979 and 1986 the import penetration rate increased by 6 percentage points to 13 %), while in the more traditional branches, where demand is moderate or weak, the Community's imports from the rest of the world tend to grow less rapidly (+1,2 and 1,3 percentage points, respectively).

[1] See footnote 2, p. 206.

4.3. Geographical origin of Community imports

About two thirds of the Community's imports of manufactured goods are supplied by the industrialized countries, whose share of the Community market has fluctuated only marginally over the last 15 years. Within this group, the major suppliers are the USA, Japan and the EFTA countries

Table 12

Import penetration rates by product demand category

(%, current values)

	1973	1979	1980	1981	1982	1983	1984	1985	1986	Difference 1979/1973	Difference 1986/1979
Industry total											
EUR 7[1]	8,7	10,4	11,1	11,3	11,4	11,9	13,1	13,1	11,6	+1,7	+1,2
USA	6,3	8,7	9,3	9,5	9,6	10,0	11,7	12,3	:	+2,4	+3,6[2]
Japan	4,9	5,1	5,2	4,9	5,2	4,9	5,1	4,8	4,2	+0,2	−0,7
Strong demand											
EUR 7[1]	10,0	13,0	14,1	15,9	16,7	17,4	19,5	19,9	19,0	+3,0	+6,0
USA	6,3	9,3	9,8	10,2	10,7	12,2	14,6	15,0	:	+3,0	+3,0[2]
Japan	4,2	5,1	4,9	4,7	5,1	4,9	5,1	4,9	4,4	+0,9	−0,7
Moderate demand											
EUR 7[1]	7,1	7,7	8,1	8,6	8,5	8,7	9,6	9,7	8,9	+0,6	+1,2
USA	5,9	7,7	8,3	8,3	8,2	8,3	9,5	10,3	:	+1,9	+2,6[2]
Japan	4,0	4,3	4,6	4,3	4,2	4,3	4,3	4,1	3,6	+0,3	−0,7
Weak demand											
EUR 7[1]	10,0	12,5	13,4	12,4	12,4	13,1	13,9	13,8	11,6	+2,4	1,3
USA	6,9	9,8	10,3	10,8	11,3	11,4	13,4	13,9	:	+2,9	+4,1[2]
Japan	5,8	5,7	5,9	5,4	6,0	5,6	5,8	5,4	4,5	−0,1	−1,2

Sources: Volimex databank, Commission services.
[1] In the case of EUR 7, this applies to extra-Community trade.
[2] 1985/1979.
Note: The sectors are divided into those for which, between 1972 and 1985, demand in the OECD countries increased by more than 5% (strong demand), around 3% (moderate demand), or less than 2% (weak demand).

(60 % of the total in 1987). During the 1980s the Japanese share of the Community market increased noticeably (by 5 percentage points to 14,3 % in 1987), while at the same time that of the USA declined by almost the same amount and that of EFTA increased slightly (see Table 13). The relative stability of the developing countries' share is the result of the increased share of South-East Asian newly industrializing producers and the loss of ground of Latin American and African countries.

The USA and, increasingly, Japan play a dominant role (52,2 % of the total) in the strong demand sectors, where the South-East Asian countries are also progressing rapidly (8,3 % of the total in 1987, from 3,2 % in 1973). The share of USA and Japan tends to become less important as one moves towards moderate (35,2 %) and, especially, weak demand products (10,7 %), where instead the role of developing countries as major suppliers of the Community market becomes more relevant (in 1987 they accounted for almost one-third of the Community's weak demand imports).

4.4. Imports for high-tech and other products

Trends by product category

The sustained growth of the Community's imports since 1984 has been mainly led by the manufacturing sectors (SITC 5-8), which account for more than two thirds of total EC imports (see Table 14). Within manufacturing, import demand has stemmed particularly from machinery and equipment (SITC 7: + 12,9 % in 1988), the largest component (accounting for some 43 % of total imports of manufactures in 1987), and to a lesser extent from the other subsectors. During the period 1986-88 extra-Community imports of manufactured goods have grown more rapidly (by 10,5 % on average) than intra-Community imports (+ 7,0 %), confirming an increased degree of integration in the world economy.

Table 13

Structure and geographical distribution of the Community's industrial imports (extra-EC)

(%)

