II

(Acts whose publication is not obligatory)

COUNCIL

COUNCIL DECISION

of 20 December 1985

adopting the annual report on the economic situation in the Community and laying down economic policy guidelines for 1986

(85/619/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

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

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament (3),

Having regard to the opinion of the Economic and Social Committee (4),

HAS ADOPTED THIS DECISION:

Article 1

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

Article 2

This Decision is addressed to the Member States.

Done at Brussels, 20 December 1985.

For the Council

The President

R. KRIEPS

(1) OJ No L 63, 5. 3. 1974, p. 16.
(2) OJ No L 330, 24. 12. 1975, p. 52.
(3) OJ No C 345, 31. 12. 1985.
(4) OJ No C 344, 31. 12. 1985.

ANNUAL ECONOMIC REPORT 1985/86

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PART I

THE COMMUNITY ECONOMY

INTRODUCTION AND SUMMARY

1. The present Annual Economic Report for 1985 to 1986, here submitted to the Community institutions in accordance with regular procedures, builds on the report which the Council adopted last year, the principal theme of which was the need to achieve a substantial and durable improvement in the employment situation. Its potential is increased by proposals for a cooperative strategy calling for balanced contributions from the Community, Governments of Member States as well as from the social partners. This strategy will be even more effective if it can rely on international cooperation.

2. In 1984/85 the Community countries have achieved some progress in respect of economic policy:

— the moderate economic recovery, which has been under way for $2^1/_2$ years, is continuing,

— considerable progress has been made towards restoring price stability,

— there has been further improvement with respect to the budgetary and external imbalances.

3. These successes are grounds neither for complacency nor for hoping that the major problem of the Community — unemployment — will be resolved if current trends continue. Indeed, all medium- and long-term forecasts of growth and employment agree that, on the basis of present policies and behaviour, there is no prospect in the medium term of raising the growth rate in the Community above some 2,5 %. This would not lead to a significant decline in unemployment in this decade. A disorderly adjustment process in the USA, a further rise in real interest rates and a worsening of the debt problem in developing countries could make the outlook even more gloomy.

The apparent inevitability of the prospect of persistently high unemployment has led to widespread pessimism with regard to economic policy. If the relationship between growth and employment observed in the 1960s still applied, medium-term growth rates above 6 % would be necessary to achieve the increase in employment (1-1,5 % per year) that is needed in order to bring down unemployment gradually but significantly. Such rates of growth are at present quite unattainable. Consequently, the unemployment problem can only be solved if there is a distinct improvement in the relationship between growth and employment.

4. We should not, however, ignore the fact that the process of moderation of real wage increases established since the end of the 1970s has already helped to make growth potentially more employment-creating. The growth rates of recent years, however, were not sufficient to permit the necessary rise in employment. It is therefore necessary to strengthen growth in Europe further and to make it more employment-creating.

5. In order to achieve this objective, a series of macro- and micro-economic conditions need to be fulfilled to the greatest possible extent.

5.1 *At the macro-economic level,* it depends in particular on a higher level of job-creating investment in the coming years. *This is first of all the task of entrepreneurs.* It is, however, also necessary that the profitability of job-creating investment should continue to improve, and that there is a sufficiently strong outlook for demand. Job-creating investment is mostly capital-widening investment, requiring favourable prospects for demand and the continuation for a certain period of moderation of real wage increases at a rate lagging behind productivity growth. If wages were to rise too fast, profitability would suffer and rationalization (capital-deepening investment), which destroys jobs, would be unnecessarily encouraged. Avoiding such an eventuality in no way implies that technological progress should be relinquished; job-creating investment also incorporates technological progress. But because of the inadequate capital stock and the high unemployment rate, Europe needs for some years a new balance between capital-widening and capital-deepening investment.

5.2 The combination of moderate real wage increases *and* safeguarding an appropriate development of demand is also an important element in improving profitability, strengthening growth and making it more employment-creating. Wage moderation *alone* would not, or only *very* slowly, lead to the required employment effects. *Simply* expanding demand would, given the inadequate level of productive

capacity, run the risk of producing higher inflation and/or public debt without having the desired effect on employment. A combination of both is therefore necessary.

5.3 With respect to the maintenance of moderate real wage increases, which has been achieved in many countries in recent years, *the cooperation of the social partners, and in particular of the unions, is required.* Moderate wage development should continue until there is a clear and lasting fall in the unemployment rate, after which real wage increases could again become close to productivity growth.

5.4 The safeguarding of an adequate level of demand is the *task of government,* to be carried out until the process becomes self-sustaining by means of strong investment and an appropriate rise in private consumption.

5.5 What Europe needs is a dual strategy of moderation of real wage increases *and* support for demand. Indeed, the accompanying measures to underpin demand hold the key to the success of the strategy and social acceptance of wage moderation. This is, at any event, true in a transitional phase during which consumer purchasing power will, to begin with, inevitably grow more slowly and aggregate demand will not rise at a sufficiently rapid pace as a result of extra business investment to expand capacity.

Only if wage moderation is accompanied by a sufficient level of aggregate demand can one have confidence that the process of improving profitability and restructuring demand (relatively more investment and relatively less consumption) will be rapid enough and not involve drastic deflation that would place social consensus under considerable strain. Only in this way can wage moderation fulfil its employment function.

5.6 As a result, the long-term tendency for capital productivity to decline would also be arrested. Together with rising employment, growing demand and mounting confidence in future trends, this would provide the most effective stimulus to the propensity to invest. As investment rises, more rapid technological progress would at the same time be incorporated into the productive apparatus, and this would in turn have a beneficial effect on the productivity of labour and capital. Profitability and the propensity to invest would therefore continue to increase. This would create a 'virtuous circle' of technological progress, capital productivity, profitability, investment and renewed embodiment of technological progress.

6. The strategy proposed in this Annual Economic Report, however, consists not only of macro-economic elements. Employment-creating growth also *depends upon important micro-economic conditions.* Action, with the aim of improving the adaptability of markets, and not only the labour market, should be reinforced. With regard to the labour market, the extent to which greater wage differentiation and reorganization and reductions of working time, without raising costs, could benefit employment should be studied in the light of results already achieved. The national governments and the Community should also examine whether existing rules and regulations impede the functioning of markets and the setting up of new, and in particular small and medium-sized businesses.

The spirit in which the debate about market adaptability is held is important for its success. The objective behind efforts to increase flexibility is not to destroy achievements made on the social front but to create more jobs. As far as at all possible, therefore, economic efficiency should be reconciled with the maintenance and further development of social achievements.

7. The central strategy of moderate growth of real wages accompanied by the maintenance of an adequate level of demand requires the monetary and budgetary policies of the Member States to be based on the following principles:

7.1 *Monetary policy* must continue to provide the framework for stability. The proposed dual strategy must thus not lead to an acceleration of inflation. On the contrary, in most Community countries, the rates of inflation need to be brought down further. Monetary policy can best safeguard this, within the EMS framework, by continuing to set a nominal framework which is orientated towards economic stability. Such a monetary policy offers considerable potential for cuts in interest rates in the Community on a sound basis, particularly if the dollar falls further. If this could be achieved, with the necessary caution and coordinated within the EMS framework, it would add an additional, not inconsiderable stimulus to business investment and significantly reduce pressure on government budgets. This is a positive effect benefiting all countries.

7.2 *Budgetary policy* must underpin the strategy of employment-creating growth in the following ways:

Macro-economically, it must continue to safeguard the consolidation objective, i.e. deficits must be further reduced in those countries which still have a level of indebtedness which is either excessive or rising

too fast. At the same time, it must sustain demand where there is room for manoeuvre, the more so since wage moderation leads temporarily to a fall-off in demand. In addition, budgetary policy should continue to restructure the expenditure side of the public budgets to reduce subsidies more strongly and in a selective way and to increase public investment; particularly in respect of infrastructure, environmental protection and urban renewal, a considerable backlog of needs has built up in recent years, which could be met with the spare capacity in the construction sector.

Budgetary policy should also provide for further measures to strengthen supply, which generally have an impact on demand at the same time, and safeguard the improvement in relative factor prices by reducing taxes and social security contributions — wherever possible, at the expense of the central government budget. In addition, micro-economic measures to promote employment (job-creation schemes and promotion of vocational training) should be taken wherever possible.

8. The success of the proposed strategy depends on a coordinated application of policies between Member States within a *Community framework*.

The economic potential of the Community will be considerably reinforced by the accelerated completion of the large internal market, including the liberalization of national financial markets, and by the promotion of technical progress, as the Commission has proposed. The completion of the internal market lies at the heart of the Community; by generating supply dynamism and by permitting, at the same time, a more sustained growth in demand, it ties in directly to the cooperative macro-economic strategy. The promotion of technical progress is essential to safeguard and promote the Community's position among the most developed economies of the world. In addition, in those sectors for which the Community is directly responsible, a greater weight should be given to the operation of the market. In all these areas, the social dimension should be taken fully into account.

The realization of major infrastructure projects in the transport, telecommunications and environmental fields, as well as exploitation of technological potential, would substantially improve the functioning of the internal market. The accelerated implementation of numerous projects, which are already available and have an adequate social rate of return, would reinforce economic dynamism and contribute to the success of the proposed strategy.

Finally, given the importance of a favourable international environment for growth and employment, the Community should at the same time continue its efforts to improve the international trading and monetary systems. It should also, together with other countries, attempt to mitigate the debt problem of developing countries, and to work towards maintaining the growth in world trade as the inevitable adjustments in the USA are made.

The contributions of the Community referred to here correspond to numerous resolutions of the European Parliament.

9. Whatever the international environment, the policies set out above are necessary. It is evident that the international environment would be considerably reinforced by the success of the Communiy strategy. Given a plausible margin of uncertainty as far as world developments are concerned, such a policy should make possible the achievement of an increase in the economic growth rate in the Community from its présent level of 2,5 % to an average of 3-3,5 % over the next few years, and at the same time make growth much more employment-creating. This would produce an average annual increase of 1-1,5 % in employment, opening up the prospect of unemployment being brought down to around 7 % by 1990.

10. Such a development is only possible, however, when all concerned — the Community, national governments, employers and unions — work fully together to implement the proposed strategy.

10.1 This overall strategy 'offers' governments and the social partners an opportunity to achieve a joint solution to the major problem confronting the Community, namely unemployment. However, the strategy provides only a general framework within which much of the debate should be held with the governments and with and between the social partners. This general framework should also incite those concerned at least to reflect upon their respective positions. For the present, there is no political approach in sight other than this strategy providing any prospect of significantly reducing unemployment by the end of the decade. It is therefore an urgent task to proceed via a wide debate to the implementation of this cooperative strategy.

10.2 Exploratory discussions which the Commission has had with the European Trade Union Confederation (ETUC) and with the Union of Industries of the European Community (UNICE) have been encouraging. They have shown that there is interest and a willingness to talk about such an approach. This

dialogue should be continued (2). It is evident that social dialogue should also be reinforced at national level. The more progress is made in such dialogue at all levels, the easier it will be for the national governments and the Community itself to make their own contributions.

10.3 The strategy should gradually be transformed into reality. This applies to the cooperation in each country between governments, unions and employers. Each should make their contribution and at yearly intervals the progress should be examined in order to determine the next steps. This approach should continue over several years. This also applies, however, to cooperation between the Community countries and at an international level. Each partner should act according to their available room for manoeuvre.

11. The coordinated application of the strategy in the Member States should engage and foster a mutually reinforcing process of supply, demand and employment. In this respect an analysis of developments forecast for Germany in 1986 is of considerable interest. Economic growth could exceed 3 % and employment rise by more than 1 %, so that unemployment declines, albeit slowly at first. The price outlook continues to be favourable. A considerable current account surplus and, despite the tax reform, a further significant decline in the government deficit is expected. Thus, a positive chain reaction is developing between price stability, more growth and employment and more *room for manoeuvre in the fiscal and external fields*. This room should be used for higher public investment in 1986 and bringing forward to 1987 the tax reform planned for 1988. This appears necessary so that the favourable economic development continues in and beyond 1987. Even in Germany it is necessary to have a growth rate of some 3,5 % and a rise in employment of about 1,5 % per annum for several years in order to achieve a lasting decline in unemployment. This is in both the national *and* the Community interest.

11.1 In the other countries such room for manoeuvre is not yet available. *In some of the countries,* however, it is possible that, with a certain time-lag as compared to Germany, similar positive chain reaction could develop from more growth and employment to greater room for manoeuvre on the fiscal and external fronts. Such a development seems possible in Denmark, the Netherlands, the United Kingdom and France. Its speed will depend upon how favourably developments proceed in Germany *and* upon appropriate behaviour of the social partners in relation to the requirements of the strategy. Every effort should be made to extend the positive chain reaction as quickly as possible to this group of countries. This would also considerably improve the situation *in the third group of countries* where room for manoeuvre is not yet in view.

11.2 The differing situations in the Member States naturally restrict a rapid implementation of the proposed cooperative strategy. In this respect, the Community's contribution could provide a certain compensating factor. This refers not only to the accelerated completion of the internal market but above all to the large projects of the Community interest in the fields of transport and telecommunications infrastructure and of environmental protection. The stronger the commitment of governments and the social partners to the implementation of the overall strategy, the greater the chance that the Community's contribution will succeed in being of significant macro-economic importance.

(1) The Commission will thus ask the ETUC and UNICE for written opinions on the draft Annual Economic Report. These opinions will be transmitted to the Council, the Parliament and the Economic and Social Committee so that they can be borne in mind in the future discussion.

I. EVOLUTION OF THE ECONOMY AND CONVERGENCE

I.1. The current situation and outlook for Europe

The present European recovery so far has lasted about 2½ years. From a starting point dominated by structural imbalances accumulated over a long period as evidenced by large budget deficits, high and continuing inflation, poor growth performance and a highly unsatisfactory labour market situation, policy management has relied heavily on supply-side considerations. Moreover, the degree of imbalance as between member countries has varied greatly across the Community.

By mid-1985 gross domestic product in the EC had risen to nearly 5 percentage points above the previous cyclical peak of 1980. Industrial production, which suffered a deeper recession than the rest of the economy, also returned to the 1980 peak level in June 1985. The Commission's recent forecasts (1) point to a continuation of this trend, with a growth rate of about 2,5 % for the Community as a whole being forecast for 1986, which is marginally more than that expected for 1985.

The outlook for growth, therefore, remains one of modest proportions. Even so, in a number of respects, there have been positive signs of progress in some areas. There has been a general awareness that, starting from a position of acute imbalance coupled with a world recession, the adjustment necessary would be a slow one. Moreover, the degree of imbalance in Member States is by no means the same. The fundamental approach suggested by the Commission in the last two Annual Reports has been to stress the need for improvements to supply conditions in member countries set within a framework of control over national budgets. A component judged necessary in this approach has been to ensure that the evolution of real employment costs continues to be maintained below the growth or productivity.

Experience across Member States has varied a good deal but, looking at average Community performance over the past year, there are some encouraging signs. To a degree, there has been real wage moderation. Of significance is the fact that after a decade in which the creation of new jobs has been negative, the Community is beginning to experience some growth in employment. Table I shows that for 1985 employment growth is estimated to be 0,4 % with an increase to 0,5 % for 1986.

By far the greater part of this growth, however, has come from increases in activity rates, particularly of women, and new entrants to the labour force. To begin to have an effect on the current and widespread unemployment problem therefore, it is necessary that this progress be improved upon and continued into the medium term. When appraised in such terms, it is clear that the situation reached remains fragile and this report acknowledges that future progress will be difficult if both policy and behaviour are not changed.

In some contrast to the relatively subdued growth in Europe, the international economy has been undergoing a much more marked cyclical development. For the United States, 1984 was a year of exceptionally strong output growth (+ 6,8 %) and even more so of imports (+ 30 %). With Japanese imports also growing fast in that year (+ 10,7 %), total world trade grew by as much as 9,3 %. For 1985 world trade growth is estimated to slow to a more normal rate (4,8 %) and on present forecasts a similar result is expected in 1986. This is subject, however, to a number of uncertainties which are discussed briefly in a later Section. The forecast includes a more moderate but still positive rate of output growth in the United States economy (+ 2,3 % in 1985, + 2,5 % in 1986) and a sustained growth rate of 4 – 5 % in Japan in both years.

It may be questioned why the European economy did not respond more strongly to the acceleration of world trade that occured in 1984. It is indeed striking that while Community exports grew by 7,7 % in 1984, imports grew almost as much by 7,1 % compared to the modest 2 % growth of domestic demand. As a result, the net impact of export and import trade volume growth was negligible. However, special factors such as strikes in the UK coal industry and German metal industries, together with a relatively high rate of stockbuilding of high import content help to explain why this happened. For 1986 the forecasts suggest a continued gradual strengthening of domestic demand.

This view is supported by evidence from surveys of both business and consumer opinion. The industrial confidence indicator for the EC as a whole has improved only very slightly over the 12 months to September 1985. Confidence in the construction sector remains very depressed. Consumer confidence recovered only a little in 1983 measured from the low points reached in preceding recession years but since then has remained stable. The remaining component of the Commission's composite economic sentiment indicator, and the only one to have risen at all significantly over the last year, is the share price index.

The rise in the share price index may be associated with the welcome rise in private industrial investment, which in Europe as a whole is now the fastest growing demand component. After three years of decline in 1981 to 1983 a recovery began in 1984, with a 7 % volume rise in industrial investment. First indications for 1985 from business survey sources pointed to a 9 % volume rise, and more recent surveys have revised this up to 11 %. Within these EC average figures there are some examples of a much stronger private industrial investment upswing. In Denmark, for

(1) Commission of the EEC, *European Economy,* Supplement A, October 1985.

example, the growth rate is estimated to be nearly 40 % and for the Netherlands over 20 % in both 1984 and 1985. In 1985 German industrial investment is expected to rise by 13 % in volume.

Of considerable significance, however, is the fact that the level of investment is still low. In 1985 the volume of investment is only that attained in 1980. It is still some 14 % below the level in 1973. Sustained and substantial rises in investment are now required if the economy's potential growth rate is to be improved. Additional evidence is provided by the behaviour of capacity utilization. Despite slow output growth, capacity utilization in industry rose to 82 % in July 1985, which is close to the 84 % level recorded at the cyclical peak in 1979/80. Thus in spite of the existence of high unemployment, the European economy is already beginning to experience production capacity constraints.

As already noted, in the meantime, total employment has increased modestly. Indeed, employment growth of over 1 % is expected in 1985 in Denmark and the United Kingdom, but even this is clearly insufficient given the growth of labour supply and the high unemployment level at the beginning of the recovery.

After a long period in which Europe has demonstrated a remarkable incapacity to create new jobs, these signs are indeed welcome. They do, however, underline the need to strengthen further those conditions necessary to secure sustained growth embodying employment creation.

TABLE 1

Main economic aggregates, EC (2), 1961 – 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current account of balance of payments	General government net lending or borrowing	Money supply (M 2/3) (3)	Unemployment (% of labour force)	Employment
	% change					% of GDP		% change	%	% change
1961 – 1970	9,0	4,6	4,2	3,7	8,8	0,4	– 0,4	10,2	2,1	0,2
1971 – 1980	13,4	2,9	10,2	10,1	13,6	– 0,1	– 2,8	14,4	4,2	0,2
1981	10,4	– 0,2	10,6	11,7	12,6	– 0,5	– 5,4	10,9	7,6	– 1,3
1982	10,7	0,5	10,1	9,8	10,6	– 0,6	– 5,6	10,7	9,2	– 1,4
1983	8,9	1,0	7,8	7,6	8,7	0,1	– 5,5	9,7	10,3	– 0,5
1984	8,0	2,2	5,7	6,2	6,7	0,1	– 5,4	8,7	10,8	0,2
1985										
Last report	(7,5)	2,3	(5,0)	(5,2)	(6,7)	0,3	– 4,8	7,2	(11,5)	0,0
This report (1)	7,6	2,3	5,1	5,2	6,3	0,5	– 5,2	8,4	11,2	0,4
1986 (1)	6,7	2,5	4,1	3,9	5,4	0,6	– 4,8	6,7	11,1	0,5

(1) Forecast of the Commission services, on the basis of present policies, September 1985.
(2) EC average calculated with current GDP weights at purchasing power parities.
(3) End of year (annual growth rate).

Note: Percentage changes are given as annual rates.

TABLE 2

World imports of goods

(% increase in volume)

	1981	1982	1983	1984	1985	1986
EUR	– 2,9	2,4	2,3	7,1	5,0	5,3
US	6,6	0,1	11,8	29,9	10,0	6,6
Japan	– 2,4	– 0,6	0,3	10,7	3,0	4,7
OPEC	27,4	5,5	– 8,2	– 9,0	– 10,9	– 4,0
Other developing countries	3,5	– 5,2	– 1,2	6,0	4,0	4,5
World	2,5	– 0,1	2,2	9,3	4,8	4,8

Source: Commission services.

TABLE 3

Rate of change of demand components, EC

(In %)

	1982	1983	1984	1985	1986
Private consumption	0,5	1,1	1,0	1,7	2,7
Public consumption	1,1	1,6	1,2	1,2	1,1
Fixed investment	−1,6	0,0	2,3	1,6	3,7
Contribution to change in GDP of:					
Final domestic demand (1) (2)	0,2	1,0	1,3	1,6	2,5
change in stocks (1)	0,5	−0,2	0,5	0,2	0,1
foreign balance (1)	−0,3	0,1	0,2	0,4	−0,2
GDP	0,5	1,0	2,2	2,3	2,5
Exports	1,5	1,9	7,2	6,4	4,6
Imports	2,6	1,5	6,6	5,0	5,3

(1) Change as percentage of GDP of preceding period.
(2) Excluding change in stocks.

Source: Commission services.

TABLE 4

Forecast increase in gross domestic product in 1985 and 1986, in %

	1985			1986		
	Nominal GDP	GDP output volume	GDP price deflator	Nominal GDP	GDP output volume	GDP price deflator
Belgium	6,7	1,9	4,7	6,2	1,7	4,4
Denmark	6,3	2,3	3,9	5,4	3,2	2,2
Germany	4,4	2,3	2,1	5,4	3,5	1,9
Greece	19,3	1,9	17,1	16,8	1,0	15,7
France	7,0	1,2	5,7	5,8	1,9	3,9
Ireland	8,7	2,5	6,1	7,5	2,3	5,0
Italy	11,0	2,7	8,1	9,5	2,7	6,6
Luxembourg	6,0	1,7	4,2	6,4	1,3	5,0
Netherlands	4,5	2,1	2,3	3,0	2,0	1,0
United Kingdom	9,1	3,4	5,5	7,0	2,0	4,8
European Community	7,6	2,3	5,1	6,7	2,5	4,1

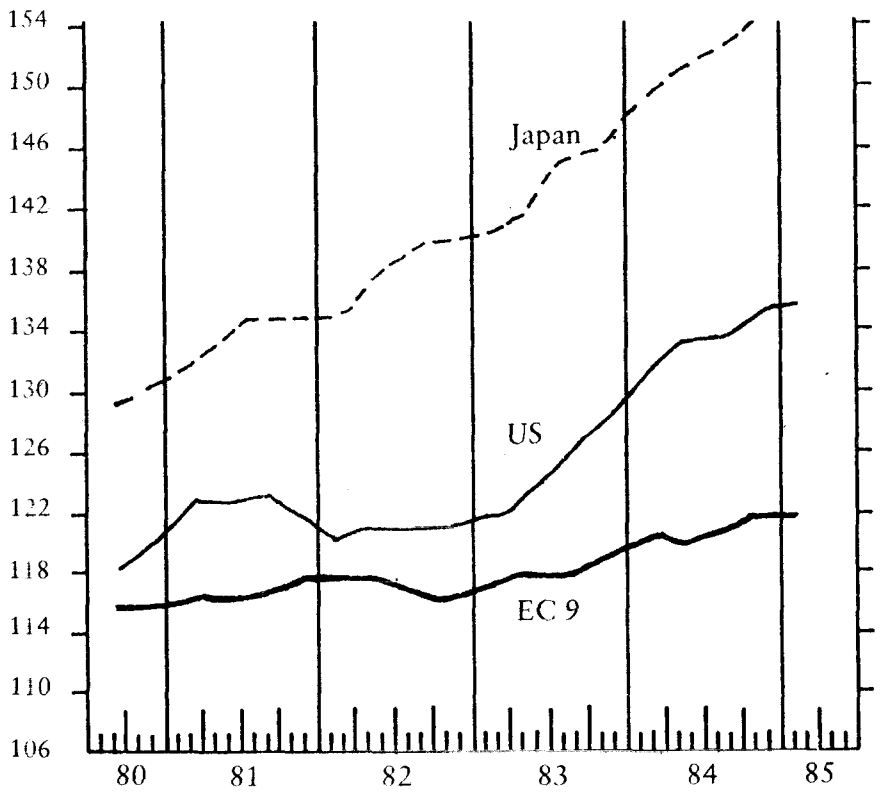
Source: Commission services.

GRAPHS 1 to 4

Comparative evolution of the EC, US and Japanese economies, 1980 to 1985

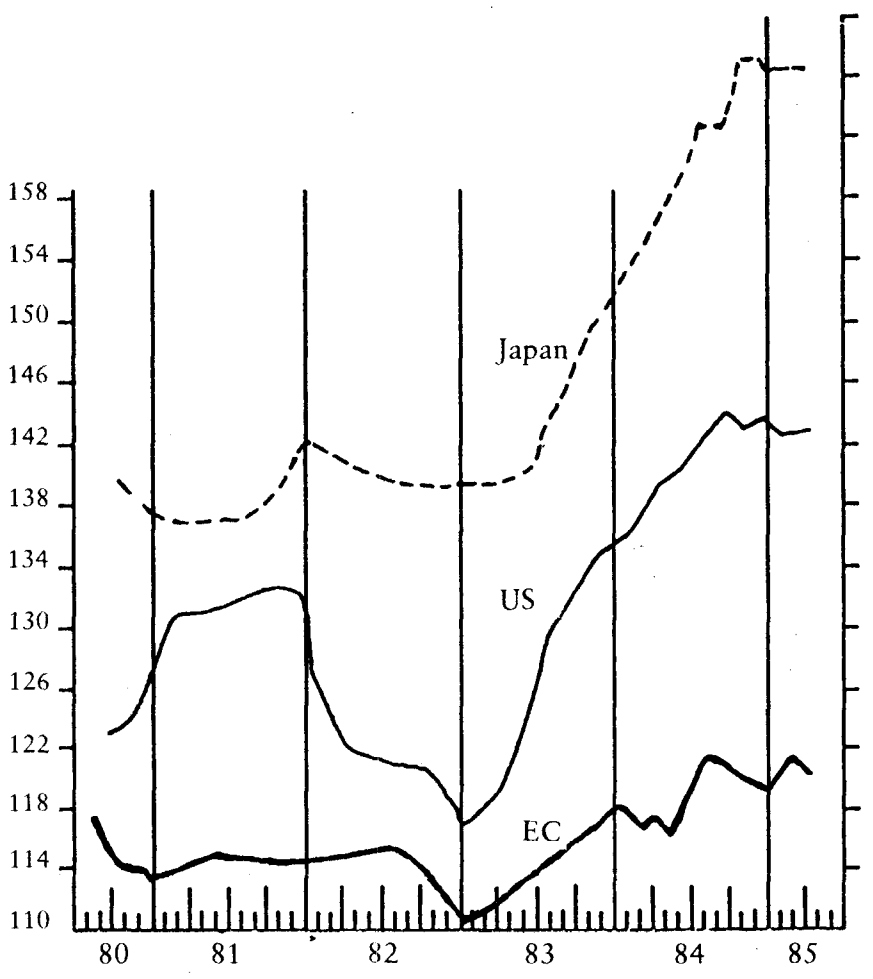
1. *Gross domestic product, s.a.*

1975 = 100

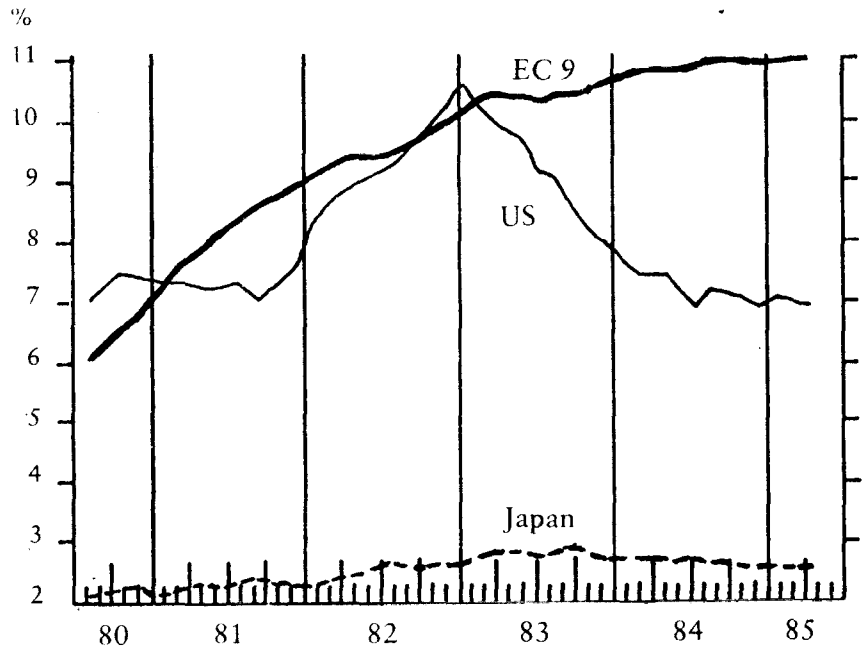


2. *Industrial production*
3-month moving average, s.a.

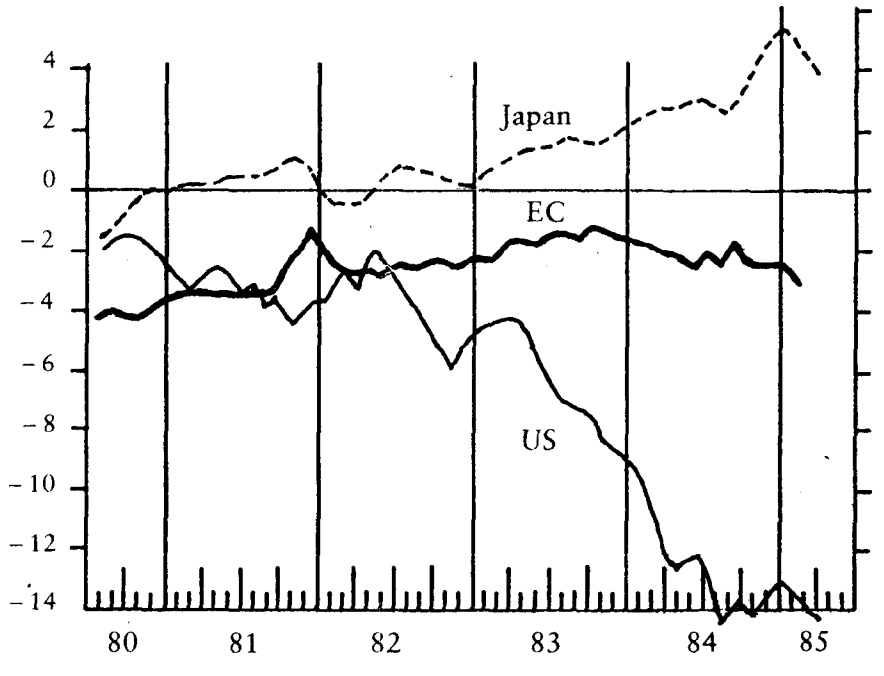
1975 = 100



3. *Unemployment rate*



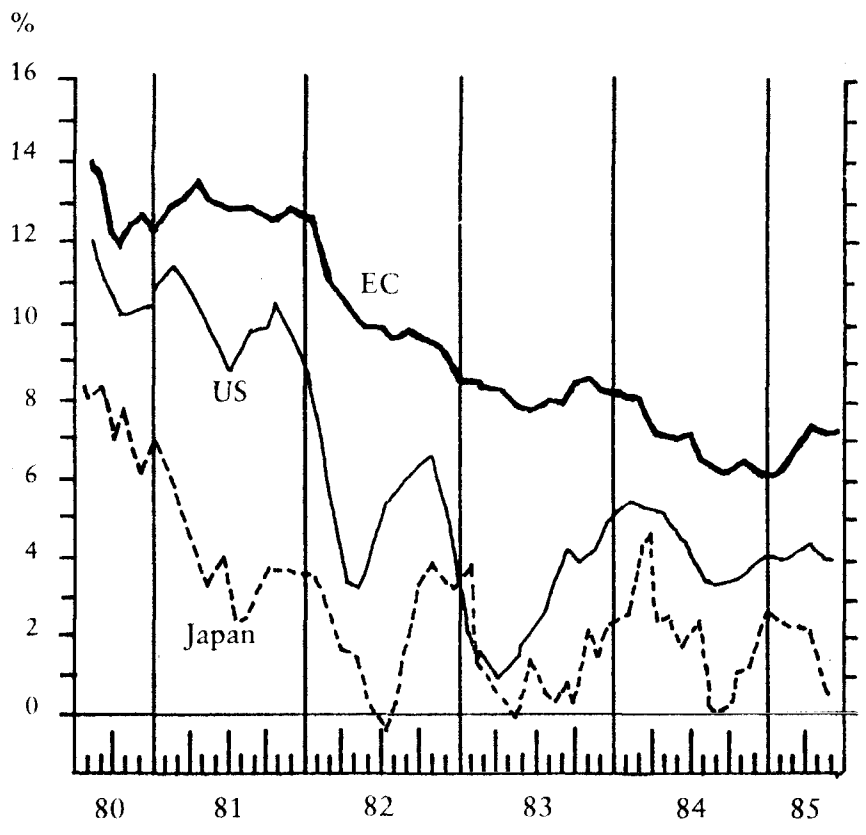
4. *Trade balance*
fob/cif, '000 million ECU
3-month moving average, s.a.



