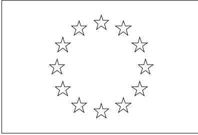


COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.01.1999
COM(1999) 7 final

1999 Annual Economic Report

THE EU ECONOMY AT THE ARRIVAL OF THE EURO: PROMOTING GROWTH, EMPLOYMENT AND STABILITY

(presented by the Commission)

TABLE OF CONTENTS

PART I: POLICY REFLECTIONS IN VIEW OF THE 1999 BROAD ECONOMIC POLICY GUIDELINES 4

PART II: SUPPORTING DOCUMENTATION FOR THE POLICY REFLECTIONS 17

1. SUCCESSFUL TRANSITION TO EMU 18

1.1. Fundamentals have been transformed 18

1.2. Convergence achievements 19

1.3. Opportunities and difficulties at the start of the third stage of EMU 24

2. CHALLENGES FACING THE WORLD ECONOMY 27

2.1. Economic and financial crisis in South-east Asia and Japan 27

2.2. Causes and consequences of the Russian financial crisis 29

2.3. Impact on Central European candidate countries 30

2.4. Prospects for the US economy 31

2.5. Functioning and reform of the international financial system 32

3. ECONOMIC SITUATION AND OUTLOOK IN THE EU 35

3.1. Healthy recovery dented by global financial crisis 35

3.2. Stronger job growth 39

3.3. Absence of inflationary pressures 42

4. CHALLENGES FOR ECONOMIC POLICY IN THE EURO AREA 47

4.1. Policy requirements in the present conjuncture...47

4.2. Wage developments 56

4.3. Budgetary policy 58

4.4. Monetary policy 66

4.5. Structural policies 70

4.6. External implications of the euro 74

BOXES

Box 1: The euro area in perspective 25

Box 2: Potential growth and the output gap...44

Box 3: The institutional framework for the conduct of economic policy in the euro area 53

TABLES

Table 1: GDP growth and its components, EUR ... 35

Table 2: International economic environment ... 37

Table 3: Employment and unemployment, EUR ... 40

Table 4: General government net lending/borrowing: Stability and Convergence programme projections ... 62

Table 5: General government investment ... 63

GRAPHS

Graph 1: Inflation, 1991 and 1998 ... 20

Graph 2: Budgetary positions, 1991 and 1998 ... 22

Graph 3: Nominal long-term interest rates, 1991 and 1998 ... 23

Graph 4: Growth and current account developments in South-east Asia ... 27

Graph 5: Business and consumer confidence, EUR ... 38

Graph 6: Employment and unemployment, EUR ... 40

Graph 7: Employment rates: EUR, USA and Japan ... 41

Graph 8: Inflation: EUR and Euro-11 ... 42

Graph 9: Economic performance in the euro area and the USA ... 49

Graph 10: Wage developments, Euro-11 ... 57

Graph 11: Actual and cyclically-adjusted general government borrowing, Euro-11 ... 59

Graph 12: Interest rates ... 68

Graph 13: Euro-area money supply growth ... 69

Part I

Policy reflections in view of the 1999 Broad Economic Policy Guidelines

Introduction

In presenting the Commission's view on the current economic situation, by examining the main challenges in the years to come and by suggesting where the main policy efforts should lie, the 1999 Annual Economic Report is intended to initiate a debate on the policy options to be considered in the forthcoming 1999 Broad Economic Policy Guidelines. With the start of the third and final stage of economic and monetary union (EMU) and the adoption of the single currency, the euro, by eleven Member States on 1 January, one of the highest priorities of economic policy in the European Union has been realised. This achievement has required important efforts but has also brought about considerable benefits. Now, raising employment and reducing unemployment is the principal social, economic and political objective of the Union.

In pursuit of this objective, substantial progress has already been made in implementing both the macroeconomic strategy outlined in the Broad Economic Policy Guidelines and the employment strategy agreed by the European Council in Luxembourg in November 1997 ("the Luxembourg process"). With respect to the latter, new targets and orientations have since been agreed in the context of the Employment Guidelines and the National employment Action Plans (NAPs). The pursuit of this dual strategy, within the stability framework of EMU, requires a whole variety of economic measures. It also requires close co-ordination and synergies between the respective sets of guidelines.

The present report concentrates essentially on macroeconomic issues and policies. Structural policies, which represent crucial ingredients in the strategy to return the EU economy to a durably higher, non-inflationary growth and employment path, will be set out in detail in other reports, especially in the Commission's reports on economic reforms, the so-called Cardiff I and II reports, to be adopted in January and February, respectively. Together with the present Annual Economic Report, these reports will provide important inputs for the Commission's recommendation for the next Broad Economic Policy Guidelines and the 2000 Employment Guidelines.

EMU process produced sound economic foundations

The launch of the euro on 1 January 1999 is the outcome of a long convergence process that has deeply transformed the structure and functioning of the EU economy. A stability culture and a stability-oriented framework are now firmly established in the Union. All economic actors now recognise that price stability and sound public finances are prerequisites to durably achieve high growth and employment. Accordingly, both economic behaviour and expectations have been adjusted in line with these objectives. This revolution in mentality has taken place in all Member States, leading to the adoption by a large number of countries of the single currency and creating sound economic foundations for the launch of the euro. This augurs well for economic developments in the EU during the third stage. In the last two years, the EU economy has already been benefiting from improved economic convergence and greater stability. The recovery has gathered considerable momentum, employment has been rising again and unemployment, while still much too high, has subsequently started to decline.

Persistently high unemployment, the EU's major deficiency

Despite the progress made, the EU's economic performance has not been unequivocally positive in all areas. The adverse consequences of the two oil price shocks of the 1970s and the inappropriate policy responses to them have eventually been overcome. Nevertheless, it remains that since the mid-1970s, the Union has never regained a high, sustained, non-inflationary economic growth path as it repeatedly was confronted with macroeconomic obstacles to growth and failed to make sufficient progress in improving the functioning of its product, service, capital and labour markets. As a consequence, unemployment has become deeply entrenched in the wheels of the Union's economy which, to some extent, has adapted itself to work with a very reduced -- but highly productive -- labour force. The central priority for economic policy therefore is to achieve both a substantial and lasting reduction in unemployment and a high level of employment.

Positive economic gains expected from the launch of the euro

The introduction of the euro will not in itself solve the Union's unemployment problem. But the single currency will strengthen the Union's capacity to foster employment, growth and stability. EMU is built upon a policy framework that is dedicated to stability. It lays the foundation for an employment-friendly economic policy characterised by a balanced policy mix, sustained convergence and monetary stability. Low inflation and interest rates and the end to harmful exchange rate fluctuations between the participating Member States will reduce the uncertainties that impede investment decisions. The euro is an essential complement of the internal market. A truly single market will make firms more competitive and will make the Union a more attractive location for investment. EMU and the introduction of the euro will be a catalyst for the creation of deep, broad and highly liquid euro financial markets in the Union. Improved access to financing, especially for small and medium-sized enterprises, will provide an important stimulus to investment and thereby reinforce the impact of the internal market. The single currency will also act as a powerful catalyst for structural reform; a prerequisite in itself to achieve enhanced economic dynamism and a greater ability to adapt effectively to changing economic circumstances. Finally, the euro will reinforce the Union's global position and contribute to a more stable international monetary system.

In order to exploit fully the positive gains from EMU and to achieve high and sustainable employment in the Union, it is essential to continue to pursue prudent and co-ordinated economic policies, as called for by the Vienna European Council in December 1998. Policy responses will need to encompass appropriate wage developments, sound budgetary policies, a stability oriented monetary policy as well as comprehensive economic reforms. Each policy actor has to contribute to ensuring an overall policy mix favourable to growth and employment. Furthermore, it will be necessary to both deepen and strengthen economic policy co-ordination, within the agreed framework and involving an intensive dialogue between all actors, including, where appropriate the European social partners. In this context, the Commission welcomes the commitment of all Member States to work towards a European Employment Pact, with the involvement of the social partners, within the framework of the Luxembourg process. For its part, the Commission will seek to actively contribute to this process. The clear commitment by Member States to seek greater synergy between the Employment Guidelines and the Broad Economic Policy Guidelines is equally to be welcomed.

Healthy recovery dented by global financial crisis

Following the pause in late 1995 and early 1996, the EU economy has experienced an accelerating, soundly-based recovery. Initially, the recovery was driven by surging exports reflecting buoyant world trade and an improved competitiveness of EU exporters. Subsequently, domestic demand has reinforced the expansion and has become the major engine of growth as private investment and private consumption were spurred by a significant easing of monetary conditions, high and increasing profitability, rising real disposable income and improving confidence. Output in the EU is now estimated to have grown by 2.9 per cent in 1998, the best performance since 1990. The pace of net job creation quickened markedly in 1998 on the back of continued strong growth, an unwinding of the cyclical peak in labour productivity and measures aimed at increasing the employment content of growth.

Although overall economic activity largely unfolded as expected, short-term economic prospects in the European Union have become less promising during 1998. Since the underlying economic fundamentals are sound in the EU (high profitability, low inflation, appropriate wage evolution…), prospects until some months ago augured well for a successful transformation of the recovery into a sustained, non-inflationary, employment-creating growth process over the medium term. The financial crises and risks, which continue to hang over the world economy, have started to affect economic activity in the Union and are jeopardising this transformation process. Indeed, the adverse external shock comes at an unfortunate moment since domestic demand has not yet fully taken over from exports as the major engine of the cyclical revival.

Fragile world economic situation …

The Southeast Asian currency turmoil, which erupted with a series of speculative attacks on the Thai baht in 1997, has evolved into a fully-fledged financial crisis affecting many emerging markets beyond the Asian region, in particular Russia, and to a lesser extent Latin America. In Asia itself, while currencies and financial markets have gradually stabilised in recent months, contractions in economic activity have been significantly larger than originally expected. The causes of Asia’s financial turmoil were rooted in the failure of Asian governments to develop financial systems that provided the incentive structure necessary to allocate capital efficiently and without excessive risk. In Russia, although external factors, such as the ongoing fall in oil and commodity prices and contagion effects from the Asian crisis, have contributed to domestic

and emerging balance-of-payments problems, the main factor causing the crisis has been the lack of energetic efforts to tackle major structural issues.

… is denting short-term growth prospects in the Union

The pace of output growth in the EU in 1999 and beyond will essentially be determined by how much the depressed international background will depart domestic demand from its initially expected healthy growth path. Despite the steadying in financial markets during the final months of 1998, uncertainties about the world economy add to downside risks and are affecting especially business sentiment in Europe. Thanks to the transformation achieved in economic fundamentals during the 1990s, the EU economy, and in particular the euro area, is in a better position to withstand these difficulties and to pursue co-ordinated policies to help sustain European and global growth. Nevertheless, there is growing evidence that the EU will not remain unscathed.

In autumn 1998 expectations were still that strong domestic fundamentals would confine the effects of the international financial crisis to a short-lived, rather limited, slowdown of economic growth in the EU. Accordingly, the Commission's forecasts predicted a growth deceleration to 2.4 per cent in the EU in 1999. However, there is now evidence that the deterioration in corporate confidence has been large enough to potentially scale down investment projects and to trigger downward adjustments of inventories. It is therefore likely that a downward revision will be necessary in the next forecast in the spring.

Policy requirements in the present conjuncture

For the European Union it will be essential to avoid that the global financial crisis results in a third downturn in the present decade, after the recession of 1992/93 and the marked slackening in 1996. But even if a pronounced downturn is avoided, the Union risks making insufficient progress towards its key priority: to achieve, over the medium term, a substantial and lasting reduction in unemployment whilst significantly increasing the employment rate.

This situation calls for an appropriate and more co-ordinated economic policy response in the Member States and at the euro-area level. On the national and the European level, economic policy actors have to deliver their respective contributions with regard to appropriate wage developments, sound public finances and a stability-oriented monetary policy. To place the responsibility for an appropriate policy mix unilaterally on one of the actors would entail social

tensions and result in economically non optimal outcomes. In fact, policy-makers face the task of pursuing policies with a view to achieving self-sustaining, non-inflationary, investment-supported, growth over the medium and longer term, thereby containing the duration and depth of the present slowdown.

The crucial importance of an adequate macroeconomic policy to foster growth and employment was clearly highlighted during the 1990s. During the period 1991-98, the EU experienced an unsatisfactory growth and employment performance. Average economic growth in the EU amounted only to 1.9 per cent per year and lack-lustre economic activity was reflected in disappointing employment trends as net employment creation fell by an average of 0.1 per cent per year. In sharp contrast, the US economy experienced a prolonged phase of strong output growth and employment: real GDP grew by 2.6 per cent per year on average while net employment increased at an average rate of 1.5 per cent per year. On the assumption of a similar pace of output growth in the EU as in the USA, the EU would have enjoyed the addition of close to 10 million jobs, other things being equal, despite a higher trend in labour productivity growth.

The response must be consistent with the cornerstone of the macroeconomic strategy established in successive Broad Economic Policy Guidelines. The main pillar of this strategy is that “the more the stability task of monetary policy is facilitated by appropriate budgetary measures and wage developments, the more monetary conditions, including exchange rates and long-term interest rates, will be favourable to growth and employment.” In addition, the response must also recognise that structural adjustment policies represent a crucial instrument in returning the EU’s economy to a durably higher, non-inflationary, growth path allied to stronger job creation.

The macroeconomic policy mix in the euro area is framed by a several-tier decision process: the single monetary policy is set by the ECB for the euro area as a whole, budgetary policy remains the responsibility of national governments, but will have to abide by the provisions of the Treaty and the requirements of the Stability and Growth Pact, while the social partners will continue to determine wage setting at the national, regional, sectoral or even at a more decentralised level following their respective traditions. Structural policies will essentially remain the province of national governments.

Continued appropriate wage developments

For wage developments to contribute to an employment-friendly policy mix, the social partners should continue to pursue a responsible course and conclude wage agreements in line with the general principles set out in the Broad Economic Policy Guidelines. Aggregate nominal wage increases must be consistent with price stability. Meanwhile, real wage increases in relation to labour productivity growth should take into account the need to strengthen where necessary, and subsequently maintain, the profitability of investment, whilst allowing a steady increase in purchasing power and private consumption. Finally, wage agreements should take into account differentials in productivity levels according to qualifications, regions and to some extent sectors. To achieve the right results, effective social dialogue at all appropriate levels will be essential. The outcomes should be closely monitored and jointly assessed from a growth and employment point of view.

In the euro area as a whole, appropriate wage trends are expected to continue in the coming years. According to the Commission’s Autumn 1998 forecasts, annual nominal wage growth per employee is likely to remain in the 2½ to 3 per cent range over the 1999-2000 period. With overall productivity gains of the order of 1.5 to 2 per cent per year, increases in unit labour costs should remain clearly below the inflation objective, thereby exerting no inflationary pressure whilst contributing to a further improvement in investment profitability and cost competitiveness. Meanwhile, real wage increases together with employment creation will allow for a steady increase in purchasing power, thus fuelling private consumption growth. Under these conditions, macroeconomic wage developments should remain fully consistent with the Broad Economic Policy Guidelines. However, the social partners should be aware of the difficult international environment and its potential repercussions on competitiveness and employment and, against this background, pursue adequate wage settlements.

Continued budgetary consolidation efforts are needed

Despite visible progress in reducing general government budget deficits, especially in 1996/97, budgetary consolidation will continue to be a matter of concern after the start of stage three. Indeed, the budgetary positions of most of the Member States are not yet in line with the Stability and Growth Pact requirements. The Pact was concluded to give substance to the Treaty provisions intended to prevent Member States from having an excessive budget deficit and to ensure that Member States exercise the required budgetary discipline after adopting the single currency. Achieving and maintaining sound public finances is an essential means to ensure sustained growth and high employment.

Budgetary positions close to balance or in surplus are necessary in order to allow for sufficient scope for budgetary flexibility over the cycle. As a consequence, in the euro area as a whole a further structural decrease of above 1 per cent of GDP would appear appropriate. In this context, it is reassuring that, after a pause this year, currently available national budgets suggest a moderate resumption of the reduction in structural deficits in 1999, to an average of 1¾ per cent for the euro area. Furthermore, in conformity with the Ecofin Council Declaration of early May 12 Member States have submitted stability or convergence programmes before the end of 1998, whereas Germany and France submitted their stability programmes in January. They indicate that Member States will aim at further improving their budgetary positions in the coming years.

On average, the improvement needed over the next years seems moderate and, pending favourable monetary conditions, should not jeopardise the recovery in the euro area. In the event of an unexpectedly severe slowdown, the automatic stabilisers might only be allowed to work to the extent that previous efforts in budgetary consolidation have created the necessary room within the remit of the Stability and Growth Pact and that the reduction in cyclically-adjusted budget deficits is not compromised. Conversely, failure to adjust now could result in tighter monetary conditions later and force governments, like in the past, to resort to pro-cyclical budgetary policies as they would try to keep deficits within 3 per cent of GDP, thereby exacerbating the next downturn.

Any assessment of the appropriateness of medium-term targets for governments' budgetary positions need also to consider factors other than the influence of the business cycle. As such, there might be a need, from time to time, to provide for additional room to supplement the operation of the automatic stabilisers through discretionary budgetary support for economic activity. Furthermore, high public debt countries will need to provide a buffer against interest rate shocks and to ensure a rapid decline in the debt ratio. Moreover, it will be necessary to create room both for a long overdue reduction in large tax wedges, especially as regards low-income workers, and to prepare for the burden on the budget of an ageing population. As a consequence, in many Member States it would appear prudent to aspire to even more ambitious medium-term budgetary positions.

Without threatening the necessary ongoing consolidation process, governments must seize all opportunities to improve the quality and the efficiency of government spending, with priority to productive investment in physical and human capital, as recommended in the Broad Economic Policy Guidelines and the 1999 Employment Guidelines. Accordingly, the steady decrease in the share of public investment in GDP should be halted and even reversed. Furthermore, it is necessary to ensure a shift from passive to active labour market policies. Efforts must be undertaken to make taxation more employment-friendly, through lowering the overall tax burden and altering the structure and incidence of taxation.

Stability-oriented monetary policy supporting growth

The favourable inflationary outlook in the euro area, together with rather reassuring wage and budgetary prospects, promise a setting for monetary conditions conducive to growth and employment without jeopardising price stability. The absence of inflationary pressures and low inflation expectations in the euro area has led to a convergence of long-term interest rates to around 4 per cent. With long-term inflation expectations of about 2 per cent, this implies real rates at the long end of 2 per cent; this is somewhat below the rate of potential growth and, taking into account the available spare production capacity, clearly below the presently possible effective output growth, a situation not seen since the late 1970s. Regarding short-term interest rates, the current level of euro-area short-term (i.e. 3-month) interest rates of 3.2 per cent in early January represents an easing of about 75 basis points relative to implicit euro-area rates in May 1998. On the other hand, the yield curve is virtually flat and exchange rate developments in the euro area have moved counter to interest rate developments as effective exchange rates have generally appreciated in the period since May 1998.

Against this background, continued adequate wage developments, sustained progress in the process of structural budget consolidation and enhanced efforts to improve the functioning of product and labour market are necessary to facilitate the task of the ECB if the economic climate in the euro area were to deteriorate further. Until public finances reach the medium-term objective assigned by the Stability and Growth Pact, monetary conditions are likely to play a very important role in the macroeconomic strategy, as already shown by the co-ordinated cut in leading short-term interest rates at the end of 1998.

However, it is unambiguously up to the monetary authorities to assess, in full independence, and in conformity with Article 105(1), whether or not short-term interest rates, currently lower than in the US and following from the non negligible recent easing in interest rates at the euro zone level, are currently set at an appropriate level to offset the adverse impact of the world crisis and the 1998 effective appreciation of the euro.

The necessary continuation of structural reforms

An appropriate macro policy mix constitutes a necessary but not a sufficient condition for ensuring a sustainable medium term growth process aimed at reducing unemployment to a significantly low level. Resolute action in implementing structural reforms is a key complement to macroeconomic policy efforts. Structural policies should help to facilitate a tension-free growth process, to reinforce competitiveness, to increase the labour content of growth and to make growth more respectful of the environment. In this respect, national governments and Community authorities have not remained inactive over the past decade. Through the impetus given by the completion of the single market and the preparation of the single currency, the functioning of key markets – goods and services, capital, labour – has been markedly improved by important structural reforms.