	1973	1979	1982	1983	1984	1985	1986	1987
Total industry								
OECD	65,7	64,5	66,4	66,7	65,3	65,8	67,7	66,5
USA	21,8	21,6	23,7	22,8	22,5	22,1	19,9	18,8
Japan	6,9	8,6	10,7	11,6	11,6	12,1	14,5	14,3
EFTA	26,5	25,8	25,2	25,8	24,6	25,0	26,9	26,8
Rest of OECD	10,5	8,5	6,9	6,5	6,6	6,6	6,4	6,6
East-European countries	7,0	6,0	5,2	4,9	4,9	4,7	4,8	4,5
Developing countries	20,3	20,8	20,7	20,6	20,6	20,1	18,9	19,4
of which: Latin America	6,9	5,9	5,9	5,7	5,6	5,5	4,6	4,2
South-East Asia	4,7	7,2	5,9	6,1	6,1	5,7	6,1	7,0
Africa (excluding OPEC)	4,8	2,9	3,6	3,5	3,6	3,5	2,9	2,7
OPEC	1,5	1,6	1,5	1,6	1,4	1,6	1,4	1,3
Rest of the world	7,0	8,7	7,7	7,7	9,2	9,4	8,6	9,6
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Strong demand								
OECD	86,9	82,2	80,2	80,9	79,1	78,8	78,5	76,8
USA	40,3	38,2	37,9	37,0	37,5	36,3	31,3	29,6
Japan	14,2	15,6	18,0	19,8	19,1	19,8	22,6	22,6
EFTA	28,3	25,4	21,5	21,5	19,9	20,1	22,1	21,9
Rest of OECD	4,0	3,1	2,7	2,7	2,7	2,6	2,6	2,7
East-European countries	4,3	4,0	3,6	3,2	3,0	2,9	2,7	2,4
Developing countries	7,2	11,6	10,4	10,7	11,3	11,2	11,4	13,1
of which: Latin America	1,9	1,9	1,7	1,7	1,6	1,6	1,3	1,2
South-East Asia	3,2	6,9	5,3	5,4	6,3	5,9	6,7	8,3
Africa (excluding OPEC)	0,4	0,4	0,5	0,5	0,5	0,5	0,4	0,3
OPEC	0,4	0,6	0,7	0,7	0,7	1,0	0,9	0,9
Rest of the world	1,5	2,2	5,9	5,1	6,6	7,0	7,4	7,7
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Moderate demand								
OECD	71,1	71,9	72,4	71,0	70,5	70,9	76,8	75,9
USA	26,0	23,4	25,3	23,4	22,0	21,6	20,4	18,9
Japan	6,0	10,5	11,9	12,7	13,1	13,2	16,9	16,3
EFTA	29,2	29,6	27,5	27,9	28,8	29,8	33,1	34,2
Rest of OECD	9,8	8,5	7,8	6,9	6,7	6,3	6,4	6,5
East-European countries	5,5	4,6	3,4	3,3	3,4	3,4	3,5	3,4
Developing countries	18,7	17,4	16,8	17,5	17,8	17,2	14,4	13,5
of which: Latin America	10,5	8,0	8,2	8,2	8,4	8,2	6,6	6,2
South-East Asia	1,8	2,8	2,2	2,8	2,6	2,3	2,3	2,1
Africa (excluding OPEC)	3,2	3,3	2,8	2,7	3,3	2,9	2,3	2,2
OPEC	1,5	1,5	1,8	1,8	1,4	1,8	1,3	1,1
Rest of the world	4,7	6,2	7,4	8,2	8,3	8,5	5,4	7,2
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
Weak demand								
OECD	50,9	47,9	49,1	50,4	47,1	47,5	47,4	46,3
USA	9,3	10,3	10,1	9,7	8,6	8,1	7,6	7,3
Japan	4,1	2,9	3,5	3,4	3,1	3,2	3,6	3,4
EFTA	23,4	22,9	26,0	27,6	25,1	25,3	25,8	24,7
Rest of OECD	14,1	11,8	9,6	9,6	10,3	10,8	10,4	10,9
East-European countries	9,6	8,4	8,2	7,9	8,2	7,9	8,4	7,8
Developing countries	27,8	29,1	33,2	32,3	32,1	32,0	31,2	31,9
of which: Latin America	6,2	6,5	7,1	6,7	6,9	6,9	6,1	5,3
South-East Asia	7,9	11,0	10,0	9,7	9,3	8,7	9,2	10,5
Africa (excluding OPEC)	8,2	4,0	7,0	6,9	7,0	7,2	6,3	5,7
OPEC	2,0	2,3	2,0	2,1	1,9	1,9	2,0	2,0
Rest of the world	11,7	14,5	9,5	9,5	12,6	12,6	13,0	14,0
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: Volimex databank.

Table 14

Community import volume by SITC groupings, 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
SITC 0+1	Intra	5,0	5,7	2,9	4,3	10,2	4,2	4,1	4,6	12,6	65,2
Food, beverages	Extra	1,5	2,3	−1,3	0,7	2,6	−0,8	5,2	2,8	9,6	34,8
and tobacco	World	3,5	4,1	1,1	2,7	7,0	2,0	4,2	4,0	11,4	100,0
SITC 2+4	Intra	5,4	0,9	9,3	5,5	7,1	0,1	7,4	3,4	4,2	38,6
Raw	Extra	1,7	−1,4	1,4	1,7	3,7	−1,2	4,1	0,5	9,5	61,4
materials	World	2,8	−0,9	3,5	2,6	4,8	−0,9	5,2	1,7	6,4	100,0
SITC 3	Intra	2,0	−1,3	9,2	10,0	7,5	−2,1	−1,8	−9,3	4,9	30,0
Fuels	Extra	−1,0	−6,0	−6,7	0,8	−0,1	−1,3	0,1	1,5	16,5	70,0
	World	−0,4	−4,8	−2,7	3,3	2,0	−2,5	0,0	−2,0	9,7	100,0
SITC 5-8	Intra	5,7	1,9	2,3	5,7	5,6	5,0	7,3	8,7	75,9	65,1
Manufactured	Extra	7,6	−0,8	2,9	9,0	2,8	8,2	9,1	14,2	58,4	34,9
products	World	6,1	1,0	1,8	7,2	4,0	5,4	7,7	10,7	68,7	100,0
SITC 5	Intra	6,7	2,7	7,7	9,2	5,6	5,5	5,4	6,9	12,3	73,4
Chemicals	Extra	7,0	0,2	5,7	12,1	6,0	5,2	5,3	7,8	6,4	26,6
	World	6,9	2,1	7,5	10,2	6,1	5,3	5,5	7,0	9,8	100,0
SITC 6	Intra	5,2	−1,4	3,2	6,4	3,5	3,6	6,5	8,1	18,9	65,6
Basic	Extra	5,9	3,3	1,0	9,9	−0,2	9,6	3,6	12,0	14,2	34,4
manufacturing	World	4,9	0,1	1,0	7,4	1,7	5,4	5,1	9,3	17,0	100,0
SITC 7	Intra	5,2	4,2	−0,3	3,9	6,7	4,1	7,6	9,7	32,9	65,2
Machinery and	Extra	7,9	−3,2	3,2	8,6	4,3	4,9	8,8	18,0	25,2	34,8
equipment	World	5,8	1,9	0,4	6,1	4,5	3,1	8,0	12,9	29,7	100,0
SITC 8	Intra	6,6	1,7	0,8	6,0	6,4	9,1	9,1	8,4	11,9	57,4
Other	Extra	9,3	−2,5	2,5	6,6	1,9	15,3	18,7	11,9	12,7	42,6
manufacturing	World	7,7	−0,1	1,5	6,5	4,3	11,2	12,9	10,1	12,2	100,0
SITC 0-8	Intra	5,7	2,0	3,4	6,1	6,5	4,4	6,3	7,3	97,6	59,8
Total excluding	Extra	4,9	−2,5	−0,8	4,7	2,4	6,2	6,7	10,5	94,0	40,2
products n.e.s.	World	4,9	−0,2	0,9	5,4	4,0	4,3	6,5	8,6	96,1	100,0
SITC 0-9	Intra									100,0	58,9
Total	Extra									100,0	41,1
	World									100,0	100,0

