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Report

Progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market

(Article 109e, 2(b) of the Treaty on European Union)

(presented by the Commission)

REPORT ON PROGRESS IN ECONOMIC AND MONETARYCONVERGENCE AND WITH THE IMPLEMENTATION OF COMMUNITY LAW REGARDING THE INTERNAL MARKET

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REPORT ON PROGRESS IN ECONOMIC AND MONETARYCONVERGENCE AND WITH OF THE IMPLEMENTATION OF COMMUNITY LAW REGARDING THE INTERNAL MARKET

SUMMARY

Achieving a high degree of convergence is a precondition for moving to the final stage of economic and monetary union (EMU) as defined in the Treaty on European Union which entered into force on 1 November 1993. The second stage of EMU will start on 1 January 1994. The move to stage two is not conditional on any particular achievements on convergence, neither economic nor institutional. However, the current state of play regarding economic and monetary convergence must be assessed in order to have a view of the progress made during stage one. The Treaty requires the Council to make such an assessment, based on a report presented by the Commission (article 109 e 2 (b)); moreover, the Treaty requires the assessment to cover also the progress made with the implementation of Community law concerning the internal market. The attached report is intended to fulfil these Treaty requirements.

Progress in economic and monetary convergence during stage one of EMU which started on 1st July 1990 was mixed: while on the inflation front there were positive developments, the same cannot be said about public finances. As regards real convergence, the progress achieved in improving supply conditions, namely through the implementation of the internal market programme has been obscured by the sharp rise in unemployment and the stalling of the catching-up process in the Community.

These developments in convergence must be seen against the background of a much worse than expected economic situation. Indeed, following a marked deceleration of economic activity since the early nineties the European Community entered into recession in mid 1992 (i.e. in the middle of stage one). The European Monetary System (EMS), which is the cornerstone of monetary integration, was not immune to these developments and the period of high turbulence in the exchange rate markets which started in the Summer of 1992 culminated in the significant widening of the fluctuation margins one year later; in between, two major currencies suspended their participation in the system and several realignments of parities took place. Finally, the recessionary context and the rise in unemployment made more evident some structural weaknesses still prevailing in the Community.

In spite of these adverse developments, which are in marked contrast with the expectations prevailing at the beginning of stage one, Member States have remained committed to the convergence process and to the necessary structural reform. Convergence programmes have been adopted by most Member States and, in general, projected measures were implemented at least on the scale initially envisaged as necessary. Reforms geared to the removal of structural rigidities affecting their national economies were taken by all Member States, in welcome contrast with the past when they were frequently postponed. On the institutional front, the process of central bank

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independence has progressed clearly ahead of the Treaty requirements. Meanwhile, the completion of the internal market, which is the most ambitious structural reform at Community level, has been largely achieved. It is therefore fair to say that although economic developments during stage one partly veil the results of the convergence efforts made by Member States, much was achieved in the structural and institutional fields. These achievements, although less visible, will provide strong support to a sound construction of EMU.

Visible progress was achieved in inflation performance during stage one, both as regards the level and the degree of convergence. The inflation rates in 1993 in seven Member States are estimated to be within the limits to be aimed for according to the Treaty, which is of the order of 3 - 4% this year. Of these Member States, six have shown a remarkable regularity during the period (Belgium, Denmark, France, Ireland, Luxembourg and the Netherlands), while the United Kingdom has entered the reference range for the first time this year. As regards the remaining Member States, the somewhat poorer performance of Germany in the recent period has been mainly due to the special circumstances of unification; in Spain and Italy inflation has been decelerating and the 5% plateau has been broken this year; in Portugal inflation is now much closer to the reference range compared with the double digit inflation in the early nineties. Although progress has been achieved, inflation in Greece remains far above the Community average.

Member States' public finances deteriorated significantly during stage one of EMU. It appears that fiscal policy has had to play a major role in accommodating the recession either through the working of the automatic stabilizers or, in a few cases, as a result of a deliberately anti-cyclical budgetary stance. The deficit of the general government represented, for the Community as a whole, 6.4% of GDP in 1993, a figure clearly above that of the beginning of the decade. Although more than three quarters of this deterioration can be accounted for by cyclical factors, the current situation is hardly sustainable. Decisive action is necessary to reduce budgetary imbalances in the Community, supported by an adequate policy mix leading to steady and sustained economic growth; indeed, developments during stage one have shown that the convergence of budgetary positions to the benchmark values of the Treaty while recession persists is a very difficult task.

The deterioration of the budgetary situation has been generalised throughout the Community. In 1993, with the exception of Ireland and Luxembourg, no other Member State is expected to comply strictly with the deficit benchmark of 3% of GDP. The deterioration is most evident in Denmark, Germany, France and the United Kingdom (where the public deficits in percent of GDP in 1993 are estimated to reach 4.4%, 4.2%, 5.9% and 7.6%, respectively), given the low level of earlier deficits. Except for Germany, these countries took deliberate measures to mitigate the effects of the economic slowdown. In Spain, the widening of the deficit in 1993 to 7.2% of GDP more than offset the progress achieved in the previous year; a similar development occurred in Portugal. Some other Member States aiming at fiscal consolidation either remained on a gradual upward trend or achieved a stabilization in their government deficit, e.g. Italy. In the Netherlands, the deficit was brought down after 1990 and was kept at relatively low

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level (4.0% of GDP in 1993), while Ireland and Luxembourg stand as the Community Member States with the lowest deficits.

Having ocurred in a period of low, if not negative, real growth and of low or decelerating inflation, the widening of governments deficits has led to a rise in the public debt to GDP ratios throughout most of the Community. This situation is particularly worrying for those Member States where the public debt to GDP ratio is clearly above the 60% benchmark; the public debt to GDP ratio is now over 100% in three Member States and has not yet been stabilized, which must first be achieved before the required steady decline.

Progress was achieved as far as convergence in long term interest rates within the Community is concerned. Long term interest rates have declined since 1990 and the dispersion among Member States has narrowed; all but four Member States already satisfy the interest-rate criterion of the Treaty. This trend largely reflects the favourable development of inflation and illustrates the high level of financial integration achieved in the Community.

The stability of exchange rates within the exchange rate mechanism (ERM) of the European Monetary System came under increasing pressures from mid 1992 as uncertainties were created about progress towards EMU by the delays in the ratification of the Treaty on European Union. For several of the currencies which have been realigned or for which participation in the ERM has been suspended, this was a reflection of accumulated divergences in inflation and cost performance. More generally, the continuing pressures on other currencies and the decision in early August 1993 to widen the fluctuation margins to +/-15% resulted from the problems created by the high interest rates needed in Germany to cope with the effects of unification for other countries faced with recession. The cautious approach to interest-rate reductions that has been adopted since August indicates a desire to maintain a commitment within the Community to monetary cooperation based on stable exchange rates.

Although not spelled out in Article 109 of the Treaty, real convergence cannot be ignored. Achievements in this domain were disappointing given the sharp increase in the unemployment rate in the Community, from 8.3% in 1990 to 10.6% in 1993, which means a jobless total of about 17 million on average this year. In addition, the process of catching up, which made significant progress during the late eighties stalled with the current recession. However, supply conditions have improved in the Community through the implementation of structural reforms; in addition, the profitability of investment, which is important to cope with the challenge of unemployment, does not seem to have been damaged overmuch by the current cyclical downswing.

Progress in implementation of Community Law regarding the Internal Market:

The legislative framework for an Internal Market, as defined in the Commission's White Paper of 1985, is now almost fully in place. 95% of the checklist of White Paper legislation has now been adopted, and is in the process of being implemented by the EC

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institutions and Member States. This accomplishment is all the more impressive as the measures which require the greatest adjustment on the part of the Member States - the switchover to the"transitional" VAT regime, the abolition of capital controls, the freedom to provide banking and insurance services throughout the EC, a framework for the liberalisation of public procurement in all sectors including the utility sectors, the liberalisation of air and road transport - have all been successfully negotiated and adopted. The legislative steps which have already been taken constitute the principal elements of the Internal Market framework, and will be sufficient to trigger the bulk of the procompetitive and resource allocation gains which will flow from internal market completion.

A handful of White Paper measures remain on the table, many of which would greatly facilitate the exercise of cross-border activities by economic operators. In particular, progress on proposals relating to the introduction of a Community trade mark, the alleviation of double taxation problems, and the creation of a European Company Statute are eagerly awaited by the business community. The Community must also look beyond the White Paper to areas where additional trade barriers have been identified. As regards the abolition of frontier controls on the free movement of persons, the recent Schengen Ministerial meeting fixed February 1, 1994 as the target date for the removal of these controls. Another area for further action includes sectors where the granting of exclusive rights at national level has precluded cross-border competition. The Commission has now tabled proposals or launched discussion on possible forms of liberalisation in voice telephony, energy, and postal services. Internal market completion in these sectors has progressed at varying speeds and with varying degrees of success.

On the whole, the back of the legislative work has been broken. The task of the Community is now to ensure that the legal openings stemming from this legal framework are now effectively translated into commercial opportunities. The first and most crucial stage of this process will be to ensure that Internal Market enabling legislation is properly transposed in all Member States. At this stage, 86% of necessary transposition measures have now been taken, and there is continual improvement on this front. Member States have been less diligent in transposing Internal Market legislation in the fields of company law, public procurement, and financial services, possibly because these measures entered into force at a later date and transposition was accorded a lower priority.

However, the task of making the Internal Market work does not stop at monitoring the rate of transposition. The Commission is currently elaborating its Strategic Programme for the Internal Market, which is designed to maximise the benefits of the Internal Market framework for consumers, citizens, and enterprises. This involves coherent action on a number of fronts. In particular, the Community must now devote increased attention and resources to the following themes:

- monitoring the quality, as well as the rate of transposition, and improving the transparency of national transposition measures:

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- ensuring the quality of enforcement by setting up necessary channels for administrative cooperation, and developing new instruments for monitoring enforcement:

- preventing the emergence of new barriers to trade through stringent application of competition policy safeguards, and the reinforcement of early-warning systems for the detection and prevention of new regulatory or administrative trade barriers:

- enforcement can also be improved by imposition of sanctions on recalcitrant Member States:

- empowering businesses and consumers to defend their rights within the Internal Market by improving access to justice, and ensuring an even interpretation and application of EC law:

- ongoing monitoring and evaluation of Internal Market legislation and its impact with a view to upgrading its performance.

In addition, the Community must look at ways of improving the interaction between Internal Market measures and other Community policies which can make a contribution to the improved functioning of the single market - notably, policies to assist SMEs, standardisation, conformity assessment, competition policy, environmental policy, and the common commercial policy.

Internal Market enabling legislation, whose impact will be amplified by the Strategic Programme, creates a legal and administrative environment in which economic operators can develop their activities on a pan-European scale. It allows them to exploit market opportunities or tap resources in other Member States. At this stage, economic operators are beginning to witness some of the concrete benefits of a single market. For instance,

- Border controls and formalities on cross-border shipments of goods are now a thing of the past.

