

II

(Acts whose publication is not obligatory)

COUNCIL

COUNCIL DECISION

of 22 December 1986

adopting the annual report on the economic situation in the Community and laying down economic policy guidelines for 1987

(86/667/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

HAS ADOPTED THIS DECISION:

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Decision 74/120/EEC of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community ⁽¹⁾, as amended by Decision 75/787/EEC ⁽²⁾ and by Decision 79/136/EEC ⁽³⁾, and in particular Article 4 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament ⁽⁴⁾,

Having regard to the opinion of the Economic and Social Committee ⁽⁵⁾,

Article 1

The Council hereby adopts the annual report on the economic situation in, and economic policy guidelines to be followed by, the Community, contained in Part I of the Report annexed hereto, and lays down the economic policy guidelines to be followed by the Member States, contained in Part II of the said Report.

Article 2

This Decision is addressed to the Member States.

Done at Brussels, 22 December 1986.

For the Council

The President

G. SHAW

⁽¹⁾ OJ No L 63, 5. 3. 1974, p. 16.

⁽²⁾ OJ No L 330, 24. 12. 1975, p. 52.

⁽³⁾ OJ No L 35, 9. 2. 1979, p. 8.

⁽⁴⁾ OJ No C 322, 15. 12. 1986.

⁽⁵⁾ OJ No C 333, 29. 12. 1986.

ANNUAL ECONOMIC REPORT
1986/87

ANNUAL ECONOMIC REPORT 1986/1987

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ANNEX

PART I

REDUCTION OF UNEMPLOYMENT IN A MORE DYNAMIC EUROPEAN ECONOMY

FOR AN EFFECTIVE IMPLEMENTATION OF THE
COOPERATIVE COMMUNITY STRATEGY

1. SUMMARY AND CONCLUSIONS

- 1.1. In adopting the last Annual Economic Report (1985/86), after taking note of the favourable opinions of Parliament, the Economic and Social Committee and the European social partners, the Council endorsed the Commission's proposed 'cooperative growth strategy for more employment' in the Community.

The aim of the strategy is to achieve a significant and lasting reduction of unemployment over a period of several years. Unemployment in Europe is the result of serious economic and social disequilibria. It cannot be overcome with *ad hoc* measures that merely treat the symptoms. The Community strategy takes both the macro- and microeconomic, as well as the social aspects of the problem, into account and attempts to tackle unemployment at its root. At a macroeconomic level, this means that there must for some time to come be continued moderation in the growth of real wages, but that *at the same time* there must be an appropriate evolution of demand conforming to stability requirements. This combination will strengthen profitability, investment and employment. At the microeconomic level, paying due regard to the social aspects, the adaptability of markets for goods, services, capital and labour must be improved, and, in particular, the establishment of new firms, the development of vocational training and the introduction of new technologies must be promoted. This will facilitate the necessary structural change, generate a new economic impetus and make it possible to improve further the competitiveness of the European economy, taking advantage of the large European internal market.

The more dynamic and more employment-creating growth resulting from such a policy was illustrated with an annual rate of some 3 to 3,5 % at Community level for the period 1986 to 1990. This might be associated with average employment growth of some 1 to 1,5 % a year, which would allow the average unemployment rate in the Community to be brought down by just under four percentage points by 1990 ⁽¹⁾. This would represent major progress

compared with the trend in recent years, when unemployment has been rising or remaining stationary at a high level.

However, such progress does not yet mean full employment. There remains an urgent need for complementary measures, particularly as regards youth unemployment and long-term unemployment, if relatively large groups of the population are not to be left jobless for a long time to come. The political and social long-term implications of such a development could be disastrous. The sectoral and regional changes associated with the necessary adjustment of production structures and technological progress also require back-up measures to take account of the social dimension: the faster the Community economy regains its momentum, the easier it will be to deal with problems here.

If the Community strategy is to be successful, there must be evolution, in some cases substantial, in economic policies and behaviour compared with the past. Such changes are under way. They must be speeded up and consolidated. It is a question of ensuring that economic agents make a balanced contribution to the success of the strategy and that the acceptance of economic policy is reinforced. The social dialogue at Community level, and in particular at national level, is therefore an important instrument in implementing the strategy.

- 1.2. This Annual Economic Report 1986/87 examines economic trends and outlook and updates economic policy guidelines in the light of the Community strategy.
- 1.3. *The Community's economic environment* has changed considerably as a result of the fall in oil prices, the normalization of the dollar exchange rate and the fall in interest rates. The oil-consuming industrial countries have never experienced such a sharp improvement in their terms of trade in so short a period of time in the post-war years. The devaluation of the dollar took place against a background of better coordination, to which the Plaza agreement in

⁽¹⁾ 1990: EUR 10 some 7%, EUR 12 some 8%.

September 1985 and the results of the Tokyo Summit in May 1986 contributed. The fall in interest rates constitutes welcome, but insufficient, assistance for the highly indebted developing countries. The recent negotiations on Mexico's foreign debt and domestic adjustment policy can also be seen as an example of positive developments. The agreement reached in Punta del Este in September 1986 to start a new round of multilateral trade talks in the framework of GATT lends strength to the hope that the trend towards protection can be halted and reversed.

Despite these positive developments at international level, considerable efforts are still necessary if the major problems facing the world economy are to be solved. There remains an urgent need to improve the international monetary system. If there is to be a return to an acceptable distribution of current account balances at world level, there must be a gradual reduction in the United States budget deficits and expansionary fiscal measures in Japan, together with a further rise in the value of the yen. The most important contribution that the Community and the EFTA countries can make to this international process of adjustment is to reinforce their own growth on solid foundations. An adequate expansion of world trade depends therefore basically on a stronger growth in Japan and Europe. Moreover, the problem of the heavily indebted developing countries can be resolved only in the longer term against a background of stronger world-wide growth.

However, compared to present forecasts, the *growth prospects for world trade* could be significantly reduced by the serious risk factors weighing upon the international economic environment. These risks can be identified as follows:

- a significant further devaluation of the dollar or uncontrolled movements of exchange rates.
- an insufficient or inappropriate adjustment process in Japan and the United States which could lead to a rapid increase in protectionism — in spite of the intentions declared at Punta del Este —, a recession in the United States or a resurgence of inflation,
- a major further change in the price of oil,
- an aggravation of the situation of the developing countries: confronted with the continued drop in the terms of trade for the primary materials which they export and a lack of sufficient external financing or growing outlets for their agricultural

or manufactured output, these countries could be constrained to reduce further their growth and their imports.

But even if there is a favourable development of the world economy, the Community will not be receiving any great stimulus towards growth from world trade in the next few years. This is due to the nature of the necessary process of adjustment: a reduction in the huge United States trade deficit, and consolidation of the position of the OPEC and developing countries. For the Community, this is a further reason to reinforce international cooperation to facilitate the necessary adjustments at the world level and intensify its effort to augment its own growth potential.

- 1.4. *Within the Community, the moderate upswing is continuing in 1986, and will probably persist in 1987.* According to forecasts, growth in real GDP should accelerate slightly (1985: 2,4 %; 1986: 2,5 %; 1987: 2,8 %) but it has not yet reached the level which would be possible and necessary in order to secure a substantial and lasting fall in unemployment in the Community. Certainly, the threshold beyond which economic growth produces higher employment is now appreciably lower than it was in the sixties or seventies. An increase of some 0,8 % in employment is expected in 1986 and 1987. The labour force is continuing to grow, however, which is due less and less to demographic factors and increasingly to changing labour market behaviour; the average unemployment rate in the Community will fall only slightly (EUR 9: 1985: 11,1 %; 1986: 11 %; 1987: 10,8 %). This is still thoroughly unsatisfactory.

Similarly unsatisfactory is the pattern of *growth across the regions and Member States of the Community*. Before the first oil shock, the less-developed regions and countries were clearly catching up in terms of real GDP per head, but this process has since come to a halt or has even partially been reversed. In 1986 and 1987 there seems still to be no real convergence under way. Promotion of this process is an essential element in reinforcing the economic and social cohesion of the Community.

In overall terms, growth in the Community now derives from *internal demand*. This shift occurred in the first half of 1986, hesitantly at first, and meant that last spring's growth forecasts for 1986 had to be revised downwards slightly. The dynamic elements in real domestic demand are now investment in equipment (1986: 6,1 %; 1987: 6,9 %) and private consumption (1986: 3,7 %; 1987: 3,5 %); investment in construction is recovering, while public consumption continues to grow very slowly. Despite

the worsening in the real current account balance for goods and services, which has negative repercussions on growth, the Community's nominal current account surplus is continuing to rise temporarily (1985: 0,5 % of GDP; 1986: 1,2 %; 1987: 0,9 %).

These developments primarily reflect the *considerable improvement in the terms of trade* as a result of the falling price of oil and the devaluation of the dollar. The Community's oil bill has been halved; the purchasing power of private households will increase considerably in 1986 and 1987 in most countries; real wage costs per head show practically no increase in 1986, but could speed up again in 1987; the profitability of firms has improved, even if the Community average is still far below the level which obtained before the first oil shock; in some Community countries, the improvement in the terms of trade has partially been used to take measures in order to relieve the pressure on public budgets.

The sustained growth of *investment* by enterprises which is apparent in 1986 and forecast for 1987 not only supports demand but also leads to an increase in *productive capacity*. However, the overall level of investment in the Community (as a percentage of GDP) remains about four points lower than its level before the first oil shock, and the increase in productive capacity and creation of new jobs still need to accelerate progressively. An increased investment effort therefore remains necessary for several years.

There has been a further fall in *inflation rates*, and a strengthened convergence towards greater stability. This favourable development is also largely due to the improvement of the terms of trade. The fall in import prices, notably for oil products, puts a brake on the rise in the consumer price index and leads, in most countries, to a slower growth in nominal wages and costs. But this must also be regarded as a success for the more convergent stabilization policies pursued for several years in the EMS and the Community. The average inflation rate in the Community (private consumption prices 1986: 3,7 %; 1987: 3,0 %) has now fallen to a level which has not been seen for 20 years. This greater stability and price convergence must be maintained and consolidated. Some optimism seems justified in this regard. Even if capacity utilization rates have risen, the recovery in investment is beginning to contribute to an increase in capacity, and the point at which tensions appear may be receding. Moreover, the evolution of import prices does not seem to imperil internal stability in 1987 and there are chances that the growth of nominal wages

will take account of the lower rate of inflation in most countries. Concerning this last point, the importance of the social dialogue is evident.

- 1.5. The clear improvements in supply-side conditions achieved over the last few years and the positive effects of the fall in the price of oil are not sufficient to move the Community spontaneously towards a path of adequate and employment-creating growth allowing unemployment to be reduced in the way which is desired. Medium-term studies show that, despite the better conditions, the average growth rate for the years 1986 to 1990 could continue to lie below 3 %, and that in these circumstances unemployment in the Community of Twelve could still be above 10 % in 1990. One reason is that, in the next few years, there will be no strong stimulus towards growth coming from the international environment. *The Community cooperative growth strategy for more employment*, which was adopted last year and is summarized in point 1.1 above, has not lost its relevance. Quite the reverse, it *must now be implemented deliberately and with determination*. It is in this way that the improvement under way in supply conditions and behaviour can be put to the service of a faster growth of employment and that the favourable conditions resulting from the fall in the oil price and lower inflation can be best exploited. If this opportunity is not seized in 1987 and 1988, it will no longer be possible to reduce unemployment in the Community significantly by the end of the decade.

The effective implementation of the Community strategy for growth and employment is also an important element for achievement of the major projects and tasks that the Community is committed to in the medium-term. In this context, there is a particular link of mutual reinforcement. The encouragement of technological advance and the completion of the internal market will supply an essential boost to the economic potential and competitiveness of the Community; simultaneously, the achievement of this task will be significantly aided – from the social point of view also – if implementation of the strategy leads effectively to a more vigorous and employment-creating growth. This growth should greatly help the catching-up process of backward regions and the reconversion of declining industrial regions; simultaneously, the reinforcement of the economic and social cohesion of the Community and the renewal of the process of real convergence should contribute to increasing the economic potential and dynamism of the Community. Finally, growth with stable monetary conditions should facilitate the development of the EMS and monetary cooperation; at the same time the creation of a zone of monetary stability encourages trade, reinforces integration and dilutes the impact of external shocks.

- 1.6. In 1987 and during the following years, the effort to improve supply conditions and the adaptability of markets must be pursued. However, when the positive impact of the improvement of the terms of trade fades, it will be necessary to sustain *internal demand*, consistently with the goals of medium-term consolidation of public finance.

Business investment should and can be the most dynamic factor. It would suffice that present trends become more dynamic to arrive at the expansion necessary for achievement of the objectives of the Community strategy. Any investment is, of course, based on a realistic economic assessment; this is why it is important to pursue efforts to improve profitability, reduce real interest rates on a sound basis and promote the use of risk capital. However, the decision to invest also depends upon confidence and entrepreneurial readiness to take risks; thus a positive influence must be brought to bear on these attitudes. The contribution of entrepreneurs therefore is to respond to increasing profitability with higher, and more job-creating investment.

Public investment and infrastructure investment in the broader sense, which must not all be financed from public funds, should likewise form a dynamic component of demand. Public investment has suffered from the consolidation of public finance; since the beginning of the 1970s, its share of Community GDP has declined by almost 1,5 percentage points. There is now a need to make up for the ground lost as far as economically viable projects of this kind are concerned. Here, the necessary initiatives must be taken, both at national and Community level, and the private and public resources required must be made available. The room for manoeuvre enjoyed by the public authorities as a result of restructuring and additional revenues or decreased expenditure through growth and employment should, to some extent, be exploited in implementing such projects.

In the next few years, *private consumption*, as the biggest aggregate in domestic demand, can also sustain demand. The moderate *increase* in real wages, increased employment and the lowering of taxes and social security contributions, due to the use of increased budgetary room for manoeuvre, enable private consumption to rise in the medium term at real rates of growth which approximate to GDP growth rates. In this connection, it is important that reductions in taxation and social security contributions are effected relatively early on, while adhering to the goal of medium-term consolidation of public finances. At a later stage, when the profitability of firms has strengthened and there is a greater increase in employment, growth in employment and gradually accelerating increases in real wages can

themselves more easily sustain private consumption and, at the same time, produce additional revenue for the public authorities as well as lower expenditure.

- 1.7. *Public finance policy* has an important but particularly difficult role to play in implementing the Community strategy. The goal of medium-term consolidation of public finances should be further pursued. At the same time, it is important that all existing and future room for manoeuvre should be exploited in a determined fashion, and as quickly as possible, in order to improve the conditions governing supply and demand through the lowering of taxes and social security contributions and by stepping up public investment. This margin comes from supplementary receipts and lower expenditures resulting from more vigorous growth and the increase in employment. However, the room for manoeuvre available to the various Member States differs very considerably. The situation appears to be most favourable in Germany and Luxembourg. In France, existing room for manoeuvre is being used, large tax reductions already being foreseen for 1987 and supplementary reductions announced for 1988, while the budget deficit would be simultaneously reduced in each of the two years. If growth were to strengthen still further abroad, and, particularly in the Community, budgetary policy in France would be facilitated all the more. In the United Kingdom, the Government, in its autumn statement, provided for an increase in public expenditure of some £ 4 750 million in 1987/88. This will mean that public expenditure in 1987/88 is planned to be about 2 % higher in real terms than the estimated out-turn in 1986/87. On the other hand, the persistent, excessively high deficits and the level of the public debt in Belgium, Greece, Ireland, Italy and Portugal mean that priority must continue to be given to the consolidation of public budgets. In recent years, Denmark has shown that this can be compatible with a favourable trend in business investment and in employment. Although, in the final group of countries (Denmark, Spain, the Netherlands), budgetary constraints are less severe, other factors in the foreseeable future limit the scope for macroeconomic action.

In 1987 and 1988 it will therefore probably only be possible for a small group of countries to use budgetary policy to exert an overall influence on supply and demand conditions. It is also of importance that the number of such countries is increasing as the economic recovery is further progressing. This beneficial chain reaction must be reinforced through concerted action. In addition, all Member States continue to have supplementary room for manoeuvre to create more favourable conditions for increasing employment through the restructuring of public revenue and expenditure (including the selective dismantling of subsidies). These possibilities should not be underestimated and an exchange of

experiences should take place. The principle of restructuring should also apply to the Community budget.

- 1.8. Despite the considerable changes that have occurred in the international monetary environment, the basic principles governing *monetary policy in the Community* do not need to be adapted. The aim of monetary policy should continue to be appropriate financing of the available scope for real growth and, at the same time, consolidating and, where necessary, extending the successes that have already been achieved in regard to the reduction in inflation rates. Until now, the task of monetary policy has been greatly facilitated by external economic developments. The devaluation of the dollar and the decline in oil prices and United States interest rates have created further headroom for interest-rate cuts without posing any risks on the inflation front. A further sharp fall in the dollar might require a flexible response on the part of interest rates in Europe in order to counter the danger of a renewed overshooting of the dollar, together with the adverse repercussions this would have in the medium term. However, care must be taken here to ensure that there is no new build-up of inflationary potential. The erosion of inflationary expectations and the stronger trend of aggregate saving are also expected to bring about a fall in long-term real interest rates on a sound basis in most countries. This is consistent with the strategy. The EMS has shown itself to be a stabilizing factor. Closer convergence coupled with moves to liberalize capital movements has accentuated the need for tighter economic policy coordination, not only domestically between monetary policy, budgetary policy and income trends but also between Member States. The progress that has been made in establishing a zone of monetary and currency stability is reducing the dependency on external influences. This provides a sound basis for further progress in integrating the economies of Europe.

- 1.9. The measures to *improve market adaptability* and the business environment, to foster the establishment of new and, in particular, small and medium-sized businesses, to promote vocational training as well as to encourage the development and application of new technologies, must be advanced as a matter of priority. Completion of the internal market is an essential element for reinforcing competition and improving markets. Labour market policy is especially important for the achievement of employment-creating growth. The social partners should continue to pursue moderate real wage increases conducive to employment until such time as employment-creating investment becomes sufficiently profitable and the unemployment rate shows a continuing marked decline from one year to the next. Substantial progress has been made in moderating real wage increases in most countries in recent years and, provided there is adequate growth in demand, this

should rapidly show up in a stronger rise in employment. Some reduction of social security contributions could also help to strengthen employment. However, this should rely on the use of available financial headroom and should not affect either the quality of social protection regimes or their financial balance. Moreover, adjustments of certain excessive or outdated labour market rules and regulations could help to create new jobs. A large number of initiatives to promote job creation, especially for the self-employed and in small businesses, have been taken or are being examined; they should be encouraged and experiences in this field exchanged.

In many cases, the measures to improve the adaptability of markets, and in particular, the labour market, have important social repercussions that should be discussed in detail with the social partners. Some of them are largely a matter of free collective bargaining between the two sides of industry. This is true, for example, of the reorganization and reduction of working time, which can likewise make the growth process more employment-creating provided it has a neutral impact on the level of costs.

In this connection, the principle set out in last year's Annual Economic Report should continue to apply, namely: 'The spirit in which the debate about market adaptability is held is important for its success. The objective behind efforts to increase flexibility is not to destroy achievements made on the social front but to create more jobs. As far as at all possible, therefore, economic efficiency should be reconciled with the maintenance and further development of social achievements.'

- 1.10. If the *Community growth strategy* for more employment is to be *successful*, it is important that the guidelines it contains should also be translated into practice in all Member States. This is true both of macroeconomic and microeconomic measures in the economic policy field and of the social dialogue at Community and national level.

In its communication, due for presentation to the Council (Economic and Financial Affairs) in July 1987, the Commission intends to conduct an interim assessment of the way in which the Community strategy is being implemented. Discussion of the Commission's interim assessment could provide the Council (Economic and Financial Affairs) with an opportunity to fulfil the mandate assigned to it by the European Council of The Hague 'to follow progress in implementation of the cooperative growth strategy adopted at the end of 1985.' In this context, and in order to facilitate this work, the Commission invites governments of the Member States to submit by the beginning of May a short report on the initiatives and tangible economic policy measures taken by them in

their own country. These reports, possibly accompanied by reports compiled by the social partners, could be discussed in the Economic Policy Committee and as a part of the European social dialogue.

At national level, the social level, the social dialogue on the various aspects of the Community strategy has not made sufficient headway in many countries. The Commission is, therefore, calling on Member States' Governments, pursuant to Article 3 of Council

Directive 74/121/EEC of 18 February 1974 on stability, growth and full employment in the Community⁽¹⁾, to take the necessary initiatives, taking into account the particular conditions in individual countries.

In addition, the Commission invites the social partners to engage, if appropriate on their own initiative, in dialogue at the national level on the themes of the Community strategy.

⁽¹⁾ OJ No L 63, 5. 3. 1974, p. 19.

2. EVOLUTION OF THE ECONOMY AND CONVERGENCE

2.1. The world economy

In the last 18 months, there have been three striking developments in the world economy — the halving of dollar oil prices, a correction of the dollar's overvaluation and the reduction in interest rates. All of these three interconnected developments will help the world economy move back towards a more stable growth path in the medium term. Nonetheless, the short-term forecast of world economic growth is not much more optimistic than it was at this time last year. Growth in the OECD area as a whole is expected to be about 2,5 % in both 1986 and 1987, slightly less than in 1985.

Oil prices have fallen from a range of US \$ 25 to 30 per barrel in 1985 to US \$ 10 to 15 per barrel during the course of this year. The proportionate fall is even greater measured in European currencies. Thus the spot oil price fell in dollars by around 50 % in the 12 months to September 1986; in ECU it fell some 65 %. The impact will not be limited to the oil market itself but there will also be widespread indirect effects, namely the reduction in the oil bill, the disinflationary impulse, the beneficial consequences for potential output in industrial countries and thus the possibility of economic policies consistent with a faster rate of growth. A halving of the price of oil is unprecedented and the effects on the world economy cannot be predicted at all surely.

Prices as low as US \$ 10 to 15 per barrel are expected to induce a significant increase in oil consumption and a greater energy intensity of growth which would be even more marked if domestic prices of other energy sources were to adjust to this fall. Domestically, this risks accentuating problems associated with the protection of the environment. Externally, allied to the fall in oil supply from producing countries, a marked increase in consumption of oil and oil-based products would increase the probability of a rapid recovery in their price.

A halving of the dollar price implies a fall in the cost of the western world's consumption of some US \$ 220 000 million. Over a half of this oil is traded internationally implying lower payments to net oil-exporting countries from net oil importers of about US \$ 120 000 million. The fall in the Community's total oil bill (including domestic production), based on 1985 consumption levels, is worth some 85 000 million ECU (2,5 % of GDP), while the net oil import bill will fall by some 60 000 million ECU (1,8 % of GDP).

The slowing of inflation caused by the oil price cut has helped in the lowering of interest rates. In the United States, short-term rates declined by 1½ percentage points in the year to July 1986, while long-term rates declined even more, by 2½ percentage points. There were similar falls in the Community (where short-term rates also declined by 1½ percentage points and long-term rates by 2 percentage points). The marked easing in monetary policy, especially in the United States, has significantly contributed to these interest-rate movements (see Graphs 8 and 9).

Lower oil prices and interest rates lead to higher profitability in energy consuming industries, with the likelihood that industrialists may either increase new investment or delay scrapping of older plant. This would imply a certain 'supply-side' increase in potential output.

The widespread falls in interest rates are a welcome but insufficient help for the heavily indebted developing countries. A generalized decline in interest rates of 1 percentage point is worth around US \$ 7 000 million per year to the indebted developing countries (reflecting the extent of their short-term or floating rate debt). However, at the same time, the indebted developing countries have suffered a further deterioration of their terms of trade (-1,7% in 1985) and a fall in their export earnings (-1,6% in 1985 and -0,9% forecast for 1986). As a

result, they incurred a larger deficit on current account and were on the whole unable to increase their growth rate (4,1 % in 1985 and 3,3 % forecast for 1986). In particular, the oil exporters (mainly OPEC but also Mexico, China and Malaysia) face a period of austerity, implying a cut in imports. The prospects are, however, better for some newly industrialized countries (for example Taiwan and South Korea) where the alignment of their currencies to the weakening US dollar has given them a great competitive advantage.

The fall in the dollar to date, although large (33 % against the ECU in the 18 months to September 1986, 40 % against the yen), is not on its own sufficient to equilibrate rapidly the United States trade account. In the first half of 1986, the fall in oil prices countered the effects on the terms of trade of the dollar's devaluation. However, dollar oil prices are not, in the Commission's short-term forecasts, expected to fall much further, so rising non-oil import prices will thereafter worsen the terms of trade. In time, this will lead to an adjustment in United States export-import volumes; but for 1986 and 1987, it is not yet possible to anticipate an improvement in the trade deficit since expenditure on imports could increase faster than receipts from exports (J-curve effect). Moreover the current account is being progressively weighed down with the interest service burden of the accumulating foreign debt of the United States. These factors mean that the United States current account deficit is expected to remain well in excess of US \$ 100 000 million in 1986 and 1987. The surpluses of the Community and Japan will increase substantially in 1986 because of the oil price effect. As a share of GDP, Japan's surplus could be over 4 % in 1986, a percentage four times greater than that of the Community.

As regards domestic adjustment policies in the *United States*, the Gramm-Rudmann-Hollings Deficit Reduction Act, enacted at the end of 1985, sought to impose rigid budgetary discipline reducing the federal budget deficit to zero over five years. However, the outlook for the achievement of this objective remains uncertain. Nevertheless, the pressure for deficit reduction from the US \$ 230 000 billion level of fiscal year 1986 is strong, implying a restrictive US fiscal policy for several years. Budgetary policy in *Japan* remains geared towards the objective of strengthening the public finances in the medium term. In the autumn, a programme of measures supporting domestic demand was, indeed, adopted by the Government including, in particular, accelerated spending of 3 000 000 000 000 yen (1 % of nominal gross domestic product) on public works. Despite these measures, it appears nevertheless that the repercussions of the gains in the terms of trade to the whole economy, and in particular to consumers, are only coming through unevenly and have not as yet generated the stimulatory effect which was initially expected.

The overall growth in world trade of manufactures should remain moderate. The terms of trade of the industrialized

countries have improved greatly in 1986 (by 7 1/2 % but by more than 30 % excluding intra-OECD trade), the largest improvement recorded since the war. However, the volume of world imports (excluding the Community), weighted by the Community's market shares, is likely to grow only very slowly (about 1,3 % in 1986, 2,4 % in 1987). This underlines the growing need for a domestically generated economic expansion in Europe as a whole.

Present economic indicators signal for 1987 neither strong growth nor a recession in the world economy. However, there are risks attached even to this rather moderate outlook, and the hypothesis of the Commission as regards world trade could prove to be optimistic. Thus:

- (i) The depreciation of the dollar has not yet led to an acceleration of inflation in the United States. However, it is probably only a matter of time before the dollar's depreciation results in more marked import prices for the United States, and some upward adjustment of world commodity prices denominated in dollars. Therefore, the risk of resurgent inflation should not be underestimated. If a contractionary budgetary policy required to reduce the budget deficit were to coincide with a tightening of monetary policy either to prevent an excessive fall of the dollar's exchange rate or to choke off a rapid increase in inflation, then a recession there could well result;
- (ii) Oil prices could recover more rapidly than presently expected, especially if, as began to be the case already in mid-1986, OPEC-countries were able to act in concert to restrict output. It is possible that the fixing of quotas by the OPEC countries in mid-1986 has already begun a movement in this direction. However, it must be recognized that the oil price is now potentially volatile in both directions.
- (iii) The international debt and banking system as a whole is still exposed to the possibility of major country defaults stemming from high international indebtedness and the rather unsatisfactory outlook for developing countries.

In the last year, the world economic environment has changed dramatically with the lower oil price and dollar exchange rate and lower interest rates. The magnitude and the suddenness of the associated improvement in the terms of trade of the oil consuming industrialized countries is unprecedented in post-war history. It should be expected that domestic demand in the industrialized countries will be strong enough to avoid a slowdown in the trend of world demand and output. However, the economic adjustment process will take time and there is a danger of disruptions in

this process towards a new, more balanced state of the world economy. Industrialized countries in particular must implement specific, coordinated policies in order to benefit fully from the improved supply side conditions and to

accelerate the process of correcting the major balance of payments disequilibria. The debt situation of the developing countries is also still precarious, and represents a risk to the international economy.

TABLE 1
World output, trade and prices

	1984	1985	1986	1987
<i>Real gross domestic product — % change on preceding year:</i>				
EUR 12	2,2	2,4	2,5	2,8
Other OECD	5,5	3,4	2,6	2,4
— USA	6,5	2,8	2,8	2,3
— Canada	5,0	4,5	3,3	2,8
— Japan	5,7	4,5	2,0	2,4
— rest OECD	3,3	3,6	2,5	2,4
Total OECD	4,4	3,0	2,6	2,5
<i>Volume of world imports — % change on preceding year:</i>				
Including EUR — world import weights	9,3	3,4	3,8	4,4
Excluding EUR — world import weights	10,4	2,2	2,3	3,1
Excluding EUR — EUR markets weights	7,5	1,9	1,3	2,4
<i>World export prices in US \$ — % change on preceding year:</i>				
Raw materials excluding fuels	-1,5	-10,5	3,2	-1,6
Crude oil (fob)	-4,5	-3,0	-47,3	-12,9
Manufactured products	-2,8	-1,2	17,3	4,0
<i>Balance on current account — billions of US \$:</i>				
EUR 12	2,8	14,4	50,5	43,5
Other OECD	-67,5	-74,4	-65,8	-75,5
— USA	-101,6	-117,7	-139,5	-140,5
— Canada	1,9	-1,7	-5,4	-6,5
— Japan	35,1	49,2	85,0	79,0
— rest OECD	-3,0	-4,3	-6,0	-7,6
Total OECD	-64,7	-60,0	-15,3	-32,0
OPEC countries	-6,0	1,4	-32,2	-24,8
Other developing countries ⁽¹⁾	-20,0	-22,2	-22,3	-21,2
Other countries ⁽²⁾	25,2	5,0	-1,4	-0,7
Errors and omissions	-65,5	-75,8	-71,1	-78,6

⁽¹⁾ Other developing countries include China, Yugoslavia and South Africa.

⁽²⁾ Other countries exclude intra-Comecon trade.

Source: Commission services (based on October economic forecasts).

TABLE 2

The savings/investment balance for the United States, Japan and the Community (% of GNP/GDP)

		Source of funds					Use of funds		
		Private savings	-	Private Investment	=	Surplus savings	=	Current account surplus	+ General Govt. deficit
USA	1985	17,2	-	16,6	=	0,6	=	-2,9	+ 3,5
	1986	16,4	-	16,5	=	-0,1	=	-3,5	+ 3,4
	1987	15,9	-	16,6	=	-0,7	=	-3,3	+ 2,6
Japan	1985	32,9	-	28,0	=	4,9	=	3,7	+ 1,2
	1986	34,2	-	28,9	=	5,3	=	4,3	+ 1,0
	1987	33,5	-	29,5	=	4,0	=	3,5	+ 0,5
EUR 12	1985	21,7	-	16,1	=	5,6	=	0,5	+ 5,1
	1986	22,4	-	16,5	=	5,9	=	1,2	+ 4,7
	1987	22,6	-	17,0	=	5,0	=	0,9	+ 4,1

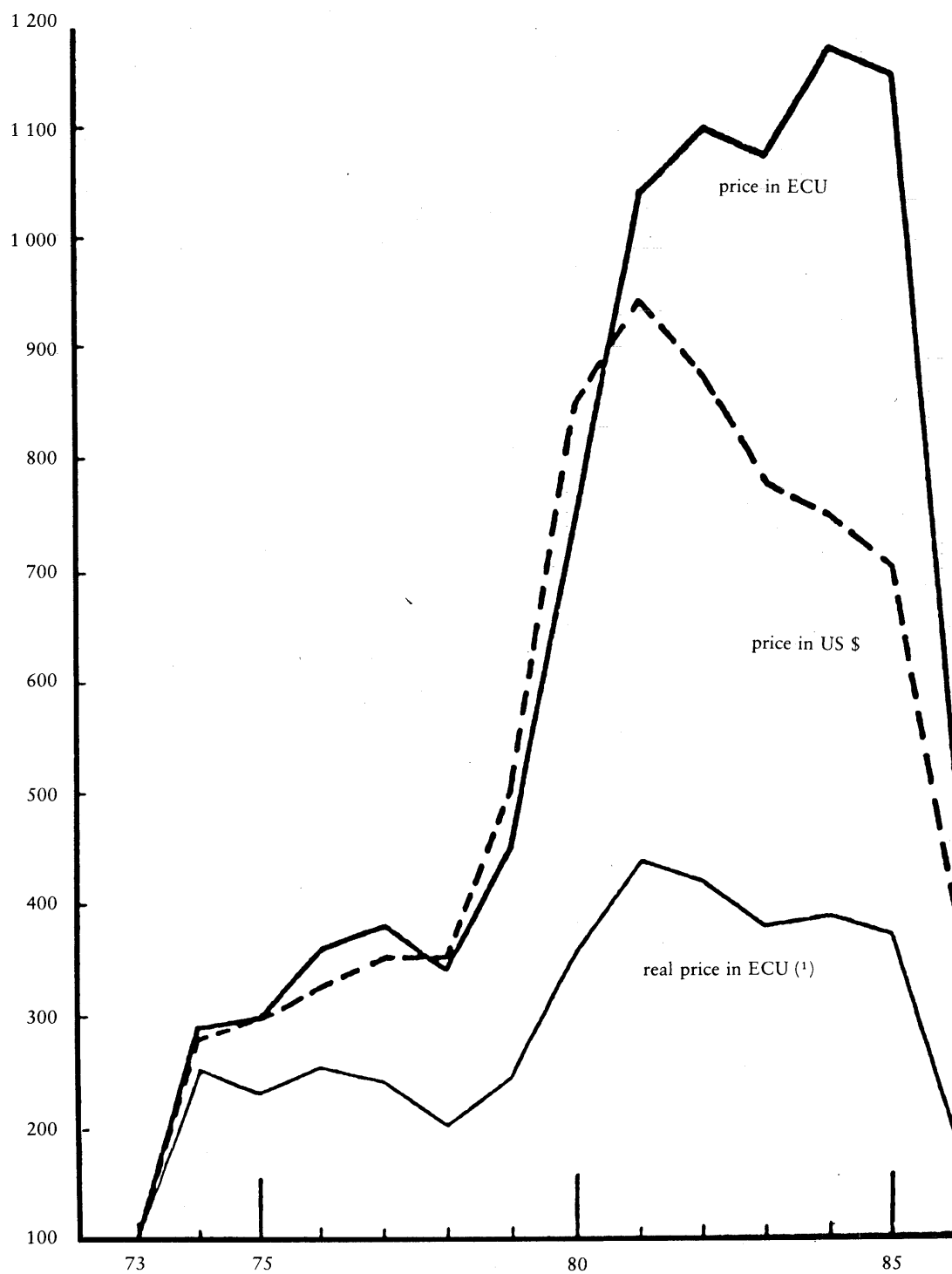
NB: National accounts data for USA, Japan and the Community are not on a strictly comparable basis.

Source: Commission services (based on October 1986 economic forecast).

GRAPH 1

The price of oil

Average import prices of crude oil in the Community (EUR 12) in US \$, ECU and in real terms
(Index 1973 = 100)



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

Source: Eurostat and Commission services.

Economic consequences of the oil price counter-shock

The fall in oil prices is one of the major factors in the economic situation in 1986. Assuming an oil price of US \$ 15 a barrel on average in 1986 (a plausible, if not certain, assumption), the decline on the 1985 dollar price is 45 %. The major depreciation of the dollar against the ECU has further amplified this development, with the ECU price of a barrel of oil in 1986 about 55 % down on the 1985 price. The extent of the decline, in view of the important role played by oil as a source of energy in our economies, suggests that this oil price counter-shock will have major implications for the outlook of the economies of Europe.

These implications will affect both the short-term and the medium-to-long-term outlook, and they will extend not only to supply and demand, but also to economic policy. Two preliminary reservations must, however, be stated:

- The assumption is made here of a *definitive* fall in the oil price. The consequences are thereof assumed to have the necessary time to work through to their full extent (in contrast to the scenarios presented in the main body of the text where the oil price recovers in the medium term). As a result, no delay in the reactions of economic agents is introduced while, in economic reality, uncertainty on the durability of the fall potentially slows down changes in behaviour.
- Besides, other developments (e.g. the depreciation of the dollar) have also occurred in 1986 which interfere with the consequences of the oil counter-shock alone. The favourable effects which can be expected for Europe cannot, therefore, be translated into an immediate and precisely predictable improvement in the European short-term economic situation.

TABLE 3

Estimated effects of the decline in oil prices from US \$ 27 to 15 per barrel

	Level of GNP (as %)		Level of consumer prices (as %)		Level of employment (as %)		Current balance (as % of GNP)	
	1986	1987	1986	1987	1986	1987	1986	1987
<i>Estimates of the Commission (1)</i>								
Germany	1,4	1,7	-1,7	-2,4	0,9	1,2	1,4	0,3
France	0,9	1,9	-1,4	-2,2	0,9	1,2	1,5	0,9
Italy	0,3	2,1	-1,2	-2,9	0,2	0,7	1,5	0,5
United Kingdom	0,3	0,9	-0,3	0,2	0	0	-1,4	-0,7
EUR 10	0,9	1,4	-1,4	-2,2	0,5	0,9	1,0	0,5
<i>Estimates of the Hermes model (2)</i>								
France	1,1	1,9	-3,5	-4,4	0,3	0,5	:	:

Sources:

(1) These estimates have been made by the Commission services and are not directly based on econometric models. The estimate for the Community as a whole (EUR 10) is based on figures for individual countries.

(2) The Hermes model (Harmonized European research for macrosectorial and energy systems) is based on the assumption that 30 % of increased profits are invested in the modernization of industry.

In the *short term*, two direct effects of the oil price counter-shock will appear: first, income transfers from oil-producing countries to net oil-importing countries; and secondly, widespread reduction in the production costs of oil users. If oil prices average US \$ 15 a barrel, substantial transfers of income will take place; equivalent to 1,8 points of GDP for the European Community, with marked differences between countries depending on their degree of dependence (ranging from 4,1 points for Portugal to - 0,8 points for the United Kingdom). Taken separately ⁽¹⁾, this would lead to a more rapid growth in GDP at constant prices, the level of which at the end of two years would be 1,5 % higher than that which would have been the case without the fall in oil prices. However, these favourable effects will be attenuated by the decline — indeed, probably, the collapse — of imports by oil-producing countries, although it seems to be agreed that the overall impact will still be positive for European countries. In addition, the fall in oil prices should ease public deficits (savings in expenditure on energy of from 0,1 to 0,5 percentage points of GDP and growth in real terms in the base of taxation and other compulsory contributions).

The improvement in the terms of trade due to the oil price counter-shock will also lead to a very marked decline in the rate of inflation in the European countries (except probably in the United Kingdom because of the depreciation of sterling). The decline might be almost 2 % by the end of two years. This has already led to a major fall in nominal long-term interest rates (- 2,0 points from July 1985 to July 1986 for the Community), while, paradoxically, the decline in short-term rates seems more hesitant, as it is strongly associated with exchange-rate movements. The decline in interest rates plays an important role because of the improvement in the solvency of borrowers, even in the short term, as a function of the percentage of their borrowing that is subject to adjustable rates. The trend towards disinflation should also facilitate the task of the monetary authorities.

In the *long-term*, the staying power of these effects will depend crucially on whether oil prices remain low, but also on economic expectations of oil prices. Even if oil prices were to remain close to US \$ 15 a barrel for some time, they could then begin to rise again under the combined pressure of increasing world demand for oil and declining supply. The long-term effects are thereof shrouded in uncertainty. Supply effects which, by definition, come through fully only in the medium-to-long term, would arise mainly from an increase in profitable capacity. Certain investment plans that would not have been implemented without the oil price counter-shock, because it would have been impossible to generate adequate profit margins, can now go ahead, owing to the improvement in expected profitability. In the early years, this effect may be reinforced by decisions to postpone the scrapping of older equipment, which will remain profitable for longer as a result of the fall in oil prices. Although these pure supply effects are difficult to evaluate, they might lead to an increase in productive capacity of 2 to 5 % in the long term for the Community as a whole.

The fall in oil prices has major consequences for economic policy. It is likely, sooner or later, depending on the country concerned, to loosen the various constraints on monetary and fiscal policy as inflation declines, public deficits contract and the balance on current account improves in most Community countries. The indirect consequences leading to a greater margin for manoeuvre of economic policy would increase. This can only help towards the implementation of the cooperative growth strategy for more employment.

⁽¹⁾ This figure is based on the *ceteris paribus* assumption, in particular unchanged economic policy, and is thus additional to the effects of other shocks (Gramm-Rudman-Hollings Law, weakness of the dollar, etc.).

2.2. The economic outlook in the Community

The fundamental changes in the economic environment mentioned — halving of the oil bill, correction of the US \$ exchange rate, decreases in interest and inflation rates — have improved the growth prospects in Europe in the medium term. However, at the beginning of 1986, the economy's upturn, which in any case was rather modest, showed signs of faltering. Oil producers had cut their demand for industrial goods faster than the oil consumers have increased their domestic demand. OPEC and Comecon countries in particular, which in 1985 together accounted for more than a third of total Community exports to third countries, even reduce significantly their imports in 1986 (by around 25 % and 11 % in volume, respectively). In addition, most non-oil developing countries could barely step up their imports in 1986 due to external debt problems, low commodity prices and associated lack of foreign exchange. Non-Community OECD countries did increase their imports, but in total the Community's export markets will barely expand in 1986. As a result, in addition to the loss in price competitiveness, Community exports at constant prices could even fall somewhat. It is thus mainly because intra-Community imports are buoyant that member countries' exports in 1986 will increase by about 2,2 % in volume terms, less than half as much as in 1985 (5,7 %).

Imports of member countries from outside the Community, on the other hand, will increase significantly more sharply. External trade will make a significant negative contribution to the Community's real growth. Without this negative impact, growth in the Community would be more than 1 percentage point higher. This negative impulse from the Community's net real exports is, however, a substantial contribution to the process of reabsorbing the imbalances in world trade. In spite of these large changes in the volume of exports and imports, the Community's current account will register a significantly higher surplus in 1986 than in 1985 (equivalent to some 1,2 % of nominal gross domestic product compared with 0,5 % in 1985), due to the marked improvement in the terms to trade.

In the first half of 1986, the weakness in exports was only partly offset by buoyant *domestic demand*. Because purchasers expected prices to fall further, they held back for a time in the early months of the year. Companies demonstrated this by their partial de-stocking of inputs. Consumers at first used the unexpectedly large increase in real incomes to build up their savings. But there is evidence of a revival in final demand, starting in the second quarter. This is also borne out by the improvement in the consumer climate, a leading indicator based on regular surveys in the Community. *Private consumption* is expected to increase in 1986 by about 3,7 % in volume terms at the Community

level, thus becoming the main factor supporting the upswing. The highest growth rate of private consumption, just under 5 %, will be achieved in Germany.

Alongside private consumption, *investment* continues to support the economic recovery, even though growth rates here are not as high as those which were typical of earlier upswings. This is mainly due to less expansionary investment in construction which in 1986, however, will grow by around 2,3 %, after declining in 1985 (—2,6 % in real terms). Investment in equipment is by contrast still on a clear upward trend (real increase around 6 %). This is confirmed by the most recent surveys of investment in European industry. According to this survey, last autumn's already expansionary investment plans of industrial companies for 1986 have been revised upwards in nearly all the member countries (from +7 to +10 % in real terms). Investment growth in industry in 1986 thus remains more buoyant than in the economy as a whole. The relatively strong investment increase in 1985 and 1986 has so far led only to a stabilization of the number of industrial jobs in the Community. This underlines the need for a continued strong investment trend in the coming years in order to replace the jobs lost as a result of insufficient investment activity in the second half of the 1970s and early 1980s (see Graph 10).

As in recent years, the increase in *public consumption* is well below the average growth rate of domestic demand (1,7 %). On the whole there will be a marked expansion of domestic demand in the Community in 1986 (+3,8 % in real terms compared with 2,2 % in 1985).

In contrast to the situation as far as the growth of real gross domestic product is concerned, the terms of trade effect has worked through almost immediately in the case of *consumer prices*, in spite of the fact that the reduction in costs has not been fully reflected in final selling prices. Yet, the average European consumer has benefitted more from the terms of trade gain than the consumer in Japan, where a relatively larger part of this external gain has remained in the enterprise sector. As the Community consumer surveys have shown, the steadying of prices has led to a significant increase in purchasing power in Europe. The average rise in consumer prices in 1986 (around 3,7 %) will be the lowest in the Community for the past 20 years.

Despite the considerable improvement in real *per capita* wages (2,3 %, using the consumer price deflator), *real labour costs per capita* will remain stable in the Community in 1986 (on the basis of the GDP deflator). This favourable situation, which will not be repeated in the coming years, is due to the large improvement in the terms of trade, which has reduced companies' costs and at the same time increased the purchasing power of consumers.