The present efforts however must continue to be pursued. Particular attention should be given to the four major reforms singled out in the 1998 Broad Economic Policy Guidelines: reforms to complete the single market; reforms to enhance competition; regulatory reforms and financial market reforms. Furthermore, and perhaps even more crucially for avoiding tensions in the growth process, the functioning of the labour market should continue to be improved. This will require a determined implementation of the strategy agreed in the Employment Guidelines and the NAPs which are designed to improve employability, adaptability, equal opportunities and entrepreneurship. This strategy, which encompasses reforms to the structure and administration of tax and benefit systems, is essential to the supply of an adequate, educated and trained labour force.

Reform of the international financial system

Thanks to the newly implemented single currency, the euro area to a large extent holds its economic destiny in its own hands. Extra-euro area trade of goods represents less than 14 per cent of GDP, while the international role of the euro is expected to expand at a relatively fast pace, given the economic weight and stability of the euro area.

Despite the fact that the euro area will be a relatively closed economy, it is not immune to all influences emanating from movements in the world economy. In this respect, globalisation is not only a major driving force towards enhanced international trade and capital flows, and therefore improved living standards, it has also increased the risk of both more frequent and deeper global and economic crises. The shortcomings of the international financial system have been plainly illustrated by the events in Asia and Russia. The international community has reacted by launching reforms in an attempt to increase stability, transparency and surveillance of the international financial system, mainly through a strengthening of the present international architecture, with more efficient Bretton Woods institutions at the centre.

All the key political decision centres in the world, including the European institutions and Member States, should support and contribute to these efforts aimed at adapting the international financial institutions to the new environment and at preventing future crises.

*

* *

The Community has endured a long lasting but salutary adjustment process, necessary to redress the economic policy errors that were made in the wake of the two oil price shocks and that exacted a heavy toll in terms of lost economic growth and employment. This process, mainly characterised by the return to a price stability framework and improved public finances, was imperatively needed for itself, but it was also necessary for an even more positive and historical achievement for the Union: the creation of a single currency.

With the launch of the euro and the creation of a truly single market, the Union is an increasingly integrated and important economic entity at the world level. If the right policies are pursued and the existing policy instruments are forged into a coherent strategy as called for by the Vienna European Council, the Union might reasonably aspire to making significant progress towards achieving its top priority of high and sustainable employment over the medium term.

Part II

Supporting documentation for the policy reflections

1. SUCCESSFUL TRANSITION TO EMU

1.1. Fundamentals have been transformed

During the period from the beginning of the 1990s until 1999 -- that is from the time when the parts of the Maastricht Treaty dealing with economic and monetary union were being negotiated and agreed to the year of the move into the third stage of EMU and the introduction of the single currency -- radical changes and improvements in a number of fundamental features of the EU economy have been achieved. These structural and institutional improvements have helped to create conditions which are already leading to stronger economic performance and, provided adjustment efforts are pursued and sustained, augur well for economic developments in the EU during the third stage, despite the current risks from the widespread financial turbulence and economic weakness in other parts of the world. While the performance of the EU economy throughout much of the decade was disappointing, with output growth mediocre and large rises in unemployment, in the last two years the EU economy has already been benefiting from improved economic convergence and greater stability. The recovery has gathered considerable momentum, employment has been rising again and unemployment, while still much too high, has subsequently started to decline.

The impressive steps taken by EU Member States to achieve sustained economic convergence have already been reviewed extensively in the Commission's 1998 convergence report, in advance of the positive decisions on the single currency taken in May 1998. Inflation has been brought down and kept under control; government budgetary positions have been adjusted significantly, with budget deficits reduced to within reasonable limits and the unsustainable upward trend in government debt ratios reversed; nominal interest rates have come down and the large differentials, which used to exist, between Member States have narrowed dramatically, both for long-term and short-term rates and especially for Member States now participating in the single currency; exchange rates, which were subject to severe bouts of turbulence in 1992 and 1993 and again early in 1995, have become progressively less volatile and, with the adoption of the euro, can now no longer vary between members of the single currency zone.

In parallel with the progress on these indicators, which were the subject of the convergence criteria, there have been a number of institutional changes intended to reinforce stability; some of these were required by the Maastricht Treaty, such as the outlawing of monetary financing of government deficits and the granting of greater independence to national central banks, while

other were more specific to the institutional arrangements of individual countries, such as changes that took place in some countries in wage formation mechanisms.

The convergence process has been accompanied and furthered by adjustments in personal and corporate behaviour and in the expectations by which these are shaped, especially in relation to inflation prospects. Moderate wage settlements have accompanied the inflation rate down, and in some cases have preceded a subsequent reduction in inflation. Small increases in unit wage costs have thus been essential for the control of inflation and have at the same time allowed a steady improvement in the profitability of investment. Investment is now recovering healthily, making a strong contribution to current growth and laying down the basis for improved growth potential in the future.

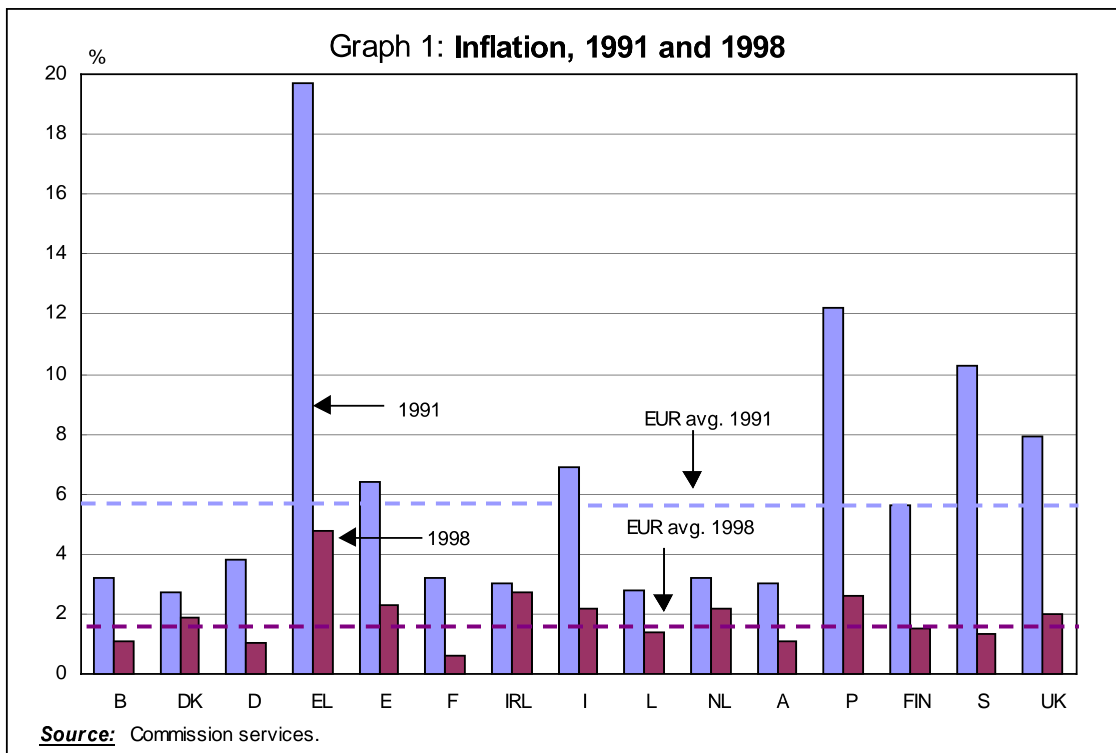
The achievement of stability has in many respects been self-reinforcing. The lowering of long-term interest rates and the narrowing of differentials has been the response of financial markets to improved inflation prospects and the move to sounder government budgetary positions and in turn helps to achieve further reductions in government deficits through declining interest payments.

1.2. Convergence achievements

Inflation now under control

Very high and volatile inflation rates were of serious concern throughout the 1970s and 1980s. This created major uncertainty and distorted the efficiency of resource allocation. The EU average rate of inflation (private consumption deflator) was 10.6 per cent in 1971-80 and 6.6 per cent in 1981-90, when Member States at the core of the ERM had some success in reasserting inflation control.

Progressively during the 1990s inflation rates were brought down towards the levels of the better performers, with the average EU inflation rate reaching 2.1 per cent in 1997 and only 1.6 per cent in 1998, a figure not seen for over forty years. At the same time, the dispersion between inflation rates in the individual Member States has narrowed very significantly. Only Greece, which has also achieved a large reduction in inflation in recent years, has not yet completed inflation convergence.



Source: Commission services.

A return to sounder budgetary positions

Ever since the onset of the first oil crisis in the early 1970s the public finances in most Member States had shown deteriorating trends. Budget deficits were too large and even periods of stronger growth such as in the late 1980s were not used to secure an underlying improvement. Government debt ratios were on an unsustainable upward trend and reached very worrying levels in several Member States. These developments crowded out private sector financing and pushed up interest rates.

When the new procedures of article 104c of the Treaty were applied for the first time in 1994, all but two Member States (Ireland and Luxembourg) were judged to have excessive deficits. Since then the picture has been turned round radically. Subjected to the disciplines of the Treaty and the incentives to qualify for the single currency and also as part of a global shift to more responsible budgetary policies in response to pressures from the financial markets, government deficits in the EU have been reduced in a massive adjustment effort. For the EU as a whole the government deficit was brought down from its historic peak of over 6 per cent of GDP in 1993 to 2.3 per cent in 1997 and 1.8 per cent in 1998. All the Member States are

expected to have a budget balance in 1998 better than a deficit of 3 per cent of GDP. Halting the rise in the government debt ratio took some time, but for the EU as a whole the ratio peaked at 73 per cent of GDP in 1996 and is now on a downward trend, with considerable declines occurring in many Member States. Unfortunately, budgetary consolidation came to a halt in 1998. Because in many Member States budgetary positions are not yet consistent with the requirements of the Stability and Growth Pact and government debt ratios are still too high in several Member States, there is a clear need to consolidate further public finances.

Towards the removal of exchange rate variability within the EU

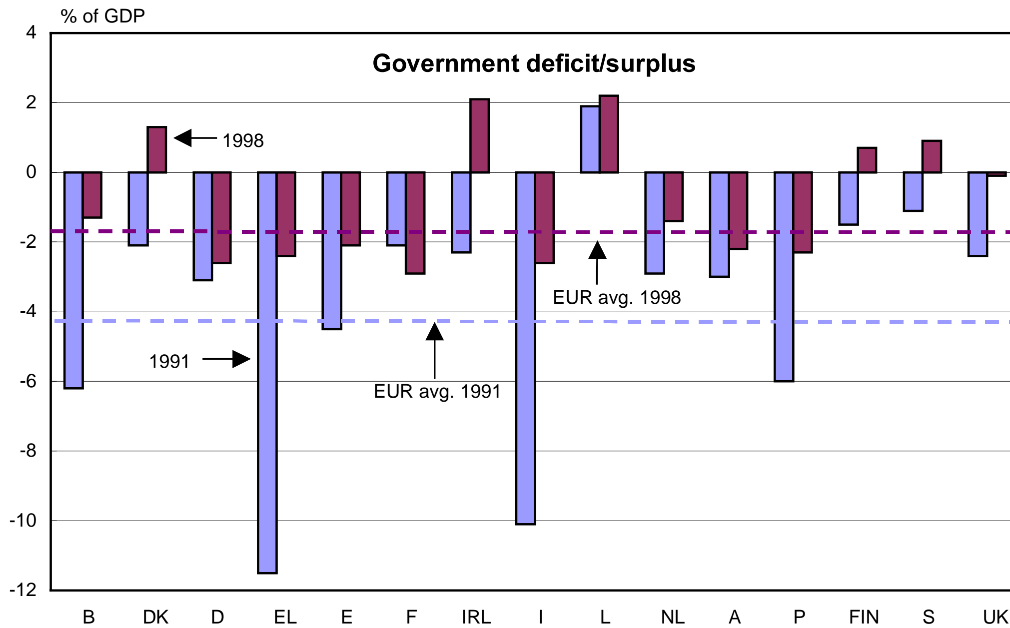
The large divergence of economic policies and fundamentals between Member States in the 1970s and 1980s inevitably led to great instability in exchange rates, thus making forward planning by exporters and investors very difficult. The core initial members of the ERM gradually achieved success during the 1980s in limiting the fluctuations in their bilateral rates, but even they were again subject to severe market pressures in 1992 and 1993. The other Member States were subject to periodic and unpredictable currency depreciations.

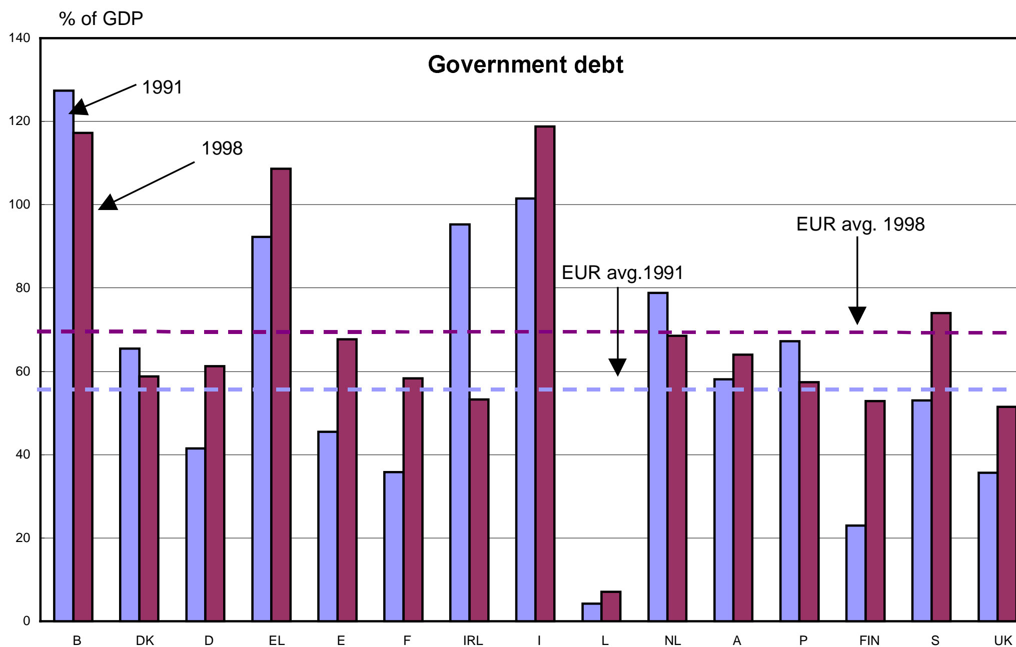
The achievement of greater convergence on the inflation and public finance fronts has also been reflected in the behaviour of exchange rates. Although from August 1993 the ERM operated with wider 15 per cent fluctuation bands, these were rarely needed. For the Member States joining the single currency exchange rate volatility has progressively diminished, culminating in the fixing of rates with the introduction of the euro on 1 January 1999.

Interest rates in nominal terms down to very low levels

Reflecting public finance imbalances, high and volatile inflation rates and exchange rate instability, interest rates in the EU were also at high levels well into the 1990s and showed great volatility through the cycle and persistent large differentials between Member States. This further burdened public finances and deterred private sector investment, particularly over longer-term horizons. In the EU on average, interest rates (both long and short-term) had reached their peak at around 15 per cent in 1981, but in 1990 they were still at about 10 per cent.

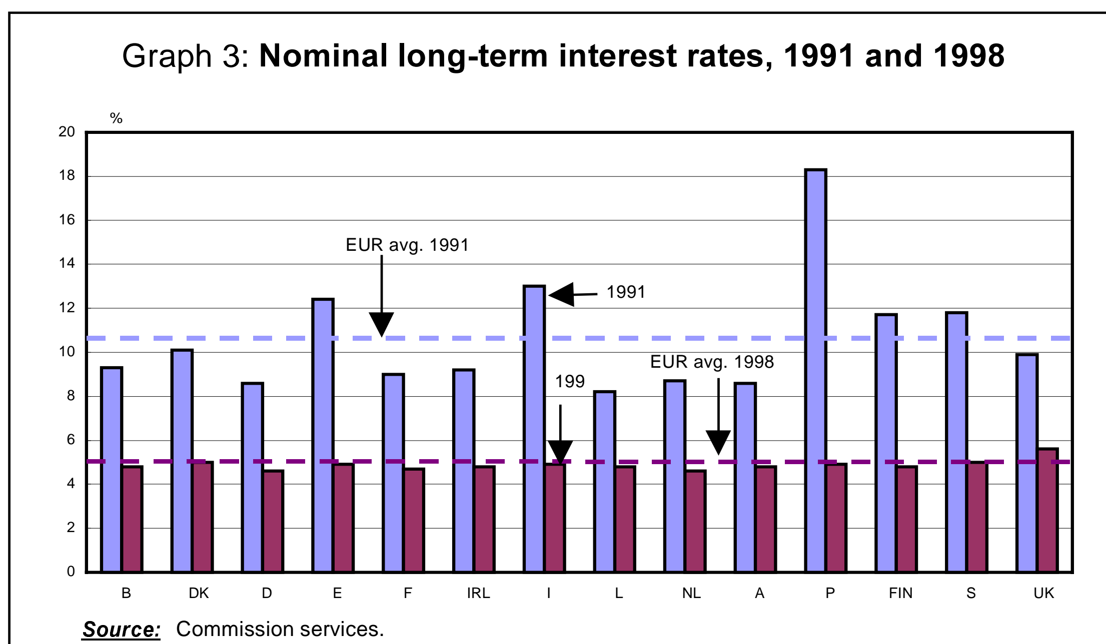
Graph 2: **Budgetary positions, 1991 and 1998**





Source: Commission services.

The successful convergence process has been recognised by financial markets and the monetary authorities and has led to a general relaxation of nominal interest rates. Especially from 1996 onwards long-term rates have declined substantially to currently close to 4 per cent. Even more striking has been the reduction in long-term interest rate differentials as convergence gained credibility, such that for Member States entering the single currency differentials against the German rate have narrowed to less than 30 basis points (by comparison in 1992 the German-Italian differential was over 500 basis points). Short-term rates too have been brought right down and for participants in the single currency differentials have now been eliminated.



Graph 3: **Nominal long-term interest rates, 1991 and 1998**

Source: Commission services.

Moderate wage increases and declining inflationary expectations

Achieving greater stability is not just a question of the right government policies. Above all, it depends on appropriate behaviour from workers, consumers and businessmen. Too rapid wage increases often pushed up inflation rates in the 1970s and 1980s, resulting in job losses and not in real income gains. In more recent years, in a framework in which both budgetary and monetary policies have been aiming for stability, the social partners appear to have been gradually convinced that inflation is being brought under control and wage settlements have become more appropriate. Wages per employee, which rose by 14 per cent per year on average in the EU in 1971-80 and by almost 8 per cent in 1981-90, have slowed to around 3¼ per cent since the mid-1990s. While faster than the inflation rate, and so representing income gains in real terms, these recent increases have been less than the rise in labour productivity and so have

allowed a further rise in the profitability of investment, which is now, thanks to a prolonged period of moderate wage increases, exceeding the levels of the 1960s.

1.3. Opportunities and difficulties at the start of the third stage of EMU

At the beginning of May 1998, when the Heads of State or Government made their decisions about the move to Stage Three on 1 January 1999, prospects for the EU economy were looking promising. The improvement in the fundamentals had laid the basis for continuing stability and an improved growth performance.

Certainly, further adjustments are required in economic policies. To ensure the lasting health of budgetary positions some further reductions in government deficits are needed in line with the requirements of the Stability and Growth Pact, but the additional efforts to be aimed for are relatively small compared with those already achieved. Getting unemployment down faster calls for macroeconomic policies conducive to growth and employment and a willingness to tackle market and institutional rigidities which hold back growth and employment creation.