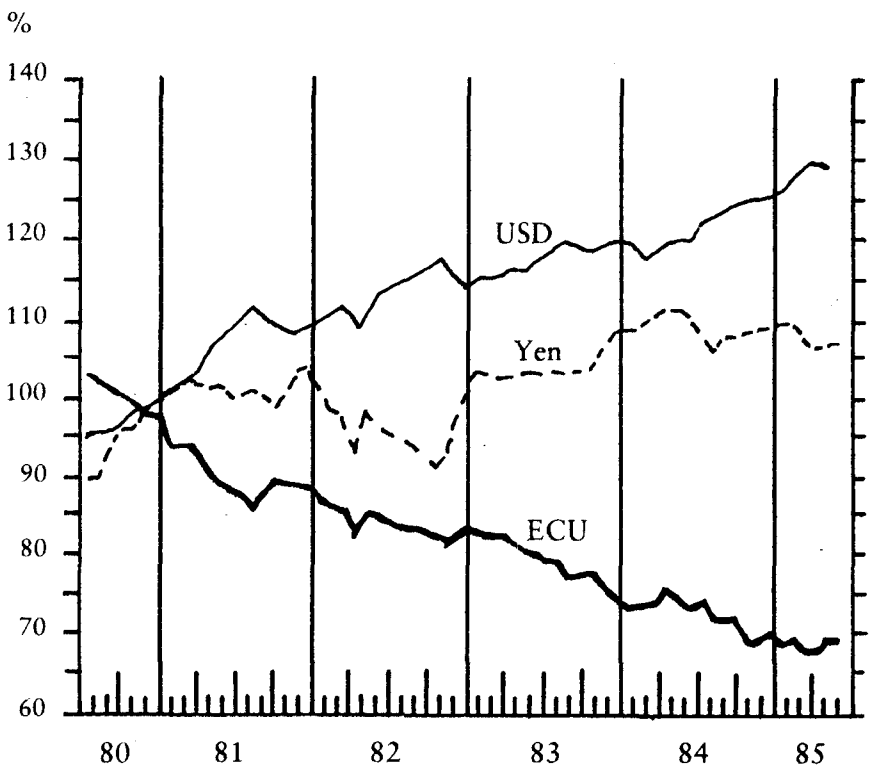
GRAPHS 5 to 8

Comparative evolution of the EC, US and Japanese economies, 1980 to 1985

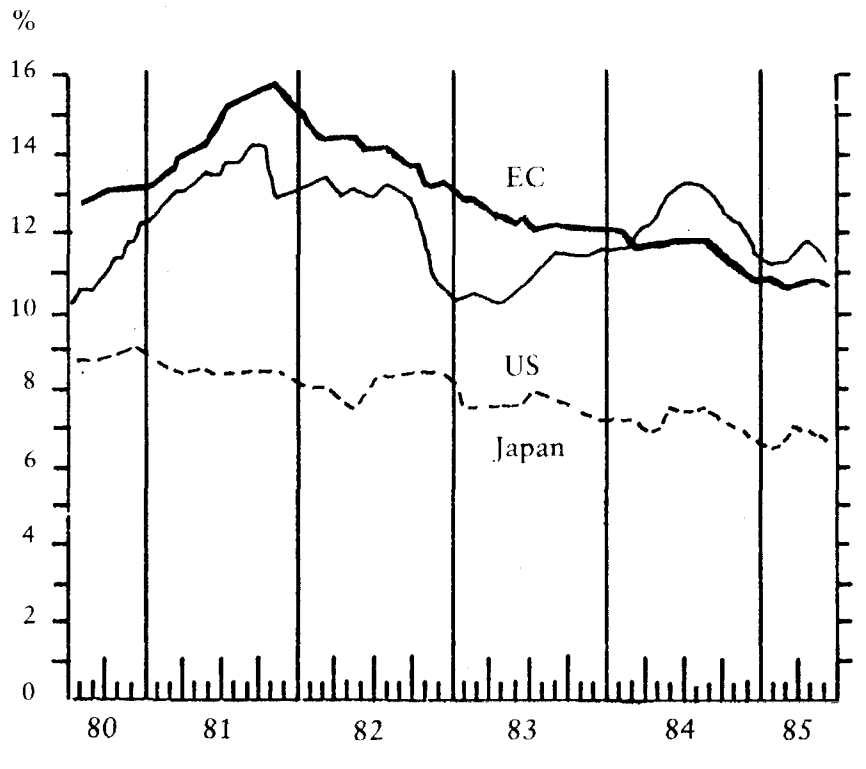
5. *Consumer prices*
6-month change, s.a., annual rates



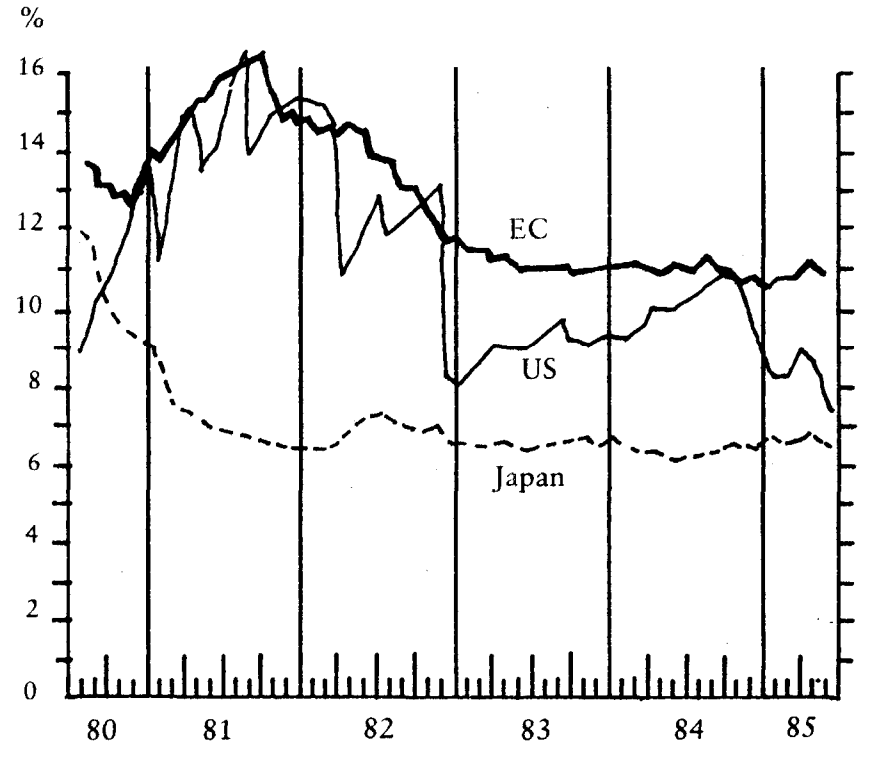
6. *Exchange rates*
Index of SDRs per currency unit
March 1979 = 100



7. *Long-term interest rates*



8. *Short-term interest rates*



The present European recovery, so far of 2½ years duration, is expected to continue through 1986 at a growth rate around 2,5 %. Although private industrial investment is showing a significant upturn, this is from a very low base. More recently employment has also begun to increase. However, there are indications that in some countries, despite the presence of continuing, unacceptably high unemployment, the economy is beginning to experience capacity constraints. This emphasizes the need for sustained growth of investment in new capacity.

I.2. Imbalances and convergence in the EC economy

The situation in 1985 may be compared with that in 1980, a period which conveniently spans a business cycle. In 1980 as in 1985, a moderate economic recovery had been under way for about 2½ years, and capacity utilization rates in industry were similar. Some of the more important macro-economic indicators are set out in Table 5.

In the labour market, the four larger Member States have experienced a rise in the rate of unemployment of between 4 and 6 percentage points. Among the smaller countries Belgium, the Netherlands and Ireland have suffered higher than average increases. In so far as a convergence process is at work here the similarity of the growth in unemployment is striking and this development remains wholly unacceptable.

Although employment growth has become positive in the last year, in no country except Denmark is the level of employment currently higher than it was at the beginning of the decade. Thus virtually the whole of the Community is facing a labour market problem of comparable gravity.

As regards price stabilization, on the whole there has been a striking and positive convergence process. Germany and the Netherlands have reduced their already below-average inflation rates to a very low level. The United Kingdom, Ireland and Italy have reduced their inflation rates from 1980 to 1985 by well over 10 percentage points, and France by over 6 points. Denmark has also made notable progress in achieving a measure of price stabilization. Greece has not progressed in this respect.

On the balance of payments the Communiy as a whole has moved from substantial current account deficit in 1980 to a surplus in 1985, but divergences in individual performance remain considerable. In addition, when seen against the very large current account deficit of the United States, the Community retains a degree of vulnerability in this respect. The most impressive adjustments have been those of Belgium and Ireland which improved their current account positions by 5 % and 9 % of GDP respectively over the five-year period, thus eliminating or very much reducing their previously alarming deficit levels. France and Italy have also made substantial progress in reducing their deficits, even if more recently in the Italian case the deficit has begun to grow again. Germany and the Netherlands on the other hand have moved into situations of widening surplus.

In spite of the severity of budget consolidation efforts, EC government deficits in 1985 are, on average, significantly higher than in 1980 (5,2 % of GDP versus 3,5 %). Moreover, in this area also, the degree of divergence continues to be relatively wide. Four countries (Belgium, Greece, Ireland and Italy) have deficits of nearly 10 % of GDP or more. Belgium and Ireland despite considerable efforts have not been able to reduce substantially the deficit level over the five-year period, even if over a more recent period some improvement has been made. The Greek and Italian deficits have become more serious still. Germany has reduced its deficit to 1,2 % of GDP, whilst Luxembourg has moved into surplus. France, the UK and Denmark are now in an intermediary category with deficits of around 3 % of GDP.

TABLE 5

Indicators of disequilibria and divergence, 1980 and 1985

	Unemployment in %		GDP deflator in %		Current account % of GDP		Budget deficit % of GDP		Gross public dept % of GDP	
	1980	1985	1980	1985	1980	1985	1980	1985	1980	1985
Belgium	9,1	13,8	3,9	4,7	– 4,5	0,6	– 9,9	– 8,6	76,1	116,0
Denmark	6,7	9,1	8,2	3,9	– 3,7	– 3,4	– 3,3	– 2,9	33,5	68,6
Germany	3,3	8,4	4,3	2,1	– 1,8	2,1	– 3,1	– 1,2	32,6	42,6
Greece	:	8,3	17,7	17,1	0,3	– 5,2	– 5,4	– 12,5	27,7	54,5
France	6,4	10,7	12,2	5,7	– 1,4	– 0,5	0,3	– 3,2	25,0	35,9
Ireland	8,2	17,1	14,2	6,1	– 12,0	– 3,3	– 11,8	– 11,5	85,9	124,3
Italy	7,1	12,6	20,6	8,1	– 2,5	– 1,7	– 8,4	– 13,6	93,9	120,4
Luxembourg	0,7	1,7	7,8	4,2	:	:	– 0,8	2,1	13,6	15,6
Netherlands	6,2	13,2	5,7	2,3	– 1,5	4,5	– 4,0	– 5,9	45,9	72,3
United Kingdom	6,0	12,0	19,8	5,5	1,8	1,1	– 3,4	– 3,3	59,7	59,7
EUR 10	5,8	11,2	12,6	5,1	– 1,3	– 0,5	– 3,5	– 5,2	50,5	64,3

Source: Commission services.

Over the five-year period, virtually all countries have seen a substantial build up in their stock of public debt. The levels however are very different. The gross stock of public debt in Germany, France and the UK appears to be of relatively moderate size (40 %, 30 % and 60 % of GDP respectively). The debt levels of Belgium, Ireland and Italy are much larger (well over 100 % of GDP), and the interest rate burden in these countries is now in the region of 20 to 25 % of total current public expenditure and some 10 % of GDP.

Virtually no country has avoided a very large rise in unemployment which has thus become the most serious imbalance in the European economy. As regards the other imbalances:

— *Germany has achieved a broadly satisfactory position, but is accumulating an increasing current account surplus,*

— *France and the United Kingdom have succeeded in reducing these imbalance to more moderate proportions,*

— *Italy has made considerable progress on inflation and until recently on the balance of payments, but still has a grave public finance problem to overcome,*

— *the other countries are mostly in rather hetereogeneous situations, with success on some scores but problems on others. Denmark has the most generally improved situation. Greece has problems on most accounts.*

I.3. Some risk factors in the medium-term outlook

Under the assumption of an approximately stable influence from the rest of the world on the European economy, and with broadly unchanged policies and economic behaviour in the Community, the Commission would except a rather steady medium-term economic growth rate of about 2,5 % per annum in the EC on average for the rest of the present decade. Inflation might stabilize at around 4 % on average, with nominal GDP therefore growing by nearly 7 % per annum. Unemployment would not fall significantly, and thus the central employment problem internal to the European economy would remain. There is little hope that it could be alleviated by the end of the decade.

However the assumption of a stable international economy may well not hold and before turning to the Community's domestic objectives and policies it is necessary to consider the sensitivity of the European economy to possible international events. Indeed the past decade has seen a sequence of massive world economic shocks: oil price rises, large exchange and interest rate movements, debt crises. For the next few years potential external sources of disturbance would lie primarily in the manner in which the process of correction of the US external deficit and related budget deficit and exchange rate imbalance takes place, and a resurgence of the debt crisis. A large fall in the price of oil would have positive and negative effects.

Some very approximate orders of magnitude are given in Table 6. It should be stressed, however, that in principle, a wide range of different estimates could be discussed, depending on assumptions about particular circumstances and on different reactions in private markets as well as official policies.

The broad picture which emerges is that, as regards the level of output in the EC, there are both negative and positive risks inherent in the potential disturbances considered, although the negative risks look on balance to be greater. As regards the rate of inflation there are possibilities for significant disinflationary impacts but none that appear likely to increase inflation significantly.

The actual position in the United States and what developments are likely over the medium term remain debatable. On this score it must be admitted that the degree of uncertainty on such matters as future US growth, its budget and external deficits, and the behaviour of interest rates and the dollar exchange rate is large. In the absence of any firm view, one can only resort to some stylized assumptions. Thus, for illustrative purposes, what might be judged to be a substantial budgetary contraction, or a substantial exchange rate depreciation would (in the amounts specified in Table 6) lower the level of output in the EC by amounts in the range of 0,75 to 1,25 percentage points for three years taken cumulatively.

Each element on its own would therefore represent a small but not trivial set-back to the European recovery. Taken together, however, the impact becomes considerable.

These estimates already take into account some decoupling of European interest rates from those in the United States (in the sense of relatively lower European rates). The magnitude of such changes is hard to judge. However, if one supposed that an extra margin of 2 percentage points' reduction in European interest rates became possible, for example as a reaction to a very sharp weakening of the dollar, there might be a compensating boost to activity in Europe of around 0,66 of a percentage point cumulatively over three years.

TABLE 6

Sensitivity of the EC economy to changes in the world economic environment

(In %)

	Impact on EC, cumulative total for three years on levels of:		
	output	prices	nominal GDP
US budget restriction in three successive years of 1 % of GDP per annum, cumulatively	– 3/4	– 1/2	– 1 1/4
US exchange rate depreciation of 20 % (1)	– 1 1/4	– 2 1/2	– 3 3/4
US budget restriction and exchange rate depreciation combined	– 2	– 3	– 5
Monetary conditions permitting a 2% fall in European real interest rates	+ 2/3	—	+ 2/3
Fall in oil price of 20 % with respect to the 1985 level	+ 2/3	– 1	– 1/3

(1) With respect to the ECU and yen.

Source: Estimates of the Commission services.

A substantial fall (20 %) in the price of oil would have a beneficial impact on conjunctural trends in the EC. (The fiscal aspects of such a development are treated in Section III.1.2.) This is estimated at cumulating to 0,66 % of GDP over three years, but the margin of uncertainty here is wide.

Real incomes of companies and households would gain on the terms of trade, which would stimulate investment and consumption. However, oil and gas producers would lose incomes. Western Europe produces a substantial part of its own oil and gas (taking production of the UK, the Netherlands and Norway as a share of EC and EFTA demand). Exports to OPEC countries would surely weaken.

The disinflationary impact would be considerable in the event of a substantial dollar exchange rate fall (2,5 % off the EC price level after three years with a 20 % depreciation againt the ECU). The 20 % fall in the price of oil would also have a significant but smaller disinflationary impact.

One of the main issues arising from these scenarios is how to judge reactions to a simultaneous weakening in the EC of both output and inflation. In some of the hypotheses discussed there would remain a significant reduction in aggregate nominal demand. Compensatory policy reactions would then need to be considered, especially in countries which have already made good progress in reducing inflation (see further below in relevant policy sections of this report).

Potential disturbances in the international economy over the foreseeable future (adjustments in the US, a possible fall in the price of oil) point to the possibility of further reductions in inflation in the EC. As regards the level of output there are different risks arising from negative and positive impacts from the rest of the world; the negative risks seem to be greater. In the event of external conditions transmitting disinflation and real contractionary influences to the EC at the same time, the question of the adequacy of nominal demand would arise.

II. A COOPERATIVE STRATEGY FOR MORE EMPLOYMENT CREATING GROWTH

II.1. The background and orders of magnitude

The principal theme of this report is focused on the prime necessity of renewed economic growth but of a character which will begin to create a significant number of new jobs and thus represent a step towards solving the problem of unemployment (1). Initially therefore, it is useful to outline the medium-term prospect for Europe in the absence of any significant changes to international trends and to existing policy and behaviour. In other words how might the output, employment and unemployment situations in Europe unfold if, at the broad macro-economic level, recent trends were maintained. Projections of this nature, whilst difficult to make, nevertheless are necessary as a means of assisting in the policy judgement process.

(1) Apart from the Programme for European economic recovery, adopted in March 1984, the European Parliament has advocated on many occasions an employment-generating investment effort (see resolution of 16 April 1985, OJ No C 122, 20. 5. 1985, p. 57, point 4).

Recognizing the well-known limitations of model-based scenarios, present policies and trends are represented in the first column of Table 7 by a *baseline assumption*. In this initial entirely illustrative case GDP growth in the EC as a whole is seen to be stabilizing at around 2,5 % until the end of the decade, with inflation decelerating further to a little over 4 % and nominal GDP thus growing between 6,5 % and 7 % a year. Budget deficits would be further reduced, and money supply kept to near its present growth rate. Labour productivity might increase by about as much as that observed during the last decade, at a little over 2 % per year. Real wages might grow a little below 2 %, thus allowing for some modest improvement in the share of profits in national income. Investment would be growing faster than GDP, perhaps 5 % per year, reflecting some response to the more recent slowdown in the rate of technological advance and to the restructuring needs of the economy.

In these conditions the rate of return on invested capital would not increase very substantially. In particular the cost of labour relative to the rate of return on fixed capital would

not change markedly. Employment growth would be quite modest, perhaps not quite 0,5 % per year, albeit better, however, than the recent record of stagnant or declining employment. Unemployment might then decline only very slightly, maybe to 10,5 % by 1990.

The characteristics of this assumed baseline projection, although disappointing, are not unreasonable given the fact that currently in Europe it remains questionable as to whether the unemployment level has stabilized when the economic growth rate is around 2,5 %. What the baseline projection underlines is the strong likelihood that it will require a set of policy changes and behavioural changes to be introduced and maintained if the growth path for output and employment is to be improved in a significant way.

Given the improved situation with respect to budget deficits shown in the baseline projection, a more obvious suggestion might be to adopt a policy of pronounced budgetary expansion. Although this particular course is not the judgement of the Commission or the Council, it is nevertheless useful to outline what this kind of policy might imply over the medium term.

The second column of Table 7 illustrates the economic effects of a straightforward *fiscal reflation* option in which the target for a significant reduction in the level of unemployment is set at 8,5 % by 1990. In this simple case, the instrument for achieving this is assumed to be a fiscal expansion with no other constraints observed and the international environment as in the baseline projection.

TABLE 7

Some illustrative orders of magnitude in a baseline scenario and alternative policy scenarios, EC, 1986 to 1990

(annual average growth rates)

	Baseline scenario	Fiscal reflation scenario	Cooperative growth scenario	(EC scenario without international cooperation)
GDP, volume growth	2,5	3,4	3,5	(3,2)
GDP deflator	4,2	5,4	3,7	(4,0)
GDP, nominal	6,7	8,8	7,2	(7,2)
Investment	5,0	5,1	6,6	(5,9)
Employment	0,4	0,8	1,1	(1,0)
Unemployment rate (1)	10,4	8,5	7,0	(7,4)
Labour productivity	2,2	2,6	2,4	(2,2)
Real wage cost	1,7	2,5	1,0	(1,0)
Profit share in national income	1,1	– 0,8	3,8	(3,3)
Budget balance (2)	– 3,8	– 7,1	– 4,0	(– 4,4)
Rate of interest (3)	10,9	12,5	8,3	(9,4)

(1) Percentage of total labour force at end of period.
(2) Percentage of GDP at end of period.
(3) Long-term rate of interest at end of period.

Source: Estimates of the Commission services.

Note:

— The 'baseline scenario' supposes the maintenance of present budgetary and monetary policies in the Community, the absence of budgetary adjustment in the United States and normal growth of world trade.

— The 'fiscal reflation scenario' comprises, for the budget deficit in the EC increased by as much as is necessary to reach 8,5 % unemployment by 1990, other variables reacting endogenously; the international environment is the same as in the 'baseline scenario'.

— The 'cooperation growth scenario' comprises, for the Community, a moderate growth in real wages until there is a significant fall in the unemployment rate (1988/89). The development of real wages then moves gradually towards that of productivity per person occupied. Budgetary and monetary policies maintain GDP at a level close to the baseline scenario; while, outside the EC, the US reduces its budget deficit, offset by expansionary action in Japan and some other countries, the dollar depreciates against the ECU and, more substantially, against the yen. This scenario is explained in Section II.5 below.

— The 'EC scenario without international cooperation' assumes the same economic policy measures in the Community as the 'cooperative growth scenario'. On the other hand, the international environment remains the same in the 'baseline scenario'.

What the projection shows is that to realize the employment target (8,5 % unemployment), the European economy would experience a continuously mounting increase in the budget deficit, which, for the EC as a whole, rises from 4,8 % of GDP in 1985 to 7,1 % in 1990. Growth is increased but so also is inflation which accelerates from 4,5 % in 1985 to 7,1 % in 1990. The projection period ends therefore with a combination of accelerating inflation and public debt burdens, after only a rather moderate reduction in unemployment. The momentum of accelerating inflation and public debt burdens at the end of the period points to the prospect of further harmful interaction between the two. In short the policy would be unsustainable and have to be reversed. The introduction of an accompanying and unavoidable stabilization policy would result in a renewed rise in the rate of unemployment.

These two scenarios can be interpreted as useful reference points in the development of a feasible stragey. Neither a continuation of the existing state of affairs nor an isolated demand-based reflationary policy embody the ingredients necessary to secure the improvement in economic performance desired.

Model-based simulations for the medium term confirm that neither a scenario based on unchanged policies and behaviour nor a simple fiscal reflation will lead to a sustainable acceleration of output growth and job creation. They corroborate the results of other analyses which show that neither a spontaneous development nor budgetary reflation would resolve the problem.

II.2. The need for more employment-creating growth

Current demographic trends and participation rates demonstrate that in order to bring the unemployment rate down from its present level of around 11 % to a level of some 7 % of the labour force between now and 190, employment growth rates of between 1 and 1,5 % a year would be necessary.

Graph 9 provides a simple illustration of the relation between the growth rates of employment and output in the Community and the United States.

The relationship observed in the Community over the period 1961 to 1973 (R 1) shows that, despite rapid economic growth averaging 4,6 % per annum, the rise in employment was very modest (an average increase of 0,2 %). If the relation established for this period were still valid at the present time, growth rates averaging over 6 % a year would be needed in order to achieve the desired increase in employment. Such a growth rate would appear to be quite out of reach in present circumstances. It should be noted, however, that the capital-intensive type of growth of the 1960s suggested by the graph was perfectly compatible with the very modest growth in the labour force at that time and permitted the maintenance of a very low unemployment rate (2 to 2,5 % of the labour force).

After the crisis years of 1974 to 1975 and the recovery in 1976 — years which were excluded from the estimating periods because of the extreme instability which they introduced into the results — a new relation was established over the period 1977 to 1985 (R 2). This shows a shift of the curve towards the left, i.e. a given economic growth rate is paralleled by a larger increase in employment. However, because economic growth remained low during this period (increasing by an average of 1,8 % a year), no growth in employment resulted. The increase in the labour force was therefore reflected in an increase in unemployment. If the new relation established between growth and employment were to prove stable, growth rates of 3,5 to 4,5 % a year would be sufficient to obtain the increase in employment necessary to reduce unemployment.

Graph 9 also illustrates the relation between employment and growth resulting from the three scenarios presented in Table 7. Thus, annual average growth rates of GDP and employment over the period 1986 to 1990 are, in the case of the basic scenario, situated virtually on the straight line R 2. This means that, with no change in policies and behaviour, the low economic growth rate associated with a fairly modest rate of increase in employment (point D) would be entirely consistent with the relation recorded in the last few years. The isolated fiscal reflation scenario would be reflected in faster economic growth and employment would increase more or less according to the relation R 2 (point E). Lastly the point corresponding to the cooperative growth scenario (point F) would be situated above the present relation: it would clearly represent growth which was faster and which is more employment-creating. This third case is treated in more detail in Section II.5.

Several elements can contribute to the achievement of growth which creates more jobs:

(1) a slower increase in real *per capita* labour costs associated with an appropriate growth in demand;

(2) a continuing effort to improve the adaptability of all markets (labour, goods and services, capital);

(3) on the labour market, changes in working time and arrangements for introducing shorter working hours which have no effect on production costs;

(4) wage differentials which give a more appropriate picture of the requirements for labour in different industries and regions, and with different skills.

An adjustment process guided by these principles is capable both of permitting growth which creates more jobs, but also of laying the foundations for a more satisfactory growth dynamic for the future, to the extent that it restores the economic conditions of supply.

Here it should be stressed that another essential feature is markedly more sustained investment growth. The report has shown that, while growth performance remained modest, the economy was already beginning to run into capacity constraints. Irrespective of the inadequacy of the level of

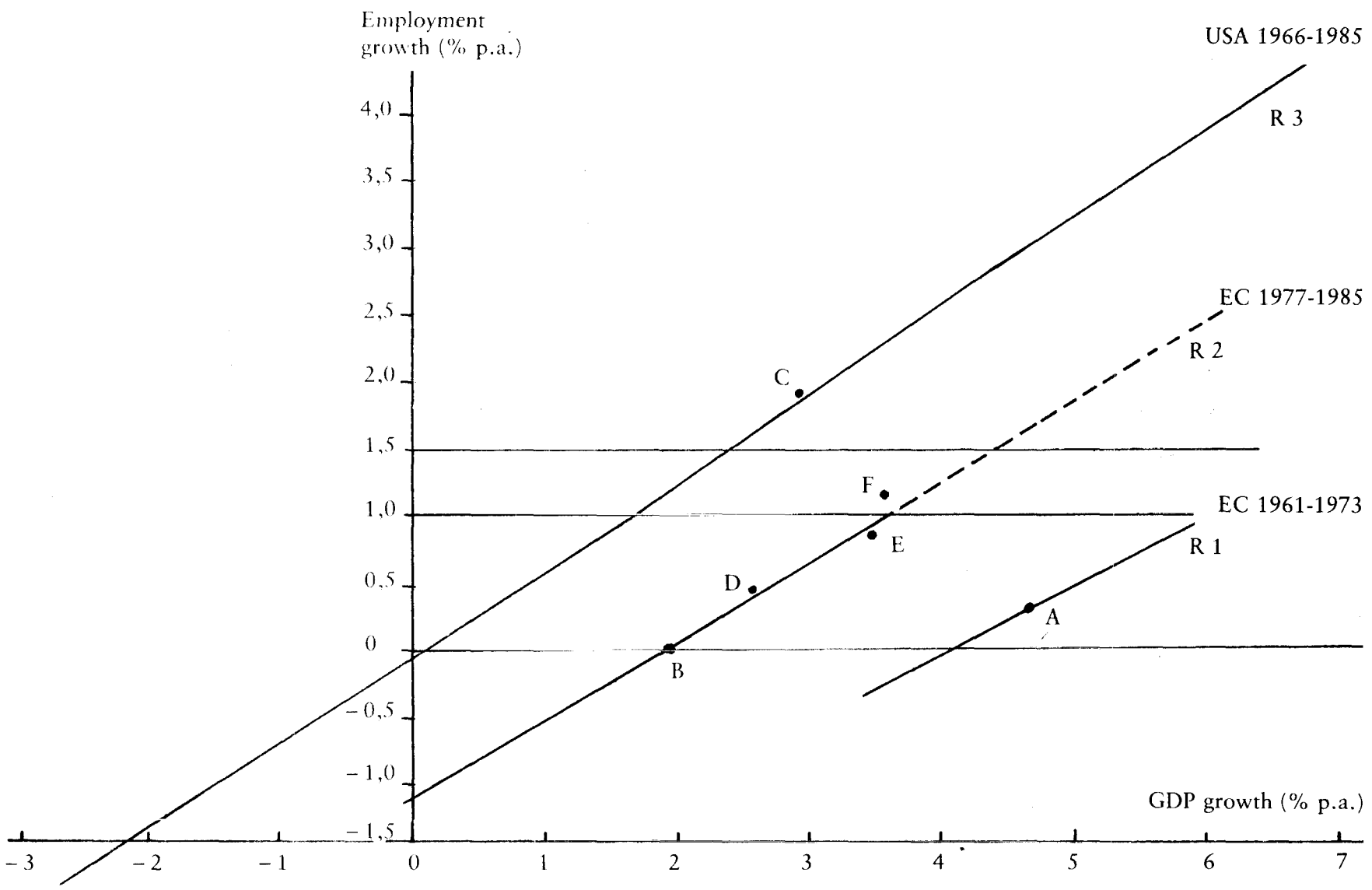
investment (the investment share fell by 5 percentage points between 1970 and 1985), it is probable that, following the shocks caused by energy prices, part of the existing stock is obsolete and less efficient. Hence, if the adjustment process is to create new jobs, it must be based on conditions propitious to new investment expenditure.

Lastly, it is at least as important to create and maintain a social framework within which the changes deemed necessary are accepted and in which their implementation is encouraged. Here, companies, governments, employees and their trade unions have an essential role to play. Companies must carry out the job-creating investment which is necessary. They will be all the more inclined to invest and more generally to spend if they expect their markets to expand and to be profitable. The trade unions will on the whole be much more receptive to calls for wage moderation if they consider that such moderation will permit more growth and employment. Governments will be more ready to cut taxes if they can see companies and trade unions working together to improve productive capacity and hence the tax base.

After the re-examination of these questions in Sections II.3 and II.4 of this report, suggestions are made in Section II.5 as to how to implement an integrated approach to the problems posed.

GRAPH 9

Relationships between growth and employment (1)



(1) The lines R 1, R 2 and R 3 summarize the observed association between the growth of employment and the growth of real output. The length of each line is restricted to the extreme observations. R 2 only has been extended as a dotted line in order to indicate how, on the basis of more recent experience, employment in the European economy might evolve if growth performance were to improve.

A =	Average of 1961-1973:	+ 4,6 % GDP;	+ 0,2 % employment
B =	Average of 1977-1985:	+ 1,8 % GDP;	– 0,03 % employment
C =	Average of 1966-1985:	+ 2,9 % GDP;	+ 1,9 % employment
D =	Basic scenario:	+ 2,5 % GDP;	+ 0,4 % employment
E =	Fiscal reflation scenario:	+ 3,4 % GDP;	+ 0,8 % employment
F =	Cooperative growth scenario:	+ 3,5 % GDP;	+ 1,1 % employment

The coordinates of points D, E and F are taken from Table 7.

For the United States the apparently favourable positioning of the line R 3 is influenced by specific demographic considerations. The active population has been growing at a rate of more than 2 % per annum. Between 1960 and 1970, however, the unemployment rate was always higher than in Europe. It is only since 1980 that unemployment in Europe has constantly exceeded that in the United States.

Performance in creating jobs in the Community has been generally poor for 25 years. However the model of capital-intensive growth developed in the 1960s was appropriate for that period, because the low increase in employment was paralleled by the small growth of the labour force, so that unemployment could be kept at a low level. Times have changed and in response to the poor growth outlook, it is urgent for the unemployment curve to be reversed. The problem is to achieve economic growth which is both faster and also creates more jobs. The main points of the economic policy to be implemented in order to attain this objective have been clearly identified. Essentially they combine a moderate growth of wages with the right degree of support for demand and must be accompanied by improved adaptability on all markets. It is therefore the conditions for the cooperative implementation of this policy which must now be considered.