The upswing, though not very dynamic so far, has also had an impact on the *labour market*. In 1986, in the Community, the number of persons in employment is expected to rise by 0,8 %, well above the average for the 1960s and 1970s (see Table 4). In macroeconomic terms the threshold, above which increases in output begin to have an effect on employment, appears to have again been brought down. However, the increase in employment is also attributable to specific measures of labour market policy as well as the growth of part-time employment. The increase in employment will be above average in Denmark (1,9 %), Spain (1,8 %) and Germany and the Netherlands (1,1 % in both countries). Despite the marked rise in the numbers employed, the Community's unemployment will decline only slightly in 1986 (from 12 % in 1985 to 11,9 %, EUR 12) because the size of the Community's labour force continues to increase (by some 0,8 % in 1986). Recently, this has been due more to the rising participation rate (especially among women), than demographic factors.

Despite this gradually improving labour market situation, certain segments of the labour force still pose specific problems. Of particular significance is the continuing rise in the share of long-term unemployment in the Community: at present about 40 % of the unemployed have been out of work for more than one year, compared with 36 % in 1983. Although it is difficult to make direct comparisons between Member States, there appear to be important differences in this respect. For example, while in Denmark the proportion of long-term unemployed in the total is only 6 %, it is over 50 % in Belgium, the Netherlands and Spain, and is between 30 and 40 % in Germany, France, Ireland, Italy and the United Kingdom. The total number of unemployed young people has declined slightly (from 4,6 million in 1985 to 4,5 million in 1986, i.e. about 35 % of total unemployed — EUR 9). This reflects demographic changes and special efforts of Member States to extend basic training and education. Nevertheless, the unemployment ratio of young persons between 15 and 25 years remains intolerably high at the Community level (around 20 %).

Economic outlook for 1987. The gradual recovery in economic activity in the Community will, in 1987, be entering its fifth year. According to the normal cyclical pattern of earlier upturns, this would mark the late phase in the recovery process, and the upper cyclical turning point would not be far off. But in the current situation, this conclusion seems unfounded, since the cyclical upswing this time differs markedly from its predecessors. Unlike 1972/73 and 1979/80, rising capacity utilization has so far not been associated with upward pressure on prices, but on the contrary with falling inflation rates. Nor have unit labour costs started to accelerate, as they have usually done in late phases of an upturn, because the labour shortages typical of earlier recoveries have not occurred.

For 1987, there is no sign so far of the risk of overheating. On average, for all the member countries in 1987, the Commission actually forecasts a further slowdown in *consumer prices* (3,0 % compared with 3,7 % in 1986), mainly because of progress in fighting inflation in the member countries which have so far still had high rates of price increase (Greece, Spain, Portugal and Italy). In the other member countries the inflation rate is probably stabilizing at the relatively low 1986 level or will only increase slightly.

In 1987, *domestic demand* (+ 3,5 %) will again make the most important contribution to growth; the increase is likely to be somewhat lower than the 1986 figure. The main growth factors will continue to be *private consumption* (3,5 % in real terms) and *fixed investment* (5,1 % in real terms); investment in equipment (6,9 % in real terms) will be much more dynamic than construction (3,2 % in real terms). The expansion of *public consumption* will still be relatively slow (1,3 %). In addition, *exports* can hardly be expected to provide a stimulus to the European economy in 1987. After standing almost still in 1986, the Community's export markets will probably grow slightly next year (by some 2,4 % in real terms) as world trade again picks up somewhat. Member country exports (inside and outside the Community) could grow by 3,5 to 4 % in 1987. But, since Community imports will go on growing vigorously (around 6,5 %), external trade will continue to make a negative contribution to the Community's real growth (probably - 0,8 % compared with - 1,2 % in 1986). The Community will therefore continue to contribute to the process of adjusting the disequilibria of world trade. Despite the unfavourable trend in the Community's external trade in volume, the current account will remain substantially positive (0,9 % of GDP or US \$ 42 000 million in 1987, 1,2 % of GDP or US \$ 52 000 million in 1986).

All in all, the growth of the Community economy as a whole in 1987 is likely, on present policies, to remain just under the 3 % mark. Growth rates will range from 3,6 % in Italy to - 0,2 % in Greece. Although employment is again increasing (0,8 % a year in 1986 and 1987) *unemployment* remains excessively high; in 1987, the unemployment rate in the Community of Twelve will probably only fall from 11,9 % to 11,7 %.

Economic recovery in the Community is continuing. This is due in large part to the transfer in incomes following the considerable fall in import prices. Domestic demand, especially private consumption and investment, are the strongest growth elements, while the Community's external export markets are on the whole weak. Lower price increases and interest rates are improving medium-term growth prospects. Some first successes are beginning to be registered in reducing the high level of unemployment in the Community, but these fall short of what is required or possible.

TABLE 4
EUR 12: Main economic aggregates 1961 to 1987

		(Annual percentage changes)								
		1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product	value	10,2	14,6	10,8	11,2	9,6	8,8	8,5	8,8	6,4
	volume	4,8	2,2	- 0,1	0,5	1,2	2,0	2,4	2,5	2,8
	deflator	5,1	12,1	10,9	10,6	8,3	6,6	6,0	6,2	3,5
Private consumption deflator		4,6	12,1	12,1	10,4	8,4	7,0	5,8	3,7	3,0
Gross fixed capital formation	private ⁽¹³⁾	5,6	1,2	- 1,7	- 2,2	- 1,7	3,5	1,7	5,2	5,0
	public ⁽¹³⁾	3,2	- 0,6	- 6,8	5,3	0,7	- 1,0	0,5	1,2	2,0
	total	5,6	0,5	- 4,1	- 1,5	- 0,4	1,3	2,4	4,2	5,1
of which:	construction	:	:	:	:	:	:	- 2,6	2,3	3,2
	equipment	:	:	:	:	:	:	8,0	6,1	6,9
Domestic demand (const. prices)		5,0	2,1	- 1,8	0,8	0,8	1,4	2,2	3,8	3,5
National indicator										
Gap with respect to other OECD countries		- 0,6	- 0,2	- 4,1	1,0	- 1,9	- 4,2	- 1,1	0,4	0,9
Compensation of employees per head	nominal	10,0	14,9	12,8	10,9	9,9	7,6	6,8	6,0	4,8
	real A ⁽³⁾	4,7	2,5	1,7	0,3	1,5	0,9	0,8	- 0,1	1,3
	B ⁽³⁾	5,2	2,5	0,6	0,4	1,4	0,6	1,0	2,3	1,8
Productivity ⁽⁴⁾		4,5	2,2	1,1	1,5	2,1	2,1	2,0	1,8	2,0
Real unit labour costs ⁽⁵⁾		100	104,5	104,3	103,0	102,4	101,1	99,9	98,1	97,4
Profitability ⁽⁵⁾ ⁽⁶⁾		100	67,4	60,0	60,4	62,3	64,7	68,2	75,5	79,0
Competitiveness ⁽⁵⁾ ⁽⁷⁾		100	108,8	105,5	98,9	93,2	86,7	85,6	95,1	95,9
Employment		0,3	0,0	- 1,2	- 0,9	- 0,8	- 0,2	0,4	0,8	0,8
Registered unemployed as % of the civilian labour force ⁽⁸⁾ ⁽⁹⁾		2,2	4,7	7,8	9,3	10,3	10,8	11,1	11,0	10,8
Current balance as % of GDP		:	:	- 0,7	- 0,8	0,0	0,1	0,5	1,2	0,9
Long-term interest rate ⁽¹⁰⁾		7,1	10,5	15,1	14,3	12,7	12,0	10,8	9,0	:
Money supply ⁽¹¹⁾		:	13,5	10,6	11,6	10,6	8,7	9,4	8,4	6,5
Net lending or borrowing of general government as % of GDP ⁽¹²⁾		- 0,6	- 3,8	- 5,4	- 5,6	- 5,5	- 5,4	- 5,1	- 4,7	- 4,1
Public debt as % of GDP		:	:	45,0	49,8	53,5	56,0	58,9	60,3	61,8
Public debt interest as % of GDP		:	2,9	4,1	4,6	4,9	4,9	5,1	5,1	5,0

⁽¹⁾ Estimates of the Commission services, October 1986.

⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies..

⁽³⁾ A: GDP deflator; B: private consumption deflator.

⁽⁴⁾ Gross value added per occupied person in the whole economy, on real terms.

⁽⁵⁾ Index: Average 1961 to 1973 = 100.

⁽⁶⁾ EUR 4: D + F + I + UK; non-agricultural business.

⁽⁷⁾ Real effective exchange rate (*vis-à-vis* the other nine industrial countries) on the basis of unit labour costs for the whole economy.

⁽⁸⁾ Eurostat definition.

⁽⁹⁾ Excluding Greece, Spain, Portugal.

⁽¹⁰⁾ Excluding Spain, Portugal.

⁽¹¹⁾ End of year. Broad money supply M2 or M3 according to country.

⁽¹²⁾ Excluding Greece, Spain, Ireland, Portugal.

⁽¹³⁾ Estimate for EUR 10.

TABLE 5
Imports of goods of the main economic zones

	(% change in volume)					
	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
EUR 12 (including intra-EUR)	2,7	2,0	7,1	5,5	6,3	6,4
USA	-2,3	12,7	23,6	4,7	10,9	6,3
Japan	0,5	-2,8	11,0	-1,9	8,5	6,4
OPEC	5,1	-10,1	-7,4	-11,3	-25,0	-12,5
Other developing countries	-8,2	-1,2	5,5	3,3	1,8	3,0
World	-0,8	1,7	8,9	3,4	3,8	4,4

⁽¹⁾ Forecast of Commission services; October 1986.

Source: Eurostat and Commission services.

TABLE 6
Rate of change of demand components, EUR 12

	(% change in volume)				
	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽¹⁾
Private consumption	1,0	0,9	2,2	3,7	3,5
Public consumption	1,7	1,0	1,7	1,7	1,3
Fixed investment	-0,3	1,3	2,4	4,2	5,1
Contribution to change in GDP of:					
Final domestic demand ⁽²⁾ ⁽³⁾	0,9	1,0	2,1	3,4	3,4
change in stocks ⁽²⁾	0,5	-0,2	0,0	0,4	0,2
foreign balance ⁽²⁾	-0,3	0,1	0,2	-1,2	-0,8
GDP	1,2	2,0	2,4	2,5	2,8
Exports (goods and services)	3,1	7,6	5,7	2,2	3,7
Imports (goods and services)	1,5	5,6	5,3	6,3	6,2

⁽¹⁾ Forecast of Commission services; October 1986.

⁽²⁾ Change as percentage of GDP of preceding period.

⁽³⁾ Excluding change in stocks.

Source: Eurostat and Commission services.

TABLE 7
Forecast increase in gross domestic product in 1986 and 1987

(%)

	1986 ⁽¹⁾			1987 ⁽¹⁾		
	GDP in value	GDP in volume	GDP deflator	GDP in value	GDP volume	GDP deflator
Belgium	6,7	2,0	4,6	3,1	1,3	1,8
Denmark	7,8	2,9	4,8	5,5	1,8	3,7
Germany	7,1	3,1	3,9	4,6	3,2	1,4
Greece	23,2	0,5	22,6	12,1	-0,2	12,3
Spain	15,1	2,9	11,8	9,3	3,0	6,1
France	6,9	2,2	4,6	5,3	2,5	2,7
Ireland	7,6	1,8	5,6	6,8	3,1	3,6
Italy	12,7	2,8	9,7	9,1	3,6	5,3
Luxembourg	8,0	2,4	5,4	5,3	2,6	2,6
Netherlands	2,0	1,6	0,4	0,1	1,8	-1,7
Portugal	23,8	3,8	19,2	14,4	3,5	10,5
United Kingdom	6,3	2,3	3,9	7,0	2,7	4,2
EUR 12	8,8	2,5	6,2	6,4	2,8	3,5

⁽¹⁾ Forecast of Commission services, October 1986.

TABLE 8
Indicators of labour market developments

	Unemployment as a percentage of the civilian labour force						Annual rate of change of total employment				
	1960	1970	1983	1985	1986	1987	1961 to 1970	1971 to 1980	1981 to 1985	1986	1987
Belgium	3,1	2,1	14,3	13,7	12,9	13,4	0,6	0,3	-0,8	0,3	-0,6
Denmark	1,6	1,1	10,1	8,8	7,6	7,7	1,1	0,7	0,9	1,9	0,3
Germany	1,0	0,6	8,4	8,4	8,1	7,7	0,2	-0,1	-0,6	1,1	1,0
Greece	:	:	7,8	7,8	7,6	8,3	-0,7	0,6	1,0	0,5	0,0
Spain	:	:	17,8	22,1	21,7	21,5	0,7	-2,1	-2,2	1,8	1,2
France	0,7	1,3	8,8	10,3	10,5	10,7	0,6	0,4	-0,5	0,1	0,3
Ireland	4,7	5,3	14,9	18,0	18,4	18,0	-0,0	0,9	-0,9	-1,1	0,7
Italy	7,2	4,4	10,9	12,9	13,4	12,8	-0,5	0,5	0,5	0,5	1,3
Luxembourg	0,1	0,0	1,6	1,6	1,3	1,2	0,6	1,3	0,1	0,8	0,7
Netherlands	0,7	1,3	14,3	13,1	12,0	11,1	1,2	0,2	-0,9	1,1	0,9
Portugal	:	:	10,2	8,7	8,6	8,5	-0,5	-0,3	-0,7	0,3	0,3
United Kingdom	1,6	2,5	11,6	12,0	12,0	12,0	0,2	0,2	-0,8	0,8	0,8
EUR 12	:	:	11,0	12,0	11,9	11,7	0,2	0,2	-0,6	0,8	0,8
EUR 9 ⁽¹⁾	2,5	2,0	10,3	11,1	11,0	10,8					
USA	5,5	4,9	9,6	7,2	6,9	6,9	1,9	2,0	1,6	2,2	1,7
Japan	1,7	1,1	2,7	2,6	2,8	2,9	1,4	0,8	1,0	:	:

⁽¹⁾ Without Greece, Spain and Portugal.

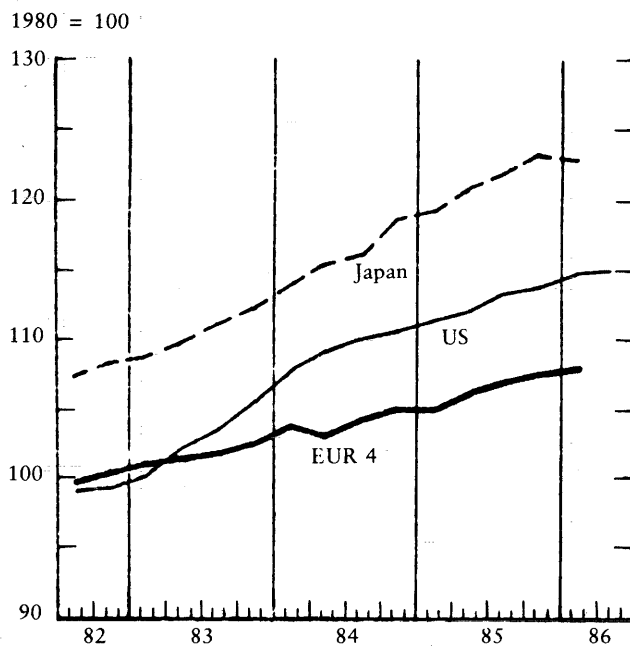
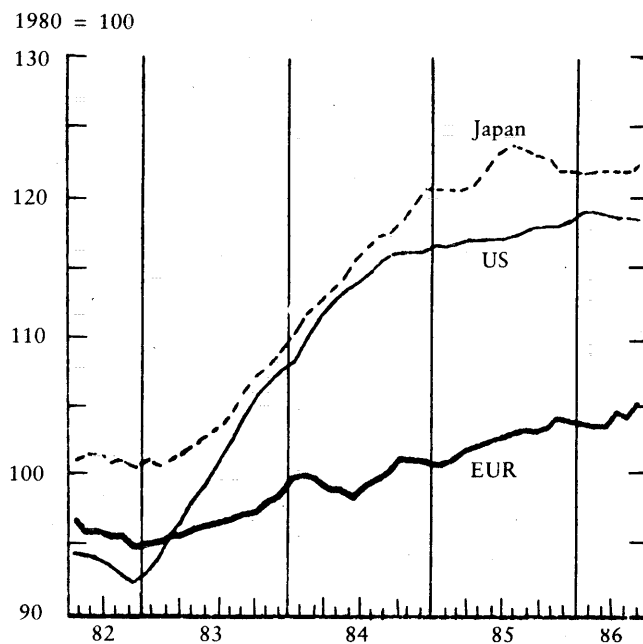
NB: The unemployment rates presented here are based on the number of registered unemployed on a common Eurostat definition. Exceptions: for Greece, Spain and Portugal national survey results are presented.

Source: Eurostat and Commission services (October 1986).

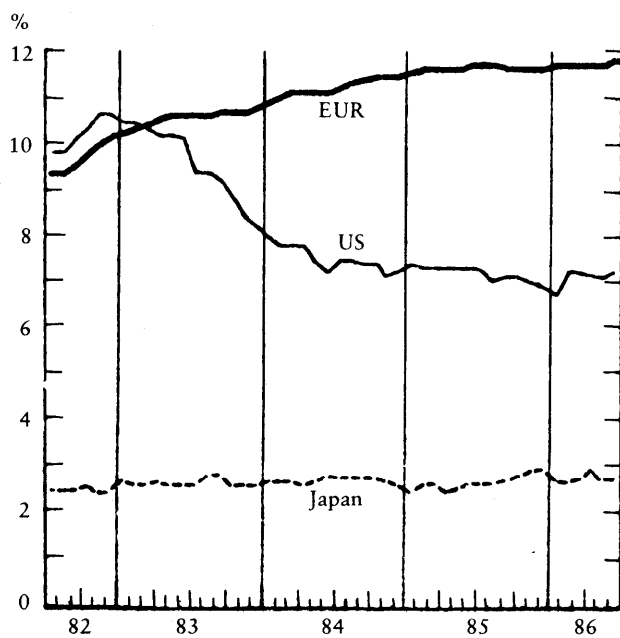
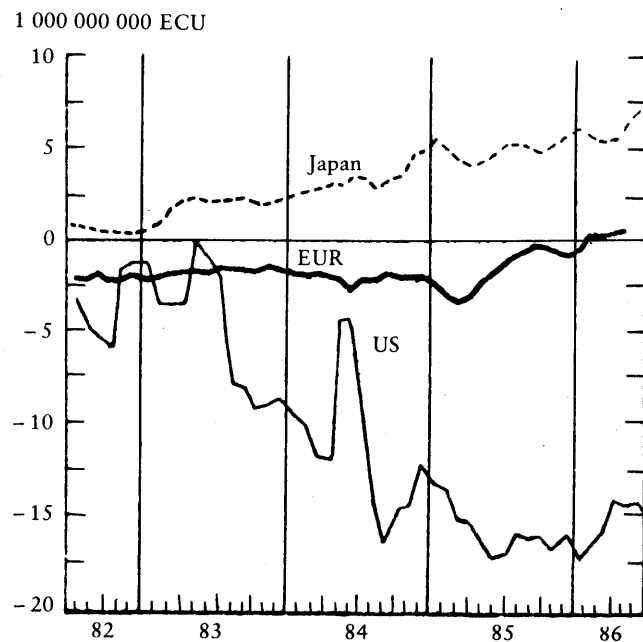
GRAPHS 2 to 5

Comparative evolution of the Community, US and Japanese economies, 1982 to 1986

2. Gross domestic product, s.a.

3. Industrial production
three-month moving average, s.a.

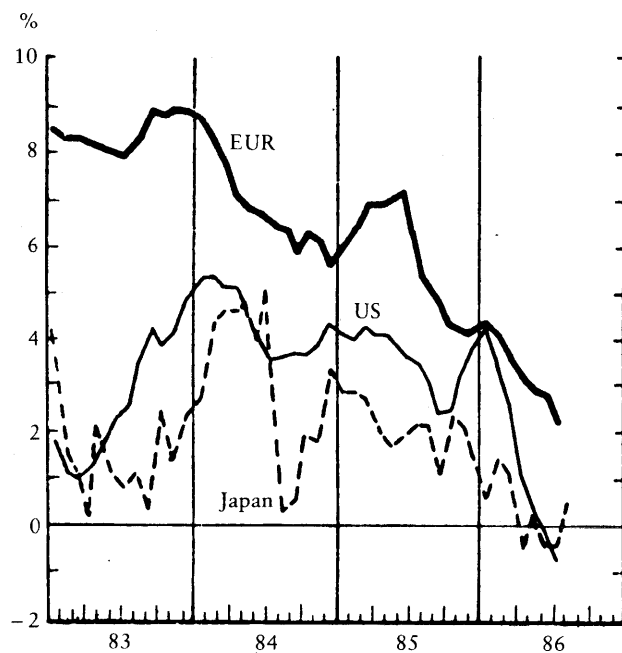
4. Unemployment rate, s.a.

5. Trade balance
fob/cif, billions ECU,
three-month moving average, s.a.

GRAPHS 6 to 9

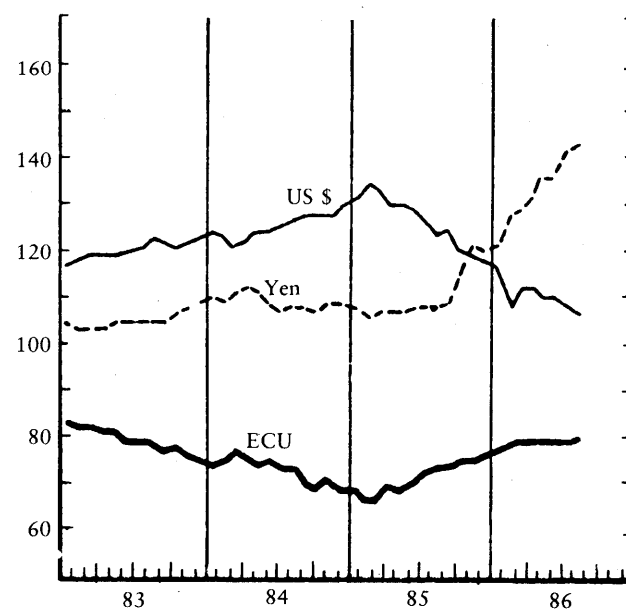
Comparative evolution of the Community, US and Japanese economies, 1983 to 1986

6. Consumer prices
six-month change, s.a., annual rates

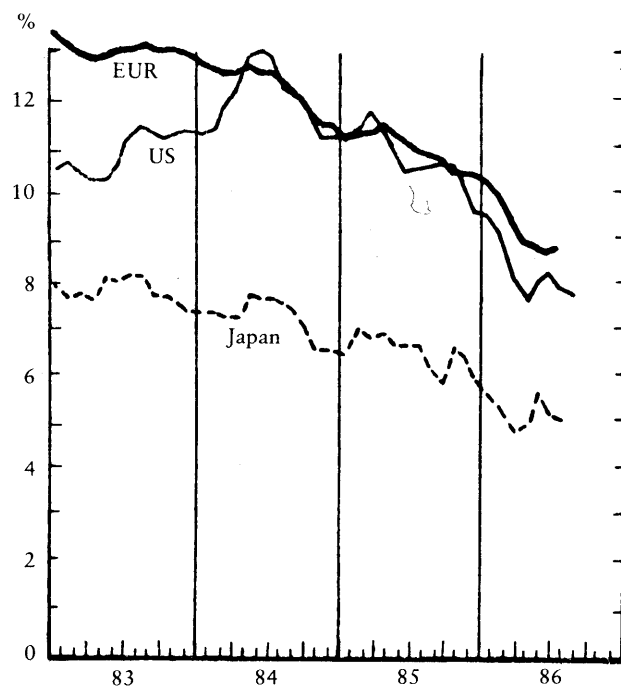


7. Exchange rates
Index of SDRs per currency unit

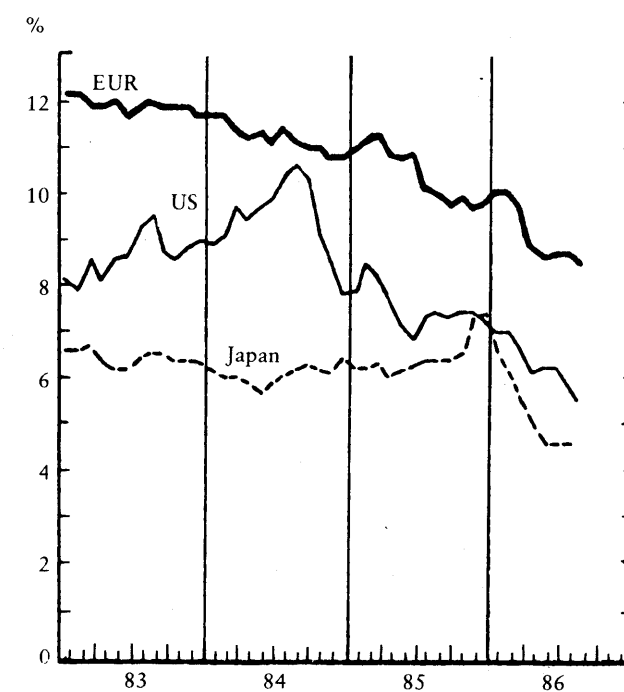
March 1979 = 100



8. Long-term interest rates

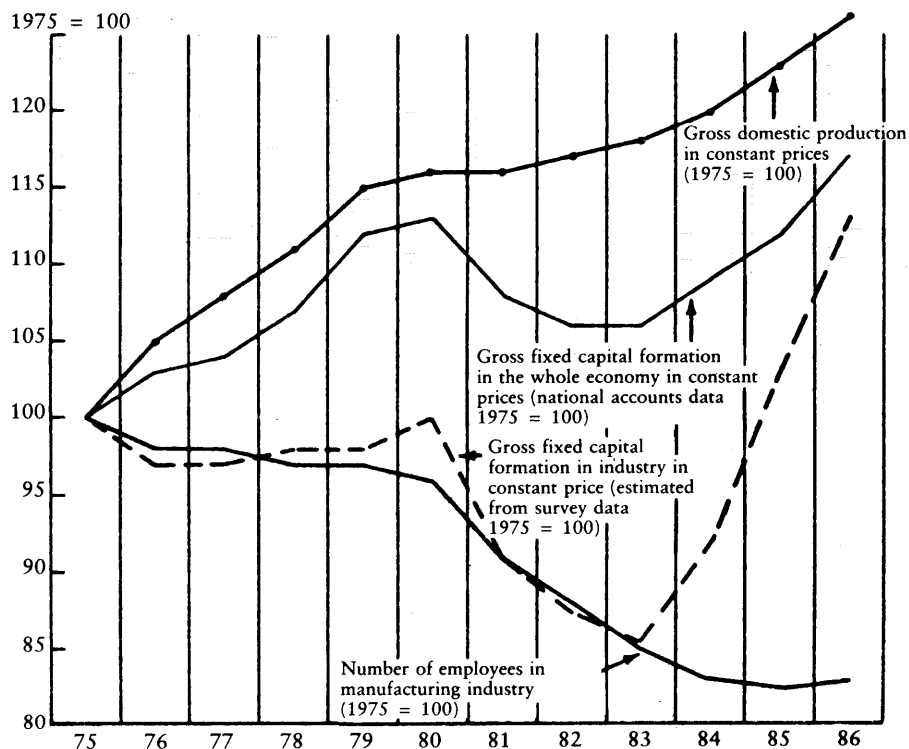


9. Short-term interest rates



GRAPH 10

Trend of industrial investment in the Community (business survey indicator) in the context of other macro-economic indicators



1985 and 1986: Estimation of the Commission's services with the exception of gross fixed capital formation in industry which are based on EC investment surveys.

Source: Eurostat and EC investment surveys.

2.3. Nominal and real convergence in the Community

The Community's major political events of the last year — agreement on the internal market programme, the Single European Act, and the accession of Spain and Portugal — all give heightened importance to economic convergence.

The notion of convergence covers essentially two distinct objectives. The first concerns convergence on a better stability of prices, but it includes also a better control of monetary trends, nominal incomes and the main economic equilibria such as for the public finances and the balance of payments; this may be called *nominal convergence*. The second objective concerns the upwards convergence of living standards, measured for example by real GDP *per capita* of the regions and Member States of the Community; but it includes also the downwards convergence of unemployment; this may be called *real convergence*. These economic policy objectives were already laid down in the preamble and Article 104 of the Treaty establishing the European Economic Community. The Single European Act, in its Article 130,

reaffirms and specifies the objective of 'reducing disparities between the various regions and the backwardness of the least-favoured regions'. It designates this objective clearly as an objective of the coordination of economic policies of Member States and of the action that the Community pursues through its structural funds and financial instruments (Article 130 B).

Nominal and real convergence are two goals that are not independent. The achievement of nominal convergence is a central condition in the pursuit of sustainable and dynamic economic growth. Such a growth makes it easier for the relatively poorer regions and Member States to diminish the gap separating them from the more prosperous ones. Convergent and low inflation rates are also required to secure stability within the EMS and enhance the predictability of the factors determining investment and savings' decisions.

In conjunction with the completion of the internal market, monetary stability should provide a major impetus to the further expansion of intra-Community trade. In addition,

the absence of serious public sector or external disequilibria allows the steady pursuit of policies favouring vigorous economic growth.

The following paragraphs review recent trends in the main economic indicators that are relevant to the assessment of convergence.

Nominal convergence. The Community inflation rate has, in line with the developments occurring elsewhere in the industrialized world, declined considerably since 1982, as borne out by Graph 11. The growth rate of the Community private consumption deflator in 1986 is expected to be 3,7%, an achievement that has not been matched for 20 years. It is forecast to continue its downward course next year.

The slowdown of the average inflation rate has gone hand in hand with a smooth reduction in inflationary disparities between the Member States, in particular since 1984, as illustrated by Table 9 and Graph 12. These show that for the private consumption deflator this convergence process is expected to continue in 1986 and 1987. The present annual percentage increase of the private consumption deflator is expected to range from over 22% for Greece — 4 percentage points up from last year's growth rate — to virtually nil for the Netherlands and Germany. Table 9 also shows that the nominal convergence phenomenon occurring in recent years is even more pronounced among the countries adhering to the EMS. The EMS has proved a catalyst for nominal convergence in that countries in which inflation has been relatively high were subject to pressure favouring better price stability during lengthy periods of unchanged exchange rate parities (cf. chapter 4.1). The reduction in, and improved convergence of, inflation rates should be seen as a success of economic policy and in particular of the EMS.

The foundations for the recent reduction in annual inflation rates were laid by efforts to enhance control over their fundamental determining factors (see Graph 13). Monetary policy was conducted increasingly with a view towards price stability, illustrated by a decline in money growth per unit of output. This deceleration resulted in part from the fact that budget deficits were monetized to a lesser degree. In addition, nominal wages were adjusted, as reflected in a marked slowdown in unit labour costs. The fact that, in the meantime, monetary conditions and unit labour costs converged between the Member States shows that most Community countries adopted a similar stabilization policy stance.

Checking inflation rates during this year and next is being facilitated by favourable yet reversible exogenous factors, such as the massive oil price fall and the large depreciation of the dollar. These factors exert only a once-and-for-all deflationary influence. For the inflation rate to remain

subdued, the course of unit labour costs and monetary conditions must be compatible with price stability. The forecast developments for 1986 and 1987 in this regard warrant some optimism for the course of European inflation rates in the near future. Growth rates of the money stock and unit labour costs are expected to continue their decline, whilst the differences between the Member States will be reduced further.

Whereas monetary policy has become increasingly more similar, the recent public finance record, both from the viewpoint of the Community as a whole and as between the Member States, has been less satisfactory. Differing degrees of success in pruning public sector deficits may threaten the consolidation of the convergence towards monetary stability achieved so far. In several countries, public sector deficits have clearly been curbed, but in a number of others the public sector borrowing requirement is still excessive. Most of the latter countries have in recent years financed their deficit more and more by issuing interest-bearing liabilities to the non-bank sector. This sounder form of debt financing has contributed to the price stability oriented monetary policy referred to earlier. On the other hand, the persistence of large deficits has inevitably given rise to a corresponding sizeable expansion of public debt and has exerted an upward pressure on real interest rates in capital markets. The resulting aggravation of the interest payments burden should be interpreted as a signal to step up efforts to correct public finance imbalances. If general government deficits in these countries are not trimmed further, the threat of increased debt monetization will be rekindled.

The Community on aggregate has reduced its general government deficits from 5,6% in 1982 to 5,1% in 1985, and is expected to continue this desirable trend this year and next to reach 4,1% in 1987. However, this decline has not so far reached the point of stopping the growth of public debt as a percentage of GDP for the Community as a whole. This ratio has risen steadily for the Community average from 50% in 1982 and will be higher than 63% in 1987 (more detail is provided in Chapter 4.2). Several countries, for example Belgium, Ireland, Italy, are now confronted with a level of debt exceeding their annual GDP. The forecasts for 1986 and 1987 suggest that these preoccupying trends are not yet being corrected.

Whereas the evolution of budget deficits still leaves a lot to be desired in a number of countries, most Member States confronted with a serious current account problem are predicted to see their situation improve significantly in 1986 and 1987. Table 10 indicates that Denmark, Greece and Ireland will cut their current account deficits following the large terms of trade improvement and measures limiting domestic consumption.

Real convergence. Upward convergence, in terms of real gross domestic product *per capita* and of the employment

level, is crucial to ensuring greater economic and social cohesion in the Community. Bringing about real convergence has clearly become a more ambitious task following the consecutive accessions to the Community in the eighties of relatively less prosperous but populous countries. The recent enlargements have rendered the Community much more dissimilar, both in terms of GDP *per capita* and of unemployment levels. Table 11, which ranks the Member States in descending order of real income *per capita* (expressed in purchasing power standards), in 1985, shows that the average inhabitant of the four poorest Community Member States (Spain, Greece, Portugal and Ireland), together representing some 20 % of the current Community population, had a real income last year which was half that of the average citizen of the four richest countries (Germany, France, Denmark and Luxembourg). The ratio of the extremes (Portugal and Luxembourg) was almost one to three.

During the 1960s, when European economic growth was dynamic, world trade liberalized and the customs union established, the Community made swift progress in real convergence. Real GDP *per capita* as well as unemployment levels converged between the Member States until about the middle of the 1970s (see Graph 14 and Graph 15). Graph 15 shows, for instance, that from 1960 up to the first oil shock, the four relatively poorest countries of the Community managed to reduce the gap separating them from the four richest Member States by about one-third. At that time, the reduction of the Member States' dispersion around the European average coincided with a rapid real GDP *per capita* expansion for the Community as a whole (4,0 % per annum, cf. Table 11).

This experience shows that the achievement of a dynamic economic growth in the Community is an important factor in sustaining the process of real convergence. If the Community were to generate a development during the next 10 to 15 years similar to the 1960s, the objective of real convergence and greater economic cohesion would be brought much nearer. However, the conditions of the 1960s are no longer present and the Community must take account of this fact.

Since 1975, when the worldwide economic crisis triggered by the first oil shock set in, and the trend rate of economic growth was sizeably reduced, the real convergence process in the Community has, however, been stalled, even reversed. This phenomenon can be seen for both real growth and the unemployment performance. The four relatively poorest countries together have fallen short of the aggregate European growth rate since the first oil shock, on account of the slow expansion experienced in Greece and particularly Spain. Meanwhile, Germany and Denmark, the two relatively richest countries after Luxembourg, outpaced the

Community in GDP *per capita* growth. The present forecasts for 1986 and 1987 suggest that this tendency for Member States' real income levels to diverge is not being arrested.

The evolution since 1975 of the various national unemployment rates — which admittedly pose some problems of comparability — was dissimilar as well. In this respect, the level of dispersion between the Member States trebled in a decade, as can be gauged from Graph 16. This increasing dispersion was both due to the development of employment as well as labour force growth rates, which both diverged from the middle of the 1970s onward.

These negative trends, as regards real convergence, since the mid-seventies are also seen between the *regions* of the European Community, for which, of course, absolute disparities are considerably higher (see Graph 16). The virtual constancy of the indicator of real GDP *per capita* inequalities over the 10 years or so prior to 1984 is also observed among the regions of each of the major Member States. None of the countries has witnessed a significant reduction of regional GDP differences. The worsening of the unemployment convergence record between Member States is also paralleled at the regional level. Whereas the weakest 25 regions of the Community had an average unemployment rate of 8 % in 1976, relative to 2,4 % for the 25 strongest, the figures registered for 1985 stood respectively at 21,1 % and 6,6 %.

It appears that a more dynamic growth of the European economy is an important condition for the relatively backward regions to catch up, and for the declining industrial regions to convert. The implementation of the cooperative strategy, as well as the completion of the Community internal market, would help assure this favourable economic climate which is indispensable. However, to reduce real income inequalities with respect to the relatively more prosperous areas of the Community, the relatively poorer regions should not only share in the overall European economic expansion, but their growth should also be faster than the European average. Therefore, besides the establishment of a more dynamic growth climate in the Community in general, it is equally necessary to create in the regions in question sound conditions for a durable and stable economic expansion.

The regional catch-up and reconversion process has to be based, among other factors, on fresh private and public investment, which will require the mobilization of considerable funds. The latter can in part be generated at home by developing domestic savings, but investment in the poorer countries and regions will also require sufficient capital movements. Spontaneous capital inflows in these areas of the Community will gather momentum provided their expected profitability is adequate. To this end, the authorities in these areas should pursue policies aimed at creating an enterprise-friendly economic and political environment. The removal of capital controls, proposed by

the Commission, will also promote capital inflows as it dispels foreign investors' fears in relation to the mobility of their funds. However, past experience suggests that private capital inflows alone are often insufficient. To this must be added a determined action on the part of the public authorities, in which the Community has an important role to play through its structural funds, the European Investment Bank and its other financial instruments.

In accordance with Article 130 D of the Single European Act, the Commission will submit to the Council a general proposal intended to modify the structure and the operating rules of the structural funds.

Its objective is to:

- specify and rationalize the role of these funds so that they contribute better to achieving the objectives of economic and social cohesion,
- reinforce their efficiency,
- permit better coordination between the operations of the funds themselves, and in relation to the financial instruments of the Community.

In this way, it should be possible to assure an important contribution to the economic and social cohesion of the Community. Moreover, the reinforcement of the process of real convergence will also contribute to the overall dynamics of the Community.

The Community has registered in the recent past significant progress as regards nominal convergence. Inflation rates in most countries have come down in the last few years as a result of the conduct of economic policy in general and of the functioning of the EMS. The correction of current account imbalances is also being undertaken with success. In several countries, public sector deficits have clearly been curbed, but in a number of others the public sector borrowing requirement is still excessive. In the period up to the mid-1970s, the Community witnessed both sustained and dynamic growth and an improvement of real convergence. Since then, however, the latter process has been arrested, even slightly reversed. For real convergence in the Community to resume, several complementary conditions need to be fulfilled. First, it is necessary to create a more dynamic growth environment in the Community as a whole, which is a central objective of the Cooperative Strategy. Secondly, it is necessary for the business environment in the relatively backward and in the declining industrial regions to be improved through appropriate adjustment policies that are the responsibility of national and regional authorities. Thirdly, it is necessary that the Community, through its financial instruments and the intervention of the European Investment Bank on the one hand, and its structural funds on the other, complements the efforts of the authorities of the disadvantaged regions to establish the foundations of durable economic growth. In this way, it can make an important contribution to achieving greater cohesion between the regions and Member States of the Community.

TABLE 9

Private consumption prices (deflator, % change per annum)

	1961 to 1969	1970 to 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Belgium	3,2	7,4	4,1	3,9	6,5	8,1	7,4	7,5	5,9	4,8	1,3	1,5
Denmark	5,7	10,0	9,2	10,4	10,7	12,0	10,2	7,2	6,5	5,0	3,3	2,8
Germany	2,7	5,5	2,8	4,0	5,8	6,0	4,7	3,1	2,4	2,1	0,0	1,1
Greece	2,4	10,5	12,8	16,5	21,2	23,3	21,2	18,6	18,0	18,4	22,5	12,5
Spain	5,9	13,4	19,2	16,2	15,6	15,1	14,2	12,2	11,1	8,4	8,6	5,3
France	4,2	8,3	8,7	10,4	13,2	12,8	11,2	9,5	7,3	5,5	2,5	2,3
Ireland	4,5	13,8	8,0	14,9	18,6	21,2	16,0	8,2	8,5	4,2	3,7	3,2
Italy	3,7	12,9	12,9	15,1	20,2	19,2	17,0	15,1	11,1	9,4	6,2	4,0
Luxembourg	2,3	6,8	3,4	5,2	7,7	8,6	10,6	8,0	6,4	4,0	0,5	1,3
Netherlands	4,0	8,0	4,5	4,3	6,9	6,3	5,3	2,8	2,6	2,6	0,0	-1,0
Portugal	2,6	13,1	21,0	24,0	22,3	16,9	22,5	25,5	29,3	19,3	11,8	9,0
United Kingdom	3,7	12,5	9,1	13,5	16,4	11,5	8,5	5,2	5,1	5,3	4,0	3,9
<i>Averages</i>												
EUR 12	3,7	9,8	9,0	10,6	13,2	12,1	10,4	8,4	7,0	5,8	3,7	3,0
EUR 10	3,6	9,3	7,7	9,8	12,9	11,7	9,8	7,7	6,2	5,3	3,1	2,6
EMS	3,6	8,5	7,2	8,7	11,6	11,5	9,9	8,1	6,2	5,0	2,4	2,1
<i>(a) Mean deviation from the average</i>												
EUR 12	1,2	3,1	3,7	4,2	4,5	3,9	4,0	4,2	3,3	2,5	2,7	1,6
EUR 10	1,0	3,0	3,1	4,0	4,8	3,9	3,9	3,9	2,8	2,1	2,3	1,4
EMS	1,0	2,5	3,6	4,2	5,0	4,6	4,3	4,1	3,0	2,3	2,0	1,1
<i>(b) Mean deviation from the minimum</i>												
EUR 12	3,3	5,3	6,1	6,7	7,3	6,1	5,8	5,6	4,6	3,7	3,7	4,0
EUR 10	1,8	4,9	4,9	5,9	6,9	5,7	5,2	4,9	3,8	3,3	3,1	3,6
EMS	1,5	3,4	4,4	4,7	5,8	5,4	5,2	5,3	3,8	2,9	2,3	3,1

Source: Eurostat and Commission services, October 1986.

TABLE 10

Current account of balance of payments as a percentage of GDP

	1961 to 1970	1971 to 1980	1981	1982	1983	1984	1985	1986	Difference between 1986 and -1982	1987
Belgium / Luxembourg	0,9	0,6	-3,2	-2,0	0,5	1,1	1,8	3,5	5,5	3,8
Denmark	-2,2	-2,9	-3,0	-4,2	-2,2	-3,2	-4,4	-4,1	0,1	-3,6
Germany	0,7	0,6	-0,7	-0,5	0,7	1,0	2,2	3,2	2,7	2,1
Greece	-3,1	-2,2	-0,2	-3,8	-4,7	-4,1	-8,4	-5,8	-2,0	-3,7
Spain	:	-0,9	-2,4	-2,3	-1,4	1,3	1,7	3,5	5,9	3,7
France	0,2	-0,4	-1,4	-3,0	-1,7	-0,9	-0,8	0,1	3,1	0,4
Ireland	-2,3	-6,4	-14,8	-10,7	-6,9	-5,7	-3,2	-1,3	9,4	-1,3
Italy	1,8	-0,2	-2,3	-1,6	0,2	-0,8	-1,1	1,2	2,8	0,9
Netherlands	0,0	1,2	2,1	2,8	2,9	4,1	4,3	3,9	1,1	2,8
Portugal	-1,0	-3,3	-11,7	13,5	-7,2	-3,0	1,8	5,4	18,9	4,2
United Kingdom	0,0	-0,6	2,4	1,5	0,8	0,3	1,0	-0,1	-1,6	-0,6
EUR 12	0,4 ⁽¹⁾	-0,1	-0,6	-0,6	0,0	0,1	0,5	1,2	1,8	0,9

⁽¹⁾ EUR 10.