This generally optimistic picture has been somewhat dented by the increasing severity of the slowdown in the world economy as turbulence has spread from Southeast Asia and Japan to Russia and more widely. After performing well up to expectations in 1998, the EU economy is now slowing and growth in 1999 will decelerate. Despite the steadying in financial markets during the final months of 1998, uncertainties about the world economy add to downside risks and are affecting especially business sentiment in Europe. As the result of the transformation achieved in economic fundamentals during the 1990s the EU economy, and in particular the euro zone, is in a better position to withstand these difficulties and to pursue policies to help sustain European and global growth.

Box 1: The euro area in perspective

With eleven Member States adopting the single currency as of 1 January 1999, namely Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland, the euro area is an important economic entity at world level and notably in comparison with the USA and Japan. The euro area is an economic entity comparable in size to the USA, it forms the world's biggest trading partner, it has a substantial government bond market and it holds the highest foreign exchange reserves.

The euro area is composed of mature industrialised countries all of which have since long operated in the competitive environment of open market economies. Due to several decades of heightened economic integration, the countries participating in the euro area exhibit fairly similar macro-structural features. Naturally, there is also diversity in various respects. Often it reflects earlier differences in economic developments or policies, as for example the labour market situation suggests.

Basic statistics

	Euro-11	EUR15	USA	JAPAN
1. Population (1997)				
- In millions of persons	290.5	374.2	268.0	126.2
- As % of world population [a]	5.0	6.5	4.6	2.2
2. Gross domestic product (GDP, 1997)				
- In billion of ECU	5549	7164	6899	3699
- As % of world GDP (in PPS) [b]	16	20	21	8
- GDP per inhabitant, in 1000 ECU	19.1	19.0	25.8	29.3
- GDP per inhabitant, Euro-11=100 [c]	100	98.9	144.2	116.3
3. Goods exports (1997)				
- As % of world exports [d]	19.5	-	14.8	9.7
- As % of GDP [e]	13.7	9.7	9.5	10.3
4. Government securities outstanding (ECU bn) [f]	3277	4091	6635	2826
5. Equity market capitalisation (ECU bn) [g]	2705	4942	9497	1839
6. Foreign exchange reserves (ECU bn) [h]	380	455	122	205

[a] Based on UN data. [b] PPS. [c] GDP in current prices and PPS. [d] Extra-euro area exports; calculation based on world figure including Euro-11; [e] Euro-11: extra-euro-area exports; EUR15: extra-EU exports [f] December 1997. [g] End of 1997. [h] Including gold, end of 1997.

Source: Commission services.

For the proper functioning of EMU and the Single Market, effective surveillance and co-ordination of economic policies will be of major importance. This in turn requires a comprehensive statistical information system providing economic policy makers with the necessary data on developments in the economic, monetary, budgetary and social fields.

Over the last few years, several important initiatives have been taken with a view to improving the statistical database. Besides the statistical preparations for the single monetary policy, major steps were taken in the area of economic policy, *inter alia* the adoption of a new, comprehensive system of national accounts (ESA-95) and the introduction of harmonised indices on consumer prices.

Despite these achievements and the important work on the provision of euro-statistics which is under way, the presently available statistical information leaves room for improvement in both quantitative and qualitative terms. Further work is necessary especially in the following fields: establishing quarterly national accounts; producing quarterly accounts for general government; improving the statistical information on labour market developments; and improving the quality and speeding up the production of short-term economic indicators, including on intra-EU trade.

Macro-structural features : similarity and diversity

1998	B	D	E	F	IRL	I	L	NL	A	P	FIN	Euro area
Share in GDP [a]	3.9	33.0	8.6	22.2	1.3	18.1	0.3	5.9	3.3	1.7	1.9	100
Openness [b]	25.6[c]	12.6	8.7	10.2	38.7	10.3	-	24.2	11.4	9.6	20.5	12.9
Interdependence [d]	39.3[c]	10.2	11.5	10.9	19.6	9.2	-	29.9	19.0	19.0	9.9	13.1
GFCF [e]	18.2	19.5	21.1	17.1	19.3	16.8	22.7	20.0	24.1	25.7	17.5	18.8
- of which public [f]	1.5	1.8	3.0	2.8	2.5	2.3	5.0	2.5	2.0	4.1	2.7	2.3
Wage/employee [g]	123	109	74	110	94	90	127	112	103	43	100	100
Productivity [h]	116	111	71	112	106	93	125	116	110	41	106	100
Unit labour costs [i]	105	98	104	99	90	98	102	97	94	105	95	100
Tax burden [j]	48.3	42.2	36.9	47.6	32.3	42.9	42.5	44.5	46.5	36.5	46.5	43.4
Unemployment [k]	8.3	9.7	18.9	11.7	8.7	12.0	2.4	4.0	4.4	5.7	11.6	11.0
Employment rate [l]	57.3	61.8	48.6	60.1	57.8	51.3	60.6	66.7	69.9	67.5	63.9	58.0
FT equivalent [m]	53.0	55.7	46.3	55.4	53.7	49.8	58.1	53.0	65.0	64.6	60.7	53.6

[a] 1998 nominal GDP, ECU. [b] Average of extra-euro area goods' exports and imports, as % of GDP. [c] Data for Belgium and Luxembourg. [d] Average of intra-euro area goods' exports and imports, as % of GDP. [e] Gross fixed capital formation at current prices, as % of GDP. [f] General government, as % of GDP. [g] Compensation per employee, in current ECU, Euro-11 = 100. [h] Nominal GDP per person employed, in current ECU, Euro-11 = 100. [i] Ratio of two preceding lines. [j] Sum of direct taxes, indirect taxes and social security contributions, general government, as % of GDP. [k] Eurostat definition; rate, as % of civilian labour force. [l] Employment as % of population of working age; benchmark; 1997 data. [m] Employment rate; full-time equivalent; 1997 data.

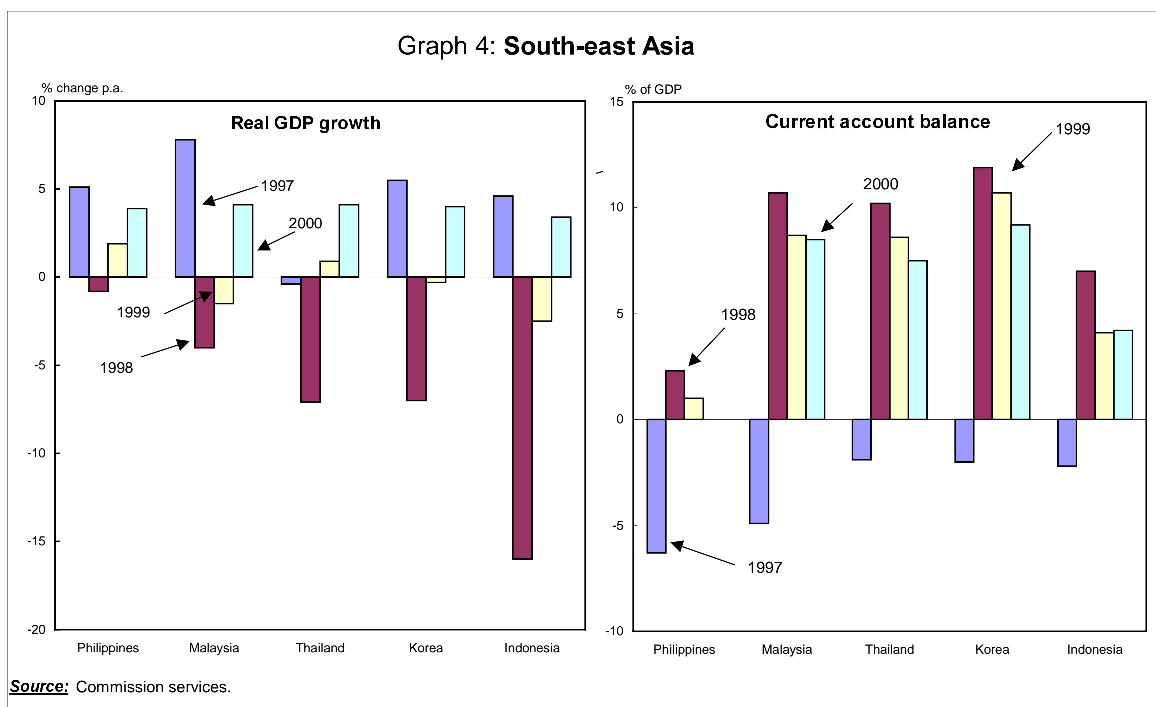
Source: Commission services.

2. CHALLENGES FACING THE WORLD ECONOMY

2.1. Economic and financial crisis in South-east Asia and Japan

The South-east Asian currency turmoil, which erupted with a series of speculative attacks on the Thai baht in 1997, has evolved into a fully-fledged financial crisis affecting many emerging markets beyond the Asian region, in particular Russia, and to a lesser extent Latin America. In Asia itself, while currencies and financial markets have gradually stabilised in recent months, contractions in economic activity have been significantly larger than originally expected. Commission services' projections are that output in ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) will fall by 10 per cent in 1998 with virtually no growth in 1999. In the Newly Industrialised Asian Economies (Hong Kong, Singapore, South Korea, and Taiwan), output is expected to fall by 2.5 per cent in 1998 with moderate growth of 1½ per cent returning in 1999. These estimates represent a significant decline in the economic fortunes of countries that used to experience growth rates of the order of 7-8 per cent per year prior to the crisis.

Graph 4: **South-east Asia**



Source: Commission services.

The causes of Asia's financial turmoil were rooted in the failure of Asian governments to develop financial systems that provide the incentive structure necessary to allocate capital efficiently and without excessive risk. In this respect, the following policy weaknesses are noteworthy. Firstly, domestic securities markets and external capital accounts were liberalised

without any associated strengthening of prudential regulation and financial supervision to oversee the behaviour of investors in a new financial environment. Secondly, the expectation that failing banks could receive government bailouts and the failure of governments to sufficiently disentangle financial and industrial policies further exacerbated the problem of excessive risk taking in the banking sector. Thirdly, the maintenance of pegged exchange rate regimes that were not accompanied by corrective policies contributed to the emergence of overvalued currencies and unsustainable current account imbalances in Asia.

The factual evidence seems to support the view that Asian countries which have taken steps to open their domestic markets and have rapidly adopted IMF-supported programmes tend to progress more rapidly toward crisis resolution, although in some cases the initial fiscal tightening was subsequently relaxed to prevent excessive declines in output. Korea and Thailand, and also the Philippines have been able to reduce interest rates to pre-crisis levels thanks to the implementation of comprehensive macro-economic stabilisation and structural reform policies, including initiatives in the key areas of the financial system and corporate debt restructuring. As a result, currency pressures have eased and their exchange rates have strengthened from the lows of early 1998. Provided that these reform efforts are pursued, the outlook for these economies is favourable and a turnaround in economic activity can be expected in 1999. By contrast, Indonesia and Malaysia have not been able to keep pace with the progress made in the other affected Asian emerging economies that rapidly embarked on adjustment programmes.

In the longer term, a return to healthy economic growth in the region will depend largely on the willingness and ability of governments to continue to implement the necessary structural reforms, in particular in the financial sector so as to establish sound financial market structures, and to promote open trade policies, reliable and open investment regimes, proper taxation systems, and sound macro-economic policies. In some countries there is also a need to curb excessive government intervention and regulation in both product and labour markets.

Economic recovery in South-east Asia will also depend on how Japan will handle its own difficulties in order to contribute to restoring growth in the region. Japan's current economic problems lie in its weak domestic demand coupled with the fragility of its financial sector resulting from many of the same excesses already outlined above, namely, interwoven industrial and financial policies, moral hazard, inappropriate accounting procedures and inadequate bankruptcy laws. Inappropriate fiscal policy is partly to blame for Japan's current

recession. Short-term interest rates have been close to zero for some time and Japan's budgetary position has deteriorated by more than 8 per cent of GDP since 1991. Instead, the long and protracted period of slow growth that Japan has experienced since the collapse in asset prices seems to be largely the result of a failure to address structural problems. Any further loosening of budgetary and monetary policies is unlikely to have anything more than a transitory impact on Japanese economic fortunes. The revival of the economy will depend on the authorities' capacity to implement rigorously the bank rescue package that was announced in October 1998 to deal with failing institutions through a process of nationalisation and recapitalization of weak banks together with other structural measures in the monetary and financial field.

2.2. Causes and consequences of the Russian financial crisis

Since August 1998, Russia has been facing a major economic and financial crisis, which has led to a de facto default on domestic and (partly) foreign debt. In addition, the collapse of living standards and social hardship associated with the transition process have undermined popular acceptance of policies. Although external factors, such as the ongoing fall in oil and commodity prices and contagion effects from the Asian crisis, have contributed to Russia's domestic and potential balance-of-payments problems, the main factor causing the crisis has been the lack of energetic efforts to tackle major structural issues. On the budgetary side, the authorities had resorted to massive short-term borrowing owing to weak tax collection, poor public administration and uncontrolled public expenditures. As a result, very substantial pension and wage arrears had accumulated, prompting social unrest. In addition, Russian banks, in the absence of a developed regulatory framework, had invested heavily in high-interest rouble-denominated debt and borrowed heavily in foreign currency. Lastly, the transition to an open market economy has been difficult, as reflected in the lack of progress with respect to privatisation, institution building and the implementation of corporate governance principles. As a result, the supply response has been weak, competition frail, and investment well below expectations.

While it is difficult to assess the full impact of the crisis on the Russian economy, it is clear that Russia has effectively abandoned its exchange rate policy, which was a key element in its stabilisation policy, and has defaulted on domestic and external financial obligations. Some of the more immediate consequences are known. Firstly, the default on domestic debt and the rouble depreciation have had a strongly negative impact on the banking sector, where a large

number of banks is reported to be ”technically bankrupt”. Secondly, a massive monetisation of deficit financing, which cannot be ruled out under the current circumstances, would trigger hyperinflation and foreclose foreign financial assistance. Thirdly, Russia will find it difficult to raise money on international financial markets for a prolonged period of time. This implies that it will be even more dependent on increasing the tax yield and on achieving a primary budget surplus. Fourthly, the impact on GDP and inflation will be severe. Gross domestic product declined by an estimated 6 percent in 1998, and following the major inflationary burst in August and September 1998, the inflation rate averaged 85 percent in 1998. Despite the temporary stabilisation of the rouble after the Central Bank introduced administrative measures, inflation is projected at 30 per cent in 1999 while real GDP is expected to decline by 10 per cent.

2.3. Impact on Central European candidate countries

Since the Commission’s Opinions concerning the application for Membership to the European Union presented by the Central European candidate countries (CECCs) were published in July 1997, the latter have felt the successive waves of the Asian and Russian financial crises. However, unlike other emerging markets, in particular in Latin America, CECCs have managed to remain largely unscathed from the global negative spillover effects. In most countries output growth has remained strong and driven by domestic demand, in particular fixed investment. On average, economic growth in the CECCs is forecast to be around 3½ per cent in 1998 and 1999, the same rate as in 1997. In 2000, with the expected stabilisation of the international environment, growth in the region should accelerate again to above 4 per cent. The decline of commodity and other input prices has supported the disinflation process in the candidate countries, though, in most countries, the actual pattern of inflation is still to a large extent determined by adjustments in administered prices, the process of price liberalisation, or the impact of indirect tax measures.

While for most emerging market economies the start of the Russian crisis in August 1998 and its unilateral debt restructuring meant a further deterioration of market sentiment with currencies weakening, equity markets declining, scarcer private capital flows and higher yield spreads, and a gloomier economic outlook, the candidate countries have shown relatively strong resilience. This was made possible for at least two main reasons. Firstly, the candidate countries have progressively and successfully reoriented their trade from the former Soviet bloc to the West since the beginning of the transition process. They have achieved a high degree of

trade integration with the European Union, which accounts for around 60 per cent of their trade. Secondly and more fundamentally, the perspective of EU accession and the gradual implementation of Community legislation have had a noticeably favourable effect on market sentiment. Increasingly these countries, and especially those where reforms are more advanced, are being perceived as future members of an enlarged EU with a high degree of economic integration.

Notwithstanding this resilience, the candidate countries have nevertheless been confronted with international financial markets that are much less supportive of their restructuring efforts. While they were able to obtain foreign financing at relatively favourable conditions before the start of the crisis, markets have dried up as a consequence of the “flight to quality” and funds are now only available at a higher cost. However, foreign direct investment (FDI) flows have continued to increase. In order to reinforce their resilience to external developments, in particular those originating from other emerging markets, the transition countries will need to strengthen further their macroeconomic stability, maintain the credibility of their exchange rate policies, and continue their structural reform efforts. In particular, if the distrust of international financial markets towards financing emerging markets continues, persistently large trade imbalances could become a cause for concern for those transition countries that make insufficient progress with structural reforms.

2.4. Prospects for the US economy

After the remarkable economic performance achieved in recent years, the prospects for the US economy are that of a soft landing. While the US economy has been able to achieve a virtuous combination of strong growth, low inflation and low unemployment, it has not been immune to the global financial crisis and started facing less favourable conditions in mid-1998 when net external demand began to decline. In late 1998, business fixed investment declined for the first time in seven years, mainly as a result of the turmoil in domestic and international financial markets.

While on-balance-sheet financial sector losses from Russia and other areas of the globe in 1998 were relatively small and manageable, off-balance-sheet losses largely related to derivatives trading were substantial, resulting in the need for the financial sector to rebuild capital and reserves. In order to prevent a possible “credit crunch” and to sustain non-inflationary economic growth and aggregate demand in the future, the Federal Reserve eased discount

interest rates three times in the span of a few weeks in October/November 1998. As a consequence, credit spreads that were reaching recessionary levels began to narrow.

Economic growth in 1999 is expected to decelerate markedly to or below the 2½ per cent potential rate. This relies on the resilience of growth in sectors that have sustained the domestic economy over the past few years. In particular, many service industries are projected to remain buoyant as a result of the technological innovation and diffusion boom under way, the response of the private sector to competitiveness gains and the changing demographic profile of the population.

Inflationary pressures should remain subdued, though a number of special favourable factors that have contributed to easing inflationary pressures up to mid-1998, such as the appreciation of the dollar or the decline in commodity prices, are not expected to continue in 1999. The fiscal surplus registered for the first time in nearly 30 years in the fiscal year that ended in September 1998 is estimated to widen even further over the next 10 years, based on a forecast of medium-term moderate growth. These surpluses would give a much-needed boost to national saving and contribute to solving the long-term financial strains on the social security and other welfare programmes related to the ageing of the population.

However, the US economy is also facing a number of risks that could push the economy into a hard landing. In particular, domestic demand could contract sharply if business sentiment were to deteriorate. This could be triggered by a number of weaknesses, including the vulnerability of the stock market to possible shifts in market sentiment, the historically low rates of private saving, the high level of households' indebtedness, and the persistent national saving-investment gap.

2.5. Functioning and reform of the international financial system

In increasing trade and financial interlinkages between national economies, globalisation has contributed to lowering production costs, to more competition and greater consumer choice throughout the world. The process has provided a major driving force behind the continued productivity gains that have raised living standards across the world, including in the EU and in emerging market economies. Globalisation has, however, also increased the risk of more global economic and financial crises. Recent events in Asia and other emerging economies have highlighted the high degree of potential market volatility throughout the world, including in industrialised countries. These events have given fresh impetus to the debate on how to address

weaknesses in the international economic system and how economic policies and institutions need to be adapted.

Since the Mexican crisis of 1995, efforts have been made at the international level, in particular under the aegis of the G7, to address the perceived shortcomings of the present international financial system. Rather than devising new structures, the emphasis has been on strengthening the present architecture, with more efficient Bretton Woods institutions at the centre. In October 1998, the G7 leaders agreed on a detailed reform plan to strengthen the international financial system. These reforms are mainly designed to increase the stability, transparency and surveillance of the system, to adapt the international financial institutions to the new environment and to prevent future crises.

To strengthen national financial systems, different sets of standards have been or are being developed in areas such as banking supervision, securities regulation, and insurance supervision, the most notable being the Basle Core Principles on Effective Banking Supervision. Countries are encouraged to adopt and implement these standards under the multilateral surveillance of the regulatory bodies involved and the International Financial Institutions (IFIs). To increase transparency and information on macro-economic aggregates, in particular on foreign exchange liquidity and external debt positions, on financial businesses and on economic policies, the IMF and the BIS have committed themselves to expand their data programmes, both in timeliness, accuracy and coverage.