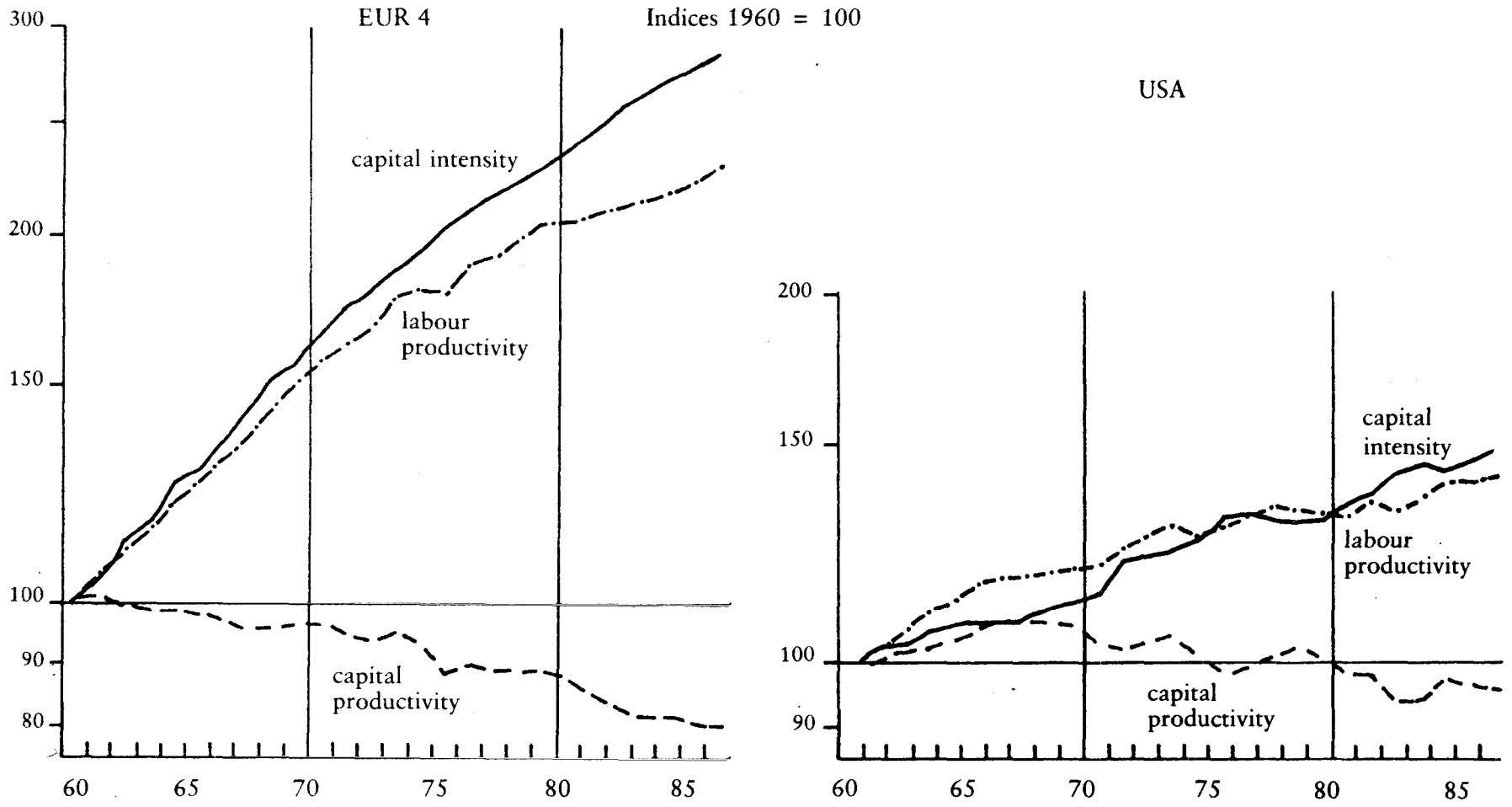
II.3. Labour, capital and technology

There is now a strong suspicion that the mix of capital and labour used in the European productive process has become biased too much against the use of labour. The stagnation of employment as we have observed is an uncontested fact. Evidence has also built up showing an increasingly distorted use of capital for labour-saving rather than for capacity expansion. Whilst there are many data problems, it is worth noting that there is a corroboration of evidence from statistical estimates for the industrial and manufacturing sectors, as well as from surveys of industrialists' opinions. The argument is also supported in comparisons with the United States, where the use of labour and capital has been rather more even-handed than in Europe.

Much of the more conventional analysis of productivity appears deceptively comfortable from a European point of view. As Graph 10 shows, labour productivity in Europe has risen much more strongly than in the United States. The graph also provides information on the trend in capital productivity (output per unit of capital stock). This progressed during the 1960s at a moderate rate in the United States and weakened thereafter. In Europe capital productivity declined markedly all through the period 1960 to 1985. In other words capital intensity (i.e. the amount of capital used per person employed), appears to have risen steeply in Europe alongside the trend in labour productivity, whereas both have grown less strongly in the United States. Thus a comparison of labour cost increases with labour productivity growth will be misleading in a period when a major part of labour productivity growth is the result of an increasing labour-saving bias in investment. If increased productivity growth results from a decline in employment, or an insufficient increase in employment with respect to the growth of the labour force, the labour force as a whole is not reaping the benefits of these apparent productivity gains.

GRAPH 10

Labour productivity, capital productivity and capital intensity in the four main Member States and the United States, 1960 to 1985



Labour productivity: real GDP per head of occupied population.
Capital productivity: real GDP per unit of capital stock.
Capital intensity: capital stock per head of occupied population.

Source: Commission services.

Increases in capital per employee are regarded naturally as a desirable thing and experience through the 1960s suggests that the growth of capital per employee did yield a reasonably acceptable growth of GDP and output per employee. A question which arises, therefore, is why capital accumulation in Europe, particularly from the 1970s onwards, has not generated more employment. There is little doubt that energy price increases reduced the net worth of the existing capital stock. Action by governments to control inflation with restrictive policies also led to under-utilization of capacity.

Looked at over the longer term, however, another important part of the answer is that these trends have been accompanied by a sustained deterioration in the profitability of or return to investment and, related to this, a marked increase in the real reward to labour relative to that of capital (see Graph 11).

Three other factors which may help in an explanation are, firstly, the existence of labour market rigidities which may have impeded the effective working of the labour market in the face of rising employment costs. Secondly, the conscious policy on the part of governments to increase taxes on labour, particularly social security contributions. Non-wage costs in the Community have risen by around 0,5 of a percentage point per annum over the past two decades. Thirdly, the need to exercise control over inflation and the necessary non-monetary financing of budget deficits has led to a high real interest rate in the Community. Taken together, these factors have produced a sustained deterioration in the profitability of investment. Reference to Graphs 11 and 12 indicates that there is a strong association between rates of return and growth of the stock of capital.

The increased relative real costs of employment and weakened profitability of fixed capital has tended to make labour-using or capital-widening investment increasingly less attractive relative to the more capital intensive methods of production. Overall, the decline in capital productivity and fall in rates of return in Europe point to a pronounced decline in the efficiency of its investment, perhaps for some considerable time. The implication is that new investment has not provided the contribution to production capacity needed.

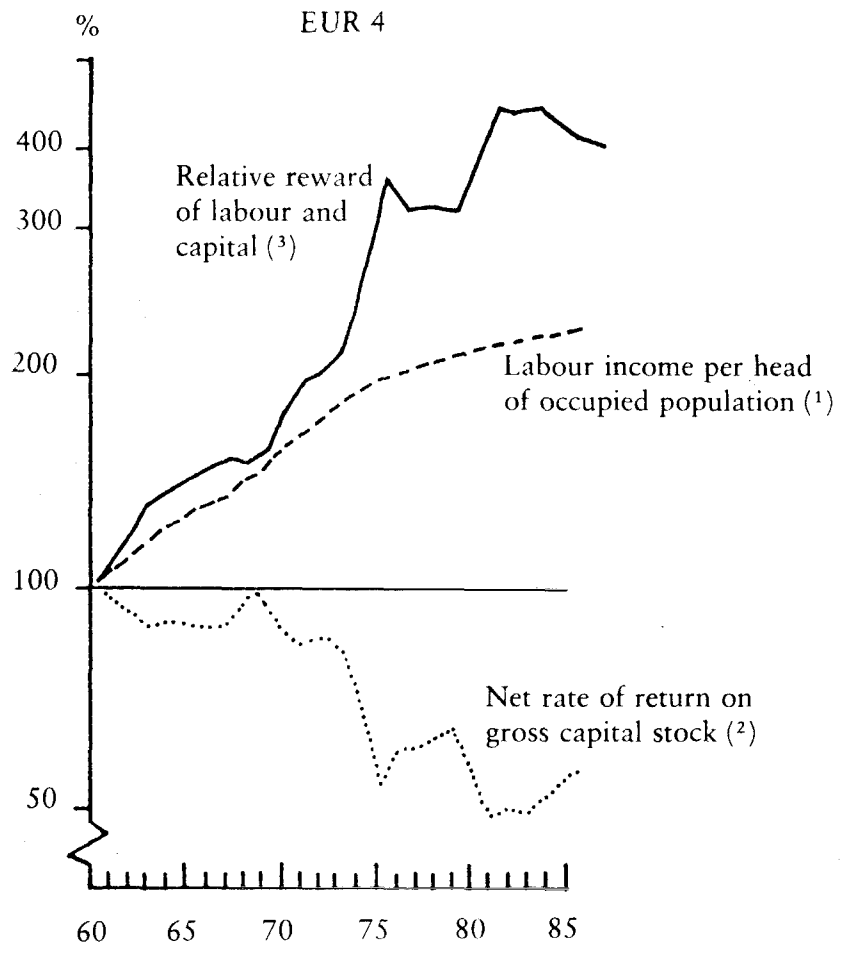
In summary, the position reached in Europe, therefore, is one where there has been too much emphasis on labour-saving investment; but, induced by poor profitability, the economy is faced with a shortage of investment for new capacity. In the low efficiency situation, the gap between the marginal product of capital and the real interest rate is too large.

Since the early 1980s there has been some correction of these trends. The trend growth of real wage costs has moderated to 1,0 % per annum over the period 1983 to 1985 compared to 2,1 % for 1974 to 1982 and 4,4 % for 1961 to 1979. The rate of return on the gross capital stock is estimated to have increased somewhat from its low point at the beginning of the 1980s following the second oil shock, but this is still a long way below the level observed in the 1960s when there was a faster rate of growth of the capital stock (see Graph 12).

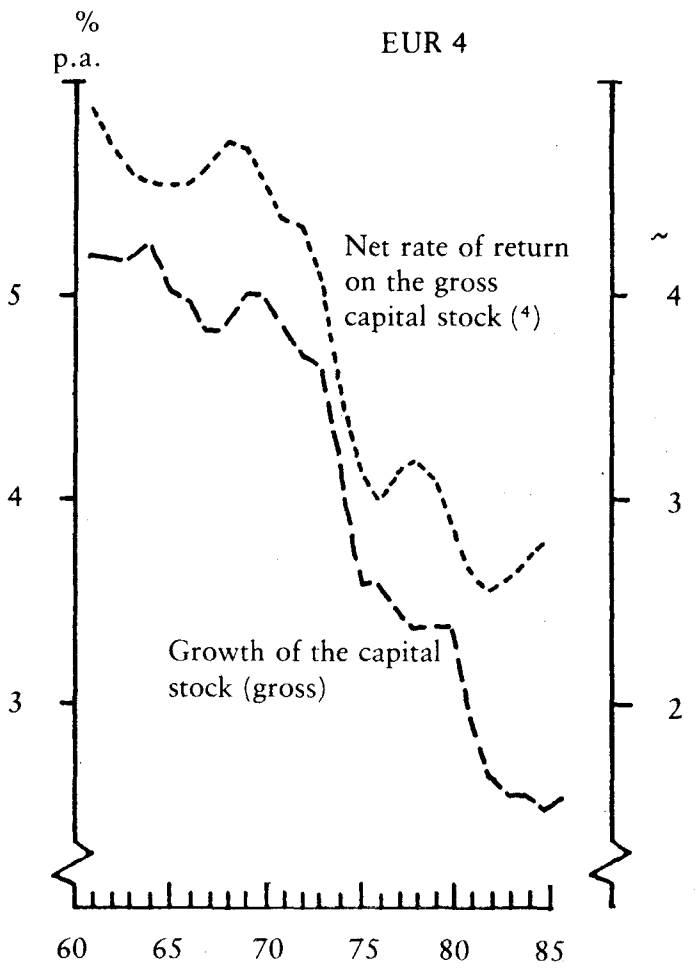
Investment has begun to pick up in 1984 and 1985, but from a very low base. As noted, however, the increase in the rate of capacity utilization in industry has continued through the last 12 months, rising from 79 % in the middle of 1984 to 82 % in 1985. Given this supply constraint, if the potential rate of growth of the European economy is to be significantly increased, there will have to be a major investment effort and one orientated away from labour saving and more towards capacity extension. This in turn implies that the recent improvement in the relative reward to capital as compared to labour will have to be continued for a considerable number of years. Such a trend would, of course, be more readily accepted as part of a social consensus if the economy were seen to be moving onto a more favourable growth path and at the same time creating more employment. This raises a question of an appropriate demand development which must go on in parallel with small increases in real wages.

GRAPHS 11 and 12

11. **Relative rewards of labour and capital**
Constant prices — indices 1960 = 100)



12. **Rates of return and growth of the capital stock**
Constant prices



(1) Compensation of employees per wage and salary earner, including an estimated labour income of the self-employed, assumed to be equal to the compensation of employees per wage and salary earner.
(2) Net operating surplus, excluding estimated labour income of the self-employed, as a % of the gross capital stock.
(3) Relative reward of labour and capital = Labour income per head of the occupied population/Net rate of return on the gross capital stock.
(4) Three-year moving average.

In this context, the role of technological innovation and the growth of technical progress more generally is particularly important. There is some evidence now that the pace of technical advance in Europe weakened during the 1970s. Contrary to some beliefs, this will have weakened rather than helped the employment situation. Whilst the process of technical advance necessarily involves the elimination of obsolete jobs, it also creates new jobs in industries that make and use the technologies. Some of the more important recent technological improvements, information technology for example, have a strong capital-saving and labour-using dimension. The pace and nature of technical progress, however, is not invariant to relative prices in markets for labour and capital. If real wages rise too much relative to the rate of return on fixed capital, this might be expected to induce more innovations of a labour-saving kind. A more appropriate structure of real employment costs and rewards to fixed capital will help to avoid this kind of bias. So long as advances in technical knowledge improve the efficiency of investment and working methods there will be less need to slow down real wage growth in order to achieve a given employment objective.

The structure of the economy has become biased too much in favour of capital-deepening and labour-saving investment, so that there has been insufficient capacity expanding investment. This seems due in no small measure to inappropriate relative factor price trends, with declining profitability matching weak overall investment and rising labour costs matching stagnant employment. More appropriate relative factor prices could see advanced technology help achieve higher potential output and employment growth.

II.4. Pay, profits and jobs

During the course of the last year, the Economic Policy Committee of the EC concluded an examination concerned with the adequacy of the return on fixed capital in the Community (1).

(1) Economic Policy Committee of the EC, 'Profitability and the rate of return in the Community', report to the Council and Commission (Doc. II/02/85-E final) May 1985.

The Committee observed that the rate of return on invested capital, which is the most significant indicator of profitability, declined in the 1960s and the 1970s in the Community. In 1984 the net rate of return on the net capital stock in the EC is estimated on average to have been 4,2 % (see Graph 14), which compares with 11 % in the 1960s (on the basis of the definitions used in Graph 14). This decline in the rate of return, however, appears to have been arrested in the more recent past, as the rate of increase of real wages moderated to an annual average growth of 1 % in the period 1983 to 1985 (compared with 2,1 % in the period 1974 to 1982 and 4,4 % in the period 1961 to 1973). Nonetheless, the recovery of the rate of return, while variable across countries, has on average been very modest when compared with the levels observed during periods of faster growth in Europe.

The wage share in national income in Europe has fallen back closer to the levels observed at the beginning of the 1970s, and the profits share has increased correspondingly. However, this change in income distribution has merely matched the change in capital-labour mix. This explains why the rate of return on fixed capital has hardly increased, and why therefore there remains a problem of insufficient profitability in Europe.

While there are serious statistical difficulties in the measurement of profitability of fixed capital, there exist also other criteria for judging the level of profits and wages, notably in the investment and employment performance of the economy. High real wage growth through the 1970s has contributed to a weak investment performance accompanied by an unfavourable investment mix.

In the judgement of the Economic Policy Committee, the great majority of Member States do still experience a level of profitability on fixed capital that is, in most sectors, probably too low from the standpoint of fostering sufficient investment and employment growth. Sustained moderate increases in real wages coupled to adequate demand growth would, of course, lead to the desired overall increase in the rate of profitability of fixed capital. An example of the very positive response of employment and investment to real wage moderation and improved profitability is being seen currently in Denmark where, in a small open economy, the increase in exports has provided the necessary demand stimulus.

The case exists therefore for an adjustment to be sustained for several years. Indeed, it may well be necessary for real wage growth to remain very modest and below the growth of labour productivity, as long as unemployment has not fallen significantly. However, this would need to be accompanied by an appropriate evolution of demand sustained progressively in part by spending on new private investment.

The issue of wage differentials, and flexibility in real wage evolution is also relevant in the pursuit of a higher level of employment. This issue of course poses considerable problems in the context of centralized wage bargaining; the appropriate balance between centralized versus decentralized negotiation is an important topic of dialogue between the social partners. Some evidence on the significance of inter-sectoral real wage flexibility for the employment-creating performance of the economy is suggested in a recent work [1]. While interpretation of this kind of evidence must be made with caution, it does appear to be the case that EC countries have shown a relatively low real wage flexibility, both inter-sectorally and at the macro-economic level, this running alongside increasing unemployment.

It is crucial importance that a greater consensus be reached over how these several difficult issues of pay, profits and employment performance should be handled in the Community in the years ahead. European countries must no doubt find solutions which can be adapted to the particular political and social traditions, whilst taking full notice of the ingredients of successful employment performance elsewhere. In this connection the role of more novel modes of pay determination could be examined, including for example a larger component of profit, bonus or performance-related pay. In pay systems which embody some of these characteristics, employees could have some measure of guarantee against excessive swings of the pendulum in favour of returns to shareholders. Moreover, the employer would be more prepared to recruit extra staff in the knowledge that labour costs were more flexible. In view of the need for a period of faster investment and higher profitability, it could also be helpful to foster a climate of wider participation on the part of employees in schemes for capital accumulation.

Wage moderation in recent years has allowed the decline in profitability of fixed capital to be arrested. However, profitability is still too low for the purpose of achieving higher investment and employment growth. Real wage flexibility in the EC, both at macro-economic and sectoral levels, is also rather low and apparently related to the weak employment propensity in the European economy. Therefore real wage moderation, of a kind actually witnessed in most Member States in the last four years or so, needs to be sustained for a period of years ahead until a substantial and continuing reduction of unemployment is achieved. Employers for their part must ensure that the necessary investment is forthcoming. Within a broad framework of concertation between the social partners there are three particular areas of concern: (i) how governments might formulate the necessary demand policies to accompany wage moderation agreements; (ii) the adjustment of relative factor prices and attainment of employment objectives; (iii) the scope for new modes of wage determination designed to attain more readily the objectives of high employment.

(1) OECD, 'Labour market flexibility and external price shocks', ESD working paper No 24, September 1985.

II.5. A cooperative medium-term growth strategy

The earlier parts of this section of the report have attempted to provide what are in effect building blocks for a suggested strategy aimed at securing a substantial and employment-creating growth. Given this earlier discussion, the judgement in this report is that the possibility of realizing such an outcome will depend heavily on a small number of particularly important conditions but set within a cooperative framework. Particular emphasis is placed on the contribution required from the different actors for the purposes of improving the profitability of capital, providing aggregate demand support and thus generating the investment necessary for growth of a more employment-creating kind.

Within this cooperative framework, the recent moderation in most countries in the rise of *real employment costs*, after a period of strong increases, must be maintained. It is clear that those countries which have not yet achieved the degree of moderation required must make efforts to do so. Associated with this is the need to encourage a more even-handed evolution of the *relative rewards* to labour and capital. Over the medium term, a reduction in the costs of employment relative to those of new investment will begin to change the investment mix and hence reverse what is now thought to be an excessive amount of capital deepening and shedding of labour.

Over the shorter period, a more moderate growth of real wages will tend to increase the profitability of firms. However, since wage incomes form such a large part of total domestic income, to a degree there is likely to be an adverse effect on demand. Given the starting point which is one where there is some evidence of capacity constraints already, the link between expected future profitability of investment and spending on new investment for capacity expansion is important. To the extent that total demand is reduced more by wage moderation than investment is increased because of improved profits, it will be necessary for some *aggregate demand-sustaining measures* on the part of governments to be effected if the desired employment response is to be realized.

The way in which the market for labour is able to respond occupies a central place and in this respect the adaptability and functioning of labour markets has been identified as a problem area in Europe. Factors such as job tenure and severance conditions, more flexible use of working time, the adequacy of professional training, the relation of wage differentials to labour needs in different sectors, regions and skills and the growth of non-wage costs should be re-examined in order to improve market efficiency without jeopardizing social protection.

The elements noted above constitute the essential core of the approach, a characteristic of which is that total demand has an important supporting role rather than one of leading in the growth process.

It is envisaged that the implementation of a growth strategy of the above kind would require an undertaking by both employers and trade unions to hold the evolution of real wages to the course of moderation witnessed in recent years for a further period until a sufficient reduction in unemployment is achieved. It should be examined in the wage-profit-investment-employment nexus whether there could be a role for wages having a larger flexible and more profit-related component. This could help boost employment by making labour less of a fixed cost. In present conditions, such an initiative would serve also to assist an investment upswing, by enabling companies to rely less on external sources of finance.

The *Community* could give a boost to a cooperative strategy by initiating measures to improve the supply side of the economy which, at the same time, have demand effects. These could consist of initiatives to accelerate completion of the internal market, develop a programme of European infrastructure and environmental projects, rapid advance of the proposed European technological community, and agreement with other countries to launch the new GATT round of trade liberalization. A rapid run-down in sector-specific subsidies and intra-Community protective practices by *governments* would open up the way for reductions in taxes. *Employers' organizations* would be expected to react favourably to these measures. Employers' organizations could also promote support in the private sector for a set of important European infrastructural projects and for an accelerated opening of the European internal market. They could give more urgent attention to the adaptation of investment and employment plans in the light of the expected change in wage-profit relations and the opening of market opportunities.

As regards demand-side policies, governments would be expected to ensure the maintenance of sufficient demand over the medium-term in order that the supply-side responses, particularly new jobs, be realized. In the event of a weakening of demand, for example because of the wage moderation proposed or international price or demand shocks, governments would be able to exploit room for manoeuvre thereby created for economic policy. In 1986 initiating contributions to a cooperative strategy could take the form of advancing public infrastructure programmes and tax reductions where possible, leaving further fiscal measures open for 1987 and 1988 depending upon progress in the overall strategy.

The *macro-economic effects* expected if a policy stance of the kind outlined can be summarized briefly in terms of a stylized model-based simulation exercise of the kind described in Section II.1.

A *Cooperative growth scenario* is constructed whereby it is assumed that Community countries pursue jointly a policy of sustained wage moderation. In the simulation it is assumed that both monetary and fiscal policy operate so as to

maintain aggregate nominal demand close to its baseline growth path. Declining inflation and wage costs contribute to a faster increase in real money stock. Outside of the Community, it is assumed that the United States reduces its budget deficit with some offsetting expansionary action being taken by Japan and the rest of the world. Action in the United States makes it possible in particular for Europe to reduce nominal and real interest rates which stimulate private investment directly and help to reduce public expenditure for debt-servicing purposes. In this context, some moderate expansion of public investment and reductions in taxation are compatible with the desired control of budget deficits, largely because of the impact of higher growth on budget revenues and the lower interest rates. In the case of a less favourable assumption about the international environment, some additional demand support would be necessary to obtain the desired reduction in unemployment.

The results of a simulation of a cooperative strategy of this kind, on an internal and international level, are illustrated in the third column of Table 7 and Graph 13.

The major feature is that the initiatives proposed, if implemented, offer the prospect of a growth rate of 3,5 % between 1986 and 1990 being associated with an average employment growth of 1,1 %. Indeed, in the final year of the projection, output grows by 3,5 % and employment increases by 1,5 %. This reduces the unemployment rate in 1990 to 7 %. This development could be sustained after 1990 and therefore opens up the perspective of a further substantial reduction in unemployment.

The assumed policy of wage moderation with demand support reduces the rate of inflation and increases company profitability. This induces a rise in private investment of over 6,5 % which, over the simulation period, is sufficient to overcome capacity constraints at the macro level. Significantly, the public sector deficit measured as a percentage of GDP is on average little different from that in the baseline projection.

It should be noted that the growth rate of 3,5 % on average as simulated is not to be judged as excessive when seen against the background of a considerable increase in productive capacity during this adjustment phase.

Labour productivity grows on average only a little faster than in the baseline assumption in spite of the much more substantial acceleration of growth from 2,5 to 3,5 %. This is the result of a gradual but widely diffused shift in the labour/capital mix in the economy. Faster growth and a gradual change in the labour/capital mix combine to give the favourable results for employment and unemployment.

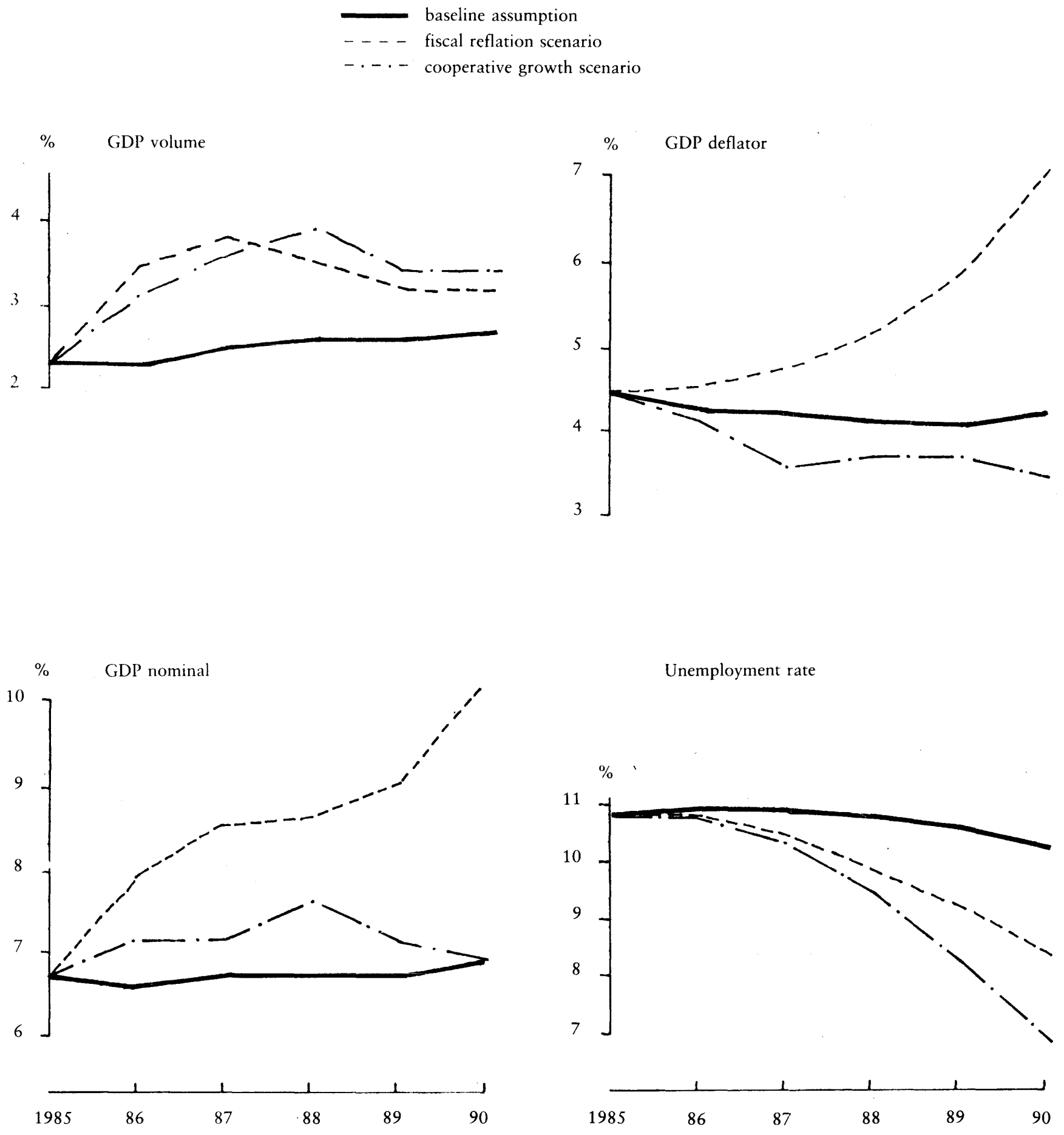
The macro-economic model simulation cannot take account of, or describe, the detailed sectoral evolution of productivity. However, such productivity growth might be expected to have some of the following characteristics. For those who are already in employment, one can assume a reasonable high skill level, that their productivity performance will also be high and, when combined with the anticipated new investment, may well increase. Of those entering employment, the younger entrants will be largely unskilled and require a period of training. Over this time, their productivity contribution will certainly be low. The same will be true for people who have been unemployed for a long time.

In summary, the simulation as constructed implies that a fulfillment of the conditions outlined could lead the European economy on to a growth path which has some characteristics of a 'virtuous circle'. Higher profitability and demand support generate the investment and output growth sufficient to absorb new jobs on a scale which reduces the pool of unemployed. Stronger growth, increased employment and lower unemployment in turn, improve public sector deficits by more revenues and less crisis-related expenditure, and this contributes, with increased self-financing of enterprises, to produce lower interest rates.

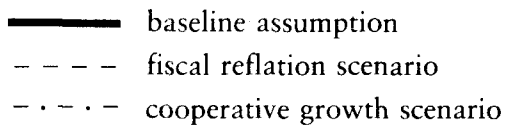
Even so, there are some factors which are not modelled in the scenario and which could generate further improvements in the economy's performance. These include various supply-side improving measures that have been taken in recent years in many countries, but which take a long time to bear fruit. Improved market adaptability with cost neutral reorganization and reduction of working time and the accelerated realization of the EC internal market, as now proposed, would add to growth and employment. Lower oil prices also (as mentioned in Section I.3) could help boost activity in the world economy more generally.

