**Proposal for a Council Decision adopting the annual economic report 1990/91 on the economic situation in the Community and determining the economic policy orientation for the Community in 1991 — Revision**

(91/C 190/02)

*COM(91) 185 final*

*(Submitted by the Commission on 24 May 1991)*

THE COUNCIL OF THE EUROPEAN COMMUNITY,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Decision 90/141/EEC of 12 March 1990 on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union, and in particular Article 4 thereof [1],

Having regard to the proposal of the Commission,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

HAS ADOPTED THIS DECISION:

*Article 1*

The Annual Economic Report 1990/91, annexed to the present Decision is adopted, and the economic policy orientations for the Community put forward in the report are adopted.

*Article 2*

This Decision is addressed to the Member States.

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[1] OJ No L 78, 24. 3. 1990, p. 23.

# ANNUAL ECONOMIC REPORT 1990/91: REVISION

Section I of the March version of the Annual Economic Report 1990/91 which discussed the short-term outlook will be replaced by the first two sections on the economic situation and outlook.

Section II of the previous report, relating to economic policy tasks during Stage I of economic and monetary union, remains valid. Its main recommendations as well as eventual adjustments are developed in section III of the present report.

CONTENTS


Page

Introduction ... 21

I. THE ECONOMIC SITUATION IN 1990 AND EARLY 1991 ... 21

A. Growth slowdown in the Community ... 21

1. The worsening of the international environment ... 22

1.1. The United States ... 22

1.2. Central and Eastern Europe ... 23

1.3. The fluctuations of the US dollar ... 23

2. A cyclical adjustment within the Community ... 24

3. The Gulf crisis and the fall in business and consumer confidence ... 26

B. Recession in the United Kingdom ... 26

C. German unification ... 27

D. Inflation and employment ... 28

II. THE OUTLOOK FOR 1991 AND 1992 ... 29

A. The risk factors ... 29

B. The policy concerns ... 30

1. Profitability, growth and employment ... 30

2. Inflation ... 31

3. Budgetary convergence ... 32

4. Inadequacy of saving ... 33

III. POLICY CONCLUSIONS ... 34

A. Maintain stability and growth climate ... 34

B. The development of Community potential ... 34

1. Complete the internal market ... 35

2. Improve economic and social cohesion ... 35

3. Structural adjustment ... 36

4. The environmental challenge ... 37

C. Policies for improved convergence ... 37

1. Price and cost convergence ... 37

2. Convergence of budgetary policies ... 39

3. Convergence of external positions ... 42

# THE EUROPEAN COMMUNITY IN THE 1990s: TOWARDS ECONOMIC AND MONETARY UNION

## INTRODUCTION

The economic outlook for the Community in the current year is much less favourable than it appeared in autumn last year. In the Community, output is expected to increase by less than 1,5 % in 1991, half the rate recorded in 1990. As a result, growth in employment is likely to slow down significantly to less than 0,25 %. This small increase in employment will, however, be more than offset by the expected increase in the labour force leading to a consequent rise in the unemployment rate to 8,7 % in 1991. Despite the slowdown in activity, inflation is expected to remain broadly stable at a relatively high level (5 %).

The deterioration in the Community's economic performance expected in 1991 is only partly explained by events in the Gulf region. The increase in oil prices in the second half of 1990 and the erosion of business and consumer confidence that followed are, without doubt, a direct result of the Gulf crisis. Some Community countries were, however, already experiencing difficulties well before August 1990. External demand was slowing down, with negative effects on investment growth, and the necessary correction of macroeconomic imbalances was dampening internal demand in some countries.

Despite the current slowdown of activity in the world economy, prospects for a resumption of stronger growth are good. The Gulf crisis now seems to have had smaller and probably more transitory effects on confidence, inflation and growth than initially feared. And there are incipient signs that the relatively pronounced cyclical downturn in some industrial countries, including the United States and the United Kingdom, is bottoming out.

The fundamentally healthy underlying growth conditions in the Community should therefore reassert themselves. These comprise the restoration of profitability during the 1980s; some progress made in reducing unsustainably large budget deficits; the implementation during the past decade of structural reforms aimed at a better functioning of markets; the achievement of a more sustainable pattern of external balances and, last but not least, the European integration prospects.

These factors have contributed to the relatively good performance during the 1983 to 1990 period. To further improve the basis for sustained non-inflationary growth during the period ahead with the aim of entering the final stage of EMU, policy makers must seek to consolidate and enhance the gains already made through a continued pursuit of the strategy that has been at the basis of the improved performance during the 1980s.

With such policies, the recent economic slowdown in the Community is expected to be reversed during the course of the year. In 1992 the overall situation is expected to improve with output growth reaching 2,25 %. Due to lag effects, however, employment growth is expected to remain at the level of 1991 (0,2 %) entailing a further modest rise in the unemployment rate to 9,2 %.

A climate of stability is an essential prerequisite for the development of the Community's potential. Monetary and fiscal policies have therefore to maintain a cautious stance. Fiscal policy ought to support to a larger extent monetary policy. The standstill of budget consolidation is from this viewpoint a cause for concern. Particularly since stage one of economic and monetary union tightens convergence requirements in the fields of prices and costs, budgetary and external positions. A considerable adjustment has still to be carried out by some member countries. Hence speedy implementation of the policy recommendations is essential to prepare succesfully the transition to full economic and monetary union.

## I. THE ECONOMIC SITUATION IN 1990 AND EARLY 1991

### A. Growth slowdown in the Community

Over the past year the world economy has had to adjust to a number of events: the dismantling of the centrally planned economies of Eastern Europe, German unification, growing uncertainties in the Soviet Union and finally the Gulf crisis. The Community has weathered this difficult international situation relatively well, not least because of the powerful stimuli emanating in the short-term from the German unification process and more durably from the progressive implementation of the Single Market Programme. Overall, however, a further slowdown of real GDP growth in the Community could not be prevented: real growth is likely to drop to only 1,5 % in 1991, about half the rate recorded in 1990, and about two percentage points less than 1989 (Table 1).

*TABLE 1*

**The EC economy at the turn of the decade**

*(annual percentage charges)*

| | 1984—1987 | 1988 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|---|
| Real GDP | +2,6 | +4,0 | +3,3 | +2,7 | +1,4 | +2,3 |
| Employment | +0,6 | +1,6 | +1,6 | +1,6 | +0,2 | +0,2 |
| Inflation (2) | +5,1 | +3,7 | +4,9 | +5,0 | +5,0 | +4,6 |
| Investment | +3,3 | +9,0 | +6,7 | +4,3 | +0,8 | +3,7 |
| of which equipment | +6,1 | +10,4 | +8,4 | +4,7 | +0,2 | +4,4 |
| Real unit labour costs | −1,1 | −1,1 | −0,7 | +0,6 | +0,3 | −0,7 |

(1) Forecast.
(2) Private consumption deflator.

A number of factors have contributed to this outcome, such as:

— the deterioration of the international environment,

— a cyclical adjustment within the Community,

— the Gulf crisis and the concomitant fall in business and consumer confidence.

1. *The worsening of the international environment*

From early 1990 until the first quarter of 1991 the external environment has deteriorated continuously; economic activity slowed down considerably in the United States, Canada and Australia and the restructuring in Central and Eastern Europe brought about a contraction of activity. Finally the Gulf crisis exacerbated weak trends in most countries and particularly in the Middle East and Latin America. Real GDP growth outside the Community slowed down from 3,2 % in 1989 to 1,7 % in 1990 and is likely to slow further in 1991 to less than 1 %. As a result import demand by the world outside the Community only grew by some 4 % in 1990 and is forecasted to grow by 2,75 % in 1991, less than half as much as before (7,4 % in 1989).

1.1. The United States

The long expected and largely cyclical slowdown in the United States started around mid-1989 and became more pronounced throughout 1990. Sharp declines were registered in consumer expenditures, in residential construction and business investment. The unavoidable tightening of monetary policy in 1989 in combination with rising private sector indebtedness, which was followed in 1990 by credit restrictions resulting from tighter standards for financial institutions, have put a brake on domestic demand.

Demand was further reduced by the oil price in the second half of 1990. As a result real GDP growth dropped from 4,6 % in 1988 to 1,0 in 1990 and will again be very weak in 1991, even if a recovery gets underway later in the year (Table 2).

*TABLE 2*

**United States, main economic indicators**

*(in percent or percent of GNP)*

| | 1984—1988 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|
| Real GNP | +4,4 | +2,8 | +1,0 | +0,1 | +1,6 |
| Domestic demand | +4,6 | +2,2 | +0,5 | −0,5 | +1,4 |
| Investment | +6,5 | +2,7 | −0,1 | −3,1 | +5,7 |
| Consumer prices | +3,5 | +4,5 | +5,0 | +4,5 | +4,9 |
| Fiscal balance (2) | −3,9 | −2,0 | −2,4 | −1,8 | −2,4 |
| Current account | −2,9 | −1,9 | −1,8 | −0,3 | −0,9 |

(1) Forecast.
(2) General government.

## 1.2. Central and Eastern Europe

To integrate their countries in the world economy, the new democratically elected governments in Central and Eastern Europe have initiated comprehensive reform programs. The boldness and frontloaded nature of these reforms make the beginning of the reform process a critical phase. While curcial market oriented policies are being implemented progressively, the behaviour of economic agents is adapting only gradually to the new environment and production is severely constrained as much of the obsolescence of the capital stock was brought out under exposure to world market prices. In these circumstances it is inevitable that output would decline at the initial stage.

Moreover, the necessary restructuring has to take place in a rather unfavourable environment: most countries face large domestic and external imbalances accumulated over years, while at the same time the system of mutual trade in the framework of the Council of Mutual Economic Assistance has collapsed, entailing a serious terms of trade loss for the Central and Eastern European countries. These difficulties were compounded by the oil price rise and the slowdown of demand in the Western world.