Developments in Asia, Russia, and Latin America have put the IFIs in the spotlight. The large financial assistance packages provided by the International Monetary Fund (IMF) in support of reform programmes, including through the new Supplemental Reserve Facility, have helped most countries to avoid total collapse and to make progress toward crisis resolution. However, these operations brought the operational reserves of the IMF to dangerously low levels. The EU has thus called on its international partners to replenish the IMF resources effectively through the ratification of the Eleventh Quota Review and the completion of the New Arrangement to Borrow (NAB). The EU and its Member States have also supported the steps taken to increase the transparency of the Fund's inner workings while making it more accountable. As a result, it should develop a formal mechanism for systematic evaluation of the effectiveness of its operations, programmes, policies, and procedures. Some EU Member States also suggested strengthening the IMF's legitimacy by enlarging the scope of the Interim Committee. In addition, to limit the moral hazard associated with the IMF being perceived as

an implicit bailing-out institution of private sector investments, there is a general consensus that the private sector should be involved in the prevention and resolution of financial crises. However, the practical steps for private sector participation remain so far relatively unclear.

Finally, the level of capital flight from many emerging countries has reopened the debate on whether countries should liberalise capital movements or maintain -- or even reintroduce -- capital controls to discourage what can often be destabilising capital flows. While short-term speculative inflows may be deterred by capital control measures, their use should be of a temporary and exceptional nature if short-term benefits are not to be outweighed by their short and long-term disadvantages. Indeed, in discouraging foreign investors, capital controls typically also deter the longer-term flows that countries need to finance their development. In addition, they encourage domestic evasion and capital flight. Capital account liberalisation can be accomplished provided the country concerned also ensures that its financial sector has the supervisory and regulatory infrastructure to deal with foreign capital. It should also proceed in an orderly way: countries should lift controls on outflows only gradually as the balance of payments strengthens, and liberalisation of inflows should start at the long end and move to the short end only as banking and financial systems are strengthened.

3. ECONOMIC SITUATION AND OUTLOOK IN THE EU

3.1. Healthy recovery dented by global financial crisis

Following the pause in late 1995 and early 1996, the EU economy has experienced an accelerating, soundly-based recovery founded on good fundamentals. Initially, the recovery was driven by surging exports reflecting buoyant world trade and improved competitiveness of EU exporters. Subsequently, domestic demand has reinforced the expansion and has become the major engine of growth as private investment and private consumption were spurred by a significant easing of monetary conditions, high and increasing profitability, rising real disposable income, higher employment and improving confidence.

Output in the European Union is now estimated to have grown by 2.9 per cent in 1998. Domestic demand was the mainstay of the expansion. In fact, slightly stronger than anticipated output growth last year resulted essentially from the unexpectedly strong growth of investment (in equipment) and private consumption. Conversely, export growth decelerated markedly as the crisis in Asia and other emerging markets and a considerable depreciation of the US dollar were taking their toll.

Table 1: **GDP growth and its components – EUR**
(real annual percentage change)

		1980-85	1986-90	1991-96	1997	1998*	1999*	2000*
Private consumption		1.5	3.7	1.6	2.1	2.6	2.5	2.4
Government consumption		1.9	2.0	1.1	0.0	1.6	1.7	1.9
Gross fixed capital formation		-0.2	5.7	-0.1	2.8	4.7	4.7	5.4
Of which:	Equipment	1.5	7.0	0.1	5.2	7.9	5.2	6.1
	Construction	-1.5	4.8	-0.2	0.6	1.9	4.1	4.7
Exports of goods and services 1)		3.5	5.0	5.4	9.7	6.5	4.7	6.1
Imports of goods and services 1)		1.9	7.4	3.9	9.1	7.7	5.8	6.6
GDP		1.5	3.3	1.5	2.7	2.9	2.4	2.8

*Autumn 1998 forecasts.
1) Total trade.

Source: Commission services.

Although overall economic activity largely unfolded as expected, short-term economic prospects in the European Union have become less promising during 1998. Prior to the outbreak of the economic and financial crisis in Southeast Asia in the summer of 1997, expectations were for a successful transformation of the recovery into a sustained, non-inflationary, employment-creating growth process over the medium term. In the spring of 1998, it was still generally thought that the financial turbulence in Asia would have only a small and temporary impact only on economic activity in the EU. The deepening and widening of the global financial crisis in the summer of 1998 have delayed the realisation of these expectations. They have also raised concern about whether the EU recovery risks once again, as in 1995 in the wake of the Mexican crisis and the subsequent exchange rate instability within the EU, getting short of the expected medium-term growth path.

The pace of output growth this year and beyond will essentially be determined by the relative strength of two opposing forces: strong domestic economic fundamentals *versus* worsened international economic and financial conditions.

Underlying economic fundamentals remain healthy in the EU. The profitability of investment exceeds that of the 1960s, continues to improve and is now close to that of the US and significantly higher than in Japan. Thanks to vigorous efforts to achieve a high degree of sustained economic convergence, the EU is now benefiting from historically-low inflation as well as record low nominal and real interest rates and advanced budgetary consolidation. Furthermore, the advent of the euro rules out intra-area exchange rate turmoil and, given the economic importance of the euro area in the world economy, could help stabilise world currency relationships.

In stark contrast to the domestic strength and stability in the EU, the situation in the world economy has turned unfavourable with about 20 per cent of the world economy in recession and another 10 per cent close to it. Although the EU is well armed to contain the adverse effects stemming from the global financial crisis, it will not stay immune. These negative influences will operate through various channels but their magnitude is difficult to estimate with great precision.

Table 2 : **International economic environment**
(real annual percentage change)

	Weights	1996	1997	1998*	1999*	2000*
	GDP					
World	100.0	4.2	4.1	2.0	2.7	3.6
World excl EU-15	80.8	4.9	4.5	1.8	2.7	3.7
USA	20.2	3.6	4.0	3.3	2.1	2.2
Japan	7.7	3.9	0.9	-2.5	0.6	1.7
ASEAN4+South Korea (1)	6.2	7.1	4.1	-10.0	0.0	3.8
EAC (2)	1.9	4.8	2.9	3.3	3.7	4.4
Russia	1.9	0.0	0.4	-3.0	-3.0	-5.0
	Imports					
World	100.0	7.7	10.2	4.7	4.9	3.9
World excl EU-15	64.7	9.9	10.9	3.0	4.4	5.5
USA	16.6	9.9	14.7	11.9	5.9	5.6
Japan	5.7	10.0	2.4	-6.7	-3.4	0.9
ASEAN 4+South Korea (1)	6.6	12.8	5.9	-18.7	5.2	7.3
EAC (2)	2.6	9.7	13.0	12.1	10.7	10.4
Russia	1.4	7.1	14.9	-16.0	-15.0	-20.0

* Autumn 1998 forecasts.

(1) Indonesia, Thailand, Malaysia and Philippines.

(2) Europe Agreement Countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

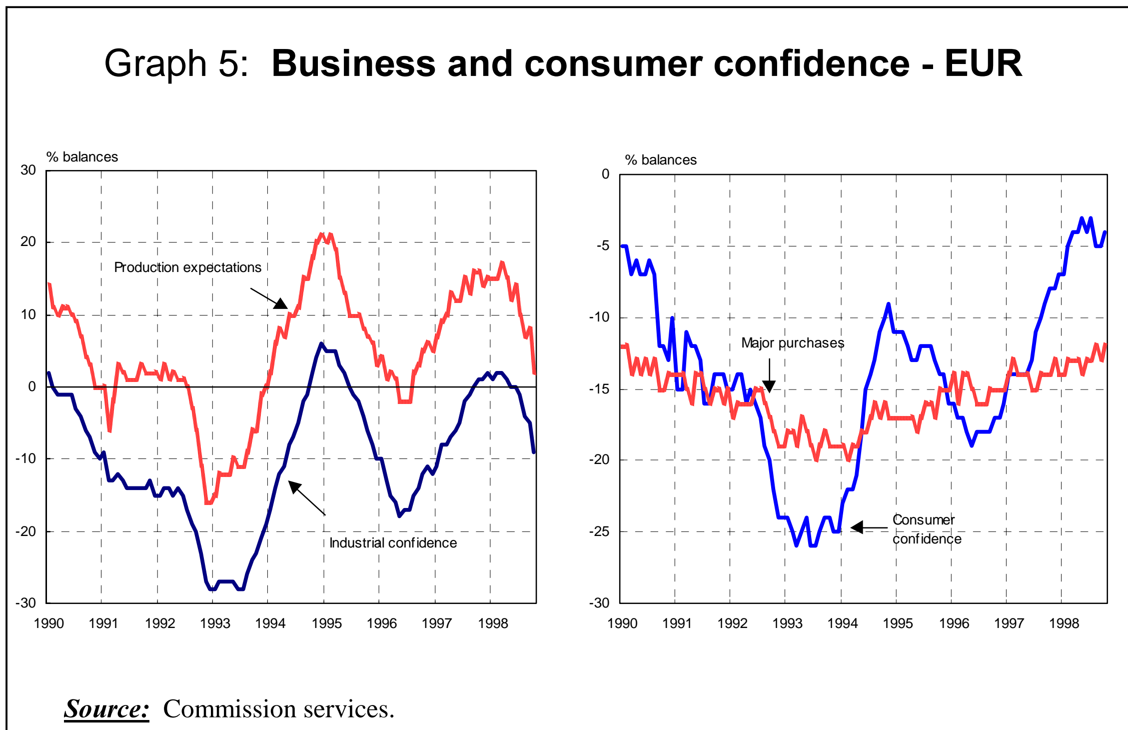
Source: Commission services.

The direct trade impact has already manifested itself and will continue to be felt in 1999. The marked deceleration in EU exports is an inevitable counterpart to the adjustment in the crisis economies and the impact is being compounded by the depreciation of the US dollar. A key risk for the EU's growth and employment outlook, however, is that the external drag spills over to private investment and consumption, thereby inhibiting the necessary development of self-sustaining domestic demand growth in the Union.

Furthermore, an increasing perception of risk and rising risk aversion led to corrections in equity markets, particularly for the shares of banks, and to tighter lending standards. Although these corrections have since been largely reversed, future trends in financial markets have to be monitored carefully. Given global uncertainty and the relatively high value of world stock markets a new correction cannot be excluded. In the event, the resulting wealth erosion, albeit considered to be small in the EU, combined with a decline in consumer confidence could deter private consumption. The exposure of EU financial institutions to emerging markets is relatively important and a general lack of transparency weighs on their operations. On the other hand, European banks are far from fragile as their capital base is comparatively high, an

appreciable part of external loans is covered by government guarantees and precautionary loan loss provisions have been built up.

A third, and potentially the most important, channel of contagion works through inhibiting confidence. Business confidence in the EU has already been visibly affected by the intensifying crisis as well as by the prospects of slackening world demand. A further drop, spilling over to consumers, could severely impair the dynamism of domestic demand in the EU.



Graph 5: **Business and consumer confidence - EUR**

Source: Commission services.

On balance, the Autumn 1998 economic forecasts of the services of the European Commission pointed to a temporary dent in EU output growth to 2.4 per cent in 1999, which is close to its potential rate, with the recovery gathering renewed momentum in 2000. The short-term economic outlook has become more uncertain, with risks predominantly being perceived to be on the downside. However, the co-ordinated move in early December to cut interest rates in the eleven countries adopting the euro will help to counter the threat of a growth slowdown, especially through sustaining confidence, thereby rebalancing somewhat the risks to the growth outlook. Nevertheless, a significantly worse outcome cannot be excluded. The potential for a deeper and more protracted slowdown and weaker job creation stems from two major sources; internationally, financial turbulence and, domestically, the curtailment of the dynamism of EU

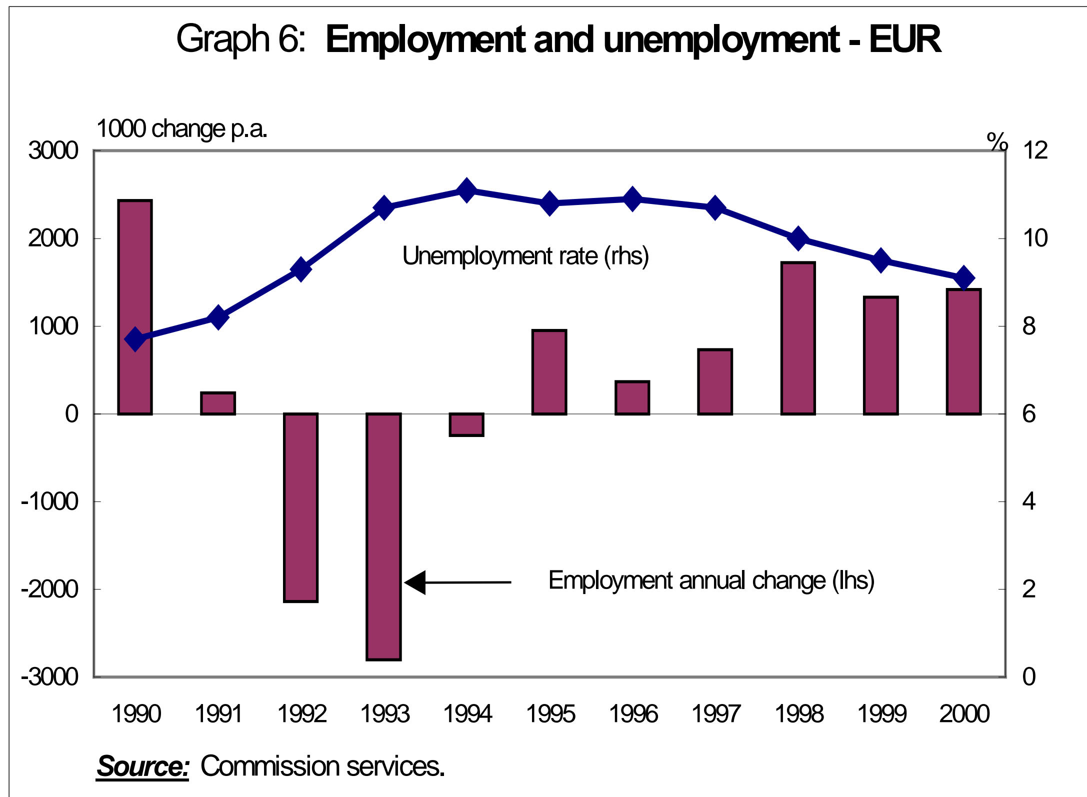
domestic demand through a deteriorating climate of confidence allied to a stronger responsiveness of investment to declining export growth.

While not downplaying the importance of the downside risks, it cannot be excluded that the growth path during the next two years will be more favourable than currently assumed if the growth supporting factors expected to be at work turn out to have a more significant effect on the economy than presently envisaged. In this context, the introduction of the euro and the prospect of important economic benefits from EMU could bolster private sector confidence and unleash higher investment, similar to the positive impact that the Single Market programme had in the late 1980s. These positive effects could be compounded by a further improvement in the macroeconomic policy mix.

3.2. Stronger job growth

Accelerating economic activity has fuelled the net creation of employment with the EU making inroads into the job losses incurred during the recession of the early 1990s. Following modest growth in employment in the previous three years, the pace of net job creation quickened markedly in 1998 on the back of continued strong growth, an unwinding of the cyclical peak in labour productivity growth and some structural reforms on product and labour markets. To the extent that employers perceive the economic slowdown to be temporary, the growth deceleration is expected to have only a muted impact on the overall encouraging employment outlook. As a consequence, the job destruction of the first half of the 1990s could be more than reversed by the year 2000.

The improving employment situation is increasingly being reflected in declining unemployment rates. Having reached historical highs in 1997 in many member countries, unemployment fell to 10 per cent of the civilian labour force in 1998 and could fall further to 9 per cent in 2000 in the EU as a whole. This means that by that time the cyclical component of unemployment in the EU would be largely absorbed. This does not imply that unemployment could not be reduced further through an investment-supported, employment-creating growth process over the medium term. Indeed, of the remaining part of unemployment, about half is composed of persons still in the normal turnover of the labour market. This means that they are employable with limited retraining, if needed, and could return to work if the necessary new jobs were created. Obviously, employment and unemployment prospects would be tarnished if economic growth would prove to be weaker than expected.



Source: Commission services.

Table 3: **Employment and unemployment – EUR**

(% change p.a. unless indicated otherwise)

	1991-1996	1997	1998*	1999*	2000*
Population of working age (15 - 64 years)	0.4	0.3	0.3	0.3	0.3
Labour force	0.1	0.3	0.3	0.4	0.5
Employment	-0.4	0.5	1.2	0.9	0.9
Labour productivity	1.9	2.2	1.7	1.5	1.8
Unemployment rate	10.2	10.7	10.0	9.5	9.1

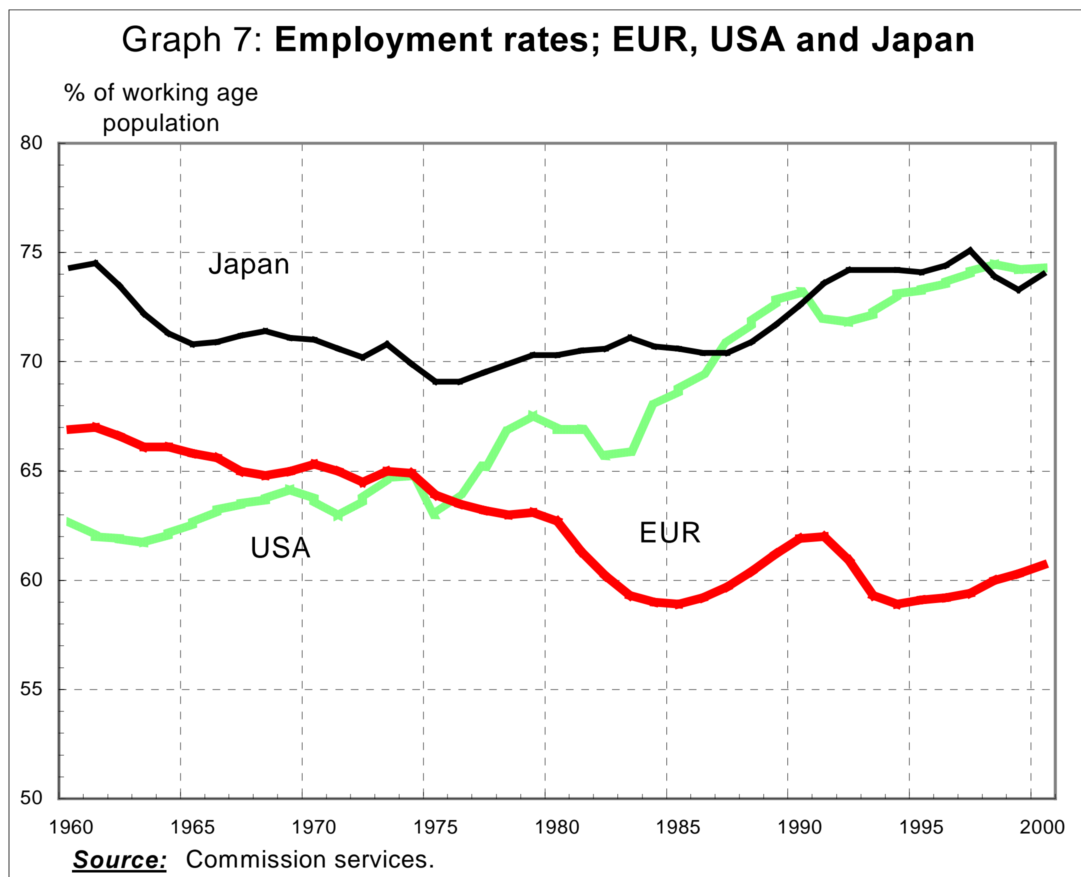
*Autumn 1998 forecasts.

Source: Commission services.

But as more people are being drawn into the labour force, resulting in a higher participation rate, movements in the measured rate of unemployment tend to understate the extent of the improvement in labour market performance during the upturn. To measure more effectively the performance of an economy in providing jobs for all those who are able to work, greater

attention has been given to the employment rate (the number of employed relative to the population of working age). Despite a slight improvement in recent years, to about 61 per cent in 1998, the employment rate in the EU as a whole is low, both in historical and international comparative terms. Achieving, over the medium term, a significantly higher employment rate would be beneficial on at least three counts: to improve living standards significantly on a lasting basis; to facilitate the sustainability of social security systems, especially in alleviating the pressures on public finances arising from an ageing population; and to ensure a cohesive society.