- Technical harmonising legislation which was adopted at an early stage of the Internal Market programme is eroding technical trade barriers in sectors such as toys, medico-surgical equipment, and pressure vessels.

- The removal of controls on capital movements has contributed in no small measure to the increased integration of some Member States into international capital markets. This in turn has facilitated cross-border investment and eased credit shortages in those Member States.

Although the advantages of internal market integration are beginning to filter through, it would be premature to undertake a global assessment of the Internal Market at this stage. For a start, much Internal Market legislation has yet to enter into force, or to be transposed into national legislation. Secondly, complementary actions to capitalise fully on the potential of the single market must be implemented in parallel with the legislative framework (e.g, Trans-European Networks, the development of European standardisation, etc). Last but by no means least, economic operators must become acclimatised to the new legislative environment and learn how to turn legal developments into commercial opportunities. This learning process may take some time, and the current recession has reduced the scope and willingness on the part of companies to undertake adventurous cross-border expansion.

Nevertheless, there are some preliminary indications that anticipation effects unleashed by the the Internal Market programme have been the catalyst for a revitalisation of corporate strategies and a shake-up of market structures in many industrial and services sectors. Many companies have responded proactively to the emerging Internal Market and this has been reflected in the following trends:

- a surge in intra-EC foreign direct investment which has been heavily concentrated in those sectors most directly concerned by internal market liberalisation:

- the wave of cross-border mergers and acquisitions which has formed part of the increase in intra-Community FDI:

- increased interest on the part of third country investors in locating in the Community:

- indications that the Internal Market has been accompanied by profound changes in the degree of market integration in banking and insurance markets.

- marked evolution in the proportion of output from particular sectors which is sold on other Community markets, and an increasing share of national consumption which is met by intra-Community imports.

These trends suggest an increasing Europeanisation of companies sales strategies and increased competitive discipline on domestic incumbents in the markets concerned. The impact of the Internal Market on business dynamics and market structures will be examined in greater detail in the study which is to be finalised by the Commission before the end of 1996. This study will also analyse the contribution of the Internal Market to the realisation of other Community objectives, such as economic and social cohesion and the achievement of sustainable non-inflationary growth which respects the environment.

The Internal Market programme is not being constructed in an economic vacuum. The current recession, which has been provoked by forces unrelated to the completion of the Internal Market, has overshadowed the process of adaptation to the emerging single market framework. The depressed state of EC markets obscures the potential market openings created by the Internal Market. In addition, many, particularly small and medium sized, companies do not have the resources or are wary of positioning themselves in order to take advantage of opportunities which lie around the corner. However, there are reasons to believe that the restructuring and investment undertaken during the late 1980s in anticipation of the internal market have strengthened the underlying competitiveness of Community industry and services. These latent strengths

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will provide individual companies with a springboard once economic recovery gets underway. In addition, the Internal Market has acted as a brake on any temptation on the part of Member States to renationalise certain elements of economic, monetary or commercial policy. Any misguided return to "go-it -alone" policies would have proved counterproductive for economic operators and the Member States concerned.

The recent widening of margins for exchange rate fluctuation contains some potential dangers for the operation of the single market, should these new exchange rate arrangements not be managed carefully. In particular, the increased scope for exchange rate fluctuations could disrupt the operation of capital markets, while sudden changes in relative competitiveness provoked by nominal exchange rate fluctuations could generate demands for safeguard restrictions on cross-border trade. To this extent, a return to greater exchange rate stability represents a precondition for the proper functioning of the Internal Market. Conversely, the Internal Market programme can promote structural and microeconomic convergence which is needed to sustain further progress towards Economic and Monetary Union.

PART ONE

PROGRESS IN ECONOMIC AND MONETARY CONVERGENCE

1. Introduction

The first stage of economic and monetary union (EMU) started on 1 July 1990. During this stage, the idea of economic convergence is embedded in the multilateral surveillance procedure (Council decision 90/141/EEC of 12.3.1990 on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union, OJ, L-78, 24.3.1990). This report is intended to fulfil the requirement of the Treaty on European Union (Article 109e, 2(b)) according to which, before the beginning of the second stage of economic and monetary union on 1 January 1994,

"The Council shall, on the basis of a report from the Commission, assess the progress made with regard to economic and monetary convergence, in particular with regard to price stability and sound public finances, and the progress made with the implementation of Community law concerning the internal market".

Part I of this report deals with the progress made in economic and monetary convergence. It covers aspects of nominal convergence, real convergence and convergence in supply conditions. Part II of the report focuses on progress with the implementation of Community law concerning the internal market.

Convergence is a wide and dynamic issue. Achieving a large degree of nominal convergence is the precondition for a smooth working of a stability-oriented monetary policy. Price stability is one of the main objectives of economic and monetary policy in the Treaty on European Union. A low inflation level is the basic target of monetary policy, while sound public finances contribute to achieving that goal. In countries where disinflation and fiscal consolidation must be achieved simultaneously, the need to avoid serious repercussions on employment will focus attention on complementary labour market policies. While achieving convergence in inflation and fiscal positions mainly depends upon the economic framework in an individual Member State, the stability of other variables, e.g. interest and exchange rates, depends also upon market perceptions of economic policies.

On the macroeconomic side the Treaty on Economic Union spells out nominal convergence requirements, but real convergence cannot be ignored. The Treaty lists four convergence criteria (Article 109 j and a separate protocol to the Treaty) to which the Member States[1)] should make progress. Although Member States are not obliged to fulfil these criteria during the first stage of EMU, they clearly act as reference targets to which Member States should converge. This report, therefore, takes these criteria as

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1) Denmark and the United Kingdom have opt-out clauses concerning the move to the third stage.

benchmarks, recognizing that approaching these targets (rather than achieving them) is the primary task of the first stage and should be continued during the second stage.

As regards real convergence, the Treaty is less precise although an important part is devoted to strengthening economic and social cohesion, which is one of the objectives of the Union (Article B of Treaty commom provisions).

Although achieving real convergence is primarily the responsibility of the Member States, many Community policies are aimed at facilitating this process[2)]. Therefore, the present report not only looks at the progress in relation to the formally stated nominal convergence criteria but also reviews the achievements in real convergence. It examines both progress in the catching-up of standards of living between Member States and divergencies in unemployment.

Convergence of supply conditions is dealt with from two perspectives. The Community dimension mainly concerns the economic aspects of the implementation of the internal market. An analysis of the progress achieved in this domain is provided in part II of this report; the internationalization of Member States' enterprises is visible in trade integration, mergers and acquisitions, and direct investment activities. At Member State level, structural reform to improve the supply side is a primary goal. Labour market reform, and measures to foster private investment and aiming at greater competition are major elements of such a strategy.

From an institutional point of view the Treaty states that Member States should start, if necessary, the process leading to central bank independence. The final section of part I of the report reviews the progress achieved in this area.

2. ACHIEVEMENTS IN CONVERGENCE: MACROECONOMIC ASPECTS

2.1 Major economic events and the current economic situation

Stage I of EMU was characterized by major economic events. The implications of German unification not only determined economic developments in that country, but also had important repercussions on the Community economy as a whole during the period under consideration. While the initial effects were favourable for Europe, the adopted policy mix triggered restrictive effects later on. Spain and the United Kingdom joined the exchange rate mechanism (ERM) in June 1989 and October 1990, respectively. Both countries were facing special challenges. In Spain the catching-up process required adequate responses in policies, while in the United Kingdom the policy assignment had to

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2) Article 130b of the Treaty on European Union states that,

"... *The Community shall also support the achievement of these objectives* (strengthening of economic and social cohesion) *by the action it takes through the structural Funds (European Agricultural Guidance and Guarantee Fund-Guidance Section; European Social Fund; European Regional Development Fund), the European Investment Bank and the other existing financial instruments*".

be altered as monetary policy was no longer available for short-term anti-cyclical stabilization purposes. Portugal subsequently joined the ERM in April 1992. The Danish "No" in June 1992, the uncertainties surrounding the outcome of the French referendum, the political process of ratification in the United Kingdom and the challenging of the Treaty on European Union before the German Supreme Court delayed the ratification process.

As explained in detail in section 2.2.5 below the exchange rate mechanism (ERM) of the European Monetary System (EMS) went through a period of marked instability from mid-1992, during which several realignments of parities took place and the United Kingdom and Italy suspended their participation in the ERM system. In August 1993 the fluctuations margins were widened markedly.

Nevertheless, during stage I, Member States remained committed to the convergence process. Convergence programmes have been adopted by most of the Member States; so far the Council has discussed and endorsed convergence programmes of nine Member States (by order of presentation: Italy, Portugal, Ireland, Germany, the Netherlands, Spain, Belgium, Greece and the United Kingdom), mainly devoted to achieving fiscal consolidation. Moreover, monetary policy was geared to the goal of achieving and preserving a high degree of price stability. Although progress in convergence was achieved in some areas, economic developments veiled some of the convergence results in other areas.

Indeed, the Community economy is faced with important challenges. The current deep recession has led to falling levels of output, rapidly rising unemployment and widening budget deficits. One positive element is the continuation of favourable inflation trends in most Community countries. Trends in consumer and investor confidence, although no longer falling, do not suggest a significant recovery in the short term. Therefore, during the last two years, the unfavourable economic climate has been hampering visible achievements in convergence, and this may well continue through 1994.

The environment within which economic policies were conducted has become more difficult during stage I of EMU. While the overall monetary stance within the Community has remained relatively tight given the extent of the slowdown in economic activity, fiscal policy has responded by either letting the automatic stabilizers work or even - in some countries - by discretionary fiscal loosening. It appears that fiscal policy has had to play the bigger role in accommodating the recession. Countries which entered the period of economic slowdown with still high budget deficits were faced with even greater difficulties in pursuing consolidation. Since 1992, high headline inflation rates and strong monetary growth in Germany have implied a strategy of caution in interest rate policy, while the economic fundamentals of the other countries would have suggested a more aggressive easing in domestic monetary conditions. The recurrent tensions on the foreign exchange markets were due both to unsound nominal exchange rate fundamentals in some countries and to inconsistencies within the policy mix adopted during a severe recession by other countries.

In this climate of unbalanced policy mixes, recession and rising unemployment certain structural weaknesses within the Community have become more evident and results in terms of convergence have been mixed. While inflation has declined almost everywhere in the Community, particularly in those countries whose inflation rates have been most divergent, budgetary outturns have worsened significantly.