## 1.3. The fluctuations of the US dollar

Besides the loss in demand following the recession in the US-Community exports to the rest of the world suffered in 1990 from a loss of competitiveness resulting from the appreciation of the European currencies *vis-à-vis* the dollar. At the end of February 1991, the dollar value of the ECU was about 20 % higher than the average for 1989. Since then, the dollar has recovered most of this loss. The yen fluctuated over the same period even more sharply, its value in ECU being in August 1990 more than 28 % lower than in 1989 on average. The value of the yen recovered subsequently more than 10 percentage points of this loss. The loss in competitiveness was one of the factors behind the slowing in exports and consequently in investment growth in the Communtiy since 1989. This illustrates that despite its internal growth, the Community could not avoid a sizable loss of competitiveness to translate into a decline in export growth which affected in turn investment.

Community export growth (EUR-10 without Germany and United Kingdom) declined as a result from 7,3 % in 1989 to 5,4 % in 1990 with a further slowing to 4,2 % likely in 1991. The slowdown was particularly marked in the case of Italy, France, Belgium and Luxembourg. Exports to markets outside the Community slowed down even more sharply and were only partially compensated by increased exports to Germany.

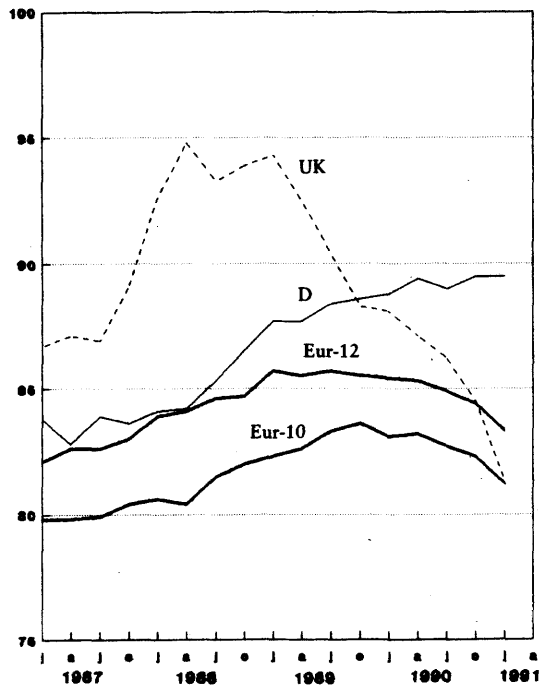
Despite these large exchange rate fluctuations and the liberalisation of capital movements, the EMS has not experienced major tensions, although positions of the different currencies within the ERM changed over time and interest rate differentials were gradually reduced.

2. *A cyclical adjustment within the Community*

To some extent the slowdown of demand was also a cyclical phenomenon after the strong recovery in the second half of the 1980s. Investment in particular expanded markedly during the period 1987 to 1990, by a yearly average of more than 7%. Hence some downward adjustment was inevitable when external demand weakened, spare capacity increased (Graph 1) and monetary policy was tightened.

*Graph 1*

**Capacity utilization in manufacturing (in %)**




Even if the cyclical downswing in the Communtiy has not fundamentally affected its growth potential, the outlook for profitability of investment has nonetheless deteriorated since 1990: the continuous decline in real unit labour costs going on since 1981 (the best proxy for company profitability) has come to an end. Profitability has no longer been recovering since 1989. The deterioration has been particularly marked in the United Kingdom from 1989 to 1991, and is likely in Germany in 1991. But also in Italy, Ireland, the Netherlands, Belgium and Luxembourg the profit improvement of the previous years has been halted or reversed. The increase is mainly due to high nominal increases in compensation per head, above 7% per annum in 1990 and 1991 in the Community on average (Table 3).

*TABLE 3*

**Nominal wages, real wages and real unit labour costs**

*(% change)*

| | 1986—1988 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|
| | Nominal compensation per employee | | | | |
| EUR-10 (2) | +6,2 | +6,6 | + 7,7 | +6,9 | +6,3 |
| Germany | +3,3 | +2,8 | + 4,1 | +6,4 | +5,5 |
| United Kingdom | +7,9 | +8,9 | +10,9 | +8,5 | +6,8 |
| EUR-12 | +6,0 | +6,2 | + 7,6 | +7,1 | +6,2 |

| | 1986—1988 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|
| | Real compensation per employee | | | | |
| EUR-10 (2) | +1,9 | +1,2 | + 2,4 | +1,6 | +1,5 |
| Germany | +2,5 | −0,2 | + 1,5 | +2,8 | +1,2 |
| United Kingdom | +3,2 | +2,8 | + 3,4 | +1,9 | +1,6 |
| EUR-12 | +2,2 | +1,2 | + 2,4 | +1,9 | +1,5 |
| | Real unit labour costs | | | | |
| EUR-10 (2) | −1,2 | −1,3 | + 0,5 | −0,2 | −0,5 |
| Germany | −0,7 | −1,6 | − 1,2 | +1,0 | +0,1 |
| United Kindom | +0 | +2,6 | + 3,0 | +1,3 | −2,3 |
| EUR-12 | −0,9 | −0,7 | + 0,6 | +0,3 | −0,7 |

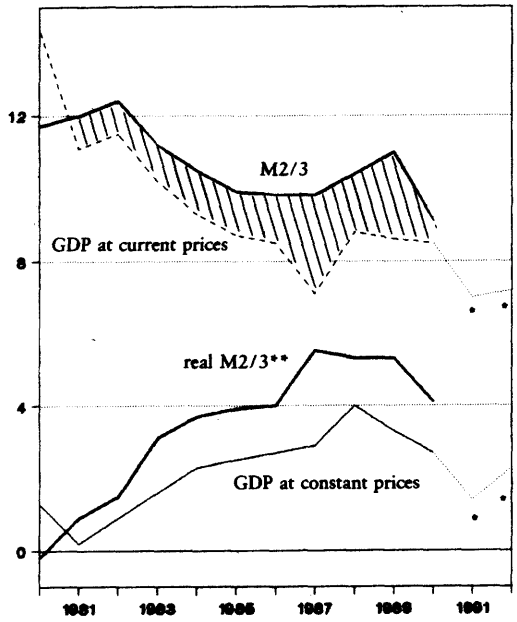
(1) Forecast.
(2) EUR-10 = EUR-12 minus Germany and United Kingdom.

Policies over recent years have, to some extent, contributed to this development. The liquidity ratio (M2/3 over nominal GDP) for the Community, although also influenced by financial innovation and other structural adjustments on money and capital markets, increased relatively sharply in 1987 and again in 1989 (Graph 2). It is therefore at least questionable whether despite rising short term interest rates, monetary policy was sufficiently consistent with potential growth over the period till 1989, as excess liquidity was allowed to build up, thereby underpinning the basis for large wage claims. In 1990 there was a much smaller increase in the liquidity ratio, reflecting the tightening of monetary policy in an attempt to prevent the oil price rise from feeding into a wage-price spiral.

*Graph 2*

**Growth money supply (M2/3) and GDP — Eur-12**

*(annual % change)*




* Forecast
** Deflated by GDP price deflator
\\\ Change in liquidity ratio

3. *The Gulf crisis and the fall in confidence*

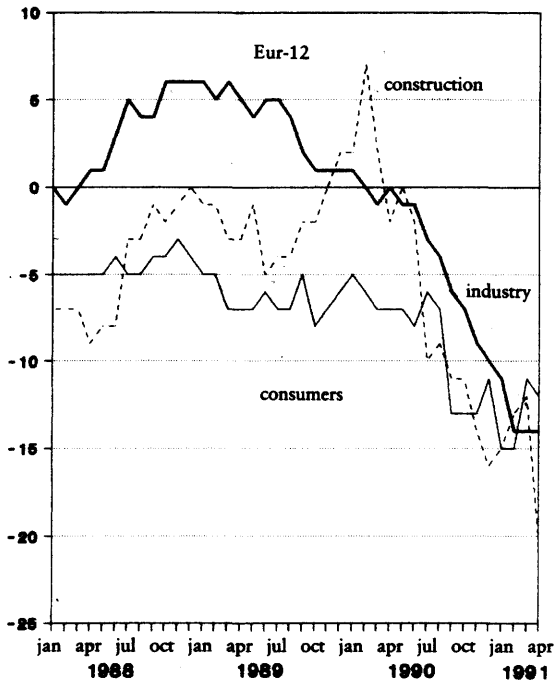
In addition to the abovementioned factors, the sharp, but short-lived rise in oil prices resulting from the Gulf crisis led to a deterioration in the terms of trade in the Community and a decline in real disposable income that affected consumption and investment. In the event that oil prices had remained high, this would have affected member states quite differently. Indeed, while overall energy intensity of production has been reduced sizably since 1973 in nine Community countries, it has increased in Spain and particularly Greece and Portugal owing to the transition in those countries to a production structure with a greater industrial content.

The subsequent drop in oil prices to pre-conflict levels reversed most of the unfavourable direct income and price effects of the higher oil price. The oil price in mid April 1991 was at about $ 19 per barrel (spot market price for Brent oil) compared to around $ 32 per barrel, in the fourth quarter of 1990.

However, the Gulf crisis led to a sharp rise in uncertainty in the second half of 1990 and the early part of 1991. Confidence was severely eroded among consumers, in industry and in construction (see Graph 3), with adverse repercussions on consumption and investment plans. While the main factor responsible for the sharp business deterioration, the Gulf conflict, has disappeared, there are few signs yet of a reestablishment of a more favourable sentiment: according to the first business survey after the end of the conflict, only consumers and the construction sector seemed to have regained some confidence; in industry on the contrary the deterioration in sentiment has stopped, but there is as yet no clear sign of a revival. A return of confidence in industry is, however, crucial for a recovery of investment.

*Graph 3*

**Confidence indicators — Eur-12 (business surveys)**




B. **Recession in the United Kingdom**

At its peak in 1988 the rate of expansion of domestic demand in the United Kingdom reached about 8 %, far in excess of the growth in capacity. Induced by this strong expansion, inflationary pressures, accommodated initially by a lax monetary policy, became apparent on the price and wage front and in

the external account. Monetary policy then changed towards an increasingly restrictive stance with a progressive increase of short-term interest rates through the latter part of 1988 and 1989. However, the monetary squeeze implemented was slow to produce the intended results. Inflation has been persistent, influencing in turn wage settlements. The highly restrictive monetary policy resulted in a steep drop in activity from the second half of 1990 on. GDP growth slowed to 0,6 % in 1990 and a sharp decline in output of some 2 % is expected in 1991, mainly as a result of a sharp fall of investment (– 10,75 % in 1991) and a decline in private consumption (– 1,75 % in 1991). Despite this slowdown in activity, nominal wage trends have remained strong, rising by 10,5 % in 1990 and likely to slow only to 8,5 % in 1991. In 1992, output is expected to pick up again.