The overall EU figure masks, however, important differences between countries both in terms of levels and trends. Those countries, which have experienced the best growth performances and made most progress in structural reforms, have achieved the greatest improvements in their employment rates in recent years.

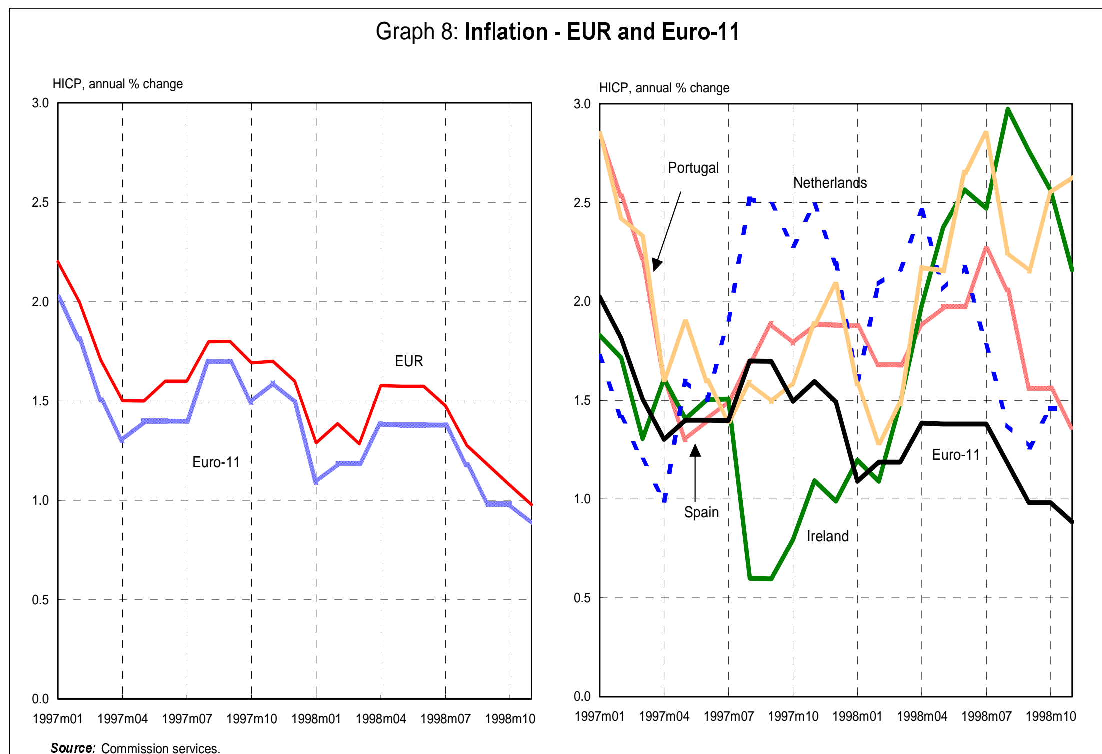


3.3. Absence of inflationary pressures

The EU continues to enjoy a high degree of price stability during the present upswing. Since early 1997, area-wide inflation as measured by the harmonised index of consumer prices (HICP) has fluctuated around an annual rate of 1½ per cent and, in the wake of the heightened financial turmoil in the summer, it has edged down further to 1 per cent during the second half of 1998. Furthermore, inflationary expectations are low and there are no inflationary risks on the horizon, as evidenced also by the continued downward trend in long-term interest rates during the last year, although the latter in part reflects a "flight to quality" through which liquidity withdrawn from emerging markets suffering from financial instability has been re-invested in Western capital markets. As a consequence, price increases in the EU as a whole are expected to remain below 2 per cent over the next two years, albeit picking up slightly towards the end of the period.

Several factors, both domestic and foreign, are contributing to this gratifying outlook. They include: very moderate increases in economy-wide unit labour costs thanks to continued moderate wage increases; a still significantly negative output gap (see also box 2), estimated by the Commission services to be around 1½ per cent in 1999; and very subdued, and even falling, import prices as a combined result of the Asian crisis, the fall in oil and non-oil commodity prices and the depreciation of the dollar.

Graph 8: **Inflation - EUR and Euro-11**



Source: Commission services.

As noticeable as the low average inflation has been a tendency for inflation differentials to widen somewhat, especially across the euro area. In contrast to developments in countries like Germany, France and Belgium, where inflation abated to below 1 per cent in the autumn of 1998, inflation rates have been somewhat higher and edged up in countries with already fairly mature expansions (Spain, Ireland, the Netherlands, Portugal). Although the annual inflation rate is only expected to moderately exceed 2 per cent over the foreseeable future in the cyclically-advanced economies, there is a greater potential for increased general price pressures given the high degree of capacity utilisation, the strong growth of credit and, in some cases, marked increases in property prices. On the other hand, the high elasticity of supply within the single market will help contain the emergence of inflationary pressures. The successful convergence of interest rates in the run-up to the introduction of the euro in these countries adds to the need for particular vigilance in managing budgetary policies, ensuring appropriate wage trends and speeding up structural reforms in order to quell inflationary pressures and sustain the upswing.

A certain degree of divergence in inflation rates between countries is likely to persist within EMU and might be wholly appropriate and necessary. To the extent that inflation differentials are caused by differences in productivity growth, such discrepancies should indeed be sustainable and desirable. For instance, the relatively higher inflation rate currently prevailing in Ireland appears, at least in part, to be due to a successful catching-up process. It is a common phenomenon that in countries or regions with high productivity growth in the tradable sectors that real wage increases exceeding productivity growth occur in the non-tradable sectors and thus generate relatively high overall price increases, without affecting external competitiveness.

The currently low level of inflation in the EU has triggered some concern about deflation, i.e. a fall in the general price level. Such concern appears exaggerated. The currently low average inflation rate in the EU is the result of shifts in relative prices; commodities and energy became cheaper while prices for services continue to rise. This shows up also in the HICP for the euro area where the rate excluding the more volatile categories of food and energy is clearly above the headline rate, but at about 1½ per cent it is well below the price stability reference value monitored by the ECB.

Box 2: Potential growth and the output gap

The implementation of the Stability and Growth Pact has brought renewed attention to the notions of **potential output growth** and the **output gap.** These concepts have great importance in the field of policy co-ordination and multilateral surveillance.

Both concepts are assessed differently depending on whether they are placed in a short, medium or long-term perspective.

In the short run (i.e. less than one year), the physical production capacity may be deemed quasi fixed and its comparison with actual output (i.e. the output gap) shows by how much total demand can develop during the short term without inducing supply constraints and inflationary pressures. According to the Commission services' estimates, the output gap is expected to be of the order of 1½ per cent in 1999-2000 in the EU as a whole and in the euro area (see table below), implying that production capacity limits are unlikely to be reached in the short run.

In the medium term (i.e. next five years), the expansion of domestic demand *when it is supported by a strong expansion of productive investment* may endogenously generate the expansion of productive capacity needed for its own support. For that to be the case, it is of course necessary that the investment is of the expansion type rather than that of rationalisation: in other words, fixed investment should be capital widening rather than capital deepening. The latter condition is all the more likely to be fulfilled when profitability is high and either increased or supported by an adequate wage evolution with respect to labour productivity, as is indeed the case at present within the EU and the euro area. Analyses made by the Commission services show that the average annual rate of growth of potential output could in such conditions increase from the present 2¼ to 2½ per cent range to about 3 – 3½ per cent over a five year horizon. Besides, given that there still exists an output gap at present, the pace of actual economic growth could and should initially exceed the potential growth rate during the period of absorption of free capacity, and equalise with potential growth thereafter. This also presupposes that the needed manpower will be available in order to utilise this new capacity. Studies by the Commission services on the structure of unemployment and potential labour supply suggest that this is indeed the case[1].

Finally, **in the long run** (10 years and beyond) the notion of full employment potential output is more linked to the future evolution of technical progress (or total factor productivity) and the growth of the labour force. For the latter, the EU is paradoxically in a much better position than the USA or Japan, thanks to its present very low rate of employment (with respect to the population in working age groups) and very high rate of unemployment (in the active population). Thus, putting into work not only the unemployed but also all those who were not included in the labour market statistics proper but would be ready to work if the right conditions are available, would enable the EU in the next 10 to 15 years to exceed the rate of growth of labour supply warranted by the demographic perspectives alone. Of course, this potential manpower should be employable, i.e. trained and/or retrained in an appropriate way in order to be able to respond to future developments. At the same time, structural reforms of the labour market together with the co-operation of the social partners should ensure a smooth adaptation of labour supply to labour demand and create the right economic and social conditions for the achievement of a much higher employment rate and lower unemployment rate without tensions and inflationary pressures.

These medium and long-run considerations should always be kept in mind when dealing with potential output since the latter is often seen in a much too static manner in some forecasting circles where the growth of capacity is often presented as invariant not only in the short run (where such an assumption is warranted) but also over the medium term, as if the projection of fixed investment had no impact on it. Similarly, the growth potential contained in the EU labour reserve is not often perceived as such.

Since a high growth potential is an absolute pre-condition for the achievement of a high ***and sustainable*** effective growth path and since this development of the output potential is undoubtedly affected by economic policies, both monetary and budgetary, as well as by wage developments, the concepts of potential growth and output gap have an important role to play in the definition of short, medium and long-run economic policies.

In a more specific way, the output gap also plays a role in the appreciation of budgetary positions. Indeed, if GDP is below potential, tax receipts are likely to be lower and expenditures (e.g. unemployment compensation) higher than they would otherwise be in a situation of full capacity utilisation, the reverse being true in the case of overheating with actual GDP above potential. Thus, the appreciation of the structural position of public finances requires the suppression of the purely cyclical elements by adjusting receipts and expenditures as a function of the estimated output gap. In this way, it is also possible to assess whether the trend in the structural budget is expansionary, neutral or restrictive.

However, notwithstanding the importance of the concept, the measurement of potential growth and the output gap is difficult and, not being observable can only result from a purely statistical approach (which may suffice in short-run analyses) or from a full econometric analysis (more appropriate for medium and long-run studies). ***All*** these analyses require arbitrary choices, either at the level of parameters (in statistical methods) or in the theoretical approach and in the choice of specification, data and estimation techniques (in econometric analyses). As a consequence, *all the available methods have pros and cons and none can unequivocally be declared better than the others in all cases*. Thus, what matters is to have a method adapted to the problem under analysis, with well defined limits and, in international comparisons, one that deals identically with all countries. Consequently, one should not hesitate to use several different techniques according to the question posed.

In this way, in its cyclical correction of government budgets, the Commission services opted for a simple, mechanical statistical method with well known properties, simple to apply, symmetrical through the cycle, prudent in its results and in which the unavoidable biases do not penalise or favour one country against another. This does not preclude, of course, the use of other indicators, based on models and explicit production frontiers, in the general framework of the Broad Economic Policy Guidelines.

[1] See European Commission, “The composition of unemployment from an economic perspective”, *European Economy,* n° 59, 1995.

Output gaps as estimated by international organisations [1], [2]

	1993	1994	1995	1996	1997	1998	1999	2000
EUR15								
- Commission: HP filter	-1.6	-0.8	-0.6	-1.1	-0.7	-0.2	-0.2	0.1
- Commission: Capital stock	-3.3	-2.0	-1.8	-2.1	-1.7	-1.3	-1.5	-1.3
- OECD	-2.4	-1.6	-1.3	-1.7	-1.4	-1.0	-1.2	-1.0
Euro area								
- Commission: HP filter	-1.2	-0.7	-0.7	-1.3	-1.0	-0.4	-0.3	0.1
- Commission: Capital stock	-4.0	-2.6	-2.3	-2.6	-2.1	-1.6	-1.8	-1.5
- OECD	-2.0	-1.5	-1.4	-1.9	-1.7	-1.3	-1.2	-1.0
EUR4								
- IMF	-2.7	-2.5	-2.0	-2.7	-2.8	-2.4	-1.2	-0.1

(1) The Commission services use two measures: the official figures published with the short term forecasts are used for the computation of cyclically-adjusted budget balances and are based on the application of the Hodrick-Prescott (HP) filter to the observed GDP figures. This approach has the merit of simplicity and strict limitation of judgmental intervention but leads to a smoothed trend GDP series that follows rather closely the observed one. For medium term projections, an approach linking potential growth to the growth of the fixed capital stock is used, corrected for changes in the capital output ratio. The OECD Secretariat uses a structural approach with a Cobb-Douglas, constant return production function with two inputs, labour and capital. Technical progress is measured as total factor productivity. The labour input is linked to the trends in the participation rate, in the population of working age, in working hours and in labour efficiency as well as to an estimate of the NAWRU. Total factor productivity, the NAWRU series and trends in participation rates and the number of hours worked are smoothed with the Hodrick-Prescott filter. The IMF uses a production function for the determination of potential output in industrial countries with methodological variations from country to country according to national specificity. Overall, however, potential output growth is linked to the growth of factor inputs (with the “normal use” of labour linked to the IMF estimates of the natural rate of unemployment) and a projected trend for total factor productivity (obtained by different approaches from country to country). For a recent analysis of these measurement issues, see “Croissance potentielle et écart de production”, special issue of *Economie Internationale, La Revue du CEPII*, n° 69, 1997. For details on the Commission services’ trend output approach, see European Commission (1995), “Technical note: The Commission services’ method for the cyclical adjustment of government budget balances”, *European Economy*, n° 60.

(2) Commission services: *Autumn 1998 economic forecasts*.
IMF: *World economic Outlook*, October 1998.
OECD, *Economic Outlook*, n° 64, November 1998.

4. CHALLENGES FOR ECONOMIC POLICY IN THE EURO AREA

4.1. Policy requirements in the present conjuncture

Macroeconomic policy mix and structural policies

For the European Union it will be essential to avoid that the global financial crisis results in a third downturn in the present decade, after the recession of 1992/93 and the marked slackening in 1996. But even if a pronounced downturn is avoided, with developments in 1999-2000 unfolding broadly as predicted in the Commission's Autumn forecasts, the Union risks making insufficient progress towards its key priority: to achieve, over the medium term, a substantial and lasting reduction in unemployment whilst significantly increasing the employment rate.

This situation calls for an appropriate and more co-ordinated economic policy response in the Member States and at the euro area level. In fact, policy-makers face the task of pursuing policies with a view to achieving self-sustaining, non-inflationary, investment-supported, growth over the medium and longer term, thereby containing the duration and depth of the present slowdown.

The response must be consistent with the cornerstone of the macroeconomic strategy established in successive Broad Economic Policy Guidelines. The main pillar of this strategy is that "the more the stability task of monetary policy is facilitated by appropriate budgetary measures and wage developments, the more monetary conditions, including exchange rates and long-term interest rates, will be favourable to growth and employment." In addition, any response must also recognise that structural adjustment policies represent a crucial instrument in returning the EU's economy to a durably higher, non-inflationary growth path allied to stronger job creation, despite a higher trend in labour productivity growth.

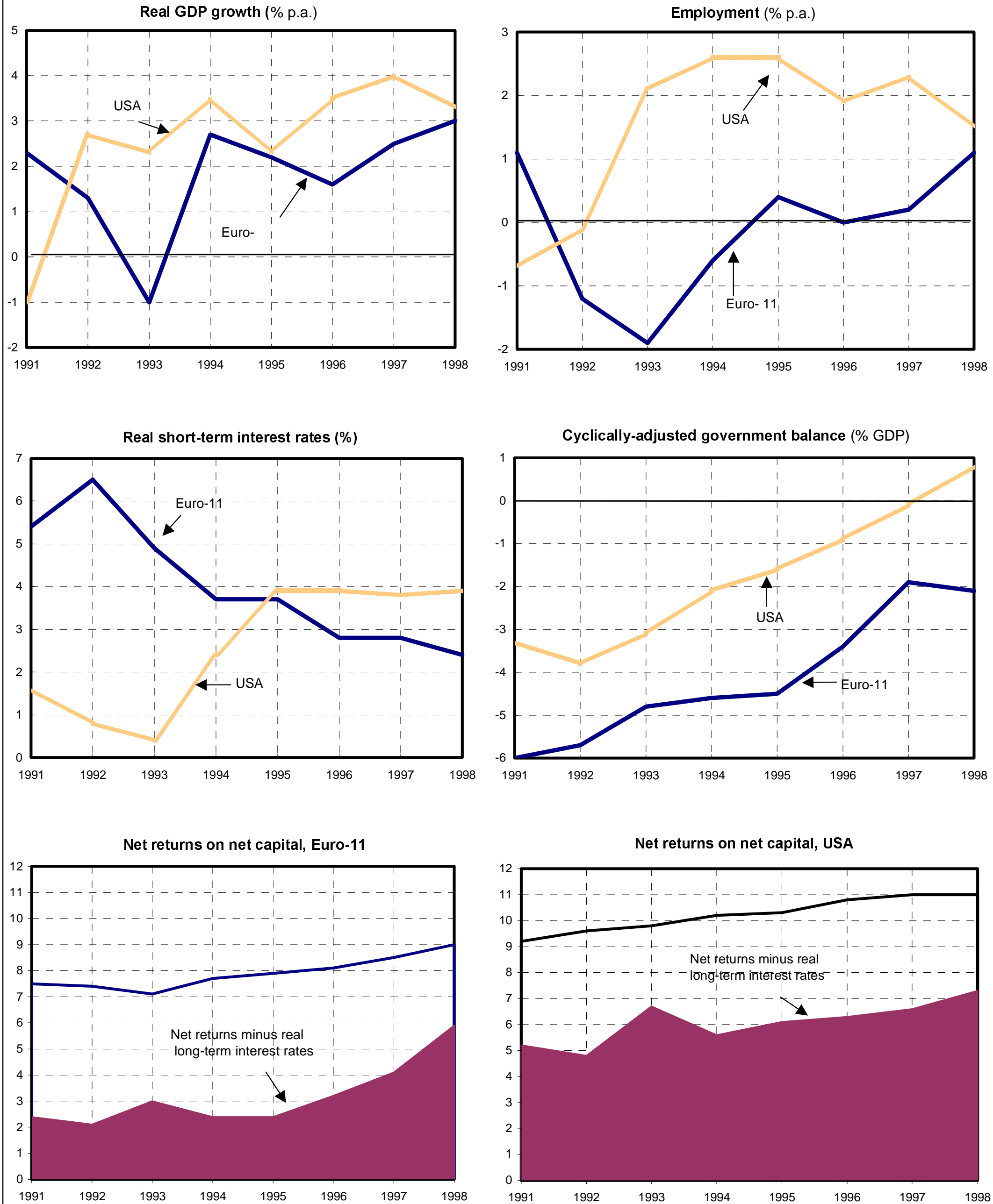
The crucial importance of an adequate macroeconomic policy to foster growth and employment was clearly highlighted during the 1990s. During the period 1991-98, the EU experienced an unsatisfactory growth and employment performance. Average economic growth in the EU amounted only to 1.9 per cent per year and lack-lustre economic activity was reflected in disappointing employment trends as net jobs fell by an average 0.1 per cent per year. In sharp contrast, the US economy experienced a prolonged phase of strong output growth and employment: real GDP grew by 2.6 per cent per year on average whilst net jobs were created at an average rate of 1.5 per cent per year. On the assumption of a similar pace of output growth

in the EU as in the USA, the EU would have achieved the creation of close to 10 million jobs, other things being equal, despite a higher trend in labour productivity growth.

What were the reasons for the rather mediocre growth and employment performance in the EU during the 1990s? The economic developments of the early 1990s were characterised by recessions mainly induced by stabilisation efforts both in the USA (1991) and in the EU (1993). In both areas inflation rates had risen to levels of 5 per cent or above following a period of strong expansion with an exceptional demand push due to German unification on the European side. The goal of bringing down inflation rates was reached on both sides of the Atlantic, although more rapidly in the USA, and the pattern of the economic recovery differed markedly.