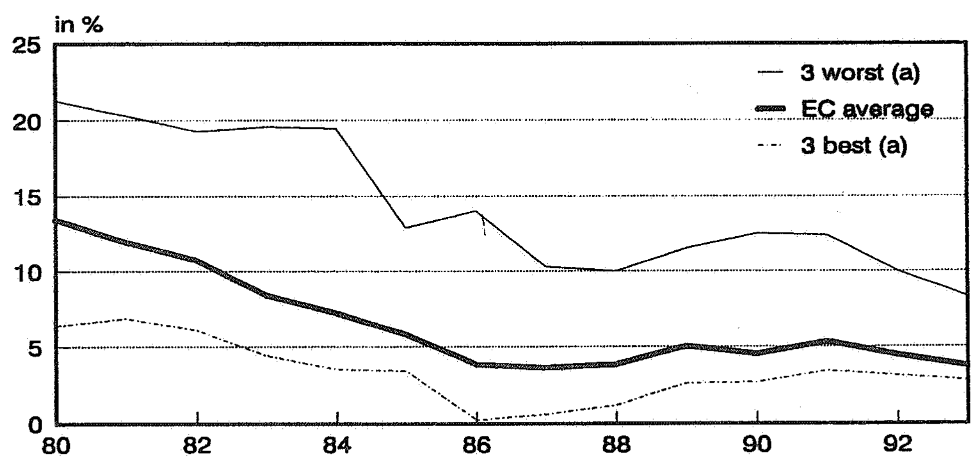
2.2 Nominal convergence: achievements and challenges

2.2.1 Inflation

In the Community, it is now recognized that a low rate of inflation is the prerequisite for sound medium-term growth as it contributes to an efficient allocation of resources. Moreover, in the perspective of constructing EMU, convergence in inflation rates of the Member States is needed in order to avoid losses in competitiveness if exchange rates are moving towards a fixed regime. Substantial price differentials, in the tradeable goods sector implying a "competitiveness gap" between Member States, would either create higher regional unemployment - as cross-border labour mobility remains comparatively low in Europe - or require a painful downward wage and price adjustment. However, within a monetary union, some differences in inflation rates can exist without detrimental effects. Assuming that the inflation rates of the three best performing countries are close to each other, the Maastricht inflation criterion (see below) envisages inflation differences comparable to those broadly prevailing in existing monetary unions (1 to 2%).

A considerable improvement in convergence among Member States was one of the encouraging features of economic developments in the Community during the second half of the 1980s. In particular, there was considerable progress in convergence of inflation rates towards a low level. Graph 1 shows that the average rate of inflation

Graph 1: Inflation,1980-93



(a) Unweighted average of the 3 worst/best performing countries

Source: Commission services, economic forecast (Autumn 1993)

declined from above 12% in the early 1980s to slightly above 3% in 1986, a year influenced by the fall in oil prices. There was then a modest acceleration until 1991 but inflation has abated again in the last two years. Moreover, the dispersion between the high inflation countries and the low inflation countries has been declining considerably.

The Treaty on European Union contains a definition of the convergence requirements regarding inflation for stage III of EMU[3]. In recent years, a number of Member States have had an impressive performance in terms of low inflation. As shown in table 1, seven Member States were below the upper value of the reference range in 1993.

Table 1: Inflation performance of Member States 1990-93

	Inflation (deflator of private consumption) % change p.a.				p.m.: consumer price index % change over 12 months
	1990	**1991**	**1992**	**1993**	
B	3.1	2.9°	2.4°	2.8	2.7(Oct.)
DK	2.6°	2.5°	1.9°	1.4°	1.2(Sept.)
WD (a)	2.8	3.8	4.0	3.6	3.9(Oct.)
D (a)	-	-	4.7	4.3	-
GR	19.7	18.4	14.9	13.7	12.3(Oct.)
E	6.4	6.2	6.4	4.7	4.3(Sept.)
F	2.9	3.0	2.4°	2.3°	2.3(Sept.)
IRL	1.6°	2.3°	2.6	2.3	1.4(Q3;b)
I	5.2	6.9	5.4	4.4	4.3(Oct.)
L	3.6	2.9	2.8	3.6	3.5(Oct.)
NL	2.2°	3.4	3.0	2.1°	1.9(Oct.)
P	12.6	11.1	9.7	6.7	6.0(Sept.)
UK	5.3	7.2	4.7	3.4	1.8(Sept.;b)
EUR- (a)	4.5	5.3	4.4	3.7	3.4(Sept.)
EUR+ (a)	-	-	4.6	3.8	-
Reference range	3.1 - 4.1	3.8 - 4.4	3.4 - 3.9	2.9 - 3.8	

Source: *Commission services, economic forecast (Autumn 1993)*

° *The three best performing Member States in inflation; the reference range has been calculated by assuming that either the best performing country or the third best performing country determines the reference range.*

(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany

(b) *Excluding the housing component the figures are: 2.2%.(IRL) and 3.6% (UK)*

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3) Price convergence is defined in the Treaty on European Union in relative rather than absolute terms. It shall mean that a Member State has a price performance that is sustainable and an average rate of inflation over a period of one year before moving to stage III does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States (article 109j,1 and article 1 of the Protocol on the convergence criteria referred to in article 109j).

The Treaty requires convergence in the consumer price index (CPI) on a comparable basis taking account of differences in national definitions. In order to ensure comparability the analysis here is made in terms of the national accounts deflator of private consumption.

There is a remarkable regularity in those countries which experienced a low rate of inflation during the period under review. Belgium, Denmark, Ireland, France, Luxembourg and the Netherlands have been within the range throughout the first stage of EMU. Germany's somewhat poorer performance since 1992 is mainly due to the special circumstances of unification. The United Kingdom which was well above the reference range in 1991, especially, has since seen a slowing in the inflation rate sufficient to be below the upper reference limit in 1993. As regards those countries which have not satisfied the criterion during the period, Spain, Italy and Portugal are moving in the right direction. It appears that up to now the depreciation of the currencies of these four countries in 1992 and 1993 against other Community currencies has not interrupted the process of disinflation although import prices contributed temporarily to inflation. Given the extent of the currency adjustment involved, this is a very encouraging feature which needs to be maintained. Although progress has been achieved, inflation in Greece remains far above the Community average.

Reducing inflation rates or maintaining an already satisfactory inflation performance has been one of the central objectives of the convergence programmes. The progress achieved has so far been broadly in line with the indicative targets set in the programmes although in Germany headline inflation is coming down more slowly than projected. Some of the programmes have placed considerable emphasis on the need to reform wage-setting procedures and other aspects of the labour market and to increase competition in product and services markets in order to restrain inflation, and some advances have been made (e.g. abolition of wage indexation and new wage-setting system in Italy). Other countries have been orientating their wage settlements toward improving external competitiveness (e.g. Denmark, France) through a strategy of low wage cost increases. More recently the moves towards central bank independence in some countries have tended to increase the credibility of stability oriented policies with favourable effects on actual wage settlements and long-term interest rates. In the United Kingdom, the impact of a deep recession in reducing the core inflation rate has been significantly enhanced by the successful labour market reforms of the 1980s.

Inflation convergence towards a low level has made even more progress with regard to tradeable goods and services. Export prices have been very flat and below 2% on average for the Community as a whole during the 1990-93 period. The greater competition already achieved in these sectors has contributed to price discipline. Similar developments can be expected if competition is increased in other sectors through the realization of the Single Market, in particular in services like transportation, insurance and financial services. In some Member States, e.g. in the catching-up countries, structural changes may to a certain extent explain relatively high inflation. While high productivity growth in manufacturing is maintaining competitiveness in the tradeable sectors, relatively high wage increases have had spill-over effects on non-tradeables where productivity growth was lower, leading to a relatively high domestic-basket inflation rate.

While the effects of stronger competition and structural changes are difficult to measure, a more traditional analysis of factors which have contributed to inflation during the 1990-93 period suggests a favourable impact from import prices in the early part of the period. In addition to their direct price-stabilising impact (see Box 1) import prices reduced input costs at the producer level which prevented profit margins from falling more significantly in the tradeable sector. In the period 1992-93 the effects of import prices were less uniform. It appears that those countries which continued to belong to the ERM core were able to import price stability while those countries which devalued in 1992 and 1993 were experiencing an upward contribution of import prices to inflation. However, there are hopes that these will prove to be once for-all effects.

After a fairly high contribution of unit labour costs to inflation in some countries (Greece, Spain, Italy, Portugal, the United Kingdom) in 1990, almost all countries are now experiencing a lower contribution from this source. Lower nominal wage increases due to the recession but also the attempts of many countries to improve productivity through structural reform are the main elements behind this feature, which is encouraging as far as inflation prospects beyond 1993 are concerned.

Increases in indirect taxes played a relatively important role as a determinant of headline inflation in a number of countries in the early 1990s. In Germany higher indirect taxes were one important means to cope with the fiscal challenges of unification, while other Member States increased indirect taxes to make progress in fiscal consolidation.

Box 1: Contributions to inflation

This box provides a mechanical assessment of the factors which have contributed to the change of the deflator of final uses (the national accounts index measuring the prices of final domestic demand and exports in aggregate). The table disentangles the domestic components into unit labour costs, net indirect taxes and the gross operating surplus. As regards the latter, an increase in profit margins would be indicated by a high contribution of the gross operating surplus. The table does not provide information about causalities. For example, profit margins might rise because of either a decline in other contributing factors, e.g. lower unit labour costs, or demand-induced inflation enabling enterprises to increase prices. Moreover, only the direct impact of import prices is considered while lower import prices for material inputs are reflected in a larger gross operating surplus.

A direct link to the implicit deflator of private consumption or the consumer price index (CPI) cannot be easily made. For example, the effects of indirect taxes on the private consumption deflator might be larger as various demand components (investment, exports) are exempted from various indirect taxes.

The data do not necessarily add up as it is mechanically impossible to differentiate between volume and price effects as far as the contribution of import prices is concerned. Therefore, information about the determinants of inflation can only be taken as a crude guide of the transmission mechanisms of inflation.

(Box 1 cont.)

Contribution to the change in the final uses deflator (b)
% points per year

	Import prices				Nominal unit labour costs			
	1990	1991	1992	1993	1990	1991	1992	1993
B	-0.5	-0.1	-0.5	1.3	1.9	1.8	1.8	1.8
DK	-0.4	0.3	-0.3	0.3	0.5	0.7	0.9	0.7
WD (a)	-0.1	0.4	-0.3	-0.1	1.0	1.9	2.2	1.7
D (a)	-	-	-0.3	-0.1	-	-	-	-
GR	2.3	4.7	2.2	3.5	12.2	6.5	6.7	6.3
E	-0.2	-0.1	0.2	1.8	4.2	3.1	3.9	1.9
F	-0.3	0.0	-0.4	-0.4	-0.9	1.8	0.9	1.3
IRL	-1.5	0.9	-0.4	1.9	-0.1	0.8	0.5	1.6
I	0.1	0.0	0.3	1.9	5.2	4.5	2.1	1.0
L	0.0	0.6	-0.7	1.4	2.7	2.0	1.7	2.3
NL	-0.4	0.0	-0.6	0.0	0.6	1.5	1.6	1.2
P	2.0	0.4	-0.9	1.4	6.0	6.5	5.5	2.8
UK	0.5	-0.4	0.0	1.8	4.8	4.1	2.2	0.1
	Net indirect taxes				**Gross operating surplus**			
	1990	1991	1992	1993	1990	1991	1992	1993
B	0.1	0.0	0.5	0.2	-0.4	-0.2	0.2	-0.3
DK	-0.2	0.1	-0.3	0.5	1.7	1.1	0.9	-0.4
WD (a)	0.3	0.8	0.6	0.6	1.2	0.4	0.6	0.4
D (a)	-	-	0.8	0.5	-	-	-	-
GR	3.1	2.9	2.0	2.0	0.3	5.3	2.2	1.7
E	0.3	0.4	1.0	-0.7	1.6	2.2	0.4	2.0
F	0.4	0.0	-0.1	0.2	3.0	0.6	1.0	0.8
IRL	-1.5	-0.1	0.6	-0.2	0.5	-0.1	-0.4	0.4
I	1.1	1.0	0.4	0.3	0.1	0.7	1.4	2.0
L	0.1	0.5	0.3	0.2	-1.3	-1.0	0.3	-0.9
NL	0.3	0.1	0.7	-0.1	0.6	0.3	-0.6	0.0
P	1.3	1.1	1.9	-0.4	2.4	2.1	2.2	2.6
UK	-0.6	1.1	0.4	0.2	0.6	0.1	1.0	2.0