Source: Eurostat Trend, Comext. Until 1985: EUR 10. Classification used: SITC Rev. 2. The 1987 structure is with respect to SITC 0-9 (first column) or with respect to world (second column).
[1] Provisional.
Note: See Table 3.

Import growth in the other sectors, namely foodstuffs (SITC 0 + 1), raw materials (SITC 2 + 4) and, especially, mineral fuels (SITC 3) has lagged behind. In fact, since 1986 the level of mineral fuel imports has actually declined in volume terms. As to the distinction between intra- and extra-Community sources of import supply, it can be seen that for foodstuffs (SITC 0 + 1) and manufacturing (SITC 5-8) almost two-thirds of the Community's imports concern intra-EC trade; for raw materials (SITC 2+4) this is almost 40 %, whereas, as expected, the corresponding share falls considerably to less than one third in the case of mineral fuels (SITC 3).

High-tech products

High-tech products account for more than one-third of total imports of manufactures in the Community. Between 1982 and 1988, imports of high-tech products have recorded a remarkable growth (+7,7 % annual average increase, see Table 15), outpacing the corresponding rate for total manufacturing (+6,1 %). In 1988 there has been a strong acceleration in the Community's imports of high-tech products: particularly in the case of ships and aircraft (+64 %), plastics (+23 %), specialized machinery (+19 %) and electrical

Table 15

Community import volume of high-technology categories, 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
SITC 54	Intra	6,1	1,4	7,6	7,0	8,4	3,5	−0,4	10,9	4,7	62,8
(Medicine and	Extra	5,6	0,2	8,0	3,7	7,2	4,7	0,6	9,5	4,0	37,2
pharmaceuticals)	World	5,8	1,0	7,8	5,7	7,9	3,9	−0,3	10,5	4,3	100,0
SITC 58	Intra	11,0	3,7	11,0	9,1	8,8	8,8	7,3	21,8	15,2	82,4
(Plastics	Extra	11,3	2,0	8,3	13,6	9,7	7,5	3,7	26,3	4,8	17,6
etc.)	World	11,2	3,4	10,7	9,7	9,1	8,7	6,6	22,9	10,9	100,0
SITC 71	Intra	−0,7	−0,7	−9,2	1,0	7,7	1,6	2,5	−6,8	8,0	54,6
(Power	Extra	5,5	7,2	4,5	−3,5	0,5	−0,2	9,0	25,2	9,8	45,4
equipment)	World	1,8	3,0	−3,4	−0,4	4,3	−0,6	4,8	6,2	8,6	100,0
SITC 72	Intra	5,1	0,3	−4,9	7,4	5,2	0,6	5,6	17,9	13,8	69,7
(Specialized	Extra	4,8	−10,5	−5,6	5,0	2,8	−0,1	8,1	20,5	8,8	30,3
machinery)	World	5,0	−3,4	−4,9	6,8	4,4	0,1	6,3	18,9	11,5	100,0
SITC 75	Intra	13,2	10,0	16,5	21,8	14,4	1,8	15,3	10,4	16,5	53,7
(Computers	Extra	14,0	4,0	17,1	26,1	2,7	2,0	19,6	18,6	20,8	46,3
etc.)	World	13,6	7,2	17,1	24,7	8,0	1,6	17,1	14,6	17,9	100,0
SITC 76	Intra	8,6	−2,4	4,4	4,6	8,7	13,1	8,9	12,2	6,7	41,3
(Telecom +	Extra	8,9	−11,8	7,6	−5,9	3,9	12,0	21,0	17,2	14,0	58,7
cons. elect.)	World	8,5	−7,9	6,1	−2,4	5,6	11,9	15,8	15,0	9,7	100,0
SITC 77	Intra	7,6	4,5	2,7	9,5	7,5	6,5	4,0	16,2	19,7	62,1
(Electrical	Extra	9,9	5,2	3,1	20,2	3,3	4,6	9,8	19,8	17,6	37,9
machinery)	World	8,4	4,7	3,3	15,3	5,1	4,9	5,6	17,0	19,0	100,0
SITC 79	Intra	3,7	26,8	6,1	−16,0	−8,7	−16,7	3,8	76,9	4,9	55,7
(Ships,	Extra	7,1	−21,9	1,1	−1,9	19,3	−9,4	−15,4	66,7	5,7	44,3
aircraft)	World	−0,8	6,8	−2,9	−4,8	−11,3	−25,8	−4,8	64,3	6,2	100,0
SITC 87	Intra	6,9	4,9	0,3	8,8	10,3	7,7	8,1	6,6	6,4	53,7
(Professional and	Extra	6,1	−0,5	0,8	6,1	6,0	3,2	8,2	13,0	8,1	46,3
scientific equipment)	World	6,6	2,3	0,7	8,3	8,1	5,1	7,9	9,7	6,9	100,0
SITC 88	Intra	5,1	1,5	−0,9	4,4	10,0	2,5	9,2	6,1	4,0	47,8
(Photo and	Extra	7,2	−3,1	2,3	5,5	6,2	6,8	17,0	5,9	6,5	52,2
optical equipment)	World	6,0	−1,1	0,7	5,1	7,8	4,3	12,6	5,9	4,9	100,0
Total	Intra	7,7	4,7	4,4	8,5	8,1	3,4	7,0	15,9	100,0	59,4
high-technology	Extra	9,0	−1,5	6,1	9,8	4,7	3,6	11,4	20,9	100,0	40,6
	World	7,7	2,2	4,8	9,7	5,4	2,4	8,3	17,9	100,0	100,0