While external determinants such as commodity prices and world trade growth have been similar for both areas, among the macroeconomic determinants of economic growth it is mainly the macroeconomic policy mix that shows significant differences between the USA and the EU. Since economic policies in the EU countries that have adopted the euro exhibit a higher degree of policy coherence, the comparison will be focused on the USA and the Euro-11.

In both the USA and the euro area, wage developments have not caused inflationary pressures in the years since the recessions. As real wages in the Euro-11 increased more slowly with respect to labour productivity than in the USA, they contributed somewhat more strongly to the increase in profitability. However, real long-term interest rates remained at relatively high levels in the Euro-11 and for that reason the difference between net returns on net capital and real long-term interest rates approached the US level very slowly and came close to it only in 1998. Due to the relatively slow growth of real wages in Euro-11, the contribution of wages to private consumption was smaller than in the USA. However, with falling inflation rates, real wage growth accelerated and contributed positively, together with employment growth, to a gradual pick-up in private consumption growth, reaching 2.5 per cent in 1998 in Euro-11.



Source: Commission services.

Budgetary consolidation has achieved remarkable results in the years since the early 1990s both in the USA and in Euro-11 but the timing of adjustment differed considerably with respect to cyclical developments. Due to a lower initial structural deficit, US budgetary policy was able to support the economy in the recession year and early in the recovery. The effect of this policy was amplified by monetary policy. During the upturn, continued budgetary consolidation was enacted, with the cyclically-adjusted budget deficit eliminated in 1998. In Europe, excessive budget deficits deprived governments from the possibility of supportive budgetary policy during the recession and the early part of the recovery. In the following years, contrary to the USA, consolidation efforts in Euro-11 were not equally distributed over time as most of them were concentrated in 1996/97 with a view to qualifying for EMU. The delayed budgetary consolidation in Euro-11 led to an inappropriate time profile and delayed the decline of long-term interest rates because budgetary policy gained credibility only very late.

Monetary policies have achieved price stability both in the USA and in Euro-11. However, monetary conditions have been more conducive to growth and employment in the former than in the latter. In the USA, official interest rates were cut significantly in the recession year 1991 and the following two years achieving very low levels of real short-term interest rates whereas the yield curve was favourable for growth in the recession year and during the beginning of the recovery. The cut in interest rates and the subsequent strong and prolonged recovery did not lead to a pick-up in inflation in the USA, reflecting in part the role of flexible supply-side conditions and in part the working of some special favourable factors. Conversely, in Euro-11 the yield curve was inverted during the period 1991-93 and real short-term interest rates were high, indicating a very restrictive stance of monetary policy. During the upswing monetary conditions eased, albeit gradually, reflecting in part slow progress in reducing budget deficits and in part the need to cope with market pressures on exchange rates. Moreover, monetary conditions suffered from the lack of a single monetary policy in Euro-11.

A depreciation of the real effective exchange rate has helped both areas in their recession years and in the following years. But in Euro-11 the development of the average real effective exchange rate hides the exchange market turmoil of 1992-93 and 1995 which was an additional obstacle to growth both for appreciating and depreciating economies (see also the Commission's 1997 Annual Economic Report).

In sum, the policy mix in the EU in the period 1991-98 was negatively affected by insufficient and delayed budgetary consolidation efforts and the lack of timely co-ordination of

consolidation efforts on the one hand and by the lack of a single monetary policy on the other hand. The determination on behalf of governments and the decision to start EMU in 1999 resulted in higher credibility and established a policy mix that is becoming more favourable for economic growth and employment.

Although efforts to redress the critical macroeconomic imbalances have largely paid off and created a solid potential for economic recovery, this should not distract the attention of policy makers from the crucial need to press ahead with economic reforms. During the 1990s reforms were implemented throughout the EU. But progress was initially slow and member countries did not adopt a sufficiently comprehensive approach. As a result, sub-optimal functioning product and labour markets, high tax pressures and inefficient welfare systems bore down on the EU's growth and employment performance.

Some general policy considerations

Since 1 January 1999, the euro exists as the single currency of eleven Member States of the EU -- within a number of years perhaps of the entire EU. On that date, these countries also *de jure* transferred their sovereignty over monetary and exchange rate policies to the Union level. As regards other fields of economic policy-making -- budgetary policy, wage developments, structural policies -- the introduction of the euro does not change the locus of responsibility which essentially remains at the national level. These policies will, however, be subjected to closer surveillance and co-ordination at the level of the euro area and the Union, with budgetary policy especially having to abide by the provisions of the Treaty (Articles 104 to 104c) and the requirements of the Stability and Growth Pact (see also box 3).

European monetary union will undoubtedly involve many opportunities but it also poses important new challenges.

With respect to the benefits, it is noteworthy that the unswerving commitment of the Member States to adopting a single currency has already delivered important benefits. Within the euro area, durably low inflation has been achieved and budget deficits have been substantially reduced. Together with judicious wage developments, this has paved the way to an easing of monetary conditions and a strengthening of growth and employment prospects throughout the euro area. The credibility of the process was also reflected in intra-EU exchange rates, which remained virtually unaffected by upheavals in the international financial markets in 1997 and 1998. Furthermore, whilst not in itself solving the EU's unemployment problem, the launch of

the single currency, together with the stability framework established by the Treaty and subsequent legislation, will help lock in macroeconomic policies favouring stable, high employment-creating growth in the EU. Finally, the single currency will increase the efficiency of the single market and act as a catalyst for structural reform.

At its outset, the euro area will, however, face important challenges. Firstly, in conducting monetary policy, the ECB is confronted with a number of pressing assignments; namely, to assess the effectiveness of its monetary framework; to define a policy stance that is appropriate for the euro area as a whole; and to give appropriate weight to the euro's importance in the world economy.

Secondly, the single monetary policy and the increased competitive environment will pose important challenges for economic policies at the national level. It will require completing the necessary budgetary consolidation and stepping up the reforms in product and labour markets. These policy requirements are underscored by the need to provide sufficient scope to address country-specific disturbances. Rather than reducing the responsibility and tasks of national policy actors, the introduction of the euro makes adequate national policy action, to contribute to stability, growth and employment, very compelling.

Thirdly, the introduction of the euro will tie the economies of the participating countries closer together. As a consequence, national economic policies will often have important spillover effects on other member countries, *inter alia* through their impact on the single monetary policy and the exchange rate of the euro. There is thus a clear need for effective co-ordination, both between economic actors and between countries, to ensure that appropriate combinations of economic policies are simultaneously conducted at the euro area level and in the individual Member States.

Finally, the introduction of the euro will carry important opportunities and challenges for the world economy. The euro will change the shape of international monetary relations, will help stabilise the international monetary system and will increase the impact of European economic policy at the world level.

Box 3: The institutional framework for the conduct of economic policy in the euro area

The institutional framework for the conduct of economic policy in the euro area acknowledges the fact that price stability is a pre-condition for sustainable economic growth and employment creation. Accordingly, economic policy objectives and the division of responsibility between the competent institutions within the Union have been designed to ensure a stability-oriented euro-area policy mix. The macroeconomic policy mix can be described in terms of the interaction between monetary policy, budgetary policy and wage developments. In addition to macroeconomic considerations, the question of the policy mix also applies to the interaction between macroeconomic and structural policies.

The conduct of euro-area monetary policy and the exchange rate

The euro-area Member States share a single monetary policy, which is conducted by the independent European Central Bank (ECB). The Governing Council of the ECB, which comprises the Governors of the euro-area national central banks (NCBs) and the Executive Board (including the President and Vice-President), is responsible for the formulation of euro-area monetary policy and for the setting of guidelines for policy implementation. Each member of the Governing Council has one vote and monetary policy decisions are made by simple majority. The Executive Board is mainly responsible for co-ordinating the implementation of monetary policy, which is decentralised and remains a responsibility of the NCBs. The other main tasks of the ECB are to conduct foreign exchange operations, to hold and manage the official foreign reserves of the euro-area member states, and to promote the smooth operation of the euro-area payments system.

According to Article 105 of the Treaty, the ECB's primary objective is to maintain price stability in the euro area. Without prejudice to its price stability objective, the ECB is also required by the Treaty to pursue a monetary policy that supports the general economic policies in order to contribute to achieving the economic objectives of the Union as laid down in Article 2, including sustainable, non-inflationary growth and a high level of employment. The stability-oriented monetary strategy of the ECB emphasises money supply growth as a reference variable (annualised reference rate for 1999 is set at 4.5 per cent) and quantifies price stability as an increase in the harmonised consumer price index of below 2 per cent over the medium term. In order to provide a broad assessment of the monetary policy stance, a range of other economic indicators – including the euro exchange rate - is also to be used. The ECB enjoys full independence from political interference in the conduct of monetary policy. However, the Treaty provides scope for policy dialogue between the ECB and other EU/national institutions so as to ensure a smooth interaction between monetary policy and other economic policies.

Responsibility for exchange rate matters is divided between the Council and the ESCB. On a recommendation from the ECB or from the Commission, and after consulting the ECB, the Council may conclude formal exchange rate arrangements involving the euro. In the absence of a formal arrangement, either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, the Council may formulate general orientations for exchange rate policy. However, any formal arrangement or policy orientations must be consistent with the price stability objective of the ECB.

The conduct of budgetary policy

The conduct of budgetary policy in the euro area remains the responsibility of national governments. In order to achieve and preserve budgetary discipline, national governments have to respect the provisions of the Treaty (Articles 104 to 104c) and the Stability and Growth Pact (SGP) in enacting budgetary policy.

Article 104, which entered into force with the start of Stage Two, prohibits the monetary financing of budget deficits. Article 104a, which also entered into force with the start of Stage Two, bans privileged access of the public sector to the financial institutions. Article 104b, which entered into force with the start of Stage Two, introduces a no-bailing out clause for defaulting governments. Article 104c introduces the legally binding principle that Member States must avoid excessive government deficits and stipulates the measures, of increasing strength, which the Council may apply in order to remedy the situation.

The SGP clarifies and accelerates the Treaty procedures for budgetary surveillance and for avoiding excessive deficits. Under the terms of the SGP, budget deficits in the euro-area Member States are to be limited to a maximum of 3 per cent of GDP in normal circumstances, with the possibility of sanctions including fines for member states breaching this limit. In addition to the upper limit for budget deficits, the SGP specifies a medium-term budgetary objective of "close to balance or in surplus" so as to allow sufficient scope for the budgetary impact of cyclical downturns without risk of breaching the deficit ceiling. This medium-term objective reflects the increased stabilisation role for budgetary policy at the member state level, as monetary policy responds only to economic conditions in the euro area as a whole. Its respect will contribute over the medium term to a saving-investment balance that is favourable to growth and employment.

Wage developments

In EMU wage setting will remain the responsibility of the social partners at the national, regional and sectoral level or even at a more decentralised level following their respective traditions. As underlined in the Amsterdam Resolution on "Growth and employment", the social partners are responsible for reconciling high employment with appropriate wage settlements and for setting up a suitable institutional framework for the wage formation process. The social dialogue is important for achieving the right results. For that reason, the Broad Guidelines urged the Commission to continue to develop the European social dialogue, especially on macroeconomic issues, on the basis of the Broad Guidelines. National governments retain a considerable responsibility for wage setting, both because of their role as a large employer and because they set the macroeconomic framework and determine the labour market rules and regulations under which the social partners operate.

In the light of the macroeconomic importance of the wage bill, including all social security contributions, it is desirable that policy-makers, whilst fully respecting the autonomy of the social partners, should closely monitor wage developments and express their views on the desired wage evolution with respect to the policy mix. The stability-orientation of the EMU framework requires that the evolution of aggregate euro-area nominal wages should be consistent with the objective of price stability. At the same time, developments of real wages with respect to productivity should take into account the need to maintain, and where appropriate strengthen, the profitability of investment in order to create more jobs whilst allowing a steady increase in purchasing power and private consumption. Moreover, wage trends need to reflect productivity differentials within and between Member State economies and take into account regional and to some extent sectoral economic conditions.

The conduct of structural policies

The effectiveness of any macroeconomic policy mix for the euro area in terms of stimulating economic growth and employment creation will be enhanced by appropriate micro-economic/structural policies. The conduct of these policies is also the responsibility of national governments.

While preparation for EMU has induced major improvements in the macroeconomic environment in the euro area, the smooth functioning of EMU requires more flexibility at the micro-economic/structural levels. Some imperfections are evident in product and capital markets, where elements of the single market remain incomplete. Moreover, there is concern about the problem of labour market rigidities, including obstacles to the EU using the potential to create jobs in the services sector. This is the specific task of the Employment Guidelines which are centred on employability, adaptability, equal opportunities and entrepreneurship. To address the need for greater economic flexibility, structural reform is at the top of the EU policy agenda and has led to the so-called Cardiff process whereby both the Member States and the Commission will submit annual reports on economic reforms.

Economic policy co-ordination

The move to Stage Three of economic and monetary union links the economies of the Member States adopting the euro more closely together. It is for this basic reason that the move to a single currency requires closer Community surveillance and co-ordination of economic policies among euro-area Member States. Moreover, close co-ordination should aim at an appropriate balance of the policy mix so as to contribute to the achievement of the Community objectives set out in Treaty Article 2. Closer co-ordination will be required both among Member States and between the various actors involved in economic decision-making. To this end, the Vienna European Council in December 1998 stressed the necessity to both deepen and strengthen economic policy co-ordination, within the agreed framework and involving an intensive dialogue between all actors, including, where appropriate the European social partners.

Economic and monetary interdependence with non-participating Member States will also be strong; they all participate in the single market. The need to ensure further convergence and a smooth functioning of the single market therefore requires that all Member States be included in the co-ordination of economic policies. Interdependence will be especially strong for those non euro-area Member States (Denmark and Greece) which participate in the new exchange rate mechanism.

The Treaty provides for several instruments for economic policy co-ordination. At the heart of the economic policy co-ordination process lies the Broad Economic Policy Guidelines (Article 103(2)). Co-ordination also crucially involves the close monitoring of economic policies and developments in each Member State and in the Community in the framework of multilateral surveillance. The Vienna European Council asked the Council to look for greater synergy between the Employment Guidelines and the Broad Economic Policy Guidelines.

In order to take account of the special needs of co-ordination for Member States participating in the euro area, the Euro-11 Group was created and has already proved to be an appropriate forum for dialogue. With respect to the external dimension of economic policy co-ordination, the Vienna European Council reached an agreement on the external representation of the Community which should ensure that the Community speaks with one voice and plays a full role in international monetary and economic policy co-operation within fora like the G7 and the IMF.

4.2. Wage developments

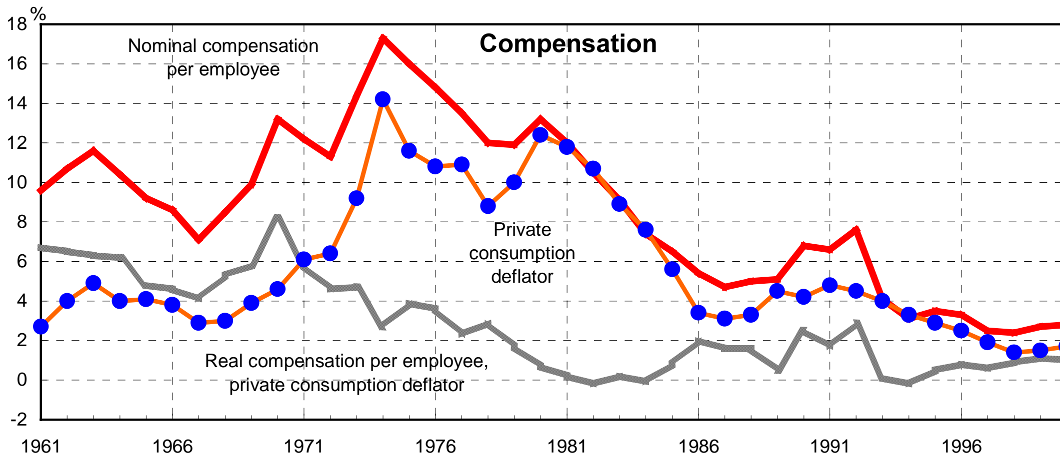
In EMU, with the single monetary regime, the link between wages and employment will become more evident and stringent. For wage developments to contribute to an employment-friendly policy mix, it will be essential that the social partners continue to pursue a responsible policy course in line with the following four guiding principles contained in the Broad Economic Policy Guidelines: (i) aggregate nominal wage increases should be consistent with price stability; (ii) at the macroeconomic level, overall real wage increases in relation to labour productivity growth should take into account the need to strengthen, where necessary, and subsequently maintain, the profitability of capacity-enhancing and employment-creating investment; (iii) real wage growth, if warranted by productivity trends, should also support the purchasing power of wage earners; and (iv) at a more microeconomic level, relative wage developments should support the creation of profitable jobs and the competitiveness of enterprises.

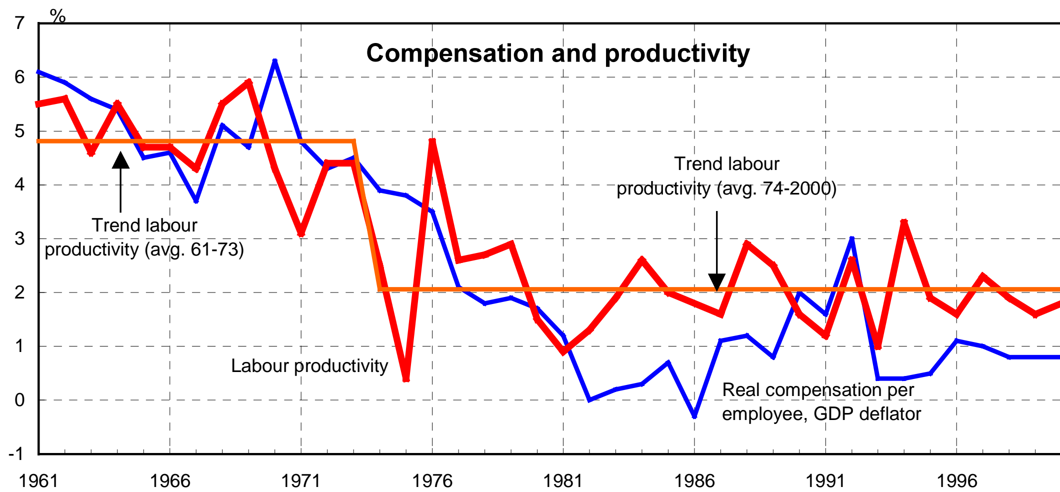
For the euro area as a whole, conditions (i) to (iii) are satisfied at present and are likely to be complied with in the near future but the fourth condition is still a source for concern.

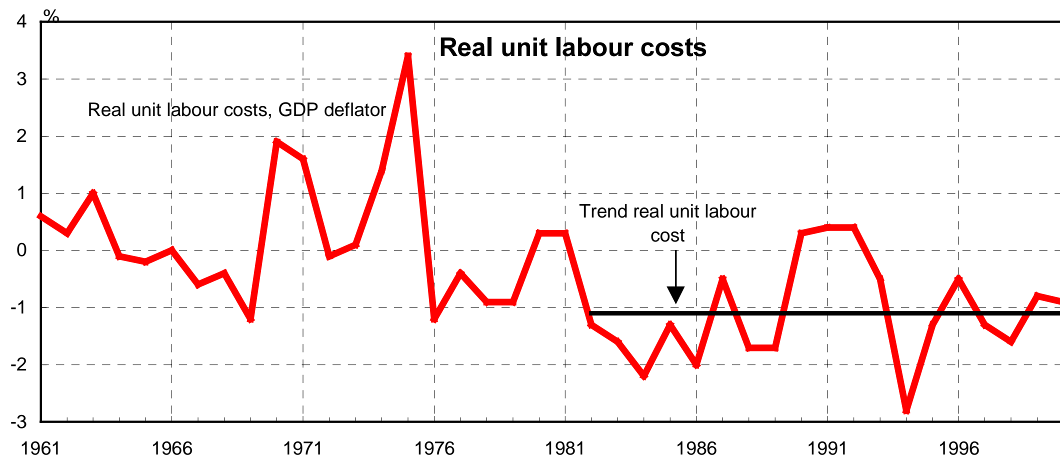
Indeed, in the euro area as a whole, appropriate wage trends are expected to continue in the coming years. According to the Commission's Autumn 1998 forecasts, annual nominal wage growth per employee is likely to remain in the 2.5 to 3 per cent range over the 1999-2000 period. With overall productivity gains of the order of 1.5 to 2 per cent per year, increases in unit labour costs should remain clearly within the inflation objective, thereby exerting no inflationary pressure and supporting a policy mix favourable to growth and employment. Furthermore, this appropriate wage behaviour will contribute to a further improvement in investment profitability and cost competitiveness. A sufficient capital return, together with adequate demand prospects, are essential conditions for investment-led, job-creating growth.