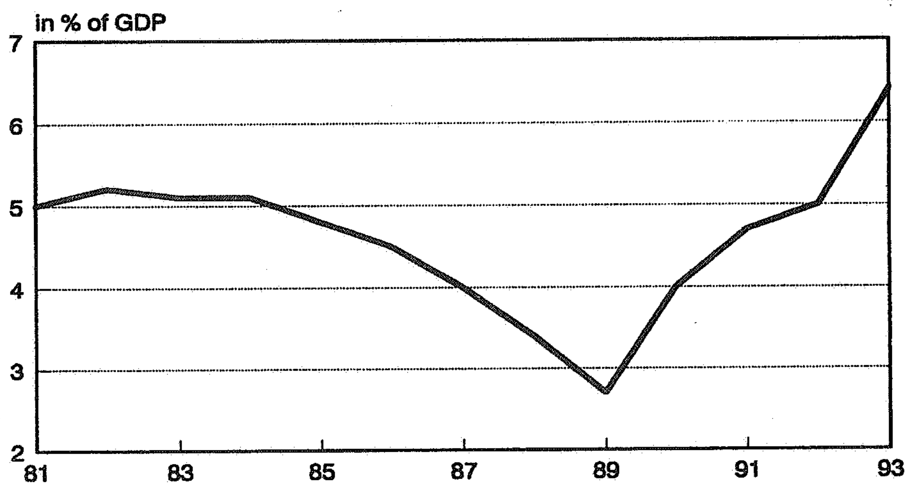
Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
(b) *The table contains mechanical calculations of the various factors contributing to final demand deflators. As regards the consumer price deflator the effects of indirect taxes might be larger as various demand components are exempted from e.g. VAT.*

2.2.2 Public finances

While the average government deficit[4] in the Community was almost halved during the 1980s (from above 5% of GDP in 1981 to less than 3% in 1989), the government deficit soared to more than 6% in 1993. Although some of this increase is due to cyclical factors, the speed of deterioration is very worrying indeed.

This rapid deterioration in the Community position is reflected in the performance of individual countries. Latest estimates for 1993 indicate that all Member States, except Greece, Italy and the Netherlands, will have higher deficits this year than in 1990. This trend deterioration is more especially evident in Denmark, Germany, France and the United Kingdom, given the low level of earlier deficits. Except for Germany, these countries took deliberate fiscal measures to mitigate the effects of the economic slowdown. In Spain, the widening of the deficit in 1993 more than offset the progress achieved in the previous year; a similar development occurred in Portugal, where, however, fiscal consolidation is more pressing. Some other Member States aiming at fiscal consolidation either remained at a gradual upward trend (Belgium) or achieved a stabilization in their government deficit, e.g. Italy despite the more unfavourable economic environment. In the Netherlands the deficit was brought down after 1990 and was kept at a relatively low level, while Ireland and Luxemburg stand as the Community Members where the deficit is the lowest.

Graph 2: Net borrowing of general government, EC, 1981-93



Source: Commission services, economic forecast (Autumn 1993)

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4) The definition used in this report for the government deficit (net borrowing of general government) largely conforms with the definition of the Treaty on European Union (article 104c of the Treaty and article 2 of the Protocol on the excessive deficit procedure). Full conformity with the Treaty requires complete harmonization of concepts which will be completed on the basis of the forthcoming secondary legislation.

In 1993 only Ireland and Luxemburg would comply strictly with the Treaty general government deficit reference value of 3% of GDP while in the early 1990s also Denmark, Germany, France and the United Kingdom had budget deficits below 3% of GDP[5]. In these countries, the expected deterioration in the public finance situation from the previous year is evident. While in Germany the combined effects of unification and the deepening recession are reflected in the public finances, Denmark and France have sought to reduce the effects of recession by a pro-active fiscal policy, an approach similar to that followed by the United Kingdom in 1992.

Table 2: Government net borrowing of Member States 1990-93

	General government net borrowing in % of GDP			
	1990	**1991**	**1992**	**1993**
B	5.8	6.6	6.9	7.4
DK	1.5	2.2	2.6	4.4
WD (a)	2.1	3.5	2.3	3.8
D (a)	-	3.2	2.6	4.2
GR	18.6	16.3	13.2	15.5
E	3.9	5.2	4.6	7.2
F	1.5	2.1	3.9	5.9
IRL	2.2	2.0	2.2	3.0
I	10.9	10.2	9.5	10.0
L	-3.3	1.0	2.5	2.5
NL	5.1	2.5	3.5	4.0
P	5.5	6.4	5.2	8.9(b)
UK	1.2	2.7	5.9	7.6
EUR- (a)	4.0	4.7	5.0	6.4
EUR+ (a)	-	4.6	5.0	6.4
Reference value	3.0	3.0	3.0	3.0

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *Latest budget estimates point to a figure of 8.3% of GDP.*

Establishing sound and sustainable public finances is a central goal of all the convergence programmes; all of them set medium-term targets for deficit reduction, generally aiming to respect the 3% of GDP deficit target by 1996 (see Box 2) and to stabilize the debt ratio and then put it on a declining trend. So far there has been a significant shortfall in

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5) The criteria of the government financial position is defined in the Treaty on European Union in absolute terms (art. 104 c para 2 and art. 2 of the Protocol on the excessive deficit procedure). The ratio of the planned or actual government deficit to gross domestic product should not exceed a reference value of 3% of GDP, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

The level of gross government debt must not exceed 60% of GDP or must be sufficiently diminishing and approaching the reference value at a satisfactory pace.

achieving the fiscal targets of the programmes (except for the United Kingdom whose convergence programme was presented relatively recently). For the most part these shortfalls are not due to an absence of adjustment effort; most of the governments have introduced successive budgetary adjustment packages at least on the scale of those initially envisaged as necessary. Instead, budgetary plans have been blown off-course by the unexpected growth slowdown, and in some cases by higher interest rates in 1992.

The pre-1993 convergence programmes were, in general, far too optimistic about growth prospects. By 1994 the level of GDP in Germany and Spain is likely to be about 8-9% lower than projected in those countries' convergence programmes, and cumulative shortfalls of over 6% are probable for Belgium, Italy and Portugal. These much weaker growth paths have inevitably meant lower tax revenues, rising expenditure shares and higher deficits through the working of the automatic stabilisers. These shortfalls increase the scale of the budgetary adjustment effort which has to be undertaken in the next few years.

Box 2: The public finance block of the convergence programmes

The table presented below allows a comparison between the targets of the convergence programmes with the performance realised in 1992 and 1993.

A comparison has to take into account that the convergence programmes have been submitted in a very different economic situation. In particular, the underlying assumptions of the convergence programmes have proved to be much too optimistic in view of the actual economic developements. Economic growth had to be revised downwards generally and real interest rates were higher than assumed in some cases. Nevertheless, the convergence programmes show the clear commitment of Member States to achieve medium term consolidation.

(Box 2 cont.)

Comparison of convergence programme (CP) projections of budget deficit and outturns for 1992 and 1993

	General government net borrowing (unless otherwise stated) in % of GDP					
Country	Date(a)	1992	1993	1994	1995	1996
Belgium						
CP	6/92	5.7	5.2	4.5	3.8	3.0
CP revised	4/93		5.8	4.7	3.6	3.0
Outturn	11/93	6.9	7.4			
Germany						
CP (b)	10/91	4.25	4.0	3.0		
Outturn (b)	6/93	3.8	5.25			
Outturn	11/93	2.6	4.2			
Greece						
CP	2/93	9.4	8.6	7.0	4.4	1.6(c)
Outturn	11/93	13.2	15.5			
Spain						
CP	4/92	4.0	3.5	2.7	1.8	1.0
Outturn	11/93	4.6	7.2			
Ireland						
CP	10/91					
Outturn	11/93	2.2	3.0			
Italy						
CP (d)	10/91	8.4	6.7	5.5		
CP revised (d)	9/92	10.2	9.3	7.3	4.7	
Outturn (d)	11/93	10.8	9.9			
Outturn	11/93	9.5	10.0			
Netherlands						
CP	4/92	3.5	2.9	2.4		
Outturn	11/93	3.5	4.0			
Portugal						
CP	10/91	4 (e)	3 (f)	3 (f)	3 (f)	
Outturn	11/93	5.2	8.9			
United Kingdom						
CP (g)	5/93	7.75	8.75	7.50	5.50	4.75 (h)
Outturn	11/93	5.9	7.6			

(a) Date when the convergence programme (or its revision) was submitted, and of latest Commission services estimate for the outturn (Autumn 1993).
(b) Public authorities financial deficit.
(c) The deficit is projected to decline to 0.8% of GDP in 1997 and 0.2% in 1998.
(d) State sector borrowing requirement.
(e) In the budget for 1992 and 1993 the official targets were set at 5.2% and 4.2% of GDP, respectively, which was claimed to be compatible, on an annualized basis, with the targets of the convergence programme for these years.
(f) Average deficit in the three years 1993 to 1995.
(g) Financial years ending in March of the following calendar year.
(h) The deficit is projected to decline to 4% of GDP in the 1997-98 financial year.

A need for further and in some cases intensified budgetary consolidation exists in almost every Community Member State. Appropriate measures to achieve fiscal consolidation are better implemented during a period of sound economic growth. During a cyclical downturn the question arises to what extent the automatic stabilizers should be allowed to work. Indeed, the deterioration in the fiscal position is also due to the economic cycle as table 3 shows.

Analysing the impact of the cycle on the budget balance is useful for understanding budgetary developments, particularly during periods of recession, but estimation of the cyclical component is subject to some uncertainties and the figures in the final column of table 3 should be interpreted as broad orders of magnitude rather than precise estimates.