TABLE 11

Real GDP *per capita* expressed in purchasing power standards

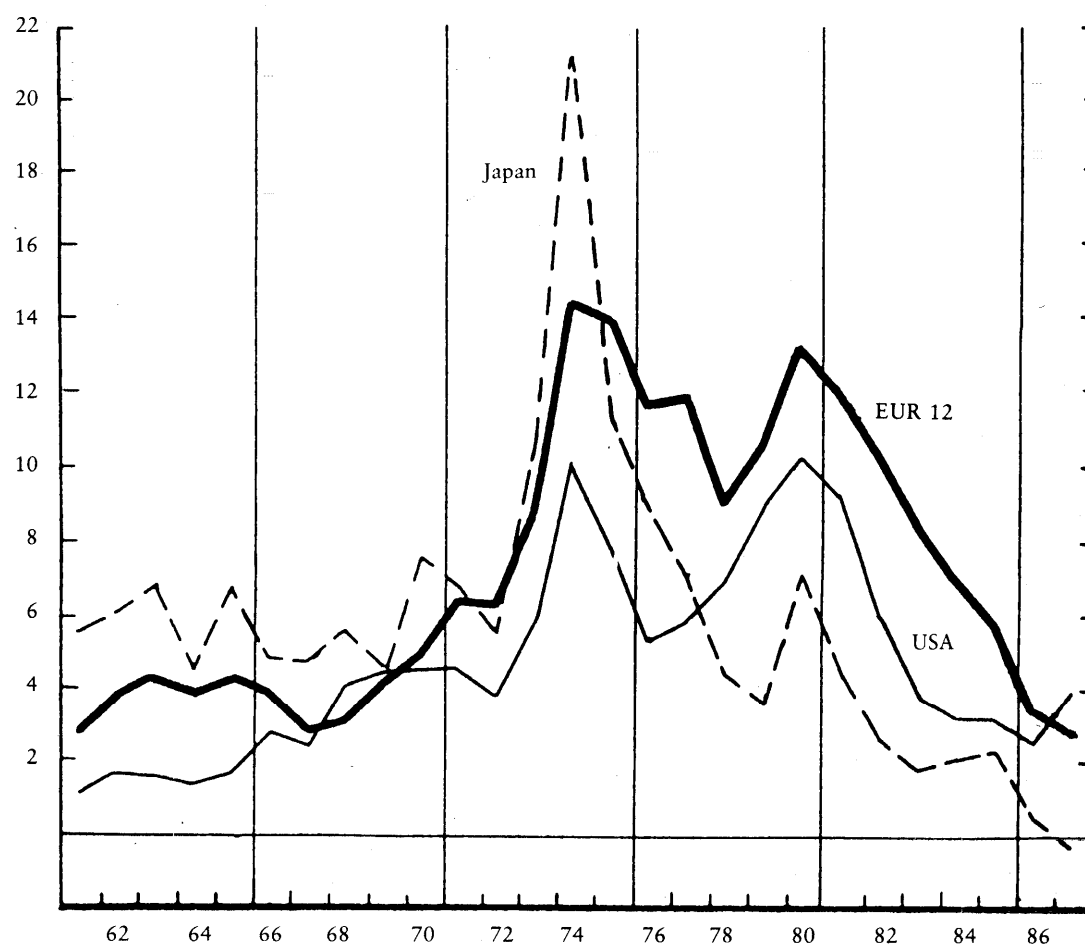
	1960	1965	1970	1975	1980	1985
Luxembourg	145,4	135,5	128,8	126,9	124,4	129,3
Denmark	126,6	129,5	123,5	117,7	115,9	123,9
Germany	123,4	121,5	118,7	114,5	119,3	121,6
France	104,9	106,9	109,9	114,4	115,6	114,0
Belgium	103,4	104,7	107,1	111,0	112,2	109,8
Netherlands	118,3	114,9	115,6	114,7	110,9	106,1
United Kingdom	125,8	116,5	105,9	103,5	98,7	102,0
Italy	83,5	85,4	92,2	89,3	93,3	91,7
Spain	59,9	69,8	73,7	81,6	75,2	75,0
Ireland	67,3	65,9	66,7	68,5	70,4	70,7
Greece	39,1	46,1	52,3	57,7	59,0	57,1
Portugal	32,8	36,5	41,2	43,5	47,3	46,2
EUR 12	100,0	100,0	100,0	100,0	100,0	100,0
USA	186,6	179,5	163,0	154,7	152,6	157,6
Japan	63,1	79,7	104,3	106,5	114,0	128,1
EUR 12 (1960 = 100)	100,0	121,8	147,7	166,4	189,0	198,2
USA (1960 = 100)	100,0	116,9	129,5	137,7	154,4	166,9
Japan (1960 = 100)	100,0	153,5	244,0	280,1	340,6	401,4

Source: Commission services.

GRAPH 11

The evolution of the private consumption deflator

(% annual rate of growth)

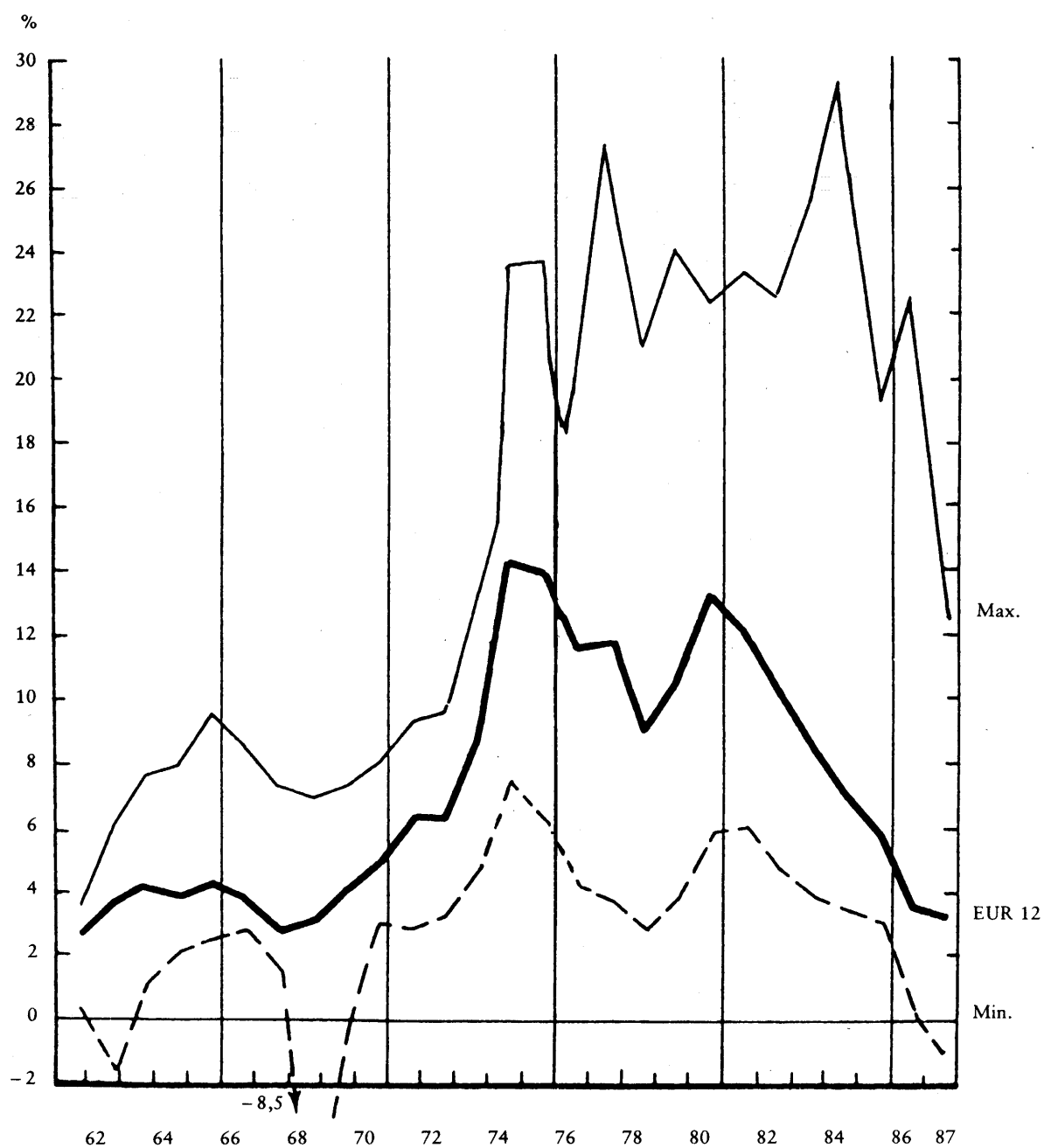


Source: Commission services.

GRAPH 12

Private consumption deflator

Weighted average EUR 12 and Member States' highest and lowest inflation rate

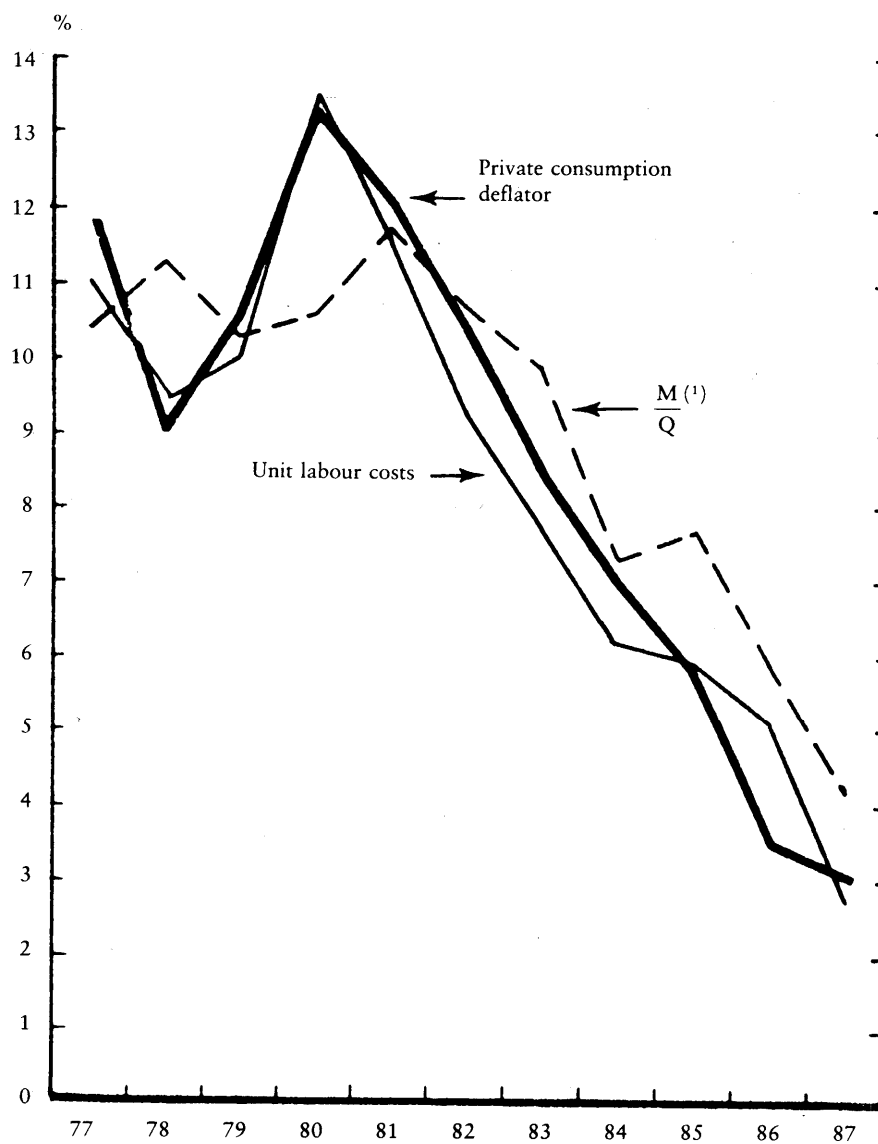


Source: Commission services.

GRAPH 13

Private consumption deflator, unit labour costs, and growth of money stock per unit of output

Weighted average percentage changes EUR 12



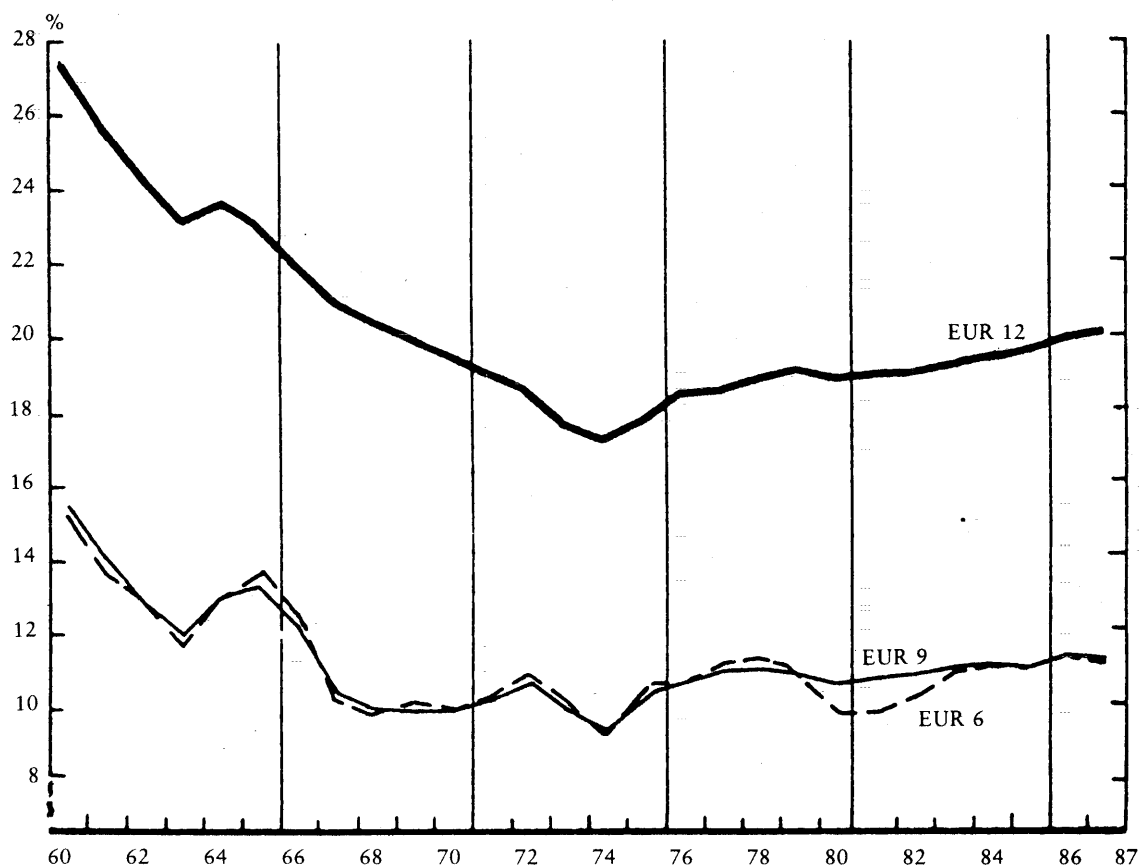
(¹) Broad money supply (M2 or M3) divided by GDP at current prices.

Source: Commission services.

GRAPH 14

The evolution of real GDP *per capita*: inequalities between Member States ⁽¹⁾

Standard deviation of real GDP *per capita* as a ratio of the Community average in percentage terms



⁽¹⁾ The inequalities are measured by the weighted variation coefficient.

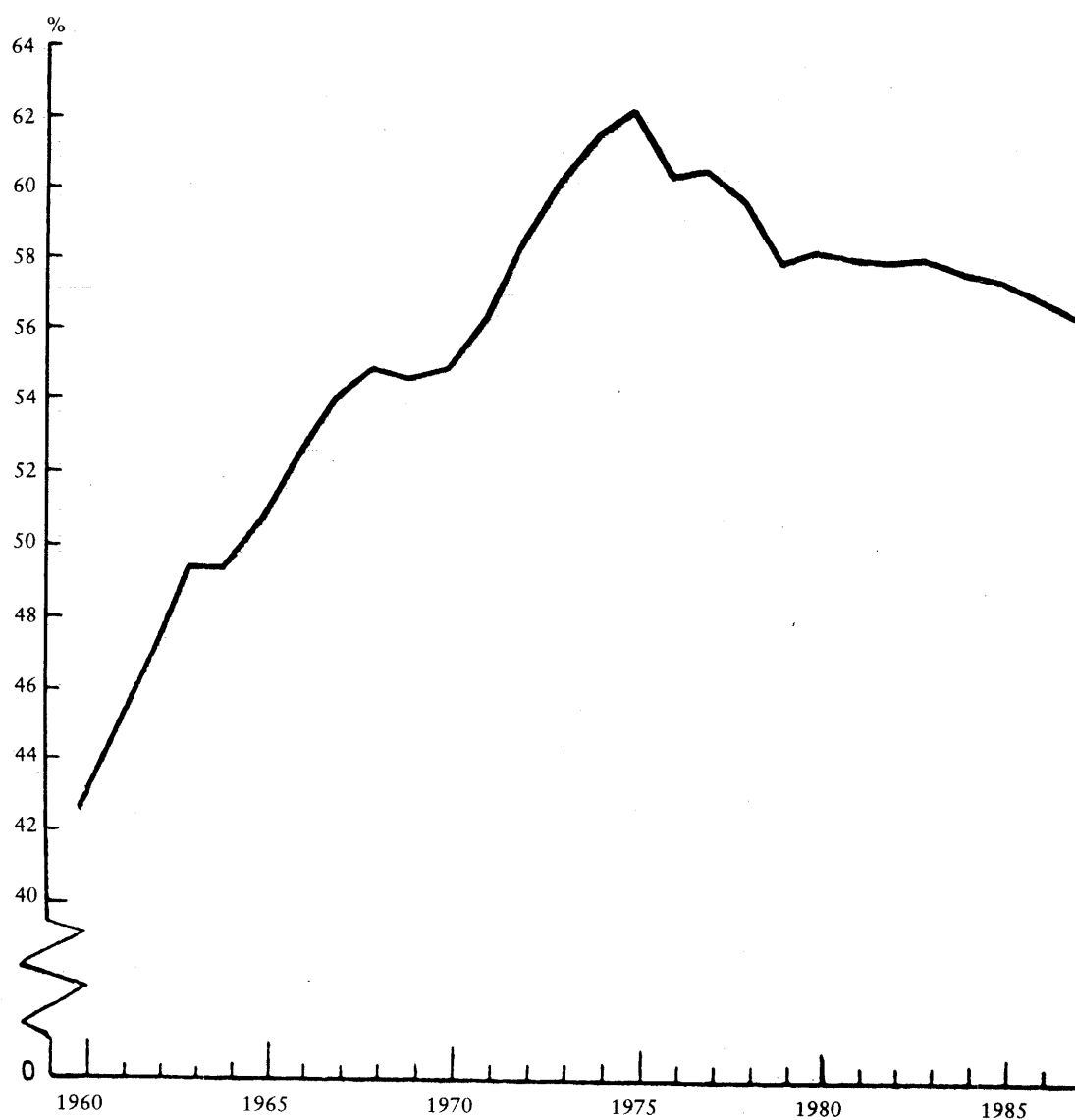
The weighted variation coefficient $\left(\frac{\text{weighted standard deviation}}{\text{mean}} \times 100 \right)$ reports the degree of relative dispersion around the average.

A decrease of the coefficient signifies a reduction of dispersion.

Source: Commission services.

GRAPH 15

Relationship between income ⁽¹⁾ per person in the four poorest and four richest countries in the Community:
EUR 12 (as a percentage) -

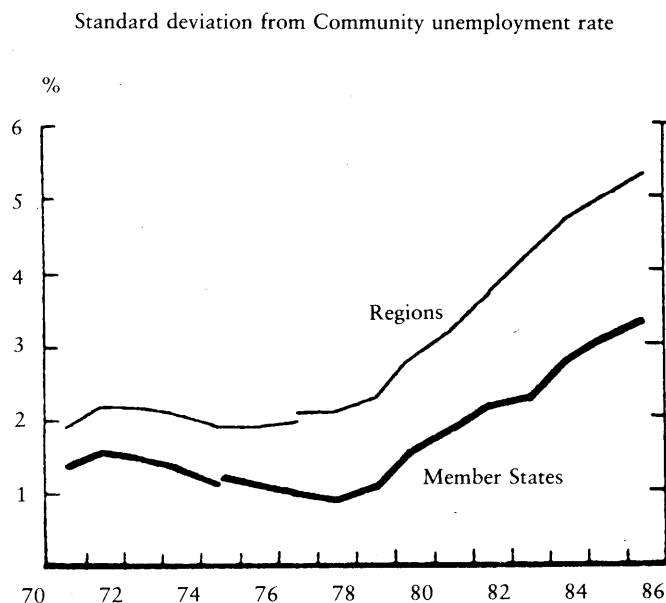


⁽¹⁾ GDP per person at constant prices and purchasing power standards of 1980.

Source: Eurostat and Commission services.

GRAPH 16

The evolution of unemployment disparities ⁽¹⁾ between the Member States and between the regions of the Community



⁽¹⁾ Disparities are measured by population weighted standard deviations. Regions are selected at level 'II' of disaggregation. These concern, for instance, Regierungsbezirke in Germany, regioni in Italy, régions in France, groups of counties for the UK, provinces for Belgium and the Netherlands. Neither of the aggregates includes Greece. Figures for the initial years are for EUR 9.

Source: Commission services, Directorate-General for Regional Policy.

3. THE COOPERATIVE GROWTH STRATEGY FOR MORE EMPLOYMENT

3.1. Objectives and methods

In the shape of the Annual Economic Report 1985/86, the Council adopted a strategy for securing a significant and sustained reduction in the rate of unemployment in the Community by the end of the decade by tackling the very root of the problem. To illustrate this objective, a reduction of some 30 to 40% in the number of people out of work (representing between 4 and 5 million people), that is to say, a decline in unemployment equivalent to between 3 and 4 percentage points was cited.

Following the accession of Spain and Portugal, the basic problem remains the same, as both countries are also faced with massive unemployment (in 1986: 21,7% in Spain and 8,6% in Portugal). As a result, the average unemployment rate for the Community of Twelve stands at 11,9% in 1986 ⁽¹⁾.

⁽¹⁾ In calculating an average for the Community of Twelve, the figures used for Greece, Spain and Portugal are not entirely comparable with those for the other countries, cf Table 8.

In their medium-term analyses, the Commission services make the assumption that the labour force in the Community will expand in the coming five years at an annual rate of 0,3%. Under the circumstances, a reduction of 3 to 4 percentage points in unemployment by 1990 will require an annual increase in employment of between 1 and 1,5% until the end of the decade.

As in the last Annual Report, medium-term scenarios are set out below in order to illustrate the orders of magnitude and the measures advocated (see box).

A first scenario, the baseline scenario, illustrates the development that would take place if present patterns of behaviour and policies remained unchanged. It does, of course, take account of the changes in the international environment in recent months and of the latest forecasts compiled for 1986/87.

On average for the years 1986 to 1990, the growth rate is expected to be 2,7% (EUR 10) while employment will

probably grow over the same period by an annual rate of 0,7%, which would still not be sufficient to reduce unemployment significantly; in 1990, the unemployment rate (EUR 10) is thus expected to be around 9,7% of the labour force, instead of 10,8% in 1986. In the Community of Twelve, the unemployment rate would, therefore, exceed 10%.

A more detailed analysis of 1986 and 1987 in terms of the imperatives of the cooperative strategy is to be found in 3.2 of this report. It will make it possible to assess to what extent the more favourable trend in 1986 and 1987 is the result of a change in behaviour patterns in the direction sought by the cooperative strategy and of the exceptional improvement this year in the terms of trade for the European economy.

In any event, however, it is clear that the problem of unemployment will not go away by itself. This is why, while taking into consideration recent short-term economic developments, this Annual Report recommends a number of measures that are consistent with the cooperative strategy defined last year.

These measures and their medium-term effect will be discussed in detail below (3.3 and Chapter 4). Their aim must be to reduce unemployment in two ways: first through a return to a sustained rate of growth that should average between 3% and 3,5% in the period 1986 to 1990 and, second, by maintaining and even raising the employment content of each percentage point of growth. Basically, these measures are centred around two main objectives: the macroeconomic objective aims at holding demand at an appropriate level and at raising the profitability of more employment-creating investment by maintaining a moderate increase in real wage costs per head. The microeconomic objective aims at continuing to improve the adaptability of the markets for goods and the factors of production, and to provide the right climate for the creation of new businesses.

Thus, for example, in the scenario illustrating the cooperative strategy this year, the growth rate is expected to average 3,5% in the period 1986 to 1990, a figure indicated in last year's Report. The unemployment rate could be cut by some 4 percentage points by 1990, to stand at around 7% in the Community of Ten (around 8% in the Community of Twelve). However, growth averaging close on 3,5% in the period 1986 to 1990 is assumed to accelerate gradually. In this situation, employment could even increase, towards the end of the decade, at a rate of above 1,5%. The determined application of the strategy should thus lead to a situation in 1990 in which not only the rate of unemployment would be already significantly reduced, but also the European economy would be in a better state so that, in the following years, an adequate growth in conditions of stability could be expected, and further rapid reduction in unemployment achieved.

In this context, *investment, both private and public*, is a key variable.

Under the cooperative strategy, investment first of all strengthens the dynamics of *demand*, without which any increase in the growth rate is impossible. From the point of view of *supply*, it reinforces the capital stock. For there to be a return to lasting, higher growth, the capital stock needs to be increased more rapidly, and hence the proportion of resources going each year to public and private investment increased. For the Community of Twelve, that proportion is still almost 4 percentage points of GDP lower than its level in the 1960s, with a good third of this decline being attributable to the falling share of GDP accounted for by public investment.

The data available on the market sector (excluding housing and agriculture) in the four largest Community countries also point to the need for a significant rise in the investment ratio. Taking the average for those four countries, the growth of the capital stock is still unchanged at its lowest level since 1980, i. e. around 2,5% (cf. Graph 18). For it to grow again at an underlying rate of 3,5% and, in so doing, to underpin on a sustainable basis an equivalent rate of growth of production, investment would have to rise by between 2 and 3 percentage points of value added in the market sector (assuming a constant intensity of capital). The investment drive required is therefore substantial.

To achieve the desired reduction in the unemployment rate, there is also a need for a continuing increase in the number of jobs created for each percentage point of growth. From a historical viewpoint, the *relationship between growth and employment* has, in any event, shifted since the 1960s in the latter's favour. This is clearly illustrated by the narrowing of the gap between economic growth and the increase in employment, that is to say, by the lowering of average productivity per person employed (see Graph 17). The rather favourable response of employment to the modest recovery in growth since 1983 is also significant here.

The fact that productivity gains per person employed in the whole economy are still relatively modest does not, however, mean that Europe must be content with a defensive employment strategy and should steer clear of technical progress. Quite the contrary, modernization of productive capacities, coupled with large productivity gains wherever this is possible, is desirable to increase economic efficiency and living standards, and is necessary if Europe is to be able to reinforce its competitiveness and assert its presence on those particularly important future-oriented markets on which it has lost ground during the 1970s.

It is therefore necessary to reconcile the modernization of productive capacity with the creation of a sufficient number of jobs in the economy as a whole. This is possible since the

relationship, at the macroeconomic level, between growth and employment is in reality the result of several factors:

- (i) In a situation of more dynamic growth, the rate of utilization of the capital stock is able to rise to a higher level on a durable basis, thus improving capital productivity and so creating conditions favourable to extra employment.
- (ii) The reduction and reorganization of working time can contribute to an increase in the employment content of growth. Such a reduction can take effect through an increase in part-time working, or by a reduction in the length of the working week or year. However, these measures will only be fully effective in terms of employment if they do not put a brake on the mechanisms which lead, at the macroeconomic level, to stronger and more employment-creating growth, and if they are neutral for the level of costs. In this case, the productivity gains distributed can also be in the form of a reduction in working time. In addition, the increase in the number of temporary workers and workers on fixed contracts can be a further factor in raising the job content of growth in particular where firms, as a result, decide not to introduce overtime working. Such measures coming largely within the ambit of agreements between the social partners should form the basis for a deeper dialogue between both parties.
- (iii) Finally, there is a long-term trend stemming from the gradual restructuring of employment in favour of sectors with low productivity gains per person employed, notably the service sector, and to the detriment of industry, where productivity gains are higher. Thus, between 1970 and 1983, the share of employment in the Community (EUR 6) accounted for by market and non-market services rose from 48 to 59%. At the same time, productivity in the service sector rose at an annual average of only 1,6% during the same period, and that in manufacturing by 3,3%.

The fact that trends in productivity gains between sectors and between firms have differed is only to be expected. Even so, favourable conditions must allow the productivity gains realized in the more dynamic sectors to be enjoyed throughout the economy and, in the final analysis, to create jobs. Moderate growth in real wage costs per head in all sectors of the economy and the mechanism of relative prices play a key role here.

In effect, when sectors with higher than average productivity gains take advantage of this situation to lower their prices in relative terms, not only do they improve their competitiveness and are able to increase production in response to increased demand, but this

fall also benefits those sectors where productivity gains are weaker. In effect, thanks to the corresponding increase in their relative prices, sectors with weak productivity gains can maintain profitability and so are in a position to create jobs. There is thus a transfer in purchasing power between sectors which is related to technical progress, and which is favourable to employment ⁽¹⁾.

For this mechanism to function well, which is desirable from the point of view of employment, two conditions must, in principle, be fulfilled: moderate growth in real wage costs per head must also benefit those sectors where productivity gains are above average. In addition, markets must play, as efficiently as possible, their role in forming prices: a strengthening of competitive forces and completing the internal market will contribute to this. A stable monetary environment also makes the market signals relative to price changes that much clearer.

Thus, a moderate growth in real wage costs in the economy as a whole, modifying the relative remuneration of labour and capital in a direction favourable to the latter, also works — at the micro- and macroeconomic level — in favour of employment. Therefore, on a company level, it encourages a more extensive utilization of the capital stock. At the same time, however, it contributes to the creation of better conditions for the development of activities which are more employment-creating.

An important aspect of the measures recommended by the cooperative strategy is thus clearly discernible, *viz* the close complementarity that exists between them, irrespective of whether they are macroeconomic or microeconomic measures. An acceleration in growth will be all the more conducive to employment if firms are able to respond flexibly to increased demand. However, greater adaptability of the markets in goods, labour and capital is not sufficient by itself to encourage firms to undertake investment the profitability of which is not also assured by favourable demand prospects. In the final analysis, it is within a context of dynamic growth that increased market adaptability will be fully justified, both economically and socially. Failing that, there may be a resurgence of defensive behaviour that will jeopardize the very foundation of the renewal of the European economy.

Without a rapid change in attitudes and policies, the Community will still be faced with unemployment of over 10% in 1990. This is an unacceptable prospect. A significant

⁽¹⁾ For the relative growth of employment, productivity and prices within the different sectors of the Community, see chapter B.3 of the Annual Economic Review 1986/87. Table 14 of this report shows that this mechanism has also had a particularly strong effect in Japan: the differences between gains in productivity, but in addition changes in relative prices, were particularly large between industry and the other sectors. The dynamism of Japanese industry has also profited other sectors of the economy which (taken together) were the only ones to have increased their employment.

and lasting reduction in unemployment can be achieved through more buoyant and employment-creating growth, of the order of 3 to 3,5 % on average in the years 1986 to 1990. Investment plays a key role here. Its share of value added would have to increase progressively by around 3 percentage points in total. Furthermore, the relationship between growth and employment must improve. This does not mean that Europe can be content with a defensive strategy regarding employment. On the contrary, competition from outside makes it necessary to modernize production structures. The relationship that is emerging between growth and employment is, however, determined by other factors, such as a reduction and reorganization in the average working time of each person employed, which is neutral for the overall level of costs, more rapid job creation in sectors with relatively low productivity gains, and the moderate growth of real wage costs per head in all sectors of the economy. In effect, when sectors with more than average productivity gains also benefit from moderate growth in real wage costs per head, they are able to reduce their relative prices. This improves their own competitiveness and also benefits the sectors of weaker productivity growth, who thus see their profitability improving and so are able to create jobs. Technical progress and increasing employment can be reconciled with each other at the macroeconomic level. These factors are conditioned, to a large extent, by an increased adaptability of markets. Such adaptability will, however, find its social justification only within a context of more dynamic growth. This underscores the close complementarity of the measures recommended by the cooperative strategy, either at the macroeconomic or microeconomic level.

3.2. Forecasts for 1986 and 1987 seen from the viewpoint of the cooperative strategy

In terms of the ambitious objectives set in the cooperative strategy, forecasts for 1986 and 1987 are hardly satisfactory. In both years, economic growth (2,5 % and 2,8 %, respectively) and the increase in employment (0,8 % on average) will fall short of the underlying rate necessary. Of course, the return to a stronger growth rate can take place only gradually. However, the slowness of the process at the moment is worrying, especially since the Community is enjoying the benefits of a substantial improvement in its terms of trade that is, in principle, influencing the conditions of supply and demand in the manner aimed at in the cooperative strategy.

The improvement in the terms of trade has provided the European economies with an opportunity to obtain a further improvement in profitability while permitting a relatively sustained increase in real household income. The fall in prices of imported goods is having a beneficial effect not only on firms, but also on households, which consume final products. For example, real *per capita* compensation of employees is likely to be more or less stable in terms of costs, whereas real compensation per head, adjusted by the private

consumption deflator, i.e. in terms of purchasing power, is expected to increase by 2,3 %, faster than at any time since 1980.

Furthermore, lower oil prices will have a positive direct effect on the level of economically productive capacities, either through more extensive use of the existing capital stock or because firms will keep in operation longer, plant that would otherwise have been scrapped.

Various indicators bear witness to the turnaround in the trend of the 1970s towards deteriorating *supply-side* conditions. The turnaround, in fact, dates from the beginning of the 1980s:

- since 1980, real labour costs per head (wages plus social security contributions) in the Community have risen on average by only some 1 % a year compared with 2,4 % between 1973 and 1980. Major sacrifices have, therefore, already been made in a number of countries by employees, especially since, in many cases, their disposable income has been eroded by even higher taxation and parafiscal charges,
- real unit labour costs in the Community, which are a measure of the relative movements of real compensation of employees and labour productivity, are now back at a level approaching that recorded in the 1960s,
- the accompanying rise in the macroeconomic profit share (operating surplus on value added) has led to a further increase in the profitability of productive capital (operating surplus on the capital stock). Even so, profitability has as yet made up, on average for the Community, only some of the ground lost since the first oil shock (see Graph 18),
- for the first time in at least 20 years, profitability is outpacing real wages per head in a lasting fashion.

Nevertheless, it would seem that the development of real labour costs per head is accelerating in 1987. According to most recent forecasts, they are expected to rise by 1,3 %, their fastest increase since 1980. Real unit labour costs will probably decline by only 0,7 %, a rate slower than in any other year since 1981. At the same time, the situation is also less encouraging as far as external competitiveness is concerned.

Indeed, the ECU rose by 42 % against the US dollar between March 1985 and June 1986 and fell by only 7,4 % against the yen. Of course, for each of the European economies taken separately, the effect of these large exchange-rate movements

was cushioned by the relative stability between Community currencies, notably those participating in the EMS. Nevertheless, the average rate of appreciation against the currencies of the Community's 19 major trading partners ranges from 14,3 % for the Federal Republic of Germany to 1,2 % for the United Kingdom. Taking the Community countries together, and excluding intra-Community trade, the average appreciation is 17,8 %. The Community, therefore, no longer enjoys the advantages afforded it on a number of third-country markets by a strong dollar.

The changing international environment has, of course, had implications for *the growth and structure of total demand*. An improvement in the terms of trade on the scale enjoyed by the Community is naturally leading to a shift of emphasis between external demand and internal demand. Yet the adverse affects on exports of the appreciation of European currencies and the slowdown in growth in some of the Community's major trading partners have not been long in making themselves felt. Since it was desirable for a number of other reasons, the transfer of income from outside the Community equivalent to around 2 % of GDP has been used in several countries either to improve the financial situation of firms, in cases where nominal wages have adapted rapidly to falling inflation, or to return to a healthier public finance position more quickly. In these countries, the revival in internal demand is much weaker and much more diluted over time than would have been the case if consumers had continued to be the ones to benefit most from the improvements in the terms of trade.

In all, *total demand* (internal demand plus exports) is expected to expand by only 3,6 % in 1987, and this is insufficient, bearing in mind the response of imports, to push GDP growth above 3 %.

The growth in internal demand since 1985 is attributable, for the most part, to a rapid increase in private consumption (3,6 % on average in 1986 and 1987) and investment in equipment (between 6 and 7 % in 1986 and 1987). The recovery in investment in construction is noticeable, but growth here remains weak (3,2 % in 1987).

The share of resources in GDP devoted to investment and the growth in capital stock still however remain below what is required in the medium term. Some of the determinants of business investment are, however, displaying favourable trends. The average profitability of the capital stock is increasing (see Graph 18) although only in the Federal Republic of Germany is it back to a level approaching that prior to the first oil shock. In all Community countries, the utilization rate of productive capacity is climbing rapidly (see Graph 19 for the four largest Community countries). The ebb in nominal interest rates is continuing, and is also one of the factors shifting the pattern of returns on financial investment and productive investment in favour of the latter.

However, the weakness of demand in recent years and the uncertainties attaching to it may work to the detriment of investment. In this connection, the more-detailed analysis of Graphs 18 and 19, which compare the growth in the capital stock in the four largest Community countries with the profitability and the utilization rate of the capital stock, brings to light two interesting points:

- although the growth in the capital stock fell in line with profitability after the first oil shock, the temporary improvement in profitability between 1976 and 1978 and the improvement discernible since 1982 have not yet provided a sufficient stimulus to investment,
- the quite close link that appears to have existed until 1975 between the rate of capacity utilization and the growth in the capital stock appears to have weakened since. As in the case of the profitability curve and the curve representing the growth of the capital stock, a large gap has opened up since 1981 between the growth in the capital stock and the utilization rate of productive capacity.

In 1986, therefore, the improvement in the terms of trade has had a beneficial effect on both supply-side and demand-side conditions. This effect will, it is true, continue with regard to internal demand in 1987 but it will remain insufficient and may rapidly diminish. Under the circumstances, an improvement in the unemployment outlook will have to come from an effective implementation of the cooperative strategy.

In order to achieve the cooperative strategy's objectives, the attitudes and policies of all those involved in economic activity will, therefore, have to be modified, in some cases significantly, as of 1987.

First, firms should respond, with even greater resolve, to the improvement already underway in supply-side conditions by increased investment. It is true that each investment decision depends on economic calculations. This is why it is advisable to continue with efforts to improve profitability, to lower long-term real interest rates, on a sound basis, and to develop the market for risk-capital; but the investment decision is also based on confidence and risk-taking. Behaviour patterns here must also be modified in a direction which is favourable to employment. Firstly, a more dynamic trend in business investment would be positive as far as demand is concerned. Secondly, from the point of view of supply, it would enable a parallel development of productive capacity and output to take place which would allow a slackening of inflationary pressures which could result from rising utilization rates. The European economies would thus benefit fully from the current situation. Inflationary pressures which could result

from this rise in capacity utilization rates at present are very largely neutralized by the moderation in import costs and wage costs. In addition, the improved profitability resulting from this moderation encourages a more extensive use of the capital stock. Thirdly, an even faster rate of job creation would also fully justify the efforts already made in many countries by employees. It would improve the chances that real wages remain favourable to employment for a sufficiently long period.

However, economic policy makers have to continue to play their part. They must also show by their actions that they are determined to contribute to more buoyant supply and demand conditions in the Community. In any event, they cannot avoid their responsibility in the matter.

In 1986, the improvement in the terms of trade has favourably influenced both supply-side and demand-side conditions. The revival in profitability, underway since the beginning of the 1980s, thanks also to the moderate growth in real wage costs, has gathered pace. However, average profitability in the Community has not yet returned to its level of the 1960s. According to the forecasts, the growth in real labour costs will speed up in 1987. In addition, the growth in total demand in 1987 will remain below the level necessary for the purposes of the cooperative strategy. In particular, investment will not stage as strong a revival as could be hoped in view of the improvement in most of its main determinants. A stimulus could, however, come from a better outlook for demand. Under the circumstances, an improvement in the unemployment outlook will have to come from effective implementation of the cooperative strategy by all those involved. Firms should react to the improvement in supply-side conditions with a more rapid investment and job-creation effort. This will create the conditions most conducive to, and will provide full justification for, the continuing moderate increase in real labour costs per head that is necessary. Economic policy makers will, however, also have a part to play.

3.3. Macroeconomic policy imperatives in 1987 and beyond

The consolidation that has taken place since the beginning of the 1980s and the recent changes in the international environment provide the European economies with an outstanding opportunity. Company profitability is picking up. Inflationary pressures originating inside the Community are still weak; the improvement in the terms of trade having had a powerful disinflationary effect, and inflation, taking the average for the Community, having fallen to its lowest level since the 1960s. The reduction in the oil bill has eased the external constraints and the Community is showing an external surplus equivalent to 1,2% of GDP in spite of the depressed level of its exports.

The opportunity open to the Community must be seized with determination, not only with a view to resolving the most pressing problem facing the European economies, but also to ensure that Europe makes its contribution to correcting current-account balances worldwide and to providing the response necessary to the problems of the developing countries.

The necessary economic policy mix was spelt out in last year's Annual Report. It must now be effectively applied. This also implies that the social dialogue at present under way at the Community level extends to the Member States so that the respective contributions of firms, employees and governments can be better adapted to each other.

At country level, the mix of policies must not only take account of the available room for manoeuvre and that which is being created but its implementation requires a broad acceptability on the part of the social partners and, to this end, must be the subject of an in-depth dialogue at national level with, and between, the two sides of industry.

Budgetary policy has a key role to play through the restructuring of public revenue and expenditure in favour of more employment-creating growth and through the way in which it underpins demand. In this respect, three types of measure may be envisaged, the implications of which are looked at in greater detail in Chapter 4:

- A recovery in economically profitable public investment could add to the revival in private investment with a view to modernizing productive capacities in Europe. It would also provide a direct stimulus to growth.
- The moderate growth in real wages should be of the same order (around 1 % per annum) as that in the Report of last year and could be complemented by some reduction in social insurance contributions. From the viewpoint of firms, this measure, which improves supply conditions and favours investment, would alleviate indirect wage costs which, as a Community average, represent about 30 % of the total wage bill. From the point of view of employees, it would allow a somewhat faster rate of growth in purchasing power and maintain the level of demand.

The financing of social security systems should, of course, be kept on a sound basis. However, account must also be taken of the fact that, for social security systems, the economic crisis is pushing up expenditure and adding to the shortfall in revenue and this will be reversed as and when the situation improves. The room for manoeuvre that will, therefore, become available would have to be used systematically to alleviate the burden on labour costs, and thus to reverse in part the trend experienced in the 1970s. The budgetization of social security expenditure associated with the crisis could further be considered.

- A reduction in direct taxation paid by households and firms would also help underpin demand and improve conditions on the supply side.

Together, these measures ⁽¹⁾ should not jeopardize the process of reducing the medium-term deficit. Indeed, combined with other measures, improving in addition supply conditions, they contribute to stronger and sustained growth and to a reduction in unemployment. As a result, expenditure linked to the crisis will diminish progressively and the tax base will increase more rapidly.

However, faster growth is also necessary from 1987 onwards. This could, it is true, be achieved through closer economic policy coordination with the Community's major partners (see Chapter 4.7). It could also be achieved if there were a further acceleration in the growth rate of private investment stemming from increased confidence on the part of business with regard to the future trend of demand and profitability. In the case of an unfavourable trend, it could be necessary to envisage a limited and temporary increase in the budget deficit on average for the Community, respecting nevertheless the objective of medium-term consolidation of public finances.

This does, of course, pose the problem of budgetary policy coordination in the Community. Some countries still have a great deal to do to achieve budgetary consolidation. Others have some headroom or would have some headroom in a context of more dynamic growth.

The task of the countries in the former category would be considerably facilitated if growth did pick up. For the countries in the latter category, budgetary consolidation in other Member States, achieved against a background of sluggish growth, may be prejudicial to their own growth. Here too, the benefits of cooperation are clear to see.

A continuing downward movement of *interest rates* in the Community, which would reflect the fall and increased alignment of inflation rates, can also make a positive contribution to demand. Moreover, the monetary authorities might have to accept further falls in interest rates in order to resist the pressures to which the dollar's exchange rate will be exposed. Internally, however, measures will have to be taken to avoid a build-up in potential liquidity that

could at a later stage jeopardize the headway made in the battle against inflation, while ensuring adequate financing of real growth. In this respect, the monetary authorities' headroom will be all the greater if the inflation rate pressures originating inside the Community, and in particular the trend of nominal wage costs, remain weak.

The application of macroeconomic policies based on the broad lines defined above will provide full justification for the efforts made by employees. It is also indispensable if the necessary microeconomic measures to make markets more adaptable are to be fully effective as regards their impact on employment.

The consolidation efforts made since the beginning of the 1980s and the recent changes in the international environment provide the European economies with an outstanding opportunity that must be seized resolutely, not only with a view to resolving the problem of unemployment, but also to ensure that Europe makes its contribution to correcting current accounts worldwide and provides the response necessary to the problems of the developing countries. Budgetary policy has an important part to play through the restructuring of public revenue and expenditure in a direction favourable to the improvement in supply conditions and employment, and through the appropriate support it should provide for growth. The reduction and closer alignment of inflation rates should allow the decline in interest rates to continue. Even so, while taking account of the problems that would arise from a further fall in the dollar on foreign-exchange markets and of the need to ensure sound financing of growth, measures should be taken to avert any build-up of potential liquidity that might ultimately prove prejudicial to stability. Implementation of the measures recommended must be the subject of close cooperation between (a) Member States, with due regard being given in particular to the different degrees of room for manoeuvre available in each country, and (b) between, and with, the social partners at national level in the interests of assuring a broad acceptance by the social groups, and so that contributions of each can be balanced.

⁽¹⁾ These measures are illustrated in more detail in the Box.