The current account deficit reached a peak in 1989 at 4,8 % of GDP and improved markedly to a deficit of 2,3 % in 1990 and a forecast of about 1 % in 1991 as imports weaken in line with falling domestic demand.

## C. German unification

In contrast to the rest of the Community, economic activity accelerated further in Germany as a result of the tax reform, unification and the ensuing expansionary impulse of fiscal policy. Real GDP growth accelerated from 3,3 % in 1989 to 4,7 % in 1990 (for data on Germany, see box). Particulary private consumption, was stimulated while also investment witnessed a strong expansion.

**STATISTICAL PROBLEMS FOR GERMANY**

All the data on Germany in this year's Annual Economic Report relate to West Germany. Due to major statistical problems it is not yet possible to present reliable data for the whole of Germany. Of course, the data on the budget deficit reflect the transfers from West to East Germany, while also the current account data incorporate these transfers.

The high level of activity led to a strong increase in employment in 1990 and 1991 and a resulting sharp drop in the unemployment rate from 6,1 % in 1988 to 4,5 % in 1991 (harmonized definition of the Statistical Office of the Community). The tightening of the labour market has, however, also resulted in increased wage demands that put an end to the continuous decline in real unit labour costs. The expansion of domestic demand and deliveries to the Eastern part of Germany could not be met by domestic supply, resulting in sharply increased imports.

The abrupt integration of the centrally planned East German economy into a market system as a result of unification, implied a fast and steep adjustment of the East German economy entailing a substantial cost to bridge the transition period. The cost of unification would swell the fiscal deficit from a small surplus in 1989 to a deficit of around 2,2 % of GDP in 1990 and around 4,7 % in 1991 despite sizable increases in taxes.

The massive transfers to East Germany also resulted in a swing in the current account from a large surplus in 1989 into presumably a small deficit in 1991.

The developments in the West contrast sharply with those in East Germany which undergoes a dramatic adjustment process: a fall of 50 % in industrial production and underemployment amounting to some 35 % of the labour force (including short-time workers) is expected by the end of 1991. Output is generally acknowledged to be falling by two-digit figures both in 1990 and 1991 as new investment and the creation of working places is not yet sufficient to offset the loss of output and employment in the old industries. A slight recovery is expected in 1992 with the help of growth in investment as well in equipment as in construction.

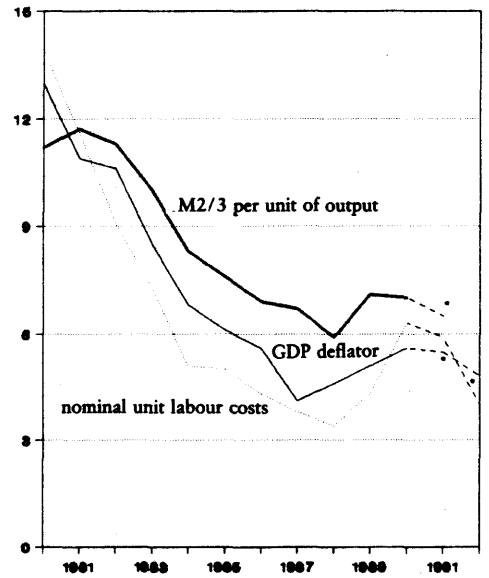
## D. Inflation and employment

Inflation has been relatively well contained since the start of the Gulf crisis. Although higher oil prices did push up rates of consumer price increases between August and October 1990, there are few signs that they have become embedded in the ongoing wage and inflation process. So far monetary policy seems to have succeeded in preventing the creation of a wage-price spiral. Indeed consumer price inflation is even subsiding: the average rate of consumer price inflation in the Community, which peaked in October 1990 at 6,3 % was down to 5,3 % in March 1991.

Still at 5 % for the year 1991, the excepted average rate of inflation in the Community is worryingly high for a period of slowing growth. With lower oil prices such a level could indicate underlying cost push pressures (Graph 4). Also worrying from the point of view of EMU is that between 1988 and 1990 price developments diverged within the Community (Graph 5).

*Graph 4*

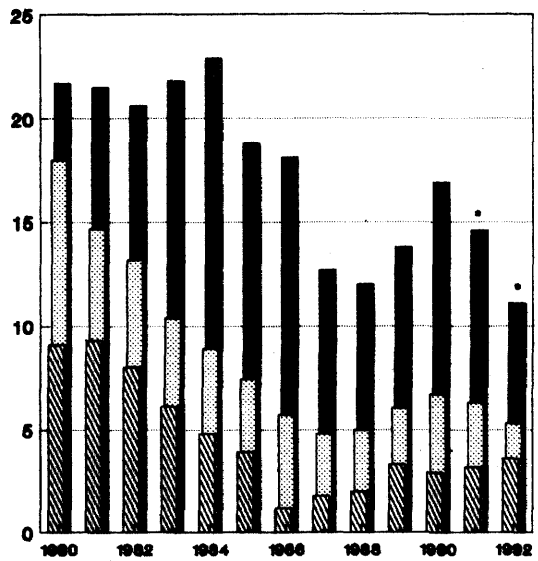
**Prices, costs and money supply growth (Eur-12, in %)**




* Forecasts

*Graph 5*

**Inflation convergence (consumption price deflator) (annual % change)**




* Forecast

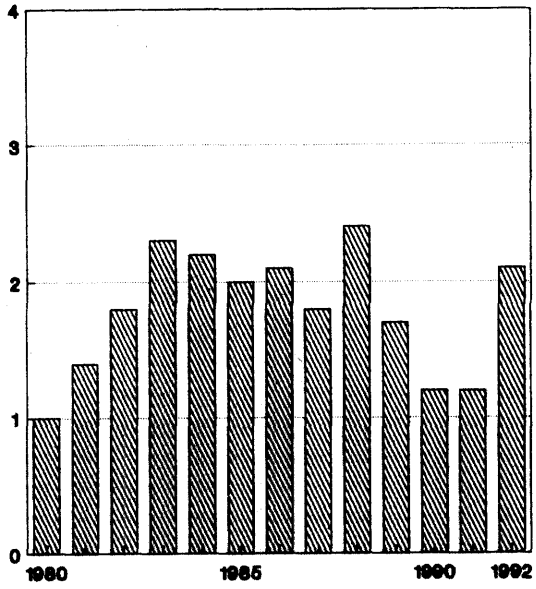
Eur-7 Eur-3 Eur-2

Eur-7: B, Dk, D, F, Irl, L, Nl. Eur-3: Sp, I, UK. Eur-2: Gr, P.

Employment growth has lagged the slowdown in activity resulting in a cyclical slowing of productivity (see Graph 6). Employment continued to grow in 1990 at the same rate as in 1989 (1,6 %). The growth was particularly strong in Germany, reflecting partly an increased availability of skilled labour from East Germany and Eastern Europe. But also in the other Community countries, with the exception of Greece, the United Kingdom and Denmark, employment growth was robust. In 1991, employment growth in the Community is excepted to slow down to 0,2 %. This small increase in employment will however be largely offset by the expected increase in the labour force. The continued fall in the unemployment rate since 1986 is expected to be reverse and increase from 8,2 % in 1990 to 8,7 % in 1991.

*Graph 6*

**The productivity cycle**




## II. THE OUTLOOK FOR 1991 AND 1992

At the end of the first quarter of 1991 the main factors that underlie the present downswing have either disappeared or turned around: the Gulf crisis has been resolved, oil prices have returned to their pre-conflict levels, economic activity in the United States in excepted to recover in the second half of the year, the dollar has reversed its downward trend and confidence is gradually being restored.

The fundamentally healthy underlying growth conditions in the Community should therefore reassert themselves. The decline in real growth is expected to bottom out during the course of the year so that activity would gradually recover in the second half of the year: real GDP growth would increase from 1,25 % in 1991 to 2,25 % in 1992 mainly under the influence of a pick-up in consumer demand and investment.

### A. The risk factors

These relatively favourable expectations hinge crucially on a recovery of the consumer and business climate. Any delay in recouping the erosion of confidence could weaken the economic performance of the Community. With consumer optimism restored and real incomes basically unaffected and even slightly increasing, consumer demand should gradually pick up.

The recovery of investment in 1992 partly relies on the assumption that the deterioration in the wage situation was only temporary and that per capita real wage increases will come down again from 2,25 % on average between 1986 to 1991 to 1,5 % in 1992. If such a development were not to materialize, profitability would not improve for the third consecutive year for the Community as a whole, which would depress expectations for investment. A further weakening of economic activity in combination with a continued fall in profits might further deteriorate the situation.

Another risk factor is the instability of the US dollar. The dollar's behaviour has been very volatile over recent years. Although a further decline now seems less likely, it can still not be excluded if the expected US recovery does not establish itself in 1991. But also a strong upward shift in the value of the dollar would not be without adverse consequences for the Community: although this would improve competitiveness, it would also considerably strengthen inflationary impulses through higher import prices from outside the Community.

## B. The policy concerns

The still ongoing cooling-off does not require any significant change of policies. Against the background of continuing positive growth fundamentals, forces are gradually taking shape that should lead to an early recovery of activity: the increase in household income, the downward tendency of long term interest rates, lean inventories during the course of 1991 are all factors pointing to an imminent reacceleration of growth. There are a few areas though where developments are less satisfactory and further progress would be warranted.