Graph 10: **Wage developments - Euro-11**

(% p.a.)







Source: Commission services.

Meanwhile, real wage increases of the order of 1 per cent per year in 1999-2000, together with employment creation, will allow for a steady increase in purchasing power, thus fuelling consumer demand. Although the strong profitability position would in principle justify real wage increases somewhat closer in tandem with labour productivity, the difficult international environment and its potential repercussions on competitiveness and employment call for prudence. It will therefore be imperative that the social partners exercise caution and adaptability in their wage agreements. In this respect, member countries might learn from the positive experience of a number of Member States, especially Ireland and the Netherlands, where continued moderate wage increases over more than one decade have contributed importantly to greatly improved employment/unemployment outcomes. Both of these latter countries have also in common that the appropriate wage behaviour was underpinned by tripartite, consensus-based wage agreements and was accompanied by a reduction in the tax burden on labour.

Though the evolution of wage differentiation is difficult to assess on the basis of existing statistics, the available evidence suggest that wage agreements take into account to an insufficient extent differences in productivity levels. The present situation reflects in part the fact that existing social legislation and tax-benefit systems create ‘implicit wage floors’ that take time to alter. Nevertheless there is growing empirical evidence that, even in the short term, low-skilled unemployed persons in the Member States would stand to benefit from a widening of the wage cost scale through reductions in non-wage labour costs targeted at the low skilled and by subsidising entry wages for the long-term unemployed. With respect to regional wage differentiation, it will be of crucial importance within the euro area to avoid a convergence of nominal and real wages across countries in advance of productivity. In fact, efforts must be made to link wages closer to regional economic and labour market conditions.

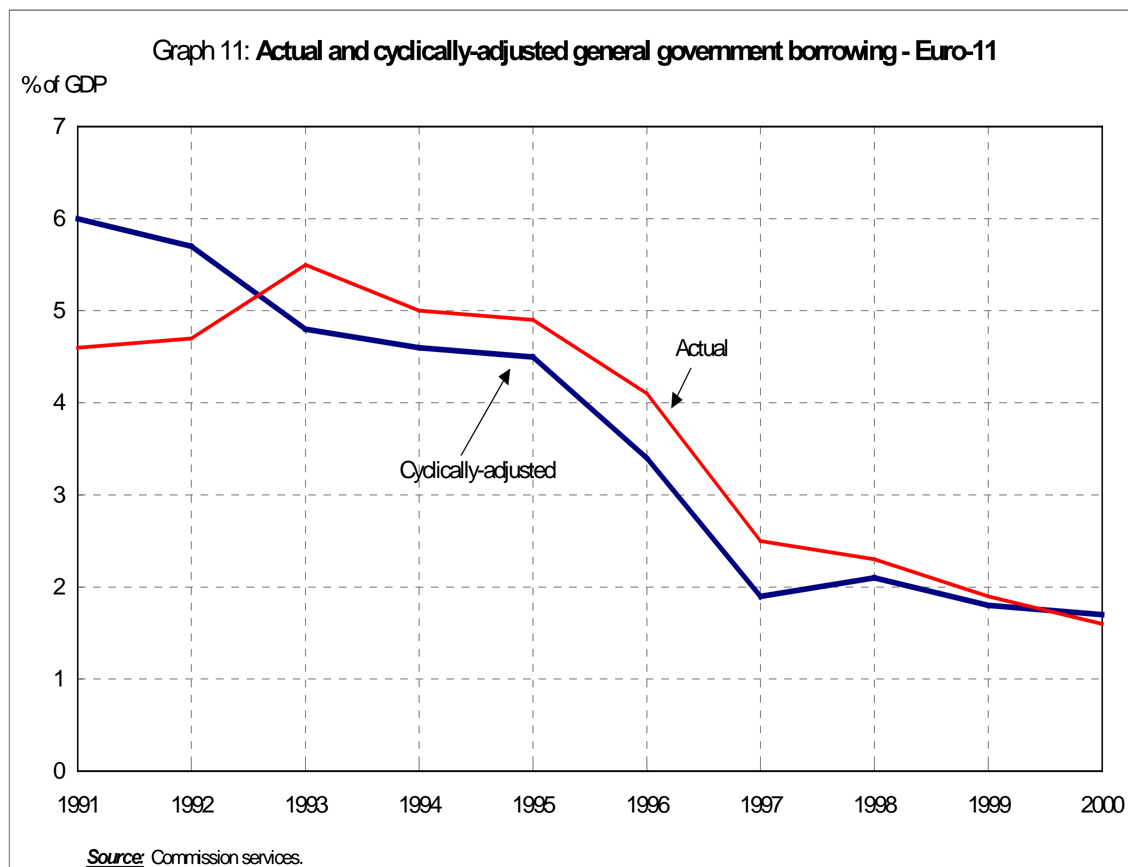
4.3. Budgetary policy

Budgetary consolidation: pause in 1998 followed by modest resumption

Following the noticeable reduction in budget deficits during stage two of EMU, budgetary consolidation came to a halt in 1998. Having fallen from a peak of 5.5 per cent of GDP in 1993 to 2.5 per cent in 1997 in the euro area as a whole, the actual general government budget deficit was only marginally reduced further to an estimated 2.3 per cent of GDP in 1998. But in many member countries the reduction in budget deficits was essentially due to the effects of higher growth and lower interest rates. Furthermore, in some countries -- Germany, France and Italy -

- the budget deficit remained close to the 3 per cent reference value. In the euro area on average, the budgetary position corrected for the influence of the business cycle showed a slight deterioration in 1998 to 2.1 per cent of GDP. It is noteworthy that further budgetary tightening took place in each of the countries not participating in the euro zone.

It is reassuring that, after a pause last year, currently available national budgets suggest a modest resumption of the reduction in cyclically-adjusted deficits in 1999, to an average of 1¾ per cent for the euro area. However, to an important extent this reduction will stem from a decline in interest payments as the euro area is reaping the fruits of past consolidation efforts through lower interest rates and a gradual decrease in the general government debt to GDP ratio. In some countries the further savings in interest payments are likely to be totally absorbed by a relaxation of the budgetary stance (as measured by the cyclically-adjusted primary balance). The projected improvement in the overall budgetary position in the euro area would entirely stem from a further decline in the share of government spending (including interest payments) to 48.5 per cent of GDP in 1999. This compares with a peak of 53.2 per cent of GDP in 1993.



Stability and Growth Pact requires continued determined consolidation efforts

Despite remarkable progress in reducing structural deficits, essentially in 1996/97, budgetary consolidation will continue to be a matter of concern after the start of stage three. Indeed, the budgetary positions of most of the Member States are not yet in line with the Stability and Growth Pact requirements. The Pact was concluded to further substantiate the Treaty provisions intended to prevent Member States from having an excessive budget deficit and to ensure that Member States exercise the required budgetary discipline after adopting the single currency.

Achieving and maintaining sound public finances is an essential means to ensure sustained growth and high employment. By reining back inflationary expectations, budgetary discipline on the part of the Member States will facilitate the ECB's task of achieving its primary objective, namely the maintenance of price stability, whilst allowing growth-supporting monetary conditions. Furthermore, sound public finances can contribute to higher sustained growth through generating a crowding-in of private investment. They help keep long-term interest rates low and avoid the absorption of private savings by the general government.

Based on past experiences Commission calculations suggest that cyclically-adjusted budgetary positions close to balance appear necessary in order to allow sufficient scope for budgetary flexibility over the cycle. As a consequence, in the euro area as a whole a further structural decrease of above 1 per cent of GDP over the next few years would appear appropriate. Such further reduction is needed in order to achieve budgetary positions consistent with the obligations under the Stability and Growth Pact.

On average, the improvement needed over the next few years seems moderate and, depending on favourable monetary conditions, should not jeopardise the recovery in the euro area. In the event of an unexpectedly severe slowdown, the automatic stabilisers might only be allowed to work to the extent that previous efforts towards budgetary consolidation have created the necessary room within the remit of the Stability and Growth Pact and that the reduction in structural deficits is not compromised. Conversely, failure to adjust now could result in tighter monetary conditions later and force governments, as in the past, to resort to pro-cyclical budgetary policies as they would try to keep deficits within 3 per cent of GDP, thereby exacerbating the next downturn.

Any assessment of the appropriateness of medium-term targets for governments' budgetary positions needs also to consider factors other than the influence of the business cycle. As such,

there might be a need, from time to time, to provide for additional room to supplement the operation of the automatic stabilisers through discretionary budgetary support for economic activity. Furthermore, those Member States (for instance Finland) that feel particularly vulnerable to asymmetric shocks might wish to introduce measures creating a budgetary buffer to cope with such shocks. In addition, countries with a high government debt to GDP ratio will need to provide a safeguard against interest rate shocks and to ensure a rapid decline in the debt ratio. Finally, it will be necessary to create room both for a long overdue reduction in large tax wedges, especially as regards low-income workers, and to prepare for the burden on the budget of an ageing population. As a consequence, in many Member States it would appear prudent to strive for even more ambitious medium-term budgetary positions.

In conformity with the Ecofin Council Declaration of early May, 12 Member States have submitted stability or convergence programmes before the end of 1998, whereas Germany and France submitted their stability programmes in January.

Without threatening the necessary ongoing consolidation process, governments must seize all opportunities both to improve the quality and the efficiency of government spending and to make taxation more employment-friendly, through lowering the overall tax burden and altering the structure and incidence of taxation. Such a re-orientation of government spending and taxation is greatly facilitated by the achievements in fiscal consolidation over the last few years. Debt service costs in the euro area as a whole are now falling as a proportion of GDP (from 5.6 per cent in 1993 to an expected 4.2 per cent in 2000) as a result of both lower interest rates and a fall in the general government debt to GDP ratio.

Table 4: **General government net lending / borrowing (% of GDP)**

Stability and Convergence programme projections

	Date [1]	1997	1998	1999	2000	2001	2002
		Stability programmes					
B	12/98	-1.9	-1.6	-1.3	-1.0	-0.7	-0.3
D	1/99	-2.7	-2.5	-2.0	-2.0	-1.5	-1.0
E	12/98	-2.6	-1.9	-1.6	-1.0	-0.4	0.1
F	1/99	-	-2.9	-2.3	-2.0 [2]	-1.6 [2]	-1.2 [2]
IRL	12/98	-	1.7	1.7	1.4	1.6	-
I	12/98	-2.7	-2.6	-2.0	-1.5	-1.0	-
L	--						
NL [3]	10/98	-0.9	-1.3	-1.3	-	-	-1.1 [4]
A	11/98	-1.9	-2.2	-2.0	-1.7	-1.5	-1.4
P	12/98	-	-	-2.0	-1.5	-1.2	-0.8
FIN	9/98	-1.1	1.1	2.4	2.2	2.1	2.3
		Convergence programmes					
DK	10/98	0.5	1.1	2.5	2.8	2.6	- [5]
EL	6/98	-4.0	-2.4	-2.1	-1.7	-0.8	-
S	12/98	-0.8	1.5	0.3	1.6	2.5	-
UK [6]	12/98	-0.6	0.8	-0.3	-0.3	-0.1	0.2 [7]

1) Date when programme was adopted.
2) Prudent scenario; favourable scenario projection: -1.7, -1.2 and -0.8 % of GDP, respectively, in the years 2000 to 2002.
3) No annual data provided for the years 2000/01.
4) Cautious scenario; middle and favourable scenario projections: -0.25 and 0.25% of GDP, respectively, in the year 2002.
5) Projection for the year 2005: 3.5% of GDP.
6) Data for the financial years beginning in each of the calendar years indicated.
7) Projection in the financial year 2003/04: 0.1 % of GDP.

Source: Commission services.

Restructuring of government spending

As regards the restructuring of government spending, priority should be given to arresting and reversing the steady decrease in the share of public investment in GDP, as called for in the Broad Economic Policy Guidelines. As in practically all industrialised countries, the relative importance of general government investment has fallen markedly in the EU over the last decades. Its present share of 2.1 per cent of GDP in the EU as a whole is less than half the level it attained in the 1960s. The reduction was particularly pronounced during the 1990s (drop by one percentage point of GDP) as a disproportionate share of the budgetary adjustment fell on government investment. The latter has been especially conspicuous in countries which had high imbalances in their public finances. Apart from consolidation efforts, other factors have also contributed to the secular fall in government spending, including the privatisation of infrastructure investment.

Table 5: **General government investment**
(as a percentage of GDP)

	B	D	E	F	IRL	I	L	NL	A	P	FIN	Euro area	DK	GR	S	UK	EUR
1970	4.0	4.6	2.5	3.6	4.1	2.9	3.3	4.9	4.6	2.3	3.5	3.8	4.5	--	6.2	5.8	4.3
1980	4.1	3.6	1.8	3.1	5.6	3.2	6.7	3.5	4.1	4.3	3.6	3.3	3.1	2.3	4.1	3.0	3.3
1990	1.3	2.3	4.9	3.3	2.1	3.3	--	2.7	3.2	3.3	3.6	3.0	1.6	2.8	3.0	2.6	2.9
1998*	1.5	1.8	3.0	2.8	2.5	2.3	5.0	2.5	2.0	4.1	2.7	2.3	1.6	3.6	2.5	1.2	2.1
2000*	1.5	1.9	3.0	2.8	2.1	2.2	5.0	2.5	1.9	4.4	2.5	2.3	1.6	4.2	2.5	1.4	2.2

* Autumn 1998 forecast.

Source: Commission services.

As a consequence, with a view to raising the medium to longer term growth potential and improving the locational attractiveness for foreign direct investment, the Member States and the Community need to pursue actively an adequate level of public investment while maintaining fiscal discipline. To this end, and as recommended in successive Broad Economic Policy Guidelines, Member States should reorient government spending towards public investment

whilst developing the private financing and operation of certain types of infrastructure. In addition, as underlined in the Commission's Communication "Investment in infrastructure in the European Union", there is a need to assure an adequate financing of the Trans-European networks (TENs) in the Community budget, to exploit fully and expand, when appropriate, existing Community financing instruments and the activities of the European Investment Bank to promote capital investment, especially in infrastructure.

Furthermore, a restructuring of government spending in favour of investment in human capital and other active labour market policies should be favoured as much as possible. Such a shift is expected to have positive effects on growth and employment. It would also help improve budgetary positions over the medium term as it should lead to a reduction in the number of people of working age receiving public income support and to an increase in the number of those at work. Despite recommendations in the Broad Guidelines to this effect, it appears that only limited progress in that direction has been made so far. Admittedly such a restructuring was difficult to achieve during recession when the number of unemployed was increasing. The current recovery offers the Member States a window of opportunity to re-orient government current outlays energetically towards investment in human capital and other active labour market policies. In this context, a determined implementation of the Employment Guidelines, which are *inter alia* designed to improve employability, will be crucial.

Lowering and shifting of the tax burden

In recent years, taxes and other government revenues have remained broadly stable at about 47 per cent of GDP in the euro area as a whole, compared with only one-third of GDP in the US and in Japan. Yet, high taxes may create disincentives to invest and work by lowering the net returns to such activities and bearing down on an economy's international competitiveness. Moreover, they encourage tax avoidance and evasion, which are economically costly. Recognising these adverse effects, in recent years some Member States have taken action and made considerable progress in turning the trend around, with noticeable gains in their overall economic performance.

About two-thirds of the long-term increase in the tax burden has been due to higher social security contributions. The latter, as any other charges on labour discourage both hiring and working. In order to remove such barriers to employment, governments should aim to stem and, wherever possible, reverse the rise in labour taxes, especially at the low end of the wage scale. One option is to finance the tax cuts by restraint on government spending; another option

would be to shift part of the burden away from labour towards other tax bases, such as energy consumption and environmental taxes ("green taxes") or VAT. The problem here is to find a suitable alternative to the payroll base without creating other kinds of disincentives or distortions to efficient resource allocation. However, in order to make significant inroads into the presently high tax burden on labour, achieving and maintaining a high employment rate will be indispensable.

The deepening economic integration that accompanies the introduction of the euro will require a greater co-ordination of tax policies in order to foster tax efficiency and discourage harmful tax competition. In principle, fair and transparent tax competition might be salutary. A systematic and regular comparative appraisal of the design and results of national tax systems forces governments to search for the most adequate tax system to maximise economic welfare. Unfettered tax competition would risk, however, undermining the proper functioning of the single market, eroding the tax base, intensifying the harmful shift in the tax burden towards labour and constraining governments in pursuing their allocation, distribution and stabilisation functions.

With a view to reducing the continuing distortions in the single market, preventing excessive losses of tax revenues and encouraging employment-friendly tax structures, since 1996 vigorous efforts have been undertaken to enhance tax co-ordination in the Union. A first, major result was the Council agreement of December 1997 on a tax package. This included a Resolution on a Code of Conduct with a view to bringing to a halt and rolling back harmful competition in business taxation as well as a commitment to bring forward legislative actions aimed at ensuring a minimum of effective taxation of income of non-residents from savings. A Code of Conduct Group drew up an indicative list of potentially harmful tax measures in December 1998. Furthermore, concerning income from savings, the Commission submitted in May 1998 a proposal for a directive on the taxation of interest paid in a country in the Community to individuals who are resident in another Member State. It is important that the Council reaches agreement on this proposal in 1999, in compliance with the requests of the Vienna European Council, and that it pursues its work on effective tax co-ordination in other areas, especially energy taxation. Furthermore, to tackle the problem of harmful tax competition, progress is needed at the international level.

4.4. Monetary policy

A smooth changeover to the euro

The changeover to the euro on 1 January 1999 was successful. The technical procedure for the changeover was implemented as planned and financial markets began trading in the new single-currency environment on 4 January 1999. The success of the changeover was, in large part, attributable to intensified co-ordination of monetary policies in the euro-area Member States in the period from the Council decisions of May 1998 to the launch of EMU. The objectives of co-ordination were to foster a smooth convergence in national short-term interest rates towards common euro-area rates and to ensure that national currency exchange rates on 31 December 1998 coincided with the pre-announced bilateral conversion rates. It should be noted that long-term interest rates in the euro-area Member States had converged significantly before May and this convergence was maintained for the rest of the year.

While the majority of short-term interest rates were already clustered between 3 and 3.5 per cent in May, there were significantly positive spreads on rates in Spain (65 basis points (bps)), Ireland (250 bps), Italy (133 bps) and Portugal (70 bps). These spreads started to be partially narrowed in several steps from October 1998. In early December 1998, against the background of increasing signs of less favourable growth prospects for the euro area, National Central Banks trimmed their benchmark rates. (Italy cut its rate to 3.5 per cent and completed the alignment at the end of December.) This co-ordinated easing in monetary policy was also taken as an opportunity to proceed to a general and nearly complete alignment of the benchmark rates in the euro zone at 3 per cent.

The exchange rates of the euro-area Member States were clustered in May 1998 around their ERM central parities. The IEP had been significantly above its ERM central parities since autumn 1996 but moved into line in May, helped by a revaluation of 3 per cent in the ERM in March 1998. Exchange rate stability within the ERM was maintained throughout the rest of the year, and each of the euro-area national currency exchange rates were at their pre-announced bilateral conversion rate on 31 December 1998. The euro conversion rates for these currencies were calculated according to the method agreed by the Finance Ministers and Central Bank Governors in May 1998 i.e. on the basis of their bilateral ERM central rates. The ECU basket ceased to exist with effect from 1 January 1999.