TABLE 12

Public investment and total investment in the Community ⁽¹⁾

(in % of GDP)

	1970	1974	1979	1984	1985 ⁽²⁾	1986 ⁽²⁾	1990 ⁽³⁾
Public gross fixed capital formation	4,2	4,0	3,2	2,8	2,8	2,7	3,6
Gross fixed capital formation for the total economy	22,7	22,3	20,8	18,6	18,4	18,5	21,7

⁽¹⁾ Excluding Greece, Ireland, Spain and Portugal.

⁽²⁾ Economic forecasts of the Commission services, October 1986.

⁽³⁾ Cooperative scenario.

Source: Eurostat and Commission services.

TABLE 13
Indicators of supply and demand

	1961 to 1973 (average)	1974 to 1981 (average)	1982	1983	1984	1985 ⁽¹⁾	1986 ⁽¹⁾	1987 ⁽¹⁾
<i>(i) Indicators of demand (% changes per annum):</i>								
Domestic demand at constant prices:								
Community index	5,0	1,6	0,8	0,8	1,4	2,2	3,8	3,5
Gap: EUR/other OECD countries	-0,5	-0,6	1,0	-1,9	-4,2	-1,1	0,4	0,9
Private consumption	5,0	3,0	0,6	1,0	0,9	2,2	3,7	3,5
GFCF	5,6	0,0	-1,5	-0,3	1,3	2,4	4,2	5,1
Exports of goods and services	9,2	4,6	1,5	3,1	7,6	5,7	2,2	3,7
<i>(ii) Indicators of supply conditions:</i>								
Employment (% change per annum)	0,3	-0,1	-0,9	-0,8	0,1	0,4	0,8	0,8
Productivity (% change per annum)	4,5	2,1	1,5	2,0	1,9	2,0	1,7	2,0
Real unit labour costs (index 100: average 1961 to 1973)	100,0	104,3	103,0	102,4	101,1	99,9	98,1	97,4
Profitability ⁽²⁾ (index 100: average 1961 to 1973)	100,0	68,0	61,8	59,8	64,7	68,4	77,9	82,8
Equipment investment (% change per annum)	—	—	0,2	0,3	3,4	8,0	6,1	6,9
Cost competitiveness ⁽³⁾ (index 100: average 1961 to 1973)	100,0	108,8	98,9	93,2	86,7	85,6	95,1	95,9

⁽¹⁾ Estimates and economic forecasts of Commission services (October 1986).

⁽²⁾ Estimate for the Community of Ten: gross operating surplus in the whole economy on the capital stock at replacement cost.

⁽³⁾ Real effective exchange rates on the basis of unit labour costs in the whole economy with respect to other OECD countries, excluding intra-Community trade.

Source: Eurostat and Commission services.

TABLE 14
Sectoral developments in Europe, the United States and Japan (1970 to 1982)

	EUR 6 ⁽³⁾	USA	Japan
<i>(1) Value added at constant prices</i> <i>(% change per annum 1970 to 1982)</i>			
Agriculture	1,8	2,1	0,2
Industry ⁽¹⁾	1,7	2,1	7,1
Market services	3,4	3,6	5,1
Non-market services ⁽⁴⁾	2,4	1,9	4,2
Total ⁽²⁾	2,5	2,7	5,2
<i>(2) Employment 1982</i> <i>(Index = 100 in 1970)</i>			
Agriculture	67,2	97,2	68,7
Industry ⁽¹⁾	83,0	97,8	100,4
Market services	117,2	136,2	132,2
Non-market services ⁽⁴⁾	124,5	121,4	133,4
Total ⁽²⁾	99,9	121,7	111,5
<i>(3) Productivity per person employed</i> <i>(% change per annum 1970 to 1982)</i>			
Agriculture	5,2	2,3	3,5
Industry ⁽¹⁾	3,3	2,3	7,1
Market services	2,1	1,0	2,7
Non-market services ⁽⁴⁾	0,5	0,2	1,8
Total ⁽²⁾	2,5	1,0	4,3
<i>(4) Relative price with respect to the</i> <i>prices of industrial products in 1982</i> <i>(Index = 100 in 1970)</i>			
Agriculture	83,5	120,7	147,9
Industry ⁽¹⁾	100,0	100,0	100,0
Market services	110,3	112,4	161,3
Non-market services ⁽⁴⁾	138,4	125,3	240,8
Total ⁽²⁾	110,6	116,4	147,8

⁽¹⁾ Narrow definition.

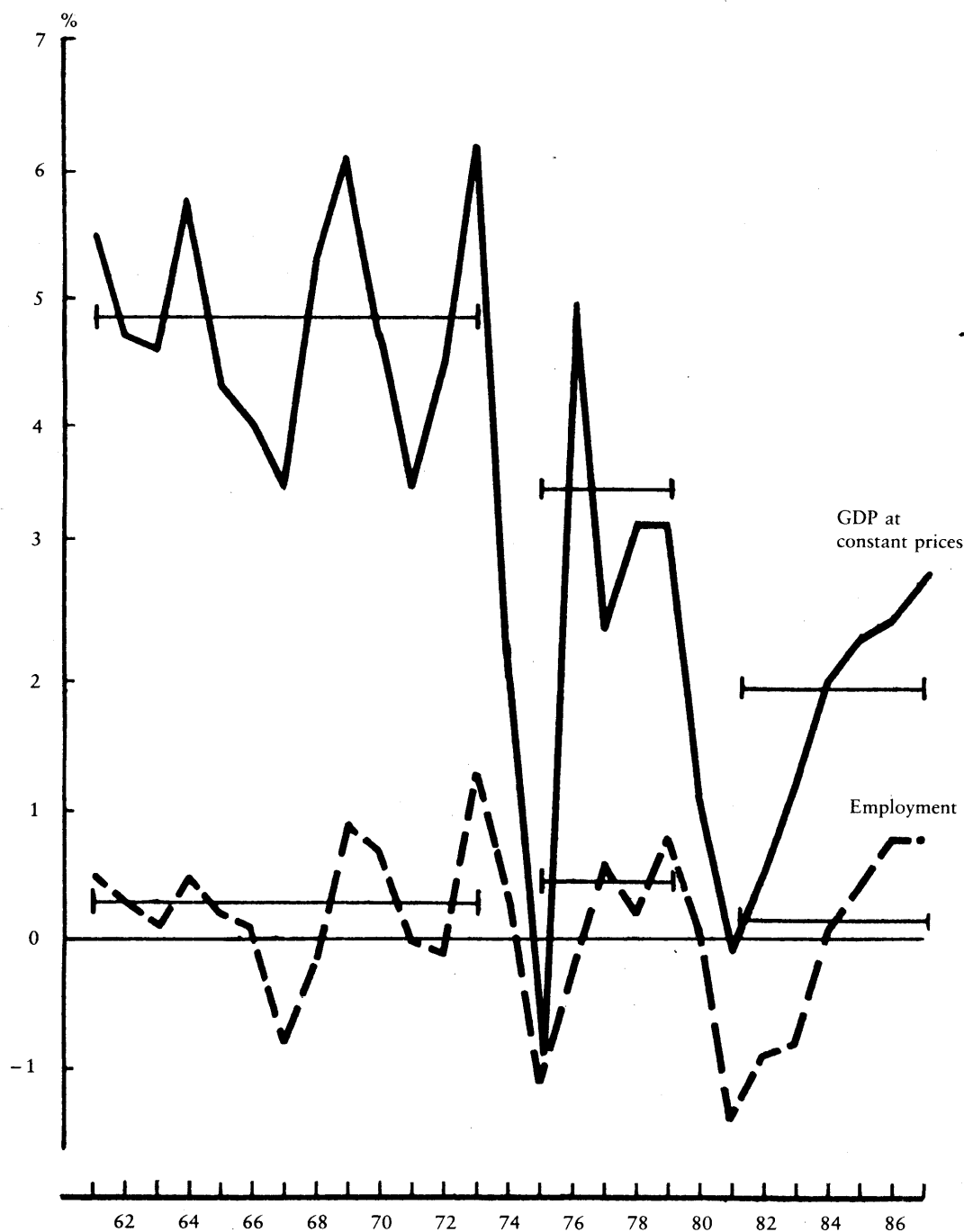
⁽²⁾ Including the other sectors; energy, building, and public works.

⁽³⁾ Belgium, Germany, France, Italy, Netherlands, United Kingdom.

⁽⁴⁾ Essentially general government.

Source: Eurostat and Commission services.

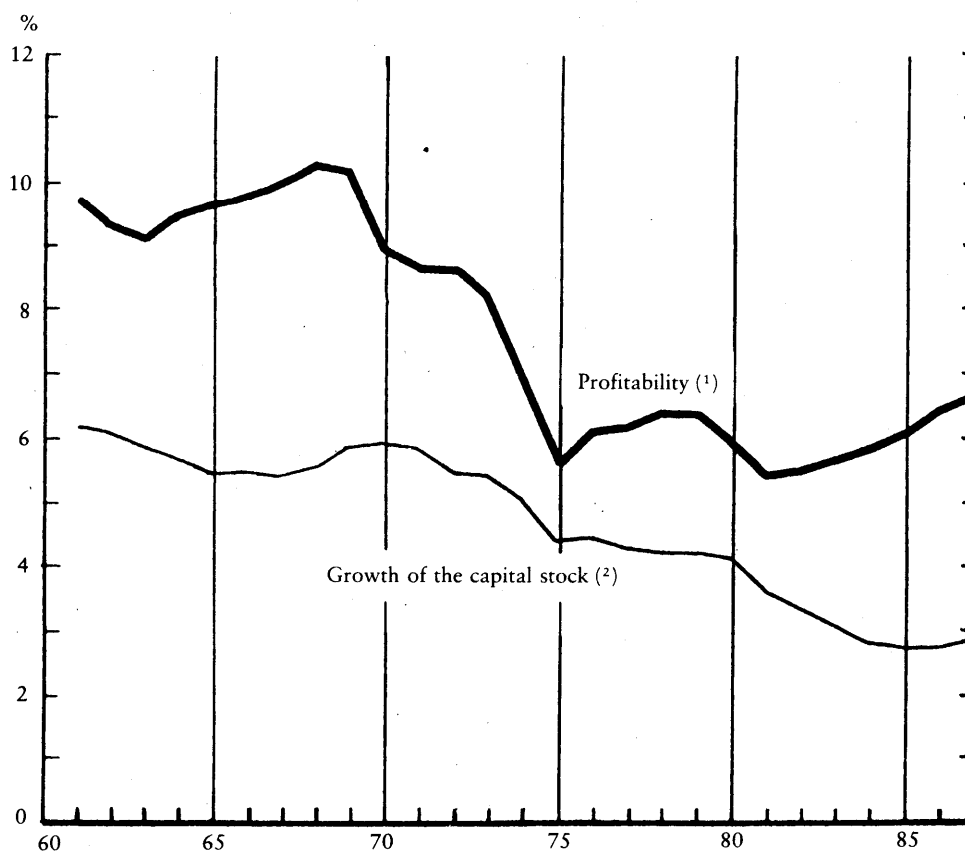
GRAPH 17

GDP and employment in the Community (EUR 12) (annual percentage growth rate) ⁽¹⁾

⁽¹⁾ The horizontal lines indicate average annual rates of growth in each of the periods.

Source: Eurostat and Commission services (1985 to 1987: Estimates and forecasts of Commission services, October 1986).

GRAPH 18

Profitability ⁽¹⁾ and growth of the capital stock ⁽²⁾ in the Community (EUR 4) ⁽³⁾

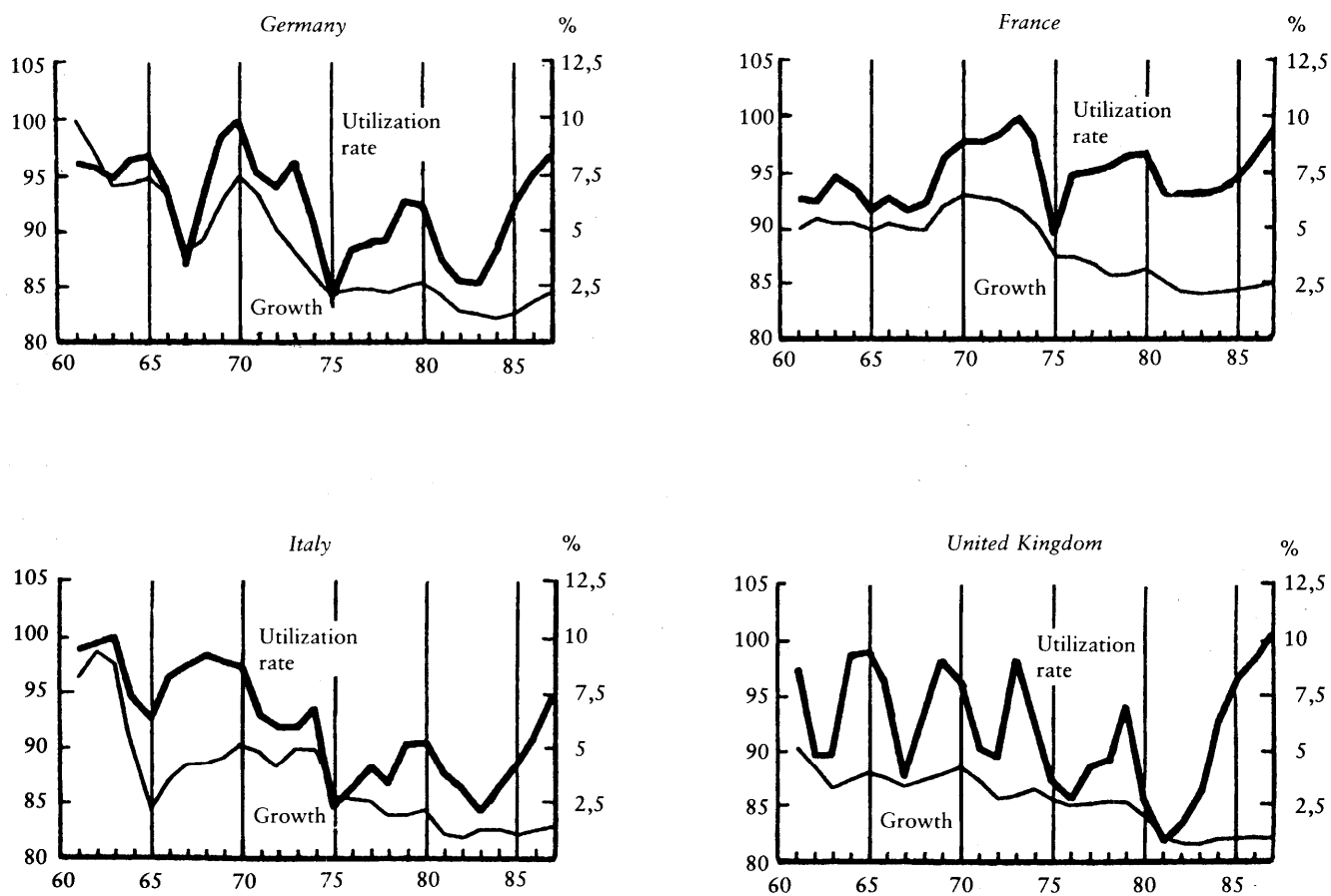
⁽¹⁾ Net operating surplus as a percentage of gross capital stock at replacement cost.

⁽²⁾ Gross capital stock at constant prices (% changes per annum).

⁽³⁾ Germany, France, Italy, United Kingdom.

Source: Commission services.

GRAPH 19

Growth and utilization rate of the capital stock ⁽¹⁾ ⁽²⁾ (Index: peak of last 25 years = 100)⁽¹⁾ Growth of the gross capital stock.⁽²⁾ Utilization rate on the basis of business survey data for manufacturing industry.

Source: Commission services.

Medium-term scenarios for the cooperative strategy

An illustration of the possible evolution of the Community economy is given, on the one hand, in a medium-term projection on the assumption of no change in present policies and economic behaviour and, on the other hand, in a highly stylized representation of the cooperative strategy. These latter figures are only intended to be illustrative and should not be interpreted as formal objectives of policy.

These scenarios have been calculated using the Compact model for the Community of Ten. This model was described in detail in European Economy No 27.

Hypotheses regarding the international environment

For both the baseline projection and the cooperative strategy it has been assumed that oil prices would continue to climb again between now and the end of the decade. This will produce a deterioration in the terms of trade amounting to some 7 % during the period 1987 to 1990. The exchange-rate hypothesis is for virtual stabilization at their average 1986 level of the dollar/ECU and yen/ECU exchange rates.

In the United States, the general government deficit would be gradually cut back, from 3,4 % of GDP in 1986 to 1 % in 1990. It would be stabilized in Japan at 0,5 % of GDP with effect from 1987, after touching 1 % in 1986. Growth would be modest in the United States (averaging 2,7 to 2,8 % in the period 1986 to 1990, depending on the scenario chosen), and fairly firm in Japan (3,7 to 3,8 %) over the same period.

A scenario illustrating the cooperative strategy

The scenario used to illustrate the cooperative strategy this year leads to the same growth rate as in last year's Annual Report (3,5 % for the average of the years 1986 to 1990). Nominal demand is maintained at approximately the same rate of growth in the cooperative scenario as in the baseline projection (6 % or slightly more). This growth rate is sufficient to generate a fall in the unemployment rate equivalent to 3,7 percentage points of the labour force between 1986 and 1990 and, at the end of the decade, brings the trend rate of increase in employment to 1,5 % per annum or a little higher. The economic policy mix is designed to bring about, under conditions of monetary stability, faster growth of the European economies through joint action on supply-side and demand-side conditions.

The same hypothesis as last year was taken for the growth in real labour costs per head, that is to say an annual increase of 1 % (average for the period 1986 to 1990); the gap between this increase and productivity gains in annual average terms being 1,3 percentage points per annum.

This moderate growth in real labour costs is obtained in two ways: firstly, through an effort on real wages excluding employers social security contributions: as in the scenario for last year, they increase by 1,1 % on average for the years 1986 to 1990; secondly, through a reduction in rates of social security contributions which is proportionally distributed between employers and employees. Cumulated over four years (1987 to 1990), the fall in social contributions assumed, amounts *ex-ante* to 1 % of GDP.

Medium-term budgetary policy is characterized by progressive reductions in direct taxation on household and an increasing level of public investment. These two measures, cumulated over four years each, amount to 1,2 % of GDP. Besides the endogenous reductions in certain transfer payments (in particular unemployment benefits), it was assumed that the progressive improvement in the economic situation would enable the growth of expenditure aimed at directly easing the situation on the labour market (early retirement programmes etc.) to be moderated.

The lasting reduction in inflation, the improvement in the financial situation of firms, which relieves pressure on the capital markets, and a monetary policy which, while remaining directed at stability, finances faster real growth, imply a reduction in long-term interest rates of about 3 percentage points on average in the Community between 1986 and 1990. For the period as a whole, the real interest rate amounts to 3,6 % on average.

Between 1987 and 1990, the medium-term tax reductions and public expenditure increases cumulate to a total of 3,2 % of GDP. The higher growth rate and lower expenditures on social security to a large degree offset measures in their impact on the budget deficit. By 1990, the budget deficit is 1,2 % of GDP lower than in 1986, which nonetheless represents a slower decline than in the baseline projection.

In the cooperative scenario, the current balance on average for the years 1986 to 1990 is 0,5 percentage points of GDP below that of the baseline scenario (0,1 % of GDP as against 0,6 %). A variant of the cooperative scenario is presented in section 4.7. The assumption behind this variant is that Japan contributes more to the process of absorbing the major world imbalances. As a result, for the years 1986 to 1990, the Community current account improves by 0,3 percentage points of GDP on the cooperative scenario.

Some principle macroeconomic aggregates illustrating the cooperative strategy

	Baseline projection	Cooperative scenario
<i>Annual average growth rates 1986 to 1990 (%)</i>		
GDP volume	2,7	3,5
GDP price	3,3	2,7
GDP value	6,0	6,2
Employment	0,7	1,2
Productivity	2,0	2,3
Private consumption	3,0	3,4
Investment	3,7	6,8
Real wages per head	1,9	1,1
Real unit labour costs	-0,3	-1,3
<i>Annual average levels, 1986 to 1990 (%)</i>		
Long-term rate of interest (%)		
Balance of payments	7,7	6,3
Current account (% GDP)	0,6	0,1
	1986 actual level	1990 level in cooperative scenario
Unemployment rate (%)	10,8	7,1
Budget deficit (% of GDP)	4,7	3,9

Note: The data are for EUR 10. For EUR 12, the main difference in the Community average would be in the rate of unemployment: 1986: 11,9 %; 1990: 8,2 %.
The above figures were derived from a highly stylized model and are only given to indicate a possible range of magnitudes.

4. CONTRIBUTION OF POLICIES TO THE COOPERATIVE STRATEGY

4.1. Monetary guidelines and coordination questions

The Community's member countries have made further progress in converging towards a monetary policy which provides the scope for real growth in an environment of monetary stability. The deceleration and more convergent development of monetary aggregates are clear indications of the increased coherence of national monetary policies (Table

15). In the late 1970s, the growth of broad money was about 15 % a year in the Community (EMS 13 %), while it is now around 9,5 % (EMS under 7 %), and is not expected to accelerate again. Thus, monetary policy has made an important contribution to the deceleration in the Community inflation rate. While inflation in the Community still averaged 13 % in 1980, an average of 3,7 % is expected this year.

One of the primary objectives of monetary policy is to achieve and preserve a high degree of monetary stability, a role which is in full accordance with the cooperative strategy. Monetary stability is the indispensable basis for the other objectives of economic policy. By reducing uncertainties on future purchasing power, it creates favourable conditions for a cooperative pattern of behaviour by those involved in economic activity and, in particular, weakens the justification for indexation mechanisms. Accordingly, it improves the climate for adjustments in relative prices and contributes to an efficient allocation of the factors of production.

A medium-term orientation of monetary policy is appropriate for influencing expectations in the desired direction in a durable way, and for safeguarding the successes already achieved in reducing inflation.

However, monetary policy must take due account of the scope for real growth. If, in the course of the implementation of the cooperative strategy, the growth rate of productive potential were to rise, monetary policy would have to accommodate this. Higher money supply would also be necessary if a permanently low level of energy prices were to increase productive potential.

Quantitative money supply or credit targets continue to play an important role in a monetary policy geared to the medium term and based on a high degree of price stability. However, financial innovations, the increasing liberalization of capital movements, structural changes in the money and capital markets, and changes in money demand behaviour can in certain circumstances have an important impact on monetary aggregates. This has to be taken into account when monetary developments are assessed. The announcement of an annual money growth target makes clear the basic course that monetary policy is intended to follow. Employers, unions and the government can adjust their decisions accordingly. Money supply targets increase the level of information available to economic agents; the scope for friction is reduced and consultation with employers and employed is made easier. Countries whose room for conducting an independent monetary policy is limited, and whose primary objective is to stabilize the exchange rate, would also benefit from the medium-term oriented monetary policy of the larger countries; exchange-rate expectations would be stabilized and these countries can import and sustain a high degree of price stability.

At present, the cyclical situation is similar in most member countries; most of the countries are in a phase of moderate upswing and all of them (except Greece) are importing stability through markedly falling import prices. There is no sign of the danger of a renewed acceleration of inflation, at least in the short run. However, the present low rate of increase in consumer prices no doubt understates the trend

rate of inflation, but this does not mean that the Member States in their monetary policy should all react to imported price stability in the same way.

In countries where the inflation rate and inflationary expectations have already stabilized at a low level, there should be no fundamental change in the course of monetary policy embarked upon before import prices started to fall. In this way, monetary policy underpins higher real growth. In other respects, a short-lived and transitory deviation from the targeted growth of money supply does not necessarily call for corrective action, since adverse effects on expectations are improbable in these countries. If the presently favourable preconditions for growth actually lead to a higher real growth trend in 1987, monetary policy should take this into consideration in defining the money supply target.

Countries which have made significant progress in fighting inflation, but whose level of inflation is still well above the Community average — e.g. Italy — should consolidate the imported contribution to stability which initially represents an effect only on the level of prices, and should aim to bring inflation down permanently. This aim can be achieved if it is made explicitly clear and credibly supported through monetary policy decisions. A monetary policy which continues to focus on reducing monetary growth would by no means prevent further falls in interest rates. On the contrary, as inflationary expectations stabilize at a low level, nominal and real long-term interest rates will come down.

Lastly, countries which are now registering a low inflation rate, but in which inflation expectations are still higher than warranted by the actual rate of price increases (e.g. France), should adhere to a moderate growth of money supply consistent with the scope for real growth in the medium term. The recently observed decline and flattening of interest yield curves in France — between January and August 1986 long-term interest rates fell by 3 percentage points and short-term rates by 2 percentage points — is an indication that monetary policy has gained in credibility. Low interest rates on a lasting basis depend on inflationary expectations stabilizing at a low level.

The stance of policy proposed here means, on the other hand, that short-term cyclical considerations should play only a minor role. Otherwise the successes in achieving a high measure of price stability would again be put at risk. Nor should it be overlooked that a monetary policy geared to the medium term also has stabilizing effects on the cycle. During a recession, money growth is, compared with GDP growth, relatively high. Liquidity increases but without adversely affecting inflationary expectations. Conversely, the

reduction of liquidity in a growth phase damps down inflationary expectations, but without triggering the painful effects of a stabilization policy.

However, in a flexible exchange rate regime monetary policy may be faced with a conflict between domestic and external requirements. Thus, to avoid distortionary real disturbances — which ultimately also endanger the primary objective of monetary stability — a flexible response of monetary policy with respect to exchange rate developments outside the Community might be necessary. Such a response, however, should not represent a fundamental change in the chosen stance.

In recent years, nominal interest rates in Europe have declined significantly. In 1981, the level of short-term interest rates averaged 15% for the Community. This compares with the present 8,8%, which roughly corresponds to the average for the 1970s (Table 16). It is assumed that interest rates will also fall further — though more slowly — in the foreseeable future. Despite all the progress made in reducing inflation, real long-term interest rates are still felt to be relatively high at present. In assessing the present level of real interest rates, it must however be borne in mind that in some countries the current inflation rate is below the medium-term rate and the level of real interest rates is therefore overestimated. Real interest rates which are too low, do not adequately reflect relative scarcity of capital. In the 1970s, they have led to an excessive capital-intensity of production, denoting the macroeconomic misallocation of relatively scarce savings, and entailing a deterioration in profitability. Moreover, real interest rates which are too low reduce saving in the economy and thus remove the basis for higher growth. As shown in Graph 20, the level of real interest rates experienced for 1986 roughly corresponds to the level of the late 1960s. On the other hand, the rate of return on physical capital is not yet back to this level.

On the one hand, sufficiently high real interest rates are necessary to avoid a misallocation of resources and to safeguard the more employment-creating growth generated by supply. On the other hand, it is certainly desirable for both nominal and real interest rates to fall as a result of inflation expectations being stabilized at a lower level, and because of higher total savings. A monetary strategy geared to the medium term is the appropriate way to achieve, on a sound basis, the desired 'organic' fall in real interest rates.

The EMS has made a decisive contribution to the increasing convergence of monetary policy and to reducing inflation by subjecting the participating countries to a clear exchange-rate discipline. Countries in which inflation has been relatively high imported a measure of price stability during lengthening periods of fixed exchange rates; this supported the disinflation process. But the EMS could gain in stability only against the background of the strict pursuit of a

common stability objective. The greater stability of exchange rates was therefore both the result of the greater price and cost stability in the EMS and its cause. The exchange-rate adjustments of April and August 1986 have changed nothing in this basic interdependence.

Nevertheless, the EMS remains a system of fixed but adjustable exchange rates. If economic policies are not perfectly coordinated, the differences which accumulate in the fundamental factors determining exchange rates must, from time to time, be corrected; but such a policy does not in principle support divergent economic trends from the beginning. In future, financial markets will be more closely integrated, not least because of a desirable increase in the liberalization of capital movements. Interest rates within the EMS have already moved considerably closer together. Indeed, the difference between German and French long-term rates has narrowed from 3 percentage points, before the realignment, to 2 percentage points thereafter. In Belgium also, the decline in the long-term interest rates is spectacular.

The realignment thus had real consequences for interest rates. Currencies which were thought likely to be devalued had to compensate for the pressure to adjust by means of higher interest rates. This shows that, in the countries suffering higher currency erosion, the delaying of the realignment had an important stabilizing effect.

Because larger movements of capital are to be expected, the increasing liberalization of the movement of capital initially poses a potential risk to the stability of the EMS, but this can be countered by the increased convergence of monetary and overall economic policy. Thus, continuing liberalization of capital movements is closely associated with an increased integration of the economies of the Community and with the further sound development of the European Monetary System.

The consequence of closer monetary integration is a greater need for coordination. This is true of each country's monetary policies within the EMS, but it is also true within a country's economy for concertation of the instruments of general economic policy: the instruments of economic policy must be combined in such a way as not to endanger the system of fixed exchange rates. Above all, a monetary policy which is directed towards internal and external stability must be supported by budgetary policy and an appropriate evolution of incomes. Within the EMS, the need for coordination, in particular between the large member countries, has grown. Most importantly, agreement must be further strengthened on the goals of stability policy.

Coordinated action on monetary policy does not, however, imply the same policy in all countries. Each country faces different problems. In particular, different methods are

needed for dealing with the very unsatisfactory convergence of budgetary policies and the related divergence which still exists in inflation expectations. Each country must, as far as it can, find the right policy mix to bring it closer to the common goal of steady, non-inflationary and more employment-creating growth.

The common course of the monetary policy of the EMS member countries must also take account of developments outside the EMS area. The more closely the economies converge, and the greater the degree of liberalization of capital movements, the less of a threat will be posed to the stability of the EMS by external influences, because an integrated monetary area would reduce their relative importance. Capital movements to and from third countries would be less of a danger to EMS stability because the member countries would be equally affected. Here, the strengthening of the ECU's role is of special importance. In the event of capital moving out of the dollar, this would help assure flows into the ECU and not, as has often been the case in the past, into the German mark. In view of the uncertainty surrounding the future movement of the dollar, this greater integration of European monetary and currency policy would be welcome. It would also make it easier for Europe to act in concert in solving international imbalances.

Monetary policy in the Community should aim at an adequate financing of the available scope for real growth and should at the same time preserve and, if necessary, advance the successes achieved in reducing the trend rate of inflation on a permanent basis. Up to the present, the task of monetary policy has been made easier by external developments. The depreciation of the dollar, as well as the the fall in oil prices and in US interest rates, have increased the potential for reductions in European interest rates without bringing the threat of inflationary pressure. A tendency for the dollar to fall substantially further might necessitate a flexible response for European interest rates, to counteract the danger of a renewed significant fall in the dollar exchange rate with its negative medium-term consequences. However, attention has to be paid to the necessity of avoiding any accumulation of new potential for future inflation. The EMS has proved to be a stabilizing factor. Progress towards convergence in association with greater freedom of capital movements have increased the necessity for a closer coordination of economic policies both internally — between monetary policy, fiscal policy and income developments — and among Member States. The progress which has been achieved in creating a zone of monetary stability reduces the impact of external influences, and is an important condition for a greater integration of the European economies.

TABLE 15

Deceleration and convergence in monetary growth

(percentages)

	1961 to 1969	1970 to 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
<i>Weighted average:</i>												
EUR	:	14,8	14,8	13,9	11,9	11,5	11,3	11,2	9,5	9,9	9,7	7,4
EMS	11,7	14,0	13,8	12,9	9,7	8,7	9,5	10,2	8,4	7,7	6,9	5,6
<i>Measures of dispersion related to average ⁽¹⁾:</i>												
EUR	:	4,2	4,0	3,9	4,1	4,1	2,7	3,6	3,0	4,4	4,2	2,6
EMS	2,1	3,4	4,2	4,0	3,4	2,5	2,3	3,5	3,1	3,2	1,5	1,2
<i>Measures of dispersion related to lowest ⁽¹⁾:</i>												
EUR	:	6,5	10,2	9,0	6,6	7,3	4,8	5,8	5,5	5,0	4,4	3,8
EMS	4,8	5,2	9,2	8,1	4,4	4,4	3,0	4,8	4,4	2,8	1,6	2,0

⁽¹⁾ The dispersion index is a weighted sum of absolute deviations from the respective reference value.

Source: Commission services.

TABLE 16
Interest rate developments

(percentages)

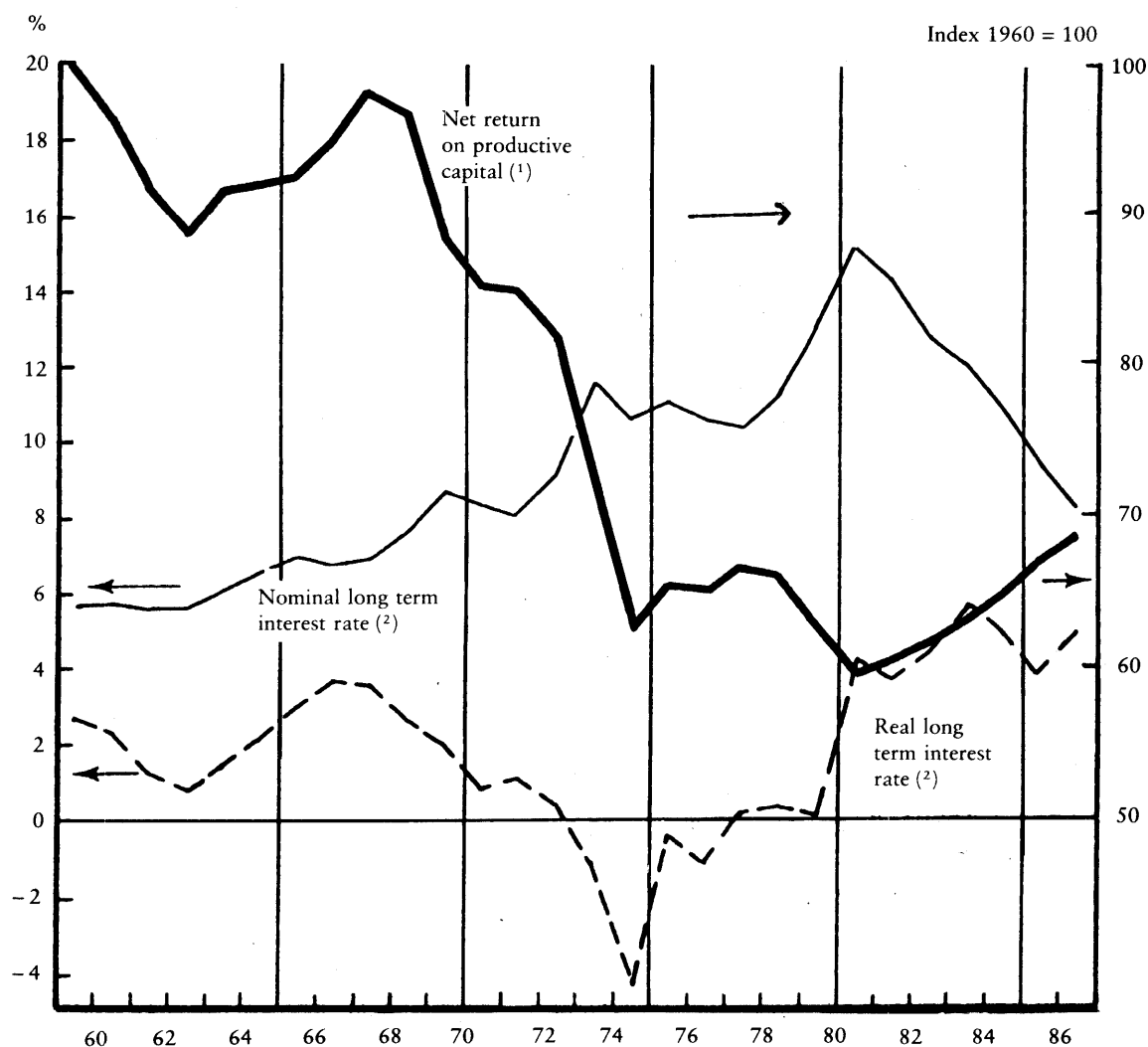
	1961 to 1969	1970 to 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
<i>Nominal short-term interest rates:</i>											
EUR 12	4,8	8,5	8,8	10,9	13,7	15,0	13,7	11,9	11,2	10,5	8,8
EMS	4,5	7,8	6,9	9,8	12,2	14,0	11,8	8,9	9,0	8,3	6,3
USA	4,1	5,7	7,4	10,1	11,6	14,0	10,6	8,7	9,4	7,5	6,5
Japan	—	8,0	5,1	5,8	10,7	7,4	6,8	6,5	6,3	6,5	5,3
<i>Nominal long-term interest rates:</i>											
EUR 12	6,5	9,8	10,3	11,2	13,0	15,1	14,3	12,7	12,0	10,8	9,0
EMS	6,3	9,2	8,8	10,1	11,5	13,5	12,5	10,6	10,3	9,1	7,5
USA	4,6	6,5	7,9	8,7	10,8	12,9	12,2	10,8	12,0	10,8	8,1
Japan	—	7,7	6,3	8,3	8,9	8,4	8,3	7,8	7,3	6,5	5,2
<i>Real long-term interest rates (adjusted for GDP prices) ⁽¹⁾:</i>											
EUR 12	2,4	-0,3	0,1	0,4	0,1	4,2	3,7	4,4	5,7	4,8	2,6
EMS	2,3	0,4	0,6	1,3	0,8	3,5	2,1	2,7	4,5	4,1	2,1
USA	1,6	0,3	0,5	0,2	1,2	4,0	5,3	7,7	8,2	7,0	3,9
Japan	—	-1,0	1,7	5,7	6,1	5,7	6,6	7,1	6,7	5,2	3,9

(¹) The definition of real interest rates poses methodological problems. These problems are accentuated when substantial changes in the terms of trade, as in 1986, bias the measurement of domestic prices with respect to the trend rate of inflation (upwards or downwards depending on the indicators). An improvement in the terms of trade tends to increase the price of GDP.

Source: Commission services.

GRAPH 20

The return on capital and interest rates in the Community



(¹) Net operating surplus of the enterprise sector (excluding the housing sector) as a percentage of its capital stock at replacement costs (EUR 4). (Index 1960 = 100)

(²) Yield on government securities deflated by the GDP price index (EUR 10).

Source: Commission services.

4.2. Budgetary policy

4.2.1. Budget deficits, public debt, growth and employment

Growth prospects in the Community can be improved by a judicious balance of budget positions among Member States. In 1986, the reduction of budget deficits was, on the whole, somewhat more rapid than the year before. For the Community as a whole (EUR 12) net borrowing, as a percentage of GDP, is being reduced from 5,1% in 1985 to 4,7% in 1986, whereas in 1985 the reduction was three-tenths of one percentage point (Tables 17 and 18). The

reduction of net borrowing was most marked in some countries where its level was very high (Greece, Italy), as well as in Denmark where, in 1986, a surplus is being achieved. Further reductions in deficits are expected to take place in 1987.

The reduction of budget deficits mentioned is not sufficient, however, in several countries to permit a stabilization, let alone a reduction of the ratio of public debt to gross domestic product. Indeed, in 1986 and 1987 combined, public debt as a percentage of gross domestic product will increase by 4 percentage points or more in half of the Community countries (Belgium, Spain, Ireland, Italy, the Netherlands

and Portugal — Table 19). The continuation of high budget deficits is at the root of this development. In several countries, interest charges are more or less equal to overall deficits. In three countries, Germany, Luxembourg, and especially Denmark, the public debt ratio is instead expected to fall.

Budget deficits that lead to high public debt burdens have two main macroeconomic consequences. Firstly, the public will be ready to hold an increasing fraction of its assets in government bonds only at increasing real interest rates. Secondly, such budget deficits increase the risks of an inflationary monetary expansion leading to an additional increase in real interest rates as a premium for higher risk. Because of the high level of real interest rates, private investment is crowded out with negative consequences for medium-term growth.

Thus, since deficits and public debt are high, negative effects predominate in the medium term, and their reduction should only have beneficial effects. In the short run, negative demand effects may dominate but, where the initial condition is one of threatened financial instability, these negative effects from corrective action may be of relatively short duration. Denmark has provided an example of this in recent years.

On the other hand, where the danger of financial instability is limited and the public debt GDP ratio is already declining, the negative demand aspects of budgetary contraction increase in importance. If taxes are reduced and other measures are taken which improve the supply side, the initial deterioration of the budget balance may, at least partially, be compensated for after a relatively short time.

In practice, judging by the level of the public debt as well as the speed at which it has grown in recent years, a substantial reduction of the budget deficit as a percentage of GDP should continue to be a primary objective in Belgium, Spain, Greece, Ireland, Italy and Portugal. If convincing medium-term budgetary consolidation measures are combined with effective monetary stabilization then large reductions in nominal and real interest rates will be possible, which could ease the effort needed to limit essential budgetary expenditure.

The reduction of budget deficits, while clearly a priority for about half of the Member States, is not an objective *per se* when the public finances are in a sustainable condition. In fact, a certain government debt position in proportion to GDP is consistent with the medium-term financial equilibrium of an economy, for example a supply-side

oriented normative budget concept, such as that of the German Council of Economic Advisers (Sachverständigenrat), shows that a certain annual increase in government debt is legitimate. The Council of Advisers considers this 'legitimate' increase to be 1,5 % of potential output for Germany, in terms of budget definitions.

Judgement of the best budget policy strategy has always to be based on both supply- and demand-side considerations. In present conditions, there are good reasons to aim at a strengthening of supply conditions and sustaining demand conditions in the economy. The main Community countries with approximately stabilized public debt situations are Germany, France and the United Kingdom. In Germany, the burden of the public debt is even declining. In France, existing room for manoeuvre is being used, large tax reductions already being foreseen for 1987 and supplementary reductions announced for 1988 while the budget deficit would be simultaneously reduced in each of the two years. If expansion strengthens abroad, and above all in the Community, budgetary policy in France will be all the more facilitated. In the United Kingdom, the Government, in its autumn statement, provided for an increase in public expenditure of some £ 4¾ billion in 1987/88. This will mean that public expenditure in 1987/88 is planned to be about 2 % higher in real terms than the estimated out-turn in 1986/87. Thus, if the cooperative strategy should become by its application the basis for economic measures for the Community as a whole, some of these three countries could reasonably envisage a further combination of tax reductions and public investment, the mixture of which could nevertheless be different from one country to the other. A partial compensation for these measures could be expected within a reasonable period of time, through the impact of higher growth in terms of supplementary fiscal receipts and lower expenditures related to the crisis.

Budgetary policy must have a major responsibility in achieving the cooperative strategy. As regards budget deficits and the public debt, consolidation is still a priority for about half the Member States of the Community. Other countries, whose share in Community GDP is about two-thirds, are in sustainable deficit situations and have some possible room for manoeuvre for budgetary measures supporting growth. These countries should now consider, where this is not the case, a cooperative acceleration of budgetary actions to strengthen supply and sustain demand conditions. With a higher activity level in these national economies, the other Member States will be able also to achieve consolidation objectives at higher levels of activity and employment.

4.2.2. Public expenditure, taxation, growth and employment

The concept of 'room for manoeuvre' in budgetary policy has at times focussed to an unfortunate degree on the important,

but only partial topic of budget deficits. For questions of medium-term growth strategy, even more important policy issues surround the level and structure of taxation and public expenditure. In these latter categories, all Community countries have, effectively, very important 'room for manoeuvre' in the sense of desirable policy moves that could contribute significantly to raising the medium-term growth rate of output, investment, savings and employment. An important issue for the social dialogue is to establish more of a consensus on how policy over the level and structure of public expenditure and taxation can contribute to the objectives of the cooperative strategy.

Level and structure of public expenditure. It may be helpful to distinguish between three broad categories of public expenditure.

(i) A first category is *infrastructural investment and other investment categories including research and development and education*. Such investments, in a wide sense, can also in part be financed by the private sector. On conditions that these investment programmes are efficiently managed and subject to requirements of a high or adequate social rate of return, there is no reason to want to cut such expenditures *per se*. A high level of such investments, with good or adequate rates of return, will normally be part of a dynamic economy. Public investment programmes have in particular been more than proportionally affected by budgetary economies, falling from 4% of GDP in 1975 to 2½% in 1985. Subject to efficiency criteria, such expenditures could now be expanded for a multi-year period as part of the cooperative strategy.

An infrastructural investment programme, comprising projects of Community interest, as set out in last year's Annual Economic Report, fits well into the strategy. Such projects of European interest can be undertaken and financed by the private sector. These concern the following projects in particular:

- the establishment of a telecommunications trans-border backbone network (some 3 000 million ECU),
- three linking networks: road, rail and inland waterways (20 000 to 25 000 million ECU),
- the Paris-Brussels-Cologne high-speed rail link (3 000 million ECU)
- the Channel tunnel (4 000 million ECU).

Overall, an investment volume of 30 000 to 35 000 million ECU over a period of five to seven years can be envisaged

in the medium term. In addition, there are other projects which could be realized in the longer term: motorway links with the Scandinavian countries through Denmark and the Baltic Straits, the Venice-Munich link, tidal power installations on the Severn, a bridge at the Straits of Messina, etc.

Such projects would also generate national public investment opportunities of an infrastructural nature. In addition, in the majority of countries, investment possibilities exist in areas such as urban renovation and the environment (water treatment, etc.). In certain regions, particularly in the new Member States, there still remains an urgent need to strengthen the infrastructure. All in all, a significant number of investment projects are therefore available with a sufficient social rate of return. Progress in realizing these projects would provide an important and useful contribution to growth and employment.