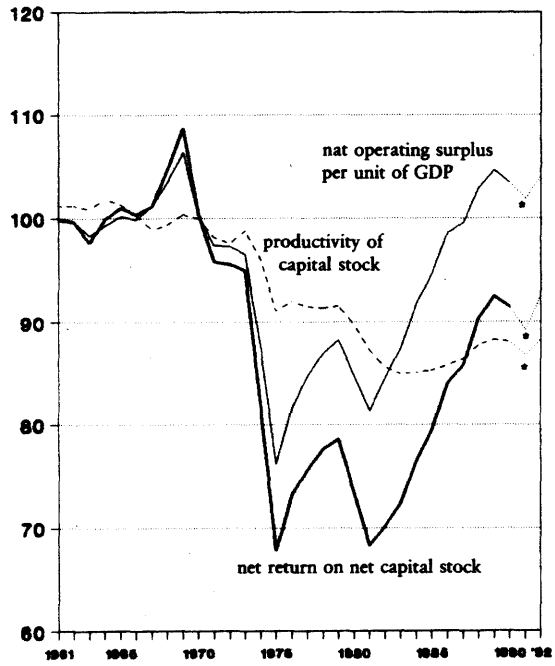
### 1. *Profitability, growth and employment*

The improvement in growth fundamentals during the 1980s was not brought about spontaneously but was a result of a consistent set of policies aiming at revigourating the European growth performance aided by a relatively favourable international environment. Besides sustained demand expectations, wage developments will play a critical role to bring about the economic recovery. Continued wage moderation is an important condition to strengthen employment-creating investment and is needed to make new inroads in the still high unemployment rate.

The relatively unfavourable recent wage developments have not yet seriously affected the medium-term outlook for profits in the Community. Profitability had improved considerably during the 1980s and the recent deterioration has not changed that picture fundamentally. The net return on the capital stock had, however, not yet recovered its average level of the period 1961 to 1973, because more capital is now employed per unit of output (see Graph 7). A further increase in the investment ratio would be welcome in view of the still high level of unemployment. This would require the re-establishment of unambiguous expectations on a further improvement of the level of profitability.

*Graph 7*

**Profitability indicators, Eur-12, indexes 1961—1973 = 100**




* Forecast

Wage moderation is an essential prerequisite to stimulate employment-creating investment. Increases in real wages must remain below increases in total factor productivity so as to avoid switches to more capital intensive forms of production and further improve the employment content of growth. Indeed, the unemployment rate, at 8,2 % in 1990, remains unacceptably high and will increase again in 1991 and 1992. It needs to be further lowered. The intensification of wage pressures in the presence of such high levels of unemployment seem to suggest rigidities in the functioning of the labour market.

While the outlook for 1991 is not yet a matter of concern, the large wage increases granted in Germany constitute a potential threat. They risk undermining price stability in the country that had the best price performance of EMS countries in the past and whose currency therefore served as an anchor. Moreover, if these increases were to spread to neighbouring countries the situation could become really disturbing and create a cost push inflation. The situation is the more worrying as there could be a tendency for such higher increases in wages to be more readily accepted in these countries since they would not erode external competitiveness. They could erode, however, profitability and could thereby undermine the growth, investment and employment potential of the economy.

The wage situation in the United Kingdom, is also still not satisfactory although some improvement is expected in 1991 and 1992. Membership of the ERM is providing the framework for a more rational setting of wages.

Also in Portugal, Greece, Italy and Spain expected wage developments, while not threatening profitability, are nonetheless not yet conducive to a better nominal convergence. In the other Community countries, there seems to be less reason for concern in as far as the assumed wage behaviour will be validated.

2. *Inflation*

Moderate wage developments are not only important to improve the employment situation, but also for better nominal convergence within the Community. Together with wage developments, the inflation performance has to be carefully monitored. While an improved

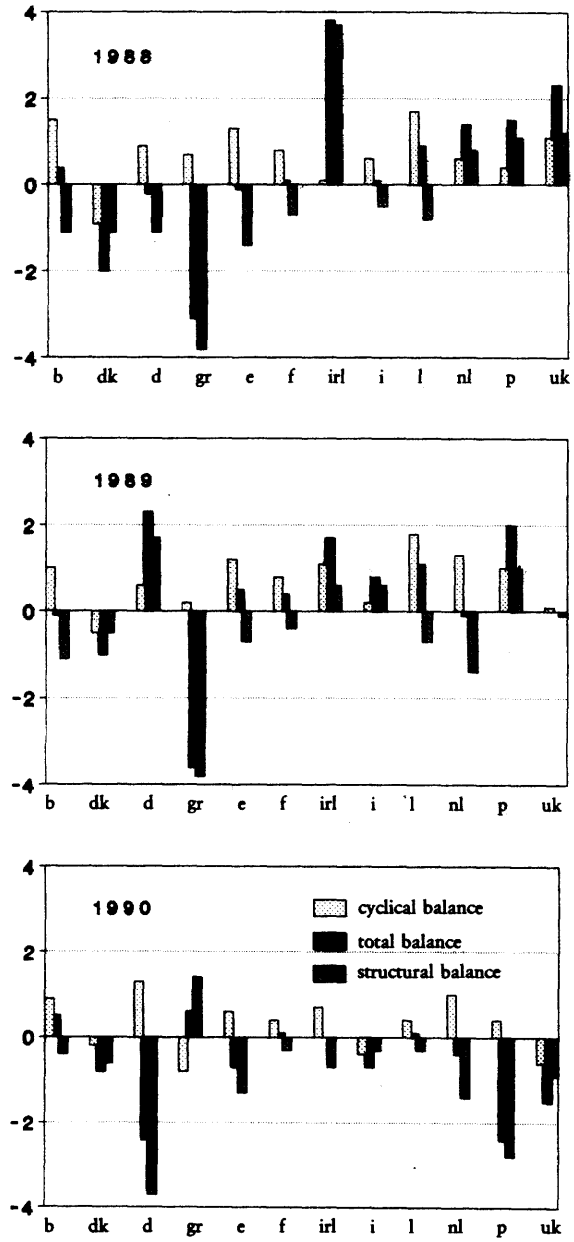
convergence of consumer price levels is expected, regrettably this is at a higher level of inflation mainly as a result of the deterioration in the price performance in Germany. From the point of view of the required nominal convergence in EMU, the situation is not satisfactory.

3. *Budgetary convergence*

Not only in the field of prices is there a lack of improved convergence, also in the budgetary area, there has been no further progress since 1989. The process of budgetary consolidation that began in most countries around 1983 has come to a standstill. In fact much of the improvement registered over the last years seems to be mainly due to the favourable cyclical situation and may even imply a structural deterioration of budget balances (see Graph 8). For the Community as a whole, net borrowing is estimated to increase from 3 % of GDP in 1989 to 4 % in 1990 and 4,5 % in 1991. Hence there is a clear need to strengthen the budgetary consolidation efforts in most countries.

*Graph 8*

**Structural and cyclical changes in budget balances (in % of GDP)**

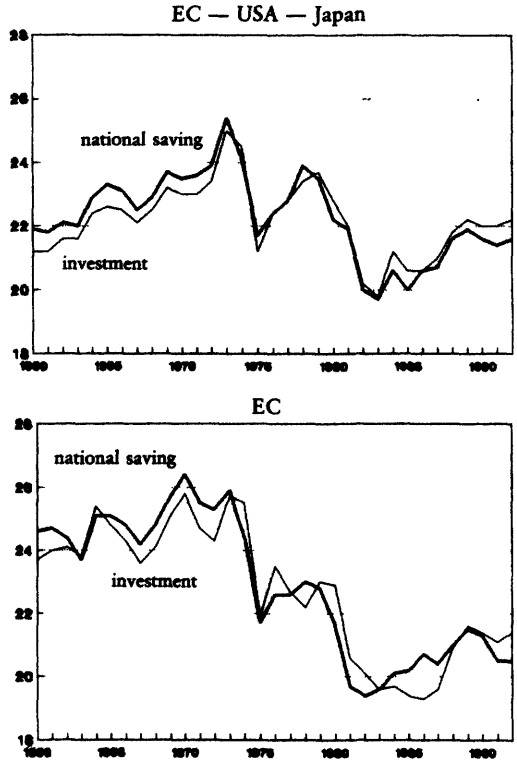


4. *Inadequacy of saving*

Recent budgetary trends in the Community are not only disquieting in light of the desired convergence towards economic and monetary union, but also in a context of growing scarcity of capital in the world economy, which has been exacerbated through the opening of Eastern European countries. Over and above that, the major industrial countries have increased their drawing on net savings from the rest of the world in recent years, mainly as a result of the reduction of the excess saving supply from Japan and particularly Germany (Graph 9). Private saving remained fairly stable during the 1980s, the decline in household saving being compensated by an increase in corporate saving. The single most important factor behind the decline in industrial country savings is the excessive government budget deficits in the major countries. A failure to redress their situation would not only reduce the domestic growth potential of these countries, but also jeopardize efforts to reverse the unsustainable and undesirable net resource flow from developing to industrial countries that has persisted during the 1980s.

*Graph 9*

**Saving and investment in the major industrial countries (in % of GDP)**




A global shortfall of savings could translate in a continued and significant tightening of global capital markets, with very high long-term interest rates. In this context it should not be forgotten that the reduction in investment demand in 1990 and 1991 has allowed the public sector to absorb a langer share of savings so far without undue further pressure on real interest rates. In these conditions real long-term interest rates may remain high, and could even rise again if investment demand were to recover strongly.

## III. POLICY CONCLUSIONS

To sustain economic growth and employment, the Community will have to rely more on its own potential. A climate of stability is an essential prerequisite for its development. Therefore the Community will have to maintain prudent and balanced monetary and fiscal policies. These policies will at the same time help to preserve the favourable growth fundamentals. The completion of the internal market, the continued implementation of structural policies and further improvements in economic and social cohesion and in the environment will in turn strengthen the Community's potential.

The deterioration in short-term growth prospects in the Community does not alter the fundamental positive assessment of the underlying potential of the Community economy. Provided appropriate policies are followed, confidence should pick up again and investment activity could resume its strong growth leading to renewed significant job creation.

To meet the challenges it is all the more important that policy coordination is strengthened in accordance with the decision on multilateral surveillance for Stage One. Multilateral surveillance is covering a wide range of macroeconomic and structural policies to ensure convergence of economic policies and performances in the Member States with the aim of maintaining or improving the conditions for a sustainable, employment creating growth.