Table 3: Cumulative changes of the general government deficits, 1990-93 (b)

	General government deficit	**Cumulative change 1990-93, in % of GDP**	
	in % of GDP 1993	**Change in actual deficit**	**Change in cyclical component**
B	7.4	1.6	2.7
DK	4.4	2.9	1.6
WD (a)	3.8	1.7	1.4
D (a)	4.2	-	-
GR	15.5	-3.1	0.4
E	7.2	3.3	2.7
F	5.9	4.4	2.2
IRL	3.0	0.8	1.7
I	10.0	-0.9	1.8
L	2.5	5.8	2.7
NL	4.0	-1.1	2.2
P	8.9	3.4	2.2
UK	7.6	6.4	3.3
EUR- (a)	6.4	2.4	2.2
EUR+ (a)	6.4	-	-

Source: *Commission services, economic forecast (Autumn 1993)*

(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany

(b) *The approach to calculate the cyclically-adjusted deficit consists of taking into account a reference path for GDP calculated by estimating a mean trend for GDP over the cycles. The change in the cyclical component measures the budgetary impact of changes in the output gap relative to trend and interest payments on public debt are not taken into account in the cyclical component.*

That a large part of the worsening in budget deficits has been induced by the recession should not be a reason for complacency. The distinction between actual and cyclically-adjusted deficits is made difficult by the fact that some cyclical factors could become structural (mainly through hysteresis phenomena in the labour market i.e. a downward rigidity in the unemployment rate) and that growing interest-rate payments tend to increase the consolidation needs in terms of non-interest expenditure.

The developments in primary balances (i.e. budgetary balances excluding interest payments) provide evidence on the determination of governments to reduce their deficits. Most Member States with large budgetary disequilibria actually have primary surpluses, clearly indicating that measures have been taken to consolidate in those areas where room for manoeuvre exists.

Table 4: Primary balance of Member States for 1990-93

	Primary balance (b) in % of GDP				p.m.: interest payments in % of GDP
	1990	1991	1992	1993	1993
B	5.2	3.9	4.3	3.7	11.1
DK	5.8	5.1	4.2	3.1	7.5
WD (a)	0.6	-0.7	0.8	-0.6	3.2
D (a)	:	-0.5	0.7	-0.8	3.5
GR	-6.7	-3.5	0.4	-0.5	15.0
E	-0.4	-1.2	-0.4	-2.2	5.0
F	1.4	1.0	-0.5	-2.2	3.7
IRL	5.7	5.6	4.9	4.2	7.3
I	-1.3	0.0	1.9	2.0	12.0
L	3.9	-0.4	-1.9	-1.7	0.8
NL	0.9	3.6	2.7	2.3	6.3
P	2.7	2.0	3.8	-1.3	7.6
UK	2.2	0.3	-3.0	-4.5	3.1
EUR- (a)	0.8	0.4	0.4	-0.8	5.6
EUR+ (a)	-	0.4	0.4	-0.9	5.6

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *General government balance excluding interest payments (surplus +, deficit -)*

Such efforts have been particularly marked in Italy where the primary balance has improved by 3.3 percentage points of GDP in the period 1990-93. In Greece, the primary deficit has been significantly reduced. Although the primary surplus is decreasing, it remains significant in Belgium, Denmark, Ireland and the Netherlands. Portugal too has been able to keep the primary balance in surplus until 1992. Conversely, in Spain, France and the United Kingdom primary deficits have widened. All in all, given continued commitment to fiscal consolidation there are grounds to believe that government deficits will be size-ably reduced once the current recession is overcome and if interest rates continue to fall.

Nevertheless, in general the primary surpluses have not been enough to reduce or stabilize the government debt level (see below). In particular the combination of a high level of government debt and high interest rates has led to increasing interest payments, which exceed 10% of GDP in a number of countries. Even some countries with a relatively moderate debt level are now confronted by an historically high level of interest payments (Denmark, Portugal and to a lesser extent Spain and the Netherlands).

Although government debt levels and thus the interest burden have in the long run mainly to be reduced by operating on the primary surplus, the need to achieve sustainable budgetary positions through significant primary surpluses is an economically, socially and politically difficult challenge. A high primary surplus could worsen the structure of expenditures, in particular if public investment is reduced, or could create social strains and lead to unwarranted income distribution effects. In any case, the need for a high primary surplus to ensure debt sustainability implies a greater vulnerability in the public finances to domestic and external shocks. Reducing the interest burden through lowering the stock of debt and lower long-term interest rates are also important for successfully achieving medium-term fiscal consolidation.

Table 5: Gross general government debt of Member States 1990-93

	Gross general government debt in % of GDP			
	1990	**1991**	**1992**	**1993**
B	128.3	129.5	131.9	138.4
DK	66.4	71.7	73.4	78.5
WD (a)	43.7	-	-	-
D (a)	-	41.9	44.7	50.2
GR	95.3	100.9	106.7	113.6
E	44.5	45.5	48.8	55.6
F	35.4	35.5	39.2	44.9
IRL	96.1	95.9	91.6	92.9
I	97.8	101.4	108.0	115.8
L	7.0	6.2	7.3	10.0
NL	78.8	79.0	79.7	83.1
P	68.4	67.4	63.5	69.5
UK	39.6	41.0	47.3	53.2
EUR- (a)	57.2	-	-	-
EUR+ (a)	-	58.0	61.7	66.4
Reference value	60.0	60.0	60.0	60.0

Source: *Commission services, based on figures presented by Member States*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany

Notes:
Belgium: *Consolidated central and local government debt; social security debt not included.*
Denmark: *Central government short-term liabilities not included; general government not consolidated*
Germany: *Gross consolidated general government debt at nominal value*
Greece: *General government not consolidated; Central bank's direct advances not included.*
Spain: *General government not consolidated.*
France: *Gross consolidated general government debt, excluding trade credits and accounts payable and receivable, at nominal value*
Ireland: *Central government (Exchequer)*
Italy: *Gross consolidated general government debt at nominal value.*
Luxembourg: *Social security debt not included; general government debt not consolidated.*
Netherlands: *Gross consolidated general government debt at nominal value.*
Portugal: *Central government and certain autonomous funds; debt of social security and local authorities not included.*
United Kingdom: *Valuation of debt at market prices.*

The developments in government debt levels mainly reflect past behaviour of public finances, real growth, and inflation. Five Member States (Germany, Spain, France, Luxembourg, and the United Kingdom) have had a gross government debt-to-GDP ratio below 60% throughout stage I. However, in all of these countries the debt ratio is now deteriorating. Ireland and Portugal made considerable progress in reducing their debt ratio until 1992. Denmark has reduced its debt ratio considerably in the 1980s, but a rising trend emerged in the 1990s. In Belgium, Greece and Italy the government debt to GDP ratio debt is again rising fast and stands at a very high level (above 100% of GDP).

Gross general government debt figures presented in Table 5 are not yet in most cases in full accordance with the definitional requirements laid down in Article 2 of the Protocol on the excessive deficit procedure annexed to the Treaty on European Union, nor with the detailed definition of debt laid down in the forthcoming Council regulation on the application of the provisions of the above mentioned Protocol.

For Table 5, the Commission services chose among the gross debt series available in the Member States the definition which they view as the closest to the Treaty definition. Therefore the figures in table 5 are only indicative and cannot be formally retained as benchmarks for comparison with the reference value of the Treaty's criterion on public debt[6)].

2.2.3 Balance of current account

Although different in nature from the explicit convergence variables dealt with in the Treaty, current account developments remain important indicators of the economic performance of a country. However, in integrating economies like in the European Community the interpretation of current account developments is becoming more difficult, in particular the financing aspects of current account imbalances lose most of their significance in the presence of fully liberalized capital movements. Rather then aiming at current account equilibrium as a target of economic policy the issue is the appropriateness of the external position within the overall economic performance of a particular economy.

In any individual Member State, the balance on the current account reflects conditions in the real economy. If unemployment is relatively high or productivity is relatively low, policies to improve the productive potential of the economy could be associated with the emergence of a current account deficit, as capital flows in from abroad to take up provitable investment opportunities. In such a case, the deficit would be a positive development as imported capital is used to temporarily alleviate the constraint imposed on the level of domestic investment by the level of national savings. As activity level in the domestic economy increases, the deficit would be expected to be self-correcting.

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6) With the coming into force of the second stage towards EMU on 1 January 1994, Member States will produce government debt data which meet the detailed definition of the Council regulation and will report them to the Commission with specific information, like the financing of public enterprises through issuance of government debt.

In a similar vein, the emergence of a current account surplus need not necessarily reflect positive supply conditions in a Member State economy. If the profitability of domestic investment opportunities is perceived to be relatively low, capital may flow out of the economy in search of higher returns abroad, resulting in reduced levels of domestic activity and the emergence of a current account surplus.

Graph 3: Balance of current transactions, EC, 1980-93

Source: Commission services, economic forecast (Autumn 1993)

While these considerations have increased in their importance now that progress has been achieved in liberalizing capital movements, traditional factors explaining current account trends still remain important too. Important changes in competitiveness at both the world level and between Community Member States have influenced trade flows and the public sector has been (partly) offsetting the saving-investment behaviour of the private sector by an anti-cyclical behaviour.

The current account balance of the Community was in deficit in the aftermath of the second oil price shock. However, the deficit of around 1% of GDP in 1980 was transformed into a surplus of above 1% of GDP in 1986. There were both external and domestic reasons for such a turnaround. As regards the external environment, the policy choice taken by the USA, which stimulated Community exports via a depreciation against the dollar, the fall in oil prices and the relatively high growth abroad must be singled out. Domestically, demand was subdued in the Community, mainly because of the efforts to consolidate public finances (e.g. in Germany) and the need to improve financial conditions in the private sector (e.g. in France at the enterprise level).

The year of 1986 marked a turning point in current account at the Community level. Starting in the United Kingdom and Denmark (1984) investment activities improved substantially in Spain and France in 1985/86, followed by all other Member States until

Table 6: Balance on current transactions of Member States 1990-93

	Balance on current transactions in % of GDP			
	1990	1991	1992	1993
B	0.9	1.7	1.8	1.3
DK	0.5	1.4	3.0	2.8
WD (a)	3.6	1.4	1.6	0.4
D (a)	-	-0.6	-1.3	-1.2
GR	-6.1	-5.1	-4.4	-3.7
E	-3.7	-3.8	-3.7	-2.7
F	-0.9	-0.5	0.2	0.6
IRL	-0.7	2.0	3.6	3.4(b)
I	-1.4	-1.8	-2.1	0.1
L	34.3	28.0	27.5	25.2
NL	3.8	3.6	3.2	3.0
P(c)	-2.5	-2.9	-2.1	-2.1
UK	-4.2	-1.8	-2.3	-2.9
EUR- (a)	-0.4	-0.5	-0.3	-0.2
EUR+ (a)	-	-1.1	-1.1	-0.4

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *In national accounts definition the figure for 1993 is equivalent to 5.1% of GDP.*
(c) *Break in the series 1991-92: - 1991: national accounts figures*
from 1992 onwards: balance of payments

the end of the decade. The decline in the current account surplus was thus a reflection of private sector optimism and of a high rate of growth and job creation and therefore no reason of concern. The swing in private sector saving was even greater than reflected in the current account balance as the net borrowing of general government narrowed substantially (by more than 2% of GDP) in that period.