Source: Eurostat Trend, Comext. Until 1985: EUR 10. Classification used: SITC Rev. 2. The 1987 structure is with respect to the high-tech total (first column) or with respect to world (second column).
[1] Provisional.
Note: See Table 3.

machinery (+17%). Although in almost all high-tech branches intra-EC imports account for a larger share than imports from outside the Community, during the 1986-88 period, with the noticeable exception of ships and aircraft (SITC 79), extra-EC imports have tended to progress more rapidly than their intra-EC counterparts, pointing to an increased dependency on third country suppliers for those products characterized by high technological content. The relative loss of ground of Community producers is particularly apparent for power equipment (SITC 71) for which in 1988 extra-EC imports rose by some 25 % whereas at the same time intra-EC imports declined by about 7 %.[1]

[1] See footnote 1, p. 209.

Table 16

Import volume of goods by Member State (SITC 0-8), 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
BLEU	Intra	4,4	0,0	5,5	3,9	5,4	3,2	8,6	0,0	10,8	72,7
	Extra	2,9	0,1	−9,4	4,6	−7,8	14,6	1,8	16,3	6,0	27,3
	World	3,5	0,0	−0,1	4,5	0,5	5,4	6,3	4,4	8,9	100,0
Denmark	Intra	2,8	3,7	0,3	5,1	12,5	5,7	−4,2	−1,8	2,5	54,7
	Extra	3,8	1,5	5,9	8,1	4,4	8,0	−2,4	−0,9	3,1	45,3
	World	3,1	2,1	2,4	6,8	8,9	6,3	−3,4	−1,7	2,7	100,0
FR of Germany	Intra	4,9	0,9	6,8	5,1	5,3	5,9	3,9	2,5	21,7	55,2
	Extra	5,1	−3,3	1,6	3,2	3,1	8,0	6,0	8,8	26,2	44,8
	World	4,6	−1,2	4,2	3,8	3,9	5,5	5,0	5,3	23,5	100,0
Greece	Intra	3,2[2]	:	6,7	4,8	6,4	4,9	−6,0	:	1,4	61,1
	Extra	−0,2[2]	:	0,5	7,4	13,7	−13,4	−6,7	:	1,4	38,9
	World	1,9[2]	:	3,3	6,3	10,1	−2,6	−6,5	:	1,4	100,0
Spain	Intra	25,1[3]	:	:	:	:	30,8	24,8	19,9	4,6	55,0
	Extra	14,2[3]	:	:	:	:	10,3	14,3	18,2	5,6	45,0
	World	19,1[3]	:	:	:	:	18,4	19,6	19,4	5,0	100,0
France	Intra	5,8	5,1	−1,7	4,7	4,4	5,2	7,4	15,5	18,8	65,9
	Extra	4,7	−3,8	−6,8	−0,9	2,0	9,1	7,3	19,1	14,4	34,1
	World	5,0	0,5	−4,2	2,1	3,3	6,3	7,4	16,5	17,0	100,0
Ireland	Intra	2,9	−4,6	0,5	6,5	0,9	5,1	−1,3	5,7	1,7	71,4
	Extra	5,5	−1,8	4,2	12,8	0,0	4,1	11,5	0,9	1,0	28,6
	World	3,6	−3,9	2,0	9,0	0,6	3,3	2,2	4,6	1,4	100,0
Italy	Intra	4,9	−1,9	−2,0	9,6	9,9	−0,5	8,4	4,7	12,6	58,6
	Extra	2,5	−2,5	−1,6	3,6	5,1	−5,1	10,8	3,0	13,2	41,4
	World	3,5	−2,4	−1,9	6,4	7,5	−3,6	9,0	4,1	12,9	100,0
Netherlands	Intra	5,3	0,5	2,5	7,6	11,4	0,7	3,0	7,0	10,6	61,7
	Extra	7,9	−2,4	5,3	10,2	5,0	11,7	6,5	8,9	9,8	38,3
	World	6,1	−0,9	4,0	9,0	8,0	4,0	4,1	7,5	10,2	100,0
Portugal	Intra	29,2[3]	:	:	:	:	27,9	32,6	27,2	1,5	63,5
	Extra	11,0[3]	:	:	:	:	10,2	11,3	11,5	1,3	36,5
	World	21,4[3]	:	:	:	:	18,4	23,9	21,8	1,5	100,0
United Kingdom	Intra	7,2	7,1	9,5	7,7	5,4	1,0	5,0	15,0	13,7	53,3
	Extra	6,4	−3,0	2,4	8,8	0,4	5,3	6,2	15,8	17,9	46,7
	World	5,8	2,0	2,6	8,0	1,2	2,5	5,7	15,5	15,4	100,0
EC	Intra	5,7	2,0	3,4	6,1	6,5	4,4	6,3	7,3	100,0	59,8
	Extra	4,9	−2,5	−0,8	4,7	2,4	6,2	6,7	10,5	100,0	40,2
	World	4,9	−0,2	0,9	5,4	4,0	4,3	6,5	8,6	100,0	100,0