Monetary conditions in the euro area

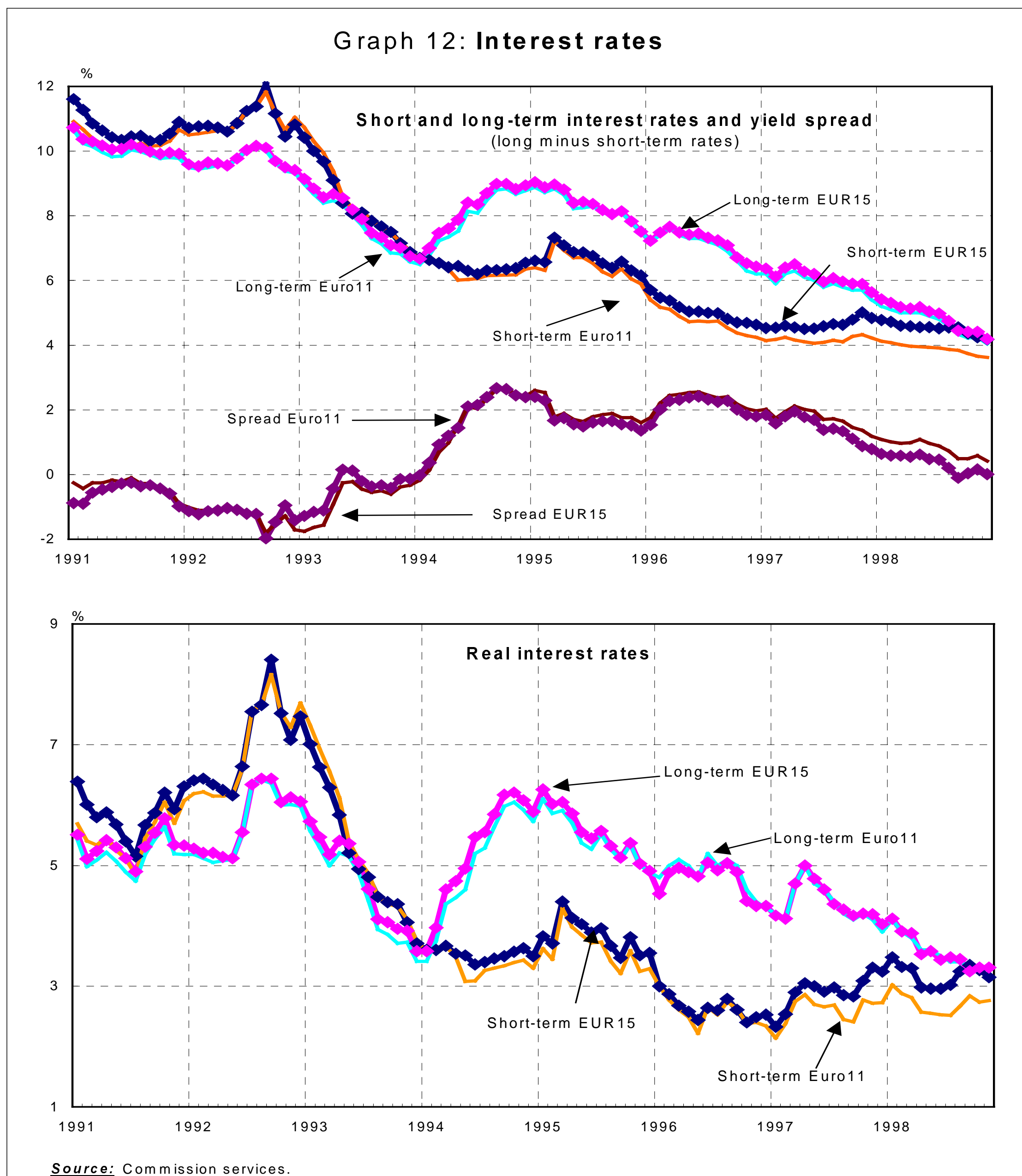
As price stability is the primary objective of the ECB, with inflation expectations and the supply and demand for capital being the major determinants for long-term interest rates,

monetary conditions are highly dependent on the evolution of the two other components of the policy mix, i.e. wages and budgetary policy.

In this respect, the present economic environment and prospects promise a setting for monetary conditions conducive to growth and employment in the euro area. As discussed in section 3.3, it appears that price stability is firmly established in the euro area. Inflation currently stands at about 1 per cent. The risk of any inflationary pressure in the foreseeable future is also very limited. The output gap for the euro zone is still undisputedly negative, both because of the presence of spare productive capacity and the huge slack in the labour market. As discussed in section 4.2, aggregate wage developments in the euro area are appropriate. Furthermore, the present high level of the unemployment rate should allow a marked decline in unemployment before the improved labour market situation would start exerting significant upward pressure on wages, especially if structural reforms in the labour markets are introduced, as planned in most Member States. As regards budgetary policy, a gradual structural reduction in budgets deficits is expected to resume in 1999, while adherence to the Stability and Growth Pact should ensure sound public finances in the medium term (see also section 4.3).

The favourable inflationary outlook in the euro area has led to a convergence of long-term interest rates to around 4 per cent. With long-term inflation expectations of about 2 per cent, this implies real rates at the long end of 2 per cent; this is somewhat below the rate of potential growth and, taking into account the available spare production capacity, clearly below the presently possible effective output growth, a situation not seen since the late 1970s.

Regarding short term interest rates, the ECB began its conduct of euro-area monetary policy by setting the marginal lending rate of 4.5 percent, a deposit rate of 2 per cent and a repo rate of 3 per cent. (For an interim period until 21 January 1999, the marginal lending rate will be 3.25 per cent and the deposit rate will be 2.75 per cent.) These rates mean that the stance of euro-area monetary policy continues the stance that prevailed in the participating Member States since the co-ordinated easing and alignment of 3 December 1998. The present euro-area short-term interest rates imply an easing that is equivalent to about 75 basis points relative to implicit euro-area rates in May 1998. Current short-term inflation prospects imply real short-term interest rates close to 2 per cent for consumers, but probably closer to 3 per cent for producers, given the very subdued profile of producer prices.



Source: Commission services.

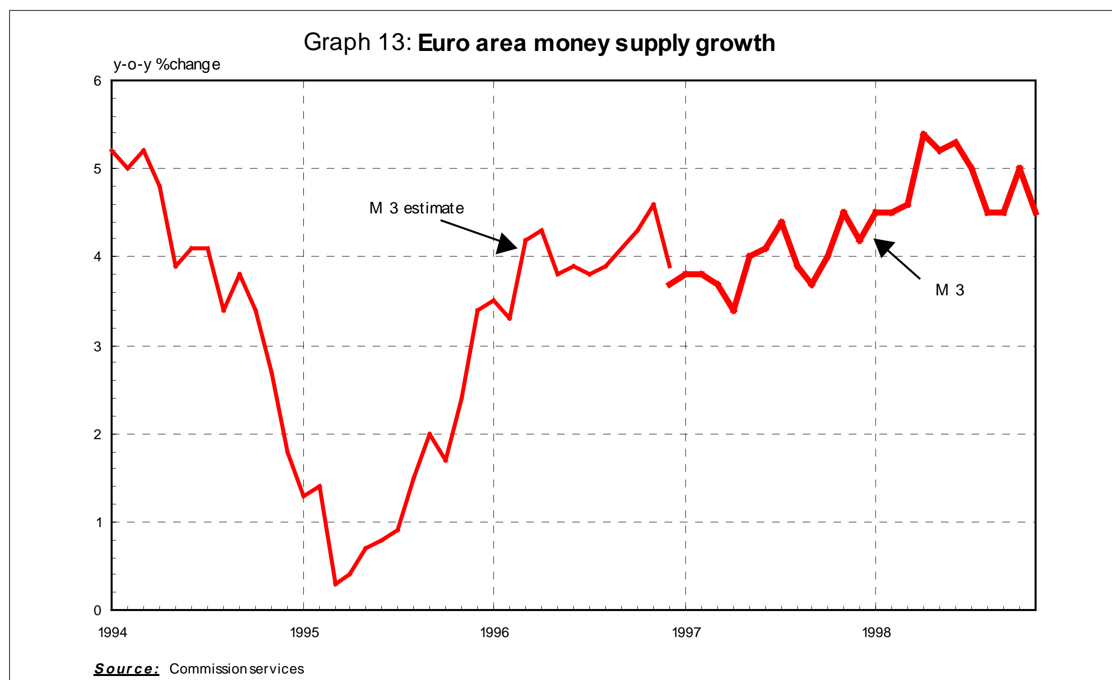
Taken separately, the recent evolution of both short-term and long-term interest rates has been favourable for growth and employment. However the virtual flatness of the yield curve delivers a less sanguine message on the monetary conditions in the euro area.

Furthermore, on the exchange front, the ECU appreciated by 5 per cent against the dollar between May 1998 and November 1998, before loosing some ground in December. The currencies of the euro area have appreciated by 6.2 per cent since May against the dollar, and by 2.9 per cent in effective terms relative to the industrial countries.

At its meeting of 1 December 1998, the Governing Council of the ECB set the reference value for annual money supply growth in the euro area in 1999 at 4.5 per cent. This reference value is derived from three components: the ECB's inflation objective of below 2 per cent; the trend growth rate of real output growth of 2 to 2½ per cent; and an expected further decline in the velocity of money of 0.5 to 1 per cent. In November 1998, the monetary aggregate (M3) grew by 4.5 per cent, against about 5.5 per cent in the spring of 1998. In assessing the evolution of money supply growth, the ECB will face a number of challenges in the near future. These are related to the fact that the move towards a single monetary policy implies a regime change, creating uncertainty about for instance the evolution of money velocity and the transmission mechanism of monetary policy in the euro area.

Against this background, continued adequate wage developments, sustained progress in the process of structural budget consolidation and enhanced efforts to improve the functioning of product and labour markets would still provide the ECB with the necessary room for manoeuvre if the economic climate in the euro area were to deteriorate further.

Graph 13: **Euro area money supply growth**



Source: Commission services

4.5. Structural policies

The role of structural reform

Structural policies have an important role to play in fostering economic growth and employment, since they help ensure sustainable long-run growth, reinforce competitiveness and increase the job-content of growth. Although this requires ongoing reform in the labour market, this should not be seen in isolation, as sub-optimal outcomes in the labour market can also be the result of rigidities in product, services or capital markets. Structural reform therefore encompasses not only improved labour market functioning, but also other important measures such as: an improved regulatory framework for firms (elimination of unnecessary barriers, simplification and streamlining of regulation), increased entrepreneurship (through improved capital markets and lower barriers to entry and exit), and opening hitherto protected markets as well as eliminating anti-competitive behaviour by firms or the public sector; whilst in all cases respecting consumer, environmental and social interests. Without these measures for boosting economic performance and adapting to economic shocks, unnecessary rigidities and costs are imposed which hinder job creation, the Union's top priority.

Such rigidities and costs will become even more important in EMU as it will lead to a more competitive environment, involving innovation and restructuring, and so requiring capital and labour mobility from declining to expanding firms and sectors. Member States' adjustment to country-specific economic disturbances will have to rely to a considerable extent on the adaptability of their markets for products, services and factors of production. Rigid product and labour market regulations may hamper such an adjustment process with negative consequences for competitiveness and employment.

There is broad agreement that many aspects of product and labour markets in the EU are currently insufficiently flexible, despite good progress in some areas due to the Single Market Programme (SMP). The economic reform process should therefore be encouraged by an adequate regulatory framework across the EU. Stylised empirical evidence suggests that labour markets, as well as many product and services markets, are still generally hampered by a lack of innovation and numerous barriers leading to a loss of welfare and employment. Jobs have thus been destroyed in manufacturing at quite striking rates, whilst gains in the services sectors have failed to compensate fully.

Member States' governments and the European Union have the responsibility to review existing regulations continuously so as to assess their appropriateness, reduce the costs of implementing and monitoring these regulations and increase their transparency and enforceability. Reforms are being implemented throughout Europe, both at national and Union level. The SMP has led to a better functioning of goods and services markets, as well as putting in place steps to improve labour and capital markets at EU level. This is been coupled with reform at national level, however, in many countries, reform efforts are still scattered, and lack co-ordination and comprehensiveness. Therefore, the issue now is how to build momentum and widen the support for reforms.

Co-ordinated and comprehensive economic reforms are essential

Co-ordination will be necessary. If reforms are difficult to implement by a country in isolation because of short term political costs, collective efforts may reduce these difficulties. On the other hand, co-ordinated structural reforms are needed to facilitate macroeconomic stability, which may be jeopardised if structural malfunctioning of markets contributes to high and persistent unemployment leading to socially unacceptable situations in individual Member States and calls for a relaxation of discipline. Finally, co-ordination is necessary because widely different structural conditions and policies require different macroeconomic responses in the event of shocks, which would be at odds with the basic features of macroeconomic policy in EMU.

Comprehensiveness is important to produce positive effects. The risks of reform reversibility in, for instance, the labour market may lead to adverse employment effects as employers may exploit the greater opportunities to shed jobs whilst refraining from hiring. The structural features of the economic and social system are interlinked in complex ways. Countries with highly regulated product markets tend also to have highly regulated labour markets, while welfare generosity (in-the-market protection) and strict job-security provisions (on-the-job protection) tend to be substitutes.

It is therefore clear that Europe's social protection systems need to adapt so as to meet better existing demands and respond to new needs, changing circumstances and the increasing pressure to contain costs. The common aims are to assure the continued effectiveness of social protection systems, to ensure that they strengthen rather than obstruct economic growth and job creation, to contain the costs of providing support to all those who need it and to shift towards a

more active policy designed to get people into employment rather than merely transferring income to them when they are not working.

The Commission's 1997 communication on modernising and improving social protection took forward a process of joint European debate on these issues, focusing on four challenges: making social protection more employment-friendly; adapting systems to the consequences of an ageing population; adjusting to the new gender balance in working life and reforming the system of social security co-ordination for people moving within the EU. These issues will remain at the centre of a new communication on social protection which the Commission intends to adopt in early 1999.

The SMP has been a successful exercise as regards co-ordination of regulatory reform in product and services markets, and the Single Market Action Plan is a step forward in comprehensiveness. In its conclusions, the Luxembourg European Council of December 1997 stressed the importance of monitoring the functioning of the Single Market as well as the need for policy co-ordination in taxation matters in order to enhance economic efficiency and to discourage harmful tax competition.

The Luxembourg European Council on Employment in November 1997 established the EU strategy for employment, which not only stresses the importance of active labour market policies but also their interplay with other policy areas such as taxation or unemployment support.

On 15 December 1997, the Council adopted a first set of employment guidelines to improve employability, develop entrepreneurship, encourage adaptability of businesses and their employees and strengthen equal opportunities policies for women and men. A key feature of the new process is the setting of clearly identifiable and measurable European and national targets. This increases the transparency and accountability of policies and has also initiated a concomitant process of strengthening indicators and statistical monitoring tools.

The Vienna European Council endorsed a revised set of guidelines for 1999. It urged Member States to pay particular attention to:

(i) achieving tangible progress in promoting equal opportunities between women and men, in particular by using benchmarks and a gender mainstreaming approach;

(ii) making a reality of the concept of lifelong learning, in particular by setting a national target for participants benefiting from such measures;

(iii) fully exploiting the potential of the service sector and industry related services, in particular information technology and the environmental sector;
(iv) creating a climate in which business, especially small businesses can flourish;
(v) examining tax-benefit systems in order to provide incentives for the unemployed and inactive to take up work or training opportunities and for employers to create new jobs;
(vi) supporting older workers with a view to increasing their participation in the labour force;
(vii) promoting social inclusion and equality of opportunity for disadvantaged groups.

The Commission will take up these points with Member States and monitor progress in the context of the submission of Member States' National Action Plans for 1999.

The Cardiff process for economic reform

In the Cardiff European Council of June 1998, Member States paved the way towards the co-ordination of and comprehensiveness in economic reform. The Cardiff European Council welcomed the involvement of the Ecofin Council in reinforcing and accelerating the economic reforms necessary to make the Single Market and EMU function optimally, as well as in integrating the economic reform issues (product and capital markets) with macroeconomic and labour market issues. The involvement of the Ecofin Council in the economic reform process will take place via the multilateral surveillance of the EU economies, leading to policy recommendations in the Broad Economic Policy Guidelines, and a system of monitoring of these recommendations.

The Commission has been asked to present an annual report (Cardiff I) focussing on Community policies concerning the Single Market in a wide sense. It will cover economic integration and efficiency, and analyse fundamental horizontal questions in the Single Market (the regulatory framework, technical barriers to trade, parallel trade in the goods market, financial services, securities and derivatives markets, competition, utility regulation, public procurement, taxation). The report should identify areas for further monitoring, as well as give basic policy prescriptions in these areas, and prepare the way for future work through requesting co-operation from Member States in providing further information on a regular basis. It will be discussed by the IMC and Ecofin Councils in February.

In a parallel process, Member States will present country reports covering their areas of competence for goods and capital markets. On the basis of these reports by the Member States and the Cardiff I report, the Commission will draw up a short report (Cardiff II) on structural issues and policies, which will be discussed in the March Ecofin Council within the context of

the multilateral surveillance and in preparation of the Broad Economic Policy Guidelines. The report will include references to the interplay between product, services, capital, and labour markets, and will also deal with structural aspects of public finances (taxation, the composition of public spending) and the macroeconomic framework. In future, the Annual Economic Report will make a reference to the above mentioned reports, Cardiff I and II.

4.6. External implications of the euro

The size of the euro area, the stability orientation of its policy framework and the integration of its financial markets imply that the euro will likely become a major world currency. This will fundamentally change the nature and functioning of the international monetary system. Probably the main channel of transmission through which the introduction of the euro will affect economic conditions in non-EU countries runs via these countries' international trade relations with the euro area.

While one can expect that these factors will affect non-EU countries only gradually over a relatively long period of time, the introduction of the euro represents a structural break in the invoicing practices in international trade relations, and trade invoicing in euro will increase very rapidly, probably already in the first years after the introduction of the euro. Under normal circumstances, there exists an important degree of inertia in the international use of currencies. However, it may be expected that companies from euro area countries will express their home currency preference for the euro very rapidly after its introduction. This phenomenon will be especially clear in the EU countries where a relatively small part of external trade has been invoiced in the home currency, due to the relative unimportance of their currency at the world level. These countries will be able to benefit from the possibility to invoice in their new home currency, and one can expect that they will switch to euro invoicing very soon after the introduction of the euro.

The role of the euro will also expand in international financial markets. Fully integrated, broad and liquid markets in the euro will develop, which, together with the stable macroeconomic environment of EMU, will lead to a substantial growth in European financial markets. Portfolio shifts can be expected to take place into these markets, while also the supply of financial assets in euro will grow. Non-EU countries will have the opportunity to diversify their international borrowings, which may contribute to correcting the possible existing mismatch between foreign trade revenues and international debt servicing. However, it is to be

expected that the role of the euro on international financial markets will expand only gradually. The same is true for the potential use of the euro as a vehicle currency on foreign exchange markets, which will benefit from its increased use as an invoicing currency in international trade and from its growing role in international capital markets.

Indirectly, the introduction of the euro may also affect non-EU countries through their own policy actions, taken in response to the new situation in the international monetary system which results from the completion of EMU. The policy reaction of non-EU countries concerns the use of the euro as an anchor for the exchange rate policy of non-EU countries, and its role as an international reserve currency.

In December 1997, the Luxembourg European Council decided that "the Council should monitor the development of the exchange rate of the euro in the light of a wide range of economic data. The Commission should provide analysis to the Council and the Economic and Financial Committee should prepare the Council's views". In order to prepare such analyses, the Commission services have started examining various methods for the analysis of exchange rate developments.

In the short run, the two major factors that are likely to contribute to future developments of the euro's exchange rate are differences in cyclical positions and the emerging market crisis.

Exchange rate developments are partially explained by cyclical developments. The currencies of countries experiencing high growth tend to appreciate relative to currencies of low growth countries. The (expected) interest rate differential between the countries serves as a link between cyclical and exchange rate developments.

Important trading partners are affected by the emerging market crisis or by its fall-out on commodity markets. Indeed, the Asian crisis has reduced demand for commodities and put downward pressure on commodity prices. Canada and Norway are the main victims among the important trading partners of Euro-11. During 1998, the weakness of the currencies of most of the major trading partners of the Euro-11 put upward pressure on the currencies of the euro countries. To the extent that the crisis economies succeed in recovering, their currencies might experience a certain appreciation, including against the euro.