Although current account developments are not uniform across Member States during the period 1990 to 1993, some common features can be identified. A rising current account surplus emerged in those countries where domestic demand was particularly depressed and unemployment rising e.g. Belgium, Denmark, France and Ireland. Nevertheless, until 1992 competitiveness was improving gradually in these countries due to the positive development of domestic costs. The relatively large current account deficits prevailing in Spain, Portugal and the United Kingdom were partly due to the real appreciation of their currencies during the phase of economic upswing; in these countries the current account deficit was also reduced temporarily because of depressed private sector demand. More recently some of those Member States which depreciated substantially relative to other Community countries show some reduction in the current account deficit (Spain, Italy).

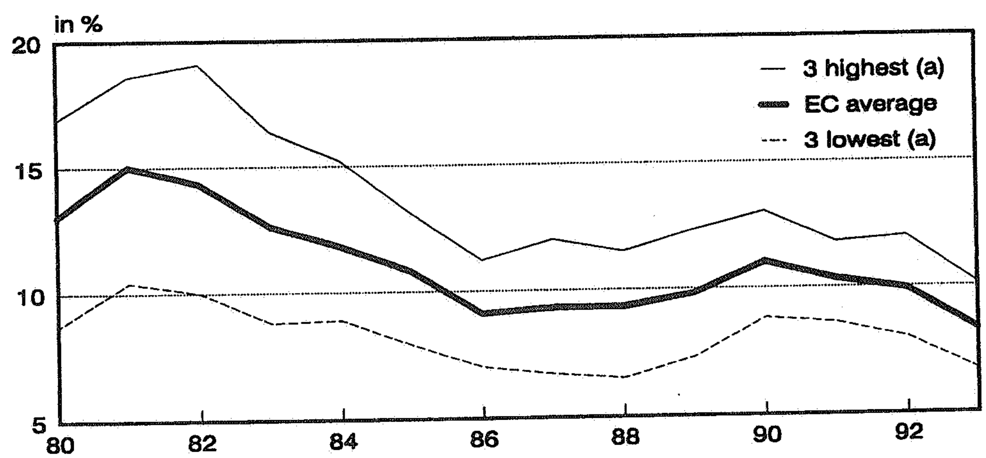
The most significant change in the current account balance has occurred in Germany as a consequence of unification. The large drop observed in the aftermath of unification was a reflection of the large gap between demand and supply in Germany at that time. While the East German production potential became largely obsolete, reducing supply, demand was stimulated by large transfers and rapid wage increases. However, the persistence of a current account deficit of around 1% of GDP during the recent recession is no longer explainable only by the shock of unification. The deterioration in competitiveness and continued weak foreign demand are becoming more dominant factors.

All in all, current account developments during the 1990s highlight some less positive developments. Firstly, current account deficits went hand in hand with a substantial decline in investment activities throughout the Community and, more recently, also of private consumption. Secondly, while private sector saving is increasing, deficits in the public sector are growing rapidly. Thirdly, competitiveness of the Community economy appears to be much less promising, than was the case in the second half of the 1980s. The present current account situation of the Community as a whole may thus be an indicator of low growth prospects and further rising unemployment. The need for policies geared to improve competitiveness, in particular through structural reform, is evident.

2.2.4 Long-term interest rates

In line with progress in reducing inflation, the Community average long-term interest rate fell from an exceptionally high level of 15% in 1981 to about 9% in 1988. A tightening of monetary policy, coupled with financial markets unease at inflationary prospects in post-unification Germany and temporary fears of world capital shortage, resulted in a reversal of this favourable trend in 1988. Since 1990, however, there has been another general easing in long-term interest rates so that the Community average is currently about 8% which mainly reflects a decline in inflation expectations.

Graph 4: Long term interest rates, 1980-93



(a) Unweighted average of the 3 countries with the highest (lowest) rates;
GR and P are excluded because of missing data

Source: Commission services, economic forecast (Autumn 1993)

Table 7: Interest rate performance of Member States 1990-93

	Long-term interest rate (b)				Benchmark government bonds 10 years (9/93)
	1990	1991	1992	1993	
B	10.1	9.3°	8.6°	7.3	7.1
DK	11.0°	10.1°	10.1°	8.9°	6.8°
WD (a)	8.9	8.6	8.0	6.3	6.1
D (a)	-	8.6	8.0	6.3	6.1
GR	-	-	-	-	-
E	14.7	12.4	12.2	10.2	9.1
F	9.9	9.0	8.6°	6.8°	6.1°
IRL	10.1°	9.2°	9.1	7.7	-
I	13.4	13.0	13.7	11.3	9.5
L	8.6	8.2	7.9	6.9	-
NL	9.0°	8.9	8.1	6.7°	6.0°
P	16.8	17.1	15.0	12.4	10.0
UK	11.1	9.9	9.1	7.9	6.9
EUR- (a)	11.0	10.3	9.9	8.1	-
EUR+ (a)	:	10.2	9.9	8.1	-
Reference range	11.0 - 13.0	11.2 -12.1	10.6 -12.1	8.7 - 10.9	

Source: *Commission services, economic forecast (Autumn 1993)*

° *The three best performing Member States in inflation are used to calculate the reference range by assuming that of these three, the countries with the lowest and highest long-term interest rate determine the reference range.*

(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany

(b) *A comparison between countries is not easily possible as the respective definitions are different:*
B : Central government bonds (over 5 years - secondary market)
DK : State and mortgage bonds
D : Public sector bonds outstanding (monthly averages)
GR : Central government bonds
E : Central government bonds at 2 years and over (since 01.88)
F : Central government bonds: 7 to 10 years
IRL : Central government bonds: 15 years
I : Public sector bonds outstanding (since 01.92)
NL : Yield of 5 state bonds with the longest maturity (monthly average) (since 01.85)
P : Bonds over 5 years (weighted average of public and private)
UK : Bonds 20 years (end-of-month)
EUR : Average of 12 countries using GDP weights

The trend in long-term interest rates has been characterized by a general decline in levels across the Community and a significant convergence among Member States. Convergence in long-term interest rates has been due mainly to a successful disinflation process in several Member States and illustrates the high degree of financial integration achieved in the Community as a result of the single market programme. Convergence is being achieved at a relatively low level of long rates reflecting moderate inflationary expectations to which the prospect of a period of slow growth is also contributing.

Assessment of convergence in long-term interest rates in the precise terms of the Treaty requirements[7] is currently hampered by the lack of homogeneity in the reported interest

7) The reference value on the convergence of interest rates referred in the Treaty (article 109j of the Treaty and article 4 of the protocol on the convergence criteria) means that the criterion is satisfied if a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long term government bonds or comparable securities, taking into account differences in national definitions.

rates as displayed in table 7. Interest rates on benchmark 10 years government bonds are also included in the table; however, in some Member States the market for these bonds is still very thin or virtually non-existent. With this caveat in mind, the table shows, based on the long-term interest rate in the three best-performing Member States in terms of inflation in 1993 (Denmark, France and the Netherlands) a reference range of 8.7 to 10.9%. Most other countries have long rates below the upper limit of the reference range.

The evolution in long-term interest rates has become less predictable as the ERM framework, which had contributed to a convergence in long rates, has been weakened (see next section). While the widened fluctuation margins persist exchange-rate discipline will no longer be assured by a known tight mechanism so that financial markets will determine the level and trend in longer-term interest rates by more direct reference to the counter-inflationary credibility of the policy mix (reflecting the inter-relationship between the inflation and public finance criteria) in each Member State.

The emergence of risk premia on long rates will only be avoided if Member States remain credibly committed to the achievement of nominal convergence and pursue monetary and fiscal policies consistent with these objectives.

2.2.5 Exchange-rate stability in the ERM

Since mid-1992, the EMS has experienced a series of crises which has fundamentally altered its operation as a framework for monetary-policy co-ordination in the Community. The source of difficulties in the EMS can be traced back to late 1980s. In this period, a growing political momentum towards economic and monetary integration transformed the EMS from a system of "fixed but adjustable" exchange-rate parities into a system with no realignments. The political commitment to unchanged EMS parities was facilitated in economic terms by a relatively high growth rate in the Community economy, which concealed the emergence of a cumulative divergence in economic performance among Member States. Inflation rates in some Member States remained higher than in others leading to an accumulated real appreciation of their currencies. In several Member States, serious budgetary imbalances were not tackled. Most importantly, however, the unification of Germany had resulted in an asymmetric demand shock to its domestic economy, setting in train a real appreciation of the DM; this, in turn, changed the impact of the DM as anchor currency in the EMS.

Initially, the Community had benefited from the increased export growth associated with higher German demand but strains began to emerge from mid-1991 when the Bundesbank gradually tightened monetary policy in response to an acceleration in the German inflation rate. As the DM the anchor currency - strengthened in response to tighter monetary conditions, the commitment to fixed exchange rates within the ERM forced other Member States to pursue a monetary policy which was too strict in relation to conditions in their domestic economy.

By this time, the demand boom of the late 1980s had petered out and economic activity was already slowing down across the Community. As economic conditions became more difficult, the consequence of the divergent economic performance among Member States was thrown into sharp relief. With growth already slipping below trend and, in some cases, budgetary imbalances deteriorating rapidly, financial markets began to question the ability of Member States to sustain the costs of maintaining exchange-rate stability through the pursuit of the tight monetary stance necessitated by inflationary pressures in Germany. The appreciation of the DM (and hence other ERM currencies) vis-à-vis the dollar as a consequence of widening short-term interest-rate differentials further added to the difficulties of many Member States.

In a period in which welcome progress was being made in the liberalization of capital movements, the increasing inconsistency between political aspirations to fixed exchange rates and underlying economic realities was potentially highly destabilizing. Free capital movement within the Community was an integral element of the Single Market programme and by 1990-1991 most Community countries had already eliminated controls on cross-border capital movements. Liberalized capital movements together with deregulation and innovation in financial markets (not only in the Community but in most industrialized countries), led to remarkable globalization of portfolio investments during the last decade. The increase in cross-border holdings, coupled with factors such as i) technological advances in dissemination of information ii) the introduction of new derivatives, iii) increased institutionalization of savings and iv) concentration of investment decisions in the hands of professional managers, has created the potential for huge and volatile capital flows between currencies if investors lose confidence in any given exchange rate. The efficiency of foreign exchange markets has undoubtedly been enhanced by capital liberalization but market participants have become much more powerful vis-à-vis central banks than was the case during the early years of the ERM.

In the context of liberalized capital markets, the mix of unchanged nominal exchange rates, inadequate economic convergence and difference in cyclical economic position set the scene for exchange-rate instability if economic policies underlying ERM parities are not seen to be consistent. Inconsistencies clearly existed but were ignored by financial markets so long as the EMU project - implying economic discipline on aspirant participants to ultimately validate their unchanged ERM parities by appropriate policy adjustments - remained unquestioned. Indeed, the pre-crisis period was characterized by capital inflows into high yielding currencies, such as the lira, sterling, peseta and escudo in so-called "convergence plays" using these currencies as profitable proxies for the DM. However, financial market fears in the face of these inconsistencies emerged strongly following the Danish rejection of the Maastricht Treaty on 2 June 1992 and the uncertainty created by the French decision to hold a referendum on the treaty in September. These events caused a major correction in the financial markets' expectations on EMU. In consequence, the markets began to question the wisdom of their portfolio positions in high-yielding currencies: the so-called "convergence plays" began to unwind as institutions sought to protect themselves against newly-perceived devaluation risks.