Source: Eurostat Trend, Comext. EC: until 1985: EUR 10.
The 1987 structure is with respect to the EC (first column) or world (second column).

[1] Provisional.
[2] 1987/1982.
[3] 1988/1985.

Note: Due to the statistical techniques used to derive the volume indices, the growth rates for trade with the world may lie outside the interval determined by the intra-EC and extra-EC growth rates.

5. Member States' trade performance

So far, the trade performance of the Community as a whole has been analysed. This section looks into the differences between Member States in the development of exports and imports during the period 1982-88.[1]

5.1. Exports and price competitiveness

Intra- and extra-Community trade

Considerable differences in export performance between Member States can be observed for intra-EC trade and even more so for extra-EC trade (see Table 3). Concerning intra-EC trade, Ireland showed a remarkable performance with an increase of 9,4 % per annum on average over the period 1982-88; it was followed by France (6,9 %), compared to a Community average of 5,5 %. On the other hand, Italy, Denmark (both 4,2 %) and Germany (4,6 %) lost ground in terms of their intra-Community export share.

The accession of Greece, Spain and Portugal has been followed by high rates of growth in intra-Community exports for these countries: 12,6 % for Greece (1983-87); 12,4 % for Portugal and 9,1 % for Spain (both 1986-88).

In 1988, the export performance of France (17,5 %), Spain (13,1 %), Ireland (11,1 %) and Portugal (9,1 %) contrasts sharply with that of the UK (2,4 %) and Italy (5,0 %).

Concerning extra-EC trade, Ireland, Denmark and the Benelux countries show between 3 and 7 percentage points stronger growth than the average; whereas extra-EC exports declined slightly for the UK and Italy. The development of extra-EC exports for Spain and Portugal (-6,9 % and -0,4 % per annum for 1986-88) is in remarkable contrast to their intra-EC performance. After accession, the enterprises of these countries quite clearly redirected their export activity to the Community's internal market. This was particularly pronounced in the first year of accession and diminished thereafter: the differential between intra-EC and extra-EC trade evolving as follows: 25,3 % for Spain and 22,1 % for Portugal in 1986, 11,6 %/14,4 % in 1987 and 10,2 %/4,7 % in 1988.

[1] For some Member States, trade data are incomplete. For Greece, some figures for 1982 and 1988 are not available; for Spain and Portugal, some data are lacking for the years before their accession, i.e. 1982-85.

Since 1986, export volume growth in all Member States (with the exception of the Netherlands) has been higher for intra-EC trade than extra-EC trade. This is in contrast to the previous three-year period when several Member States such as the BLEU, Denmark, Germany and Ireland, relied more on extra-EC trade.

Export volume market shares and price competitiveness

The evolution of a country's exports may be ascribed to 'normal' factors such as demand and price competitiveness, but also to 'structural' factors such as trade integration or supply effects. The 'normal' factors may be analysed by comparing the export volume market share growth of individual Member States to their price competitiveness (see Table 17). If the former has increased despite a deterioration in the latter, this implies (apart from statistical uncertainties), that structural effects may have exerted some influence. This can be clearly illustrated for the UK, Spain, Portugal and Greece by reference to their accession to the Community.

For the UK, over the period 1960-73, the average annual export volume growth was 2,8 percentage points lower than the growth of its relevant export markets. Over the period 1974-81 the loss of export volume market share decreased to 1,7 %, while, at the same time, its export price performance deteriorated. This is likely to be a sign of the positive integration effects of the United Kingdom joining the Community. For Greece, the market share during the period 1974-81 increased by only 0,4 % per annum despite an improvement in its price competitiveness of 3,5 %. After its accession, the situation reversed for the years 1982-84: its market share increased by more than 10 % on average per year, with price competitiveness improving less than in the years before. For the Iberian countries, similar integration effects are visible as well. Between 1986 and 1988, the Spanish competitive position deteriorated by 18 % while its market volume share even improved by 2 %. Similarly, Portugal experienced a loss of competitiveness of 16 %, and improved its market volume share by a remarkable 18 %.