### A. Maintain stability and growth climate

Monetary policy will have to remain vigilant to quell inflationary pressures. The divergent cyclical positions of the member countries and the steadying of exchange rate expectations have provided some scope for reducing interest rate differentials without undermining the exchange rate commitment. In the absence of a common monetary policy during the transition to the final stage of economic and monetary union, however, monetary policy will have to be gearded as well to the domestic price situation as to exchange rate considerations. Unless inflationary pressures subside clearly and in the absence of greater support from fiscal policy ther is no room for a relaxation of monetary policy in the Community.

Fiscal policy needs further tightening not only with a view to better convergence in Stage One of economic and monetary union, but also as a contribution to increasing global savings and relieving the pressure on monetary policy. With budgetary revenues less forthcoming and outlays on unemployment increasing, some deterioration of budget balance seems inevitable in 1991 as a result of automatic stabilizers. To further the process of consolidation, however, it would seem appropriate that the cyclical deterioration of the budget position would only partly be reflected in the total budget balance so that structural improvement would be resumed. The rules aimed at limiting public sector deficits and indebtedness, which the Community is in the process of defining in the framework of the Intergovernmental Conference, could be an important contribution for sound medium-term budget balances. As a matter of fact already now, during the transition period, these rules should serve as an informal guideline to assess budget balances to ensure that sufficient progress would be achieved in Stage One.

Rising wage pressure in a context of a still high level of unemployment points to the need for more fundamental structural reform in labour markets to strengthen employment creating investment. There seems to be a good case for encouraging a more active labour market policy with greater emphasis on retraining than on provision of unemployment support. Further obstacles to employment creation should be removed and wage setting procedures should allow a fuller reflection of differences in productivity so as to improve adjustment of demand and supply of labour.

### B. The development of Community potential

The general policies which must be implemented to curb the re-emergence of inflationary pressures and inflation divergences are also those needed to create the conditions for the realization of the great Community projects: economic and monetary union, completion of the internal market, economic and social cohesion. At the same time, these projects complement the policies being implemented at the national level.

1. *Complete the internal market*

To secure its economic future, Europe has embarked on a programme for creating a market of continental dimensions. One of the main constraints the Community still faces on the competitive world stage is the fragmented nature of its markets, which makes it difficult to produce at optimum levels, holds back technological progress and impedes development of the services sector, where growth is particularly strong. The opening of the Community frontiers will enhance competition. Increased specialization and efficiency of production will greatly improve consumer choice

The internal market programme is the decisive driving force in adding to Community growth prospects and prosperity. Economic operators are increasingly anticipating the highly competitive environment which will prevail and the new operating conditions and opportunities which will exist by 1992. An increasing number of firms have begun to operate on greatly enlarged market horizons and are actively changing their strategies. In addition to the positive growth effects stemming from the abolition of internal border controls, and the removal of technical barriers to the free movement of goods and services, particularly as regards the latter in the financial services sector, growth will also be attributable to the positive effects arising from the necessary restructuring in industrial and services sectors and from positive changes in marketing strategies.

In the single market, an effective Community competition policy is essential since measures and practices aimed at reducing or avoiding competition (such as increased subsidies or market sharing agreements) would reduce these positive effects. To crown the achievement of the internal market with a single currency in the near future would — as recent business surveys show — further bolster the positive mood of management.

The high expectations that have been created must not be disappointed. Therefore the deadline of 1 January 1993 for completing the internal market must be respected. Hence, it is essential that the remaining decisions in respect of the proposals contained in the 1985 White Paper must be taken as soon as possible. Significant progress has already been achieved and decisions have been taken in all areas of economic activity. The Commission has already tabled all the proposals contained in the white paper, and over two-thirds have been approved by the Council. The Commission is turning its attention to the problems of implementation (some 72 % of the so far required national implementing measures have been taken) and to the proper functioning of the single market. Decisions have still to be taken in important fields relating to the complete removal of internal border controls. The Council must give priority to these areas (which include the approximation of indirect taxation rates) and monitor the situation on a regular basis to ensure that decisions are taken such that progress towards removing completely the internal borders becomes irreversible, as is the case for the rest of the programme. Member States ought to accelerate the rate of implementation of decisions and to eliminate all delays by the end of 1991

2. *Improve economic and social cohesion*

The improvement of economic and social cohesion will also strengthen growth prospects. Above average growth in the less favoured countries would contribute to expanding the growth potential of the Community economy as whole.

The strengthening of economic and social cohesion and the objective of a harmonious development across European regions have been reaffirmed in Article 130 of the Single Act. Above-average growth in those countries and regions, as has been the case in recent years in Spain, Portugal and Ireland, but not in Greece, has started to reduce the income gap (Table 4) and has expanded the growth potential in the Community as a whole. The gap remains sizable though, and will require a long-term effort of catching-up.

*TABLE 4*

**The catching-up process in the Comunity. GDP (1) at current market prices and purchasing parities per head of population (Eur-12 = 100)**

| | Greece | Spain | Ireland | Portugal |
|---|---|---|---|---|
| 1986 | 55,9 | 72,8 | 63,4 | 52,5 |
| 1987 | 54,1 | 74,7 | 64,4 | 53,7 |
| 1988 | 54,2 | 75,7 | 64,7 | 53,7 |
| 1989 | 54,0 | 76,9 | 67,0 | 54,9 |
| 1990 | 52,9 | 77,8 | 68,6 | 55,6 |
| 1991 | 52,6 | 79,2 | 68,7 | 57,1 |
| 1991—1986 | −3,3 | +6,4 | +5,3 | +4,6 |

(1) Reference to GDP may overstate progress to the extent that income transfers to abroad may have outpaced nominal GDP growth.

The economically stronger countries could contribute to this process by the maintenance of a dynamic growth pattern and the opening of markets to trade. The doubling of the Structural Funds and the simultaneous strengthening of the financial instruments will make available to Greece, Portugal and Ireland resources equivalent to between 3 and 5 % of GDP in 1993. They support the considerable improvement in structural policies achieved so far. Economic and social policies on the national and Community level have to provide the basis for a continuous relative growth of real GDP, without inflationary pressure and unsustainable internal and external imbalances. The catching-up countries will, however, remain primarily resonspible for their own development through the pursuit of appropriate policies.

3. *Structural adjustment*

Structural policies improve the capacity of Member States' economies to adjust. They enhance flexibility in goods and factor markets and should lead to an improvement in the extent and speed of response of prices in those markets to changes in market conditions. Structural policies thereby reduce the potential size and duration of adjustment costs associated with disturbances.

Beyond the internal market programme, Member States have engaged in a number of structural improvements to be able to cope with increased competition on the unified market. So far the major initiatives fell within the liberalization of financial markets and the restructuring of personal and corporate taxation.

Governments and the Community have taken initiatives to improve the capacity of labour markets to cope with change and policies for education and vocational training are being given high priority in many Member States. They are an important instrument for the absorption of the long-term unemployed. Structural policy initiatives for labour market flexibility will need further emphasis.

Also in the public sector, structural reform has to be carried further so as to improve the efficiency of the public sector and to ensure transparent and fair competition between private and public enterprises.

Higher economic efficiency and improved resource allocation should not only be sought within the Community, but also in the world. The Uruguay Round is a cooperative effort to promote trade and economic growth. As the world's largest trading block, the Community has a natural interest in a successful conclusion of the Round. It is at the same time an instrument to provide a better platform for its weaker trading partners, in particular the Central and Eastern European and the developing countries.

4. *The environmental challenge*

Just as the previous oil shocks helped to break the parallelism that was perceived in the fifties and sixties between economic growth and energy use, there is presently a growing awareness, that was given added impetus through the Gulf crisis, that the link between economic growth and pollution needs to be broken. Experience in Eastern European countries, which have a much higher level of pollution than the richer Community countries, shows, however, that the link is not straightforward. The Community's better performance is no reason for complacency and needs to be substantially improved. There does exist, though, a clearer link between the price mechanism and pollution. Often market prices do not reflect the full environmental cost to society of their production or use. Moreover, private economic agents are not inclined to take into account the environmental effect of their activities, when taking consumption or investment decisions.

At the centre of any comprehensive policy to address the pollution problem (beyond the inevitable need for regulatory instruments), is therefore the need to internalize these external environmental effects in order to give the right signals to market participants.

The aim is to transform the patterns of economic growth in such a way as to reach a sustainable development path. A reinforced policy of environmental protection would not necessarily represent a constraint on private business, but could offer significant market opportunities for those pioneering environmentally friendly products and production processes.

There is now a broad consensus that more use of economic and fiscal instruments should be made in environmental policy, but that the optimal policy would still consist of a balanced mix of market-based and traditional regulatory instruments. The main examples of economic and fiscal instruments have been identified as taxes, charges or fiscal incentives, deposit refund systems, tradable emission permits and financial aid or subsidies. In the case of taxes and charges, the impact on the competitive position of the Community and the priorities of the internal market ought to be given due consideration.

In view of the importance of the international dimension of pollution close international coordination is called for. Within the Community there is a need for a minimum of harmonization in order to avoid policy instruments being in potential conflict with other Community objectives and to ensure compatibility of instruments among Member States when the issue is transnational.

## C. Policies for improved convergence

While the Community has significantly improved its economic convergence performance since the beginning of the decade, some worrying divergence has emerged between 1988 and 1990. Serious problems remain in some countries and in some areas. Convergence requirements will furthermore be tightened as a result of the multilateral surveillance. The significant progress already realised is testimony to the prositive effects of the discipline imposed by the exchange rate mechanism of the EMS. In fact, the present convergence positions of Member States are closely correlated with their degree of exposure to this descipline.

1. *Price and cost convergence*

The degree of price convergence is most marked among those countries which have respected the narrow band of fluctuation from the outset. The average rate of inflation (private consumption deflator) in this group of countries has been close to, or below, the three per cent mark since 1986, although the rate has been rising recently. The dispersion in the individual rates of inflation is lower than in the 1960s and the gap between the highest (3,8 % in Luxembourg) and the lowest (2,5 % in Denmark) rates of inflation for 1990 is just over one point (Table 5).