GRAPH 13

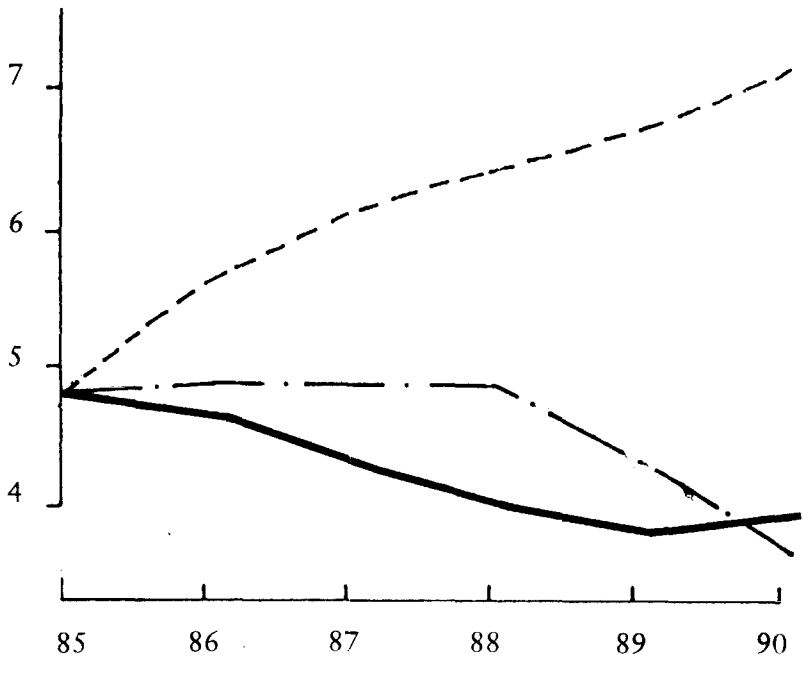
Some illustrative orders of magnitude in a baseline assumption and alternative policy strategies, EC, 1985 to 1990



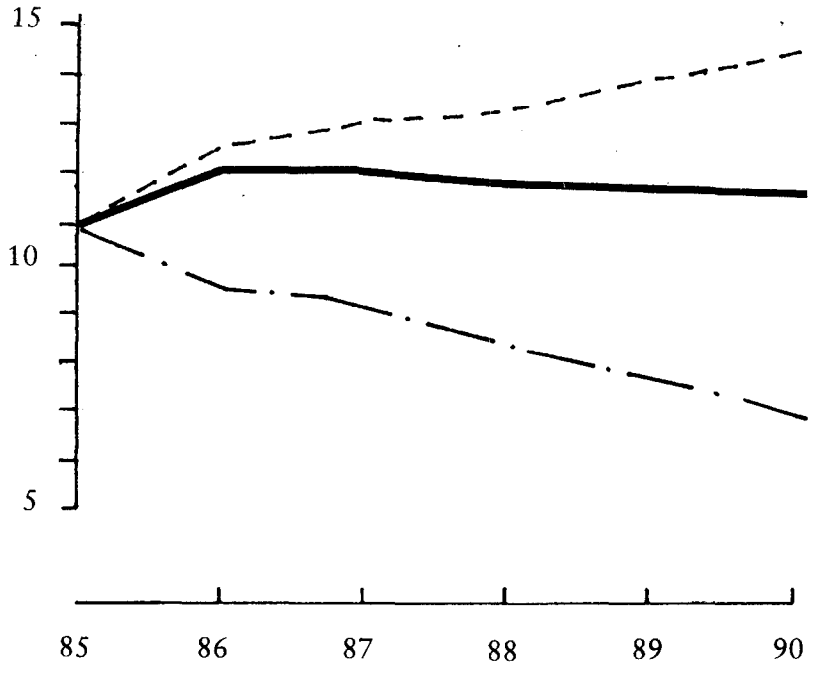
GRAPH 13 *(continued)*



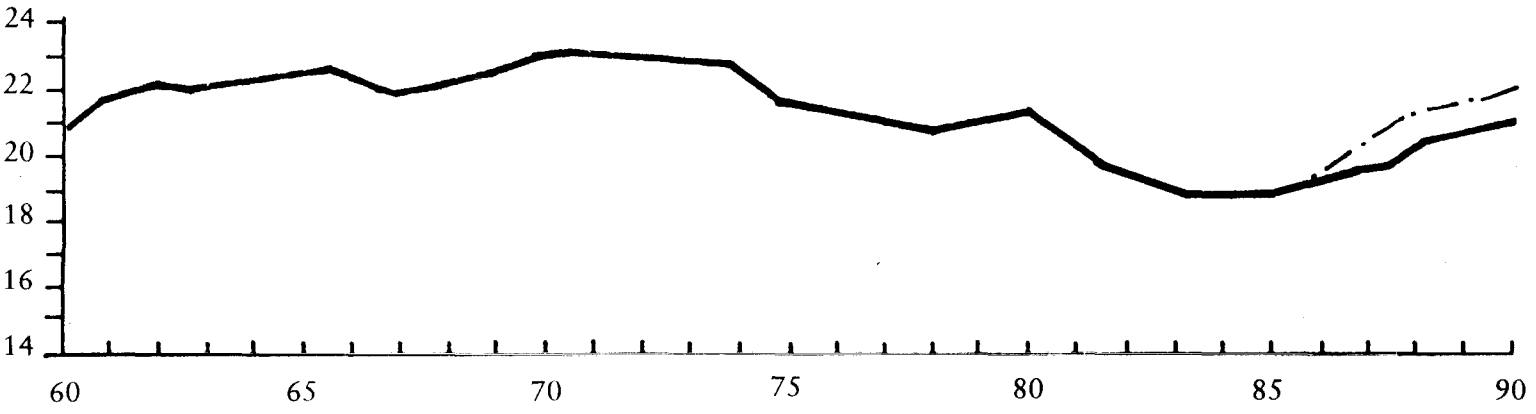
Budget deficit



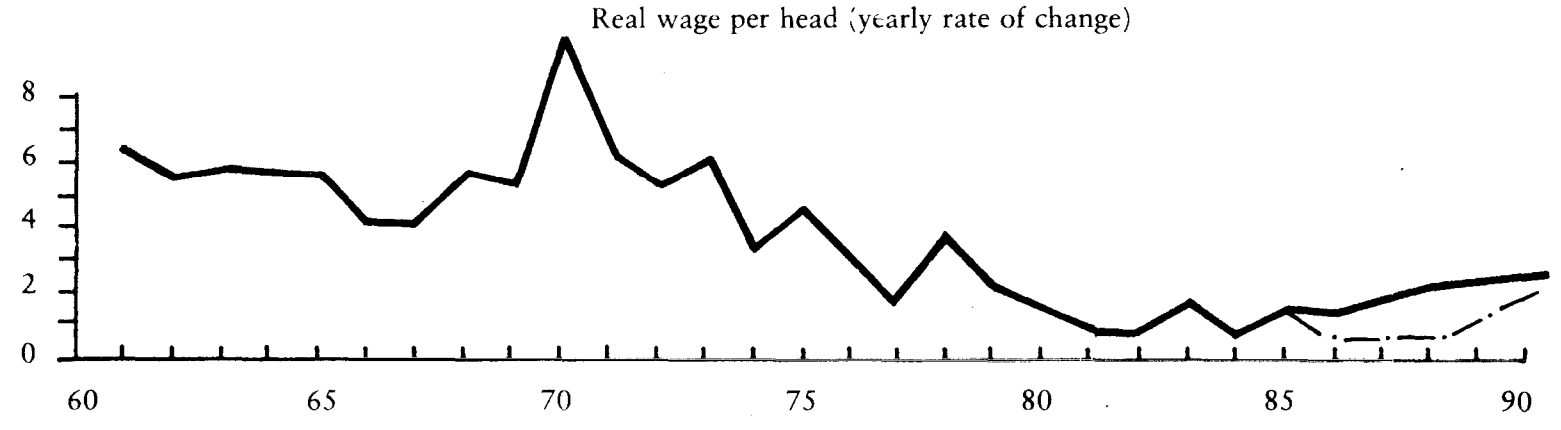
Long-term rate of interest



Investment share (gross) (1)



Real wage per head (yearly rate of change)



(1) As a % of GDP market prices.

Source: Eurostat, Commission Services.

The strategy thus depends heavily on the mutual supporting action of the major partners — employers, trade unions and governments. There must be a conscious will to both ensure the desired supply response on the one hand, and to ensure that the nominal demand is sufficient to absorb this supply on the other.

A policy strategy is suggested, for discussion by the social partners and government, designed to raise employment growth and reduce unemployment very substantially over the medium term. If pursued, it is conceivable that unemployment could fall to about 7 % by 1990 and, in this event, the gains to real output would also be significant. The core elements, namely a temporary moderation of real employment costs, relative factor price flexibility, and nominal demand support are highly interdependent. However, an important contribution will also be provided by extensive improvements in the functioning of labour, goods, services and capital markets and notably in the EC internal market in many fields. The implementation, success and credibility of the adjustment strategy rests, however, on a joint willingness by all parties to ensure that the necessary conditions are met with a step-by-step implementation starting in 1986, extending over several years.

III. ECONOMIC POLICY IN THE FRAMEWORK OF A COOPERATIVE GROWTH STRATEGY

III.1. Public finances

III.1.1. *The public sector*

Last year's Annual Report advocated a reversal of the mounting share of public expenditure and taxation in the gross domestic product of the European Community. Recent estimates by the Commission suggest that the previous trend is now being checked if not reversed. The volume of public expenditure is expected to grow by under 1 % in 1986. Total public expenditure in the EC as a share of GDP is estimated to decline slightly from 51,9 % in 1984 to 51,5 % in 1985, and then more substantially to 50,8 % in 1986. Similarly, the total tax burden is estimated to be declining, although by a somewhat smaller margin, because of budgetary consolidation. Total taxes amounted to 46,4 % in 1984, are expected to be 46,3 % in 1985 and 46,0 % in 1986.

Given institutional differences in the organization and extent of the public sector, such highly aggregated data must be used with caution, especially in inter-country comparisons. Some summary comparisons between the EC and US are shown in Table 8 which point to similarities as well as differences between the two economies. Government consumption expenditures, for example, stand in both cases at about 19 % of GDP, and the weight of direct income taxation is also similar at about 13,5 % of GDP. The higher level of government capital formation in Europe no doubt reflects the wider extent of public intervention in certain services, for example transport and health. Striking differences arise in the magnitude of government *current transfer payments* which reflect the greater involvement of government in the provision of health and social security. Social security contributions in Europe as a percentage of GDP are correspondingly higher than those in the United States. The EC average tax and social security burden, however, covers a considerable range; in 1985 for example, from around 55 % in Denmark and the Netherlands to 41 % in the United Kingdom and 35 % in Greece.

The reasons why the scale of both public expenditure and taxation can influence economic growth and employment over the longer term are extremely complex. However, three channels of influence can be identified which create the possibility of risks to the achievement of an efficient economic performance.

As the taxation on labour income rises, so also does the difference or 'wedge' between what an employee costs to the employer, and what the employee receives as net-of-tax income. Higher labour costs tend to reduce the demand for labour and therefore private employment. Further, in so far as lower net-of-tax incomes induce wage earners to claim higher wages in compensation, this will create inflationary pressure and worsen employment prospects again when this inflation has to be reversed. Higher taxation on wage income helps also to account for the increase in the price of labour relative to capital and hence the increase in the capital-labour ratio observed in the 1970s, and noted earlier in this report. The increase in this taxation 'wedge' has been pronounced in most European countries over the last two decades, as compared with experience in the United States and Japan. For example, between 1960 and 1983, the difference between gross and net wages expressed as a percentage of net wages grew on average in the four larger EC countries from 36 to 60 %. In the United States over this same period, the increase was from 29 to 37 %.

A second channel concerns the efficiency and value of public services. If wage earners perceive public services and transfers to be giving good and fair value, there will be a more ready consensus over accepting the tax burden implied. Inefficient and unduly extensive transfer payment systems on the other hand will tend to undermine such a consensus and thus lead to higher wage pressure with detrimental effects on growth and employment.

A third channel of influence occurs when public borrowing rather than taxation is used to finance current public expenditure. Here, given the need to pursue anti-inflationary policies, the deficits should not be financed by money

creation. The impact on performance will thus operate primarily through a higher rate of interest. In so far as this reduces private investment it will harm the growth of productive potential.

Although the timing and nature of the final incidence of these effects on economic performance are highly uncertain, there is a presumption that in Europe the rapid growth of public expenditure and changes in its composition together with the evolution of the tax burden has had detrimental effects on economic performance when measured over the longer term. The fact that the Community is beginning to reverse some of the trends observed indicates an awareness of these possibilities and this is to be encouraged.

TABLE 8

Level and structure of public expenditure, receipts and public debt in the United States and the EC

(% or % of GDP)

	United States		Europe		
	1970	1982	1970	1982	1985
A. *General government expenditure, total*	32,8	37,6	37,9	51,2	51,5
(1) General government capital formation	2,5	1,5	4,2	3,0	2,8
(2) Net capital transfers	– 0,5	– 0,3	0,8	1,0	1,1
(3) Government final consumption expenditure, total	19,2	18,7	15,3	19,3	19,2
(4) Subsidies	0,5	0,5	1,8	2,3	2,4
(5) Interest payments	2,3	4,5	2,0	4,7	5,3
(6) Current transfers	8,3	12,4	13,8	20,9	23,1
B. *General government receipts, total*	31,0	33,6	38,2	45,8	46,3
(1) Indirect taxes	9,5	8,5	13,9	13,5	13,8
(2) Direct taxes	13,9	13,6	10,3	13,0	13,2
(3) Social security contributions	4,7	6,8	11,0	15,4	15,5
(4) Other current receipts	2,9	4,7	2,9	3,8	3,8
	1971	1982	1971	1982	1985
C. *Public debt*					
(1) Gross public debt	26,1(1)	28,5(1)	47,8	57,5	64,3
(2) Net public debt	:	:	14,7(2)	26,3(2)	33,4
D. *General government share in total employment, %*	18,1	16,7	13,7	17,5	:
E. *General government financial balance (in % of GDP)* (3)	– 1,8	– 3,9	0,3	– 5,6	– 5,2

(1) Federal government.
(2) Average for EUR 5 (D, F, I, UK, DK).
(3) Projected financial balance for 1985 for the United States: – 3,7 % of GDP.

It is highly unlikely that economic performance is invariant to both the weight and shape of the public sector. Undesirable consequences can follow from the difference between gross and net incomes, a weakening of social acceptance of the tax burden and the effects of public debt on capital formation. There are signs of increasing awareness in the Community that these are real problems, and the observed tendency to begin a reversal of earlier trends is to be welcomed.

III.1.2. *Taxation policy for economic growth*

There are a number of ways in which taxation policy can contribute to a strategy aimed at higher growth of a more employment-creating nature.

One question is whether such a strategy could be furthered by means of increased incentives and subsidies for investment.

This has been discussed extensively in the relevant Community bodies during the last year. The predominant judgement is that the experience of trying to stimulate growth through increased specific investment subsidies has been rather disappointing. Although a sustained increase in investment spending is needed now as part of a growth strategy, it is felt that inducement of this through the introduction of specific investment incentives creates the risk of worsening any trend in the direction of capital-deepening and labour-saving activities. Given the present condition of the European economy, with its notably poor employment record, it may be desirable to create conditions which are more even-handed with respect to business expansion. Any feasible tax concessions should therefore be used primarily to cut labour costs, so improving the profitability of private enterprise in order to initiate a more balanced mix of labour-using and labour-saving investment.

A related issue is whether public deficit considerations permitting faster progress in the reduction of both subsidies and taxes in various sectors of the economy could be made. There are some persuasive reasons for doing this. Notably, it will help to re-allocate resources from the more stagnant or declining sectors to the more productive and growing sectors of the economy. This is an area of policy where the responsibilities of the European Community itself are considerable, in competition policy in general and in some specific sectors (see further below on agriculture, steel, and shipbuilding). A mutually reinforcing action by the Community and Member States is needed to effect a more rapid series of tax cuts and of subsidies, so adding a further dynamic element to the economic strategy.

In the same class of ideas, but this is clearly a matter of national competences, is a detectable notion of tax reform. Examples are seen currently in the United Kingdom, Denmark and other countries. What is envisaged is that a simplification of existing tax systems, through the elimination of the numerous tax offsets and advantages for special purposes especially in the income taxation of persons and companies, will enable basic rates of taxation to be reduced within existing revenue constraints. This encourages the market to allocate resources in response to more appropriate price signals and thus helps to avoid the kind of bias which have become all too obvious over the past decade.

Finally, the possibility of a substantial fall in the price of oil raises issues concerned with the taxation of energy, labour and capital. The objective of a more employment-creating growth is easier to attain in the presence of reductions in the taxation of employment income. A pronounced fall in the price of oil over a few years could endanger progress being made towards securing a situation whereby the economy is less vulnerable to imported price or supply shocks. It is, of course, difficult to judge what the long-term equilibrium price of energy might be. Nevertheless, the raising of duties or taxes on oil products would contribute to budget flexibility and thus provide more room for manoeuvre in the job-creation investment strategy proposed here.

There are several ways in which taxation policy can contribute to a strategy for higher growth and more employment-creating growth: (i) a switch in emphasis away from specific fiscal incentives for investment, which will help to foster employment and enterprise profitability; (ii) reduction of industry-specific subsidies coupled with general tax reductions; (iii) reduction of other specific tax offsets accompanied by lower tax rates; and (iv) in the event of an energy price fall, the raising of duties or taxes on energy could provide room for manoeuvre for employment creation.

III.1.3. *The role of public debt*

Fluctuations is budget deficits and public debt can have important effects on both supply and demand conditions in the economy. However, these are not easy to define in a simple way. Rising public debt burdens tend to increase the rate of interest and, other things being equal, depress private capital formation. This interest rate effect, however, need not necessarily be a dominant factor since, under certain conditions, budget deficit movements can contribute positively to economic growth. If an appropriate policy succeeds in raising the potential output of the economy, a temporary rise in borrowing may increase demand, in a way which matches broadly the increased potential tax base of the economy. The structural public debt burden, as measured, for example, by the medium-term value of public debt as a percentage of GDP, may then not rise.

What level of the public debt burden might be judged appropriate depends very much on specific economic circumstances. However, at very high levels of the public debt burden, such as around 100 % of GDP or more, as currently is the case in Belgium, Ireland and Italy, the serious economic problems caused by excessive borrowing and the resulting debt burden become quite obvious. Interest payments on the public debt can reach 10 % or more of GDP, and account for 20 to 25 % of public expenditure. The rate of interest itself is, under conditions of non-inflationary monetary policy, subject to strong upward pressure. If the risk associated with a rise in the debt burden becomes important, a country's domestic interest rate eventually will incorporate a substantial risk premium. This is a direct reflection of markets' view of the financial problem. There may also develop income distribution problems between bond-holders and salary earners. A combination of arguments, concerned with economic growth, monetary stability and income distribution therefore, all plead in favour of action to reverse what can easily become an unsustainable trend situation.

As for the adjustment process required, examples show that comprehensive stabilization programmes need not necessarily be excessively costly or disruptive even in the short run. Denmark, in particular, has been reducing its government borrowing requirement massively, from 9 % of GDP as recently as 1982 (which is comparable or lower than the present deficits of Belgium, Greece, Ireland and Italy) to under 2 % of GDP forecast for 1986. In the meantime, the

Danish economy will have grown by 15 % (from 1981 to 1986), whereas in the same period the EC on average grew only by 8 %. Danish employment growth was also much faster than in any other EC economy during this period.

In other EC countries the debt burden currently is not so great. The gross public debt burden in Germany presently appears to be stabilizing at around 42,5 % of GDP. That of France is currently rising but remains at a lower level of 36 % of GDP. That of the United Kingdom is higher, at 60 % of GDP in 1985, but has been decreasing since 1983. Thus these countries perhaps have some margin within which the evolution of the public debt burden as a share of GDP could vary, depending upon their economic policy strategy. If some temporary rise in the public debt burden were to be accepted in the next few years, great care should be taken to ensure that (a) this formed part of a combined supply and demand strategy that effectively raised the profile of actual and potential production and (b) remained within the constraints of a sound medium-term financial stratgegy. These conditions should be easier to satisfy if the following criteria are observed:

(i) On the supply side, the counterpart to increased public debt where possible, should represent investment in productive potential, either in the form of public investments offering acceptable social rates of return, or, in the case of tax reductions, in a stimulation of private investment which will lead to a widening of the future tax base of the economy. Such tax reductions might be expected to have beneficial incentive effects in the markets for labour and capital. In this way a virtuous circle of interrelated movements can be possible. With enhanced productive capacity the tax base is increased; thus tax rates can be reduced which further stimulates growth, even within the constraint of given budget deficit levels.

(ii) On the demand side, expansionary measures in the budget should be justified by the need to correct any inadequacy in the growth of demand. In the event of further disinflationary effects on the European economy resulting from dollar depreciation or falls in commodity prices, it may be desirable to sustain demand, in particular to prevent excessive deflation of the tax base. In these conditions it makes little sense to raise taxes or cut expenditure to offset such shortfalls.

(iii) The evolution of wage incomes has important implications for both supply and demand sides of the economy. Starting from a situation of inadequate profitability and high unemployment, wage moderation helps create and increase profitable productive capacity. It increases the potential tax base, and in a situation where public finances are in reasonable balance, justifies tax rate reductions. Wage moderation itself, however, may create a transitional problem of demand weakness, and this is another case where accompanying support from demand policy is desirable.

Public debt strategy is an important ingredient of both supply and demand policy. Such a strategy cannot always be defined in simple terms. There are cases in the Community where the growth of the public debt burden is clearly alarming and must now be put onto a corrected trend (Italy, Belgium, Ireland). Elsewhere public debt burdens are generally lower and, in some cases, approximately stabilized. Whether there is a sound case for using room for manoeuvre here for some increase in the public debt burden during an adjustment period to help the economy onto a higher growth trajectory, depends upon a specific set of supply and demand conditions. If supply potential is improved by wage moderation and micro-economic policies to improve markets, and if demand is temporarily weak because of, for example, wage moderation or international influences, then some transitory increase in the public debt may contribute a valuable element to the wider growth strategy.

III.1.4. *The European Community budget*

An additional level of public finance is developing in Europe. With a revenue or expenditure volume of around 1 % of Community GDP the Community budget, admittedly, has not a major macro-economic impact but is playing a greater role in structural adaptation. With the enlargement of the Community the total own resources of the budget are being increased, as from 1986, with revision in the maximum rate of value added tax call from 1,0 to 1,4 %. At the same time, an increased effort is being made to contain the large share of agricultural price support expenditure in the Community budget.

The policy priorities for the enlarged Community budget are to facilitate the structural improvement and convergence of the Community economy. This comes out clearly in Table 9. The 1986 figures are taken from the preliminary draft budget. In several of its faster growing functions, the budget is contributing aids to compensate for the effects of the opening of the Community's markets and help to restructure regions or sectors in difficulty.

TABLE 9

European Community budget, 1984 to 1986 — Preliminary draft proposed by the Commission

(million ECU)

Expenditures	1984 EUR 10	1985 EUR 10	1986 EUR 12
Policy functions			
Agriculture — guarantee section	18 126	19 691	20 688
Agriculture — structural funds	667	687	946
Fisheries	87	105	236
Social Fund	1 212	1 410	2 399
Regional Fund	1 413	1 610	2 600
Integrated Mediterranean projects	10	10	151
Transport	505 (1)	36	74
Energy and industry	659 (2)	130	105
Research and innovation	533	570	673
Food aid	737	772	954
Development aid	527	531	697
Other expenditures including refunds to Member States	2 733	2 881	5 527
Total	27 208	28 433	35 050
Revenues	**1984 EUR 10**	**1985 EUR 10**	**1986 EUR 12**
Agriculture levies	2 435	2 106	2 699
Customs duties	7 961	8 596	9 700
Value added tax (VAT)	14 594	15 198	22 184
Special contributions	596	2 247	204
Miscellaneous	466	286	263
Total	26 052	28 433	35 050
p.m.			
Maximum rate of VAT	1,00	1,00	1,40
Effective rate of VAT	1,00	1,00	1,34 (3)
Budget total as share of GDP	0,94	0,85	1,10

(1) Includes 471 million ECU of special measures in the United Kingdom and Germany.
(2) Includes 456 million ECU of special measures in the United Kingdom and Germany.
(3) Except for Germany 1,31 and United Kingdom 0,82.

Source 1984 — Management accounts; 1985/86 preliminary draft budget 1986 adopted by the Commission on 14 June 1985.

The increase in expenditure in 1986 is partly due to the accession of Spain and Portugal, but also reflects an increase in respect of the other Member States. This is particularly true of the Regional Fund which, under the new Regulation applicable from 1985, increases the share of expenditure going to more selectively defined regions with the most severe problems.

Expenditure on integrated Mediterranean projects, aimed at helping mediterranean regions adapt to the consequences of the Community's enlargement, becomes significant for the first time in 1986. Expenditure on transport infrastructure projects, the Social Fund (retraining and job-creation projects), and R & D and innovation and development aid also becomes more important in 1986. About 50 % of new

expenditure in 1986 can be attributed to the accession of Spain and Portugal. This part, however, will be covered by own resources paid in by the new members. The remaining part of the increase takes place because of the substantial rise in payments to finance commitments incurred before 1986 and also because of new commitments.

Priorities for the Community budget, endowed from 1986 with increased own resources are (i) to contain agricultural expenditures more effectively and (ii) to devote increasing resources to structural improvement and convergence of the Community economy.

III.2. Monetary policy and the European Monetary System

In recent years, a consensus has gradually emerged on the need to create a stable monetary environment and on the contributory role of monetary policy. This consensus contrasts with the marked differences in the management of national monetary policies in the 1970s. By imposing exchange rate discipline on the participating countries, the European Monetary System has shown itself to be an essential factor in the cohesion of monetary policies with a common objective of stability. Such consensus is an important achievement which must be preserved: monetary stability must, for several reasons, be an essential part of any strategy which aims at restoring lasting growth, capable of creating more jobs.

First of all, monetary stability creates an environment which encourages those involved in the economic process to cooperate with each other and in particular reduces the justification for indexation mechanisms. Some of these mechanisms, a relic of periods of high inflation, both obscured and held back the necessary adjustment of relative prices and costs and so contributed to present macro-economic imbalances.

Secondly, expectations of a permanently low inflation rate enable interest rates to play more efficiently their role in establishing the balance between supply and demand on the capital market. An artificially low or even negative real cost of capital, such as that which obtained in certain countries in the 1970s, gives a distorted indication of the scarcity of capital, encourages the waste of scarce resources formed from savings and leads to a pattern of growth which creates fewer jobs. Of course, excessive real interest rates (for example greater than the underlying growth rate of the economy) accompanying budget deficits which are too high, have considerable structural consequences. But now the level of real interest rates must make it possible to attract the funds needed to finance not only public deficits, still excessive in certain cases inside and outside the Community, but also to finance the required investment drive. Furthermore, an essential justification for the policy indicated for certain countries of a continued reduction in the public deficit is that it contributes to lower real interest rates in the medium term.

Finally, the level of the real return on capital is a key factor in the investment Decision. Present distortions between the cost of capital and the profitability of productive fixed capital originate, as illustrated in Graph 14, in the decline in profitability which occurred in the 1970s, rather than in the more recent rise in real interest rates. Thus, whilst a fall in real interest rates of, say, one or two percentage points from their present level would certainly help to stimulate investment, it would come nowhere near to restoring the differential which prevailed between real interest rates and the profitability of productive capital in the 1960s, a period of full employment, and existed again during part of the second half of the 1970s.

As is evidenced by the downward convergence of inflation rates in the Community, considerable progress has been made towards the creation in Europe of an internal and external zone of monetary stability (see Table 5 of this report). Since March 1983 there has been no change in the central rates of almost all the currencies participating in the EMS. The adjustment of the Italian lira's parity, which took place in July 1985 by unanimous decision of the partner countries, remained limited in scale. The stability of nominal and real exchange rates between the currencies participating in the EMS exchange rate mechanism provides a striking contrast with the often sharp variations recorded before the establishment of the EMS and those which are today still affecting other currencies. This stability is naturally reflected in small exchange rate variations between the ECU and its chief component currencies. It satisfies a need felt by private operators, as can be seen from the development of the private ECU as a borrowing and investment currency and its growing use for commercial transactions. Monetary policies, pursuing the *common objective of stability*, but which have to be differently framed to take account of the progress still necessary in each country, are a guarantee that these achievements will be consolidated and improved.

A number of countries — in particular the Federal Republic of Germany, France, Italy and the United Kingdom — are pursuing normative targets for the growth of monetary aggregates or domestic credit expansion. For countries where the inflation rate is still too high, the aim should continue to be a progressive reduction in the growth rates of monetary aggregates of domestic credit expansion, so as to underpin the stabilization process. Where the rate of inflation and inflationary expectations are sufficiently low, monetary growth should release a margin for real growth in line with the medium-term trend of productive capacity while preserving what has been achieved in terms of stability. This would provide lasting support for economic activity. In these countries the setting of the target for monetary growth must, however, be largely influenced by the judgement made on the growth of productive potential, notably with regard to the effects of supply policies carried out in other areas and the increase in capacity utilization rates which can be achieved without creating inflationary strains. To the extent that supply-side policies speed the growth of the productive potential, such a strategy goes hand in hand with the sound financing of the increase in demand which then becomes desirable.

It is true that the present changes on financial markets, especially the spread of financial innovations which are tending to make the demand for money more unstable, sometimes complicate the implementation of policies based on monetary aggregates or credit targets. But experience has shown that, where the authorities of the EMS countries are determined to pursue a policy which conforms with guidelines based on the above criteria, the exchange rate mechanism is stabilized and its macro-economic effects reinforced. For EMS countries, the quantitative intermediate objectives of monetary policy and the exchange rate objective thus mutually reinforce one another. Furthermore, the United Kingdom authorities are tending to attribute more importance to the sterling exchange rate alongside their quantitative intermediate objectives.

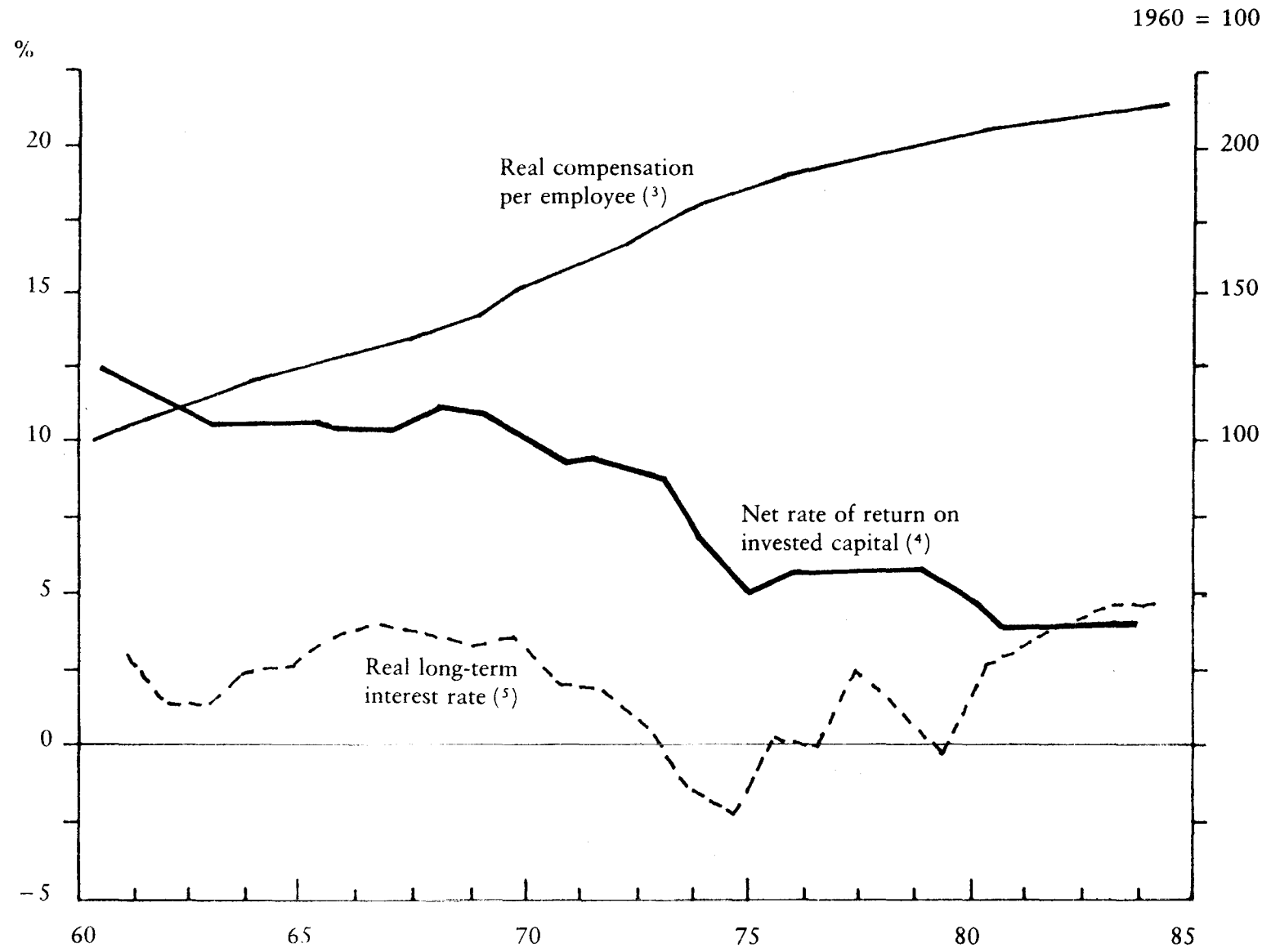
In the other EMS countries, which are even more open to the outside world, the chief intermediate objective remains their currencies' central rates within the system, and the domestic intermediate objectives are, perhaps, less binding in nature. The authorities must, however, ensure that domestic money creation continues to be compatible with price stability and a sustainable external position.

A marked fall in the dollar, and the improvement in the terms of trade which could result, would ease the monetary policy burden in pursuing the final objective of price stability. With the same rate of monetary growth, a faster fall in inflation associated with external factors would in itself release an additional real margin for growth. But given the present instability of the International Monetary System, lasting stability can be guaranteed only by the continuing control of monetary growth. However, following the recent declaration by the Ministers of Finance of the five major industrialized countries, it is to be hoped that a solution to this instability will be found which, at the same time, will help to relax even further the external constraints which may stop interest rates from falling in Europe.

In the convergence process, the stability of bilateral exchange rates within the EMS is of prime importance. For one thing, in the countries where inflation is highest, such stability reinforces internal efforts to bring down inflation. In these countries, because of the greater covergence of inflation rates and allowing for the lira parity adjustment in July 1985, the rise in nominal effective exchange rates weighted by inflation differentials against partner countries (real exchange rates) is still moderate, but nevertheless illustrates the stabilizing effect of an exchange rate mechanism which provides for fixed but adjustable parities. Secondly, the competitiveness gains obtained by the more stable countries help them to acquire a comfortable external position and contribute to the release of a real margin for growth. But these considerations do not exclude a realignment of central rates in the event of fundamental disequilibria.

GRAPH 14

Rewards of labour, fixed capital and financial capital in the Community (1) (2)



(1) The above graph has taken from the report of Economic Policy Committee concerning 'Profitability and the rate of return in the Community'. The graph provides an illustration, on the basis of different definitions, of the development of profitability as presented in Graphs 11 and 12 above.
(2) Community average weighted with GDP of 1975 and 1975 purchasing power parities.
(3) Deflated by GDP-prices.
(4) Net operating surplus of enterprises (excluding housing) as % of corresponding net capital stock (left-hand scale). Because of well known statistical problems, the level of this curve has to be interpreted with caution and it is its evolution which is of greater relevance.
Source: Deutsches Institut für Wirtschaftsforschung (Berlin) on behalf of the Bundesministerium für Wirtschaft (Bonn). Recent years and the Community average have been calculated by the Commission services.
(5) Interest rate on government bond yields. Deflated by consumer price index (left-hand scale).

In the last few years, the internal cohesiveness of the EMS, which admittedly has at certain times also benefited from favourable external factors, has above all been guaranteed by the stronger *consensus* on the priorities to be adopted and the methods to be used in all areas of economic policy, the increased *convergence* of performances and the close *coordination* of monetary policies both internal and external. However, major progress is still necessary to achieve a satisfying degree of convergence. In this respect, some countries must, in any event, still make substantial efforts with regard to budgets and incomes so as to reduce the sometimes excessive burden borne by monetary policy in the stabilization process. The greater growth is in the Community, the more rapidly will these efforts be crowned with success.