Given the close links that exist between growth, employment and technology, most governments have recognized the importance of a strong research and development policy for a more robust economic growth. In this respect, priority is being given to research on advanced technologies aimed at favouring innovation and a better link between basic research and industry. European successes, in actions such as Airbus, Ariane, Jet, Esprit and Brite, underline the value and effectiveness of Europe's potential for R & D. In addition they illustrate different possibilities for financing through European programmes and financial participation in precompetitive industrial research. The Community has established framework programmes to obtain an increased effectiveness of the Community's research activities. Also to be noted is the Eureka initiative, which reflects the will of governments to find new financial and economic synergies in the field of European industrial cooperation.

As far as infrastructural investment is concerned, the State has an essential role to play in the improvement of human capital through training and the upgrading of professional skills. Here also, close cooperation between public authorities and those concerned should enable appropriate forms of financing to be established, taking account of the possibilities available and the gains to each party of improved professional qualification (see also section 4.3.2).

(ii) A second category covers *normal public services, such as health care and pensions*. A high level of these public services is socially desirable. There are, of course, important management issues present here, and reasonable discipline in economic terms has to be maintained since the demands for increased expenditures on these programmes can outstrip the capacity of the economy. The question of the public *versus* private mix in the organization of these programmes is also an important issue for reasons of management efficiency as well as social equity. However, the option of partial privatization of health care and pensions has to be assessed

with considerable caution. In particular, the transfer of these social charges to private insurance systems will not necessarily ease their costs. It could be, for example, that lower social security taxes are offset by higher contractual payments paid to private bodies and levied in the same way by employers. The impact on overall labour costs and wage behaviour would not then be very significant. Overall, reasonable economy in the management of these programmes is required, but not their run-down.

(iii) A third category is *social benefits that are paid because of faults in the functioning of the economic system*. Unemployment benefits are an obvious example, at least at a level above a minimal unemployment rate. However, this category of 'avoidable' public expenditures is in fact much more extensive, and includes also supplementary family benefits to unemployed persons, expanded programmes of early retirement pensions and, in several countries, disability pension programmes that have been expanded to include people with little or no medical disability. The total of these 'avoidable' public expenditures has increased by as much as 5 % of GDP over the course of the last 15 years in the Community on average. In terms of increased social security charges, this amounts to about 10 % of labour costs, which is clearly a very large margin in relation to any debate about the economically warranted level of labour costs.

Implementation of the cooperative strategy should make it possible to reconsider the pertinence of certain of these programmes as employment prospects improve. For example, the criteria for new admissions to some special pension programmes may be reconsidered, while respecting the acquired rights of existing pensioners, as part of a policy to achieve a rising participation rate among those of working age, as well as declining unemployment. Policy initiatives of this kind are envisaged in several countries, such as Italy and the Netherlands, where special pension programmes for people of working age have expanded to the point of covering over 10 % of the labour force. In other countries too, analogous expenditures have led to a growth of social security taxes that has contributed to the weak evolution of employment. Economies in public expenditure and social security taxes could in this way thus be part of a new virtuous circle of employment creation and tax reduction. Greater efficiency in these social expenditures may be obtained through improving the employment possibilities of a considerable proportion of the people currently benefiting from these programmes.

Possibilities for tax reform. The economic policy objectives of reform in the levels and structure of taxation fall under four main headings, concerning (a) the demand for labour, (b) the supply of labour, (c) the level of savings and thence capital accumulation, and (d) the efficiency of resource allocation.

Taxation, labour costs and the demand for labour. It is likely that a considerable part of the tax and social security burden

falling on employees is passed on to higher labour costs. Assuming that a higher cost of labour tends to dampen the demand for labour by firms, private employment will be discouraged and economic growth will be lower; hence the importance of measures to cut social security costs and taxes just discussed above.

Taxation and supply of labour. High marginal tax rates may influence the incentive to work in a negative way and weaken the foundations of economic growth.

Taxation, disposable income and household savings. There are other factors which have indirect effects on employment by discouraging savings and hence capital accumulation. Higher taxes on households' income reduce disposable income and household savings. If the government spends a higher fraction of its proceeds, net of transfers, on consumption goods than do households, national savings go down.

Taxation and resource allocation. Where many categories of income or expenditure benefit from tax exemptions there will be distortions in the allocation of resources that will reduce their average productivity. In this case, higher general rates of taxation will have to be applied, leading to dampened incentives to work, employ, save and invest, as already mentioned. Accordingly, it is desirable to verify that each existing tax exemption still has an economic or social justification, at the same time taking account of the fact that its abolition would enable the tax base to be widened and general rates to be lowered. This is the argument behind the recent United States' reductions in income tax rates and exemptions.

Within the Community at present there are several tax reform themes which may be highlighted.

As regards corporate profits taxes, several countries are reducing rates of taxation (United Kingdom, France, Netherlands, Belgium, Luxembourg), partly offset by lower depreciation allowances. Some countries envisage reducing or eliminating other business taxes which are not based on profits, such as a wealth tax on enterprises in Germany, the 'taxe professionnelle' in France and a trade tax in Germany.

As regards income taxes on persons, France, Germany and the United Kingdom are all engaged in a process of making successive cuts in high marginal tax rates, partly financed with a broadening of the tax base (United Kingdom), partly

through general budgetary economies. In France, Germany and the United Kingdom, further reductions in personal income tax are major governmental objectives for the next few years.

In the context of the fall in the price of oil, several countries have taken the opportunity to raise oil consumption taxes, often with a view to reducing deficits (Denmark, Spain, Greece, Italy, Ireland and Portugal).

The Commission's proposals for the approximation of legislation on indirect taxes could also imply changes in the structure of taxation in certain countries.

Important contributions to the cooperative strategy should come through specific actions affecting the level and structure of public expenditure and taxation. Public investments with a sufficient social rate of return could now be increased which would also support the expansion in productive potential and private investment. Social security contributions should be reduced over a medium-term period. The improvement in growth and employment and the resulting increases in public sector revenue and savings in transfer payments can create a virtuous circle. Tax reforms should also aim at reductions in income tax rates and other changes in the structure helpful to employment policy and facilitate indirect tax approximation in the Community.

TABLE 17

General government revenue and expenditure ⁽¹⁾, EUR 12

	1 000 million PPS		Percentage of GDP				Percentage change		
	1985	1986 ⁽²⁾	1984	1985	1986 ⁽²⁾	1987 ⁽²⁾	1985	1986 ⁽²⁾	1987 ⁽²⁾
Indirect taxes	517,3	568,3	13,5	13,3	13,4	13,5	7,4	9,9	6,8
Direct taxes	497,0	526,9	12,7	12,8	12,5	12,4	9,7	6,0	6,2
Social security contributions received	589,1	631,8	15,2	15,2	14,9	14,9	8,1	7,2	6,1
Total taxes and social security contributions	1 603,4	1 727,0	41,3	41,3	40,8	40,8	8,4	7,7	6,3
Other current revenue	148,4	152,4	3,7	3,8	3,6	3,3	12,3	2,7	-3,3
Total current revenue	1 751,8	1 879,4	45,0	45,1	44,4	44,1	8,7	7,3	5,6
Current transfers paid	877,8	933,4	22,8	22,6	22,1	21,7	7,5	6,3	4,4
Actual interest payments	198,7	217,1	4,9	5,1	5,1	5,0	12,3	9,3	2,7
Government consumption	722,6	770,1	18,8	18,6	18,2	18,0	7,6	6,6	5,1
Total current expenditure	1 799,0	1 920,7	46,5	46,3	45,4	44,6	8,1	6,8	4,5
Gross saving	-47,3	-41,2	-1,5	-1,2	-1,0	-0,5	—	—	—
Net capital transfers	45,5	41,5	1,1	1,2	1,0	0,9	17,1	-8,8	-4,5
Gross capital formation	107,3	114,8	2,8	2,8	2,7	2,7	7,7	7,0	6,0
Net lending (+) or borrowing (-)	-200,0	-197,5	-5,4	-5,1	-4,7	-4,1	—	—	—
Memorandum: nominal GDP	3 882,2	4 225,8	100,0	100,0	100,0	100,0	8,6	8,9	6,4

⁽¹⁾ National accounts definition, excluding loans, advances and participations.

⁽²⁾ Forecasts.

Source: Commission services.

TABLE 18

General government lending (+) and borrowing (-)

(as % of GDP)

	1970	1973	1981	1982	1983	1984	1985 ⁽¹⁾	1986 ⁽¹⁾	1987 ⁽¹⁾
Belgium	- 2,2	- 3,3	- 12,6	- 11,1	- 11,7	- 9,5	- 8,4	- 8,0	- 6,2
Denmark	4,1	5,2	- 7,1	- 9,3	- 7,3	- 4,2	- 1,9	2,8	2,8
Germany	0,2	1,2	- 3,9	- 3,4	- 2,5	- 1,9	- 1,1	- 0,9	- 0,7
Greece	—	—	- 10,6	- 9,4	- 8,9	- 10,1	- 13,9	- 10,6	- 7,1
Spain	0,7	1,1	- 3,0	- 5,8	- 5,4	- 5,0	- 6,2	- 4,9	- 4,4
France	0,9	0,9	- 1,8	- 2,5	- 3,2	- 2,9	- 2,6	- 2,9	- 2,6
Ireland	—	—	- 15,8	- 14,2	- 11,8	- 9,8	- 11,6	- 10,7	- 9,9
Italy	- 3,5	- 7,0	- 11,7	- 12,7	- 12,4	- 13,0	- 14,0	- 12,7	- 11,0
Luxembourg	2,7	3,3	- 2,3	- 1,3	- 0,8	1,5	4,1	3,7	2,6
Netherlands	- 1,2	1,0	- 5,2	- 7,1	- 6,5	- 6,2	- 5,1	- 5,5	- 6,6
Portugal	—	—	- 10,1	- 8,8	- 7,1	- 7,7	- 11,2	- 8,0	- 7,5
United Kingdom	3,0	- 2,7	- 2,7	- 2,4	- 3,7	- 3,9	- 2,8	- 2,9	- 2,5
EUR 12	0,3 ⁽²⁾	1,0 ⁽²⁾	- 5,4	- 5,6	- 5,5	- 5,4	- 5,1	- 4,7	- 4,1

⁽¹⁾ Estimates and economic forecasts of the Commission services (October 1986).⁽²⁾ Without Greece, Ireland and Portugal.

TABLE 19

Public Debt ⁽²⁾

(as % of GDP)

	1973	1981	1982	1983	1984	1985 ⁽¹⁾	1986 ⁽¹⁾	1987 ⁽¹⁾
Belgium ⁽³⁾	63,2	88,1	96,1	105,1	111,6	118,3	121,9	125,6
Denmark	5,0	43,6	52,7	62,7	67,6	66,3	62,1	57,6
Germany	18,6	36,4	39,5	41,7	42,0	42,7	41,9	41,7
Greece ⁽⁴⁾	—	33,0	36,7	41,4	49,9	56,8	58,4	61,2
Spain	—	21,0	26,2	32,1	39,3	46,3	48,8	52,5
France	25,1	26,0	29,1	30,7	29,3	31,8	34,0	35,0
Ireland ⁽⁴⁾	65,5	89,8	96,6	107,7	113,6	115,7	119,1	124,8
Italy	62,5	73,2	80,0	87,6	94,5	103,0	106,3	108,1
Luxembourg	20,5	14,0	14,4	14,8	14,8	14,5	13,8	12,8
Netherlands ⁽³⁾	43,4	50,3	55,6	62,3	67,0	70,6	76,3	82,9
Portugal	—	59,0	62,2	70,9	75,7	81,2	81,5	85,2
United Kingdom ⁽⁵⁾	63,3	51,1	57,7	57,4	58,7	56,9	57,9	58,0
EUR 12	40,3 ⁽⁶⁾	45,0	49,8	53,5	56,0	58,9	60,3	61,8

⁽¹⁾ Estimates and forecasts of the Commission services on the basis of the October 1986 economic forecasts.⁽²⁾ General government except Belgium, Greece, Ireland and the Netherlands.⁽³⁾ General government without social security system.⁽⁴⁾ Central government.⁽⁵⁾ Debt at market prices.⁽⁶⁾ Without Greece, Spain and Portugal.

Source: Eurostat and Commission services.

TABLE 20
Evolution of public expenditure on social programmes from 1970 to 1983

(percentages of GDP)

	Belgium	Denmark	Germany	France	Ireland	Italy	Luxem- bourg	Nether- lands	United Kingdom	EUR 8 ⁽¹⁾
<i>1970:</i>										
Health care, sickness	3,8	5,6	5,7	4,9	4,1	—	2,7	5,7	3,9	5,0
Invalidity and work accidents	2,2	2,7	2,6	1,8	1,3	—	2,9	3,1	1,2	2,1
Pensions	7,1	6,9	9,4	7,5	4,6	—	7,8	7,7	6,7	7,9
Maternity and family	3,5	2,7	2,1	3,1	2,3	—	1,8	2,6	1,5	2,3
Unemployment	0,6	0,4	0,1	0,3	0,4	—	0,0	0,6	0,3	0,3
Others	0,0	0,1	0,3	0,0	0,1	—	0,0	0,8	0,1	0,2
Total	17,4	19,0	20,7	18,2	13,3	—	15,4	19,0	13,8	18,0
<i>1983:</i>										
Health care, sickness	6,5	7,1	7,5	6,8	8,4	5,7	11,1	8,4	4,7	6,7
Invalidity and work accidents	3,3	2,5	3,1	2,3	—	5,4	—	6,4	2,2	2,9
Pensions	11,5	10,4	12,1	11,2	7,4	11,5	12,0	10,3	9,8	11,1
Maternity and family	3,0	3,1	2,0	3,1	—	2,0	1,2	2,7	2,8	2,6
Unemployment	4,2	4,1	2,0	2,7	—	0,8	0,0	4,2	2,3	2,5
Others	0,5	1,1	0,6	0,2	3,1	0,0	0,8	0,0	0,3	0,4
Total	29,5	30,1	27,8	27,4	23,2	25,5	25,5	32,7	23,1	27,0
<i>Increase, 1970 to 1983:</i>										
Health care, sickness	2,7	1,5	1,8	1,9	4,3	—	8,4	2,7	0,8	1,7
Invalidity and work accidents	1,1	-0,1	0,5	0,5	—	—	—	3,3	1,0	0,8
Pensions	4,4	3,5	2,7	3,7	2,8	—	4,2	2,6	3,1	3,1
Maternity and family	-0,5	0,4	-0,1	0,0	—	—	-0,6	0,1	1,3	0,2
Unemployment	3,6	3,7	1,9	2,4	—	—	0,0	3,6	2,0	2,3
Others	0,5	1,0	0,3	0,2	3,0	—	0,8	-0,8	0,2	0,2
Total	12,1	11,1	7,1	9,2	9,9	—	10,1	13,7	9,3	9,0

(¹) Excluding Italy.

Source: Eurostat (European system of social protection statistics) data file.

Note: Figures are not comparable since the nature of benefits differ; amounts of public *versus* private expenditures on some categories of expenditures (e.g. health, pensions) vary considerably between countries.

4.3. Wages and the labour market

4.3.1. Incomes and wage costs

The cooperative strategy proposes that the social partners agree on a development of labour costs which is compatible with a significant increase in employment. The scenario illustrating the cooperative strategy accordingly envisages that real wages, in the form which is undoubtedly close to that generally considered in the wage bargaining process, that is to say net of social contributions of employers, will grow, in real terms, on average for the years 1986 to 1990 at a moderate rate, close to 1,1 % per annum. Added to the effects of this moderate growth would be that of some lowering of employers' social contributions. The increase in

average productivity per head would be 2,3 % during the same period. Taking into account the fall in social contributions of employees and direct taxes, as well as modifications in the terms of trade, purchasing power of net wages would grow on average over the period 1986 to 1990 a little more rapidly.

These developments in total labour costs and net wage incomes thus merit the support of both employers and employees, since they should be conducive to a much stronger employment performance and improved profitability for enterprises as well as moderately growing real incomes for employees.

All countries have made some progress since the early 1980s in the moderation of real wage increases compared to

productivity growth. Profits have therefore improved. Between 1981 and 1985, progress has however been quite different between countries (cf. Table 21).

However, in 1986, a greater degree of convergence could be attained within the Community. The improvement in the terms of trade has enabled countries like Belgium, France and Italy, where progress had been slower up to 1985, to achieve considerable improvements in the profitability of firms this year. This is explained for example in Belgium by index-linking arrangements, which are still fairly rigid, and have made it possible to pass on the reduction in inflation automatically to nominal wages. In France, in the framework of the policy of collective agreements, which aims at aligning nominal wages *ex ante* on the target for prices, account has been taken of a faster than expected decline in inflation.

Only in five countries, Belgium, Greece, Spain, France and Italy, will the increase in real labour costs per head in 1987 be lower than or close to 1 %. In Greece, Spain and France, indeed, the weakness of the employment recovery and the especially high level of unemployment seem to justify an increase in real labour costs below the Community average. The same applies to Belgium and Portugal, where real labour costs per head are expected to increase by close on 1 %.

In the other Community countries, the increase in real labour costs per head will probably be 2 to 3 % (cf. Table 22). In these countries, it is desirable that the social partners take account of the development of employment and the level of unemployment in pay negotiations. For example, the change in trend brought to labour costs could be less marked in Germany, where unemployment is relatively low and profits have increased fairly rapidly. In the United Kingdom, on the other hand, the problem of a rapid increase in real wage incomes, despite a high rate of unemployment, is an especially acute one.

The need for wage moderation implies that both sides of industry will act in a responsible manner. Wages are determined in each country on the basis of traditional procedures that have often stood the test of time. Although they need not be called into question, they should ensure respect for some basic principles.

Wage agreements should allow for rapid adjustments, in the direction required by the cooperative strategy, to take account of the very marked changes — largely unpredictable — in the terms of trade. The social partners should examine the possibility of maintaining some flexibility in the actual development of nominal wages in such a situation. One of the possibilities which could be envisaged would be the introduction of safeguard clauses into wage agreements protecting to a certain degree both parties. This ought to ensure that either the recovery in profitability is not compromised when the terms of trade deteriorate, or, in the

case of an improvement in the terms of trade, that this recovery is speeded up and accompanied by a satisfactory development in real wages. Efforts undertaken in recent years to reduce the rigidity of indexation arrangements should also be continued. The present stable situation should make this easier to achieve.

Within each country, the formation of wages at regional level should be kept fairly pliant. Greater economic and social cohesion within the Community also requires convergence of regional unemployment rates towards the lowest rates, without implying depopulation in the poorest regions.

Resource transfers organized either by the Member States or by the Community can and must contribute to achieving this aim. To be fully effective, however, the resources must be supplemented by private capital attracted by a rate of return at least equal to that prevailing in more favoured regions.

Lastly, the moderate rise in real wage costs per head should be generalized, and benefit all sectors and firms.

In this respect, productivity gains realized in the most efficient sectors should be used first of all to improve the competitiveness and profitability of the economy, rather than to ensure higher than average wage rises in those sectors. This permits an increase in the margin for manoeuvre of sectors with lower gains in productivity. This room can then be used to increase employment.

At the level of the individual firm, it could however be useful to keep rates of pay adaptable to react to the situation. This is often necessary in order to assure stability of employment in the face of cyclical changes in demand or prices. One technique which could be envisaged is possibly to divide pay into a fixed component and a variable component linked to the firm's profits, which may help improve the motivation of the work force. Adaptability of this type can also help to give existing firms the margin required for restructuring while maintaining a particular level of employment.

The various aspects of wage formation mentioned here concern first and foremost the social partners. These are thus subjects that should be examined thoroughly in the context of the social dialogue, with a view to assuring an appropriate equilibrium between labour market adaptability and the protection of employees.

The evolution of labour costs has in recent years permitted a certain improvement of the profitability of the enterprise sector, and will thus help employment. The reduction of the price of oil adds to these trends. For the medium-term future, a consensus needs to be formed favouring moderate real wage increases, coupled to the extent possible to decreases in social security charges, thus allowing a sustained improvement in profitability and competitiveness. To increase the chances of a rapid reduction in unemployment, care should be taken to ensure that wage formation procedures remain sufficiently adaptable both in relation to unforeseeable developments in the international context and in relation to regional disparities. At the level of individual firms, some adaptability in pay could be examined in order to improve the motivation of the workforce and to make it possible to stabilize employment in the face of cyclical changes in demand or prices. However, above average productivity gains realized in the most efficient sectors and firms should be used mainly to improve competitiveness in the economy as a whole, and not to achieve higher than average pay rises in these sectors.

4.3.2. *Adapting the labour market for more employment-creating growth*

Apart from the major macroeconomic determinants of employment already discussed — aggregate demand, pay levels and social security costs — there exist a larger number of microeconomic policy instruments that can help or hinder the employment propensity of the economy. Some of the main headings are:

- working time practices,
- employment protection regulations,
- training and retraining facilities,
- regulations affecting the start-up of small enterprises, self-employment and cooperative enterprises,
- measures to help the long-term unemployed back into activity and to integrate the young unemployed into the workforce.

In these domains, initiatives have recently been taken or are being considered in most Member States and at the Community level. Moreover, many detailed measures to improve the labour market have recently been the subject of a memorandum entitled, *Employment Growth into the 1990s — a Strategy for the Labour Market* submitted in June 1986 to the Council for Employment and Social Affairs by the ministers from Ireland, Italy and the United Kingdom.

The reorganization and reduction of working time can make growth more employment-creating, on condition that it be neutral for the level of costs. This goal can be attained in association with a reorganization of the production process which combines a reduction in working time with the longer use of production facilities and a more flexible use of labour within the company. This could increase capital productivity which is desirable as a contribution towards boosting private investment. The possibility of using existing plant for more production with a larger workforce would also help to reduce the insufficiency of the capital stock in relation to the level which would be required at a high employment level in the economy.

Since the uncertainties and adjustment costs associated with a reorganization of the working process can be considerable, it must be incorporated in a cooperative approach. In particular, capital as well as labour cost increases have to be avoided. In many cases, public support is also necessary in the encouragement of experiments, and the exchange of experiences and, in some situations, in order to cover adjustment costs. In a number of Member States, the government supports this restructuring process in a variety of ways.

The deregulation of *employment protection systems* does not constitute an objective in itself. There are advantages in having a general framework of employment laws, as seen in all European countries and Japan, in order to assure stability and fairness in employment conditions. Employment protection law can also form part of a wider social contract, in which a cooperative approach to industrial relations relies on forward-looking employment policies.

The considerable range of employment protection practices in the Community, all within a context of a comprehensive legal framework, gives some evidence of how unduly heavy regulatory burdens may damage the employment propensity of the economy. Surveys of employers made by the Commission indicate that the regulations governing dismissals and redundancies are perceived in some countries as being particularly detrimental to employment. In such cases, the severity of costs, procedures or judicial systems of appeal concerning recruitment and termination of employment contracts should be reconsidered, without, however, calling into question basic social rights. Such reforms should be compatible with the objectives set out in Article 118A of the Single European Act.

The rules governing part-time work and fixed-term contracts are also of considerable importance in determining the balance struck between the quality and volume of jobs offered. Evidence of an increasing supply of persons willing to take such employment, and of the supply of jobs of this type is sufficiently important in relation to the job shortage in the Community that the conditions of these types of employment contract should not be too restrictive. In

particular, if the Community is to succeed in increasing its labour force participation rate, which it needs to do in view of looming problems of changes in demographic structures, it will have to rely in part on these forms of employment contract, which are particularly suited to the preferences of certain groups (for example to the needs of the second worker in families and of elderly workers). These forms of employment contract also have the advantage in present conditions of reducing the regulatory costs at the margin for new recruitment, without questioning the secure employment status of existing permanent employees; they would also help assure a more employment-creating growth process. On the other hand, precautions have to be taken to limit the risks from developing precarious jobs and assure the quality of such forms of contract. They should, for example, be governed by minimal social security coverage and other labour laws such as those setting minimum wages.

Education, training and retraining constitute a key variable in the economic adjustment process and must be considered in conjunction with employment policy initiatives if major bottlenecks are to be avoided and the social consequences of industrial restructuring are to be attenuated. The central role that education and training is now playing in Member States is underlined by the increasing recognition of the links between training, productivity and business success, and of the importance for enterprises to invest more heavily in training provision. As a tool of social adjustment, retraining is particularly necessary to accompany business closure and sectoral shrinkage, and even more so in areas of industrial decline.

In this regard, and within the framework of the social dialogue at the Community level (Val Duchesse), the working party on training and motivation for workers in connection with new technologies is seeking to contribute to a positive environment. This is especially important in relation to the Euro-Tecnet programme for new information technologies, vocational training, and to the Comett decision on cooperation between universities and enterprises on high-level training.

A particular effort is called for to ensure effective local and regional management of human resources, with sufficient investment in training from both private and public sources to ensure the general upgrading and modernization of skills at all levels. Small and medium-sized businesses face particular training and retraining problems (in terms of management development and advice, access to training, flexibility of delivery); in this connection, Member States are being invited to respond positively to a comprehensive package of measures proposed by the Commission. The need for more manpower flexibility within the company also stresses the importance to increase the level of training to facilitate this internal mobility.

The contribution of training and qualifications towards the greater regional flexibility of the labour market within the Community was effectively recognized by the Council's decision to work towards the comparability between vocational training qualifications for semi-skilled (level 2) workers. The decision complements the Community action to accelerate the mutual recognition of professional qualifications, and will benefit in the first instance workers in those sectors in which a high level of cross-border mobility is already prevalent. It constitutes a step towards achieving the human dimension of the internal market.

Two of the most important factors conditioning the adaptability of the labour market, with a view to achieving more employment-creating growth, are the regulations and negotiated practices governing (a) working time, and (b) employment protection. In both areas, surveys recently conducted by the Commission ⁽¹⁾ suggested that there exists, in the opinions of both employers and employees, a wish to ease certain rules governing the labour market. This willingness should be fully exploited by deepening the social dialogue on these various themes.

As stressed already in a Commission communication to the Council in 1984 (COM(84) 484 final), the *long-term unemployed* will tend to be amongst the last to benefit from any improvement in overall economic performance. Policies to promote general economic and employment growth must be supplemented by policy interventions targeted specifically at the long-term unemployed. The Commission therefore proposed a set of measures designed both to prevent people from becoming long-term unemployed and to reintegrate those who had already been unemployed for 12 months or more. These measures formed the basis of the Council resolution of December 1984 ⁽²⁾ which gave a commitment to tackle the problem by increasing the efficiency of existing social and employment policies as part of an effective Community policy to combat unemployment. These commitments were in addition to those set out in the Council resolution of January 1984 concerning youth unemployment in which the Member States agreed a series of actions to promote training and employment opportunities for young people.

A range of initiatives specifically to help the long-term unemployed has been supported through the European Social Fund and through the Poverty Programme ⁽³⁾. Many Member States have introduced new measures in favour of the long-term unemployed or extended existing measures.

⁽¹⁾ 'Employment prospects: views of businessmen and the workforce' *European Economy*, No 27, March 1986.

⁽²⁾ Council resolution of 19 December 1984 on action to combat long-term unemployment.

⁽³⁾ COM(83) 211 final, 25 April 1983.

However, the proportion of those registered as unemployed who have been without work for a year or more has continued to increase and now stands at an average of about 40 % across the Community. Furthermore, there has been a significant increase in the proportion of people unemployed for two years or more. The scale of the Community's response to the problem clearly does not reflect the scale of the problem itself; a greater political and financial commitment to action is needed to meet the objectives set out in the 1984 resolution. Concrete measures, such as lower social security charges for taking on the long-term unemployed, could therefore be considered.

In addition, it is clear that, with respect to youth employment, it will be necessary to focus attention on those measures which are most likely to lead to subsequent employment, rather than simply delay entry into the labour market. Particular attention needs to be given to the problems of young people over 20, many of whom already risk being numbered among the long-term unemployed when training or temporary job-creation possibilities are exhausted.

At the end of 1986, the Commission will review progress in implementing the actions agreed in the Council resolution.

A report in the form of a communication will be submitted to the Council in early 1987 with proposals for further action. The report will be based on information obtained from Member States and on the findings of recent reports undertaken by the Commission and by other organizations with an interest in policy on long-term unemployment.

Many types of regulatory policies and job creation initiatives can help improve the employment propensity of the economy. Such initiatives need to fit coherently with a positive macroeconomic policy as envisaged in the cooperative strategy. The Community should not aim at a general deregulation in employment protection law, but Member States should, in some cases, adjust unduly onerous regulations so as not to discourage the growth of various forms of employment, so long as basic social security and other conditions are respected. The adaptation of working time, on conditions which are neutral for the level of costs, can also help achieve more employment-creating growth. Stronger action is required to ease the problems of the long-term unemployed and of youth unemployment, and the Community will soon be reviewing the adequacy of such measures.

TABLE 21

Real unit labour costs (Ratio of real *per capita* labour costs to productivity) (Index 100: average 1961 to 1973)

	Average 1961 to 1973	1975	1981	1982	1984	1985 ⁽¹⁾	1986 ⁽¹⁾	1987 ⁽¹⁾
Belgium	100	110,0	115,0	112,9	111,9	110,2	106,1	104,6
Denmark	100	104,6	100,5	99,2	96,1	94,4	92,9	93,5
Germany	100	105,9	103,5	102,2	98,9	97,8	96,1	95,7
Greece	100	90,2	106,4	106,1	107,2	109,2	101,2	98,9
Spain	100	104,0	102,9	100,7	94,4	91,8	89,1	87,7
France	100	105,9	108,1	107,3	105,3	104,4	102,1	100,2
Ireland	100	104,6	101,3	99,5	95,2	92,9	91,4	91,3
Italy	100	110,9	108,6	108,6	109,4	108,5	103,2	101,7
Luxembourg	100	123,4	124,9	120,4	111,2	109,3	106,4	107,5
Netherlands	100	108,8	102,5	101,1	95,8	94,3	95,4	97,8
Portugal	100	136,2	116,1	108,6	100,5	96,9	92,0	90,6
United Kingdom	100	110,1	100,3	98,5	98,8	97,9	99,9	100,3
EUR 12	100	107,2	104,3	103,0	101,1	99,9	98,1	97,4

⁽¹⁾ Estimates and forecasts of the Commission services, October 1986.

Source: Eurostat and Commission services.

TABLE 22
Labour costs and employment forecast for 1987 ⁽¹⁾

	Unem- ployment rate ⁽⁶⁾	Employment (percentage change per annum)	Wage costs per employee ⁽²⁾ (annual variation in %)			Productivity in the whole economy (GDP per occupied person)	Real unit labour costs ⁽³⁾ (percentage change per annum)
			nominal	real ⁽³⁾ on the basis of GDP prices	real ⁽⁴⁾ on the basis of private consumer prices		
	1	2	3	4	5	6	7
Belgium	13,4	-0,6	2,2	0,4	0,7	1,9	-1,4
Denmark	7,7	0,3	5,9	2,1	3,0	1,5	0,6
Germany	7,7	1,0	3,2	1,8	2,1	2,2	-0,3
Greece	8,3	0,0	9,6	-2,4	-2,6	-0,2	-2,2
Spain	21,5	1,2	6,3	0,2	1,0	1,8	-1,6
France	10,7	0,3	3,0	0,3	0,7	2,2	-1,9
Ireland	18,0	0,7	6,0	2,3	2,7	2,5	-0,1
Italy	12,8	1,3	6,1	0,8	2,1	2,3	-1,5
Luxembourg	1,2	0,7	5,6	2,9	4,2	1,9	1,1
Netherlands	11,1	0,9	1,7	3,4	2,7	0,9	2,4
Portugal	8,5	0,3	12,3	1,6	3,1	3,2	-1,5
United Kingdom	12,0	0,8	6,6	2,3	2,6	1,9	0,4
EUR 12	11,7	0,8	4,8	1,3	1,8	2,0	-0,7

⁽¹⁾ Forecasts of October 1986.

⁽²⁾ Wages and social security contributions.

⁽³⁾ From the point of view of costs.

⁽⁴⁾ From the point of view of purchasing power.

⁽⁵⁾ Column 4 divided by the increase in productivity.

⁽⁶⁾ Registered unemployed, Eurostat definition as a percentage of the civilian labour force: except for Greece, Spain and Portugal where national survey results are presented.

Source: Eurostat and Commission services.

4.4. The adaptability of markets

Among the lines of action in the cooperative strategy, action to improve the adaptability of markets is a basic factor in the process of improving the competitiveness of firms and their performance, in particular on the employment front. While it is true that this improvement can be brought about by medium-term measures that produce effects only gradually, the policy that is suggested can also have more immediate positive effects in that it helps to guide and stabilize economic expectations. The declared aim is to improve the functioning of market mechanisms:

- by establishing a large area with no internal barriers to the free circulation of goods, persons, services and capital,
- by providing each country with conditions conducive to the development of companies and the promotion of enterprise.

The reinforcement of the potential for growth and the resulting employment performance necessarily go hand in hand with structural adjustment, but this structural adjustment will be that much smoother if it unfolds against a background of dynamic growth in which the social dimension of the adjustment can be more easily taken into consideration.

Progress towards completion of the internal market: in June 1986, the European Council meeting in The Hague stressed that if the objectives fixed not only for the current year but also for the period up to 1992 were to be attained, then the decision-making process leading to the completion of the internal market would have to be substantially improved. Considerable progress is needed to pass from the present situation of advanced customs union to an *economic area without frontiers in 1992*.

Among the major initiatives identified in the White Paper on the internal market, the most substantial economic results are to be expected from the following measures:

- Removing barriers to intra-Community trade: this involves first of all removing barriers at frontiers, with the major effect of reducing the cost of intra-Community trade and thus encouraging its expansion, after the period of relative stagnation that has followed the strong expansion of 1958 to 1973, when the share of intra-Community trade in total Community trade rose from 34 to 53%. The removal of barriers to intra-Community trade also involves a move towards a common market in services, especially financial services, with increased competition leading to a decline in the cost of services rendered (financial intermediaries, prices of services) both to business and to consumers.
- Opening up public procurement to competition: public procurement is a fairly substantial item, since general government purchases of goods and services (including gross fixed capital formation) represented about 18 % of total public expenditure, or 9 % of Community GDP, in 1985; this figure does not include the purchases of the numerous public sector firms in the competitive sector that come under private law. Opening up public procurement to competition will lead to budgetary savings that may, according to initial estimates, be considerable in certain sectors. Moreover, major benefits will be forthcoming for suppliers, who will be able to specialize more narrowly and take advantage of economies of scale.
- The development of supply effects: the most striking effects, those of increased competition in Europe, will be a greater specialization of firms and consequently, at least in certain sectors, economies of scale. The effects could be reinforced by such developments as more intense industrial cooperation in Europe, and more efficient and concentrated R & D expenditure. Very favourable effects may also be expected from eliminating disparities between technical specifications (rules, standards, type-approval procedures), which are used at present both by the authorities and by dominant firms as instruments to segment markets, and thus reduce competitiveness in the Community economy as a whole.
- Finally, the approximation of legislation on indirect taxes: this could be a major element in reinforcing intra-Community competition, in particular because it will introduce greater transparency into final consumer prices in the different countries. Moreover, in certain cases or countries, it could provide an opportunity to adopt a structure of compulsory levies better suited to the purposes of supply policy (see point 4.2).

Although it is difficult to predict the precise effects of closer economic integration on output, productivity and employment, it is clear that the opening-up of the internal

market will accelerate the process of structural change. From this viewpoint, it is necessary to ensure that the *social dimension is fully taken into consideration*, as required by Article 118 A of the Single European Act. In addition, in order to avoid both social resistance and injustice, it is important that the costs and burdens of change are not borne by some groups while others reap the benefits. Economic and social policies, including current measures to assist the process of structural change, e.g. the Social and Regional Development Funds, will need to be particularly attentive to ensuring a fair distribution of the costs and benefits of integration and of promoting greater economic and social cohesion.

It is also important to give *the large internal market its full financial dimension*.

The liberalization of capital movements is a concomitant of the general aim of ensuring the best possible allocation of resources. It should be based on close convergence of economic and monetary policies, which is a factor of stability and confidence favourable to investment behaviour and to lasting growth in the Community as a whole.

More specifically, liberalizing capital flows, while at the same time progressing towards the creation of a common market in financial services, will reinforce Europe's attractiveness as a financial area and encourage the development of a complete range of instruments based on the most recent techniques. By offering savers a wider variety of investment opportunities, and firms of all sizes an international range of financing possibilities, the liberalization of capital movements should enlarge the pool of European savings that can be tapped for investment and job creation at lower cost.

With this in mind, the Commission adopted a communication to the Council on 21 May 1986, presenting a programme for the liberalization of capital movements in the Community. The proposed programme has two stages.

The first stage has now begun; its aim is to achieve effective liberalization, throughout the Community, of the capital transactions most directly necessary for the smooth functioning of the common market and the interlinking of financial markets.

This means first of all the gradual dismantling of existing exemptions from Community obligations. It is important to ensure that the restrictions still authorized — either under the safeguard clauses of the Treaty (Ireland, Italy, Greece) or under the Act of Accession (Spain, Portugal) — can be gradually removed.

It also means extending current liberalization obligations. A proposal for a Directive was sent to the Council in June 1986, with a view to extending the liberalization obligation to long-term credits related to commercial transactions, the acquisition of securities not traded on a stock exchange, and the admission of transferable securities to national capital markets.

In the second stage, the principle of completely free capital movements should be recognized, covering financial credits and monetary investments (deposits, money market securities). The timetable for liberalizing these transactions will have to make allowance for the variety of economic situations in the Member States, and the present wide differences in exchange controls. The Commission will be sending further proposals to the Council during 1987.

Ensuring more favourable conditions for the development of businesses: if markets are to be more adaptable to the fluctuations of supply and demand and to external shocks, firms must be able to carry out their activities in an environment that is both stable and favourable to their development.

The improvement of the environment of firms from the points of view of taxation, financial arrangements and legal administrative provisions, is one of the Commission's continuing policy aims. Such an improvement — generally based on recommendations for alignment on the most suitable national practices within the Community — contributes to increasing transparency and to harmonizing the conditions for the activity of firms in the Community, as well as discouraging discretionary measures that may well distort competition. As a follow-up, in particular, to its communication of 1983 on tax and financial measures in favour of investment, the Commission has taken several steps to improve firms' tax environment (carry-over of losses, reduced capital duties), financial environment (promotion of Europe-wide risk-capital activities) and legal and administrative environment (examination of the impact of Community and national regulations on small businesses and cooperatives). This policy will be actively pursued: its impact will be the greater as it is relayed and reinforced at national level by measures taken both at central and regional level.

The emphasis placed on *greater competition as a factor in the adaptability of Community economies* has led some member countries to take measures that increase firms' margin for manoeuvre or improve the flexibility and effectiveness of their management. For example, the trend in several countries — in many cases helped along by disinflation — is towards restoring firms' freedom to determine prices. Indeed, most member countries consider price flexibility in general as a particularly important factor in improving growth and employment performance. In particular, through the action of competition, the above-

average productivity gains achieved in the high performance sectors can spread to the economy as a whole in the form of a relative fall in the prices of these sectors' products. The additional demand directed to these sectors thus reinforces their process of growth and employment. As a result of this mechanism it is also possible to improve the profitability of the less-efficient sectors and hence put them in a position to create jobs.

Moreover, with a view to achieving greater economic efficiency, the governments of a number of countries have endeavoured to reduce government intervention in their economies. Whether it is a question of deregulation in a certain number of areas (transport, energy, etc.), by transferring (or restoring) to the private sector certain activities previously entrusted to the public sector, or by announcing the intention of reducing the volume of public intervention in the form of subsidies, the aim is to improve economic efficiency. From this point of view, the completion of the internal market, to the extent that it implies stricter control of state aids, requires greater transparency and periodic assessments of all public intervention in favour of firms, whatever form it takes (subsidies, interest rebates, tax expenditure, guarantees, purchase of equity), in particular so as to assess effects and efficiency in terms of the competitiveness of Community firms.

The improvement of the environment of firms and the reinforcement of the role of competition are liable to help small businesses; but the Commission also intends to *develop a more dynamic and more specific policy towards small businesses and cooperatives*, because of their importance in job creation. To this end, it has adopted a programme ⁽¹⁾ of action which, as well as establishing a favourable environment for the creation and development of small firms, is aimed at responding to the specific needs of these firms in terms of the provision of capital and adaptability to the market (flexibility). The measures proposed in this context relate in particular to training (retraining of staff, training of managers and heads of small businesses), encouraging arrangements for 'one-stop' information offices in each Member State, and organizing pilot Community information centres for small businesses, helping small businesses penetrate the markets of third countries, supporting creation and innovation, encouraging partnerships between large and small firms, adjusting Community financing to the needs of small firms, and developing risk-capital activity on a European scale.

All these measures, which have been the subject of dialogue and consultations with both sides of industry (bodies representing small business and trade unions), should make for a dynamic process of development and job creation in

⁽¹⁾ Action programme for SME COM(86) 445 of 16 July 1985.

small firms; they can therefore play an important part in the cooperative growth strategy for more employment.

Critical to the cooperative strategy are actions by the Community and Member States to improve functioning of goods, services and capital markets. Among the major initiatives proposed by the Commission's internal market programme are measures for (a) the removal of technical barriers to trade and frontier costs, (b) cooperation in public procurement, (c) indirect tax approximation, and (d) capital market liberalization. Also, in this context, the social dimension should not be neglected. The Commission has also made proposals for improving the fiscal and regulatory environment of the enterprise sector, with special attention given to the needs of small and medium-sized enterprises.

4.5. Financing Community policies: the budget and financial engineering

Structural adjustment in, and convergence of, the Member States' economies constitute, along with the control of the financing of the common agricultural policy, priorities for the budget of the enlarged Community. In conformity with the cooperative strategy, the Community budget could make an even greater contribution to aims such as more employment-creating growth, stronger economic and social cohesion, trouble-free integration of the new Community Member States, and an improved internal market. Moreover, the Community's financial instruments should be employed to serve the strategy in the most imaginative and efficient way possible.

In line with the conclusions of the Fontainebleau European Council, the Commission is currently considering proposing to the Council an increase in the VAT financing limit to take effect in 1988.

The Community budget: the precarious situation of the Community budget reflects the difficult balance between the financing of the common agricultural policy decided by the Council and the development of non-obligatory spending, the role of which, in the search for greater economic and social cohesion in the Community, has grown since enlargement. In so far as agricultural spending is concerned, the problem is accentuated by the fact that its volume also depends on external factors. Thus, for this expenditure, the framework for budgetary discipline adopted by the Council has had to be revised in 1986 as a result of the increasing competition with other producers on third markets.

In this context, the priorities laid down by the Commission in 'A Future for European Agriculture' are the progressive reduction of supply in sectors producing surpluses, qualitative improvements of products and a structural policy which more accurately reflects market realities. Moreover,

pursuant to the provisions of Article 130 of the Single Act, the Commission will improve the operation of the structural funds, the instruments of the Community's financial solidarity, so that they can contribute as effectively as possible to achieving economic and social cohesion and to removing the handicaps of the less-favoured regions and the declining industrial regions. The decision to streamline is part of the cooperative strategy, which, by promoting dynamic growth, should reduce the disparities between standards of living in the Member countries and their regions.

Further efforts are thus now needed in favour of industry, research and innovation thus aiding and accelerating structural adjustment and improving the competitiveness of firms. This type of expenditure is especially important to the success of the cooperative strategy, in that it improves the scientific and technological base of enterprises, provides a favourable educational base for the dissemination of information technology, and reinforces the process of establishing the Community market by its effects on industrial supply.

The Community's 1987 budget is in the course of being established. The Commission's preliminary draft budget totalled 36,6 thousand million ECU, thus remaining within the margin of the maximum VAT rate of 1,4 %. The small expansion in expenditure for the EAGGF-guarantee section (3,8 %), which still represents 62,5 % of all budgetary expenditure, made it possible to propose appreciable increases in structural expenditure.

The budget adopted by the Council in its first reading amounted to 35,9 thousand million ECU, with reductions, however, in amounts allocated to structural funds and research.

Financial engineering: although budgetary resources are scarce, abundant private funds are available and the Commission proposes to take advantage of this financial situation by concentrating on the development of financial engineering. To this end, a new chapter has been inserted in the preliminary draft budget for 1987 proposed by the Commission.

This new activity would mean persuading the market to create or develop instruments or mechanisms to facilitate the financing of measures or projects which the Community considers of special interest. Existing instruments (loans and subsidies) could be used to the best advantage to act as catalysts, while the scope and functioning of Community intervention should be expanded and improved, and the relationship between Community and private financing should be organized to enable the market to offer new types

of financing tailored to innovation, technology and enterprise.

In the Commission's opinion many projects exist in the Community that could be more easily launched and completed if suitable financing arrangements were available. The Commission has defined, for the immediate future, three priority areas of its financial engineering activity where it is studying, in close collaboration with the EIB, the possibilities for development:

- Advanced technology projects well upstream in the chain leading from research to industrial application; in particular, projects constituting the industrial follow-up to joint research programmes that have been part-financed by the Community. As such projects are best financed from equity resources, the Commission has put forward some ideas (private investment companies backed by a guarantee mechanism), after consulting the financial community to ensure that they would be appropriate.
- Small and medium-sized firms, in particular innovative firms, facing specific financing problems. This is the area with the widest scope for a variety of instruments (risk capital, guarantee funds, credit insurance, consultancy bodies, etc.) and the Commission will be engaged in getting these instruments developed.