5.2. Divergencies in imports

The differences between Member States in the development of their imports are at least as big as for exports (see Table 16). For Spain and Portugal, the accession effect is again clearly visible. Intra-Community imports have risen even more steeply than exports by 29,2 % per annum on average for Portugal during 1986-88 and 25,1 % per annum for Spain. This has led to a very significant deterioration in their intra-Community trade balance. The industrialization

Table 17

Gains of Member States in export volume market shares and price competitiveness, 1960-88

(% average annual growth rates)

	1973/1960	1981/1973	1982	1983	1984	1985	1986	1987	1988[1]	1988/1982
Gain in market shares										
BLEU	2,0	−0,2	1,8	−1,2	−4,1	−0,4	5,2	1,7	0,3	0,2
Denmark	0,1	1,0	0,6	3,3	−9,5	0,7	−3,6	1,6	−1,1	−1,5
FR of Germany	0,2	0,8	4,5	−4,2	−3,4	1,6	−3,9	0,9	−2,2	−2,1
Greece	4,3	0,4	5,0	12,9	12,9	−3,7	16,7	−0,3	−1,1	5,9
Spain	3,9	1,6	10,4	3,4	5,3	−5,3	−5,1	7,2	0,2	0,8
France	1,2	1,5	−0,0	−2,0	−4,8	−4,8	−0,1	0,1	−0,3	−2,0
Ireland	1,8	6,0	6,0	5,6	5,9	3,4	−2,2	11,3	1,0	4,1
Italy	2,8	1,9	1,4	−0,0	−4,4	−1,6	1,8	0,9	−1,4	−0,8
Netherlands	1,4	−0,2	0,5	−1,0	−1,6	−0,7	0,2	0,9	−0,3	−0,4
Portugal	1,2	0,8	16,5	15,6	−1,3	4,6	9,3	5,5	2,3	5,9
United Kingdom	−2,8	−1,7	3,2	−3,2	−4,4	0,4	−7,6	1,8	−3,7	−2,8
Gain in price competitiveness										
BLEU	0,6	3,9	3,9	−0,6	1,8	−0,6	−8,1	−3,1	0,3	−1,7
Denmark	−0,2	4,0	0,4	0,5	2,0	−2,4	−15,6	−6,6	2,8	−3,0
FR of Germany	−1,5	4,7	−1,2	−1,6	5,0	−2,3	−22,8	−8,4	0,3	−4,6
Greece	−0,1	3,5	−2,8	2,6	8,2	4,6	3,8	−2,3	−2,4	2,5
Spain	0,2	−0,5	1,7	5,8	−5,2	−2,3	−9,0	−5,4	−5,2	−3,4
France	−0,4	4,1	2,2	0,2	−0,2	−3,9	−14,0	−5,1	−0,1	−3,7
Ireland	−0,1	3,7	−1,8	−0,1	2,9	−2,2	−6,4	0,1	−2,0	−1,2
Italy	0,8	1,9	−0,6	−0,5	2,7	−1,2	−11,8	−6,1	1,0	−2,5
Netherlands	0,2	1,4	−1,5	2,3	1,9	−0,6	−3,7	0,3	1,3	0,3
Portugal	−2,0	4,3	7,9	4,7	−2,6	−1,1	−6,4	−7,4	−2,8	−2,5
United Kingdom	0,4	−0,8	3,2	1,8	2,9	−3,5	−0,1	−6,0	−4,2	−1,5

Source: Quest model. (For definitions, see Table 7).
[1] Provisional.

process of both countries has also been accompanied by high growth rates for extra-Community imports: 14,2 % for Spain and 11,0 % for Portugal.

For the rest of the Community, the high average increase during 1982-88 of intra-EC imports to the UK (7,2 %) and the import surges in 1988 for the UK (15 %) and France (15,5 %) are remarkable. On the other hand, Ireland imported relatively little more from the Community (2,9 % per annum), a sharp contrast to its outstanding export performance.

Extra-Community imports have risen fast during 1982-88 for the Netherlands (7,9 %) and for the UK (6,4 %), whereas the growth in Italy (2,5 %) was particularly low. For Greece, there was even a decline (-0,2 % per annum) during the period for which data exist (1983-87).

In 1988, divergencies in import growth (for intra- as well as extra-EC imports) are particularly pronounced. On the one hand, there are surges of 15 to 20 % for intra- and/or extra-EC imports for France, Spain, Portugal and the UK. For Belgium/Luxembourg there is a strong discrepancy between intra-EC imports, which stagnated, and extra-EC imports growing by 16,3 %. On the other hand, intra- and extra-EC imports declined for Denmark (-1,8/-0,9 %). With total import increases of 4 to 5 % compared to a Community average of 8,6 %, Germany, Ireland and Italy experienced a relatively slow growth in imports.

Germany and Italy had below-average growth rates for imports and exports (equally for intra- and extra-EC trade) on average over the period 1982-88 as well as for 1988.

5.3. Equipment goods as trade engine

It was shown above that the buoyancy of intra-Community trade in 1988 was, to a considerable extent, due to the trade in equipment goods, which represents approximately one-third of intra-EC trade. Tables 18 and 19 provide a breakdown by Member States of intra- and extra-EC volume growth of imports and exports of equipment goods over the period 1982-88. Extra-Community exports of equipment goods declined for the Community as a whole by 1,4 % per annum; the decline affected several Member States in a similar way, Greece and Spain with declines of 23 % and 6 % being exceptional. Ireland and the Netherlands were not affected by the average decline, their exports rose by 7 and 5 %. Intra-Community exports showed an improvement led by Portugal (17,5 %), Ireland (11,9 %), Spain (9,1 %), the Netherlands (8,7 %), France (8,6 %) and Greece (8,5 %). Again, a relatively poor performance on the part of Germany (3,8 %) can be observed.

Imports of equipment goods have shown increases in the order of 30 % per annum for Spain and Portugal. Most other countries' imports have grown by 4 to 8 % per annum; Greece showing a steady decline of more than 4 % and Ireland (2,4 %) and Belgium/Luxembourg (0,9 %), particularly low increases.

It appears that the strong growth of trade in equipment goods in 1988 is due to relatively few countries, Spain, France, Portugal and the United Kingdom each importing 20 % more in volume. While this provided a strong impetus to intra-Community trade in equipment goods, extra-Community imports increased even faster for these countries, the exception being Portugal, whose extra-EC share is relatively small (some 25 %) compared to the Community average, which is about one-third.