The ensuing period of eighteen months was characterized by repeated bouts of market pressure on ERM currencies as huge amounts of capital flowed between currencies, primarily into the DM. The severity of pressure resulted in a sequence of adjustments within the ERM, involving the withdrawal of two currencies from the system, five realignments involving four currencies and ultimately in early August 1993 the temporary widening of fluctuation margins to +/-15%.

The widening of ERM bands implies a major change of regime in monetary co-operation in the Community. A system of quasi-fixed exchange rates has been temporarily replaced by a system allowing, in principle, greater flexibility in exchange rate movements within wide bands. The weakening of exchange-rate discipline within the ERM represents a setback to the integration process within the Community as previously envisaged but, in the present circumstances, wider ERM bands are the most pragmatic response to the recurrent tensions on the foreign-exchange markets. The EMS remains in existence in a modified form, while speculative pressure on the ERM grid has been significantly eased. Despite the potential for differentiated monetary policies within the modified EMS, there has been no dramatic adjustment in the monetary stance in Member States since the beginning of August. The cautious approach to interest-rate reductions that has been adopted reflects a desire to maintain a commitment within the Community to monetary co-operation based on stable exchange rates. In consequence, exchange-rate movements within the ERM have been rather limited.

Any effort to re-establish narrow bands without improved economic convergence among Member States would almost certainly not be accepted by the financial markets and would incite renewed speculative attacks on the ERM grid. The experience of the recent crises has demonstrated that a necessary condition for exchange-rate stability is achieved by the pursuit of credible and consistent economic policies designed to foster economic convergence in conditions of economic growth , while focusing on the fundamentals of price stability and sound public finances.

2.3 Real convergence

2.3.1 Introduction

As regards real convergence this report distinguishes three aspects: (i) catching-up in real income i.e. the narrowing of differences in standards of living, (ii) unemployment performances and finally (iii) convergence in general supply performances.

The catching-up process made significant progress during the 1980s. Average income grew faster than the EC average in Spain, Ireland and Portugal, but not in Greece. However, the current recession is limiting the possibility of fast rising per capita income in the countries concerned. Nevertheless, as long as competitiveness is kept under control, these countries should be able to achieve a higher growth trend relative to Community partner countries.

The Community is still faced by large differences in unemployment levels. This not only concerns differences between Member States but also unacceptably large discrepancies existing within individual countries (e.g. in Germany, Greece, Spain and Italy). Reducing these differences is important in finding a socially acceptable balance as integration proceeds. Otherwise regional challenges will grow. Creating new jobs through investment is an essential means to reduce unemployment.

Following the liberalization of capital movements investment is now likely to take place in those areas where the expected rate of return is highest. Creating improved supply conditions through structural reform and establishing favourable and durable expectations for a competitive real rate of return are decisive to cope with the challenge of unemployment. The successful implementation of the internal market is contributing to the improvement of supply conditions within the Community. During the 1980s there has been an improving trend in profit margins. Even more encouraging is that in the current recession the deterioration in profitability has been relatively modest compared with earlier cyclical downswings.

2.3.2 Catching-up in real income

The achievement of real convergence is a central goal of Community policies. Just as with nominal convergence, achieving real convergence is the responsibility of each Member State. However Community policies, e.g. the structural Funds and the Cohesion Fund, contribute importantly to this process.

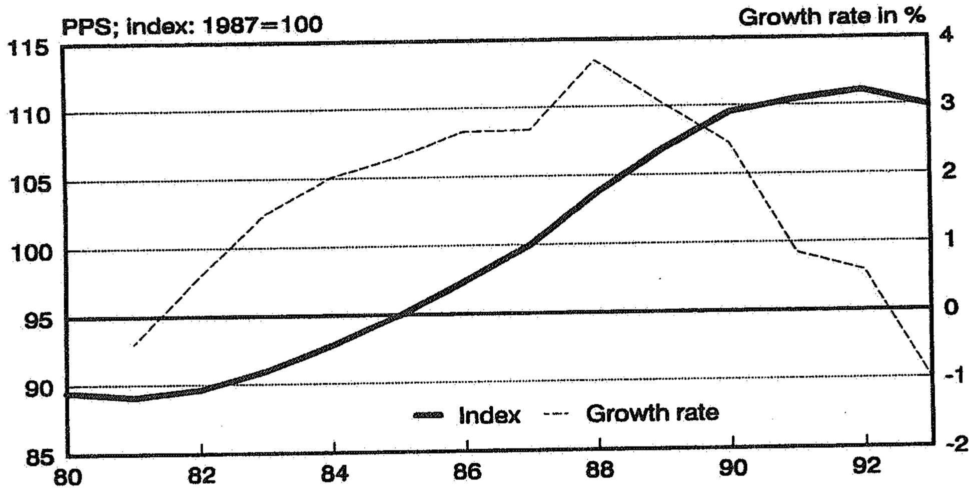
In a strict sense real convergence means the narrowing in the differencies in standards of living across regions. As the mobility of labour is expected to remain limited during the European integration process, it is equally important that large differences in unemployment between countries are avoided.

During the 1980s the conditions for a successful catching-up process in the Community have improved. Greater integration improved the scope for division of labour so that each country could exploit more successfully its comparative advantages. The liberalization of capital movements further enhanced the conditions for catching-up as it alleviated the external constraint on financing investment. In the presence of favourable opportunities, both foreign and domestic investment have taken place on a large scale. In addition, greater macroeconomic stability contributed to attracting foreign investments to the catching-up Member States, e.g. Spain, Ireland and Portugal.

Nevertheless, catching-up does not depend only upon economic conditions in the country in question. In general, catching-up is facilitated in an environment of favourable growth in the Community as a whole or even worldwide. Since investment is the cyclically most volatile demand component, catching-up Member States might be most hit by recession as investment is cut back. Low demand might increase fears of over-capacity and initial expectations of a high rate of return might be reduced, increasing pessimism about economic prospects. Moreover, recession enhances the risk of slower economic integration if countries try to protect domestic sectors.

During the 1980s the standard of living in the European Community has increased remarkably. Real GDP per head was around 25% higher at the end of the decade compared with 1980. After modest growth at the beginning of the decade, the growth rate accelerated to 3% per year on average in the second half of the decade. The average growth rate in the EC (2.3%) during the 1980s was only marginally below that of the USA (2.5%) but considerably below the growth rate in Japan (4.2%).

Graph 5: Real GDP/head of population, EC, 1980-93



Source: Commission services, economic forecast (Autumn 1993)

Table 8 shows that there are still wide differences between Member States as far as GDP per head is concerned, measured in terms of purchasing power standards[8]. While a group of richer countries exceeds the Community average by about 10% (Denmark, France, Luxembourg), Greece only reaches 48% of the average income level. However, there has been an important boost to catching-up in Spain and Portugal since their accession to the Community in 1986. While in these countries GDP per head was only 70% and 51% of the Community average in 1985 respectively, in 1993 they stand at 78% and 62%. Ireland also went through a similarly successful catching-up process, narrowing the gap in income level from the Community average by more than 10 percentage points in the last decade. In contrast, Greece has fallen back by 3 percentage points over this period.

As regards the richer countries, France (in the second half of the 1980s) and the United Kingdom (in the first half of the 1980s) have improved their relative position in the Community, while Denmark (in the second half of the 1980s) and the Netherlands (over the whole period) have experienced a relative decline. Luxembourg was able to extend its top position, meanwhile Belgium and Italy remained slightly above the Community average. The relative position of Germany is strongly affected by unification. While the standard of living in West Germany was second highest in 1990, unified Germany is in 4th position, with an average income level only slightly higher than wider Community average.

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8) Purchasing power standards (PPS) allow a comparison of GDP per head because it takes into account the price level in each Member State and excludes short-term exchange rate fluctuations.

Table 8: GDP per head of population in Member States
(according to purchasing power standards)

	GDP per head of population Index: EUR- = 100					
	1980	1985	1990	1991	1992	1993
B	106.1	103.9	104.4	104.9	104.6	103.7
DK	105.6	113.6	106.2	107.4	107.8	108.6
WD (a)	118.7	119.1	117.3	119.8	119.5	117.0
D (a)	-	-	-	102.6	104.2	104.1
GR	52.2	51.0	47.3	47.4	47.3	47.5
E	71.6	70.1	75.1	77.6	77.6	77.6
F	113.6	112.5	110.7	110.8	111.0	110.6
IRL	62.2	63.8	71.3	72.6	75.1	77.0
I	102.3	102.1	102.3	102.9	103.1	103.6
L	115.3	119.8	126.6	127.5	128.7	129.8
NL	108.9	105.3	101.9	100.4	100.5	100.5
P	52.7	51.2	55.9	58.7	62.0	62.3
UK	97.5	101.0	101.3	95.5	94.2	96.7
EUR- (a)	100.0	100.0	100.0	100.0	100.0	100.0
EUR+ (a)	-	-	-	96.9	97.3	97.8

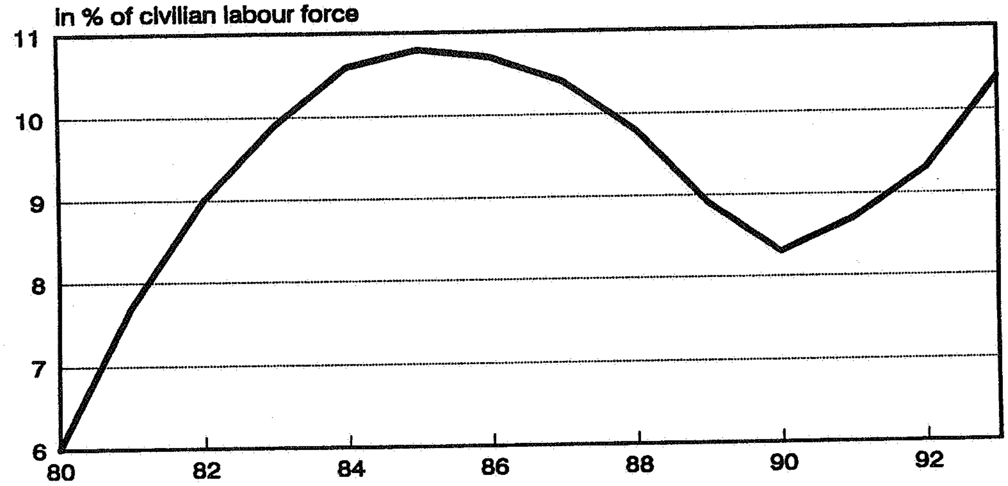
Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany

2.3.3 Unemployment

Reducing unemployment was a big challenge among European countries during the last decade. The following graph shows that unemployment in the Community rose steadily from 6% in 1980 to a peak level of 10.8% in 1985. During the second half of the 1980s unemployment fell, approximately to the level of 1982. All Member States made considerable progress in creating jobs in the second half of the 1980s. Employment growth even exceeded 3% per year for a few years in a row e.g. in Spain in 1987-90, Luxembourg in 1988-91, the United Kingdom in 1988-89 and to a somewhat lesser extent in West Germany after unification. For the Community as a whole employment grew by about 1.5% in the high growth years 1987-89. Employment growth was, however, relatively low or even negative in Denmark, Greece, Ireland and Portugal during the second half of the 1980s.