*TABLE 5*

**Inflation convergence in the Community in the second half of the 1980s (1)**

| | 1986 | 1989 | 1990 | 1991 (2) | 1992 (2) |
|---|---|---|---|---|---|
| EUR-12 | +3,8 | +4,9 | +5,0 | +5,0 | +4,6 |
| | Countries with low and converging inflation (3) | | | | |
| EUR-7 | +1,2 | +3,3 | +2,8 | +3,2 | +3,6 |
| Belgium | +0,5 | +3,5 | +3,5 | +3,2 | +3,6 |
| Denmark | +2,9 | +5,1 | +2,6 | +2,4 | +2,6 |
| Germany | −0,2 | +3,1 | +2,5 | +3,5 | +4,2 |
| France | +2,9 | +3,5 | +3,0 | +3,1 | +3,2 |
| Ireland | +4,3 | +3,9 | +2,6 | +3,0 | +3,0 |
| Luxemburg | +1,1 | +3,4 | +3,8 | +3,5 | +3,5 |
| Netherlands | +0,2 | +2,9 | +2,6 | +2,8 | +2,9 |
| | Countries with high inflation | | | | |
| EUR-3 | +5,7 | +6,0 | +6,7 | +6,3 | +5,3 |
| Italy | +5,7 | +5,8 | +6,2 | +6,3 | +5,6 |
| Spain | +8,6 | +6,6 | +6,4 | +5,9 | +5,3 |
| United Kingdom | +4,4 | +5,9 | +7,2 | +6,5 | +5,1 |
| | Countries with double-digit inflation | | | | |
| EUR-2 | +18,1 | +13,8 | +16,9 | +14,6 | +11,3 |
| Portugal | +13,8 | +12,8 | +13,6 | +11,5 | + 9,8 |
| Greece | +22,1 | +14,7 | +20,5 | +18,0 | +13,0 |

(1) Private consumption deflator.
(2) Forecast.
(3) Countries which registered low and converging inflation rates in the second half of the 1980s; they are the countries which participated from the outset in the narrow band of the EMS.

The price convergence in these countries up to 1990 already broadly corresponds to what might be required for the transition to the final stage of EMU. This convergence in the rate of inflation has been accompanied by a clear deceleration in the rates of increase in nominal unit labour costs.

The acceleration of inflation in 1990 and 1991 in these countries and particularly in Germany in 1992, cannot be considered satisfactory from the point of view of stability and needs therefore to be rolled back as soon as possible. Particularly since the main source of inflation seems to be higher wage costs.

A second group of countries had in 1990 an inflation rate which is still double that of the first group. Italy, which belongs to the narrow band, and Spain, which joined the wider band in 1989, have also made significant progress since the beginning of the 1980s, but they still show a much less favourable convergence position. Italy faces strong wage pressures with nominal unit labour costs rising by more than 9 % in 1990 against less than 5 % for most of the original participants in the narrow-band. These countries should gradually improve their inflation performance over the next two to three years to the level of the narrow band countries. This will require that the claims on resources of the different sectors of the economy be made more compatible with each other. Setting more ambitious but realistic inflation targets and pursuing them by stability oriented monetary and fiscal policies may help to create a stability environment and may contribute to provide a reference framework for wage developments.

The United Kingdom, which belongs to the wider band of the Exchange Rate Mechanism, is experiencing a high rate of inflation (more than 7 % in 1990 for the deflator of private

consumption adjusted for the impact of local government taxation changes) and a large current account deficit (about 2,25 % of GDP in 1990). The current recession of the economy will bring some improvement on both fronts in 1991 and 1992. The main problem for the United Kingdom's economy is the excessive increase in wage costs. What is even more worrying is that wage settlements are still running at a high rate and are only showing limited signs of reacting to the slowdown in the economy. The composition of the retail price index may also partly explain this development. After entry of the pound sterling into the ERM, expectations are favourably affected creating a better prospect for the United Kingdom to reduce inflation.

Portugal still has a very high rate of inflation (over 13 % in 1990). Nominal unit labour costs are still growing too rapidly (14,5 %). A persistent effort will be needed to reduce inflation progressively to the level in the narrow-band. Such an endeavour remains possible as experience in other countries has shown. In 1982 and 1983, when exchange rate policy in the EMS became tighter, Ireland had rates of inflation comparable to that now experienced by Portugal. The more flexible exchange rate policy implemented since October 1990 and the framework for wage moderation recently agreed with the social partners should help to put downward pressure on inflation, allowing early participation in the ERM.

The Greek economy is characterized by serious imbalances in many areas, which call for radical measures. The rate of inflation exceeded 20 % in 1990, and the budget deficit has reached unprecedented levels in the Community, leading to a rapidly rising public debt to GDP ratio. A serious adjustment effort is essential, and should be sustained over the medium-term. The Greek Government's medium-term programme proposes significant adjustments which are expected to lead to a sizable decline in inflation in 1992.

2. *Convergence of budgetary policies*

Convergence must not only be fostered from the cost and price side, but public authorities also have to reduce their claims on resources, so as to avoid unsustainable imbalances, to improve the supply side of the economy and to create room for manoeuvre when adverse developments have to be addressed.

In the budgetary area, progress in convergence has been distinctly less marked than for prices and costs. In about half the number of Member States the level of the budget deficit gives causes for concern. As indicated the process of consolidation has come to a standstill. Further progress is essential because unsustainable fiscal positions undermine over the medium and longer term the credibility of the commitment to monetary stability and impair the conduct of economic policy.

A new budgetary problem has emerged in Germany. Unification has led to a sizable deterioration in its fiscal position. Recent measures adopted in January and February 1991 increasing social contributions, income taxes and excise duties would provide the State with extra revenues amounting to some 1 % of GDP in 1991. This would result in limiting the public borrowing requirement to 4,7 % of GDP in 1991 (Table 6). Although the use of national savings to solve a temporary domestic problem can hardly be challenged, the size and abruptness of the swing in the federal budget position is from the conjunctural point of view not without risks. The strong demand from the former GDR, supported by large budgetary transfers required to avoid an economic breakdown in the five new *Länder*, may strain production capacity in West Germany, putting pressure on inflation and appreciating the exchange rate in real terms. To guard against these dangers and to avoid an overburdening of monetary policy, a more ambitious tightening of the fiscal stance would be appropriate. Moreover greater emphasis might be put on reducing expenditures and particularly subsidies to regions that are no longer peripheral as a result of unification.

*TABEL 6*

**General Government net lending (+) or borrowing (−)**

*(in percent of GDP)*

| | 1985 | 1987 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|---|
| EC | −4,6 | −4,2 | −3,0 | −4,1 | −4,6 | −4,4 |
| | High deficit/high debt countries | | | | | |
| Greece | −13,8 | −12,4 | −19,2 | −18,9 | −15,4 | −10,7 |
| Italy | −12,5 | −11,1 | −10,1 | −10,6 | −10,0 | −10,0 |
| | High debt countries | | | | | |
| Belgium | −8,5 | −7,0 | −6,6 | −6,0 | −6,4 | −6,1 |
| Ireland | −11,2 | −9,1 | −3,5 | −3,4 | −3,8 | −3,5 |
| Netherlands | −4,8 | −6,6 | −5,0 | −5,7 | −4,8 | −4,9 |
| Portugal | −10,1 | −6,8 | −3,4 | −5,8 | −5,5 | −5,0 |
| | Other countries | | | | | |
| Denmark | −2,0 | +2,4 | −0,5 | −1,5 | −1,3 | −1,1 |
| Germany | +1,1 | −1,9 | +0,2 | −2,2 | −4,7 | −3,9 |
| Spain | −6,9 | −3,2 | −2,7 | −3,7 | −2,7 | −2,0 |
| France | −2,9 | −1,9 | −1,4 | −1,6 | −1,6 | −1,5 |
| Luxemburg | +5,3 | +1,2 | +3,1 | +4,2 | +1,7 | +1,6 |
| United Kingdom | −2,8 | −1,3 | +1,0 | −0,5 | −2,2 | −3,1 |

(1) Forecast.

In Greece and Italy progress has been fairly limited. In Italy, the fiscal position deteriorated again slightly in 1990, and shows limited signs of improving despite repeated attempts at correction. The necessary reduction in the rate of inflation will have to go in tandem with significant reductions in budget deficits that allow first a stabilization, and then a reduction in the level of debt as a percentage of GDP that is now exceeding 100 % (Table 7). A disinflation process not accompanied by an appropriate budgetary adjustment woud result in an even faster rise in the public debt ratio, as was also the case in Belgium in the early and middle eighties. Given the unsustainable debt position of Italy, any postponement of corrective action only increases the adjustment effort that ultimately will have to be carried out, as the snowballing interest charges crowd out other expenditures.

*TABLE 7*

**Gross public debt in the Community countries**

*(in percent of GDP)*

| | 1986 | 1989 | 1990 | 1991 (1) | 1992 (1) |
|---|---|---|---|---|---|
| Belgium | 123,7 | 128,9 | 127,5 | 128,1 | 127,8 |
| Italy | 88,4 | 98,6 | 100,7 | 103,3 | 105,8 |
| Ireland | 115,3 | 103,8 | 99,8 | 97,4 | 95,2 |
| Greece | 65,1 | 82,9 | 86,3 | 86,0 | 83,3 |
| Netherlands | 71,7 | 78,0 | 78,5 | 78,8 | 79,9 |
| Portugal | 68,4 | 71,2 | 67,3 | 63,8 | 61,6 |
| Denmark | 66,9 | 62,5 | 62,4 | 62,3 | 61,7 |
| Germany | 42,7 | 43,6 | 43,0 | 45,4 | 47,2 |
| Spain | 48,0 | 44,6 | 45,2 | 44,5 | 43,7 |
| United Kingdom | 57,7 | 45,1 | 43,2 | 44,4 | 45,6 |
| France | 34,1 | 35,7 | 36,4 | 37,3 | 37,8 |
| Luxemburg | 13,4 | 8,5 | 6,3 | 4,7 | 3,2 |
| EUR-12 | 58,3 | 58,6 | 58,6 | 60,0 | 61,0 |

(1) Forecast.