The room for manoeuvre available to the authorities for influencing interest rates is largely determined by interest rate levels on international markets and by the pursuit of the intermediate and final objectives of monetary policy. As regards the external constraint, European short-term interest rates did not completely follow the upward movement of United States short-term rates in the first six months of 1984, and then their marked fall in the following 12 months. As an

average for the Community countries, the fall in short-term rates between December 1983 and July 1985 was steadier but slightly less marked than in the United States (1,1 percentage points for Europe compared with 1,7 percentage points in the United States). The prudent management of short-term interest rates in Europe, tailored to the needs which still exist as regards internal stabilization and to the severity of the external constraint, and a more favourable trend of fundamentals (external and budget deficits) reinforces, on this side of the Atlantic, the credibility of the policies implemented. This has contributed to a notable fall in nominal long-term rates (1,7 percentage points) which, between December 1983 and July 1985, was more marked in Europe than in the United States.

Until March 1985, the strength of the dollar impeded the fall of short-term interest rates in Europe, but the situation has since changed, and some room for manoeuvre has appeared. It is already being utilized in the Community countries with the lowest inflation rates. In Germany, the money market rate has thus been cut by around 1,6 percentage points since March 1985 and now stands at 4,5 %, its lowest level since the end of 1978. A favourable international context would make it possible to make even more use of this margin. In countries where there is still a major need for stabilization, and where monetary policy must go on contributing to the convergence process, nominal interest rates could, however, continue to fall in line with the reduction in the inflation rate. To the extent that this difference in managing interest rates, in line with the internal monetary policy objectives in the different countries, leads to the maintenance of the right interest rate differential within the EMS, it also reinforces the stability of the exchange rate mechanism and its internal cohesiveness in response to external shocks, despite the divergences which still exist in certain fundamentals.

In the Community countries real long-term interest rates, measured as a first approximation by the differential between nominal interest rates and the rate of increase in consumer prices, rose by an average of 4,5 percentage points between 1981 and 1984. The rise was particularly marked in countries where they had been close to zero or even negative at the start of the 1980s, while the rise was only some two percentage points in the more stable countries. When disinflation is rapid or when the inflation rate is historically low, the real interest rate, measured by the differential between the nominal interest rate and the *current* rate of price increase, is probably overestimated in relation to a measure which would take account of the inflation rate *expected in the medium term*, which is probably then higher than current inflation. Conversely, in countries where the inflation rate is still high but where the disinflation process is well under way and credible, the real interest rate expected in the medium term is higher than that measured by the current inflation rate. In any event, inflationary expectations play a key role in the formation of nominal interest rates which increases the importance which should be attached to the conduct of monetary policies with the lasting and credible aim of price stability. Such policies help to bring the current inflation rate and the expected inflation rate closer to one another and to stabilize them at the lowest level and this makes the formation of nominal interest rates more rational and creates a suitable environment for their steady and lasting reduction.

Within the Community, the upward convergence of real interest rates is evidence of the now common course of monetary policies in a context of generally high public deficits and severe strains on international capital markets, particularly in the United States. Their progressive fall, which is desirable, will have to be soundly based and will depend mainly on both the satisfactory progress and the credibility of the disinflation process and on the absorption of financial imbalances, particularly of the public deficits inside and outside the Community.

The effective liberalization of capital movements inside the Community and, at the same time, efforts towards a greater convergence of economic policies for higher growth, will make possible the completion of the European Monetary System, which is necessary in order to create a European monetary and financial area. Liberalization would favour the development in Europe of a dynamic and attractive financial market and would thus contribute to the better allocation of savings.

Since the establishment of the EMS in March 1979, the objective of liberalizing capital movements has become even more important. To the extent that the restrictions placed on capital movements artificially increase the autonomy of monetary policies, they reduce the disciplinary effect of the exchange rate mechanism and are thus liable to hold back the convergence process. However the convergence of monetary policies and the gradual fading of money illusion among economic agents mean that this room for manoeuvre is not utilized or even non-existent — as can be seen from the upward equalization of real interest rates in the Community. As and when divergences narrow, the restrictions on the freedom of capital movements gradually lose their usefulness. This underpins the argument for a progressive dismantling of the restrictions placed on capital movements while not undermining the stability of the exchange rate mechanism during the adjustment phase.

A climate which favours the strengthening of the exchange rate system has gradually grown up since the start of 1984. A variety of factors have contributed: the satisfactory convergence of monetary policies, the credibility gained by the general process of bringing down inflation, a more open and more evenly spread attitude as to the advisability of resuming the liberalization of capital movements in the interests of the EMS itself and, the strength of the parity grid agreed in March 1983 in withstanding external currency movements. This state of mind was demonstrated by the adoption in 1985, by the Council and by the Central Banks of the Community, of preliminary technical measures which will slightly widen the use of the ECU in the effective operation of the exchange rate system. The possibility has even been mentioned of giving third country holders access to the ECU in the European Monetary Cooperation Fund.

The Community bodies concerned have agreed to keep under review the possibilities of fresh progress in the monetary area, and the conditions for achieving this. The Council of Finance Ministers has confirmed the ultimate objective of Economic and Monetary Union. The development of the EMS, reinforcement of which is doubtless an objective in itself, must also be seen in this perspective. Of special interest here are questions relating to the expansion of the international role of the ECU, both in its public and private uses, and to the participation, on an equal footing, of the component currencies in the exchange rate mechanism.

The creation of a zone of monetary stability is an integral part of the strategy for lasting growth, capable of creating more jobs. By reducing uncertainties as to the future real value of the currency, an environment is created which encourages those involved in the economic process to cooperate with each other. The stabilization of inflation expectations also makes the determination of interest rates on capital markets, which have an essential rule in the optimal allocation of the scarce resources formed by savings, more rational. As regards stability, achievements in recent years have been encouraging. Monetary policies, designed to achieve the common objective of stability, but framed accordingly to take account of the progress still necessary, are the guarantee that these achievements will be consolidated. In some countries monetary policy must still underpin the stabilization process, by reducing the rate of monetary growth and by lowering short-term interest rates in line with the progress made in bringing down inflation. The internal cohesiveness of the European Monetary System should, however, be strengthened by additional progress in all areas of economic policy in order to reduce the, sometimes still excessive, burden borne by monetary policy in the stabilization process. In other countries, monetary policy should continue to use the margin available for bringing down interest rates and, while preserving what has been achieved in terms of stability, provide the liquidity necessary for the establishment of a growth rate in line with the medium-term improvement in productive capacity. Here it is to be hoped that recent progress in international monetary cooperation will further relax the external constraints and thus make a fall in real interest rates possible. This would encourage investment in fixed capital rather than in financial assets. Within Europe the adoption of the abovementioned monetary policy guidelines would, in addition to reinforcing the Community's internal monetary cohesiveness, increase interest in further progress in the construction of the EMS, and in particular in measures to liberalize capital movements and to develop the role of the ECU.

III.3. **Market and sectoral policies**

III.3.1. *Improving the internal market*

The completion of a large internal market, as has been proposed by the Commission in its White Paper of June 1985, provides strong support for the successful achievement of a cooperative growth strategy for more employment in so far as it supports a growth in supply, which is both profitable and efficient. A wider market provides the opportunity for firms to expand production and exploit economies of scale. The resulting cost reductions lead to lower prices and hence demand will be strengthened. A faster growth of both demand and output will be reflected in productivity growth and this in turn will feed into the exploitation of new investment opportunities and employment creation. The benefits of improved efficiency and competitivity will be affected also through an increase in the economy's longer term equilibrium exchange rate and more beneficial terms of trade. A lower trend evolution of both domestic and import prices will in turn mean that a given expansion of nominal demand will result in a higher real demand. Again, there will be beneficial effects on output and employment. Thus, the economy enters what can be called a virtuous circle of economic growth which is not unlike Community experience in the 1960s.

At the same time promoting better competition on markets would be ineffective if structural and social inequalities prevented the completion of the internal market. If the internal market is realized in the context of more dynamic and harmonious growth, imbalances at the regional and sectoral level will be more easily overcome. This is also the best way to take account of the Community 'social dimension' and structural problems. In addition, this requires the development of more coherent European-wide social policies and the strengthening of existing national and Community instruments, the European Social Fund and the European Fund for Regional Development for example. Success in overcoming adjustment problems and in achieving the full employment and social benefits of improvement of the internal market will require considerable cooperation between the social partners and Governments in the development of these actions and in encouraging the attitudes consistent with the growing integration of the European economy.

Consensus on the importance of improving the Community's internal market has strengthened greatly at the political level and amongst industrialists and trade unionists. At its meeting in Brussels in March 1985 the European Council called for 'action to achieve a single large market by 1992 thereby creating a more favourable environment for stimulating enterprise, competition and trade'. The Commission responded to this call with publication of a White Paper addressed to the European Council meeting in Milan in June 1985, entitled 'Completing the Internal Market' (1). The White Paper sets out a detailed programme, calling for over 300 legislative acts, most of them before 1990.

(1) Commission of the EC, 'Completing the Internal Market' (Com(85) 310), June 1985.

Given the extremely complex and extensive nature of the proposals in total, the Commission has given particular attention to ways to lighten the administrative and legislative burdens of achieving the objective. An integrated and balanced set of proposals made to this end are: (i) to maximize use of the principle of mutual recognition of national technical standards and minimize the amount of harmonization legislation at the EC level, (ii) to maximize the off-loading of technical matters from the Council, by making more use of the institutional powers of delegation that exist, and (iii) to increase recourse to majority-voting in Community decision-making processes concerning the internal market. Although the various elements interact and should be considered as a whole, some individual examples serve to illustrate the substance of the proposals.

As regards *technical standards* for industrial goods, food products and construction, it is proposed that legislative harmonization (Council directives bases on Article 100 of the Treaty of Rome) will in future be restricted to essential health and safety requirements.

Public procurement competition will be enhanced for sectors already covered by EC Directives by more prior information and publication of contracts. Existing restrictions on public procurement of services, compared to goods, should be removed. Four major sectors — energy, transport, water and telecommunications — not yet covered by public procurement Directives are to be made the subject of further proposals.

In the *transport* sector important actions to ensure the freedom to provide transport services are proposed.

Service branches of the more conventional kind such as banking and insurance together with newer forms such as information and data processing, computerised marketing and distribution services, audiovisual services including broadcasting by satellite are undergoing unprecedented technological development. Many of these fastest growing branches of the economy have little chance of being internationally competitive without being given a large open market in which to develop.

Turning to *financial market*, the improvement of the internal market for financial services links directly to the policy objectives of improving the functioning of domestic financial markets, the convergence of macro-economic policies and strengthening of the European Monetary System. In this context, in April 1983 the Commission submitted to the Council a communication on financial integration [1] which stressed the need for more freedom of capital movements between the Member States and for the creation of a unified network of financial services in the areas of credit, insurance, and stock exchanges.

Such integration gives rise to direct and indirect benefits. The direct advantages come through a reduction in financial costs for borrowers and through helping assure access for savers to higher yielding investments. An increase in the effective size of the market induced by financial integration encourages financial institutions to specialize more, creates additional competition and effects a more efficient transfer of savings into real investment.

As regards indirect benefits, the greater liberalization of financial markets enhances discipline in the conduct of economic policies and thus contributes to price stability and to the strengthening of the EMS. A second indirect benefit would relate to reducing dependence of European economies on the US dollar, which is likely to occur if European capital markets become more integrated. This would insulate Europe to some extent from external shocks. Thirdly, controls on capital flows interfere to some extent with the free movement of goods, services and persons, by increasing the cost of related financial transfers whose legality has to be checked. Fourthly, the utility of capital controls in terms of greater independence of monetary policy has been greatly reduced through commitments to monetary policy coordination implicit in EMS membership.

Financial integration should be sought in a balanced way on four fronts: (i) gradual removal of the remaining capital controls, (ii) free flow of financial services, (iii) rationalization of domestic financial markets, and (iv) the promotion of the ECU in the credit and capital markets.

At present two Council Directives classify *capital flows* in four lists (A to D). Member States are obliged unconditionally to free transactions contained in list A (including direct and real estate investment) and in list B (operations in listed securities). Transactions in list C (including other types of portfolio investments and long-term credits) are conditionally liberalized. There is no obligation to free transactions in list D (deposits with financial intermediaries and other short-term monetary operations). The actual degree of capital freedom varies considerably in the Community. A number of Member States have liberalized virtually all transactions contained in lists C and D. On the other hand, three Member States (France, Italy and Ireland) have had to make use of the protective clauses provided for in the Treaty in order to apply restrictions on transactions which are unconditionally liberalized. In December 1984 the Commission reviewed these derogations and renewed them for a limited scope and period (*Official Journal of the European Communities* L 8, 10 January 1985). In addition, the Commission is studying proposals with the Monetary Committee for a new Directive which would extend the obligations of Member States to liberalize certain transactions contained at present in list C.

The creation of an efficient network of *financial services* in the areas of credit, non-life insurance, and stock exchange

[1] Commission of the EC, 'Communication of 20 April 1983 on Financial Integration', European Economy No 18, November 1983.

services can be aided through assuring the right of establishment and the provision of financial services on a non-discriminatory basis across frontiers.

The rationalization of *domestic financial markets* should go in parallel with the removal of controls on the circulation of capital and services. Although there has been some action towards harmonizing national provisions governing the activities of financial intermediaries, the regulatory and allocative aspects of the domestic financial markets should be given more attention.

Community companies and institutions have used the Euromarkets in order to avoid the disadvantages of narrow national markets. More recently, as the risk in the use of the dollar has become large, the market has increasingly turned to the use of the *ECU* which exhibits small variability *vis-à-vis* member currencies and is free of purely national controls. It is, therefore, well placed to be a vehicle for capital transfer within the Community.

The Milan European Council in June 1985 welcomed the Commission's White Paper for improving the internal market, and charged the Council to elaborate a work programme to achieve the single market objective by 1992. Ways of achieving this objective are identified as (i) suppression of physical barriers; (ii) the removal of fiscal frontiers; (iii) suppression of technical barriers (especially for new technologies); (iv) creation of a free market in financial and transport services; (v) complete freedom of establishment for the professions and (vi) liberalization of capital movements. The integration and modernization of European financial markets should be pursued further through rationalization of domestic financial markets and promotion of the ECU in credit and capital markets. This process will be facilitated by the more dynamic growth fostered by the overall economic strategy, and thus enhance with other more specific measures the social dimension.

III.3.2. *Infrastructure projects of European interest and infrastructure financing*

Improving the internal market needs also the provision of an adequate infrastructure. In the programme for 1985, the Commission identified the benefits to be obtained from a coordinated infrastructure strategy. Such an approach would contribute significantly to the aim of unifying the internal market, strengthening industrial competitiveness, integration of the peripheral regions and stimulating new technologies (1). It could also become, progressively, an important element in the development of demand and economic activity.

In the area of *telecommunication* concertation mechanisms have been set up between the Commission, Member States, industry, and national telecommunications administrations. The work and reflection carried out so far have identified the common prospects for the evolution of telecommunications networks and services and the strategic objectives upon which a consensus at Community level could be reached, in order to define infrastructure projects of European interest in this field.

This is in particular the case for the establishment of a telecommunication transborder backbone network which could set up the base of future integrated broadband (IBC) communications to be operational by 1995.

According to available estimates, the total investment related to the project could amount to some 3 000 million ECUs. Currently, studies are carried out to specify the project further. The project will, however, depend on prior agreement between the public authorities and the telecommunications administrations concerned.

The Commission will make proposals on the use of the ERDF to help improve modernization of telecommunications networks in the less favoured regions of the Community.

In the area of *transport,* the Commission's proposed medium term infrastructure programme already provides a framework for the development of three linking networks of Community interest: road, rail and inland waterways. The investment in question would exceed 20 000 million ECU. This programme contains a range of small and medium sized projects some of which have already been started and receive Community finance from the ERDF and the EIB and specific credits for the support of transport infrastructure of Community interest (line 581); as well as some major projects. The financing of these projects will naturally differ according to their relative size and character. A large number of smaller projects will have been included already in national public investment programmes and will have received Community financial support. However, the financing of the larger projects has yet to be arranged.

Two major projects should be added, the Paris—Cologne high speed rail link, the cost of which has been put at some 3 000 million ECU. An 'intergovernmental group' has been set up to work out the general specification of requirements, each party's responsibilities and the possible financial package. The final report is expected in March 1986. Also the fixed Channel link which, depending on the type of link, varies widely in cost from 3 000 to 9 000 million ECU. In April 1985 the French and United Kingdom governments published the guidelines enabling those promoters interested to prepare by 31 October 1985 a proposal for financing, executing and exploiting the project. Work could thus start by the end of 1986, completion being planned for 1992/93.

In the longer term other projects are envisaged in the area of road and rail transport, in particular the motorway link with

(1) The necessity for investment in employment-creating infrastructural projects in transport, telecommunications and environmental protection was stressed in parliamentary resolutions (OJ No C 122/59, 20. 5. 1985, point f and Doc. B 2-103/85, point 1a).

the Scandinavian countries through Denmark and the Baltic straits, the Venice-Munich link with its passages through the Alps, etc.

In the area of environmental protection, a programme of investment is necessary to improve the quality of life and protect the basis for future economic growth. The damage caused by air pollution can only be reversed by investment in large combustion installations, while in many Member States investment in effluent treatment is essential to improve water quality. The treatment of waste and its recycling would both improve environmental quality and reduce the Community's raw material dependence. Such investment, leading to the development of new products, will not only improve the quality of life but also create markets for new products in third countries.

Thus all in all, the infrastructure programme which can be envisaged in the medium term would represent an investment volume of 30 to 45 000 million ECU over a period of five to seven years.

All these infrastructure projects are not, of course, at the same stage of development. The Community can facilitate the advancement of the larger projects in several different ways. By giving its support to the proposals already made, easing administration and fiscal conditions, taking the initiative in bringing together interested parties, and by financing the necessary feasibility studies.

At the same time the Commission has undertaken to study the scope for using or adapting the range of financial instruments at its disposal as well as ways in which the Community could improve and simplify the administrative and legal framework in which infrastructure projects can be carried out.

Apart from continuing with the traditional types of infrastructure financing, the use of new financing formulae can be envisaged, which aim in particular to reduce the guarantees required from the promoters or to base these guarantees on the assets of the project rather than on those of the promoter (formula of the project financing type or preferential claim on receipts). Because the financial package required for this type of investment needs to combine in variable proportions, capital formation, bond market flotations and bank loans, Community intervention should bring together new and traditional financing techniques.

There exists a considerable economic potential in a number of large infrastructure projects of Community interest, notably in the areas of cross-frontier transport, telecommunications and environmental protection. At the macro-economic level these would make a modest but nevertheless useful contribution to growth. The Community should facilitate the advancement of the projects, inter alia through the easing of administrative and fiscal conditions, through the development of its own financial instruments, and thus contribute over the next five years a useful dynamic element in the Community's economic development.

III.3.3. *Adaptability of the labour market*

Given the urgent need to improve the conditions for employment growth in the economy, increasing attention is being given currently by governments and the social partners to the task of making the labour market work more efficiently. This involves improving the adaptability of the European labour market to structural change, especially to the introduction of new technologies and to competition from the United States and Japan as well as the newly industrialized countries.

In the last Annual Economic Report, the Commission identified examples of labour market Regulations which had turned out to be designed inefficiently or in ways that serve to deter employment. It called for a re-examination of labour market regulations in order to ensure both greater equality of access to employment and greater efficiency in the use of labour within enterprises.

TABLE 10

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

(in millions of ECU)

	1983	1984	(1985) estimate
Lending by institution or mechanism:			
European Investment Bank	4 256	5 013	:
Commission:			
European Coal and Steel Community	778	825	:
Euratom	366	186	:
New Community Instrument	1 212	1 181	:
Total	6 612	7 206	7 400 to 7 700
Lending by sector or policy objective:			
Private industrial sector	1 938	2 850	2 700 to 2 900
of which: global loans to small and medium enterprises	(1 263)	(1 860)	(1 900 to 2 100)
Infrastructure	2 241	2 344	2 250 to 2 300
Energy	2 433	2 012	2 450 to 2 500
Total	6 612	7 206	7 400 to 7 700

Source: Commission of the EC, 'Report of the Commission to the Council and the European Parliament on the borrowing and lending activities of the Community in 1984' (COM(85) 213 final), May 1985.

The Economic Policy Committee is in the process of examining this question in relation to labour and other markets. In addition to the question of wages and non-wage labour costs discussed above, the Committee has paid attention also to the question of labour market regulation, mobility, training and more flexible use of working time.

In conjunction with the Member States and the social partners, the Commission is currently carrying out a comprehensive review of the legislation and collective agreements in these fields. A group of experts is studying also the attitudes of social partners and governments to the problem of labour market flexibility. A communication will be sent to the Council.

The social partners are principally responsible for the adaptability of the labour market. Where government regulations are important, any specific proposals to change them — particularly those concerning job tenure or dismissals — should be fully discussed with the social partners. Governments should also review to what extent they themselves are inhibiting the workings of the labour market by the complexity of administrative regulations they impose on employers.

Some actions have recently been taken by Member Governments with the intention of improving the adaptability of the labour market. For example, in Germany, new measures allow limited term employment contracts and promote part-time employment. In France, regulations governing fixed-term contracts have been relaxed to promote the recruitment of the long-term unemployed, and measures have been taken to promote part-time employment. In Italy, rules restricting the choice of employers on whom to recruit have been relaxed.

Another important factor inhibiting adaptability of the labour market are weaknesses in employment and training services geared to current and future labour market needs. To make good these weaknesses will require the cooperation of representatives of governments, and social partners at local, regional and national levels. The Commission is currently pursuing a programme of consultations designed to promote this kind of forward-looking labour market management in the Community.

For their part, governments should continue to examine whether the structure and organization of their employment services are adequate to meet the demands of a rapidly changing market.

Improving the adaptability of the labour market also encompasses the need to reorganize existing work patterns, and in particular working time but in ways which would be broadly neutral with respect to costs. The reorganization and reduction of working hours can be designed to maximize employment effects while maintaining competitiveness and the basic social rights of the employees. Collectively, agreed

working time reductions in France, Belgium, Netherlands and the Federal Republic of Germany have often been accompanied by a rearrangement of working hours, so that productive equipment, especially advanced machinery in high growth markets, is utilized more efficiently. Traditional barriers between daily full-time work, shift work in its various forms, part-time work over periods of time, overtime working, etc. have become less pronounced. The traditional full-time work in a standard working week, which continues to apply to the majority of those in work, coexists with an increasing number of more differentiated work contracts which can meet both the aspirations of the employees and the requirements of production. Such measures in the industrial sector have helped to save jobs which would otherwise have been lost. In the service sector an increase in employment has been reinforced by these measures. In some branches, e. g. retail trade, the number of employees may rise despite a declining volume of work, due to the growing importance of part-time work.

Within the framework of the collective agreement in the German metal-working industry which reduced average weekly working hours from 40 to 38,5, about 70 % of the companies have reached agreements to maintain operation time. The company agreements take various forms. In France more than 500 enterprises, usually in the context of solidarity contract, have re-organized working and production time in agreement with the unions. These have often led to a substantial increase in the utilization of capital equipment. In Belgium and the Netherlands innovations in working-time arrangements have also been numerous. A recent survey carried out for the Commission indicated that a large proportion of the labour force would be prepared to consider the possibility of new working time arrangements.

Improved adaptability of the labour market is an important component of a strategy for more employment creating growth. This broad concept has in practice many detailed aspects, including the various conditions of employment in addition to pay, the organization and reduction of working time and the adaptation of working skills and patterns to new technologies. These, however, should be appraised within the general constraint of avoiding cost increases. While governments have to consider whether legal regulations inhibit the workings of the labour market, the social partners have often the major role in negotiating together conditions that will be helpful for an employment creating growth strategy. The general objective must be to seek improvements to the functioning of the labour market that reconcile to the maximum degree the objectives of economic efficiency and an enhanced employment propensity with social values of equity and security.

III.3.4. *Specific employment programmes*

The process of reducing unemployment by means of macro-economic policy measures will take several years. Thus, in the meantime, specific employment measures will still be required. The high level of unemployment is particularly serious in old industrialized areas of declining employment and the under-developed areas which had never achieved self-sustaining industrialization. Its effects can also be seen in the very high rates of youth unemployment (three times the adult rate) and in the increasing number of long-term unemployed (39 % of the total unemployed have been unemployed for more than one year).

The Commission proposed guidelines for temporary work measures already in its Communication on Long-Term Unemployment in 1984 (1). At that time, it stressed the need for temporary work programmes to be prepared in collaboration with local and regional governments, and so be suitably adapted to local needs. Temporary work measures of this kind need to be publicly funded but often involve the voluntary sector or non-profit enterprises as well. The net financial costs to public budgets is generally small since a high proportion of the unemployed who would be engaged on temporary employment programmes are already in receipt of unemployment benefit or other forms of social support.

Many Member States have been developing such temporary work schemes specifically aimed at particular groups of unemployed. For example, in Germany, the public interest jobs ('ABM' — *Arbeitsbeschaffungsmaßnahmen*) for up to one year are aimed at 'difficult to place' unemployed who are in receipt of unemployment benefit. The government pays 60 to 100 % of the cost. In France, young people aged 18—21 can be given jobs in the 'TUC' schemes *(Travaux d'Utilité Collective* — jobs of benefit to the Community) and through 'solidarity contracts' between local authorities and non-profit organizations. The jobs include vocational training and the government contributes to the cost. In the United Kingdom, the Community Programme is aimed at adult long-term unemployed. The government pays a wage subsidy. These various schemes are in 1985 reaching around 100 000 people in each of the three countries mentioned.

In general, these types of programmes have several advantages over alternative public job creation schemes (limited substitution effects, more precise demographic and geographical targeting, lower budgetary costs). Nevertheless, as a solution to the problem of unemployment, they can only play a relatively minor role. The productivity of these jobs may be relatively low, and the slight amount of associated training does little to enhance the long-term job prospects of participants.

Another specific measure adopted by a number of Member States is the provision of assistance to help the unemployed set up their own business. In general, such measures allow the unemployed, under certain conditions, to capitalize their

(1) Commission of the EC, 'Action to combat long-term unemployment', (COM(84) 484 final), 1984.

unemployment benefit into a lump sum, or to continue receiving unemployment benefit at the same time as they are self-employed, or a combination of the two. In France, for example, the government gives a subsidy to unemployed people who set up their own business. In the United Kingdom and Ireland, a weekly allowance is granted to unemployed persons who can also put up a certain amount of their own resources. In the Netherlands, people can receive a loan and an income supplement up to the level of social assistance during the start-up period. In most cases, eligibility for the allowance is conditional upon having been unemployed for a certain period or is limited to the maximum period of qualification for unemployment benefit (usually 12 months).

The role of local government and non-government organizations in the development of small local-level enterprises is crucial. In a recent Communication (1) the Commission highlights the key role of local support structures which are able to offer encouragement, information, guidance and assistance to those involved in enterprise and employment creation.

While fundamental solutions to the unemployment problem will take many years, quicker solutions have to be found to alleviate the heaviest concentrations of unemployment, for example among young people and depresses regions. Several countries have developed schemes for relatively low-cost employment on activities of public interest, targeted on such groups and areas. There are also example of incentive schemes for unemployed persons to set up their own businesses. Rapid experimentation and development of such schemes is called for, drawing on local organization in public and private (profit and non-profit) sectors.

III.3.5. *Education, training and technology*

The speed and scale of technological change is creating new and urgent needs, particularly for considerable numbers of technical specialists, and for the retraining of adults whose jobs are affected by technological change. These pressures, combined with the demographic bulge in the numbers of young people, persistent high unemployment and the continuing restructuring of industry in the Community, are leading already to major changes in the education and training policies of the Member States.

For example, a striking development has been the rapid expansion in youth training provision in recent years. Some 700 000 apprentice places are now available annually under the German dual system; the United Kingdom's Youth Training Scheme has over 300 000 participants at any one time; and in France the number of training places supported under the Government's special measures is approaching 500 000. Member States are also making major efforts to ensure that young people acquire a basic understanding of the new information technologies before they leave school, and to improve the vocational relevance of the curriculum — even in non-technical subjects. Policies on the youth employment and training problems have been recently reviewed in a Commission Memorandum (2).

Through its work programme on 'new information technologies and the school systems' (3) the Commission is offering technical support in the areas of new information technologies and the school curriculum, the training of teachers, and educational software and hardware.

A parallel programme is under way in the field of vocational training (4). Under the new guidelines for the management of the European Social Fund issued in April, the Commission is giving priority to training programmes linked with the introduction of new technologies.

In July 1985 the Commission published proposals for a new Community programme in education and training for technology (COMETT) (5). This is designed to encourage university-industry cooperation, within a Community framework, on advanced training in the new technologies. It will help ensure that the competitiveness of the Community's industries is not inhibited by shortages of highly skilled manpower, and encourage economies of scale by facilitating joint training programmes in specialist skills. The programme, which is due to start in 1986, includes: (i) funding for a Community network of university-industry training partnerships; (ii) grants to enable students, academics, managers, trade unionists and others to be seconded to universities or enterprises in other Member States; (iii) joint training projects involving enterprises and universities from different Member States, designed to meet specific manpower shortages; (iv) the feasibility of establishing a European technological open university system will also be examined. The Commission intends to submit a communication, before the end of 1985, proposing Community action in the field of education technology (especially through the use of information technology) in order to improve the access and the cost/efficiency of education and training.

(1) Commission of the EC, 'Community action to combat unemployment — the contribution of local employment initiatives: (COM(83) 662 final), 1983.

(2) Commission of the EC, 'International Youth Year' (COM(85) 247 final), July 1985.

(3) Commission of the EC, 'New information technologies and the school systems in the EC' (COM(84) 722 final), June 1984.

(4) Commission of the EC 'Vocational training and the new information technology' (COM(85) 167 final), April 1985.

(5) Commission of the EC, 'Community programme in education and training for technology' (COM(85) 431 final), July 1985.

The speed and scale of technological change is creating new and urgent needs to develop a technological awareness among the working population at all levels. Combined with the problem of high unemployment, especially among young people, major changes are being made in the education and training policies of the Member States. The Community can add to this process, as illustrated by recent Commission proposals for giving a Community dimension to university-industry cooperation on training in new technologies.

III.3.6. *Sectoral policies, technology and enterprise*

The adjustment and improvement of industrial structures, technological development and the creation of new enterprises constitute some of the main objectives of Community policies. With regard to sectors suffering from excess capacity, the Commission has adopted policy proposals in several areas.

Agriculture: the problems which occurred in the markets of certain agricultural products — especially the problem of surplus production — have led to substantial changes of the mechanisms of the common agricultural policy (CAP) in recent years.

'Guarantee thresholds' were introduced for main agricultural commodities together with quotas in the milk sector, thereby limiting the previously open-ended support guarantees. In so far as the decisions on agriculture prices for 1985 to 1986 are concerned, the Commission proposed a continuation of its restrictive price policy; to a large extent the Council did not follow these proposals, in particular for cereals and rape seed. The Commission proposed a reduction in prices of 3,6 % but the Council did not reach an agreement. As a result the Commission has been obliged to take special measures for this product under its own authority. The new structural policy, which was decided upon in 1984 and 1985, avoids encouraging the production of surplus products. In line with these measures to adjust supply to demand for agricultural goods, the Commission has recently published a Green Paper on the perspectives for the CAP [1] in which it proposes various options and insists on the need for a price policy which is more related to market conditions. The income-support function which has so far been ensured by the price policy could in future be met increasingly by production-neutral income aids.

To support the necessary adaptation of the European agricultural sector, the Green Paper opts for measures to facilitate structural adjustments, to change to efficient alternative productions and to create additional income, or alternative employment for farmers.

[1] Commission of the EC, 'Perspectives for the Common Agricultural Policy' (COM(85) 333 final), July 1985.

Steel, shipbuilding and energy policies: Community policy for steel and shipbuilding is aimed at restructuring in line with a more market-orientated approach, together with concern for the social consequences of the rapid decline in size that these industries have been experiencing.

The Commission's recent decisions bearing on the *steel* industry clearly illustrate this general approach [2]. Their aim is to achieve further cuts in capacity within a much more market-orientated framework while increasing the provision to handle the social effects of restructuring. Thus all investment and operating aids are to be suspended after the end of 1985, the present minimum price system for steel products will be ended, and production quotas will be phased out over a three-year period. Special state subsidies will continue to be permitted only for environmental protection programmes, research and development and plant closures.

At the same time, increased and better coordinated spending on regional and social programmes in areas affected by the continued rundown of the industry are envisaged.

In 1985 the Commission published a study of *energy* prospects to the end of the century, and then followed this by proposing new Community energy objectives for the year 1995 [3]. These objectives are designed to ensure that the Community's economic performance is not undermined by renewed energy problems in the longer term. The Commission also published an analysis of restructuring in the Community's oil refining sector which paid particular attention to the impact of exports of refined products from the Middle East and North Africa.

Technology: Europe has traditionally looked to knowledge-intensive, high value-added industry as the basis for its economic prosperity. But Europe's leadership in many fields of technology has been increasingly eroded as new competitors have managed to diffuse many significant innovations faster. The share of the Community of Ten in total industrial world (OECD) high-tech manufactured export fell from 58 % in 1963 to 43 % in 1983; those of the US from 27 % to 21 %, while those in Japan rose from 5 % to 23 % during this period.