More than 90 % of intra-Community exports of equipment goods are provided by the six original members plus the United Kingdom. These seven countries have, however, benefited in an uneven way from the 1988 surge in intra-EC trade of equipment goods. For the BLEU and Germany, intra-EC exports of equipment goods increased by a modest 5 to 7 % compared to the average of 12 %. Italy, Portugal and the United Kingdom more or less followed the average, while Spain, France, Ireland and the Netherlands increased their intra-EC exports by almost 20 % or more. Particularly for Germany, which supplies more than one-third of intra-EC exports, this is a remarkable result. It can be partly explained by the geographical composition of its intra-Community exports of equipment goods, of which about 30 % (1987 figure) go to Belgium, Denmark and the Netherlands, whose intra-EC imports of equipment goods either decreased (Belgium and Denmark) or increased only slightly (The Netherlands) in 1988. Exactly the opposite phenomenon occurred for France, whose export markets in Spain, Portugal and the United Kingdom, together representing some 30 % (1987 figure) of intra-EC exports of equipment, all increased their intra-EC imports by more than 20 %.

From these data it appears that the 1988 boom in intra-EC trade in equipment goods was spread unevenly across both importers and exporters. Noteworthy are the relatively small contribution of Germany to the supply of this trade and the fact that the continuing process of industrialization in the Iberian countries has led to a surge not only in imports but also in exports of equipment goods. Nonetheless, equipment goods accounted for 85 % (Spain) and 100 % (Portugal) of their 1988 intra-EC trade deficit.

Table 18

Export volume of equipment goods (SITC 7), 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
BLEU	Intra	3,1	6,1	−1,4	−3,0	8,5	1,6	9,0	4,7	9,5	78,1
	Extra	1,1	2,7	−1,7	1,6	14,6	−1,6	−4,1	−1,0	3,2	21,9
	World	2,6	4,9	−1,7	−1,7	9,8	0,3	6,0	3,4	6,6	100,0
Denmark	Intra	4,8	−2,5	7,0	−3,3	17,5	−0,3	7,3	1,8	1,5	43,9
	Extra	1,7	−5,4	4,8	10,6	5,3	−8,4	−9,2	9,1	2,3	56,1
	World	2,7	−4,4	5,1	5,5	9,7	−5,7	−3,1	5,6	1,9	100,0
FR of Germany	Intra	3,8	9,2	−5,5	7,6	5,7	3,3	5,3	6,8	38,3	49,7
	Extra	−1,7	0,0	−8,4	8,1	8,6	−4,9	−7,0	−5,4	46,9	50,3
	World	0,9	3,9	−7,1	7,8	6,9	−1,5	−1,0	1,0	42,2	100,0
Greece	Intra	8,9[2]	:	−8,5	61,9	−9,7	22,8	−8,5	:	0,1	57,5
	Extra	−23,0[2]	:	−10,4	−33,9	40,9	−33,2	−51,5	:	0,0	42,5
	World	−11,3[2]	:	−10,3	−8,2	15,4	−11,6	−34,8	:	0,1	100,0
Spain	Intra	9,1[3]	:	:	:	:	2,6	4,0	21,6	4,4	71,7
	Extra	−5,9[3]	:	:	:	:	−24,8	−2,0	12,9	2,1	28,3
	World	4,5[3]	:	:	:	:	−6,7	2,7	19,4	3,3	100,0
France	Intra	8,6	7,1	4,0	3,6	5,5	5,1	9,1	25,7	15,3	56,0
	Extra	−1,4	0,7	−2,6	5,1	−6,8	−11,5	−6,6	16,2	14,6	44,0
	World	3,2	−2,4	−0,3	4,6	−1,9	−3,9	1,4	21,0	15,0	100,0
Ireland	Intra	11,9	9,4	13,7	19,5	−6,2	6,6	21,5	18,8	2,1	75,5
	Extra	6,8	49,6	24,0	15,7	14,4	−11,8	3,3	−0,5	0,8	24,5
	World	11,2	13,2	16,3	19,9	−1,0	0,3	18,1	15,6	1,5	100,0
Italy	Intra	6,7	8,9	4,1	−0,3	8,8	10,3	7,2	10,4	12,1	54,9
	Extra	−0,4	−10,4	1,7	4,0	5,8	−6,4	−6,5	−0,1	12,0	45,1
	World	3,0	−3,2	2,4	2,3	6,6	0,9	0,4	5,6	12,0	100,0
Netherlands	Intra	8,7	3,6	−0,9	8,4	6,9	6,4	11,3	21,3	6,2	66,4
	Extra	4,9	−7,8	8,3	4,1	2,0	−4,4	−3,3	25,5	3,8	33,6
	World	5,6	−1,8	2,4	7,2	4,0	1,4	4,6	14,6	5,1	100,0
Portugal	Intra	17,5[3]	:	:	:	:	9,9	32,6	11,3	0,7	80,6
	Extra	−0,3[3]	:	:	:	:	5,3	−10,3	4,9	0,2	19,4
	World	13,1[3]	:	:	:	:	7,8	22,3	9,7	0,5	100,0
United Kingdom	Intra	7,1	−2,7	−5,0	12,7	8,0	2,4	11,6	14,0	10,0	46,3
	Extra	−3,9	−5,6	−17,0	3,2	3,4	−11,2	0,3	−0,3	14,0	53,7
	World	−0,2	−2,7	−11,9	5,0	−0,4	−4,6	6,0	5,8	11,8	100,0
EC	Intra	5,7	4,1	−1,7	5,6	6,4	4,3	8,0	12,3	100,0	54,8
	Extra	−1,4	−2,5	−6,4	6,0	4,2	−7,5	−5,6	1,3	100,0	45,2
	World	1,9	0,5	−4,5	5,6	4,2	−2,0	1,5	7,0	100,0	100,0

Source: Eurostat Trend, Comext. EC: until 1985: EUR 10.
The 1987 structure is with respect to the EC (first column) or world (second column).
[1] Provisional.
[2] 1987/1982.
[3] 1988/1985.
Note: Due to the statistical techniques used to derive the volume indices, the growth rates for trade with the world may lie outside the interval determined by the intra-EC and extra-EC growth rates.