— Major infrastructure projects, which are particularly difficult to get off the ground and feasible only if a considerable volume of capital with special characteristics is available. The possible role for the Community would be:

- for launching major projects ('declaration of European utility', budgetary aid),
- to improve the environment for private investors,
- to mobilize the capital market by the use of a revised form of Community aid (e.g. financing of projects).

The enlargement of the Community, the completion of the internal market and the need to reduce unemployment are all factors tending to increase the rate of structural change in the Community. The Community budget should facilitate this process through use of its various funds. In addition, in the opinion of the Commission, financial engineering activities, which would encourage the market to cover the main share of the financing of work or projects to which the Community attaches particular importance, would also make a contribution; current priorities for the development of these financial instruments would include high-technology projects, innovation among small and medium-sized enterprises, and some large infrastructure projects.

TABLE 23

European Community general budget, 1985 to 1987: Payment appropriations

	(millions of ECU)			
	1985 ⁽¹⁾ EUR 10	1986 ⁽²⁾ EUR 12	1987 ⁽³⁾ EUR 12	1987 ⁽⁴⁾ EUR 12
<i>Expenditure:</i>				
Agriculture — guarantee section	19 726	22 112	22 961	22 961
Agriculture — structural funds	738	802	966	983
Fisheries	82	190	221	208
Social Fund	1 413	2 533	2 589	2 499
Regional Fund	1 624	2 373	2 495	2 422
Integrated Mediterranean projects	9	133	240	175
Transport	76	27	34	21
Energy and industry	129	114	173	147
Research and innovation	578	648	847	744
Food aid	544	553	616	524
Development aid	541	618	642	536
Other expenditure including refunds to Member States	2 763	5 071	4 892	4 726
Total	28 223	35 174 ⁽⁵⁾	36 676 ⁽⁶⁾	35 946

⁽¹⁾ Out-turn.

⁽²⁾ Budget adopted by the Parliament on 10 July 1986.

⁽³⁾ Preliminary draft budget for 1987 presented by the Commission to the Council on 21 July 1986.

⁽⁴⁾ Draft budget adopted by the Council on 9 September.

⁽⁵⁾ The correction of the budgetary imbalance for the United Kingdom which amounts to 2 685 million ECU is included in receipts.

⁽⁶⁾ The correction of the budgetary imbalance for the United Kingdom which amounts to 2 366 million ECU is included in receipts.

(millions of ECU)

	1985 ⁽¹⁾ EUR 10	1986 ⁽²⁾ EUR 12	1987 ⁽³⁾ EUR 12	1987 ⁽⁴⁾ EUR 12
<i>Receipts:</i>				
Agricultural levies	2 179	2 699	3 297	
Customs duties	8 310	9 700	9 762	
Value added tax (VAT)	15 218	22 468	23 130	
Special contributions	1 911	211	212	
Miscellaneous	654	96	275	
Total	28 272 ⁽⁷⁾	35 174 ⁽⁵⁾	36 676 ⁽⁶⁾	35 946
Maximum rate of VAT	1,0	1,4	1,4	
Effective rate of VAT	1,0	1,39 ⁽⁸⁾	1,38 ⁽⁹⁾	
Budget total as a % of GDP	0,85	1,03	1,02	

⁽¹⁾ Out-turn.⁽²⁾ Budget adopted by the Parliament on 10 July 1986.⁽³⁾ Preliminary draft budget for 1987 presented by the Commission to the Council on 21 July 1986.⁽⁴⁾ Draft budget adopted by the Council on 9 September.⁽⁵⁾ The correction of the budgetary imbalance for the United Kingdom which amounts to 2 685 million ECU is included in receipts.⁽⁶⁾ The correction of the budgetary imbalance for the United Kingdom which amounts to 2 366 million ECU is included in receipts.⁽⁷⁾ Including a surplus of 49 million ECU carried over to 1986.⁽⁸⁾ Except for the Federal Republic of Germany (1,33697) and the United Kingdom (0,67663).⁽⁹⁾ Except for the Federal Republic of Germany (1,3296) and the United Kingdom (0,8176).

Sources: 1985, Management accounts; 1986, Budget adopted on 10 July 1986 by the European Parliament; 1987, preliminary draft budget presented by the Commission to the Council on 21 July 1986, draft budget adopted by the Council on 9 September.

TABLE 24

European Community investment financing through capital market borrowing and on-lending

(million ECU)

	1984	1985	1986
<i>Lending by institution or mechanism:</i>			
European Investment Bank	5 007	5 641	
Commission:			
European Coal and Steel Community	825	1 010	
Euratom	186	211	
New Community Instrument	1 182	884	
Total	7 200	7 746	7 800 to 8 300
<i>Lending by sector or policy objective:</i>			
Private industrial sector	2 709	2 830	2 500 to 2 800
of which: global loans to small and medium enterprises	1 719	1 735	1 400 to 1 600
Infrastructure	2 132	2 413	2 800 to 2 900
Energy	2 359	2 503	2 500 to 2 600
Total	7 200	7 746	7 800 to 8 300

Source: Commission of the European Communities 'Report of the Commission to the Council and the European Parliament on the borrowing and lending activities of the Community in 1985' (COM(86) 289 final). The figures for 1986 are forecasts by the Commission.

4.6. Social dialogue

The success of the cooperative strategy implies changes, sometimes marked, in behaviour and economic policies. Rising unemployment during the 1970s and weak growth have gone hand in hand with the reinforcement of defensive behaviour, often as a reaction aimed at preserving legitimate rights and positions in the face of the radical changes wrought by the oil crisis. However, such behaviour has often not given enough attention to the rise in unemployment and makes a solution to this problem more difficult.

This applies to firms, which became more hesitant to invest in a context which they considered uncertain. It applies to wage earners endeavouring to protect their purchasing power and the stability of existing jobs, but it also now seems to apply to economic policymakers, who, considering the duration and the cost of cutbacks at the beginning of the 1980s, may be reticent to make use of available leeway.

Present imbalances are the result of such modes of behaviour, and the renewal of the European economy can only be brought about by their simultaneous modification. The propensity to invest can increase if the outlook for profitability and demand is assured. Wage earners can be more ready to accept moderate real wage growth and greater labour market adaptability if, in return, the effects on employment are seen to be coming through, and if the social consequences of measures are fully taken into account. There will be less risk of macroeconomic policies more firmly targeted on growth leading to rekindled inflation and the reappearance of external imbalances if domestic costs are harnessed, if enterprises can increase their productive capacity, and if this takes place within a more dynamic Community context.

The objective of social dialogue should be the simultaneous modification of the behaviour of all groups in economic activity.

It therefore seems clear that social dialogue should cover all the themes of the cooperative strategy, both at the macroeconomic and at the microeconomic level. Social dialogue gathers together representatives of employers and employees as well as governments. It should make possible a broader consensus on the contributions of each group to the cooperative strategy. By meeting at regular intervals, short enough to take into account short-term economic developments, the participants will be able to see that the cooperative strategy is effectively applied and to adjust their action to recent developments. Social dialogue at all levels should therefore enable the social and employment consequences of the necessary structural and technological shifts to be harnessed more effectively.

The Commission has stimulated a fruitful dialogue at the Community level, with, and between, the two sides of

industry represented by Unice (Union of the Industries of the European Community), CEEP (Confederation of European Public Enterprises) and the ETUC (European Trade Union Confederation). As a result of the work carried out in two groups, one dealing with macroeconomic, the other with microeconomic themes, an agreement covering several points has been reached. It can be summarized as follows:

- the need for all parties — firms employees and the authorities — to apply the cooperative strategy effectively in order to obtain the desirable decline in unemployment,
- the need for a rapid reallocation of resources to employment-creating investment through a further improvement in business profitability resulting from a moderate increase in real wages *and* through action to ensure that the lag between increases in profitability and investment activity is as short as possible,
- the need to preserve a stable monetary framework and to reduce inflation where it is still too high,
- the need to promote R & D and the training of the labour force,
- the need to complete rapidly the internal market, taking full account of its social aspects,
- the need to back up business investment by reviving economically and socially profitable public investment.

Naturally, some differences in points of view have also emerged. These principally concern the role of the State in economic activity, both in its expenditure and taxation activities and in its market-regulating responsibilities, as well as the role of the reorganization and reduction of working time, neutral with respect to the level of costs, in the creation of employment.

At the Community level, the Commission will continue for its part to intensify the social dialogue but, as the Commission pointed out in its communication of July 1986 (COM(86) 364 final), the desire for cooperation, which the social partners have demonstrated at European level, has not been fully utilized at the national level. Governments in all the Member States should take practical steps, bearing national traditions in mind, but perhaps breaking new ground as well, to enter into dialogue at national level covering all aspects of the strategy, and to create a favourable environment for dialogue at the sectoral and enterprise level ⁽¹⁾. In countries

⁽¹⁾ See Article 3 of Council Directive 74/121/EEC of 18 February 1974 on stability, growth and full employment in the Community, OJ No L 63, 5. 3. 1974, p. 19.

where governments, for particular reasons, do not see their way to encourage social dialogue themselves, the social partners are invited to take the initiative. In this way, dialogue on the themes of the Community strategy can also be entered into in these countries between the social partners and, as far as possible, with the participation of government.

Social dialogue is an important element of the cooperative strategy. By bringing together representatives of employers and employees, as well as governments, the objective is in particular to contribute to the necessary changes in the behaviour of all parties in economic activity and bring about a broad consensus on their respective contributions. The themes covered should cover all economic and social aspects of the cooperative strategy. At the Community level, the Commission has stimulated a fruitful dialogue with, and between, the social partners. The Commission will endeavour to intensify still further this dialogue. Governments of all Member States should take practical steps in order to encourage, at national level, dialogue on all the themes of the strategy, building on the desire for cooperation shown by both sides of industry at the European level, and taking account of the particular circumstances in individual countries.

4.7. International economic policy coordination

The process of correcting the major balance of payments disequilibria, which have affected the world economy since 1982, has now been under way for more than a year. Already, with effect from March 1985, when the dollar reached its peak, the exchange rates of major currencies had begun to move in a direction more consistent with fundamental economic factors. This process was given an additional impetus when the Group of Five finance ministers, at their meeting in New York in September last year, agreed that a depreciation of the dollar, and a corresponding appreciation of the other major currencies, in particular the yen, would be necessary to restore the structure of international payments to a sustainable basis.

By the end of September 1986, the currencies of the other Group of Five countries had all appreciated substantially against the dollar. In trade-weighted terms, the dollar itself had depreciated by 22 %, and the yen had appreciated by 38 %, from their average 1985 levels. The European currencies had appreciated less in trade-weighted terms, since about half of their trade is conducted between European countries. These exchange-rate adjustments, at least as regards the ECU in relation to the dollar, are probably now about sufficient.

However, in view of the enormous imbalances which have built up over the years, especially in the United States and Japan, these exchange-rate adjustments will need to be

complemented by domestic policy adaptations in order for either the United States deficit or the Japanese surplus to be reduced to acceptable dimensions. Despite the recognition in the Group of Five agreement of the need for such changes, there has in fact been little progress in this area so far. As a result, both the US deficit and the Japanese surplus are likely to remain excessively large in 1986 and 1987. The surplus of the Community as a whole may be expected to increase temporarily from its 1985 level, while remaining within acceptable limits. However, within the Community total, the distribution of surpluses and deficits between member countries may require more adjustment, although there is clearly no necessity for all member countries to run exactly balanced current accounts.

The United States has repeatedly urged surplus countries, in particular Japan and Germany, to take additional measures designed to stimulate domestic demand and thus accelerate the reduction of their external surpluses and by that the United States' deficit. However, faster growth in these two countries alone, which account for only 15 % of US exports, would probably not have much effect in reducing the US deficit. If all industrialized countries outside the United States took measures to accelerate the growth of domestic demand the impact on the US current balance would, of course, be much greater, because in this case the benefit would be extended directly to some 60 % of US exports. On the other hand, while faster growth in all industrialized countries outside the US would help to reduce the US deficit it would do little, if anything, to reduce the Japanese and German surpluses. This is because additional demand for Japanese and German exports from other industrialized countries would tend to offset the increase in imports generated by the faster growth of their own domestic demand.

In order to bring down the United States' current account deficit to sustainable proportions, it seems necessary to envisage a certain slowdown in the evolution of domestic demand there, which would imply a period of relatively slower growth compared to other industrialized countries. United States imports, unlike United States exports, are highly income-elastic and could thus be expected to respond sharply to slower growth of domestic demand. Table 25 shows the distribution of current surpluses and deficits that might be expected to result if fiscal policy in the United States were more restrictive, and assuming that real exchange rates remained at their mid-1986 levels. The United States deficit would be reduced to about 2 % of GDP by the late 1980s and the Community surplus would disappear, but the Japanese surplus would remain unacceptably large.

A determined application of the cooperative strategy over the next four years, would, in these circumstances, result in some deterioration of the current account of the Community. This could certainly be acceptable, but would not correspond to a lasting equilibrium. The main beneficiaries, in balance of payments terms, would be other European and developing

countries. The impact on the United States current balance would be fairly small, and in the Japanese case progress towards reducing the surplus would be delayed still further (see Table 26). This would not be the optimal option. Therefore, an international policy mix designed to reduce imbalances to sustainable levels would appear to require some further combination of yen appreciation and fiscal stimulus in Japan, in addition to a period of relatively moderate growth in the United States and faster growth in the Community. Table 27 shows the distribution of current balances that would result from fiscal expansion equal to 1 % of GDP in Japan in 1987 and sustained throughout the period until 1990 and a further 20 % effective appreciation of the yen during 1987/88. This combination of measures, together with measures to assure the continued opening of goods and financial markets, would reduce the Japanese surplus substantially. This example shows that the overall outcome can be significantly improved through cooperation. It would be further improved by the participation of the EFTA countries, which have already signaled some sympathy for this effort.

Recent developments in world output and trade have not been helpful to developing countries. Sluggish growth in the industrialized world has held down the rate of increase in the volume of developing countries' exports and has depressed commodity prices, with the result that the purchasing power of developing countries' exports (export earnings deflated by import prices) is estimated to have fallen this year by 11 %, and the aggregate current deficit of this group, after four years of steady improvement, has deteriorated sharply again, in spite of the decrease in interest payments on external debts. The main channel to improve the external position of the developing countries must be to increase their exports. More open markets for the developing countries' products are a precondition for some progress in restoring their creditworthiness. In addition, fresh capital is necessary for a successful restructuring and adjustment of the economies of the indebted countries towards more economic growth as proposed in the Baker initiative. The recent negotiations over Mexico's external debt and domestic adjustment policies are a positive example in this regard.

The revival of growth in the developing countries is necessary to avoid a further deterioration of the standard of living of their populations and for progress towards solving their debt problems. To this end, it is vital that the adjustment of current account imbalances between the developed countries does not have a contractionary overall effect on the growth of the indebted developing countries. Indeed, their growth can make a significant contribution to the steady expansion of world trade.

It is clear from recent experience that there is still ample room for improvement in the arrangements for international

economic policy coordination. The participants at the Tokyo Summit have decided that the most promising way of achieving such improvement would be to develop a regime of indicators that would enable countries' objectives to be specified in fairly precise quantitative terms and their success in achieving these objectives to be closely monitored. It is envisaged that national forecasts should be checked for internal consistency and mutual compatibility with a view to diagnosing future sources of tension and reaching agreement on what changes in policy would be most appropriate to forestalling them. Subsequently, the indicators would be used to check performance in relation to objectives and to identify appropriate remedial action where necessary. Clearly a regime of this kind is no panacea for solving the problems of international economic cooperation. However, to the extent that it provides a more complete quantitative analytical framework within which the policies of the major countries can be examined and the likely consequences of those policies, both for the country concerned and for others, assessed, it should improve the prospects for avoiding serious incompatibility between the policies of the participant countries and the tensions which such incompatibility provokes.

The decision taken in Punta del Este in September to launch a new round of multilateral trade under the GATT, lends strength to the hope that the trend towards protectionism can be halted and reversed. This is an essential condition to allow the development of a more open and durable multilateral trading system. Furthermore, these negotiations should strengthen the structures and disciplines of the GATT, at a time when they are perceived as having weakened against an unfavourable background. In this context, the concerted attempt to bring agricultural trade within the scope of these negotiations will be of particular significance. Last, but not least, GATT should adapt to new developments in the structure of trade. An important step in this regard is the decision to include liberalization of trading services into the negotiations, bringing a new major sector within the scope of the multilateral trading system.

Recent exchange-rate changes have created more favourable conditions for correcting the large external imbalances which had built up over previous years. They will not, however, achieve this result by themselves. The return to a sustainable pattern of current payments will, above all, require budgetary restriction in the United States and expansionary budgetary measures, accompanied by further appreciation of the yen in Japan. In the event of policy adjustments along these lines, major corrections to the United States and Japanese current account imbalances could be achieved by 1990. The more favourable growth trend achieved in the

Community, by implementing the cooperative growth strategy for more employment, and in the EFTA countries will have a beneficial impact on world trade. The new round of multilateral trade negotiations within GATT could

strengthen this positive tendency. This would have a favourable effect on developing countries' exports and would increase the chances of consolidating their external payments' position in the medium term.

Projected current balances as percentages of GDP 1986 to 1990

TABLE 25

Present policies and mid-1986 exchange rates (baseline scenario)

	1985	1986	Average 1987 to 1990
USA	- 3,0	- 2,5	- 2,2
Japan	+ 3,7	+ 4,5	+ 3,2
EUR	+ 0,5	+ 1,2	+ 0,4

Annual average growth rates of real GDP during 1986 to 1990 inclusive would, in this scenario, be: USA 2,7 %, Japan: 3,6 %, EUR: 2,6 %.

TABLE 26

Cooperative strategy (without specific cooperative measures in Japan)

	1985	1986	Average 1987 to 1990
USA	- 3,0	- 2,5	- 2,0
Japan	+ 3,7	+ 4,5	+ 3,5
EUR	+ 0,5	+ 1,2	- 0,1

Annual average growth rates of real GDP during 1986 to 1990 inclusive would, in this scenario, be: USA 2,8 %, Japan: 3,7 %, EUR: 3,5 %.

TABLE 27

Cooperative strategy combined with fiscal expansion and further 20 % effective yen revaluation in Japan

	1985	1986	Average 1987 to 1990
USA	- 3,0	- 2,5	- 1,7
Japan	+ 3,7	+ 4,5	+ 2,2
EUR	+ 0,5	+ 1,2	+ 0,1

Annual average growth rates of real GDP during 1986 to 1990 inclusive would, in this scenario, be: USA 2,9 %, Japan: 3,4 %, EUR: 3,6 %.

PART II

ECONOMIC POLICY IN THE MEMBER STATES

APPLICATION OF THE COOPERATIVE GROWTH STRATEGY FOR MORE EMPLOYMENT IN THE MEMBER STATES IN 1987

The inescapable conclusion which emerges from an examination of employment trends in recent years is that energetic action is necessary in *all* the Member States to reduce the level of unemployment substantially; the single exception is Luxembourg, where unemployment remains low. On an annual average basis, the unemployment rate will fall in only four out of the 12 Member States in 1986, while in 1987 it will fall in half of the Member States, but only two (Germany and the Netherlands) will register a fall over the two years. In 1986, the GDP growth of only two countries (Germany and Portugal) will be within the 3 to 3,5 % range considered necessary, in the medium term, to reduce the unemployment rate substantially. The outcome will be decidedly better in 1987, when six Member States will be in this situation, three of them countries whose relative share in Community GDP is high (Germany, Spain and Italy) while the result for France and the United Kingdom is only one-quarter of a percentage point outside the bottom of the range. Thus, although progress is being made in the right direction, it is particularly important to examine whether and how this progress can be consolidated and improved in each of the Member States in 1987 and thereafter, and, similarly, how far economic and social policy should differ from country to country to take account of the special features of the economic situation in each Member State.

As was already stressed in the Annual Economic Report 1985/86, it is clearly very difficult, if not impossible, to implement in isolation measures to boost employment; consequently, the success of any action of this type also depends on reinforcing the social dialogue, not only at Community level, but also in each Member State. The interaction of government initiatives with those of the social partners will be an essential precondition for the success of any action to increase employment.

An approach which takes account of the specific characteristics of each country's economic situation does not necessarily mean a differentiation, from country to country, in applying all the measures recommended in Part I of the present report.

A uniform and synchronized application of the proposals made in Part I, chapter 4, sections 4.3 to 4.6 should be made.

Broadly comparable efforts will have to be made by the Member States to improve the operation of the markets in goods, services and capital, and to put into effect the Community programme for completing the large internal

market. At the very most, transitional measures could be envisaged to take account of the special problems in the acceding countries.

It is also desirable for the Member States to act largely in parallel in regard to the labour markets and labour costs (in particular through moderation of real wage increases, shortening working time, provided that this is cost neutral, introducing more flexible use of working time, reducing social security charges, improving the regulatory system so as to stimulate the recruitment of workers, encouraging the creation of small businesses).

In the course of 1987, when the stimulatory effects of the terms of trade gains begin to weaken, support of *domestic demand* could become necessary; this support must necessarily differ from country to country, in view of the requirements dictated by the situation in each Member State.

From the monetary aspect, the continued fall in interest rates is much to be desired as a source of stimulus for the expansion of investment. However, in countries such as the Federal Republic of Germany and the Netherlands, there has already been an appreciable fall in interest rates due to the sharp drop in inflation. A forced reduction would be liable to imperil the aim of stability inherent in a sound monetary policy. In most of the other Member States, and particularly in France and Italy, the abatement of inflationary expectations points to a continuing downward trend in interest rates.

It will not be possible to attain these internal objectives, however, unless the Member States turn their joint attention to the external aspects of these problems within the framework of international monetary cooperation. In all probability, the downward pressure on the dollar will remain appreciable throughout 1987, given the need for a deep-seated adjustment of the United States' external account. It would not be in the Community's interest to tolerate an excessive depreciation of the dollar which could have adverse effects on its own growth. Nevertheless, the adjustments to domestic monetary policy, which might by implication be necessary in order to prevent the dollar from falling too far, cannot go beyond certain limits, otherwise they would become self-defeating.

All these considerations indicate that, within the policy mix, monetary policy can still have a stimulatory effect on growth in some Member States, but that its role is very limited in others.

With regard to public finance, the possibilities for action differ even more. In the Federal Republic of Germany and in Luxembourg, the budgetary situation seems comfortable enough to give the public authorities some room for manoeuvre. In the United Kingdom, the Government in its autumn statement provided for an increase in public expenditure of some £ 4³/₄ thousand million in 1987/88. This will mean that public expenditure in 1987/88 is planned to be about 2% higher in real terms than the estimated out-turn in 1986/87. In France, substantial tax cuts are already planned for 1987 and further reductions have been announced for 1988, the intention being simultaneously to reduce the budget deficit in each of the two years. By contrast, the state of the public finances, and in particular the high level of the public debt, means that consolidation must continue in Belgium, Greece, Ireland, Italy and Portugal. In a third group of countries (Denmark, Spain and the Netherlands), the budgetary constraints are less severe, but certain aspects of

the outlook for 1987 limit the room for manoeuvre in macroeconomic policy.

Consequently, only a fairly small group of countries will be able comprehensively to influence supply and demand conditions. However, all the Member States will be able to create more favourable circumstances for the expansion of employment by modifying the structure of public expenditure and revenue.

Nevertheless, an increasing number of countries can be expected to have more room for manoeuvre in the course of 1987 and, in the countries where it already exists, the possibilities for action will become more evident. This would obviously be the case if, as is likely, the improvement in the fundamental conditions for economic equilibrium already experienced in 1986 were to be sustained in 1987.

BELGIUM

In *Belgium*, economic growth in 1986 is likely to be distinctly faster than the rates achieved in the period 1981 to 1985; the acceleration is due not only to the reverse oil shock but also to the delays in finalizing a new fiscal consolidation programme. Real personal disposable income and private consumption are likely to increase by over 2,5%, after remaining virtually static for several years. Business investment is likely to expand sharply because of the improvement in profit margins. In 1987, however, growth will inevitably be held back by the effect of the moderation of personal incomes following the fiscal consolidation programme decided in the spring of 1986. Growth will therefore have to be more reliant on business investment and exports. Price increases are likely to remain weak after the sharp slowdown in inflation in 1986 (from 4,9 to 1,3%). The current account should produce a comfortable surplus in the two years under review. General government net borrowing, by contrast, is likely to show no more than a slight improvement in 1986, but in 1987 should be reduced by 1,5 to 2 percentage points of GDP. The efforts to strengthen the public finances will, in the first place, have a negative effect on the employment level in the public sector, which will be offset to a large extent by an increase in the private sector as a result, in particular, of the agreements reached in the framework of the national negotiations. Over the two years 1986 and 1987, the level of total employment and the unemployment rate will hardly change.

Incomes in 1986 and 1987 will evolve in line with the policy adopted since 1982 and directed towards a moderate development of real wages in order to safeguard the level of competitiveness achieved after 1982 and to promote employment-sharing. Adherence of these objectives will be

facilitated in 1986 by the slowdown in inflation which, through the working of the indexation system, has been rapidly reflected in a deceleration of nominal wage increases. Wage negotiations for the years after 1986 will be subject to the restriction imposed by the Government's powers to secure compliance with the general competitiveness norm. Statutory powers of constraint can be invoked when sectoral wage agreements depart too far from the general recommendations set out in the national agreement reached, in September 1986, between the social partners; these are geared to maintain a certain level of competitiveness and to create jobs, especially for young people. The slowdown in wage increases has helped to reduce real unit-labour costs by nearly 9% between 1981 and 1986. This was paralleled by an increase in the profitability of companies and an improvement in their financial situation. A further reduction in corporation tax was also decided, bringing the top rate down from 45 to 43% in 1988. Lastly, monetary policy was centred on the reduction of short-term interest rates to the maximum degree compatible with the maintenance of a stable exchange rate, so that the interest rate on investment credit was down to 8,25% by April 1986, whereas it was still 12,75% at the beginning of 1985. It was only in 1986, however, that these improved conditions began to generate a significant growth in company investment, since the implementation of new projects was held back, probably because of uncertainty as to how personal incomes would evolve in the context of the fiscal consolidation measures. Working hours will soon become more flexible, and, as legislation enshrines the consensus between management and unions on the general use of flexible time, firms will be better able to react to fluctuations in demand once new wage agreements enter into force.

On the other hand, the condition of the public finances is such that the only possible priority is for a vigorous and rapid improvement so as to break the 'interest charges-debt' spiral. In the spring, the Belgian government gave details of the fiscal consolidation programme announced in its December 1985 investiture declaration, which aims to reduce the Treasury borrowing requirement to the equivalent of 8 % of GDP in 1987 and 7 % in 1989, compared with 11,5 % in 1985. The main emphasis is on cutting expenditure. The programme of reducing personal taxation, decided earlier, has been retained and heavier taxation of petroleum products has been rejected. These programmes, taken together, should temporarily counteract recent developments favourable to employment and domestic demand. Nevertheless, the reverse oil shock enables the Belgian economy to maintain relatively favourable growth during the period of internal adjustment.

The public finance situation necessarily restricts the possibilities for boosting demand by budgetary action. As before, priority should be given to bringing the public finances back into balance and eliminating supply-side rigidities, since these two obstacles must be removed in order to return to steadier and more lasting growth. The implementation of a monetary policy aimed at cutting interest rates by as much as is compatible with the maintenance of the Belgian franc's parity within the EMS is also largely dependent on a reduction in the public sector's financing needs.

The scale of the budget imbalance means that the government's borrowing requirement target must be fully attained within the planned time-limits, especially since, in several respects, the international situation is relatively favourable while, in 1986 and 1987, cutting expenditure will be aided by the fall in interest rates. Before the special powers expire, it is essential to implement, if necessary, new corrective measures to ensure that the target (a Treasury borrowing requirement equivalent to 8 % of GDP in 1987) is attained, in order to avoid the public finances being blown off course should the planned measures fail to produce the desired results, or should exogenous factors develop less favourably. The only room for manoeuvre available to budgetary policy in the short term relates to the structure of revenue which could be modified with a view to generating growth with a greater job content. One of the possibilities would be to compensate for a reduction in social security charges on wages by increasing indirect taxes in general, or the taxation of petroleum products in particular.

It is desirable to keep open the possibility of setting limits to wage developments after the special powers in this respect expire, given the imperative need for the Belgian economy to remain competitive in meeting external demand during the period of internal adjustment. Nevertheless, the maintenance of a policy of wage rigidity over a long period could now justify some limited cases of relaxation, in order to respond to the signals emanating from the labour market when bottle-necks appear that are difficult to deal with by retraining measures.

TABLE 28

Belgium: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	9,2	10,0	3,4	8,7	6,3	6,8	6,7	6,7	3,1
{ volume	4,9	2,5	-1,5	1,5	-0,1	1,4	1,5	2,0	1,3
{ deflator	4,1	7,5	5,0	7,1	6,3	5,5	5,1	4,6	1,8
Private consumption deflator	3,7	7,8	8,1	7,4	7,5	5,9	4,8	1,3	1,5
Gross fixed capital formation volume									
{ private	:	:	-18,1	-0,3	-3,6	4,4	3,8	7,0	6,9
{ public	:	:	-6,3	-8,9	-7,6	-8,8	-13,2	-6,4	-9,8
{ total	5,1	1,9	-16,3	-1,7	-3,9	1,0	1,2	5,3	5,0
of which: construction	:	:	-22,9	-5,4	-5,1	-4,2	-0,4	2,1	2,2
equipment	:	:	3,6	8,0	-9,5	9,9	3,6	9,5	8,4
Domestic demand at constant prices	:	:	-4,1	0,3	-2,5	1,7	1,3	3,0	1,3
Gap with respect to other Community countries ⁽³⁾	:	:	:	-0,8	-2,6	-0,3	-0,8	-0,5	-1,4
Compensation of employees per head									
{ nominal	8,9	11,6	6,4	8,1	6,4	6,8	4,5	2,5	2,2
{ real A ⁽⁴⁾	4,6	3,8	1,4	1,0	0,0	1,4	-0,6	-2,0	0,4
B ⁽⁴⁾	5,1	3,5	-1,5	0,7	-1,0	0,8	-0,3	1,2	0,7
Productivity ⁽⁵⁾	4,3	2,4	0,5	2,9	0,9	1,4	1,0	1,7	1,9
Real unit labour costs	0,3	1,4	0,9	-1,8	-0,9	0,0	-1,6	-3,6	-1,5
Competitiveness ⁽⁶⁾	-0,2	1,5	-8,2	-11,5	-2,3	0,1	1,8	2,9	-0,6
Employment	0,6	0,1	-2,1	-1,3	-1,6	0,2	0,5	0,3	-0,6
Registered unemployed as % of the civilian labour force ⁽⁷⁾	2,2	6,8	11,1	13,0	14,3	14,4	13,7	12,9	13,4
Current balance as % of GDP	1,0	-1,4	-4,6	-3,3	-0,6	-0,4	0,4	2,3	2,8
Long-term interest rate	6,5	9,4	13,8	13,5	11,8	12,0	10,6	8,0	7,2
Money supply ⁽⁸⁾	10,1	11,2	10,0	7,5	7,0	6,1	6,7	5,8	4,0
Net lending or borrowing requirement of general government as % of GDP	-1,9	-5,8	-12,6	-11,1	-11,7	-9,5	-8,4	-8,0	-6,2
Public debt as % of GDP	:	64,8	88,2	95,9	105,1	110,7	117,4	120,6	125,7
Public debt interest as % of GDP	:	4,4	8,0	9,3	9,4	9,9	10,6	10,6	10,7

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁷⁾ Eurostat definition.⁽⁸⁾ End of year.

DENMARK

In *Denmark*, economic performance in recent years has improved significantly in important respects: gross domestic product rose quickly both in 1984 and 1985 (3,9 and 3,8 %, respectively), employment expanded by 2,4 % in the former and by 3,1 % in the latter year and, although labour supply rose rapidly in reaction to the increase in demand for manpower, the rate of unemployment was reduced from a peak of 10,2 % in 1983 to 8,2 % at the end of 1985. The upturn was led by a pronounced recovery in gross fixed asset formation, which responded strongly to a marked improvement in the profitability of investment resulting from the policy of wage restraint in the early 1980s.

The fast increase in employment since 1983, of the order of 2 % *per annum*, is the most spectacular result of the economic policy pursued by the Danish authorities since 1982, corresponding in many respects to the cooperative growth strategy adopted by the Council last year. This strategy has aimed mainly at stimulating the supply side of the economy through real and nominal wage restraint, cuts in public expenditure and adherence to a principle of external and internal monetary stability within the framework of the EMS. Real compensation of employees actually fell from 1983 to 1985, and rose slowly from then on due to moderate settlements and the ending of indexation. The consequent rise in profitability helped to stimulate private business investment. With a severe restraint on public expenditure and some modest rise in receipts, the general government borrowing requirement was reduced in the process from 9,3 % of GDP in 1982 to 1,9 % in 1985, while a surplus of some 3 % could emerge in 1986. Tight budgetary management gave more room for the expansion of the tradeables sector. The thrust of incomes and budgetary policy meant that monetary policy no longer had to bear alone the burden of stabilization, and so domestic interest rates declined sharply.

Despite this strong correction in the public finances, the current external deficit widened considerably between 1983 and 1985, partly as a result of some deterioration of the trade balance and partly due to a substantial increase in net interest payments abroad. The latter was a consequence partly of the rise in the dollar in the period up to mid-1985, which boosted the domestic currency value of the existing debt, and also of the continued rise in the debt. Although, compared to the position of 1979, the trade deficit by 1985 had been reduced by 4,4 percentage points of GDP, the overall current external deficit in 1985, at 4,4 % of GDP, was barely lower than the deficit recorded in 1979 (4,7 %), and up from 3,3 % in 1984.

In 1986, domestic demand continued to increase markedly in the first half of the year, again outgrowing potential supply.

A decline in the private savings ratio, reflected also in stronger borrowing by households, was a major reason for this buoyancy. The external payments position deteriorated further, although it prompted government action in December 1985 and in March 1986 in order to restore external balance. However, as a result of these measures, consumer demand levelled off and the rate of activity in the construction sector, while at a high level, also showed signs of weakening. Nevertheless, there was a moderate rise in other business investment except in a few sectors such as energy and shipping. Although the trade balance should improve in the course of the year, interest payments abroad remain high, and the deficit on current transactions may not improve for the year as a whole. The slowing down of GDP growth due to the restrictive measures, to some 3 % in 1986, reduced the rise in employment and the unemployment rate levelled off at some 7³/₄ % of the labour force. The rise in the consumer price deflator should be of the order of 3¹/₂ % in 1986, as against 5 % in 1985, despite the increase in indirect taxes.

In October 1986, new measures were introduced in order to strengthen personal savings and discourage credit-financed consumption. They include a shortening of the average redemption period of new mortgage loans, higher stamp duties on loan documents and a special tax on interest payments on personal loans for consumption purposes. In addition to these measures, the main events influencing economic developments next year will be the implementation from 1 January 1987 of the tax reform adopted at the beginning of 1986 and the wage settlement of March 1987. The purpose of the tax reform is to increase private household savings.

In 1987 it could somewhat stimulate consumer spending by shifting taxation from households to corporations and certain other institutions, including some non-profit institutions, which until now were tax-exempt. This stimulative effect is however counterbalanced by the increase in local government taxation and by measures taken in October 1986. As a result of the full compensation for the cut in working time and the planned extension of sickness payment, average wage costs will have increased by more than 3 % at the beginning of 1987, reducing the room for wage concessions during the biennial deal in March 1987. Investment in plant and equipment, following its sharp rise in 1984 – 1986, will be much less buoyant in 1987, particularly in the energy sector. Overall the growth performance will be considerably slower than in 1986 and will therefore become more dependent on the international economic environment. The rate of unemployment will be slightly higher than the likely outcome in 1986. On average, consumer prices will probably increase at a rate similar to that of 1986 (3,5 to 4,0 %) which includes the effects of energy tax rises to eliminate the impact of lower oil prices and of the dollar

exchange rate on consumer spending power ⁽¹⁾. The current account of the balance of payments should show a considerable improvement.

The wage drift experienced during 1986, as a result of sectoral imbalances in the labour market, together with the envisaged rise in productivity, suggests that a moderate wage settlement in line with previous experience would be appropriate, particularly taking into consideration the expected alleviation of personal taxation in 1987.

Disregarding interest payments abroad, the current account deficit appears to be essentially the result of excessive domestic absorption rather than the consequence of reduced price competitiveness. The recent weakening of the Danish krone within the EMS illustrates, however, that the margin of manoeuvre of the authorities remains narrow and that monetary policy must take due account of the need to ensure sufficient capital imports. Measures to raise the level of private savings and to reduce the debt of households – such as those introduced in October – are therefore of prime importance. In this respect, an extension of pension schemes, to cover a wider section of the population, based on personal contributions and possibly as part of the wage settlement, might be another useful contribution. In the shorter run the external constraint would thus be loosened whereas, in the longer run, increased savings would ensure the financing of higher investment and improve growth potential without endangering the external balance.

⁽¹⁾ The forecasts in the text seek to take into account the effects of the measures adopted in October, whereas it has not been possible to make corresponding revisions to the figures in Table 29.

There is also the need to adapt the structure of the Danish economy to the changing international environment. Action has already been taken, and further proposals are pending, to extend training and research facilities in areas where their application may be particularly effective. Opportunities to reorganize existing work patterns, to deregulate and to increase the adaptability of the labour market should be considered and discussed with the social partners.

As a result of past current deficits, the external gross debt is now close to 40 % of GDP, with private and public debt each accounting for about half. With an increase in nominal GDP of some 6 % per year on average over the coming years, the external debt/GDP ratio could be maintained constant with a current external deficit of some 2,5 % of GDP. With a lower deficit, the external debt would tend to fall in proportion to GDP. As a first step, it would seem urgent already in 1988 to bring the external deficit down to the level consistent with a constant debt/GDP ratio and, in the short run, this can hardly be achieved without a continued tight fiscal policy stance in line with the official objectives. A further reduction of the external deficit should take place in subsequent years to the extent that a lowering of the debt/GDP ratio is aimed at. For 1987, the general government net lending implicit in the finance bill is, at about 3 % of GDP, approximately unchanged from 1986 and is consistent with a small surplus in the central government budget. In view of the existing external constraint and the necessity to ensure a balanced development of the Danish economy, the effective achievement of this target is desirable, implying a vigorous implementation of the policy of zero real growth in public expenditure pursued in recent years.

TABLE 29

Denmark: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product	11,7	11,7	9,1	14,4	10,4	9,9	9,5	7,8	5,5
{ value	:	1,6	-0,9	3,0	2,0	3,4	3,8	2,9	1,8
{ volume	:	9,9	10,1	11,3	8,1	5,8	5,4	4,8	3,7
{ deflator									
Private consumption deflator	6,6	10,1	12,0	10,8	7,2	6,6	5,0	3,3	2,8
{ private	:	-5,1	-19,7	10,9	4,0	12,4	15,9	10,7	-1,3
{ public	:	-2,2	-17,0	-9,4	-15,4	1,7	5,4	2,4	2,1
Gross fixed capital formation volume	6,6	-3,1	-19,2	7,1	0,9	11,0	14,6	9,8	-0,9
{ total									
of which: construction	:	-4,9	-21,7	-1,3	1,1	7,2	13,1	6,3	-0,7
equipment	:	0,7	-15,0	20,1	0,6	15,8	16,5	13,7	-1,2
Domestic demand at constant prices	:	0,6	-4,1	3,5	0,9	4,0	5,3	4,1	1,8
Gap with respect to other Community countries ⁽³⁾	:	:	:	2,7	-0,3	2,6	3,3	-0,7	-1,5
Compensation of employees per head	10,7	11,7	9,2	12,1	7,9	5,4	4,4	4,0	5,9
{ nominal									
{ real A ⁽⁴⁾	3,4	1,6	-0,8	1,4	-0,2	-0,3	-1,0	-0,7	2,1
B ⁽⁴⁾	3,8	0,8	-2,5	1,6	0,6	-1,1	-0,6	0,7	3,0
Productivity ⁽⁵⁾	3,2	1,2	0,4	2,7	1,6	1,2	0,7	0,0	1,5
Real unit labour costs	0,2	0,4	-0,9	-1,3	-1,8	-1,5	-1,7	-0,7	0,6
Competitiveness ⁽⁶⁾	1,7	-0,3	-7,5	-3,2	-0,5	-3,5	0,9	3,8	0,6
Employment	1,1	0,4	-1,3	0,3	0,5	2,4	3,1	1,9	0,3
Registered unemployed as % of the civilian labour force ⁽⁷⁾	1,1	5,5	8,9	9,5	10,2	9,8	8,7	7,5	7,6
Current balance as % of GDP	-2,1	-3,5	-3,0	-4,2	-2,2	-3,3	-4,4	-4,1	-3,6
Long-term interest rate	9,0	16,0	19,3	20,5	14,4	14,0	11,6	10,4	10,5
Money supply ⁽⁸⁾	10,6	11,7	9,1	11,4	25,5	17,0	15,8	7,7	2,9
Net lending or borrowing requirement of general government as % of GDP	2,0	-0,6	-7,1	-9,3	-7,3	-4,2	-1,9	2,8	2,8
Public debt as % of GDP	:	19,2	43,6	53,0	62,8	67,7	66,4	61,1	57,1
Public dept interest as % of GDP	:	2,2	5,3	6,0	8,1	9,6	9,8	8,8	8,0

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, which do not take into account the effects of the measures adopted later in that month.⁽³⁾ Differences in percentages points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁷⁾ Eurostat definition.⁽⁸⁾ End of the year.

FEDERAL REPUBLIC OF GERMANY

1986 marks the fourth year of upswing in the *Federal Republic of Germany*. At the beginning of the year, however, the growth trend was outweighed by the combined effects of a number of special adverse factors, such as the unusually harsh winter, uncertainties as to future dollar and oil price movements, and the particularly low number of working days. Despite renewed strong economic expansion from the second quarter onwards, the economy's growth in 1986, at some 3 % in real terms, is likely to be somewhat lower than was still expected at the beginning of the year. The principal driving forces behind growth have been private consumption and business investment. Consumer spending has been boosted by wage increases which, in view of virtually stable consumer prices, are permitting real private consumption in 1986 to grow at its fastest rate since 1971. Investment, on the other hand, has been supported by stronger domestic sales and a further increase in profits related to the improvement in the terms of trade. The weak trend of export volumes and strong growth of import volumes, both of which had become evident at the end of 1985, have led to a considerable deterioration of the real external balance (—1,4 % of GDP). Nevertheless, the current account surplus has climbed to a new record level (almost DM 63 thousand million) as a result of a substantial improvement in the terms of trade.

Although the special factors which supported demand in 1986 will weaken in 1987, there will be further inherent strength in domestic demand and export prospects (particularly in the EMS area) should again improve somewhat. The upswing will therefore continue into its fifth year; in 1987 real gross domestic product is likely to grow by 3¼ %. With the terms of trade remaining more or less unchanged, prices will move in line with domestic costs and rise only moderately. The surplus on current account is likely to contract considerably to around DM 44 thousand million (or 2,1 % of GDP).

Employment is likely to increase, on an annual average, by about 280 000 in 1986 and by another 250 000 in 1987. Unlike previous phases of economic upswing, in which the increase was concentrated in the services sector, employment in manufacturing industry should also grow considerably, at rates of 1½ % this year and 1 % next. Despite increased use of measures to improve the labour market situation, the fall in unemployment, by 80 000 in 1986 and some 90 000 in 1987, is still much smaller than the rise in employment, since most of the new jobs are being filled by jobseekers not registered as unemployed.

Although in recent years, by comparison with its European neighbours, the Federal Republic of Germany has enjoyed a more favourable economic situation, the unemployment problem is still acute. It should therefore be a top priority to redress this state of affairs through decisive action. In past

years, the two sides of industry have already taken account of the changing conditions on the labour market; the negotiated wage settlements resulted in a decline of the wage share in the economy as a whole by more than 4 % between 1981 and 1985. This trend has continued in 1986, helped by the terms of trade improvement, even though the unexpectedly favourable movement of domestic prices in 1986 was, understandably, not anticipated in wage settlements.

The moderate increase of real wages in recent years has resulted in a marked improvement in enterprises' profits, with a corresponding rise in rates of return on investment. The more favourable investment climate has already led to a rise in business investment as a whole, which is now once again increasingly serving to expand capacity, and investment in construction other than in dwellings has also risen again noticeably for the first time.

Investment in dwellings has developed less favourably, with the declining population trend and the mismatch between building costs and incomes severely exacerbating the prevailing underlying tendency of weakening demand. Here much will depend in future years on building costs rising at a slower rate than the overall price trend. The change of emphasis in residential investment towards maintaining the existing housing stock and increasing its quality provides an opportunity for increasing the employment content of investment activity in this area.