The organization of a European effort to reverse these trends has in the last year been progressively taking shape, especially through the definition and implementation of Community strategic R & D programmes such as ESPRIT or BRITE. In the sector of telecommunications, which is to play a major

[2] Commission of the EC, 'The organization of the steel market after 1985' (COM(85) 382 final), July 1985.

[3] Commission of the EC, 'Energy policy objectives for 1995' COM(85) 245, July 1985.

role in the reinforcement of the competitivity in the world economy, the Council has approved in July 1985 the definition phase of the programme RACE (Research in Advanced Communication for Europe).

The actions undertaken in the technology field are complemented by measures aimed at creating the European wide market necessary to recoup the R & D and production investments required by the high technology products and services (common standards, opening of public procurement, etc.).

The European Council, meeting in Milan in June 1985, gave a new impulse to these efforts, approving a Communication of the Commission on the strengthening of technological cooperation [1] and supporting the EUREKA initiative proposed by the French Government.

The Commission's Communication to the European Council 'Towards a European Technological Community' sketches out the range of organizational techniques, as well as the possible substantive domains of technological advances, that the Community should now pursue. The general objectives are to: (a) exploit to the maximum the Community dimension of a continental market and network of research institutes and facilities; (b) promote the greatest possible synergetic effects from the interactions of national and Community efforts, possibly with an additional Community contribution and participation of non-member countries.

Creation of new enterprises and simplification of existing regulations: A number of measures have recently been proposed or adopted in several countries of the Community with the intention of reducing regulation and thereby the costs imposed on small companies, particularly in their creation. It is to be noted that the biggest increases in employment in the Community in recent years have occurred in new enterprises. Small and medium-sized enterprises are thus seen to be an important source of new employment creation for the future.

The examination of existing regulations does not mean that all rules should necessarily be called into question. It is more a question of simplifying existing regulations and ensuring that the manner in which they are applied does not constitute a handicap for employment.

At a Community level, the Economic Policy Committee, in parallel with its work on flexibility in the labour market, is examining the flexibility of product markets including the impact of regulations on companies as well as other aspects of government intervention. The Commission intends to submit a communication before the end of 1985 on the reform of business regulation and the promotion of a dynamic small and medium-sized enterprise sector.

Small and medium-sized enterprises are dependent to an important extent on the general conditions in which they operate, in particular those relating to taxes and social security contributions. For such enterprises the access to capital markets is generally narrower than for large public companies; their investment plans therefore depend particularly on their capacity for self-financing. In most member countries the characteristics of small and medium-sized enterprises are not given due consideration in income tax legislation, which thus tends to impede the setting up of new enterprises and to slow the growth of existing enterprises. It is therefore appropriate to examine income tax legislation in the Member States for its effects on small and medium-sized enterprises, and if necessary change the provisions relating to the definition of taxable income and the structure of tax rates in order to strengthen the employment potential of such enterprises.

As regards the frontiers between private and public sectors, one of the interesting consequences of technological advance is that, in some sectors, traditional 'natural' monopolies may no longer exist. One example is in telecommunications networks, where privatization and de-regulation have taken place in the United Kingdom (with parallel or similar developments in the USA and Japan) and where discussion is also underway on the role of the Bundespost in the telecommunications market in Germany.

The Commission has adopted specific proposals either to reduce production capacity in sectors such as steel and shipbuilding, or to reinforce control on production in agriculture. It also made proposals for the organization of a 'technological community'. Allied to these sectoral objectives are the many detailed initiatives which are being undertaken to make the European business environment more conducive to the creation and expansion of enterprises.

(1) Commission of the EC, 'Towards a European Technological Community' (COM(85) 350 final), June 1985.

IV. EUROPEAN INTERESTS IN THE INTERNATIONAL ECONOMY

IV.1. The world trading system

The prosperity of the European economy depends greatly upon an open world trading system. There is strong evidence, in economic theory and practice, to show that protectionism does not pay as an instrument of general economic policy. The protection of limited producer interest groups does provide income and employment protection to those groups in the short-run. However other adverse effects of protectionism are present even in the short-run, while the

negative long-run effects are even more disadvantageous. Protection has the effect of increasing consumer prices, cutting real incomes and real consumer demand and hence output and employment in the economy as a whole. Where the protected goods or services are inputs into the production of other branches of the economy, as is often the case, then those branches themselves lose in competitiveness in world markets. They then lose orders and have to cut employment, unless the exchange rate is devalued to compensate. With devaluation, standards of living are reduced and the problem of inflation is worsened. Macro-economic policy has to become more restrictive, thus again weakening real demand and output. Alternatively, branches of industry faced with uncompetitive inputs from protected sectors are forced to try to evade this disadvantage by substituting these inputs with alternatives (e.g. plastic for steel components), or by relocating their investments in other countries where the inputs are competitive (e.g. some EC biotechnology firms are investing outside the EC to gain access to cheaper agriculture inputs). These general arguments have been set out in greater detail in official documents of the EC (1), as well as elsewhere such as the OECD (2).

For these reasons the EC is in favour of a new round of multilateral trade negotiations. Preliminary discussions have been under way in the course of 1985, and the decision in principle to begin the negotiation process is expected to be taken shortly.

Trade liberalization and the unwinding of protectionism can of course be a difficult process for the industries concerned, and for working people when their existing jobs may be threatened in the absence of encouraging prospects of alternative jobs. Therefore there has to be agreement over a balanced set of trade liberalizing measures, otherwise the adjustment costs may be unfairly distributed across the world trading community.

The Community's attitude towards a new GATT multilateral trade round is expressed in the Council's declaration on 19 March 1985; and it has subsequently set out its ideas on the subject matter of such a negotiation and the Community's principal objectives in a written submission to GATT on 8 July. Commitments undertaken in the OECD and GATT to halt protectionism and roll back protectionist measures should be implemented, without waiting for the new round. In this regard it is important to note that some protectionist measures (e.g. steel products) were taken by the United States after the Williamsburg Summit. In addition, some disquieting protectionist trends have appeared in Congress, although these have in general been opposed by the Administration. Japan could be supportive in helping to alleviate protectionist pressures in both the US and the EC by rapidly and substantially giving effect to its declared objective of facilitating access for imports, especially of manufactured goods. The US deficit and Japanese surplus cannot, however, be sufficiently rectified by trade policy measures alone, which is why the Community argues in favour of a more concerted approach to exchange rate and macro-economic policy internationally. This point of view is reinforced by the outcome of the September 1985 meeting of the Group of Five ministers of finance and central bank governors which underlined the importance of maintaining an adequate level of world demand and the joint responsibility to reduce world current account imbalances and resist protectionist pressures.

The Community also favours the participation in a new GATT round of the largest possible number of newly industrialized countries. Several of these countries have achieved impressive penetration of export markets while maintaining extremely high protective barriers to their own markets. Further liberalization by these countries is a necessary counterpart to their expressed desire to see their own conditions of access to world markets improved in a new round. Finally the EC has indicated its willingness to include trade in services in a new round, and is actively seeking a basis for agreement on this point with developing countries, some of whom remain sceptical or even opposed to negotiations in GATT on this subject.

The Community is strongly in favour of a new round of multilateral trade negotiations. This, together with improvements in the functioning of the international monetary system, will offer the most appropriate framework for a global review of trade policy options which must be addressed if the threats confronting the multilateral trading system are to be averted.

IV.2. **Improving the international monetary system**

The international monetary scene has continued to be characterized by a high degree of exchange rate instability. Both the US dollar and the pound sterling have recorded very sharp fluctuations during the first half of this year in both nominal and real terms. However, what is probably more damaging to the performance of the world economy as a whole is the tendency for the exchange rates of major currencies to move progressively further out of line from what might be considered their 'equilibrium' levels over long periods of time. Over the six years from the first quarter of 1979 to the first quarter of 1985 the US dollar appreciated in real terms on a trade weighted basis by 63 %, admittedly from an undervalued starting position.

(1) Economic Policy Committee of the EC, 'Opinion on protectionism', European Economy No 19, March 1984.
(2) OECD, 'Costs of Protectionism', 1985.

These prolonged shifts have produced a pattern of exchange rates which is incompatible with a stable structure of international trade and capital flows and thus is clearly unsustainable over the medium or longer term. Moreover, import penetration in the United States, resulting from the overvaluation of the dollar, is producing a formidable accumulation of protectionist pressure, which now threatens seriously to undermine the liberal system of international trade that was established under the GATT and promoted further over the post-war period.

Against a background such as this it is regrettable that the Group of Ten (leading industrialized countries), which received a mandate from the Williamsburg Summit in 1983 to examine ways of improving the working of the international monetary system, has been unable to reach agreement on a concrete and more comprehensive programme of action designed effectively to tackle the problem of exchange rate instability. However, following the agreement of 22 September between the Group of Five countries, there now appears to be some measure of accord concerning both the dampening effects of currency misalignments and the scope for concerted action to influence exchange rates and other key economic variables with a view to correcting major imbalance in the world economy.

The main focus of the Group of Ten's report, published in April [1], has been on the need to improve multilateral surveillance procedures, with a view to achieving better coordination and mutual consistency between the policies of the major industrial countries. Whether the procedural changes recommended in the Group's report will lead to significant improvement in this respect remains to be seen. The time may not be ripe to establish a regime of target zones for exchange rates, entailing an obligation to intervene when the limits of such zones are attained. It might nevertheless be fruitful to examine seriously the possibility of an intermediate stage, involving indicative zones, whereby consultation, rather than central bank intervention, would be triggered when the limits were breached. The meeting of the Group of Five in September 1985 marked a certain advance with agreement for the first time in recent years on the desirable direction of movement of the dollar's exchange rate and readiness to cooperate to this end when this would be helpful.

The Community for its part has found that the existence of an exchange rate constraint, as embodied within the EMS rules, has undoubtedly contributed to the achievement of more convergent policies and performance among its members. The institutions which are appropriate and effective within a closely integrated economic region such as the European Community are not necessarily applicable to a wider and more diversified group of countries. However, the Community would welcome more effective multilateral surveillance of the exchange rate and of monetary and economic policies of major countries such as the United States and Japan (as well as the Community's own Member States) with a view to achieving more compatible policies. As noted, there are serious problems created for the world trading system due to a major misalignment of exchange rates which in turn result from poor internal and international coordination of monetary and fiscal policies.

International exchange rate instability and misalignment has led to a clearly unsustainable pattern of trade and capital flows. The Group of Ten has so far only been able to agree on modest procedural proposals improving the system. It is extremely difficult for trade policy alone to absorb the problems caused by exchange rate disorders. This is why the Community is pressing for parallel progress in improving the international monetary system alongside the new GATT round. The September 1985 meeting of the Group of Five represents a certain advance in the approach to exchange rate and macro-economic policy coordination.

IV.3. European economic space

The EC exports more to the rest of Western Europe (26 % of total EC exports, excluding inter EC trade) than it does to any other region of the world. At the beginning of 1984 the EC and EFTA completed the removal of all tariffs and quantitative restrictions between the two blocs. In April of last year they followed this up with a joint declaration expressing the political will to extend Community-EFTA cooperation 'with the aim of creating a dynamic European economic space'. In 1985 a joint communiqué of the Commission and EFTA countries set out the domains of policy which should in the future contribute to developing this relationship. The Commission for its part published a Communication detailing how, in its view, this might be done [2].

First priority should be given to abolishing a series of technical and administrative obstacles to deepen trade relations through simplification of border facilities and origin rules, reciprocal cooperation in technical standards and rules, mutual recognition of test results and certificates.

Other areas where cooperation should be enhanced are in research and development, trade in processed agricultural products, public procurement, border controls on travellers, transport projects and policies, environmental policy and economic and monetary consultations. On several of these topics the Community has recently taken initiatives. It has, for example, been suggested that new programmes to create a European technological community should be open for other

(1) International Monetary Fund, Supplement on the Group of Ten Deputies Report 'The Functioning of the International Monetary System', *IMF Survey,* July 1985.

(2) Commission of the EC, 'The Community and EFTA Countries' (COM(85) 206 final), May 1985.

West European countries to participate. The Council is in the process of authorizing the European Monetary Cooperation Fund to designate certain non-Community central banks to become holders of official ECU reserves, and this arrangement could be used by some EFTA countries. Already some of these countries have begun to hold privately traded ECU assets as part of their foreign exchange reserves.

Good progress has been made in opening trade between the EC and EFTA countries. On both sides it is now agreed to build further on these achievements. The Community is seeking, in the light of its own efforts to complete the internal market and deepen economic cooperation, to make it possible for EFTA countries to participate closely in the European economy's integration process. These efforts should of course continue to respect the distinct institutional identities and objectives of the EC and EFTA. The EFTA countries could be invited to contribute to the implementation of the cooperative growth strategy. Current negotiations to adapt the existing free trade arrangements between the Community and EFTA countries, necessary because of the accession of Spain and Portugal, aim at a further consolidation and extension of the free trade system in Western Europe.

IV.4. International cooperation for world economic adjustments

As already noted, in the medium-term the United States economy must move into a phase of major correction of its still mounting external current account deficit. What is still uncertain is the timing and amplitude of this correction, and how it will be induced. Contributing to the adjustment process there will no doubt be elements of both budgetary restriction and cyclical slow-down and of dollar exchange rate depreciation.

The prospect of some adjustment by the United States and its possible effects poses important issues for international economic cooperation. The objective would clearly be to achieve the necessary adjustments with the smallest possible cyclical reverse in the United States itself (obviously the United States' own interest) and, equally also, in the growth of the world economy as a whole. A disorderly adjustment entailing trade restrictions would, of course, be very damaging to the world economy.

From the United States' point of view a given balance of payments correction can be achieved at a higher level of internal economic activity, the higher the level of activity in the rest of the world economy. For the Community it is necessary to achieve more dynamic economic growth and the question arises of how to maintain this in the case of an adjustment to growth in the United States. If such were the case there would also be the question of whether the EC would be acting on its own or in concert with a larger number of countries.

In the hypothesis that the European Community alone tried to sustain its growth trajectory, while other regions in the world passively allowed a US slow-down to depress their growth rates, the EC could move into substantial current account deficit. To a certain extent the Community can afford a reduction in its surplus and even a temporary current account deficit. But it cannot aim to have a deficit on the scale of that in the United States. The United States' massive external deficit is not an example for the EC to copy.

There would, on the other hand, be a case for the EC to urge that the largest possible number of countries participate in a world economic adjustment. In this context Japan is in a position of particular importance. It has the largest single counterpart to the United States deficit, as well as serious problems of an unbalanced trade structure in relation to the EC. An international cooperative action to sustain the world business cycle should see an above average contribution by Japan as regards both exchange rate appreciation and domestic demand expansion. If this contribution were assured, then it might well be possible to extend further a world cooperative action. The European Community could suggest to EFTA countries that they join the EC's initiative. Japan and the newly industrializing countries of the Pacific region could contribute a useful counterpart to the reduction of the US external deficit. The United States could most usefully help by actions to lower its interest rates, which are a particularly heavy constraint on the growth possibilities of the heavily indebted developing countries, especially in Latin America.

Avoiding a situation where the US economic adjustment process leads to a pronounced and generalized slow-down in world trade is essential to the continuation of an orderly adjustment process in the indebted developing countries, as pointed out by the IBRD in its recent World Development Report (1).

The IBRD sets out in particular 'High' and 'Low' case scenarios for the developing and industrialized countries which are quite in line with the conclusions drawn above (in Section II.2) about the potential gains from a cooperative growth strategy. Depending upon whether developing countries find themselves operating in favourable or unfavourable conditions as regards the growth of world trade, the terms of trade and the level of interest rates, their capacity to import is substantially affected. For the years 1985 to 1990 the annual average growth rate of developing countries' imports is projected to range from 9,3 % in the high case to 2,5 % in the low case. The debt service burden of developing countries would rise in the low case to 28 %; thus the range here is between the debt problem being

(1) IBRD, 'World Development Report 1985', July 1985.

brought under control to it being aggravated to even more acute crisis proportions than so far experienced. In the latter case the threat to world economic stability would be considerable.

The prospect of an important internal and external adjustment by the United States economy for a period of years ahead poses the question of how the rest of the world's economy will be kept on an adequate growth path. The European Community should be prepared to take up its responsibilities as a large economic region to sustain its own internally generated growth during this period. However, it is equally important that Japan lends its support to a wide-scale international adjustment of this kind, without which the EC might face unacceptable risks as regards its own external account. Without an adequate global cooperation the risks of upsetting the fragile recovery of the indebted developing countries would be very great.

V. CONCLUSIONS: OBJECTIVE, INSTRUMENTS AND METHOD

In the present report, the Commission offers to the Council, Parliament and Social Partners the outline of a cooperative growth strategy which aims at a decisive improvement in the Community's economic performance between now and 1990. The application of this strategy is necessary if a reduction in unemployment, without a rekindling of inflation, is desired. It will produce positive results irrespective of the international environment. Clearly, a favourable environment will facilitate a successful outcome. However, in the uncertain conditions which exist today for the world economy because of the persistent financial imbalances in the United States and the critical problem in some large and highly indebted developing countries, the signal which would emerge from the Community embarking on a cooperative growth strategy would be far reaching. The proposal may be summarized as follows:

Objective

The Community should set clear aims for economic policy. In this report, the Commission proposes a cooperative strategy designed to realize a sustainable growth rate of 3,5 % over the period 1986 to 1990. This will make possible a growth of employment rising to 1,5 % per annum and will provide the means by which unemployment can be reduced to 7 % by the final year. The pattern of growth will thus become more employment creating and can take place within a framework consistent with stability of national budgets and the reduction of inflation. Such results will only be possible if all participants furnish the contribution required from them by the strategy and if international cooperation progresses satisfactorily.

Instruments

No single instrument suffices to achieve this objective. However, a number of recent policy initiatives fit well into the cooperative growth strategy, but their implementation needs to be accelerated and accompanied by a further dynamic element in order to secure a sufficient change in the economy's growth trajectory. The main elements may be itemized as follows:

— monetary policy implemented so as to continue further the progress made already in reducing inflation but also allowing room for faster real growth. Faster growth will be possible also by exploiting opportunities which are likely to arise as international monetary conditions serve to accentuate the reduction of European interest rates,

— budgetary policies which, at a micro-economic level, favour more employment-creating growth. At the macro-economic level a first aim would be to correct present imbalances but at the same time exploiting, where room exists, opportunities for improving supply and demand together and moving the European economy on to a 'virtuous circle' of investment, output growth and new job creation and thereby to a better equilibrium of public finance. Within the framework of the cooperative growth strategy tax cuts and increased infrastructural investment would be some of the principal measures envisaged,

— a moderate increase in real wages to increase the profitability of fixed capital. Together with demand support, this will create a climate at the macro level favourable to fostering an upsurge in investments which at the same time will be more employment-creating,

— initiatives designed to improve labour market adaptability, the reorganization and reduction of working time, under cost-neutral conditions, should also contribute to making growth richer in terms of employment,

— improved and integrated market policies designed to open up the Community's internal market; liberalize domestic financial markets, and to give a better market orientation to interventionist policies of the Community with due regard to the 'social dimension',

— greater investment in Europe's economic potential in the widest sense, ranging from major transport and communication projects of Community interest, through environmental investment, to the better use of Europe's technological potential,

— international policies whereby the Community strives to improve continually the GATT trade system and international monetary system, and, with other countries, acting so as to sustain the growth of world trade and to mitigate the LDC debt problem while inevitable adjustments occur in the US.

Method

The Commission considers that it would be appropriate to adopt a step-by-step approach, so as to assure sufficiently clear initial commitments to give a credible launch to the strategy and establish dialogue between the parties involved, while allowing for later steps to be adapted in view of an assessment of the results, the evolution of economic events and the validity of each parties' contribution:

Step 1 — before the end of 1985 Community institutions and the social partners will seek to achieve consensus on the objectives of the Cooperative Growth Strategy and initiating action judged to be necessary.

Step 2 — a first set of actions will be put into operation in 1986, including in particular macro-economic policy measures, pledges by the social partners on incomes and labour market adjustments, expanded public investment at national and EC level, and proposals for international coordinated action in order to reinforce the dynamics of the movement. In addition, significant progress in the implementation of Commission proposals, contained in its White Paper on the internal market, is necessary.

Step 3 — after an appraisal of the results of Step 2, a second set of actions will be implemented in 1987 to confirm and deepen the employment-creating growth movement. Some of these actions will be contingent, however, upon evolution of the EC and international economy, and the adequacy of contributions on the part of all concerned to the cooperative growth strategy. The 1986/87 Annual Economic Report will contain an evaluation of progress in this respect.

This outline has been deliberately set out in a very schematic form and much must remain for discussion between the parties involved. However, the principal point is that this should provide a *basis for reflection on their own positions of each of the major actors concerned — governments, employers and trade unions*. Each actor is, in particular, invited to consider how his existing position might envolve in the direction of the common interest if it was evident that the other actors were prepared also to adapt their positions.

Part II of this report contains specific guidelines for economic policy in the Member States. As emphasized earlier, the strategy cannot be implemented at a stroke but should be introduced gradually. To achieve this, close cooperation between governments, unions and employers will be necessary.

As far as the demand-side aspect of the strategy is concerned, the room for manoeuvre in the two main areas of macro-economic policy differs considerably. The situation regarding monetary policy is relatively satisfactory. Within the context of a monetary policy geared towards stability, which is largely determined by the EMS, significant potential exists for bringing down interest rates, particularly if the dollar continues to weaken against the ECU.

As far as a possible demand support through government budgets is concerned, implementing the strategy of employment-creating growth presents specific problems in individual Member States. Since the strategy cannot be implemented at a stroke, the recommendations addressed to the various countries must remain realistic and capable of being coordinated. Simultaneously with the moderate increase in wages and the widening room for manoeuvre in fiscal policy — more growth and employment boost revenue, while expenditure caused by the crisis is reduced — demand support should occur step by step, until the process becomes self-sustaining through private investment and an appropriate development of private consumption.

In some Community countries (Italy, Belgium, Ireland and Greece), the relative level, or the growth, of public debt is such that the consolidation process must be continued at all events. Elsewhere, the German case is particularly interesting. As is indicated in the forecast presented below in the German chapter, growth of 3,5 % and an increase in employment of 1,3 % are expected in 1986. The price outlook continues to be favourable. The surplus on the balance of payments current account should remain very high (2 % of GDP). The budgetary deficit will decline more strongly than was earlier expected (from 1,2 % of GDP in 1985 to 0,8 % of GDP in 1986). In Germany, therefore, a positive chain reaction is developing between price stability, more growth and employment and expansion of room for manoeuvre in the fiscal and external fields. This room for manoeuvre should be exploited in order to ensure beyond 1986 the steady growth (annual average increase of some 3,5 %) necessary for a continuing reduction in unemployment. Such a development is in the interests both of Germany and the Community. By acting in this way, Germany would not repeat the 'locomotive policy' experience of 1978. Monetary policy would remain geared to stability; the cooperative dimension of the strategy between governments and social partners, applied in the Community, would facilitate the transposition of the positive chain reaction to other Member States.

In the other Member States budgetary and/or external room for manoeuvre has not yet been re-established. In some of these countries (Denmark, France, the Netherlands and the United Kingdom) it is possible that a similar positive chain reaction to that being experienced in Germany will arise in the near future. Such a progress will appear all the more rapidly in so far as there is a positive contribution from the social partners to the realization of the strategy and as developments proceed favourably in Germany.

PART II

ECONOMIC POLICY IN THE MEMBER STATES

BELGIUM

In Belgium, despite the fairly weak private consumption, economic activity accelerated slightly in 1985 because of the vigorous growth of investment and the greater contribution of foreign trade to growth. Inflation continued to slacken. The unemployment rate fell somewhat in the course of the year and the general government borrowing requirement was cut by slightly over one percentage point of gross domestic product. The Belgian franc remained firm even though interest rates fell more sharply than in the other EMS countries.

In 1986, growth is again likely to be modest. The current account surplus will probably grow rapidly, mainly because of the improvement in the terms of trade but the gain in competitivity experienced after the 1982 devaluation will continue to diminish. Consumer price rises will again slow down under the moderating effect of world prices. In view of these prospects, an improvement in unemployment will be difficult to achieve.

Although expansion remains moderate in 1985 and 1986, it is encouraging to note that it is based primarily on exports and investment: this proves that the two priority objectives attained after the first phase of the economic recovery policy (the restoration of the economy's competitiveness and of company finances) are bearing fruit in terms of growth. Nevertheless, given the scale of the imbalances which were created in the 1970s, the recovery remains incomplete and fragile; efforts cannot be relaxed if existent achievements are to be consolidated.

In the 1970s, a gap between the growth rate of labour costs and productivity was accompanied by an important destruction of jobs in manufacturing industry. At the end of the period, in 1981, the rate of return had plummeted from the early 1970s level, the remuneration of capital in comparison with that of labour had deteriorated appreciably and investment activity had dropped. Since then certain profitability indicators point to a recovery, but the remuneration of capital relative to labour has scarcely improved, apart from a revival in 1982 and 1983.

Therefore the conditions underlying a lasting expansion of capital-widening investment are not sufficiently satisfied, whereas the capacity utilization rate is approaching the maximum value of the previous cycle. This is the background against which government efforts to increase competitive capacity should be assessed. In the social recovery law of 22 January 1985, the Government set a norm, valid for 1985 and 1986, designed to maintain competitiveness at the 1982 to 1984 average level. This norm is based on the remuneration per head in a common currency relative to the weighted average for Belgium's seven main trading partners. Afer assessing the statutory norm for the first time early in July, the government concluded that it was being respected in 1985.

Although the merit of setting a norm for the maintenance of competitiveness is that an economic policy priority is clearly defined, the fact should not be overlooked that this reduces the problem of competitiveness to a single measure with all its limitations and imperfections. Other approaches, which place greater emphasis on the 1985 to 1986 collective agreements or on other indicators, tend to suggest that the competitive advantage achieved in 1982 and 1983 began to be eroded in 1984. When the statutory norm is assessed for the second time early in 1986, the situation ought to be reexamined with all the requisite caution, and taking account of the progress relating to elements other than the trend of compensation per employee achieved or planned by competing countries, such as the evolution of labour productivity and effective exchange rates.

It is especially important to safeguard competitiveness because the improvement of employment and public finance hinges on this in the immediate future. The new collective wage agreements covering 1985 and 1986 were signed in the spring. Because the social recovery law, by prohibiting all new advantages, has obliged management and labour to translate productivity gains into work sharing, these agreements open up the prospect that jobs will be created equivalent to some 1,5 % of the number of wage and salary earners concerned by the agreements. The scope within the country for underpinning activity is limited by the constraints imposed by the still precarious public finance situation and current efforts to improve it are closely bound up with the measures designed to maintain competitiveness. The decisions of March 1984, imposing a three-year moderation of disposable incomes by requiring a 2 % slice of wages to be paid to the Treasury, introduce a wider split between the growth of wages as costs and wages as income without alleviating the former. A correction of indirect labour costs, which is likely to prove necessary in order to restore competitiveness, would immediately interfere with the programme of improving the public finance situation or would have a moderation effect on domestic demand because of the budget spending cuts necessary to prevent a widening of the deficit. Yet, even though the general government net borrowing has already been pruned by almost four percentage points of gross domestic product, from 12,8 % of gross domestic product in 1981 to 8,9 % in 1985, it is still too high. To measure the fragility of what has been achieved, suffice it to say that although non-interest expenditure was markedly reduced, it was barely possible to stabilize total expenditure because of the debt interest burden which climbed from 7,3 % to 10,9 % of gross domestic product in the same period. It should be stressed that the increase in

revenue includes a greater yield from company taxation, although from 1982 on, companies benefited from a variety of tax cuts (the top rate of tax on company profits was brought down from 48 % to 45 %, the additional 'solidarity' tax was abolished, tax exemptions were introduced in exchange for investment).

Despite the efforts made, the vicious circle of deficit-interest payments-larger deficit means that the borrowing requirement is still too high. Therefore for 1986 the last section of the 15 March 1984 programme must be implemented in full and all overspending and any fall in revenue, notably as a result of the programme for cutting taxation from 1986 to 1989 which was voted in July, must be offset within the budgetary ceiling. If all these conditions are met, and given the automatic growth of revenue, the central government Treasury financing requirement should be limited to 9,6 % of gross domestic product in 1986 compared with 10,4 % in 1985. Because of the tax cuts voted, from which disposable income will, from 1989, benefit by the equivalent of 1,5 %, even tighter management of public finance will be required. However, the structure of revenue, and notably the high level of social security charges compared with an average level of indirect taxation, gives some margin for cutting the cost of labour, provided that the effect of this change in structure is not wiped out by the indexation mechanism. On the expenditure side, virtually the only stimulus which the public sector can provide in the short-term is to shift expenditure more firmly into areas which favour employment.

Until now, the chief weapon in the fight against unemployment has been wage moderation as a means of improving the economy's competitiveness and company profitability and financial structure. It has been supplemented by a revival, from 1984 on, of public-sector programmes to absorb unemployment – programmes which employ 2,1 % of the labour force in 1985 compared with 1,4 % in 1983 – and by measures to help people to be taken on in their first job, to encourage the unemployed to start their own businesses, and to promote work sharing.

Given the existing measures to reduce taxation and to support employment directly, and the need to go on trimming the public deficit, external trade must provide most opportunities for raising the growth rate and expanding the volume of employment. Here, the economic policy priority must continue to be the maintenance of the right level of competitiveness. Cooperative action at Community level would also help to cut the public-sector deficit more quickly and would allow the more rapid creation of the room for manoeuvre which is now missing.

TABLE 11

Belgium: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	8,5	4,9	3,4	3,1	7,8	0,6	– 1,5	8,6	2,2	0,6
1971 to 1980	10,5	3,1	7,1	7,1	11,9	– 0,2	– 5,0	10,3	5,5	0,3
1981	4,2	– 1,2	5,4	8,6	7,7	– 4,5	– 12,8	5,8	11,2 (10,3)	– 2,0
1982	8,3	1,1	7,1	7,6	7,9	– 3,4	– 11,0	5,7	13,1 (12,1)	– 1,3
1983	6,3	0,4	5,9	7,5	6,7	– 0,7	– 11,7	7,0	14,4 (13,3)	– 1,6
1984 (1)	7,0	1,7	5,3	6,2	6,2	– 0,3	– 9,9	6,1	14,5 (13,3)	0,4
1985 (2)	6,7	1,9	4,7	4,9	5,7	0,6	– 8,6	6,0	13,8 (12,4)	0,4
1986 (2)	6,2	1,7	4,4	3,2	4,2	2,0	– 7,4	5,5	13,4 (12,2)	0,3

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.
(4) Eurostat concept; between parenthesis: national concept.

DENMARK

In Denmark economic activity continued to expand during 1985; estimated real GDP growth was close to 2,5 %, down from the almost 4 % recorded the year before, but corresponding to the average annual medium-term trend. Whereas the excellent harvest bolstered total output in 1984 a number of factors combined to slow the rate of increase

during 1985. In particular, domestic demand was less buoyant with the sluggish development of private consumption and residential construction offsetting the continued rapid rise in private business investment. Imports of capital investment goods as well as specific consumer items remained strong. Despite the reinforced industrial competitiveness resulting from tight incomes policies, exports, which triggered the present phase of economic expansion, performed less strongly against the background of slower growth in the country's markets. Consequently, the deficit on the current balance of payments, which includes a large amount of interest payments abroad, remained large. More positively, however, inflation continued to level off as domestic costs declined, while private sector employment rose faster than total labour force growth so that the unemployment rate fell by almost one percentage point. In addition, the general government deficit narrowed to some 3 % of GDP as real expenditure remained unchanged with current receipts growing in line with GDP.

In 1986, gross domestic product is expected to grow by more than 3 %. Although domestic demand is due to rise at a rate close to that for 1985, changes in the structure of demand reinforced by import substitution are likely to produce a smaller increase in imports. Private consumption should grow, underpinned particularly by a rise in employment, but public consumption will reflect the tight budgetary stance pursued by the authorities. The cyclically sensitive investment categories should benefit from lower financial costs and improved profitability, while discretionary components, particularly in the energy area, are expected to begin to wind down. The relative fall in domestic costs, reflected in lower inflation, should contribute to a further gain in market shares for manufactured goods. Unemployment should show a further improvement compared with the year before.

External constraints and tight budgetary management may mean that realized growth in the period 1984 to 1986 will emerge at slightly below potential. The economic policy pursued by the authorities since 1982 aims at a return to external balance and equilibrium on the central government budget by 1988 and 1990 respectively, and, though the achievement of these objectives also depends to a considerable extent on the continuation of sufficiently vigorous growth in world demand, appreciable progress has been made. The wage restraint pursued in recent years has altered the relative costs of labour and capital and strengthened profitability. At the same time, tight budgetary control has reduced the general government borrowing requirement. Lower inflationary expectations helped to bring down nominal interest rates. Against this background, improved business confidence favoured a rise in the stock of productive capital with private employment growing simultaneously. The result has been the achievement of a much improved equilibrium in domestic macro-economic conditions with the external balance still lagging however behind the desired objective.

The incomes policy measures adopted in March imply a rise in nominal wages of the order of 2 % per annum. Together with a cut in indirect labour costs equivalent to 1,5 % of the wage bill as from October 1985 and limitations on other forms of income increase this should bring about a slowdown in inflation and improve profitability. There will also be a favourable impact on employment not only as result of greater potential output due to higher industrial investment, but also due to an improved mix of capital and labour inputs. However, relatively rapid changes in the product mix and market conditions require a high degree of adaptability in the labour market. It has become increasingly important to update skills acquired in the past in view of current technological progress and to review labour market regulations in order to remove possible obstacles to the potential of the economy to generate jobs. Various measures have been taken to reintegrate long-term unemployed and other groups hit by unemployment.