Table 19

Import volume of equipment goods (SITC 7), 1982-88

(% average annual growth rates)

		1988/1982	1982	1983	1984	1985	1986	1987	1988[1]	Structure (1987)	
BLEU	Intra	−0,9	2,2	−4,0	1,9	6,4	4,7	6,5	−18,6	10,0	75,8
	Extra	6,4	−7,7	1,6	1,8	4,6	12,0	8,8	9,9	6,0	24,2
	World	0,9	−0,5	−2,4	2,2	5,6	6,1	6,9	−12,0	8,6	100,0
Denmark	Intra	5,8	17,8	7,2	14,1	18,8	11,1	−10,5	−2,9	2,6	61,5
	Extra	2,0	−7,1	−6,2	12,1	21,7	9,1	−13,9	−6,4	3,1	38,5
	World	4,3	5,5	1,2	13,4	20,0	10,2	−11,9	−4,0	2,8	100,0
FR of Germany	Intra	3,0	7,4	5,7	1,6	2,3	4,7	4,8	−0,7	18,5	53,7
	Extra	8,6	−4,5	6,5	10,2	7,7	9,3	7,5	10,3	29,8	46,3
	World	5,1	1,4	5,6	5,1	4,6	4,8	6,1	4,4	22,4	100,0
Greece	Intra	−4,0[2]	:	−0,8	0,2	8,4	−4,5	−20,6	:	1,1	61,7
	Extra	−4,5[2]	:	−4,0	24,9	−11,9	−10,8	−15,8	:	1,2	38,3
	World	−4,3[2]	:	−2,4	10,9	−1,0	−7,1	−19,5	:	1,1	100,0
Spain	Intra	27,8[3]	:	:	:	:	21,4	38,1	24,4	6,4	72,6
	Extra	29,1[3]	:	:	:	:	23,4	24,5	40,1	4,5	27,4
	World	28,0[3]	:	:	:	:	21,8	33,8	28,7	5,7	100,0
France	Intra	6,9	6,6	−8,0	1,4	5,1	8,4	9,8	27,6	19,6	73,5
	Extra	9,8	3,8	−4,5	−0,9	8,0	2,7	11,3	50,4	13,2	26,5
	World	7,8	5,6	−6,9	1,1	6,4	6,6	10,0	33,2	17,4	100,0
Ireland	Intra	1,8	−9,8	−0,2	10,4	−1,9	−0,3	−1,7	4,8	1,4	55,6
	Extra	2,9	−1,5	1,2	22,5	−0,3	−13,4	19,7	−7,3	2,0	44,4
	World	2,4	−5,7	2,5	16,3	−2,6	−6,2	6,0	−0,1	1,6	100,0
Italy	Intra	4,1	−8,1	−14,2	11,7	7,1	1,9	12,4	8,2	13,4	73,3
	Extra	3,7	−9,7	−10,4	21,6	0,7	−8,4	17,7	4,8	9,1	26,7
	World	4,0	−8,6	−12,8	15,7	5,1	−1,4	12,9	7,4	11,9	100,0
Netherlands	Intra	5,0	−1,8	3,7	9,2	14,1	0,3	−0,8	4,0	9,5	67,1
	Extra	9,3	1,8	14,6	10,9	−0,8	10,7	7,2	14,1	8,7	32,9
	World	6,0	−0,8	7,3	10,7	7,9	2,3	1,2	6,6	9,2	100,0
Portugal	Intra	33,3[3]	:	:	:	:	23,1	35,4	42,1	1,9	76,7
	Extra	22,9[3]	:	:	:	:	13,6	40,6	16,2	1,1	23,3
	World	29,9[3]	:	:	:	:	18,3	36,2	35,9	1,6	100,0
United Kingdom	Intra	7,2	13,9	12,4	0,9	7,8	−2,9	5,8	20,7	15,7	58,0
	Extra	8,4	−4,9	10,5	7,2	1,3	1,7	6,8	24,6	21,3	42,0
	World	6,2	7,4	6,9	4,5	0,1	−3,8	7,0	24,3	17,6	100,0
EC	Intra	5,2	4,2	−0,3	3,9	6,7	4,1	7,6	9,7	100,0	65,2
	Extra	7,9	−3,2	3,2	8,6	4,3	4,9	8,8	18,0	100,0	34,8
	World	5,8	1,9	0,4	6,1	4,5	3,1	8,0	12,9	100,0	100,0

Source: Eurostat Trend, Comext. EC: until 1985: EUR 10.
The 1987 structure is with respect to the EC (first column) or world (second column).

[1] Provisional.
[2] 1987/1982.
[3] 1988/1985.

Note: Due to the statistical techniques used to derive the volume indices, the growth rates for trade with the world may lie outside the interval determined by the intra-EC and extra-EC growth rates.