The crisis in the building industry was intensified in the last few years by the decline in the public investment. In the framework of public finance consolidation, particularly with respect to local authority budgets, progress was made partly at the expense of public investment. Since 1985, however, public investment has again been rising, in the current year by about 6 % in nominal terms. Investment in the infrastructure, environmental protection and urban renewal has been supported by additional measures, which were also of benefit to private investment. The first stage of the tax reform and the small reduction in social security contributions for unemployment insurance (by 0,1 %) has also helped to improve supply-side conditions while at the same time underpinning demand. Furthermore, the medium-term financial plans of the territorial authorities provide for annual growth of public investment of 4 to 5 % (in nominal terms) up to 1990. In contrast to recent years, the increase in such investment would thus correspond to the growth of the economy as a whole.

Monetary policy has stayed on a course of stability, permitting a further fall in the inflation rate and a market-induced reduction in loan interest rates to a historical low. So far this development has been favoured by external

factors. In the course of 1986, the growth of central bank money continuously overshot its target range, which led the Bundesbank to proceed cautiously in respect of a further reduction in short-term interest rates.

Supply conditions of enterprises have been further improved at the microeconomic level. Even though skill-related wage differentials have not been pursued extensively, shorter working hours were agreed in several more industries, and a growing number of new types of working time arrangements are being introduced, in order to improve employment opportunities. In view of the significant shortage of skilled workers which has arisen in the Federal Republic, employers' endeavours to provide vocational training and retraining should be reinforced.

Monetary, budgetary and wages policies, in their efforts to improve the environment for more employment-creating growth, have together had an effect in the desired direction. In addition, helped by the improvement in the terms of trade, the evolution of internal demand has been buoyant. As the positive impact of the oil shock slowly diminishes, future German economic policy, in its efforts to achieve steady economic growth at an appropriate rate and with price stability, faces a new test.

With regard to the budgetary policy of recent years, the public deficit has been reduced to such an extent that an easing of income tax in two stages — in 1986 and 1988 — is possible without endangering the success of consolidation. The central government (consolidated federal government and Länder) deficit has only narrowed slightly in 1986 and, against the background of present growth prospects, the deficit of approximately 2% of GNP forecast for 1987 appears acceptable. Particularly in view of the risks to economic activity which could emanate from external developments, budgetary policy should be prepared to react rapidly to any significant slackening of demand in the economy as a whole. The second step of the tax cuts, which in 1988 will provide relief of almost DM 10 thousand million to households, should raise incentives, by reducing the progressive element of taxation, and support demand. The tax reform announced for the next legislative period should also contribute to raising incentives and thereby strengthen the forces for growth. This will be all the

more successful, the sooner the details of the tax reform are decided. If the associated necessary expenditure cuts were set out at the same time, it would be easier for the repeatedly announced selective dismantling of subsidies to take shape. In addition, one could envisage, where appropriate, and within the limits of available capacity, expanding worthwhile public investment beyond the budgetary provisions. Finally, consideration could also be given to the possibility of reducing social security contributions to the Federal Labour Office; in recent years its budget has been in surplus, and this is likely to grow in future, given falling unemployment.

Wage developments should also further contribute towards employment policy. This is all the more likely, the more secure the demand prospects. The rise in real *per capita* wages should also remain below productivity growth in the economy as a whole. Wage negotiators must therefore be aware that next year, in contrast to the unique situation of 1986, there will be no additional income gains available for distribution arising from the terms of trade, and that it is important that export prices reflect as little as possible of the deterioration of competitiveness due to the appreciation against the dollar, which naturally puts pressure on the profit situation of enterprises.

Monetary policy should stick to its present course, which is directed towards financing sufficient growth of productive potential in the medium term while keeping prices stable. Provided that wage costs do not have the effect of pushing up prices, such a policy is likely to offer some scope for further market-induced reductions in interest rates. On the other hand, a reduction of key interest rates, necessitated by external economic developments, could even have an unfavourable impact on interest rate expectations at the long end of the market, depending on the strength of monetary expansion.

In order to improve supply conditions at the microeconomic level, numerous measures have already been taken, affecting the markets both for factors of production and for goods. Administrative obstacles and, in some sectors, excessive government influence continue to stand in the way of an efficient allocation of resources. Such obstacles should be dismantled more energetically than has so far been the case.

TABLE 30

Federal Republic of Germany: Main economic aggregates 1961 to 1987

(Annual percentage changes)									
	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	8,9	7,1	4,2	3,7	4,8	4,7	4,9	7,1	4,6
{ volume	4,4	2,2	0,2	-0,6	1,5	2,7	2,6	3,1	3,2
{ deflator	4,4	4,8	4,0	4,4	3,3	1,9	2,2	3,9	1,4
Private consumption deflator	3,5	4,8	6,2	4,8	3,2	2,5	2,1	0,0	1,1
Gross fixed capital formation (volume)									
{ private	3,7	0,9	-3,9	-4,5	5,1	1,2	-0,3	7,1	5,5
{ public	5,9	0,3	-9,7	-9,3	-8,6	-2,1	-0,4	5,0	4,8
{ total	4,0	0,8	-4,8	-5,3	3,2	0,8	-0,3	3,5	5,5
of which: construction	3,5	-0,3	-5,1	-4,3	1,7	1,6	-6,2	0,7	3,5
equipment	5,2	3,0	-4,3	-6,7	5,6	-0,5	9,4	7,5	8,0
Domestic demand at constant prices	4,5	2,3	-2,7	-2,0	2,3	1,9	1,5	4,8	4,2
Gap with respect to other Community countries ⁽³⁾	:	:	:	-3,4	1,5	0,2	-0,9	2,0	0,7
Compensation of employees per head									
{ nominal	9,2	7,4	5,2	4,1	3,8	3,4	3,0	4,0	3,2
{ real A ⁽⁴⁾	4,6	2,5	1,2	-0,3	0,5	1,4	0,8	0,1	1,8
B ⁽⁴⁾	5,5	2,5	-0,9	-0,7	0,6	0,9	0,9	4,0	2,1
Productivity ⁽⁵⁾	4,1	2,5	0,9	1,1	3,0	2,6	1,9	1,9	2,2
Real unit labour costs ⁽⁶⁾	0,5	0,0	0,3	-1,4	-2,4	-1,1	-1,0	-1,8	-0,4
Profitability ⁽⁷⁾	:	:	:	4,2	11,2	4,4	6,4	12,6	2,9
idem (1961 to 1973 = 100)	100	70,9	70,9	73,9	82,2	85,8	91,3	102,8	105,8
Competitiveness ⁽⁸⁾	:	:	:	2,5	1,5	-2,0	-2,5	5,4	1,8
Employment	0,2	-0,3	-0,7	-1,7	-1,5	0,1	0,7	1,1	1,0
Registered unemployed as % of the civilian labour force ⁽⁹⁾	0,8	3,6	4,8	6,9	8,4	8,4	8,4	8,1	7,7
Current balance as % of GDP	0,7	0,4	-0,8	0,5	0,6	1,0	2,2	3,2	2,1
Long-term interest rate	7,2	7,8	10,4	9,0	7,9	7,8	6,9	5,6	5,1
Money supply ⁽¹⁰⁾	10,9	8,5	5,0	7,1	5,3	4,7	5,0	5,6	5,4
Net lending or borrowing of general government as % of GDP	0,3	-2,9	-3,7	-3,3	-2,5	-1,9	-1,1	-0,9	-0,7
Public debt as % of GDP	17,7	27,7	36,4	39,5	41,0	41,9	42,5	41,6	41,3
Public debt interest as % of GDP	0,9	1,6	2,3	2,8	3,0	3,0	3,0	2,9	2,9

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Ratio of real wages per head to productivity.⁽⁷⁾ Net operating surplus relative to net capital stock at current replacement cost.⁽⁸⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy, positive figure = loss of competitiveness.⁽⁹⁾ Eurostat definition.⁽¹⁰⁾ M3; end of year.

GREECE

In Greece, the stabilization measures taken in October 1985 to re-establish conditions for durable growth and eventual convergence of the economy with the rest of the Community, represent a turning away from the economic policy that had allowed the disequilibria to get worse. In 1985, the public sector net borrowing requirement had thus reached some 18 % of GDP, with the current balance of payments deficit at US \$ 3 300 million, or 10 % of GDP. In response to this situation, the Government, in October 1985, finalized a rigorous stabilization plan consisting, notably, of a 15 % devaluation of the drachma and the introduction of an obligatory non-interest bearing deposit on certain imports. This two-year plan aims at bringing about a marked slowdown in the rise in wage costs, a sharp reduction in the public sector borrowing requirement, and a significant decrease in monetary growth. The Government was assisted in its efforts to redress the balance of payments by a Community loan, the first instalment of which was paid immediately, with the second instalment to follow at the beginning of 1987.

Wage policy is now based on the adjustment of wages to the targeted, rather than the observed, rate of inflation, which excludes the effects of import prices. Applied with determination, this policy will have helped to reduce real wages by more than 7 % in 1986, and to limit the rise in unit wage costs in manufacturing industry to an annual average of 13 %, compared with 20,5 % in 1985. This trend, together with an exchange-rate policy which is disinflationary in that it offsets the differential in unit wage costs and not the differential in retail prices, and a moderate adjustment in administered prices during 1986, will have allowed a slowdown in the rise in consumer prices from 25 % at the end of 1985 to 16 % at the end of 1986. However, because of the substantial overhang from the end of 1985, the slowdown will not show up in the annual average, which is likely to reach 22,5 % in 1986, compared with 19,3 % in 1985 ⁽¹⁾.

On the public finance front, where the emphasis has been more on boosting revenue than on curbing expenditure, the public sector borrowing requirement in 1986 will be down to about 14 % of GDP, in other words an improvement of 4 points compared to 1985, a reduction in conformity with the Council Decision granting the Community loan but considerably below that planned at budget time. Moreover, a significant proportion of the improvement — about 2,5 % of GDP — will have been due to the fall in oil prices, most of which the Government decided to offset by an increase in taxation on petroleum products. In regard to monetary policy, the target for aggregate domestic credit expansion

could be exceeded, not only because of the disappointing results of the sales of government bonds to the public, but also because the margin for increasing private sector credit was overestimated by reference to the actual trend in the public deficit.

Moreover, other factors have contributed to the delay of the adjustment in demand. Consumption, after many years of growth, responded only very slowly to the stabilization measures, this inherent inertia aided by the working of the underground economy. On top of this, there were expectations in the early months of a further devaluation, the effects of which were amplified by the high degree of liquidity in the economy reflecting the excess level of domestic credit in the first half relative to the targets set. Consequently, real domestic demand in 1986 as a whole showed only a relatively small fall, mainly because of the decline in public sector investment, while private consumption will have scarcely changed from its level of the previous year. Thus, imports did not slow down to the extent expected, while, on the other hand, exports were less buoyant than forecast. Overall, GDP will still have recorded some slight growth in 1986. The belated improvement in the real external balance, as a result of a temporarily unfavourable structure of exports and a mediocre outcome recorded for tourism, combined with the unfavourable effect which devaluation had initially on the terms of trade, has meant that, despite an appreciable improvement in the second half of the year, the current balance of payments could show a deficit for 1986 as a whole between 4,5 and 5 % of GDP, slightly more than the planned target of US \$ 1 700 million.

These developments should encourage determination in the application of the stabilization plan in 1987.

Wage policy should aim to ensure moderate growth in nominal wages and salaries on the basis of an inflation rate which will have been brought down to 10 % by mid-1987 — if the effects of introducing VAT are excluded — and by strict application of the indexation system adopted at the end of 1985. The disinflationary effects of wage policy in 1987 will nevertheless be limited, so that the main focus of the stabilization policy should be on budgetary and monetary management.

The strengthening of the public finances will have to be pursued rigorously in order to bring the public sector net borrowing requirement in 1987 down to a level compatible with the budgetary objective set in the stabilization plan. Given the rapid rise in the interest burden, this requires very strict control of other expenditure, particularly that on public consumption. In addition, transfers to firms will have to be sharply reduced by, *inter alia*, cutting back on export aids, agricultural subsidies and financial assistance to firms in difficulty. The necessary increase in revenue will come

⁽¹⁾ In November 1986, the Government imposed a freeze on prices until the end of January 1987 in order to prevent excessive price rises, following the introduction of VAT.

from the widening of the tax base, greater efforts to combat fraud and the extra receipts generated by the introduction of VAT on 1 January 1987.

Strict control of the public finances will again have to be accompanied by an expansion of credit to the private sector below the growth rate of nominal GDP, estimated at 12%. To this end, policy on interest rates will have to be more active in 1987: the movement towards positive real interest rates, bearing in mind the scarcity of capital resources, should be maintained and the efforts to unify lending rates, already started in 1986, continued. In addition, the sale of medium-term government securities to the general public should be developed. Such a policy will allow more efficient allocation of financial resources and will encourage saving and capital inflows while at the same time exercising its own disinflationary effect.

Such stabilization measures are essential if macroeconomic equilibrium is to be restored but are nevertheless insufficient to ensure the economy's longer-term growth; this can only come from achieving the type of investment that will strengthen and modernize the country's industrial base. The competitiveness of the economy could thus be improved in a way which would enable the external constraint to be overcome for good, while at the same time increasing employment sufficiently to bring down unemployment. In this context, there is a need to make progress in deregulating prices and profits as well as freeing the operation of the labour market.

Implementation of the policy outlined above should allow the results achieved in the second half of 1986 to be maintained in 1987 and, in particular, to reduce further the external deficit and the rate of inflation. The decline in real personal disposable income and the restrictive budget policy stance will lead to a decrease in consumption, while industrial investment should pick up in response to the expected improvement in business profitability, though without entailing an increase in equipment investment as a whole, as a result of the restrictions imposed by the budget on public enterprises. The decline which this will bring about in domestic demand should lead to a further reduction in imports, while exports should continue to be buoyed up by a relatively expansive environment. Overall, real GDP could, nevertheless, show a slight fall in 1987 as a whole. Since this outlook does not suggest any improvement in employment, unemployment could very well increase. By contrast, if oil prices remain at their 1986 level, it will be possible to bring the current account deficit down to US \$ 1 300 million, or 3,5 % of GDP, still a relatively high level.

Therefore, the stabilization plan aiming to restore major equilibria will have to be applied rigorously in 1987. In the longer term, it will be necessary to pursue an adjustment policy based on efforts to restructure the economy within the framework of prudent monetary and budgetary policies.

Only in this way will the Greek economy be able to become competitive again and enjoy lasting growth.

TABLE 31

Greece: Main economic aggregates 1961 to 1987

(Annual percentage changes)									
	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	12,5	19,8	19,6	24,5	20,3	23,0	19,6	23,2	12,1
{ volume	7,6	3,4	-0,3	-0,2	0,3	2,6	2,1	0,5	-0,2
{ deflator	4,5	15,8	20,0	24,7	19,9	19,9	17,1	22,6	12,3
Private consumption deflator	3,6	16,0	23,3	21,2	18,6	18,0	18,4	22,5	12,5
Gross fixed capital formation volume									
{ private	:	:	:	:	:	:	:	:	:
{ public	:	:	:	:	:	:	:	:	:
{ total	10,0	-1,0	-7,5	-1,9	-1,9	-4,7	3,4	-3,0	0,5
of which: construction	:	:	-7,7	-13,2	3,9	-7,7	2,6	2,0	1,6
equipment	:	:	-7,1	14,1	-8,2	-0,9	4,4	-9,0	-1,0
Domestic demand at constant prices	:	:	:	2,9	-0,7	0,8	4,9	-0,8	-1,2
Ga0 with respect to other Community countries ⁽³⁾	:	:	:	2,2	-1,4	-1,0	2,8	-6,1	-4,5
Compensation of employees per head									
{ nominal	10,2	21,1	23,4	25,4	21,8	22,6	20,4	13,6	9,6
{ real A ⁽⁴⁾	5,5	4,6	2,9	0,5	1,5	2,3	2,8	-7,3	-2,4
B ⁽⁴⁾	6,5	4,5	0,1	3,4	2,7	3,9	1,7	-7,2	-2,6
Productivity ⁽⁵⁾	8,2	2,7	-5,0	0,9	-0,1	2,9	1,0	0,0	-0,2
Real unit labour costs	:	:	:	-0,3	1,6	-0,6	1,9	-7,3	-2,3
Competitiveness ⁽⁶⁾	2,6	0,0	3,5	9,0	-3,4	1,4	-2,8	-16,0	-2,9
Employment	-0,6	0,8	0,1	-1,3	-1,0	-0,2	1,1	0,5	0,0
Registered unemployed as % of the civilian labour force ⁽⁷⁾	:	:	:	:	7,9	8,1	7,8	7,6	8,3
Current balance as % of GDP	-2,9	-2,2	-0,2	-3,8	-4,7	-4,1	-8,4	-5,8	-3,7
Long-term interest rate	:	11,3	17,7	15,4	18,2	18,5	15,6	14,0	14,5
Money supply ⁽⁸⁾	18,2	23,7	34,7	29,0	20,3	29,4	26,7	19,0	14,9
Net lending or borrowing requirement of general government as % of GDP	:	:	-10,6	-9,4	-8,9	-10,1	-13,9	-10,6	-7,1
Public debt as % of GDP	:	:	33,0	36,7	41,4	47,5	54,8	55,0	56,5
Public debt interest as % of GDP	:	1,7	3,2	2,6	3,4	4,6	5,5	6,0	6,1

(1) Estimates of the Commission services, October 1986.

(2) Forecasts of the Commission services, October 1986, on the basis of present policies.

(3) Differences in percentage points.

(4) A: GDP deflator; B: private consumption deflator.

(5) Gross value added per occupied person in the whole economy.

(6) Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.

(7) Eurostat definition.

(8) End of year.

SPAIN

In *Spain*, there was a marked acceleration in economic growth in 1986; GDP, underpinned by an appreciable upturn in domestic demand, could grow by some 3 % in volume terms. Private consumption has benefited not only from a degree of improvement in real wages but also, for the first time since the first oil shock, from a appreciable recovery in employment and a reversal of the tendency of the unemployment rate to go on rising. Gross fixed capital formation has felt the favourable effects of the improvement in profits, of better market prospects and of the need for industrial modernization connected in particular with the Community's enlargement. Because of the weakness of export markets and the jump in import volume, notably of manufactures, the external account's contribution to growth was substantially negative in real terms. Nevertheless, balance of payments on current account improved sharply because of the very large terms of trade gain resulting from the fall in energy and commodity prices. The acceleration observed at the beginning of the year following the introduction of VAT and the upsurge in food prices in the middle of the year did not compromise the basic disinflation trend in 1986. However, in terms of annual averages, there is an appreciable inflation differential between Spain and other Member countries.

For 1987, the real GDP growth rate should be at least of the same order of magnitude as in 1986, i. e. some 3 %. In view of the expected recovery in the growth of third-country markets, exports should prove more dynamic and help maintain a large external surplus. Domestic demand will probably benefit from the same favourable influences as in 1986, but private and public consumption will probably expand a little less rapidly than in the previous year. The rate of price increase should fall quite markedly while still remaining above the Community average. Overall employment should continue to improve in 1987, under the impetus of a favourable economic environment. Nevertheless, unemployment will remain very high (21,5 % of the labour force) chiefly because the active population will go on increasing rapidly (at a rate of over 1 % a year).

The economic policy implemented since 1983 corresponds, in its intentions and many of its aspects, to the main lines of the 'cooperative growth strategy for more employment' adopted by the Community in the autumn of 1985, and the social dialogue is well advanced. In particular, the aim is, by moderating real wages, to stimulate job-creating investment while ensuring that domestic demand expands sufficiently and that the competitiveness of the Spanish economy is maintained. In addition to the main challenge facing this strategy — to obtain a very significant reduction in unemployment, which is far higher in Spain than in the other Member States — these policies are also aimed at meeting the challenge presented by accession to the Community.

The severe overshooting of labour costs, observed after the first oil shock, was followed by a more moderate evolution in recent years. Maintaining the purchasing power of wages has

continued to be the objective in 1985 and 1986, under the Social and Economic Agreement signed in October 1984. The Agreement provided for nominal wage increases to be held within the limits of the target inflation rate. However, because nominal wage increases were accompanied by considerable wage drift, the slowdown in the growth of nominal wages per head seen in recent years was interrupted in 1986.

Significant progress has been recorded in restoring the fundamental conditions necessary to achieve a balanced development of the economy. For the first time in many years, price increases at the consumption stage fell to a single-digit rate in 1985. In 1986, the decline in the inflation rate is being fostered by the fall in the prices of oil and other raw materials, but the introduction of VAT and the rise in food prices have acted in the opposite direction. Nominal unit labour costs have risen slightly faster as a result of a slower productivity increase, contributing particularly to relatively rapid price increases in the services sector. The current account, which was in deficit until 1983, showed growing surpluses thereafter as a result mainly of the steady increase in the surplus on the services account and, in particular, tourism.

Because of the improvement in the economic environment, corporate profits, after falling to a relatively low level at the start of the 1980s, staged a recovery reinforced by the application of tax measures which authorized investments for 1985 and 1986 to be fully written off. These investments have been undertaken primarily for the purpose of rationalization, and, until recently, in order to save energy. Moreover the significant inflow of foreign direct investment, which has expanded in the last few years, actually continued in 1986, chiefly as a result of the favourable prospects opened up by accession.

The efforts taken in hand to reduce the general government borrowing requirement, which amounted to 6,2 % of GDP in 1985, should allow it to be brought down to below 5 % of GDP in 1986 despite the relatively rapid increase in the local authorities' deficit. The effect on tax revenue of the introduction of VAT seems to have been slightly positive rather than neutral, as originally forecast, while two-thirds or so of the reduction in oil prices has been compensated by an increase in government revenue. On the expenditure side, the chief factors which have helped to cut the deficit in 1986 have been the smaller increase in interest charges and the stabilization of capital transfers. Monetary policy will probably achieve during 1986 the planned slowdown in the growth of the monetary aggregate (ALP). The overshooting recorded in the first half implied a tightening of monetary policy and a rise in interest rates, which only resumed their downward movement after July. Even though relatively high in nominal terms, interest rates have remained considerably lower in real terms than the Community average.

Exchange-rate policy is aimed at stabilizing the effective nominal exchange rate of the peseta against the trading partners in the Community; because of a relatively strong rise in domestic prices, this has entailed a slight competitiveness loss in 1986.

On the supply side, the adjustment policy has been strengthened since 1983 and again reinforced in March 1986 by provisions designed particularly to stimulate saving and investment, to reduce the impact of bureaucracy on the economy, and to increase labour-market flexibility.

If employment is to stage a lasting recovery and unemployment is to be gradually scaled down, it is essential to consolidate the results already achieved in restoring the major equilibria and pursuing an energetic adjustment policy. The options adopted by the Government formed after the last elections are in line with this aim.

Because of the particularly severe imbalance between the supply of, and the demand for, jobs, the objective to be

pursued when renewing the Social and Economic Agreement should be the strict control of real labour costs per head. This is the path which must be followed by a highly protected economy, which is now being liberalized and which has a large number of vulnerable small and medium-sized enterprises, if it wishes to maintain its competitiveness while continuing the process of reducing inflation and ensuring its smooth integration into the large common market.

With regard to macroeconomic policy, budgetary policy for 1987 should continue to conform with the medium-term objectives set by the authorities. Further progress in the collection of VAT and in combating tax evasion should result in a relatively buoyant evolution of budget resources. On the other hand, the policy of moderating operating expenditure should continue, the main aim being to create some margin for the more sustained evolution of public investment. It seems advisable to reduce the general government borrowing requirement to some 4% of GDP in 1987. This will, moreover, ease the task of monetary policy and, in particular, will help interest rates to come down while permitting a further reduction in external indebtedness.

TABLE 32

Spain: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	14,8	20,0	14,1	14,7	14,6	13,9	11,3	15,1	9,3
{ volume	7,2	1,8	0,4	0,9	2,5	2,3	2,1	2,9	3,0
{ deflator	7,1	17,8	13,6	13,7	11,9	11,3	9,0	11,8	6,1
Private consumption deflator	6,7	18,2	14,9	13,9	12,5	19,8	8,4	8,6	5,3
Gross fixed capital formation volume									
{ private	:	:	:	:	:	:	:	:	:
{ public	:	:	:	:	:	:	:	:	:
{ total	:	-2,0	1,2	-2,5	-1,0	-3,0	5,4	7,2	7,0
of which: construction	:	-2,2	-2,0	1,5	:	:	1,5	6,0	5,8
equipment	:	-1,7	5,2	-7,1	:	:	12,0	9,0	8,8
Domestic demand at constant prices	7,8	2,2	-1,5	0,5	0,8	-0,9	2,4	4,9	3,9
Gap with respect to other Community countries ⁽³⁾	:	:	:	:	:	:	:	:	:
Compensation of employees per head									
{ nominal	14,7	22,3	16,3	12,8	13,5	13,0	9,5	9,7	6,3
{ real A ⁽⁴⁾	7,2	3,9	2,3	-0,7	1,5	1,2	-0,5	-1,9	0,2
{ B ⁽⁴⁾	7,6	3,9	1,0	-1,2	1,1	1,7	1,1	1,0	0,9
Productivity ⁽⁵⁾	6,4	3,9	3,3	1,4	2,9	6,6	3,4	1,0	1,8
Real unit labour costs	0,8	0,0	-1,0	-2,1	-1,4	-5,1	-2,8	-2,9	-1,6
Competitiveness ⁽⁶⁾	:	:	:	-0,5	-10,9	3,1	0,3	-0,2	-0,5
Employment	:	(-1,9)	(-2,8)	-1,0	-0,7	-2,9	-1,2	1,8	1,2
Registered unemployed as % of the civilian labour force ⁽⁷⁾	:	(7,1)	14,4	16,2	17,7	20,7	22,1	21,7	21,5
Current balance as % of GDP	:	-1,7	-2,4	-2,3	-1,4	1,3	1,7	3,5	3,7
Long-term interest rate	:	:	15,8	16,0	16,9	16,5	13,4	11,6	10,6
Money supply ⁽⁸⁾	:	17,6	17,0	16,6	16,0	13,2	12,9	11,0	8,0
Net lending or borrowing requirement of general government as % of GDP	:	-0,9	-3,0	-5,3	-5,3	-5,0	-6,2	-4,9	-4,4
Public debt as % of GDP	:	13,8	21,0	26,2	32,1	39,3	46,3	49,0	52,7
Public debt interest as % of GDP	:	0,6	0,7	1,0	1,3	2,1	3,5	3,4	3,3

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁷⁾ Eurostat definition.⁽⁸⁾ End of year.

FRANCE

In France, private consumption has held up better in 1986 than in 1985 thanks to the appreciably faster growth in spending power, due, *inter alia*, to the progress made in reducing inflation. Helped by the improvement in firms' financial situations, the upturn in investment has also been maintained and has continued to spread to the distributive trades and services. Domestic demand has thus been much more buoyant than in previous years. This has resulted in a high level of imports; exports, however, have grown only slightly, implying further losses of market shares. Given the normal reaction lags, the April exchange-rates adjustment has only very partially checked the trend towards deterioration of the real external balance in 1986. Nevertheless, the terms of trade gains will have been sufficient to bring about a marked improvement in the trade balance in value terms. Moreover, considerable progress has been made in reducing inflation, as a result of moderating wage costs and the sharp fall in energy and raw material costs, with consumer prices rising at an annual rate of 2,4 %. In this situation, real GDP should grow by 2,3 % and employment in the enterprise sector should increase very slightly, though not enough to reverse the upward trend in unemployment.

In 1987, the trend of domestic demand should be similar to that in 1986 if, as the continuing improvement in firms' financial positions would suggest, the level of investment increases. Furthermore, the lagged impact of improved competitiveness following the 1986 currency adjustment is likely to reduce the restraining effect of external trade on growth. All in all, GDP growth should reach 2,5 %; this should permit a slightly greater increase in employment but still no fall in unemployment. The rise in consumer prices should again tend to fall somewhat and the trade balance should continue to improve.

The stabilizing measures taken since 1983 and the improved terms of trade have therefore brought about a marked acceleration in growth, but the hoped-for recovery in the employment situation has not yet begun. Although there has been a slight increase in the numbers employed, the measures taken in connection with the social security treatment of unemployment have been insufficient to compensate for the natural increase of the labour force, so that unemployment has again risen slightly.

Concerned by the inadequate achievements on the employment front, the Government elected on 16 March 1986 has taken, or is preparing to take, a number of social measures intended to stimulate recruitment. It has made a series of amendments to labour legislation, which are designed, by making employment conditions more flexible, to encourage firms to take on more staff. Thus,

in addition to the adjustments made to the rules and regulations governing working hours at the end of the last parliament, the new Government has introduced provisions designed to ease the conditions governing redundancies, thus removing, with effect from 1 January 1987, the obligation to obtain prior administrative authorization. New redundancy procedures are at present under negotiation between the two sides of industry. A further series of measures introduced by decree are intended to extend the use of fixed-period employment contracts, part-time working and casual labour. Finally, in addition to the measures already taken by the previous government regarding the social security treatment of unemployment, provisions were incorporated in the June 1986 amending budget to give direct encouragement to firms to take on young people between the ages of 16 and 25 through temporary reductions in social security contributions; other measures to boost employment are being prepared.

Nevertheless, any upturn in employment depends more fundamentally on the competitiveness of the economy and on the profitability of enterprises. These are the two determinants of the increased pick-up of investment required to expand production capacities. The inadequacy of investment in the competitive sector over a period of many years, its unsatisfactory distribution across industries, its belated recovery, and the fact that it has been predominantly directed towards rationalization, have prevented the productive system from responding satisfactorily to changing and potentially accelerating demand. The Government is therefore aiming to give direct or indirect support to the effort that firms still have to make to meet this priority need.

Thus, the new Government has resolutely continued the liberalization policy intended to restore firms' pricing freedom, removing the restrictions on their foreign exchange transactions and making it easier for them to obtain finance. On the prices front, a number of measures have been taken since the autumn of 1985, which will have led, by the end of 1986, to the virtually complete liberalization of industrial prices and trade margins and to a total freeing of prices and margins in the service sector. Exchange controls have, for the most part, been abolished for firms and for private individuals. Finally, major reforms have been made to the operation of the financial market; these include the opening-up of the money market to non-financial operators, and a set of measures to restore competition between financial intermediaries through the abolition of certain privileges regarding deposit-taking, through the replacement of ceiling controls on credit by liquidity regulation based on interest rates and through the gradual liberalization of interest rates in banking. This package of measures is intended to create a climate more propitious to enterprise, enabling businesses to adapt more readily to market trends.

In the wages field, the policy followed in the public sector and behaviour in the private sector should continue to exhibit considerable restraint, implying only a limited rise in the purchasing power of earnings. These developments should allow firms' competitiveness to be strengthened and enable them to invest sufficiently to make possible a gradual acceleration in capacity expansion.

Public finance policy should also help to achieve this goal as it seeks to reduce the burden on the economy of taxation and social security contributions and of the public deficit. While it is true that the direct tax concessions already made or planned will be partially offset by the increase in certain social security contributions intended to forestall a social security deficit, the measures adopted should generally be neutral in regard to households, but favourable to firms, not only because of the direct benefits but also because they should promote a flow of funds to the financial market. Furthermore, although the need to maintain the public finances in equilibrium is bound to lead to further expenditure cuts and therefore to the abolition of certain subsidies, firms should nevertheless derive greater benefit from the fact that the contraction in the deficit is likely to help

bring interest rates down. In attempting, in the manner described, to reduce the central government's borrowing requirement and the general government net borrowing to approximately 2,6 % of GDP, budgetary policy in 1987 is committed to public finance consolidation while encouraging the growth of productive capacity and employment.

The monetary policy stance has continued to be one of great caution, but has, nevertheless, permitted an appreciable fall in nominal interest rates. The capital inflows which followed the April 1986 currency adjustment have made possible the early repayment of certain external debts. Together with other neutralizing factors, this has helped to keep the growth in the money supply at around the 5 % target, which is appreciably lower than the growth rate of nominal GDP. The same caution should prevail in 1987 in order to consolidate the substantial progress already made in reducing inflation. Provided that the international environment is favourable, it should not prevent a further fall in interest rates, the normal outcome of the improved financial equilibrium of firms and of central government.

TABLE 33

France: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	10,7	13,9	12,3	14,7	10,3	8,7	7,2	6,9	5,3
{ volume	5,6	2,8	0,5	1,8	0,7	1,3	1,4	2,2	2,5
{ deflator	4,9	10,8	11,8	12,6	9,5	7,3	5,8	4,6	2,7
Private consumption deflator	4,7	10,8	12,8	11,2	9,5	7,3	5,5	2,5	2,3
Gross fixed capital formation volume									
{ private	7,7	1,5	-1,0	-0,4	-2,2	-2,0	2,8	5,7	6,2
{ public	3,2	0,3	-1,4	9,7	-3,0	2,3	2,2	2,8	2,4
{ total	7,6	1,3	-1,1	0,7	-2,3	-2,2	3,1	5,3	5,7
of which: construction	:	0,3	-2,1	-3,5	-3,5	-4,4	-0,6	1,0	3,0
equipment	:	1,8	-1,6	6,7	1,6	-1,5	5,1	6,9	6,0
Domestic demand at constant prices	5,8	2,9	-0,4	3,8	-0,2	0,6	2,1	3,6	2,9
Gap with respect to other Community countries ⁽³⁾	1,1	0,8	1,4	3,0	-1,1	-1,2	0,1	0,2	0,6
Compensation of employees per head									
{ nominal	9,9	14,7	14,3	13,7	10,7	7,8	6,7	4,5	3,0
{ real A ⁽⁴⁾	4,8	3,6	2,2	1,0	1,1	0,5	0,9	-0,1	0,3
B ⁽⁴⁾	5,1	3,5	1,3	2,3	1,1	0,5	1,2	2,0	0,7
Productivity ⁽⁵⁾	4,8	2,5	1,0	1,7	1,2	2,4	1,7	2,1	2,2
Real unit labour costs	0,0	1,1	1,6	-0,7	-0,1	-1,8	-0,6	-2,2	-1,9
Rates of return ⁽⁶⁾	:	:	:	-1,5	5,5	5,0	5,7	14,0	9,9
idem (1961 to 1973 = 100)	100	57,8	46,3	45,6	48,1	50,5	53,4	60,9	66,9
Competitiveness ⁽⁷⁾	-0,8	0,9	-5,3	-2,2	-1,0	-0,1	3,0	-0,2	-2,3
Employment	0,6	0,2	-0,7	0,1	-0,6	-1,0	-0,3	0,1	0,3
Registered unemployed as % of the civilian labour force ⁽⁸⁾	1,1	5,0	7,7	8,7	8,8	9,9	10,3	10,5	10,7
Current balance as % of GDP	0,2	-0,7	-1,4	-3,0	-1,7	-0,9	-0,8	0,1	0,4
Long-term interest rate	7,0	11,1	16,3	16,0	14,4	13,4	11,9	9,5	7,5
Money supply ⁽⁹⁾	13,7	13,6	10,4	10,8	11,2	8,3	5,6	4,8	4,5
Net lending or borrowing requirement of general government as % of GDP	0,5	-0,8	-1,8	-2,5	-3,2	-2,9	-2,6	-2,9	-2,6
Public debt as % of GDP	:	25,4	26,0	29,1	30,7	32,9	35,2	36,9	39,2
Public debt interest as % of GDP	:	1,3	2,1	2,2	2,6	2,8	2,8	2,9	2,9

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Net operating surplus on the net capital stock of current replacement cost.⁽⁷⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of the competitiveness.⁽⁸⁾ Eurostat definition.⁽⁹⁾ End of year.

IRELAND

In Ireland, the immediate economic outlook has brightened. Favourable external factors have powerfully reinforced the gradual recovery already under way. Private consumption regained an upward path in 1985/86, but this has to be seen in the light of the steep fall in the first half of the decade. Aggregate investment has not yet stabilized, but is likely to strengthen gradually next year, particularly as the contraction in public sector activity slows. As yet, building and construction activity shows little sign of renewed vitality; on the other hand, private sector investment in capital goods, which had fallen back following a peak in the replacement cycle in 1984/85, is likely to return to a more positive trend in 1987. Export volumes are no longer increasing at the very high levels of recent years, but continue to grow, though at more modest rates. Import movements have tended to be volatile but are expected to respond to stronger final demand. In 1987 therefore, when the beneficial effects of the fall in the price of crude oil earlier this year are more fully felt in the economy, and on the basis of existing policies, real GDP should grow by over 3 %, with inflation, at about 3 %, the lowest since 1966 and the current account in small deficit. On the negative side, relatively slow progress is being made in reducing the large public deficits while the situation in the labour market remains very serious. In 1986, the fall in employment slowed while the unemployment rate steadied.

An acceleration in net emigration and a decline in participation rates have, at least temporarily, checked growth in the labour supply and allowed the unemployment rate to stabilize at around 18 %. In the year to April 1986, net emigration reached 30 000, causing a small population fall for the first time in a quarter of a century. Nevertheless, the interplay of demographic influences over the medium term is still likely to produce an average annual labour force growth of $\frac{1}{2}$ %. Thus, if unemployment is to be reduced substantially, employment must rise at a much faster rate. Ultimately, the level of employment growth required can only be achieved if the capacity of the economy itself to generate significant numbers of new jobs is considerably enhanced.

This will require appropriate macroeconomic policies, in particular a loosening of the constraints imposed on the economy by the high public deficits, more moderate increases in real wages, and more attention to the efficient and flexible functioning of markets. The recently expanded training and marginal employment schemes have an important contribution to make in the shorter term. A social employment scheme, introduced in early 1985, offering 10 000 longer-term unemployed part-time work for one year, mainly on local authority projects, reached its participation target by mid-1986 after an initially slow response. Other schemes, particularly the Enterprise Allowance Scheme, designed to help unemployed persons start their own business, and the Employment Incentive

Scheme, which subsidizes incremental employment, have also been successful, at least in terms of participation.

The very open nature of the Irish economy means that wages policy must be designed not only to improve the profitability of investment, and to reduce the share of labour-saving investment, but also to maintain international competitiveness. Recently, competitiveness pressures have intensified, in particular as a result of the weakness of sterling, and have prompted an 8 % devaluation of the Irish pound within the EMS in August 1986. Viewed under all these aspects, recent wage trends in Ireland have not been appropriate. Real *per capita* wages for the total economy, measured using the private consumption deflator, fell somewhat in the early 1980s after a period of sharp increase; they recovered thereafter and in both 1986 and 1987 are expected to grow by 3 % (and by $1\frac{1}{4}$ % and $2\frac{3}{4}$ %, respectively, measured using the GDP deflator); the relatively high 1987 figure is partly due to the current public-service wage agreement, which will give public servants a 3 % real wage increase in that year. Real wage increases in manufacturing industry have tended to exceed those for the total economy. Moreover, while the dispersion in the level and timing of wage settlements has allowed greater wage flexibility in weaker firms, it has not protected them from the impact on their costs of developments in the sheltered sector of the economy, where a policy of moderation in real wages has been less rigorously pursued.

A specific feature of the Irish economy is the leading role of branches of foreign-owned firms in the export base; these are established mainly in a few 'high-tech' sectors. Current policy recognizes the continuing importance of direct foreign investment, but aims at securing a better balance of output and employment through encouraging native-owned firms to compete more successfully in exporting and related activities. This will require major investment. In this regard, adequate levels of corporate profitability have become a more important determinant for investment, given current constraints on public spending and, in particular, a more selective use of investment incentives. In addition, high real interest rates have reversed a trend towards tax-based capital borrowing by companies from the banks. While global profit levels in recent years have improved, the relatively more dynamic performance of the foreign-owned sector implies that many native firms have been doing badly. The general boost to profits imparted by the oil price fall may thus be directed initially to consolidating balance sheet positions and only later to new investment. Bearing in mind also that recent trends in investment in capital goods reflect replacement or capital deepening activity to a greater extent than the desired capital widening among native firms, investment in manufacturing seems likely to fall considerably short of the

level required to meet the target of 7% annual growth in output set in the 1984 White Paper on Industrial Policy.

If the improvement in the economy now in train is to stimulate better balanced investment and output and a resumption of growth in employment, increased efforts are necessary to secure moderate increases in incomes. In this context, the Government's recent guidelines on new pay settlements are to be welcomed. It is equally essential to correct the imbalances in the public accounts at a faster pace. An appreciable reduction in the Exchequer deficit over the medium term is the only way of arresting growth in the public debt, and would also contribute to lower real interest rates, more moderate levels of taxation and, in general, an environment more favourable to the healthy growth of output and employment. Declared official policy ⁽¹⁾ is to reduce the Exchequer deficit to just under 10% of GNP (8½% of GDP) by 1987. In 1986, however, it now appears likely that the planned budget target for the deficit, 10¾% of GDP, will be exceeded by 1 percentage point. While part of the excess is due to circumstances of a non-recurring nature, a number of factors, principally the full year incidence of the income tax reductions made in the 1986

budget and the current public-service wage agreement, imply a substantial commitment of resources already and therefore a correspondingly limited scope for the authorities to achieve the planned level of adjustment in 1987. In these circumstances, the authorities should make every effort to reach their declared target, but in any event should reduce the Exchequer deficit by some 1½ percentage points of GDP relative to the expected out-turn of nearly 12% for 1986. It is equally important however, that they take adequate account of the medium-term dimension in framing budgetary policy for 1987. In particular, it is essential to avoid budgetary commitments which reduce the scope for a substantial degree of adjustment in 1988 and thereafter; it is equally important to decide on appropriate expenditure cuts to set spending on a firm downward trend in the near future, even if not having their major impact in 1987. These expenditure cuts must be correspondingly larger to the extent that any adjustments in tax rates or allowances and any modest expansion of public investment are accommodated within overall resource constraints.

⁽¹⁾ Set out in the medium-term macroeconomic plan 'Building on Reality'.

TABLE 34

Ireland: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product ⁽³⁾									
{ value	12,0	19,4	21,3	17,3	9,1	10,8	7,1	7,6	6,8
{ volume	5,4	2,7	3,4	1,4	-1,9	4,2	2,0	1,8	3,1
{ deflator	6,4	16,2	17,4	15,7	11,3	6,3	5,0	5,6	3,6
Private consumption deflator	6,3	16,2	19,6	15,9	10,0	7,5	4,2	3,7	3,2
Gross fixed capital formation volume									
{ private	:	:	:	:	:	:	4,7	4,0	8,3
{ public	:	:	:	:	:	:	-5,2	-7,6	-3,7
{ total	9,3	4,1	7,3	-5,5	-9,3	-2,7	-0,3	-1,6	2,9
of which: construction	8,0	3,6	6,6	-4,8	-12,2	-13,5	-7,5	-4,5	1,3
equipment	11,2	4,6	8,1	-6,3	-6,1	8,1	5,5	0,5	4,0
Domestic demand at constant prices	5,4	2,2	3,0	-2,9	-4,1	1,0	-0,4	1,5	2,5
Gap with respect to other Community countries ⁽⁴⁾	:	:	:	:	:	:	:	:	:
Compensation of employees per head									
{ nominal	11,5	19,6	18,3	15,3	11,1	12,3	7,3	6,9	6,0
{ real A ⁽⁵⁾	4,1	3,8	0,8	-0,3	-0,2	5,7	2,2	1,3	2,3
{ B ⁽⁵⁾	5,2	3,0	-1,1	-0,5	1,0	4,5	3,0	3,1	2,7
Productivity ⁽⁶⁾	4,1	2,5	4,0	1,9	0,0	6,2	4,6	2,9	2,5
Real unit labour costs ⁽⁷⁾	1,0	2,0	-3,1	-2,2	-0,2	-0,5	-2,3	-1,6	-0,1
Competitiveness ⁽⁸⁾	:	:	:	:	:	:	:	:	:
Employment	0,2	1,1	-0,7	0,5	-2,0	-1,9	-2,5	-1,1	0,7
Registered unemployed as % of the civilian labour force ⁽⁹⁾	4,7	8,1	10,2	12,2	15,0	16,6	18,0	18,4	18,0
Current balance as % of GDP	-4,7	-7,4	-14,0	-9,9	-6,4	-5,5	-3,2	-1,3	-1,3
Long-term interest rate	7,2	14,2	17,3	17,0	13,9	14,6	12,7	9,8	8,8
Money supply ⁽¹⁰⁾	12,1	19,5	17,4	13,0	5,6	10,1	5,3	5,4	7,3
Net lending or borrowing of general government as % of GDP	:	-10,1	-13,2	-13,8	-11,8	-9,8	-11,6	-10,7	-9,8
Public debt as % of GDP ⁽¹¹⁾	:	76,2	89,8	96,2	108,3	114,9	118,2	121,5	125,1
Public debt interest as % of GDP ⁽¹¹⁾	:	5,4	7,0	8,6	9,1	9,7	10,6	10,0	9,6

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Expenditure measure at market prices.⁽⁴⁾ Differences in percentage points.⁽⁵⁾ A: GDP deflator; B: private consumption deflator.⁽⁶⁾ Gross value added per occupied person in the whole economy.⁽⁷⁾ Ratio of real wages per head to productivity.⁽⁸⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁹⁾ Eurostat definition.⁽¹⁰⁾ M3; end of year.⁽¹¹⁾ Refers to Exchequer debt.