The pressing need for further improvement in the balance of payments remains a decisive element for the stance of monetary and budgetary policy. Adjustments might be necessary if domestic demand, particularly private consumption, should deviate from the trend compatible with improved external equilibrium. Restoration of external equilibrium must remain an essential policy-objective but the authorities room for manoeuvre in this respect would be enlarged if foreign demand was supported through cooperative Community action.

The growth in money supply fell during 1984 and continued to level off in 1985 as did bank lending. Interest rates declined considerably in response both to the anticipated slowdown in inflation and to a rise in private capital inflows. The differential between domestic and foreign interest rates narrowed consequently; this should reduce the propensity of industry to contract foreign debt. In order to allow a more market-orientated control of domestic liquidity, the National Bank modified at mid year the domestic credit monitoring system by establishing a new system of marginal reserve requirement. A more flexible management of liquidity and short-term interest rates based on short-term deposit certificates issued by the National Bank and traded only among banks was implemented in August replacing the existing tranche division of banks' borrowing facilities with the National Bank.

A lower share of public expenditure in gross domestic product would help alleviate monetary constraints and stimulate the growth potential of the economy. The draft budget for 1986 remains in line with the medium term strategy adopted by the government and corresponds to what appears to be an appropriate guideline from the Community point of view. The level of expenditure will stabilize at the ceiling fixed for 1985, whereby it declines as percentage of GDP, whereas taxation should grow more or less in proportion to nominal GDP. The outcome will therefore be a further reduction in the central government deficit to some 3 % of GDP and 1 % for general government. The relative cutback in total expenditure, in terms of GDP, necessitates a continuous reappraisal of existing schemes with a view to reallocating resources on a priority basis among various expenditure categories. Total taxation will remain

approximately unchanged in relative terms as the cut in indirect labour costs is financed by a rise in corporate taxes, which, due to improved competitiveness, should leave profitability unaffected. In addition, a reform of income tax is planned for 1987. Its aim is to discourage tax induced diseconomies as marginal rates are reduced and the fiscal disincentives to save are diminished. In budgetary terms the envisaged changes in taxation should balance, but they may very well have an expansionary impact on domestic demand. It will be necessary not to lose sight of such likely effects.

TABLE 12

Denmark: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply (M2) (2)	Unemployment in labour force (3)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	11,2	4,5	6,4	5,8	10,6	−2,2	1,3	10,2	1,1	1,1
1971 to 1980	12,2	2,3	9,6	10,1	11,5	−2,9	0,9	11,3	3,8	0,7
1981	9,1	−0,9	10,1	12,0	9,2	−3,0	−6,9	9,6	9,2	−1,3
1982	14,6	3,0	11,3	11,0	11,5	−4,1	−9,3	11,8	9,8	0,3
1983	10,3	2,0	8,1	7,1	6,4	−2,2	−7,4	25,5	10,4	0,5
1984	9,9	3,9	5,8	6,6	4,9	−3,2	−4,6	17,0	10,0	2,2
1985 (1)	6,4	2,3	3,9	4,2	3,7	−3,4	−2,9	11,0	9,1	2,0
1986 (1)	5,4	3,2	2,2	1,7	2,4	−2,7	−0,7	7,5	8,6	1,6

(1) Forecast of the Commission services, October 1985, on the basis of present policies.
(2) End of the year.
(3) National concept.

FEDERAL REPUBLIC OF GERMANY

Economic conditions in the Federal Republic of Germany have improved significantly during 1985: economic growth strengthened through the year, the rise in consumer prices slowed further and employment rose more strongly than was generally expected. There was another considerable reduction in the financial deficit of the territorial authorities while the surplus on the current account of the balance of payments, however, has reached a new record level.

The rate of growth of gross domestic product in 1985 is likely to be only 2,25 %, remaining therefore slightly below the rate of growth forecast by the Government in its latest annual economic report (2,5 %). This must be seen however in the light of the fall in output in the first quarter, mainly due to the effect of extremely harsh weather conditions on construction activity. From the second quarter onwards, real GDP has risen appreciably. External demand has continued to provide expansionary pressure but domestic demand, especially for capital goods, has increasingly contributed to growth. The expansion in the economy has been reflected in the labour market. According to the latest employment data, which incorporate substantial upward revisions, aggregate employment rose in the year to mid-1985 by about 155 000. The reductions in working time contributed somewhat to this rise. The increase in employment in industry and services has thus more than compensated for redundancies in the construction sector. Unemployment, however, rose over the same period by 55 000, reflecting demographic factors and, above all, a renewed rise in participation rates; the unemployment rate in 1985 is thus at the same high level as in 1984 (8,4 %).

The slowdown in inflation was due to competition and, to a considerable extent, to a favourable development of unit labour costs; the moderate increase more than offset the inflationary pressure resulting from higher import prices in the opening months of the year. The rise in consumer prices in 1985 (annual average) is expected to measure some 2 %, compared to 2,5 % in 1984.

The surplus on the current account of the balance of payments in 1985 is estimated at 2,1 % of GDP, more than twice as high as in 1984, reflecting a much higher trade

surplus and a broadly unchanged deficit on services and transfers.

In 1986 the momentum of economic expansion should continue and real GDP growth is expected to reach 3,5 %. This year-on-year growth rate — relatively high by European standards — is, however, strongly influenced by the expected rapid recovery in activity during the second half of 1985. Indeed, GDP growth between the fourth quarters of 1985 and 1986 is not expected to be more than 2,5 %.

Growth in 1986 will result mainly from the increase in domestic demand, where private consumption will play an essential role. Real disposable income is expected to rise appreciably in 1986 in view of a further reduction in inflation due principally to falling DM import prices. Moreover, the introduction on 1 January 1986 of the first stage of the tax cuts, which should benefit families with children in particular, will contribute substantially to improving the financial position of households. Finally, disposable income is expected to be boosted by a rise in employment in 1986, estimated at 330 000 persons, compared with the average for 1985. Nevertheless, the unemployment rate will fall only slightly, from 8,4 % to 8,0 %.

Investment in equipment in 1986 is likely to lose only a little of its momentum (growing by almost 9 %, as compared to 11 % in 1985). After the downturn in housing in 1985, investment in construction should again show a slight real increase in 1986. Total fixed investment is thus expected to rise by almost 5 %, following a decline by more than 1 % in 1985.

The growth of exports is expected to slow down in 1986. On account of the present favourable competitive position, in terms of prices and technology, the volume of German exports is nevertheless expected to continue rising somewhat faster than the increase in world trade. Imports, however, are likely to rise much more strongly. The faster economic growth rate expected in the Federal Republic indicates that there is a widening difference in the relative cyclical position as compared to other Member States, and to the USA. Experience from earlier cycles suggests that, with a relatively short lag, this will lead to a strong upturn in German imports. The Federal Republic would thus also provide an appreciable contribution to growth in other countries. Nevertheless, the current account surplus will remain almost unchanged, at around 2 % of GDP.

During the last three years, considerable progress has been made in the consolidation of the public finances. The deficit of the territorial authorities, which amounted to about DM 60 000 million in 1982 (on national accounts definitions), will probably be less than half that figure in 1985. It is true that, initially, consolidation had a negative impact on demand; expectations were stabilized, however, and the positive effects of the strategy have subsequently come to the fore. Restraint on public expenditure and borrowing has opened up wider scope for reducing taxes and interest rates than would otherwise have been the case. This room for manoeuvre should now be used. The introduction in 1986 of the first stage of the tax reductions, corresponding to about 0,5 % of GDP, is thus to be welcomed. Despite these tax cuts, the increase in tax revenue in 1986 is expected to be only marginally slower than in 1985. Total revenue of general government will grow even somewhat faster than in 1985 because of a significant rise in social security contributions resulting mainly from the increase in employment. The government deficit is thus falling more quickly than was earlier expected. In the Commission's current forecast the budget deficit is estimated to narrow, despite the tax reform, from 1,2 % of GDP in 1985 to 0,8 % in 1986. In the absence of additional expenditure, the out-turn for the central government (Federation and Länder) deficit in 1986 is likely to be several thousand million DM below the level of some DM 40 000 million considered to be appropriate by the Commission.

The stronger growth and rising employment are opening up room for manoeuvre at the level of general government which in 1986 should be used essentially to raise public investment. The improved depreciation provisions for industrial buildings already decided upon by the government represents an initial step in this direction.

In addition, the urban renewal programme, for which federal assistance has already been increased from DM 300 million to DM 1 000 million in both 1986 and 1987, must be supplemented by a proportional increase in the financial contributions of the Länder and the local authorities. There is evidence that there is a large number of worthwhile projects in the field of environmental improvement and urban renewal on which decisions could now be taken. As such funds are provided in the form of partial grants, their overall effect is considerably greater. There is also scope for graduating the grants from the point of view of structural and regional policy (e.g. according to regional unemployment rates) so as to achieve greater employment effects in problem areas. A further increase in ERP funds in order to encourage investment in environmental protection (e.g. sewage works) also seems advisable in 1987. These specific measures to create employment and to support the building industry seem appropriate in a wider macro-economic context, since they would help to meet needs which have been neglected in recent years, but which are important both for the present and for the future. Because of existing spare capacity in the building industry, there is no danger that such measures would impede the process of structural adjustment in this industry. A restructuring of resources away from the declining sector of new house building into the direction indicated above therefore also appears justified from a medium-term viewpoint.

In addition, supply conditions should be improved as soon as possible through changes in the tax system directed towards specific objectives. This should also cover taxes which, while contributing insignificantly to total government revenue, restrict the efficiency of the capital market, such as taxes relating to share transactions and issues (Börsenumsatzsteuer

and Gesellschaftssteuer – together contributing barely 0,5 % of the Federation's total tax revenue). The Commission has already submitted proposals in this respect.

After the entry into force of the law on the alleviation of taxation *(Steuerentlastungsgesetz)* providing for a two-stage (1986 and 1988) reduction in taxation, it is important for the broad outlines of the tax reform envisaged over and above this to be proposed as soon as possible. In this regard, further steps that should be taken are an increase in the fiscal room for manoeuvre and further improvement of supply conditions through a compulsory and specific reduction in subsidies. Such a prospect could help to underpin the expectations of enterprises and consumers and to boost the rate of investment. If, contrary to all expectations, the economic situation were to deteriorate appreciably, the conditions within which supply and demand operate would have to be improved according to the requirements of the situation.

The development of the public finances is an impressive example of a positive chain reaction resulting from more growth and employment. The interlocking effects of faster growth and greater room for manoeuvre for financial policy provide the basis for a virtuous circle which will eventually bring the economy onto a steady growth path with rising employment.

Over the last three years monetary policy has managed to achieve a marked reduction in the inflation rate and – what is equally important – in inflationary expectations. The confidence which this has created in the German mark has made it possible to decouple interest rates to a considerable extent from US levels. Since the spring of 1985, the room for manoeuvre in monetary policy has grown even further, since the dollar has been falling since then, albeit irregularly. Monetary policy should continue to exploit fully the developing potential for interest rate reductions in the framework of the price stability objective. To the extent that growth potential rises as a result of higher investment and more flexible use of the capital stock, additional scope will develop for monetary growth which is still consistent with price stability.

The dynamic recovery in investment must continue. As the capital stock in many areas is obsolete, gross fixed investment must expand appreciably in real terms for a number of years in order to permit both adequate modernization and the extension of the capital stock necessary to generate additional jobs. The growing need for capital-widening investment is demonstrated by the high level of capacity utilization recorded in mid-1985; the level of utilization in industry was only one percentage point lower than at the previous cyclical peak at the beginning of 1980.

In recent years wage moderation has made a considerable contribution to the recovery of companies' financial situation. While the profit share in value added has again reached the level of the early 1970s, the yield on physical capital in many areas is, however, still too low. This underlines the need to use the capital stock more efficiently and in such a way as to generate more employment.

Now that productivity is again rising more strongly, real wage increases are clearly possible in 1986. The increase in real per capita incomes should however continue to lie below overall productivity growth. Thanks to the first stage of the tax reform and to the further success in combating inflation (achieved mainly through a fall in import prices in 1985), there will be a further appreciable improvement in real incomes despite a moderate wage round. Given the economic situation in 1986, a rise in real per capita income is not only possible but within limits also desirable, since private consumption should compensate for the slow growth of exports in order to support the overall level of activity, as long as it does not impede investment growth.

In negotiations between employers and unions in 1986 it might be considered whether, as a direct counterpart to continued moderation of wage settlements, additional jobs could be created. This form of arrangement could signal an increase in employment.

More employment-creating growth could also be promoted if working hours were made more flexible than is currently the case in most firms. This would also facilitate reductions in working hours. The experience gained so far in the metal and printing industries, where employers and unions last years agreed on a cut in working time combined with more flexible arrangement of the hours worked, is certainly encouraging. A recent survey carried out on behalf of the Commission among a representative cross-section of European employees has shown that there is a high degree of readiness in the Federal Republic of Germany (and in most other member countries) to accept new working time arrangements. For example, a third of the employees surveyed favour working irregular and, in some cases, inconvenient hours (e.g. in the evening until 22.00 and once a month on a Saturday) if this is matched by a reduction of some 5 % in annual working hours. Furthermore, approximately one in every six of those currently employed on a full time basis would welcome a working week reduced to some 30 hours on the same hourly wage. These preferences regarding working hours can generally be reconciled with business reality only if the whole pattern of working is made more flexible. Only in this way could shorter working hours for the individual be consistent with the current length, or even an extension, of operating hours, while at the same time creating additional employment opportunities. The new legislation governing limited-period contracts and part-time working should be used more actively by employers and workers so that the evident large potential for flexibility among workers can be better exploited for the benefit of both sides. In the services sector in particular, a considerable increase in employment might be achieved if more flexible working hours were accompanied by changes in operating hours. Such measures are no less appropriate for the fact that more attractive working hours have the effect of bringing persons from outside the labour force onto the labour market and that the number of registered unemployed falls less sharply as a result.

A particularly important task in the next few years is to further improve the vocational training opportunities for school leavers and to guarantee them employment after their training, even if this initially has to be in some form of part-time working. One way of doing this is to make early retirement more attractive financially — at least for a limited period up to 1988 — in order to boost the numbers opting for early retirement during the next few years, which will still see an appreciable increase in the potential labour force.

The economic outlook for 1986 is generally favourable. Nevertheless, there are still two appreciable imbalances, the current account surplus and, above all, unemployment. The regained room for manoeuvre for financial policy should be fully used, not only to counteract in time a possible cyclical weakening of the economy in 1987, but also to maintain the momentum of the positive chain reaction between growth, employment and the room for manoeuvre. A medium-term growth rate similar to that expected for 1986 and an increase in employment of about 1,5 % per year are pre-conditions for a significant reduction in unemployment. Because of the resulting higher import requirement, the Federal Republic would also help to ease the employment problem in its partner countries.

TABLE 13

Federal Republic of Germany: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current balance	General government net lending or borrowing	Money supply (M3) (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	8,4	4,5	3,7	2,7	8,5	0,7	0,4	10,4	0,8	0,2
1971 to 1980	8,2	2,7	5,3	5,1	8,5	0,6	2,0	9,8	2,7	−0,1
1981	4,2	0,2	4,0	6,2	5,2	−1,0	−3,7	5,0	4,7	−0,7
1982	3,7	−0,6	4,4	4,8	4,2	0,5	−3,3	7,1	6,8	−1,7
1983	4,6	1,2	3,3	3,2	3,9	0,7	−2,5	5,3	8,4	−1,5
1984	4,5	2,6	1,9	2,5	3,2	1,0	−1,9	4,7	8,4	0,0
1985 (1)	4,4	2,3	2,1	2,1	3,2	2,1	−1,2	5,0	8,4	0,6
1986 (2)	5,4	3,5	1,9	1,5	3,8	2,0	−0,8	4,8	8,0	1,3

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.

GREECE

In Greece domestic demand in 1985 has continued to be substained by the still vigorous expansion of public expenditure and by a further increase in the number of tourists. However, the contribution of the real foreign trade balance has deteriorated sharply due to the combined effects of a marked slowdown in the rate of growth of exports (exceptionally high in 1984) and an appreciable upturn in imports. The growth rate for 1985 is thus likely to fall to around 2 %. Moreover, major disequilibria have continued to affect the economy. The rise in consumer prices has slowed down only temporarily and, on a year-on-year basis, could climb to 19 % again. Business investment has continued at a very low level, showing no tendency to recover. Lastly, the sharp increase in the tourism surplus has not been sufficient to offset the deterioration in other current account items; the deficit on current account (on Bank of Greece definitions) could be as much as 8,5 % of gross domestic product.

Faced by these developments, which represented a lasting change in the competitiveness of the economy, the authorities decided on 11 October 1985 to devalue the drachma by 15 % and to introduce a compulsory deposit on a large proportion of imports. At the same time a series of complementary measures was announced, which demonstrates a will to get the economy onto the adjustment path necessary for the recovery of growth on a sounder basis. The fact that external indebtedness was continuing to increase rapidly, whereas the share of business investment in domestic demand was declining steadily, was among other factors particularly disturbing. The economy was in effect tending to become trapped in a vicious circle, so that it was liable to become increasingly difficult to restore external equilibrium as a result of inadequate investment to increase production capacity and to improve competitiveness. The priority aim of economic policy had therefore to be to break this circle as

soon as possible. This means not only gradually adjusting domestic demand as a whole to the external constraint, but also increasing as rapidly as possible the share of productive investment in domestic demand, in order to bring it to the level required to ensure growth in the future.

The precondition for attaining these results was to bring about as quickly as possible a disinflation of the economy. The lasting re-establishment of competitiveness depends on this, and so does the return to normal of investment and savings behaviour. Fulfilling this objective implied major efforts – on which the authorities have now decided as shown by the measures announced – to curb spiralling costs and the public deficit, the two essential factors which perpetuate inflation.

The first step was to seek to obtain a substantial moderation in the nominal increase in earnings, as compared with the rate of 20 % or so still evident in 1985. This aim was not compatible with the continuation of the old system of indexation, which had the disadvantages not only of feeding automatically into costs, whether directly or indirectly, a large proportion of earlier price rises and of thus permitting only very slow disinflation, but also of making wage adjustment too independent of changes in productivity in the various sectors of the economy. It has been decided to make a fundamental change to this system, by linking wage increases from now on to the targeted, rather than the observed, rate of inflation, excluding the impact of import price rises. It has also been decided to freeze incomes above a certain level for a period of four months. These decisions should make possible a faster deceleration of prices, as well as a start in the process of improving the substantially deteriorated financial position of enterprises. The reduction in inflation and the recovery of business profitability aimed for by these measures are an essential condition for the re-establishment of balanced growth.

A start should also be made on reducing the public deficit, which, partly because of the insufficient yield from the tax system, will in 1985 again have overshot the very high level of previous years. The effort to be made should help, in 1986, to reduce public sector net borrowing by 4 % of GDP and to bring the central government budget deficit down to 9 % of GDP. Given the momentum of interest charges – which will however be held back by the decline in inflation – and the need to maintain adequate investment in the public sector, these aims imply very rigorous management of administrative expenditure, including wages, and a considerable reduction in the burden of subsidies. This reduction, among other things, will require an appropriate adjustment of public utility charges and other administered prices, which have been kept at artificially low levels relative to the rise in the general price level. To this end, an initial series of measures has already been taken. It will be no less necessary, as foreseen in the government programme, to increase the pressure of taxation not only by means of the steps taken to intensify the fight against evasion, but also by deliberate tax increases, which appear unavoidable.

This two-pronged effort to reduce inflation should considerably reduce the pace at which the demand for credit increases; yet, monetary policy will still have to exercise restrictive action, confirming the current trend for positive real interest rates, with a view to encouraging the development of a stable pattern of saving and, in particular, to extend the public placement of government securities which was started in 1985.

These measures should make it possible to point the economy more resolutely in the direction of sounder management which is essential for its subsequent recovery. It will nevertheless be necessary to supplement them by new measures designed to hasten the recovery of business investment. *Inter alia,* prices policy will have to contribute by becoming more flexible, provided that there is no danger of vigilance being relaxed with regard to dominant positions.

As early as 1986, the policy described above could begin to bear fruit. Domestic demand should slow down to the advantage of the external account but, on balance, it will not be possible to avoid an appreciable check on in growth. Private investment should also pick up; this is likely to be reflected in a gradual climb in the share of investment in domestic demand. The year-on-year increase in consumer prices could be around 21 %, which would mean a rate through the year much lower than this figure. Lastly, given favourable prospects for the international environment, the balance of payments on current account, expressed as a percentage of gross domestic product, should show a marked recovery. These results however will be merely a first step towards the necessary adjustments. They will imply the maintenance of a policy of consolidation for several years, which should contribute after an unavoidable phase of slower growth to more rapid expansion.

This outlook does not hold out any hope of a rapid improvement in the employment situation. Long-term recovery on this front will depend on the gradual strengthening of the upturn in investment, the primary condition for which is the maintenance of the policy of consolidation.

TABLE 14

Greece: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current balance	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	11,0	7,6	3,1	2,5	9,8	−3,1	:	17,6	:	−0,7
1971 to 1980	19,1	4,7	13,8	13,6	18,3	−2,7	:	23,8	:	0,6
1981	18,9	−0,3	19,3	23,4	21,8	−0,2	−11,1	34,3	4,1	4,8
1982	24,4	−0,1	24,6	20,5	26,8	−3,9	− 8,5	29,1	5,8	−1,0
1983	20,2	0,3	19,8	19,5	19,7	−4,7	− 8,9	20,3	7,9	−1,0
1984	23,0	2,6	19,9	18,1	21,3	−4,0	− 9,9	29,4	8,1	−0,2
1985 (1)	20,9	1,7	18,9	19,1	20,0	−6,6	−13,4	27,0	8,3	0,8
1986 (2)	18,1	0,1	18,0	21,5	13,8	−4,5	−11,0	20,0	9,3	−0,1

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.

FRANCE

In France, domestic demand has been kept under strict control in 1985; even though it has accelerated slightly during the year, it will have grown nearly as slowly as in 1984. Private consumption has been slightly more buoyant overall, while there has been evidence of a vigorous upturn in industrial investment, which after several years of uninterrupted decline, has been sufficient to bring about a positive, though tiny, change in aggregate investment. Export growth has been distinctly slower than in 1984 because of the weaker expansion of world trade, while imports remain on a moderate upward trend. This has produced a further slight improvement in the real foreign trade balance and gross domestic product growth in the region of 1 %, despite a zero, or even slightly negative, contribution from agricultural production. The trade deficit is likely to narrow further helped by the weakness of energy and imported raw material prices and the reversal of the upward trend of the dollar from the second quarter on. The current account should thus be roughly in balance, despite the smaller surplus on invisible transactions. Lastly, the rise in consumer prices has started to slow again after an interruption in the early part of the year, and the annual drift should be under 5 %.

Thanks to the pursuit since 1983 of efforts to achieve sounder economic management, the economy has made further progress in returning to balance. This progress, however, still requires to be consolidated. It is indeed necessary to go further than simply eliminating the inflation differential between France and the average of its trading partners, which is about to be achieved, and to obtain a lasting significant current account surplus which allow the gradual reduction of external indebtedness. Moreover, in the case of manufactures, the rapid rise in import penetration and the renewed contraction in export market shares, after the improvement of 1983 to 1984, are indeed clear signs that the economy's competitive position is still weak. Restraint must therefore continue to be the watchword of economic policy. It is also the prerequisite for a return to the more sustained growth rate which is the aim of the Community strategy, since the effort now being made to improve the health of the economy is also directed towards the lasting improvement of its competitiveness by stimulating the recovery of investment through a return to profitability. This is a long-term strategy, in which economic policy has been involved since 1983. It implies not only appropriate wage developments, but also sometimes major adjustments in manning levels. Nevertheless, as the rate of capital formation gradually becomes more sustained again, the time is probably approaching when a reversal of the downward trend of employment will begin. The strategy has in any case already brought some results in that a significant recovery in the trend of investment has occured right in the crucial area of competitive industry. Under the strategy, any stimulation of private consumer demand is of course out of the question so long as production capacity has not been reinforced to the point of being able to cope with this acceleration without damaging the balance of payments. Caution is all the more essential here because the upturn in industrial investment is liable to boost import penetration, at least temporarily.

Persistence with a pay policy based both on economic stability and on employment creation is therefore the first requirement of the continued emphasis on restraint. This

means that the increase in per capita earnings must still not exceed the target inflation rate by the end of the year, and must therefore be well below 1 % a quarter. Based on the experience of the last two years, this norm will probably be respected in both the public and private sectors. Such moderation seems all the more reasonable because price rises will have decelerated sharply by the time the 1986 pay round opens at the end of 1985. As the pressure of costs, and with it inflationary expectations, gradually slackens, it should also be possible to contemplate further relaxation of the price code, but without jeopardizing the objective of reducing inflation. Relaxation could go at least as far as the complete de-control of industrial prices, which are sufficiently constrained by external competition for them to be in no danger of moving out of line.

Public finance will have to be kept within the strict framework laid down in 1983 in order to avoid excess pressure from the deficit on the financial markets. As provided in the draft budget for 1986, adopted on 18 September 1985, the net balance to be financed in the central government budget and the general government net borrowing must still be kept very close to 3 % of gross domestic product. The danger is, however, that there will be some difficulty in combining this constraint of keeping borrowing stable with the reduction, however limited, in the level of tax and social security deductions implied by the newly announced cuts in personal income tax. There is an essential need for balance in the social security system, in which certain schemes, particularly for retirement and unemployment insurance, are affected by the progressive change in the ratio of beneficiaries to contributors. It is therefore not certain that social security contributions will not have to be increased sooner or later to prevent these schemes from again moving into deficit. In any event, extremely tight control of expenditure must be continued at all levels in order to keep the volume increase of total expenditure slightly below the real growth rate, even though interest charges and the cost of social transfer payments are bound to increase much more sharply. Consequently, the management of central government spending must leave no room for a real increase in expenditure exclusive of debt interest. This means that the growth margin required in order to press ahead with the priority measures in the fields of security, employment, training and research must be obtained by diminishing the real burden of the other spending areas. It also means that overall public service manning levels should stop rising and that, taking all the components of increases together, pay rises cannot accomodate any improvement in purchasing power.

Lastly, if the rise in earnings and the public sector deficit are kept within the projected limits, monetary policy can continue to reinforce the reduction of inflation in the economy by lowering interest rates as progress is achieved and by aiming at an increase in the money supply M 2 in 1986 below that of 1985.

In these circumstances, domestic demand might well be able to grow slightly more, pushing the growth of gross domestic product to about 2%, despite the expected smaller contribution of the real foreign balance resulting from the probable acceleration of imports. The terms of trade should, however, move favourably, so that the trade balance is likely to return to equilibrium and the current account should remain roughly in balance. At the same time, consumer price increases are again likely to slow down, helped by the weakening of the dollar exchange rate, and should average under 4 % for the year.

The inevitable counterpart of this effort to achieve sounder economic management is the temporary persistence of a downward trend in employment and of an accompanying slight increase in unemployment. This problem could, however, start to ease in 1986 with the completion of the principal industrial restructuring operations, the progress achieved in real wage adjustment, the upturn in investment and the simultaneous slowdown in the increase in the labour force. In fact, the rate of increase in unemployment has already fallen significantly in 1985, for reasons due partly, it is true, to the success encountered by the part-time work programme mounted by the local authorities and other public agencies, as part of the public authority drive to promote employment, notably among young people. The introduction of community work schemes marks the last stage in this drive and might also be the starting point for a more general trend towards the easing of conditions for integrating the young into working life. More generally still, employment as a whole should benefit from the new initiatives agreed in the area of training as well as from certain proposed changes in labour legislation and working hours.

Economic policy must continue to give priority to restoring the conditions making for balanced growth, and endeavour to mitigate, by specific measures, the temporarily adverse consequences for employment of this necessary approach; in so doing it will best be able to fulfil the objectives of the cooperative strategy for growth devised for the Community as a whole. If the international environment continues to develop favourably domestic demand should again be given a larger margin for growth from 1987 on. Nevertheless the bulk of this margin should be utilized by corporate investment, which still has much ground to make up.

TABLE 15

France: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,2	5,6	4,4	4,3	9,4	0,2	0,4	12,7	0,9	0,6
1971 to 1980	13,4	3,6	9,5	9,5	13,8	−0,4	−0,1	14,8	3,8	0,4
1981	12,1	0,2	11,9	12,9	14,5	−1,4	−1,8	11,4	7,8	−0,7
1982	14,8	1,8	12,8	10,9	14,5	−2,9	−2,7	10,8	8,7 (8,8)	−0,8
1983	10,9	1,0	9,8	9,4	10,9	−1,7	−3,1	11,2	8,8 (9,0)	−0,6
1984	8,7	1,6	7,0	7,3	8,1	−0,7	−2,8	8,3	9,9 (9,9)	−1,0
1985 (1)	7,0	1,2	5,7	5,8	5,9	−0,5	−3,2	5,8	10,7 (10,7)	−1,0
1986 (2)	5,8	1,9	3,9	4,0	4,5	−0,3	−3,3	4,9	11,0 (10,9)	−0,7

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year. Up to 1980: M2.
(4) Eurostat definition in parenthesis.

IRELAND

In Ireland the pattern of vivid contrasts, which has characterized macro-economic performance since recovery began in 1983, remained marked in 1985. Exports continued to expand vigorously despite slower growth in external markets; domestic demand, on the other hand, remained at a low level, reflecting factors whose cumulative influence is likely to dampen aggregate activity for some time to come — in particular, a still relatively modest amount of domestic sourcing for important export categories, the implications of further fiscal adjustment, and the impact on global investment as work on major projects in the public sector comes to an end, offsetting the strong resurgence in private investment in capital goods. The benefits of rapid export expansion are also weakened by the high level of net factor income outflows, 11 % of GDP in 1985, mainly attributable to interest charges on the external public debt and profit repatriations by Irish branches of foreign owned firms. As a consequence, growth in real GNP, the appropriate measure of the resources actually available to the economy, is a full percentage point below the comparative GDP figure, estimated at about 2,5 %. Against this background, unemployment continued to rise during the year to the unprecedented rate of 17 %. In other respects however, adjustment has proceeded much faster. A significant degree of wage moderation has been achieved. The rate of inflation (CPI), as high as 20 % in 1981, is expected to come down to almost 5 % in 1985. The deficit on the current account of the balance of payments as a percentage of GDP has also been reduced dramatically by an estimated 11 percentage points in the same period. Indeed, the trade balance has moved into modest surplus for the first time in many years. The small overrun expected on the planned budgetary target of 11,5 % of GDP for the Exchequer Borrowing Requirement (EBR) should be seen in the light of the approximately equivalent saving recorded in the previous year. However, fiscal adjustment has effectively marked time for the past two years so that the size of the national debt continues to grow by further substantial annual increments and may indeed approach 120 % of GDP by end-year of which close to half will be owed abroad. Moreover, the deficit on the current balance of payments is still rather high in view of the relatively low level of domestic demand.

Growth prospects for 1986, with real GDP expected to rise by nearly 2,5 % on the assumption that progress in fiscal adjustment will resume as provided for in the Government's medium-term economic plan 'Building on Realitiy', are similar to those in the current year although the balance of growth should shift somewhat towards stronger domestic demand. Nonetheless, some further reduction is likely in the deficit on the current balance of payments while the underlying rate of inflation should continue to improve. Employment is likely to grow at a modest pace but unemployment will probably remain at around 17 % during the year.

The considerable success achieved by the authorities in some areas of the economy throws into sharper focus the relatively slow progress being made in improving labour market

conditions. In Ireland, particular demographic influences have been superimposed on more commonly experienced cyclical and structural factors. The labour supply is likely to increase by about 1 % per annum in the next few years even allowing for significant net emigration. The problem therefore, if any inroad into the level of unemployment is to be made, is to raise employment by a much faster rate each year. To this effect, the authorities should endeavour to make simultaneous progress in three areas, namely, restoring order to the public finances, improving labour market management and making industrial policy more effective in terms of retaining more value added in the economy and generating more employment.

The persistence of high public deficits entailed not only a rapid accumulation of external debt (almost 50 % of GDP at end 1984) and resultant interest charges (1981, 2 % of GDP; 1985, 4,5 %) but also, bearing in mind the relatively narrow tax base, exceptionally high levels of personal taxation. Over 40 % of income tax payers fall into the two higher tax bands (48 % and 60 %). 'Building on Reality' proposes to reduce the EBR and Current Budget Deficit (CBD) to 9,8 % and 5 % of GNP respectively by 1987 (that is, a reduction of over 3 percentage points in each relative to 1985) while holding taxation constant as a percentage of GNP, at the 1984 level. Substantial imbalances will thus persist in the period after 1987.

These targets must be regarded as a minimum. Consequently, the authorities should in 1986 aim to make as much progress as possible in the direction of the 1987 targets. A half-way step towards those targets would entail a reduction in the EBR of the order of 1,5 percentage points of GDF on the 1985 out-turn, which is an ambitious target given the sluggish revenue buoyancy. While the expected moderation of international interest rates and the dollar exchange rate will ease the debt interest burden somewhat in 1986, a significant reduction in the EBR, given tax revenue constraints, will be feasible only if there are substantial volume reductions in non-interest expenditure including the maintenance of strict limits on the rise in public service pay and the second and final phase of the abolition of consumer subsidies. It would be appropriate to continue the reform of the tax system initiated in the January 1985 Budget with a view to promote incentive and enterprise. While more emphasis on reducing the income tax burden would appear desirable, progress in this direction must depend on how far expenditure can be reduced. Resources could be freed by restructuring the system of transfers to households so as to reflect priorities and direct expenditure to areas of real need. It is questionable, in the context of overall budgetary targets, whether the real value of social transfers can be maintained — these have risen by as much as 4 percentage points since 1981 to an estimated 19 % of GNP in 1985.