In Greece, the budget deficit, at more than 18 % of GDP in 1990, has led to a rapid increase in the gross public debt ratio, from less than 30 % of GDP in 1980 to about 86 % in 1990. The adjustment efforts undertaken by the Greek Government are expected to result in a sizable reduction of the budget deficit this year and next. Sustained efforts over several years will be needed, however, before sufficient convergence will be achieved.

Also in Belgium, the Netherlands and Portugal the level of the budget deficit is worrying for economic and monetary union. The public debt ratio is still very high and has not yet fully been stabilized. The fiscal deficit should be reduced further so as to bring the public debt ratio on a clearly declining trend. In Belgium the public debt ratio is still excessively high (128 % of GDP in 1990). The budget deficit is still too large to put the public debt ratio on a downward path, if growth slows or interest rates rise. The double government norm aiming at freezing in real terms non-interest expenditures and at keeping constant the deficit in nominal terms, should be applied to all levels of government. Only its strict and global application will ensure that the public debt ratio will be progressively reduced, which is essential to guarantee long-term stability. In the Netherlands, the public debt ratio, though not as high as in the case of Belgium and Ireland, is still not fully stabilized. Some tightening of fiscal policy would be warranted. The budgetary situation in Portugal also needs to be improved in parallel with the disinflation process so as to maintain the progress in stabilizing the public debt ratio.

Ireland has already reduced its budget deficit substantially, so that the public debt ratio is on a clearly declining trend. This trend should now be continued.

In a last group of countries, including Denmark, Spain, France, Luxembourg and the United Kingdom, the budgetary position in terms of net lending or borrowing and public debt seems to be under control and does not present the Community with a convergence problem. The increase in the budget deficit in the United Kingdom, although partly attributable to the recession, nevertheless calls for attention. The general assessment does not detract, however, from the need, also valid for the other countries, to improve the structural features of their

public finance to benefit the supply side of the economy, to prepare for the single market of 1992 and to increase budgetary flexibility as required by a better policy mix. This will particularly involve improving the structure of expenditure and receipts, winding down in some cases the share of expenditure in GDP and lessening the tax burden.

Moreover, a few of these countries continue to suffer from strong inflationary pressures and large external deficits, such as the United Kingdom and Spain, or from high foreign debt, such as Denmark. Hence, there is a need to maintain a cautious budgetary policy in these countries.

3. *Convergence of external positions*

In an integrating economy with fully liberalized capital movements and increasing exchange rate fixity, convergence of current account balances is to be judged in a different context and the appropriateness of current account imbalances has to be individually assessed.

Spain is confronted with a high current account deficit (more than 3,5 % of GDP in 1990). A current account deficit per se would not be worrying in the Spanish case as long as it corresponds to capital imports financing rapid growth in productive investment. Such capital imports, though, exerted strong upward pressure on the exchange rate. What gives cause for concern, however, is the rapidity of the deterioration of the current account position which was still in equilibrium in 1987. However, the deficit is expected to stabilize in 1991 and 1992. If exchange rate stability is to be maintained, the rate of growth of unit labour costs in Spain must soon be brought below that of its main trading partners so as to improve its competitive position. This would also create the conditions for the continued strong growth needed both to reduce the persistently high levels of unemployment and to allow the catching-up process to continue. These considerations also apply to Greece where the external position has deteriorated sharply in recent years and only modest improvement is expected in 1991 and 1992.

In Italy the external position, while not yet giving cause for concern, nevertheless calls for a critical look at wage developments to preserve external competitiveness. In the United Kingdom some improvement is expected in the external position, largely as a result of the drop in domestic demand. Still cost developments will need to be monitored carefully to avoid a renewed deterioration of the current account once domestic demand picks up again.

The current account positions of the initial narrow band countries appear broadly sustainable. The German external surplus, which had given cause for concern in the recent past, is being eliminated from 1991 on as a consequence of the unification process. Considerable progress has been made in Denmark, where in 1990, for the first time since the early sixties, the current account has turned into a surplus and is expected to stay so in 1991 and 1992. This has been achieved, however, at a considerable cost in terms of growth. A further improvement in the competitive position, migth help to consolidate this improvement, at higher levels of activity and employment.

With appropriate monetary, budgetary and structural policies, internal inflationary pressures can be absorbed, thus preserving the positive fundamental growth conditions of the Community. At the same time, the development of the Community potential will improve the supply side of the economy and contribute to resume its medium-term growth trend. Such policy mix fulfils at the same time the requirements for a successful move towards economic and monetary union.

## MAIN ECONOMIC INDICATORS 1988 to 1992

### COMMUNITY, USA AND JAPAN

(a) **GDP at constant prices** [1]
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 4,6 | 3,9 | 3,7 | 2,25 | 2,5 |
| DK | 0,5 | 1,2 | 1,6 | 1,5 | 2,25 |
| D | 3,7 | 3,3 | 4,7 | 2,75 | 1,75 |
| GR | 4,1 | 2,8 | 0,1 | 0,75 | 1,5 |
| E | 5,2 | 4,8 | 3,7 | 3 | 3,5 |
| F | 3,6 | 3,6 | 2,8 | 1,5 | 2,5 |
| IRL | 3,9 | 5,9 | 5,2 | 1,75 | 2,25 |
| I | 4,2 | 3,2 | 2,0 | 1,75 | 2,5 |
| L | 5,5 | 6,1 | 3,7 | 3 | 3,25 |
| NL | 2,7 | 4,0 | 3,3 | 2,75 | 1,75 |
| P | 3,9 | 5,4 | 4,0 | 2,75 | 2,75 |
| UK | 4,6 | 2,2 | 0,6 | −2,25 | 2,25 |
| EC | 4,0 | 3,3 | 2,7 | 1,25 | 2,25 |
| USA | 4,5 | 2,8 | 1,0 | 0 | 1,5 |
| JAP | 5,7 | 4,9 | 5,6 | 3,75 | 4 |

(b) **Domestic demand at constant prices**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 4,1 | 4,9 | 3,6 | 2,25 | 2,25 |
| DK | −1,7 | 0,3 | −0,8 | 0,25 | 1,5 |
| D | 3,8 | 2,7 | 5,1 | 3 | 2,5 |
| GR | 7,0 | 3,3 | 2,5 | 0,75 | 2 |
| E | 7,1 | 7,8 | 4,6 | 3,5 | 4,25 |
| F | 3,8 | 3,2 | 3,2 | 1,75 | 2,75 |
| IRL | 0,4 | 6,0 | 5,5 | 1,5 | 1,75 |
| I | 5,0 | 3,6 | 1,9 | 2 | 3 |
| L | 3,6 | 7,8 | 3,7 | 4,25 | 3,75 |
| NL | 1,6 | 4,9 | 3,8 | 2,25 | 1 |
| P | 7,4 | 4,0 | 5,8 | 5,25 | 4,5 |
| UK | 8,0 | 3,1 | −0,1 | −3 | 2,5 |
| EC | 5,0 | 3,7 | 2,8 | 1,5 | 2,75 |
| USA | 3,3 | 2,2 | 0,5 | −0,5 | 1,5 |
| JAP | 7,3 | 5,7 | 5,8 | 4 | 4,5 |

(c) **Deflator of private consumption**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 1,6 | 3,5 | 3,5 | 3,25 | 3,5 |
| DK | 4,9 | 5,1 | 2,6 | 2,5 | 2,5 |
| D | 1,3 | 3,1 | 2,5 | 3,5 | 4,25 |
| GR | 14,2 | 14,7 | 20,5 | 18 | 13 |
| E | 5,1 | 6,6 | 6,4 | 6,75 | 5,25 |
| F | 2,9 | 3,5 | 3,0 | 3 | 3,25 |
| IRL | 2,5 | 3,9 | 2,6 | 3 | 3 |
| I | 5,2 | 5,8 | 6,2 | 6,25 | 5,5 |
| L | 2,8 | 3,4 | 3,8 | 3,5 | 3,5 |
| NL | 0,4 | 2,9 | 2,6 | 2,75 | 3 |
| P | 10,0 | 12,8 | 13,6 | 11,5 | 9,75 |
| UK | 4,9 | 5,9 | 7,2 | 6,5 | 5 |
| EC | 3,7 | 4,9 | 5,0 | 5 | 4,75 |
| USA | 4,0 | 4,5 | 5,0 | 4,5 | 5 |
| JAP | −0,1 | 1,7 | 2,4 | 2,75 | 2,5 |

(d) **Balance on current transactions**
(as a % of GDP)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 1,5 | 1,1 | 0,7 | 1 | 1 |
| DK | −1,2 | −1,2 | 0,8 | 1,5 | 2,5 |
| D | 4,2 | 4,7 | 3,0 | 0 | −0,25 |
| GR | −2,0 | −4,8 | −5,7 | −5 | −4 |
| E | −1,1 | −3,2 | −3,5 | −3 | −3,25 |
| F | −0,3 | −0,1 | −1,0 | −0,75 | −1 |
| IRL | 1,7 | 1,3 | 2,7 | 2,25 | 1,75 |
| I | −0,8 | −1,4 | −1,4 | −1,25 | −1,5 |
| L | 33,5 | 34,4 | 29,3 | 26,5 | 24,75 |
| NL | 2,5 | 3,3 | 4,0 | 4 | 4 |
| P | −4,4 | −2,9 | −0,1 | −1,25 | −2,25 |
| UK | −4,6 | −4,8 | −2,3 | −1 | −1,25 |
| EC | 0,1 | −0,1 | −0,2 | −0,5 | −0,75 |
| USA | −2,5 | −1,9 | −1,8 | −0,25 | −1 |
| JAP | 2,8 | 2,1 | 1,2 | 1 | 1 |

(*) Based on the forecasts of May 1991.
(1) GNP for USA and Japan from 1989 onwards.