ITALY

In *Italy*, measures tending to reduce the automatic nature of wage and salary adjustments, and fiscal changes designed partly to achieve a better balance of direct taxation as between wage and salary earners and the self-employed, had the effect of curbing private consumption at the beginning of the year. This factor, tending to slow activity temporarily, was offset by the strength of exports. Subsequently, domestic demand as a whole grew faster, helped by the effects of the marked fall in import prices on households' purchasing power and on enterprises' profits, while exports have remained on an upward trend. Overall, real GDP is likely to expand by 2,6 % in 1986, inducing employment growth of 0,5 %. This faster growth is coupled with a substantial slowing of inflation, the private consumption deflator, on an annual average basis, falling from 9,4 % in 1985 to 6,2 % in 1986. At the same time, despite the high import elasticity, the trade balance has recovered sharply under the influence of the considerable terms of trade improvement. The current balance should thus register a surplus amounting to some 1,2 % of GDP in 1986, compared with a deficit of 1 % in 1985.

In 1987, consumer demand will be stimulated by the application of the new collective wage settlements, agreed towards the end of 1986, and by the continued rapid rise of non-wage incomes, while enterprises' propensity to invest should strengthen further. Moreover, the momentum of external demand should be maintained. Demand as a whole is therefore likely to be strong, so that real GDP could increase by about 3,5 %, which, however, in all probability implies a significant reduction of the external surplus. The rate of inflation could drop below 4 %, and thus to a level not seen since the end of the 1960s.

Against this background, the authorities should continue their efforts to reduce the structural imbalances on the labour market and in the public finances and thus restore conditions for lasting and balanced growth. The two problem areas are not unconnected, since the still excessively high level of absorption of resources by the public sector hinders the progress of the productive system towards greater efficiency and a higher level of employment.

Even though the economic background described above should, in the short term, be conducive to a progressive improvement in the labour market and to bringing down the unemployment rate, this has not yet been evidenced during 1986. In fact, companies have begun by taking back workers who were temporarily laid off and using the authorized scope for overtime before taking on new recruits. Furthermore, the improved employment prospects have had a positive impact on the activity rate. As a result, the unemployment rate has not fallen as hoped, remaining at 10,6 %.

This unsatisfactory evolution does not reflect the efforts already made by the public authorities in the last three years to improve the functioning of the labour market. Since 1984,

companies have been authorized to recruit part of their workforce from the persons appearing on the employment office lists, solely on the basis of their professional skills, rather than being constrained to follow the order of inscription on the lists. Attempts have also been made to develop fixed-term employment contracts and training contracts for young workers, but with limited success. The Ministry of Labour has also produced an important medium-term programme for reforming the labour market, intended to modify its structure and increase its flexibility. This programme has led to the adoption of an emergency plan for the recruitment, over two years, of 40 000 young people into the public and semi-public sectors, with the help of financial contributions from the central government. Finally, at the end of September, the Government provided for the allocation of funds for infrastructure and reconstruction work in the south of Italy, which should allow an estimated 200 000 temporary jobs to be created.

Also, at the end of 1985, as a result of conciliation by the Government, the wage-indexation system was substantially modified, by tacit agreement, for a four-year period; indexation now compensates for only about half of inflation. In a more relaxed climate of labour relations, a framework agreement was signed in industry in May 1986, settling the dispute concerning the decimal point increases on the sliding scale which were not paid in 1985 ⁽¹⁾, and setting out the principle of measures to help the recruitment of young people, among whom the unemployment rate is particularly high in Italy. The conclusion of three-year collective agreements in industry should ratify the framework agreement signed in May in a more relaxed climate than usual; the only serious problem remaining is the reduction of working hours.

The social dialogue has thus helped towards an appreciable easing of production costs, which is being reinforced by the large fall in import prices, and which is bound to spread progressively from the sectors which are closely linked to oil imports towards those less directly linked.

In 1987, the progress made in reducing inflation and the foreseeable acceleration of economic activity will tend to stabilize the pressure of the public deficit on the financial markets; this will still be excessive, however, and will continue to be a major problem, thus justifying the stated intention of the Government to eliminate gradually the part of the deficit in excess of interest charges. The economic outlook for 1987 offers an exceptional opportunity to make

⁽¹⁾ The Italian industrial confederation and the trades unions differed on the interpretation of one point of their collective agreements of 1983, which had for the first time modified the indexation system but had not set out clearly whether fractions of a point of the index would be cancelled or taken into account at a later date.

definite progress in the direction indicated by the Treasury Minister's consolidation plan. In order to ensure that this comes about, a new budgetary procedure was adopted in June. Each year, by the end of July, Parliament is to approve a three-year economic and financial planning document comprising the chief macroeconomic objectives and the major budget aggregates. The autumn discussion in Parliament would thus take place within an agreed framework, and a safeguard clause would freeze appropriations to the extent of the spending cuts set out in legislation yet to be adopted. The document, produced by the three responsible ministers (Treasury, Financial Affairs and Budget), and adopted by Parliament with a lengthy delay following the government crisis, sets a macroeconomic framework for 1987 which is close to the Commission's forecasts. It reflects the Government's intention to bring the Treasury borrowing requirement down to below the target set for 1986 and to reduce it to Lit 100 000 000 000 000 or 12,2% of GDP, compared with Lit 110 000 000 000 000, or 14,6% of GDP, in 1986. The achievement of this objective, with taxes and social security contributions as a whole unchanged as a percentage of GDP compared to 1986, depends on implementing, as is the Government's declared intention, a further shift of emphasis in taxation towards indirect taxes, together with a strict limitation of current expenditure, in line with inflation, and of capital spending, in line with nominal GDP growth.

Monetary policy is set on a course of progressively easing interest rates as inflationary forces moderate. The three successive cuts in the discount rate which were made in March, April and May 1986, nevertheless, slightly exceeded the decline in inflation because of the easing of international

interest rates. A further decline could come about as a result of the effective implementation of the announced budgetary policy. While reaffirming its determination to defend the lira's position on the foreign exchanges, the Government has also embarked on a cautious but resolute policy of liberalization of capital movements.

Now that these economic policies are in the course of implementation there are already signs that the fundamental equilibria can be durably restored as mainly evidenced in the return to stability of the lira exchange rate within the EMS. This course, and, in particular, the policy of budgetary austerity, should be pursued, taking all necessary measures to limit the Treasury deficit to the target of Lit 100 000 000 000 000 set for 1987.

The disappointing evolution of employment is evidence that the adjustment of real wage rates in relation to productivity does not yet appear adequate, and that the productive base has not developed at the desired pace. These deficiencies, while being reduced in the north and centre, are still very evident in the south. Whilst this situation calls for further prudence in wage trends, it could also be improved by adjusting government receipts, without impairing the overall equilibrium of the public finances, in order to ease to a greater extent social security contributions in the southern regions. With the same goal in view, the improvement of the financial structure of enterprises, achieved notably through directing savings into investment in shares, and the continued strengthening of deficit areas of the public sector would help to strengthen the competitiveness of the economy and, in consequence, promote employment on a more stable basis.

TABLE 35

Italy: Main economic aggregates 1961 to 1987

		(Annual percentage changes)								
		1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product	value	11,0	20,9	18,5	17,2	14,6	13,6	11,3	12,7	9,1
	volume	5,3	2,8	0,2	-0,5	-0,4	2,6	2,3	2,8	3,6
	deflator	5,4	17,6	18,3	17,8	15,0	10,7	8,8	9,7	5,3
Private consumption, deflator		4,9	17,3	19,2	17,0	15,1	11,1	9,4	6,2	4,0
Gross fixed capital formation volume	private	:	:	:	:	:	:	:	:	:
	public	:	:	:	:	:	:	:	:	:
	total	5,7	0,9	0,6	-5,2	-3,8	4,1	4,1	4,6	7,2
of which:	construction	6,6	-0,2	0,5	-3,2	-2,0	-0,4	-1,7	1,9	2,4
	equipment	5,0	2,2	1,8	-6,8	-5,7	10,1	9,9	7,1	11,3
Domestic demand at constant prices		5,3	2,5	-2,2	-0,3	-2,0	3,3	2,4	3,6	5,1
Gap with respect to other Community countries ⁽³⁾		0,6	0,4	0,4	-1,0	-3,2	1,9	0,2	-2,0	1,6
Compensation of employees per head	nominal	11,6	20,2	21,9	17,2	16,5	12,0	10,0	6,7	6,1
	real A ⁽⁴⁾	5,9	2,2	3,0	-0,4	1,2	1,1	1,1	-2,7	0,8
	B ⁽⁴⁾	6,5	2,3	2,3	0,2	1,2	0,8	0,5	0,4	2,1
Productivity ⁽⁵⁾		5,7	2,2	-0,3	-0,4	-0,5	2,2	1,8	2,3	2,3
Real unit labour costs		:	:	:	0,0	1,8	-1,0	-0,8	-4,9	-1,5
Rates of return ⁽⁶⁾		:	:	:	-8,6	-28,5	21,0	7,9	40,8	10,4
<i>idem</i> (1961 to 1973 = 100)		100	51,7	51,1	46,7	33,4	40,4	43,6	61,4	67,8
Competitiveness ⁽⁷⁾		-0,3	-0,1	-0,7	2,2	11,3	3,7	-0,5	0,8	1,9
Employment		-0,4	0,8	0,5	-0,1	0,1	0,4	0,5	0,5	1,3
Registered unemployed as % of the civilian labour force ⁽⁸⁾		5,2	5,9	8,0	9,7	10,9	11,9	12,9	13,4	12,8
Current balance as % of GDP		1,5	-0,5	-2,3	-1,6	0,2	-0,8	-1,1	1,2	0,9
Long-term interest rate		6,9	13,3	20,6	20,9	18,0	14,9	13,0	10,6	8,7
Money supply ⁽⁹⁾		14,7	21,5	15,9	17,2	13,2	12,1	11,1	7,5	7,5
Net lending or borrowing requirement of general government as % of GDP		-3,3	-9,0	-11,7	-12,7	-12,4	-13,0	-14,0	-12,7	-11,0
Public debt as % of GDP		44,8	67,7	70,2	76,8	84,3	91,1	99,5	103,1	106,8
Public debt interest as % of GDP		1,8	4,9	7,2	8,5	9,0	9,6	9,3	9,6	8,8

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Net operating surplus on the net capital stock of current replacement cost.⁽⁷⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁸⁾ Eurostat definition.⁽⁹⁾ End of year.

LUXEMBOURG

In *Luxembourg*, economic activity has remained at a high level in 1986, due to the increase in domestic demand; its driving force, private consumption, has benefited from the big rise in personal disposable income. Total exports have advanced less rapidly than last year because of a slight dip in the sales of steel products. All in all, gross domestic product should grow by about 2,5 %. Inflation has abated sharply and the unemployment rate has fallen slightly.

In 1987, gross domestic product should grow at a rate similar to that recorded in 1986. A stabilization in the level of sales of steel products and the continuing vigorous increase in deliveries of other products will underpin the faster growth of total exports. However, the expansion of business investment could run out of steam. The upward movement of consumer prices is liable to pick up speed because of a sharper increase in wage costs in the services sector, and because an open economy is very exposed to externally induced inflationary risks. On the labour market, the increase in numbers employed will be accompanied, as in the preceding year, by a fall in the number of unemployed and a sharp cut in the number of persons covered by special employment schemes.

In most respects, the economic policy pursued by the Government is compatible with the guidelines of the cooperative strategy for growth and employment. Budgetary policy has also contributed by measures underpinning demand: part of the room for manoeuvre which became available after the steel industry was restructured was used to reduce personal income tax in 1986, and in 1987 it will again be possible to reduce personal and company taxation. There will also be scope for supplementing the public investment funds in order to guarantee the financing of their medium-term programmes. The efforts to diversify the structure of the Luxembourg economy have been continued by selective action to assist new enterprises.

The trend of wages and salaries started to pick up speed at the end of 1984, leading to rises in 1986 and 1987 which are making up for earlier losses. In real terms, compensation of employees per head will probably increase by more than the growth of labour productivity. Even if this has positive effects on domestic demand in the short term, the risk is that competitiveness of enterprises will be damaged while rationalization investment — unsuited to the creation of more jobs — will be encouraged and industrial diversification held back. As a result, the next wage negotiations will be particularly important.

The integration of young people into the labour market will require an additional effort to adapt vocational training to enterprises' skilled labour requirements, in order to eliminate the existence of a hard core of young unemployed, although it is also necessary to recruit non-resident workers for new jobs. Against the background of international competition, it is becoming increasingly desirable to modify working hours in line with the needs of companies. Less rigid legislation would enable management and unions to negotiate, at the level of the firms, more flexible systems of work organization.

As a result of the slow rise in tax receipts, partly due to a cut in direct taxes, and a steady rise in expenditure, in particular on salaries and transfers, general government net lending will fall in 1986 and 1987. Although the investment fund reserves are sufficient to finance projects for the provision of adequate infrastructure in the fields of both traditional public investment and of telecommunications and electronic data processing, a certain amount of prudence will have to be exercised in the management of other expenditure, in order to maintain equilibrium in the central government budget and thus ensure some room for manoeuvre for the future.

TABLE 36

Luxembourg: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	8,6	8,5	9,8	10,3	9,4	12,4	7,7	8,0	5,3
{ volume	4,1	1,5	-0,1	0,9	1,6	5,3	2,2	2,4	2,6
{ deflator	4,4	6,6	9,9	9,4	7,7	6,7	5,4	5,4	2,6
Private consumption deflator	3,1	7,5	8,6	10,6	8,0	6,4	4,0	0,5	1,3
Gross fixed capital formation volume									
{ private	:	:	-7,7	-0,7	-5,2	-0,2	2,5	3,0	2,1
{ public	:	:	-1,4	0,6	2,3	-4,9	-0,5	3,0	1,1
{ total	5,1	-0,3	-6,2	-0,4	-3,3	-1,4	1,7	3,0	1,9
of which: construction	:	:	-2,5	1,1	-1,4	-3,1	0,7	2,1	0,8
equipment	:	:	-13,2	-3,7	-7,5	2,5	4,0	5,0	4,0
Domestic demand at constant prices	:	:	1,8	-0,2	0,4	0,2	1,8	3,0	3,0
Gap with respect to other Community countries ⁽³⁾	:	:	:	0,4	0,4	-0,9	0,2	-0,8	-0,4
Compensation of employees per head									
{ nominal	7,3	11,1	8,8	7,2	7,6	6,8	4,5	4,2	5,6
{ real A ⁽⁴⁾	3,0	4,3	0,6	-2,5	-0,6	0,2	-0,8	-1,2	2,9
B ⁽⁴⁾	4,2	3,5	0,1	-3,1	0,4	0,4	0,5	3,7	4,2
Productivity ⁽⁵⁾	3,1	0,9	-1,7	1,1	2,8	4,9	0,8	1,6	1,9
Real unit labour costs	-0,1	3,4	2,3	-3,6	-3,3	-4,5	-1,6	-2,8	1,0
Employment	1,0	0,8	0,4	-0,4	-0,1	0,6	1,4	0,8	0,7
Registered unemployed as % of the civilian labour force ⁽⁶⁾	0,0	0,4	1,0	1,3	1,6	1,7	1,6	1,3	1,2
Current balance as % of GDP	6,7	20,1	19,0	25,0	28,2	30,2	29,6	31,5	30,7
Long-term interest rate	:	:	:	:	:	:	:	:	:
Money supply ⁽⁷⁾	:	:	:	:	:	:	:	:	:
Net lending or borrowing requirement of general government as % of GDP	2,0	2,9	-3,1	-2,3	-0,6	1,5	4,1	3,7	2,6
Public debt as % of GDP	:	15,9	14,0	14,4	14,8	14,7	14,3	14,0	14,0
Public debt interest as % of GDP	:	0,8	1,0	1,0	1,1	1,2	1,3	1,3	1,3

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Eurostat definition.⁽⁷⁾ End of year.

THE NETHERLANDS

In the *Netherlands*, economic performance in 1986 has been marked by a less rapid growth in export volume due to the fall in sales of natural gas. By contrast, the rise in the purchasing power of households – resulting from the reduction in social security contributions and the fall in inflation, due to an improvement in the terms of trade when money wages had already been fixed to a large extent – has led to a sharp increase in private consumption. Business investment has again been buoyant, whereas investment in residential construction and public sector investment have remained sluggish. Overall, at 1,6 %, GDP will have grown almost as much as last year, while the output of the corporate sector, excluding the energy sector, is likely to have increased by 2,7 %. The rate of inflation is down to zero, and interest rates have fallen by almost a percentage point. The less favourable movement of the trade balance and of transfers has led to a slight reduction in the surplus on current account, in spite of the 2,6 % improvement in the terms of trade, due to the fact that the fall in the export price of natural gas has lagged behind the fall in oil prices.

In 1987, GDP growth is not likely to accelerate greatly, probably reaching a rate of approximately 1,8 %. Exports are likely to grow more rapidly overall, as the volume of sales of natural gas will show a less marked fall than in 1986. The 1986 oil price fall will cause a redistribution of income in 1987, taking into account its lagged effect on the price of natural gas (of the order of 3 % of GDP), from the government budget to companies, households and abroad. Notwithstanding Government measures, affecting expenditure and current receipts, to prevent a too-strong deterioration of its deficit, which will slow down private consumption, internal demand should increase at a rate comparable with that of 1986. The improvement in corporate profitability and the increase in capacity utilization rates will stimulate business investment further, residential construction will probably increase slightly but public sector investment is likely to slow down. The general level of prices may well be lower than in 1986. The deterioration in the terms of trade by more than 1 % should reduce the surplus on current account. Thanks to the growth in manufacturing output, employment will increase and, in addition, because of the reorganization of working time, the unemployment rate will decline, though still remaining very high (11,1 %).

The economic policy which the Government has pursued in recent years on the basis of its autumn 1982 programme has already been broadly in line with certain principles and ideas now underlying the cooperative strategy for growth and employment. This has been true, for example, of the improvement in the working of the labour market, wage

moderation and better balance for the budget. The measures taken to increase the adaptability of the labour market have concentrated mainly on the decentralizing wage negotiations, freezing minimum wages, reducing working hours and extending opportunities for part-time employment and early retirement. Supply conditions have also been helped by the two-stage reduction in corporation tax. Real wage rises have been moderate in recent years; the policy of decentralized negotiations has worked satisfactorily, and the Government has not participated directly in the framing of agreements. In the public sector, a freeze on nominal salary levels was introduced and the Government is currently imposing very strict limits on pay negotiations in this sector, which will have to take account of budgetary policy constraints and developments in the market sector. In 1984/85, this wage policy caused private demand to slacken; in 1986, however, the reduction in employees' social security contributions is boosting the real spending power of households, who are also benefiting from the decline in inflation. Falling interest rates have reinforced the stimulatory effect that the improvement in business profitability has had upon investment.

The policy pursued by the Central Bank, based mainly on maintaining the guilder's parity against the German mark within the EMS, has helped to reduce inflation to a very low level, and has allowed interest rates to be brought down in line with the international trend. Liberalization measures have been taken on the financial and money markets to facilitate access by foreign banking institutions to the Dutch market and the use of new financing instruments by Dutch companies. Priority has had to be given in budgetary policy to reducing the medium-term public sector deficit in order to reinforce budget management and to underpin the structural adjustment of the economy; this has left little scope for supporting economic growth in the short-term. Despite the substantial reduction made in the deficit in 1985, developments on the energy markets have worsened the budget problem. In order to forestall too serious a deterioration in the deficit in 1987, decisions have had to be taken to cut expenditure and to increase indirect taxes; thus, active measures to sustain demand through the budget will be virtually impossible.

The new Government's economic policy objectives are to reduce the budget deficit, to stabilize or lower the burden of taxes and social security contributions, to maintain purchasing power and to reduce unemployment. Because of the high level of unemployment, continued priority will need to be given to exploring all possible means of increasing employment, and the measures already taken will need to be extended, even though some of them, such as the reduction in working hours, have not yet produced the expected equivalent increase in recruitment. It is therefore highly important to ensure that the agreement between employers and unions and the Government's programme for providing

the young unemployed with vocational training or work experience are implemented as soon as possible. The emergence of bottlenecks in some sectors of the labour market demonstrates how urgent it is to improve skills.

The results of the decentralized wage negotiations appear to allow the competitive position of firms to be maintained. Similarly, the Government's policy of standing back from wage negotiations is unlikely to affect the trend of public expenditure, since the link between adjustments to pay and transfer payments in the public sector and adjustments to wages and salaries in the private sector has been severed and there are no plans to restore it. The public sector will probably not escape entirely from some adjustment to wage and salary levels, at least for certain categories, since it will otherwise be impossible to recruit qualified staff, the lack of which is already beginning to be felt.

The appreciable fall in natural gas revenue from 1987 will make it considerably more difficult to reduce the central government budget deficit, which, according to the

Government's programme, should be cut to 5¼% of net national income in 1990 compared with 6,7% in 1986. Some deterioration in the general government borrowing requirement (excluding early repayment of social housing loans), which is expected to exceed 8% of net national income in 1987, with a central government deficit of 7,9%, is thus unavoidable. This outcome presumes the implementation of an extensive programme for making up the shortfall due to changes in hydrocarbon prices, both through cuts in expenditure and through the raising of new revenue. In 1987, government debt increases further, by more than 7 percentage points of GDP, and it is therefore important to pursue a tight budgetary stance in order to contain the central government net borrowing requirement within the limits implicit in the budget, and to create the necessary conditions for subsequent reductions.

This guideline in no way detracts from a policy of restructuring public expenditure and, as far as possible, revenue, intended to stimulate the growth of the private sector and including direct employment measures which have already produced satisfactory results.

TABLE 37

Netherlands: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	11,3	9,6	4,8	4,5	3,0	4,9	4,2	2,0	0,1
{ volume	5,3	2,4	-0,7	-1,4	1,4	2,4	1,7	1,6	1,8
{ deflator	6,0	7,1	5,5	6,0	1,6	2,5	2,4	0,4	-1,7
Private consumption deflator	5,2	7,3	6,3	5,3	2,7	2,5	2,6	0,0	-1,0
Gross fixed capital formation volume									
{ private	:	:	-11,5	-3,5	3,3	3,7	5,2	6,2	3,7
{ public	:	:	-4,6	-7,1	-4,6	7,6	-4,3	0,4	-3,1
{ total	6,3	-0,2	-10,4	-4,1	2,1	4,3	3,7	5,4	2,8
of which: construction	:	:	-10,8	-6,4	-3,4	2,5	-3,3	4,1	2,4
equipment	:	:	-9,6	0,2	10,0	7,0	13,7	7,0	3,3
Domestic demand at constant prices	:	:	-4,6	-0,9	1,5	1,4	2,2	2,3	2,4
Gap with respect to other Community countries ⁽³⁾	:	:	:	-1,2	-0,2	-0,7	0,7	-1,5	-1,4
Compensation of employees per head									
{ nominal	11,4	9,5	3,5	5,8	3,2	0,8	1,4	2,1	1,7
{ real A ⁽⁴⁾	5,0	2,2	-1,9	-0,3	1,5	-1,7	-1,0	1,7	3,4
{ B ⁽⁴⁾	6,0	2,0	-2,7	0,5	0,4	-1,7	-1,2	2,1	2,7
Productivity ⁽⁵⁾	3,9	2,1	0,8	1,1	3,0	2,2	0,6	0,5	0,9
Real unit labour costs	1,1	0,1	-2,7	-1,4	-1,5	-3,8	-2,6	1,2	2,5
Competitiveness ⁽⁶⁾	2,7	0,7	-9,7	2,5	-2,7	-6,2	-3,9	4,4	0,6
Employment	0,9	0,3	-1,5	-2,5	-1,9	-0,4	1,1	1,1	0,8
Registered unemployed as % of the civilian labour force ⁽⁷⁾	1,3	5,3	8,6	11,6	14,0	14,3	13,1	12,0	11,1
Current balance as % of GDP	0,5	0,8	2,2	3,2	2,9	4,1	4,3	3,9	2,8
Long-term interest rate	5,9	9,4	12,2	10,5	8,8	8,6	7,8	6,8	6,1
Money supply ⁽⁸⁾	10,3	9,6	5,3	7,6	10,5	7,7	10,5	5,1	3,5
Net lending or borrowing requirement of general government as % of GDP	-0,4	-2,5	-5,5	-6,6	-5,9	-6,2	-5,1	-5,5	-6,6
Public debt as % of GDP	:	41,7	50,3	55,6	62,3	66,3	70,0	75,5	82,6
Public debt interest as % of GDP	:	3,1	4,4	4,7	5,3	5,6	6,0	6,4	6,4

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Differences in percentage points.⁽⁴⁾ A: GDP deflator; B: private consumption deflator.⁽⁵⁾ Gross value added per occupied person in the whole economy.⁽⁶⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁷⁾ Eurostat definition.⁽⁸⁾ End of year.

PORTUGAL

Because of its heavy dependence on imported energy, the Portuguese economy derived particular benefit from the reverse oil shock, and continued its expansion at a rate above the Community average in 1986. The rate of growth of GDP (in volume), estimated at near 4 %, was close to the one recorded in 1985. At the same time, the main source of buoyancy shifted from exports to domestic demand. After declining for some years, real wages embarked on a stronger-than-forecast catching-up process mainly because the inflation rate, though remaining well above the Community average, turned out to be appreciably below the initial forecasts. This provided a lively stimulus for private consumption. Fixed investment, which had fallen back markedly until 1985, recovered as a result of the improvement in companies' financial positions, the growing support provided by the measures to promote productive investment and investment in dwellings as well as the public investment programme. There was a slowdown in export growth, mainly because third country markets contracted. Due, however, to the substantial improvement in the terms of trade, the balance of payments surplus climbed to a record level (5,4 % of GDP). The decline in employment was halted, and the unemployment rate fell slightly for the first time in many years.

In 1987, private consumption will be slightly less buoyant, but the increase in gross fixed capital formation could accelerate under the impetus of lower interest rates and the sharp expansion of public investment. The growth of GDP in volume terms should be slightly slower than in 1986 (in the region of 3,5 %). Developments on Portugal's external markets should permit a moderate export recovery; even though it will deteriorate slightly, the balance of payments on current account should remain comfortably in surplus. Inflation should continue to fall, but the consumer price rise (+9 %) remains markedly above the Community average. Employment will benefit from the favourable economic situation. However, the recorded unemployment rate will be slow to fall (from 8,6 % of the labour force in 1986 to 8,5 % in 1987), mainly because of a further increase in the population working age.

With regard to the evolution of wages in 1986, the Government granted a 16,5 % increase to civil servants and recommended increases of 17 % to the private sector. The collective negotiations produced sometimes even larger increases initially, particularly in the public enterprises. However, when the prospect of lower inflation was confirmed (an annualized rate of 12 instead of 14 %), the authorities took a somewhat tighter line on pay and nominal wage increases per head have decelerated. Overall the increase in nominal labour costs has been notably higher than the Community average. However, the share of wages in national income has declined, although in terms of purchasing power (deflated by the consumer price index) the real wage level increased.

Gross fixed capital formation has grown satisfactorily. After a cumulative fall of 25,5 % in real terms in the three

preceding years, investment increased by some 8 % in volume terms during 1986, and a comparable, or even higher, rate is anticipated for 1987.

The size of the public debt and its rapid expansion (47,4 % of GDP in 1980 and 81,2 % in 1985) have, in particular, prompted the authorities to aim at a sharp reduction in the general government borrowing requirement in 1986. In the past, budgetary policy had been conducted on a short-term perspective; this caused distortions in resource allocation, in particular by supporting unprofitable public enterprises and exercising a crowding-out effect to the detriment of private enterprises. From now on, the authorities intend to pursue the objective of medium-term consolidation based, in particular, on the greater transparency of central government accounts, bringing public expenditure under control, establishing a new system of tax incentives for investment, and financing the borrowing requirement by greater resort to the market.

Despite some progress observed in the modernization of financial channels, these are still inadequate to sustain the proper development of long-term saving and risk capital. In particular, interest rates are still at very high levels, mainly because of the strong demand for finance from government departments and public enterprises, the instability of the escudo's exchange rate and expectations of high inflation.

The main challenge facing Portugal is to find a way out of the vicious circle of a 'stop-go' cycle which has severely hampered its development in the last decade, so that it can grapple with its fundamental problems, particularly that of modernizing the system of production. This has become more urgent because of the country's accession to the Community. As a result of insufficient investment, the export structure has hardly been diversified, while any upturn in domestic demand is rapidly blocked by the external constraint. The government which took office in the autumn of 1985 has chosen as its priority objective to bring about the recovery of investment and to improve the conditions conducive to economic growth by putting the public finances on a sounder footing, eliminating the inflation differential with the rest of the Community and, at a microeconomic level, making markets more flexible.

In 1987, significant progress should be made in eliminating the underlying imbalances in the economy. To achieve this, the public sector borrowing requirement, which is a crucial strategic variable, should be considerably reduced. The drive to moderate operating expenditure and to limit subsidies to public enterprises will have to be kept up, as will the action to combat tax evasion and avoidance. As a result, it should be possible to bring the central government borrowing requirement down to under 8 to 8,5 % of GDP. This policy

would, in particular, permit the required deceleration in domestic credit expansion, while strengthening the tendency for the escudo's exchange rate to stabilize. These are the essential conditions for the country to realize the ambitious objective of keeping price increases under 10 %, and for real

wages, in conformity with the spirit of the tripartite agreement concluded last June, to follow a course compatible with an improvement in the competitiveness of the Portuguese economy and hence with its participation, in favourable circumstances, in the wider common market.

TABLE 38

Portugal: Main economic aggregates 1961 to 1987

(Annual percentage changes)

	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product									
{ value	11,2	23,2	18,7	26,1	23,7	23,4	25,9	23,8	14,4
{ volume	6,9	3,3	0,4	3,5	-0,3	-1,7	3,7	3,8	3,5
{ deflator	4,0	19,8	18,2	21,8	24,1	25,6	21,3	19,2	10,5
Private consumption deflator	3,4	21,4	20,0	22,5	25,5	29,3	19,3	11,8	9,0
Gross fixed capital formation volume									
{ private	:	:	:	:	:	:	:	:	:
{ public	:	:	:	:	:	:	:	:	:
{ total	8,0	5,4	4,6	2,9	-7,5	-18,0	-1,8	7,8	8,5
Of which: construction	:	:	4,4	2,0	-3,0	-13,5	-4,0	6,1	8,5
equipment	:	:	4,8	4,0	-13,1	-23,0	1,0	10,0	8,6
Domestic demand at constant prices	7,5	2,9	2,9	3,4	-7,0	-7,0	0,6	6,7	4,8
Gap with respect to other Community countries ⁽³⁾	:	:	:	:	:	:	:	:	:
Compensation of employees per head									
{ nominal	12,0	25,2	20,6	18,5	21,6	19,8	22,0	17,1	12,3
{ real A ⁽⁴⁾	7,8	4,5	3,5	-2,7	-2,0	-4,6	0,5	-1,8	1,6
{ B ⁽⁴⁾	8,4	2,8	3,2	-3,3	-3,1	-7,4	2,2	4,7	3,0
Productivity ⁽⁵⁾	7,4	3,4	-0,2	4,0	1,4	-0,4	4,2	3,5	3,2
Real unit labour costs	0,4	1,1	3,7	6,4	-3,4	-4,2	-3,6	-5,1	-1,6
Competitiveness ⁽⁶⁾	:	:	:	-5,7	-8,4	-1,5	0,4	-1,1	-2,9
Employment	-0,5	-0,1	0,6	-0,5	-1,7	-1,3	-0,5	0,5	0,6
Registered unemployed as % of the civilian labour force ⁽⁷⁾	:	:	:	:	7,9	8,5	8,7	8,6	8,5
Current balance as % of GDP	0,7	-6,2	-11,7	-13,5	-7,2	-3,0	1,8	5,4	4,2
Long-term interest rate	6,5	16,4	22,6	25,2	30,3	32,5	25,4	19,5	16,5
Money supply ⁽⁸⁾	:	:	23,8	24,6	16,3	24,5	28,5	26,0	16,0
Net lending or borrowing requirement of general government as % of GDP	:	:	-10,1	-8,8	-7,1	-7,7	-11,2	-8,0	-7,5
Public debt as % of GDP	:	:	59,0	62,2	70,9	75,7	81,2	83,5	88,0
Public debt interest as % of GDP	:	:	5,4	5,5	6,4	7,1	7,7	9,7	9,3

⁽¹⁾ Estimates of the Commission services, October 1986.

⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.

⁽³⁾ Differences in percentage points.

⁽⁴⁾ A: GDP deflator; B: private consumption deflator.

⁽⁵⁾ Gross value added per occupied person in the whole economy.

⁽⁶⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.

⁽⁷⁾ Eurostat definition.

⁽⁸⁾ End of year.

UNITED KINGDOM

In the *United Kingdom*, economic activity is again expanding at a moderate pace, after a period of slower growth during the latter part of 1985 and the first half of 1986. GDP is likely to rise by $2\frac{1}{4}\%$ in real terms in 1986 and to accelerate somewhat in 1987, with an expected growth rate of $2\frac{3}{4}\%$. The main contribution to growth in both years is coming from private consumption, the strength of which is explained by steady growth of earnings combined with a renewed slowing of inflation in 1986, and a further easing of the personal income tax burden. Other elements of demand have been relatively subdued, although exports and investment activity are expected to grow somewhat faster in 1987.

The forecast rate of GDP growth is sufficient to permit a continuing expansion of employment but, with much of the increase accounted for by new entrants to the labour force going into self-employment or part-time jobs, it is not enough to make serious inroads into the unemployment level. Over the period from March 1983 to March 1986 total employment rose by about one million, while the numbers unemployed still grew by more than 150 000; this represents a rise in the activity rate of some three percentage points, a trend which can be expected to taper off. The rise in employment was made up of increases of half a million in self-employed people and of more than 550 000 women in part-time employment, while full-time dependent employment fell.

The effects of the sharp fall in the oil price on the United Kingdom, as a major oil producer, are different from those on most of the other Community economies. While industrial and domestic energy input costs have been lowered (as in other countries), the economy as a whole has suffered a terms-of-trade loss and, associated with this, there was a downward adjustment to the sterling exchange rate in early 1986 and again in the summer, particularly against other European currencies. The financial position of non-oil companies has improved substantially, although profits of the whole economy have fallen because of the deterioration in the oil sector.

Because of the lower oil export prices, the current-account surplus has shrunk and a deficit (0,6 % of GDP) is expected for 1987. There has also been a sharp fall in government oil revenues (roughly halving to an estimated £ 5 000 million in the 1986/87 financial year), but greater than expected buoyancy of other tax revenues has limited the impact on the fiscal position. The different measures of money supply have been growing at strikingly different rates, with broad money expanding at a rate well above its target range. United Kingdom interest rates, however, while following the international downward trend, have remained high in real terms, perhaps partly because a risk premium arises from the uncertainty associated with future inflation and exchange-rate movements.

The moderation of wage increases, both in nominal and real terms, is one of the key issues in improving employment prospects in the United Kingdom. The growth of nominal earnings decelerated sharply at the beginning of the 1980s but, since mid-1982, the underlying annual rate of increase has been roughly stable at about $7\frac{1}{2}\%$, while consumer price inflation (private consumption deflator) has been around or below the 5 % *per annum* mark. In 1986, particularly under the influence of lower energy and other commodity prices, inflation should turn out to be about 4 % (or, as measured by the retail price index, some 3 %), but as yet this has had little impact on wage settlements. Given the faster progress on inflation achieved by other industrialized countries, this implies a further erosion of the United Kingdom's competitive position; this process was more than offset by the exchange-rate movements during 1986, but the underlying weakness remains a threat to employment.

Despite the steady rise in real wages, profitability has also been improving significantly in recent years. This was made possible initially by a more rapid expansion of labour productivity than of real wages during the first three years of the recovery, and subsequently by the weakness of non-wage input costs. A Bank of England study concluded that the pre-tax real rate of return of United Kingdom industrial and commercial companies rose from 6 % in 1980 to $12\frac{1}{2}\%$ in 1985. This figure will have fallen in 1986, because of the setback to oil companies' profits, but there will have been a further improvement in the profitability of companies in other sectors taken as a whole, their rate of return having already risen from the trough of 3 % in 1981 to 8 % in 1985.

Despite the improvement in profitability, the growth of private investment has slowed down over the last two years. This may be a reaction to the relatively rapid expansion of capital spending in 1982 to 1984 and to the higher level of real interest rates in the recent period. Another important influence on the pattern of investment has been a change in the corporation tax system, intended to reduce the distortions between different types of investment and sources of finance, and between capital as a whole and labour. This consisted of a reduction of the tax rate (in three steps, from 50 to 35 %), accompanied by the gradual removal of initial investment allowances. In recent years, the strong investment performance in the service industries has been paralleled by a substantial rise in employment in these sectors, even if many of the additional jobs are part time, while the more modest recovery of investment in manufacturing has been insufficient to reverse the continuing decline in jobs.

The area in which progress is most urgently needed in the United Kingdom is that of a slower increase in wages. Lower

wage settlements would open the way for slower inflation, an improvement in the United Kingdom's competitiveness, a further strengthening of profitability, and lower interest rates (both nominal and real), which would increase the attractiveness of investment in new capacity and augment the employment content of growth. It is however clear that, despite the high unemployment level, the present functioning of the labour market is resulting in little slowing of wage settlements. The Government has taken steps intended to improve flexibility of the labour market and, in particular, of the wage determination process by measures such as the reduction of the scope of wages councils to set minimum wages for young people and has also introduced proposals for a form of profit-sharing, in which a part of gross wages could be linked to corporate profit performance. Against the background of the declared aim of government policy to guard against any shortfall of demand in the economy, contact between government and the representatives of employers and employees can contribute to a greater awareness on all sides of the importance of lower wage increases for employment creation.

In recent years, the emphasis of fiscal policy in the United Kingdom has been on reducing the budget deficit as a proportion of GDP, containing the growth of public expenditure, and introducing a number of tax reductions and changes intended to encourage enterprise and to promote market flexibility. The public sector borrowing requirement (PSBR) in the financial year ending March 1986, at 1,7 % of GDP, turned out to be slightly lower than planned, while general government expenditure as a proportion of GDP was (at 44,5 %) two points lower than in 1984/85. The fiscal stance for the current year, set in the March 1986 budget, is broadly unchanged, with only a slight widening (to 1,9 % of GDP) of the forecast PSBR. In spite of the substantial loss of oil revenue, the Government, in this year's budget, was still able to implement a further cut in personal income tax amounting to one percentage point off the basic tax rate, thus helping to reduce the taxation 'wedge' between what an employee costs to the employer and what the employee receives as net-of-tax income. As in the past, there has been some upward slippage of successive plans for public expenditure, although the impact on the PSBR is largely offset by the accelerated programme of privatization.

Before the autumn statement, the outlook for fiscal developments in 1987 suggested that the Government would again have at its disposal some room for manoeuvre to reduce the tax burden or to raise public spending in the 1987/88 financial year, within the framework of its medium-term financial strategy. This position is now overtaken by the

announcement in the Government's autumn statement of an increase in the provision for public expenditure in 1987/88 of some £ 4 750 million. This will mean that public expenditure in 1987/88 is planned to be about 2 % higher in real terms than the estimated out-turn in 1986/87. If output were to grow less rapidly than productive potential (about 2 1/4 %), it may be appropriate to allow some increase in the PSBR above the figure of £ 7 000 million (1,7 % of GDP) included in the MTFS, providing that there is no upsurge of inflation. However, there can be no automatic relationship between the appropriate PSBR and the state of the economic cycle. Any fiscal relaxation beyond that foreseen in the MTFS would need to be accompanied by the maintenance of downward pressure on the increase in real wages and the maintenance of a firm monetary stance so as to avoid an exacerbation of the vicious circle of wage and price increases, and the associated risk of further exchange-rate depreciation. It should also be seen within the framework of action decided at Community level.

The Government is committed to using the fiscal room for manoeuvre, at least in part, for a further easing of the personal income tax burden, so as to increase incentive and boost after-tax incomes. In view of the likely continued strong growth of real personal incomes in 1987, however, there would be a more balanced pattern of growth if some of the room were used to support demand components other than private consumption. The scope for additional public sector infrastructure investment offering an acceptable rate of return should be examined. Such investment might have a greater short-term impact on employment than income tax cuts and, like such cuts, would tend to strengthen productive potential.

The Government has continued its programme of microeconomic measures aimed at improving supply conditions and increasing incentives for enterprise. The programme of privatizing public-sector business has continued, and a number of developments are contributing to the creation of a more competitive market in financial services. In the summer, new proposals were introduced as part of the continuing deregulation programme to lift the burdens on businesses. Proposals include simplifying tax and accounting procedures for small businesses, easing requirements for permission to change the use of buildings, and modification of employment rights in certain circumstances. The deregulation programme complements other measures intended to stimulate business start-ups and expansion, with particular benefits to the self-employed and small businesses which have an important influence on job creation.

TABLE 39

United Kingdom: Main economic aggregates 1961 to 1987

(Annual percentage changes)									
	1961 to 1973	1974 to 1980	1981	1982	1983	1984	1985	1986 ⁽¹⁾	1987 ⁽²⁾
Gross domestic product ⁽³⁾									
{ value	8,4	17,7	10,2	8,8	9,0	6,3	9,8	6,3	7,0
{ volume	3,1	1,0	-1,2	1,0	3,8	2,2	3,7	2,3	2,7
{ deflator	5,1	16,5	11,5	7,9	4,9	4,1	5,8	3,9	4,2
Private consumption deflator	4,8	15,7	11,4	8,7	5,0	4,8	5,3	4,0	3,9
Gross fixed capital formation volume									
{ private	:	1,6	-7,0	5,6	2,4	8,7	2,5	0,8	4,1
{ public	:	-10,6	-26,2	-6,6	36,6	11,8	-2,8	10,2	-0,8
{ total	4,6	-0,6	-9,5	4,3	5,7	9,1	1,8	1,9	3,5
of which: construction	:	-2,0	-8,4	6,4	6,7	8,3	-3,1	2,8	3,0
equipment	:	1,6	-10,7	1,8	4,5	10,1	7,8	0,9	4,0
Domestic demand at constant prices	3,2	0,3	-1,7	2,2	4,7	2,8	2,8	3,2	3,2
Gap with respect to other Community countries ⁽⁴⁾	:	:	:	2,6	4,4	0,8	0,4	-0,8	-0,3
Compensation of employees per head									
{ nominal	8,3	17,5	13,2	9,1	9,2	5,5	7,3	7,5	6,6
{ real A ⁽⁵⁾	3,1	0,9	1,2	1,5	4,0	1,1	1,3	3,5	2,3
B ⁽⁵⁾	3,3	1,5	1,5	0,5	3,9	0,4	2,0	3,4	2,6
Productivity ⁽⁶⁾	:	:	:	3,3	4,7	0,2	2,4	1,4	1,9
Real unit labour costs	:	:	:	-1,7	-0,6	1,0	-1,1	2,1	0,4
Profitability ⁽⁷⁾	:	-4,4	1,5	4,8	9,4	-3,8	3,2	-7,1	-0,6
idem (1961 to 1973 = 100)	100	69,0	62,1	65,1	71,2	68,5	70,7	65,7	65,3
Competitiveness ⁽⁸⁾	-1,5	4,0	2,1	-3,7	-5,4	1,4	1,7	-9,2	-2,1
Employment	0,2	0,1	-3,9	-1,4	-0,8	1,5	1,3	0,8	0,8
Registered unemployed as % of the civilian labour force ⁽⁹⁾	2,1	4,5	9,2	10,6	11,6	11,8	12,0	12,0	12,0
Current balance as % of GDP	-0,0	-0,8	2,4	1,4	1,0	0,4	1,0	-0,1	-0,6
Long-term interest rate	7,6	13,7	14,8	12,7	10,8	10,7	10,6	9,5	9,5
Money supply ⁽¹⁰⁾	9,4	11,9	13,7	8,9	10,3	9,8	13,4	15,4	8,0
Net lending or borrowing of general government as % of GDP	-0,7	-3,9	-2,8	-2,3	-3,7	-3,9	-2,8	-2,9	-2,5
Public debt as % of GDP ⁽¹¹⁾	:	56,6	51,1	57,8	57,5	59,2	57,8	59,0	57,8
Public debt interest as % of GDP	:	4,4	5,0	5,1	4,7	4,9	5,0	4,8	4,6

⁽¹⁾ Estimates of the Commission services, October 1986.⁽²⁾ Forecasts of the Commission services, October 1986, on the basis of present policies.⁽³⁾ Expenditure measure at market prices.⁽⁴⁾ Differences in percentage points.⁽⁵⁾ A: GDP deflator; B: private consumption deflator.⁽⁶⁾ Gross value added per occupied person in the whole economy.⁽⁷⁾ Net operating surplus relative to the net capital stock at current replacement cost.⁽⁸⁾ Effective exchange rate (*vis-à-vis* 19 industrial countries) on the basis of unit labour costs for the whole economy. Positive figure = loss of competitiveness.⁽⁹⁾ Eurostat definition.⁽¹⁰⁾ Sterling M3; end of year.⁽¹¹⁾ General government gross debt at market values.