Monetary policy will have to mitigate the strains arising from the pressures exerted by large public deficits. The improvement in the external current account deficit is reducing the role played by external financing of the public sector. Despite subdued demand for private sector credit, which has facilitated the recent reduction in the role of quantitative credit controls, the continuance of Exchequer external borrowing at the high level of 1985 could contribute to excessively fast growth in the money supply. In regard to interest rate policy, the authorities must strike a balance between ensuring that the economy benefits proportionately from the easing in international rates and maintaining a strong flow of savings from the non-bank public to the Exchequer. Avoidance of short-run volatility in domestic interest rates is obviously essential.

The prospect of high levels of unemployment over the medium-term has been the main stimulus behind initiatives taken by the authorities in labour market management. Training schemes, particularly for young people, are now being greatly expanded. A social employment scheme has been introduced, offering 10 000 longer-term unemployed part-time work for one year mainly on Local Authority projects. The scope for this type of scheme is limited however, both by the cost, and by the rather slow take up of job opportunities linked partly to limited trade union acceptance. However, the Enterprise Allowance Scheme, designed to help unemployed persons start their own business, has been much more successful in terms of demand for the scheme combined with a relatively low degree of initial failure. The Employment Incentive Scheme, which subsidizes incremental employment, is also attracting growing demand, but to evaluate its success is more difficult because some employers may have hired more labour anyway. Overall, there is now need for greater coordination in administering manpower policy, given the recent rapid expansion of schemes and the number of bodies involved.

An important development to date in promoting labour market adaptability has been the increasing dispersion, in terms of timing and size, of wage settlements. In regard to the replacement ratio (level of unemployment benefit relative to net income after tax), a more emphatic stress on reducing personal taxation, particularly for those on lower incomes, could encourage a greater take-up of less well paid job opportunities especially since there is little scope for increasing the value of social transfers. The correction of the longer term trend towards excessive capital deepening is more problematic but there is evidence that generous levels of investment incentives, which have attracted many capital intensive production operations, have had an important effect. Since Ireland is likely to require foreign inward investment for some time to come, it may be difficult to reduce the level of these incentives, but, in line with the White Paper on Industrial Policy, they can be used more selectively to ensure the creation of more jobs. At present, it makes sense to put a strong emphasis in industrial policy on improving supply linkages between the foreign and domestic sectors in manufacturing. Ultimately however, the best prospects for a wider basis of output and employment growth in manufacturing lie with the recovery and expansion of domestic firms; this will not come about in the absence of

sustained wage moderation, to generate profits and investment and protect competitiveness, and of an appropriate business climate in terms of taxation and interest rate levels. Wage moderation, in combination with budgetary restraint, is not only imperative solely from the point of view of Ireland, but would be in harmony with a consistent, more employment intensive, growth strategy in the Community as a whole.

TABLE 16

Ireland: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current balance	General government net lending or borrowing	Money supply (M3) (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	9,9	4,2	5,5	4,6	9,9	– 2,3	– 2,7	10,4	4,5	0,0
1971 to 1980	19,5	4,6	14,2	13,8	18,0	– 4,6	– 8,1	18,5	7,4	1,0
1981	21,2	1,8	18,2	21,2	19,6	– 14,1	– 13,2	21,5	10,6	– 0,9
1982	16,9	0,8	15,9	15,9	15,7	– 9,9	– 13,8	13,5	12,8	0,2
1983	10,4	0,8	10,4	8,3	9,3	– 6,3	– 11,8	5,6	14,6	– 2,0
1984	11,3	4,4	6,6	8,5	9,6	– 5,1	– 10,1	10,1	16,1	– 0,9
1985 (1)	8,7	2,5	6,1	5,7	7,0	– 3,3	– 11,5	6,6	17,1	– 0,3
1986 (2)	7,5	2,3	5,0	5,3	5,7	– 2,0	– 10,4	9,8	17,4	0,6

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.

ITALY

In Italy, the absence of arrangements for containing the in-built momentum of earnings, the insufficient control of the public deficit and the consequent accelerated growth in the monetary aggregates have provided a further boost to private consumer demand in the first quarter of 1985 while business demand was still stimulated by the favourable trend of profits. All these factors increased the extent to which the economic situation was out of step with that in the rest of the Community. The momentum of domestic demand, coupled with worsened competitiveness, has tended to pull in appreciably more imports and to curb the rise in exports, which has nevertheless remained strong. Despite the strongly negative influence of the real balance of foreign trade, the growth of gross domestic product will, however, be similar to that in 1984. But the maintenance of demand at a relatively high level and the rise in the dollar in the first half of the year temporarily interrupted the slowdown in the inflation rate, which should settle at about 9 % instead of the 7 % aimed at on average in 1985. Above all, no favourable factor reduced the impact on the current account of the deterioration in the real external balance: the current account deficit for the year is therefore likely to reach 1,7 % of gross domestic product. Following two successive slides in the exchange rate of the lira, in February/March, and again in July, the new downward adjustment of its central rate within the European Monetary System on 20 July was the consequence of these major imbalances.

Italy's improved competitiveness *vis-à-vis* the countries of the European Monetary System, and the simultaneous improvement in her terms of trade linked with the decline of both the dollar and the oil price brought about some recovery in the balance of payments in the second quarter. It will not, however, be possible to confirm this recovery unless the causes of the present disequilibrium are corrected rapidly. There is even the danger that the persistence of relatively high inflation will wipe out the exchange rate advantage obtained before it can be fully exploited in respect of real flows. Fundamental measures must therefore be taken not only to curb domestic demand to the appropriate extent but also to break the inflationary spiral itself, which tends to perpetuate economic instability and, by so doing, impede the expansion of productive capacity. Over and above the chronic precariousness of external equilibrium, the most serious medium-term consequence of this situation has been the decline in the rate of formation of productive capital connected with the fall in its profitability and the resultant severe crowding out of labour in the sectors exposed to competition which continued during the 1984 to 1985

investment recovery phase. It is therefore essential for economic policy to attack the very roots of this problem by calling into question certain automatic institutional procedures which deprive labour costs and public expenditure of the flexibility needed to restore the key equilibria on a lasting basis. Unless there is resolute action along these lines, the monetary authorities will inevitably be faced with contradictory policy options, permitting neither the necessary progress towards re-establishing equilibrium, nor a lasting return of productive investment to a level compatible with a gradual reduction in unemployment.

In this context, the revision of wage adjustment procedures is of key importance: on it depends the control not only of the evolution of costs in the competitive sector but also to a large extent that of public expenditure. Even when it was alleviated down in 1983, the undifferentiated indexation system introduced in 1975 retained most of its disadvantages: it impedes disinflation by automatically feeding into the wage bill much of the impact of any past rise in prices; its effects of squeezing wage differentials is bound to be offset by differentiated pay increases, the addition of which is incompatible with the desirable slowing down of nominal pay rises; and in the end it implies a trend of real wage increases which until 1983 was higher than that of productivity growth.

Management and unions seem to be working out an agreement to abandon this mechanism, already rejected by private industry employers, with effect from the start of 1986, although there is no question of abandoning all idea of automatically protecting wages against the decline in the value of money. It might thus be possible to move towards a method of wage-fixing which would retain some indexation, but in the diluted form of a half-yearly adjustment of an amount of salary limited to a level far lower than the current rate of coverage, with the other elements of the increase being no longer determined at branch and company level three years at a time, but for shorter periods. Generalization of such a system might go a long way towards reducing the rigidities of the former system and should do away with most of its disadvantages. As a result, it should be possible to make much faster progress in reducing inflation and also to reduce, by leaving more room for negotiation, the risk of rises in real wages beyond the increase of productivity and even, where necessary, to make appropriate corrections to the distortions which occurred in the past.

But the expected results will not be achieved unless the shift in the system of wage formation is matched by an extremely energetic effort to reduce, and not just contain, the enormous inflationary pressure emanating from public finance. Contrary to the initial forecasts, the Treasury deficit shows no sign of falling in 1985. Its underlying trend is even tending to rise from levels which already imply a rapid increase in the burden of indebtedness, already close to 100 % of gross national product. The strategy necessary has been outlined in a plan for the reform of public finance in 1990, the aim of which is the gradual reduction of the public finance burden on the productive system, by stabilizing overall government receipts as a percentage of GDP as well as the real share of current expenditure, excluding debt interest, at levels very close to their present ones. If these two objectives were achieved, and assuming that growth averages close on 3 % a year until the end of the decade, and that inflation tends rapidly towards an annual rate of 4 %, the government deficit, expressed as a proportion of gross domestic product, could be cut from 15,7 % in 1985 to 7 to 8 % in 1990 and the current deficit to be almost completely eliminated.

The major difficulty of this strategy is the stabilization of the growth in real terms of current expenditure excluding debt interest, especially since much of this expenditure is controlled by decentralized departments. The objective means that the volume of total public service pay must be lastingly stabilized, i.e. that the mechanism for its adjustment — notably indexation and automatic career increases — be amended accordingly, and that the numbers employed in government and public departments should only be increased when strictly necessary. It also means that in order to compensate for the inevitable increase in the real cost of pensions, the costs to the budget of public services must be reduced by an appropriate increase in the user contribution to their operating costs. Lastly it requires the introduction of provisions designed to limit the increase in the burden of pensions as much as possible. The 1986 budget proposal, presented to the Parliament on 30 September 1985, includes a collection of fundamental changes which already seem to meet some of these requirements and make it possible to move towards the goal of stabilizing real non-interest expenditure.

The revenue measures adopted in the budget proposal provide for a reduction in personal income tax, adjusting the tax bands so as to neutralize inflation effects, for the abolition with affect from 1987 of the tax on invested profits, and also a reduction in the taxation of inheritances. They also comprise, on the other hand, substantial increases in social security contributions. In total, revenue as a percentage of GDP should be broadly maintained at its 1985 level, which might not be sufficient to keep the Treasury deficit for 1986 within the limit set earlier of 110 million Lit (14,8 % of GDP). This target figure, which shows an improvement of one percentage point compared to the probable 1985 out-turn, should be considered as a ceiling, taking into account the absolute need to stabilize the relative level of the debt by 1990. It is essential, in these circumstances, to ensure that it is not exceeded, by making additional cuts in spending unless there is a spontaneous rise in tax yields.

These guidelines with respect to pay and fiscal policy should be coupled with a monetary policy which continues the present efforts to slow down the growth in the money supply in order to stabilize the economy's M 2 liquidity ratio by the end of 1986, after its rise in 1985. This measure would produce some slowdown in domestic demand, which should bear more heavily on consumption than on investment. The real external balance would again make a positive contribution to growth permitting gross domestic product

growth for the year of the order of 2,5 %, and the current account could begin to improve helped by the favourable movement of the terms of trade. At the same time, the rise in consumer prices should slow down very sharply to settle at an annual average of around 6,5 %, approaching the Community average by the end of the year.

If pursued with sufficient vigour, the twofold drive to control costs and the public deficit, on which substantially depends the ulitmate return to more stable growth, leading to an expansion of productive capacity which would allow employment to increase, is likely to be fully in keeping with a cooperative strategy for growth. In order to fulfil its objectives completely, this drive must nevertheless, and as far as possible, be supplemented by direct and immediate measures to bring down unemployment. Even if the problem is today no longer growing appreciably worse, because the increase in the labour force is tending to slow down, it is sufficiently worrying to require intensification in scale of the specific efforts undertaken to reduce it, be they to increase labour market adaptability, to adjust vocational training and re-training schemes, or to promote directly jobs in the southern regions. As far as budgetary constraints permit, these efforts must also be extended to include measures to stimulate research, technological advance and the redeployment of energy so as to improve production structures and consequently growth and employment prospects in the medium term.

TABLE 17

Italy: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current balance	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,5	5,7	4,5	3,8	10,7	1,8	– 2,3	13,3	5,2	– 0,4
1971 to 1980	18,3	3,1	14,7	14,6	18,4	– 0,2	– 8,0	19,5	6,0	0,5
1981	18,5	0,2	18,3	19,2	21,9	– 2,3	– 11,7	10,0	8,8	0,5
1982	17,2	– 0,5	17,8	17,1	17,3	– 1,6	– 12,7	18,0	8,7 (10,5)	– 0,2
1983	13,6	– 1,2	15,0	14,9	16,0	0,2	– 12,4	12,3	9,9 (10,8)	0,1
1984	13,6	2,6	10,7	11,1	12,1	– 0,9	– 13,5	12,1	10,4 (12,0)	0,4
1985 (1)	11,0	2,7	8,1	8,6	10,2	– 1,7	– 13,6	12,1	10,9 (12,6)	0,2
1986 (2)	9,5	2,7	6,6	6,5	7,6	– 1,1	– 12,8	8,5	11,2 (13,1)	0,3

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.
(4) Eurostat definition.

LUXEMBOURG

In Luxembourg, economic activity contracted in 1985, because of the slowdown of steel production after the very sharp increase recorded last year. Nevertheless, because demand for other products remained buoyant, total exports again advanced slightly. Domestic demand improved markedly as a result of the upturn in private consumption and business investment, but investment by the public sector and in housing fell in real terms. Overall, gross domestic product will grow by around 1,7 %. The rise in consumer prices (of 3,2 % on average) weakened perceptibly.

In 1986, the growth of gross domestic product is likely to remain fairly modest and should not go much above 1,5 %. A stabilization of activity in the steel industry is likely to be more than offset by the continuing vigorous advance in the other sectors. The greater dynamism of private consumption and the continuing buoyancy of investment, mainly by companies, is likely to underpin domestic demand so that its growth rate will compare with this year's. The rate of increase of consumer prices is likely to weaken further during the year.

The financial position of steel enterprises has improved at the end of three years of considerable efforts. Consolidation of profitability in this sector is likely to involve further substantial costs for the central government budget in 1986, but this is not likely to hold back efforts to diversify the Luxembourg economy by developing and modernizing existing enterprises and introducing new industries.

Restructuring must take place in an economic climate which favours investment, and this implies adequate corporate profitability. In this context, the wages trend plays a key role. The ending of specific measures to hold down wages in the steel industry, the restoration of indexation and the granting of benefits outside the collective agreements could have an effect in other sectors very sensitive to international competition, reducing the country's attractiveness for new enterprises and impeding industrial diversification, especially since wage moderation will continue in the neighbouring countries. If the efforts made so far in the Grand Duchy were relaxed, the competitive position of companies would suffer. Participation in a cooperative strategy for growth and income moderation would, by contrast, have favourable effects on export prospects.

In comparison with the other Community countries, unemployment has remained relatively limited owing among other things to specific programmes to provide employment for workers in the steel industry. However, imbalances persist in relation to the qualifications of manual workers, and these could be remedied by looking for suitable methods of youth guidance and vocational training. By increasing the attractiveness of various training arrangements in industry and by making working hours more flexible, company requirements could also be better served.

As a result of the spontaneous increase in revenue, combined with a continuing strict hold on central government expenditure, it should be possible to keep the 1986 net budget surplus at the 1985 level (2 % of GDP). If this budget guideline is respected in 1986, it will again give some room for manoeuvre which would permit the rebuilding of investment fund reserves and, over the next few years, a further reduction in the burden of taxation and parafiscal charges on top of those proposed in the draft budget for 1986. It would also immediately give the authorities the finance needed for the planned capital expenditure, notably on roads and telecommunications infrastructure. Apart from the intrinsic advantages of such investment, in particular for the industrial restructuring policy, execution of these programmes would give appreciable support to the construction industry which is now facing a contraction in demand.

TABLE 18

Luxembourg: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	7,6	3,6	3,8	2,5	6,7	7,4	1,8	:	0,1	0,6
1971 to 1980	9,6	3,1	6,3	6,7	10,5	21,5	2,2	:	0,3	1,3
1981	4,2	– 2,6	7,0	7,8	9,0	32,0	– 2,3	:	1,0	– 0,6
1982	9,9	0,3	9,6	10,5	6,0	40,8	– 1,4	:	1,2	0,6
1983	6,1	– 2,2	8,5	9,1	6,6	31,0	0,0	:	1,5	– 0,3
1984 (1)	9,2	3,2	5,8	6,7	4,2	33,2	1,5	:	1,7	0,5
1985 (2)	6,0	1,7	4,2	3,7	4,9	32,1	2,1	:	1,7	0,6
1986 (2)	6,4	1,3	5,0	3,5	5,6	30,8	1,9	:	1,6	0,4

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.
(4) Eurostat concept.

THE NETHERLANDS

In the Netherlands, the rate of increase of economic activity in 1985 was comparable with that in 1984. Real gross domestic product grew by around 2 %, mainly due to the fairly buoyant expansion of exports. However, despite the upturn in private consumption, domestic demand grew less sharply, mainly because of the weakness of demand for housing and the decline in public-sector investment. The moderation of labour costs in earlier years made it possible to improve the level of corporate profits. This was a favourable influence on the sharp upturn in corporate investment in plant and machinery, which started early in 1984; but the increase in building investment is still small. Overall, corporate investment remains below the late 1970s level, expressed as a percentage of gross domestic product (10,0 % from 1983 to 1985 compared with 11,3 % from 1977 to 1979). The number of unemployed fell, as an annual average, and the unemployment rate declined from 14,2 % of the labour force in 1984 to 13,5 %. Consumer price rises remained very moderate. The current account surplus increased further, to 4,4 % of gross domestic product. The resultant increase in the liquidity ratio has not been entirely offset by monetary policy, given the low inflation rate, and the still high general government borrowing requirement – 8 % of net national income.

In 1986, the rate of increase of gross domestic product is not likely to accelerate greatly and will probably reach almost 2 %. Exports will go on expanding but at a somewhat lower rate. Domestic demand will, on the whole, become more buoyant. Private consumption will be boosted slightly by the rise in wages resulting from the new collective agreements and the increase in employment. The improvement in company profitability and the higher capacity utilization are likely to favour the expansion of capital-widening investment, particularly by companies in the exporting industries. But residential construction and public investment will again dip slightly. Inflation will fall to a very low rate, with lower import prices largely offsetting the effect of the somewhat faster rise in unit labour costs. The favourable movement of the terms of trade will produce a sharp rise in the current account surplus which could exceed 5 % of gross domestic product in 1986. Employment in manufacturing industry could well increase slightly for the second year in succession.

In recent years, economic policy has chiefly concentrated on reducing the budget deficit and the level of taxation and social security contributions, improving company profitability and making changes in working hours and employment opportunities; but the results obtained so far are still insufficient in view of the seriousness of the problems.

Industrial companies have been able to increase their profitability appreciably, and subsequently, their investment. Company finances and competitiveness were improved by holding down the rise in labour costs, partly as a result of a cut in social security contributions. However, the level of profitability now reached is still an argument in favour of a moderate increase in real wages.

The prospects for 1986 are fairly encouraging in this respect. The 1982 agreements between labour and management severly limited the rise in earnings, but the current decentralized negotiations at industry and company level will bring about a more substantial rise in wages overall. A

general consensus should be sought and maintained on the priorities of collective agreements, in order to prevent them from deviating too sharply from productivity gains and so becoming incompatible with the maintenance of competitiveness.

The result of decentralizing wage negotiations is likely to be greater pay differentiation between sectors, and this could promote greater labour mobility, which would favour even more the wages structure and would curb the tendency for excessive rationalization investment. In the 1980s, many selective measures have been taken with the view to hold back the rise in unemployment: lower minimum wages, reduced parafiscal pressure, restricted unemployment compensation, more part-time jobs, shorter working hours, and compensatory recruitment with no increase in labour costs. The greater flexibility of demand on the labour market, and the wage differentiation which may become possible under negotiations at industry and company level, are further improving the favourable recruitment climate. Until recently this policy had not had the expected effects on the level of employment, but there are signs of an improvement in 1985. Because of the upturn in activity and all the measures mentioned, employment has risen sufficiently to reduce unemployment in 1985 somewhat. However, programmes to provide employment for young people should be expanded so as to give them easier access to the labour market from which they are often debarred by inadequate vocational training.

Progress has been made in achieving a healthier public finance situation: the size of the public sector has been reduced markedly between 1982 and 1985 and the general government net cash deficit was cut from 10 to 8 % of net national income. In the same period the burden of taxes and social security contributions was reduced by some 1 % of net national income. The reduction of the deficit is not only due to the major effort in controlling expenditure, partly nullified, moreover, by overshoots on social security costs and debt interest charges but it stems also from the rise in natural gas revenue. The marked drop forecast in gas revenue from 1986 is likely to make it even more difficult to trim the budget deficit. So even by making the savings provided for by the government agreement, there is limited room in the draft 1986 budget for any further appreciable reduction in the borrowing requirement, although, care should be taken to bring the general government cash deficit down to under 8 % of net national income in 1986. Nevertheless, a temporary slowdown in the rate of reducing the general government borrowing requirement, is in present circumstances advisable in order to avoid the necessity of deliberate increase in the tax burden or the introduction of additional measures which might hamper the recovery of corporate investment and private consumption. Faster growth stemming from the improved investment and export performance appears to be a necessary condition to create the financial room for manoeuvre so that purchasing power of the private households could be increased, notably by reducing social security contributions or direct taxes, without in the long run jeopardizing the desirable stabilization of the rapidly increasing debt interest charges. This could provide a solution to the external surplus dilemma which cannot be solved in the present circumstances by simply relaxing the management of public finance.

TABLE 19

The Netherlands: Main economic aggregates 1961 to 1986

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply (M2) (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,6	5,2	5,2	4,1	10,6	0,0	−0,8	9,1	1,0	1,2
1971 to 1980	10,8	2,9	7,7	7,8	10,7	1,3	−1,5	10,8	4,5	0,2
1981	4,8	−0,6	5,4	6,3	3,6	2,1	−5,5	5,3	8,8	−1,5
1982	4,5	−1,8	6,5	5,3	5,6	2,8	−7,1	7,6	11,7	−2,5
1983	2,5	0,6	1,9	2,8	3,4	2,9	−6,5	10,5	14,0	−2,0
1984 (1)	4,3	1,7	2,6	2,6	0,6	4,1	−6,3	7,7	14,2	−0,5
1985 (2)	4,5	2,1	2,3	2,4	1,4	4,5	−5,9	8,0	13,2	0,4
1986 (2)	3,0	2,0	1,0	1,1	2,5	4,5	−6,5	6,5	13,0	0,6

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) End of the year.
(4) Eurostat concept.

UNITED KINGDOM

The upturn in the United Kingdom economy, which started in 1981, has lasted longer and been somewhat stronger than in the rest of the Community. Economic expansion has been accompanied since early 1983 by a rise in employment, but this has not been sufficient to allow any decline in the number of unemployed. The annual inflation rate appeared to have stabilized at around 5 % in 1983 and 1984, but inflation performance was threatened at the beginning of 1985 by a steep depreciation in the sterling exchange rate (caused mainly by worries about the miners' strike, about oil prices and about the Government's resolve to contain public spending and borrowing). The authorities reacted by raising interest rates sharply and by reaffirming a tight budgetary stance. Sterling subsequently strengthened, and the outlook for inflation over the next year is now improved. The higher sterling exchange rate, however, especially against other European currencies, together with unit wage costs rising noticeably faster in the United Kingdom than in the main competitor countries, has led to a deterioration in the international competitiveness of UK manufacturers, worsening prospects for exports in 1986. This factor contributes to the slower growth in real GDP expected for 1986, when the pattern of growth is likely to be strongly weighted towards private consumption.

A rise in real GDP of almost 3,5 % is likely to be recorded for 1985, but adjusted for the distortions caused by the coal strike, which ended in March of this year, the growth rate is between 2,5 % and 3 %. Fuel imports have fallen back since the end of the strike and other imports have also grown at a slower rate than in 1984, while exports have gained a market share in buoyant world trade, so that the external balance has contributed strongly to GDP growth. While real disposable incomes have been growing fairly fast, as a result of a sustained increase in average earnings and boosted by tax cuts in the March 1985 Budget and the recovery of miners' earnings, growth of private consumption has been moderated by a higher saving ratio probably induced by somewhat faster inflation and higher interest rates. In spite of continued strength in investment by the enterprise sector (particularly in the first quarter, as some expenditure was brought forward to take advantage of tax arrangements), lower capital expenditure by the public sector and for residential purposes is likely to result in the slowest expansion of total fixed investment since the 1980 to 1981 recession. Employment has continued to rise. Until recently, this led only to a slowing in the increase of unemployment because many of those entering new jobs were not previously recorded as unemployed, but since the summer the level of unemployment appears to have stopped rising.

In 1986 there is likely to be a significant shift in the pattern of demand from net exports towards private consumption. With average earnings in nominal terms likely to continue rising appreciably (by some 7 %), the slowing expected in consumer prices, mainly as a result of weak import prices following the appreciation this year of the sterling exchange rate, will boost real household incomes and, together with a possible fall in the saving ratio, will lead to faster growth of private consumers' expenditure in real terms. This could be further reinforced by a cut in personal taxation, as the outlook for the public finances suggests that, on the basis of the lastest version of the medium-term financial strategy (MTFS), there will be some room for easing of taxation or increase in public expenditure ('fiscal adjustment'). Stronger consumer demand is likely to be offset, however, by weak public consumption and slower growth of exports resulting from the loss of competitiveness. Overall real GDP growth is expected to slow to a rate of about 2 %. There may be some slight improvement in the outlook for the unemployment count, particularly in view of measures already announced in the 1985 Budget to extend youth training and community work for the long-term unemployed.

Budgetary policy is aiming to bring general government expenditure and the public sector borrowing requirement (PSBR) back on to declining paths in relation to GDP, after the overshooting in 1984/85 mainly caused by the extra costs associated with the miners' strike. There are certain risks to the MTFS objectives in the form of upward pressure on spending from public sector pay awards and from increases in social security benefits and of a possible shortfall on revenue associated with North Sea oil output. These risks appear at present, however, to be largely covered for the current and next financial years by the contingency reserves, the level of which was increased in the 1985 Budget. On balance it is still expected that the official projection for the PSBR of £ 7 500 million in 1986/87 will allow some room for a fiscal adjustment to be introduced in the Budget next spring, though the size of this adjustment is uncertain and could be below the latest official estimate of £ 3 500 million.

In view of the emerging weaker export and investment trends, which may well be prolonged, particularly if expansion of the world economy slows down, there is a danger that slower growth could persist in the United Kingdom for two or three years, making any significant reduction of unemployment unlikely. In these circumstances, any margin of manoeuvre for supporting the economy via fiscal and interest rate policy should be fully used. In this respect it is important to note that the overall budgetary and public debt position of the United Kingdom now appears to be comparatively robust. However, the extent to which fiscal policy can be used to strengthen activity depends also on inflation performance. The acceleration of retail prices in the early months of this year was a temporary movement, resulting from a weakening of the exchange rate and the associated rise of interest rates, and has since been clearly reversed. Although the outlook is for an improved inflation performance in 1986, helped by falling import prices, domestic cost pressures are such that, in the absence of wage moderation bringing the increase in average earnings down from its present rate of 7 to 8 %, it will be difficult to bring the annual inflation rate below 5 % (the average rate since 1983) on a lasting basis.

In using the available room for manoeuvre afforded for fiscal policy, priority should be given to those measures which are most beneficial to the supply side of the economy and the creation of employment. The main emphasis of the present government in respect of fiscal changes has been to lower the burden of personal income tax in order to increase incentives to work and for enterprise. While reflecting a long-term approach, this may already be in part responsible for the increase in employment since 1983, much of which has been accounted for by people newly entering or re-entering the labour force. A further easing of income tax would be welcome, particularly if it were again used to raise substantially the tax threshold, since the provisions of the tax and social security systems still combine in some circumstances to set high effective marginal tax rates for those on low incomes. It is to be hoped that such anomalies will be eliminated in the reform of the social security system which is under discussion. Proposals for wide-ranging reform, published in a Green Paper in June this year, emphasized the need to integrate the different social benefits and to concentrate benefits on those most in need.

In 1986, when private consumption is in any case likely to be growing at a rapid rate (3 to 4%), it would as usual be appropriate to consider other ways, in addition to income tax reduction, of using the fiscal room for manoeuvre. For instance, there would also be direct benefits to employment and inflation from reducing the cost of employment to enterprises, by lowering social contributions. There is also increasing evidence to support the argument that some of the room for manoeuvre should be used to finance public sector infrastructure investment, some of which is relatively labour-intensive. The state of some of the infrastructure was described earlier this year in a series of reports submitted by government departments for discussion in the framework of the National Economic Development Council. In view of these apparent deficiencies the situation should be carefully reviewed when spending plans are reformulated.

Monetary developments over the last year have been a source of some concern. The various indicators of monetary conditions, in particular the monetary aggregates and the exchange rate have often provided divergent information. In January, at a time when monetary growth was largely satisfactory, the sterling exchange rate came under considerable pressure and bank base rates which had fallen to below 10% in late 1984 were raised to 14%. In recent months, however, despite high (nominal and real) interest rates, the rate of growth of the broad measure of money supply, sterling M 3, has been well above the 5 to 9% target range for 1985/86 set out in the latest MTFS. Since March interest rates have declined slightly, but it is to be hoped that further reductions consistent with the maintenance of monetary conditions conducive to less inflation can be achieved.

In spite of the downward movement in interest rates during 1985, differentials with other countries have remained high and movements in sterling have at times been volatile. Within a period of 12 months from July 1984, the composite sterling exchange rate index first fell by more than 10% and subsequently appreciated by more than 15%. Such movements can have undesirable effects on prices and resource allocation and generate uncertainties. In both the previous and current financial years, this has been particularly evident with respect to the level of tax revenue linked to oil output, which depends upon both the dollar price of oil and the sterling-dollar exchange rate. Such experience illustrates the potential benefits of avoiding exchange rate overshooting that might be gained from full participation in the EMS. Given the greater convergence now existing in the economic policies of member countries, such a step should be given renewed consideration.

1985 and 1986 are thought to be the years of peak output of North Sea oil and gas, this sector accounting for some 6 to 7% of total GDP and more than 20% of visible exports. Even though the decline of oil output will occur at a much slower pace than its expansion (ten years ago, output was negligible), the economy will have to adapt to this important change. The most direct impact on economic policy may be with respect to tax revenue associated with oil, which is estimated to account for 9% of general government receipts in the present financial year. Official projections indicate that this share will be roughly halved by 1988/89. The decline of the oil surplus in the balance of payments will also need to be offset by improvements in other areas. The continuing strengthening of the invisible account will contribute towards this, but any further worsening of the non-oil trade account (which has moved from small surplus in 1981 to sizeable deficit in 1985, estimated at almost 3% of GDP) could lead to considerable imbalance. It is therefore essential that the performance of the non-oil economy, which has been growing since the recovery began in 1981 by less than 2,5% per annum on average, should strengthen.

The series of supply-side measures taken in recent years, such as the changes relating to personal taxation have, together with the improved growth performance, contributed to the substantial increase in the employed labour force (by more than 600 000, or almost 3%, from the first quarter of 1983 to the first quarter of 1985). Further measures with regard to the labour market are being prepared. It is to be hoped that, if employment growth can be maintained, jobs will be filled increasingly from the pool of unemployed and to a lesser extent than has so far been the case from new entrants to the labour force. The substantial productivity gains of the early 1980's have now slowed down, leading to an acceleration of unit labour costs, which is weakening the international competitive position of enterprises and threatening to reverse the improving trend of company profitability. In order to sustain the growth of investment and thus expand the capacity of the economy (particularly as the role of oil declines), and hence potential employment, a further shift in relative factor remuneration towards returns on capital is needed. In consequence, the growth of real wages, which for several years has been notably stronger than in other Member States, now needs to become much slower. Indeed, a better understanding between both sides of industry on this and other matters and better functioning of the labour market would greatly facilitate the implementation of an overall strategy conducive to a significant reduction on unemployment in the medium term.

TABLE 20

United Kingdom: Main economic aggregates 1961 to 1986

	GDP current prices (3)	GDP real terms (3)	GDP deflator	Private consumption deflator	Compensation per employee	Current balance	General government net lending or borrowing	Money supply (4)	Unemployment in labour force (5)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	7,1	2,8	4,2	3,9	7,1	0,0	– 0,6	5,9	1,9	0,2
1971 to 1980	16,2	1,9	14,0	13,3	16,0	– 0,6	– 3,1	14,5	4,0	0,2
1981	10,4	– 1,1	11,7	11,2	13,5	2,7	– 3,1	14,6	9,2	– 3,9
1982	9,1	1,9	7,1	8,3	8,8	1,7	– 2,3	10,6	10,6	– 1,4
1983	8,6	3,3	5,1	5,1	8,8	1,1	– 3,6	10,3	11,6	– 0,8
1984	6,2	1,8	4,4	5,1	5,5	0,3	– 3,8	9,6	11,8	1,5
1985 (1)	9,1	3,4	5,5	5,3	7,7	1,1	– 3,3	11,3	12,0	1,1
1986 (2)	7,0	2,0	4,8	4,3	7,1	0,9	– 2,8	8,6	11,7	0,9

(1) Estimates of the Commission services, October 1985.
(2) Forecast of the Commission services, October 1985, on the basis of present policies.
(3) Expenditure measure at market prices.
(4) Sterling M 3, end of the year.
(5) Eurostat definition.