(e) **Number of unemployed**
(as % of the civilian labour force)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 10,0 | 8,5 | 8,1 | 8,5 | 8,25 |
| DK | 6,5 | 7,7 | 8,6 | 9 | 8,75 |
| D | 6,1 | 5,5 | 5,1 | 4,5 | 4,75 |
| GR | 7,6 | 7,5 | 7,5 | 8,75 | 9,25 |
| E | 19,3 | 17,1 | 16,1 | 16 | 15,5 |
| F | 9,9 | 9,4 | 9,0 | 9,25 | 9,5 |
| IRL | 17,4 | 16,0 | 15,1 | 16 | 16,75 |
| I | 10,8 | 10,7 | 9,8 | 9,75 | 9,5 |
| L | 2,1 | 1,8 | 1,7 | 1,5 | 1,5 |
| NL | 9,3 | 8,7 | 8,1 | 7,75 | 7,75 |
| P | 5,6 | 4,8 | 4,6 | 4,75 | 5,25 |
| UK | 8,5 | 7,0 | 5,7 | 8,5 | 10,75 |
| EC | 9,7 | 8,9 | 8,2 | 8,75 | 9,25 |
| USA | 5,5 | 5,3 | 5,4 | 6,5 | 6,5 |
| JAP | 2,5 | 2,3 | 2,1 | 2,25 | 2,25 |

(f) **General government lending and borrowing**
(as a % of GDP)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | -6,6 | -6,7 | -6,0 | -0,25 | -6 |
| DK | 0,5 | -0,5 | -1,5 | -0,25 | -1 |
| D | -2,1 | 0,2 | -2,2 | -4,75 | -4 |
| GR | -15,5 | -19,2 | -18,9 | -15,5 | -10,75 |
| E | -3,3 | -2,7 | -3,7 | -2,75 | -2 |
| F | -1,8 | -1,2 | -1,6 | -1,5 | -1,5 |
| IRL | -5,2 | -3,5 | -3,4 | -3,75 | -3,5 |
| I | -10,9 | -10,1 | -10,6 | -10 | -10 |
| L | 2,1 | 3,3 | 4,2 | 1,75 | 1,5 |
| NL | -5,2 | -5,0 | -5,7 | -4,75 | -5 |
| P | -5,4 | -3,4 | -5,8 | -5,5 | -5 |
| UK | 1,1 | 1,0 | -0,5 | -2,25 | -3,25 |
| EC | -3,7 | -2,9 | -4,1 | -4,5 | -4,5 |
| USA | -2,0 | -1,7 | -2,4 | -1,75 | -2,5 |
| JAP | 2,1 | 1,8 | 2,2 | 1,75 | 2 |

(g) **Total employment**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 1,5 | 1,1 | 1,0 | 0 | 0 |
| DK | -0,0 | -0,6 | -0,7 | -0,25 | 0,25 |
| D | 0,8 | 1,4 | 2,8 | 1,75 | 0,75 |
| GR | 1,6 | 1,5 | 0,4 | -0,25 | 0 |
| E | 3,5 | 3,6 | 2,6 | 1,5 | 1,75 |
| F | 0,7 | 1,2 | 1,2 | 0,5 | 0,5 |
| IRL | 0,4 | -0,1 | 2,1 | 0,25 | 0,5 |
| I | 0,9 | 0,2 | 1,4 | 0,5 | 0,5 |
| L | 3,1 | 4,0 | 2,4 | 1,25 | 1,5 |
| NL | 1,4 | 1,6 | 1,9 | 1 | 0,5 |
| P | 0,1 | 1,0 | 2,5 | 1 | 0,5 |
| UK | 3,3 | 2,8 | 0,6 | -2,5 | -2 |
| EC | 1,6 | 1,6 | 1,6 | 0,25 | 0,25 |
| USA | 2,8 | 2,3 | 0,4 | -1 | 1 |
| JAP | 1,6 | 1,9 | 2,0 | 1,5 | 1,5 |

(h) **Real compensation of employees per head**
(annual % change) (1)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 0,8 | 0,6 | 2,3 | 2,5 | 2,5 |
| DK | -0,9 | -1,6 | 1,0 | 1 | 1 |
| D | 1,7 | -0,2 | 1,5 | 2,75 | 1,25 |
| GR | 3,7 | 4,1 | 0,6 | -2 | -0,25 |
| E | 1,1 | -0,5 | 1,2 | 1,25 | 1 |
| F | 1,2 | 1,2 | 1,8 | 1,5 | 1 |
| IRL | 2,9 | 2,2 | 3,0 | 3,25 | 2,5 |
| I | 4,0 | 3,1 | 3,9 | 1,75 | 2 |
| L | 0,5 | 3,0 | 1,8 | 2,5 | 2,25 |
| NL | 1,1 | -2,4 | 1,6 | 2 | 1,75 |
| P | 3,1 | 0,8 | 3,7 | 5,25 | 4,75 |
| UK | 2,9 | 2,8 | 3,4 | 2 | 1,75 |
| EC | 2,1 | 1,2 | 2,4 | 2,5 | 1,5 |
| USA | 1,9 | -0,7 | -0,1 | 0 | 0,5 |
| JAP | 3,4 | 2,2 | 1,7 | 1,25 | 1,5 |

(*) Based on the forecasts of May 1991.
(1) Deflated by the deflator of private consumption.

(i) **Investment in construction at constant prices**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 15,0 | 9,6 | 5,7 | -1 | 3 |
| DK | -3,1 | -4,6 | -3,8 | -3 | 0,25 |
| D | 4,7 | 5,1 | 5,2 | 3,25 | 2 |
| GR | 7,6 | 2,1 | 0,7 | 0 | 4 |
| E | 12,6 | 14,9 | 10,7 | 6,5 | 7,5 |
| F | 6,2 | 6,6 | 2,3 | 1,25 | 2,25 |
| IRL | -0,7 | 9,8 | 8,4 | 1,5 | 3 |
| I | 3,7 | 3,9 | 2,5 | 0,75 | 2,5 |
| L | 9,9 | 8,8 | 5,9 | 5,5 | 4,5 |
| NL | 11,8 | 2,6 | 2,5 | -0,25 | 0,25 |
| P | 10,1 | 3,5 | 6,5 | 6,25 | 6 |
| UK | 6,1 | -0,5 | 0,1 | -3,25 | 2 |
| EC | 6,4 | 5,3 | 3,8 | 1,5 | 3 |

(j) **Investment in equipment at constant prices**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 17,7 | 19,0 | 9,9 | 3,5 | 4 |
| DK | -7,5 | 6,6 | 2,3 | -1,25 | 4,75 |
| D | 7,7 | 9,8 | 12,9 | 8,75 | 5,75 |
| GR | 10,8 | 17,3 | 10,4 | 6 | 10 |
| E | 16,5 | 12,1 | 1,2 | 2,5 | 5,75 |
| F | 8,9 | 8,1 | 5,3 | 1 | 2,5 |
| IRL | 5,6 | 14,1 | 6,8 | 3,75 | 4,5 |
| I | 6,4 | 5,2 | 3,5 | 1,25 | 5,25 |
| L | -5,4 | 14,9 | 5,6 | 6,25 | 5,75 |
| NL | 6,8 | 5,5 | 6,0 | 2,75 | 0,25 |
| P | 23,2 | 7,7 | 8,5 | 5,25 | 5,5 |
| UK | 17,7 | 8,4 | -3,7 | -17 | 3,5 |
| EC | 10,4 | 8,6 | 4,7 | 0,25 | 4,5 |

(k) **Gross fixed capital formation at constant prices**
(annual % change)

| | 1988 | 1989 | 1990 (*) | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 13,5 | 13,6 | 7,6 | 1 | 3,5 |
| DK | -6,6 | 0,2 | -1,0 | -2,25 | 2,25 |
| D | 5,1 | 7,1 | 8,8 | 6 | 4 |
| GR | 8,8 | 8,6 | 5,2 | 3 | 7 |
| E | 14,0 | 13,7 | 6,7 | 5 | 6,75 |
| F | 8,5 | 5,8 | 4,0 | 1,25 | 2,5 |
| IRL | 4,6 | 11,3 | 7,5 | 2,75 | 3,75 |
| I | 6,7 | 5,1 | 3,0 | 1 | 4 |
| L | -5,5 | 13,4 | 5,8 | 5,75 | 5 |
| NL | 9,4 | 3,0 | 4,1 | 1,25 | 0,25 |
| P | 15,0 | 7,5 | 7,5 | 5,75 | 5,75 |
| UK | 14,8 | 4,8 | -1,9 | -10,5 | 2,75 |
| EC | 9,0 | 6,7 | 4,3 | 0,75 | 3,75 |
| USA | 5,0 | 2,7 | -0,1 | -3 | 5,75 |
| JAP | 12,6 | 11,0 | 10,8 | 5 | 6,5 |

(l) **GDP per head**
(EC = 100), at current prices and current PPS

| | 1960 | 1973 | 1986 | 1991 (*) | 1992 (*) |
|---|---|---|---|---|---|
| B | 95,4 | 101,2 | 100,6 | 104,4 | 105,1 |
| DK | 118,3 | 113,1 | 117,0 | 108,5 | 108,9 |
| D | 117,9 | 111,1 | 114,0 | 113,8 | 112,3 |
| GR | 38,6 | 56,8 | 55,9 | 52,5 | 52,3 |
| E | 60,3 | 79,0 | 72,8 | 79,3 | 80,5 |
| F | 105,8 | 110,4 | 110,1 | 108,9 | 109,1 |
| IRL | 60,8 | 58,9 | 63,4 | 68,9 | 69,0 |
| I | 86,5 | 93,3 | 103,0 | 103,6 | 104,0 |
| L | 158,5 | 141,9 | 126,2 | 133,0 | 134,9 |
| NL | 118,6 | 113,1 | 106,0 | 103,9 | 103,3 |
| P | 38,7 | 56,4 | 52,5 | 56,7 | 57,1 |
| UK | 128,6 | 108,5 | 105,4 | 101,3 | 101,3 |
| EC | 100,0 | 100,0 | 100,0 | 100,0 | 100,0 |
| USA | 189,6 | 161,6 | 155,7 | 147,3 | 145,6 |
| JAP | 55,8 | 96,3 | 110,7 | 121,7 | 124,0 |

(*) Based on the forecasts of May 1991.
*Source:* Commission services.