Although still higher than in the trough of the early 1980s, employment is now falling by more than 1½ % per year. Indeed, the early 1990s are witnessing a renewed and very significant deterioration in the labour market situation. Within three years (1991-93) the unemployment rate has risen by 3 percentage points, back to the peak level of the mid 1980s.

Graph 6: Unemployment rate, EC, 1980-93



Source: Commission services, economic forecast (Autumn 1993)

Table 9: Unemployment rates of Member States

	Unemployment rate (b) % of civilian labour force					
	1980	1985	1990	1991	1992	1993
B	7.4	11.8	7.6	7.5	8.2	9.5
DK	5.2	7.2	8.1	8.9	9.5	10.5
WD (a)	2.7	7.1	4.8	4.2	4.5	5.6
D (a)	-	-	-	5.1	5.9	6.8
GR	2.7	7.7	7.0	7.7	7.7	7.8
E	11.6	21.6	16.1	16.3	18.0	21.2
F	6.2	10.1	9.0	9.5	10.0	10.8
IRL	8.0	18.2	14.5	16.2	17.8	18.4
I	7.1	9.9	10.0	10.0	10.3	11.0
L	2.4	2.9	1.7	1.6	1.9	2.6
NL	6.4	10.5	7.5	7.0	6.7	8.2
P	7.6	8.8	4.6	4.1	4.7	5.2
UK	5.6	11.4	7.0	8.8	10.0	10.4
EUR- (a)	6.0	10.8	8.3	8.7	9.3	10.4
EUR+ (a)	-	-	-	8.8	9.5	10.6

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *EUROSTAT definition*

Although the levels of unemployment were very different, almost all Member States witnessed a similar profile in unemployment with a peak in 1985 and a declining trend thereafter. Some countries (Belgium, the Netherlands, Portugal and the United

Kingdom) achieved lower rates of unemployment at the end of the decade than at the beginning while unemployment was higher in Germany, Spain and France. Italy's unemploymenet rate was on a rising but contained trend over the last decade and was characterized by weaker cyclical fluctuations than most of the other Member States. Unemployment rates are extraordinarily high in Spain and Ireland.

Table 9 illustrates that large differences in rates of unemployment are prevailing at the beginning of the 1990s. Unemployment rates in 1993 are around 7-8% in Germany (unified), Greece, and the Netherlands but about 20% in Spain and Ireland. Belgium, Denmark, France, Italy and the United Kingdom have unemployment rates between 9 and 11%. In Portugal the unemployment rate has been increasing from 4.1% (1991) to 5.2% (1993).

2.4 Convergence in supply performance

2.4.1 Convergence of supply conditions matters

European economic integration, in particular when the internal market has been put in place, should go together with a high degree of convergence in supply performance between Community Member States. The co-existence of liberalised capital movements and continued limitations on mobility within the European labour market makes convergence in supply conditions even more important.

Differences in supply conditions among Member States, globally measured by the expected rate of return on physical capital, will influence private sector investment decisions. A region (country) in which the (expected) marginal real rate of return on capital is inferior to that of other regions would suffer. Investment and, therefore, job creation would take place elsewhere and the result would be regional unemployment.

As investment decisions depend upon expectations (i.e. what really matters is the expected real rate of return), it is important to establish a high degree of micro-economic credibility i.e. markets should be flexible enough to sustain a sufficient real rate of return. A lack of supply-side credibility in a given Member State would result in a micro-economic risk premium, which would require a real rate of return superior to that of other countries. The credibility of any micro-economic regime depends upon various factors among which the operation of the labour market, commitment to market openess and competition, the taxation system and infrastructural conditions are most important.

A detailed analysis of all these aspects is beyond the scope of this report. However, the link between macro-economic performance and the supply side is obvious. Structural reforms at the Member State level aimed at improving the functioning of markets and supported by the implementation of the internal market programme are a crucial element in this context. Market participants will have greater concerns about the sustainability of macro-economic and exchange-rate commitments if they doubt the ability of economies to respond flexibly to the type of disturbances that are likely to occur.

On a macro-economic level, wages, real unit labour costs and investment profitability are the important determinants of the supply side performance of a country, while micro-economic flexibility is difficult to measure empirically.

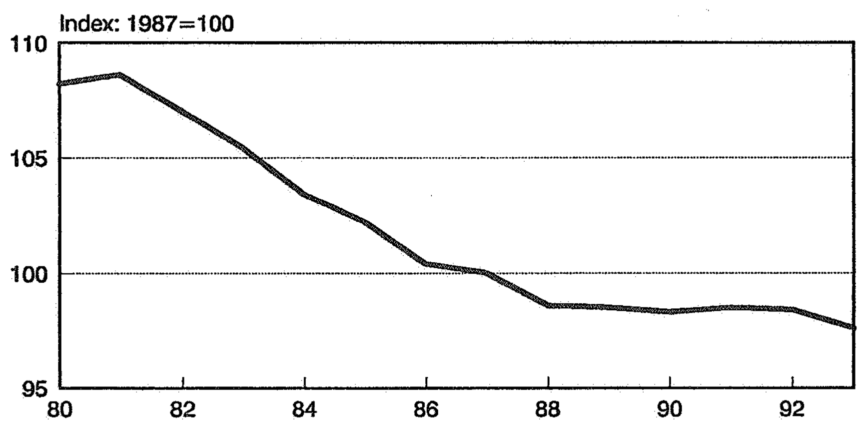
Wage developments have a pivotal role to play not only in the process of convergence and in sustaining macro-economic stability but also in revitalising an employment-creating growth trend in the Community at the present time. A certain degree of wage moderation has been experienced recently but continued moderation is warranted given the high and rising rate of unemployment.

An effective response to the latter problem necessitates a rise in the investment ratio in order to increase the Community's growth potential. A rise in investment is dependent on actions in a number of areas including measures to improve investment profitability. The latter can be ameliorated through an appropriate evolution of real unit labour costs which, in turn, is an amalgam of real wage and productivity developments.

Over the period 1982-1989 a strong adjustment took place in the overall macroeconomic evolution of wages in relation to productivity which contributed strongly to the improvement in the general environment for investment, employment and growth. Annual rates of growth in real compensation per employee, while still remaining positive, grew at moderate rates in relation to productivity. This pattern of real incomes growing at rates lower than that of productivitiy was consequently reflected in a continuous decline in real unit labour costs (RULCs) (see Box 3) over the period.

The decline in RULCs was the single most important factor in boosting the profitability of capital (i.e. the rate of return on fixed capital) which rose steadily in the 1980s from the low point reached in 1981 of less than 70% of the average of the, quasi full-

Graph 7: Real unit labour costs, EC (a,b) , 1980-93
total economy



(a) Real unit labour costs (i.e. the share of labour income in national income) are used as a proxy for profitability
(b) PPS weighted

Source: Commission services, economic forecast (Autumn 1993)

Table 10: Real unit labour costs of Member States
Total economy

	Real unit labour costs; total economy (b) Index: 1987=100					
	1980	1985	1990	1991	1992	1993
B	107.2	102.0	96.5	98.5	98.8	100.5
DK	106.1	97.6	96.8	95.9	95.8	96.2
WD (a)	104.7	100.0	95.9	95.9	96.1	96.2
D (a)	-	-	-	-	-	-
GR	97.2	107.6	102.8	95.7	94.0	92.8
E	113.7	103.0	98.0	97.2	98.2	98.0
F	107.5	104.3	96.8	97.5	97.1	96.9
IRL	113.4	102.2	97.5	98.5	98.5	99.4
I	103.4	103.1	100.3	101.0	100.1	98.1
L	105.7	96.7	99.4	102.0	102.2	105.2
NL	109.1	96.5	94.8	95.6	97.0	98.2
P	114.5	104.7	94.1	95.5	94.8	94.4
UK	105.3	100.7	105.4	106.6	106.4	103.6
EUR- (a,c)	107.7	102.0	98.3	98.5	98.4	97.6
EUR+ (a,c)	-	-	-	-	-	-

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *Nominal unit labour costs deflated by the GDP price deflator.*
(c) *PPS weighted*

employment, period 1961-73 to over 90% in 1990. In addition to the decline in RULCs, the improvement in profitability was assisted by a slight improvement in capital productivity which emanated essentially from a strong rise in capacity utilisation.

The overall improvement in profitability more than compensated for the higher real long-term interest rates prevailing in the 1980s, compared with the previous decade, and provided the basis for an upturn in gross fixed capital formation which underpinned a durable and strong recovery in output and employment over the period.

A comparative analysis reveals that the decline in RULCs, and consequent improvement in profit margins occurred in almost all countries (table 10). It was most pronounced in the catching-up countries Spain, Ireland and Portugal, but Belgium, West Germany, France and the the Netherlands also improved their profitability more than other countries up to 1989. Italy and in particular the United Kingdom have not succeeded in improving their profit margins to the same extent as partner countries.

This favourable assessment does not hold entirely if manufacturing industry is looked at alone. Although the underlying data is somewhat less reliable, it seems clear that in manufacturing the improvement in profitability is much less evident. Although in Denmark, France, and the Netherlands profitability improved markedly since the mid 1980s, some other countries have experienced quite a significant deterioration e.g. Belgium, West Germany, Spain and the United Kingdom. In Spain, Italy, and the United Kingdom output prices were squeezed by competition in tradeables up to 1992.

Thereafter, devaluation together with no significant acceleration in domestic labour costs has helped to restore profitability in industry in these countries.

Table 11: Real unit labour costs performance of Member States
Manufacturing industry

	Real unit labour costs; manufacturing industry (b) Index: 1987=100					
	1980	1985	1990	1991	1992	1993
B	109.6	99.3	92.4	100.9	103.8	103.8
DK	104.8	95.3	85.5	85.9	84.4	82.7
WD (a)	103.9	100.0	100.3	103.6	107.5	110.5
D (a)	-	-	-	-	-	-
GR	-	-	-	-	-	-
E	112.2	96.5	106.3	109.7	114.9	110.4
F	108.9	106.5	91.4	94.1	94.0	96.4
IRL	141.8	111.8	98.3	98.3	-	-
I	104.0	103.1	102.9	107.7	109.5	106.4
L	116.7	90.7	89.0	92.0	89.6	90.6
NL	116.1	101.4	88.7	91.0	93.4	94.6
P	115.3	100.0	93.7	93.9	99.2	100.5
UK	113.1	103.2	106.6	114.0	110.0	110.1
EUR- (a)	-	-	-	-	-	-
EUR+ (a)	-	-	-	-	-	-

Source: *Commission services, economic forecast (Autumn 1993)*
(a) *WD = West Germany, D = Unified Germany*
EUR- = EUR12 incl. West Germany, EUR+ = EUR12 incl. Unified Germany
(b) *1992-93: estimates for B, DK, WD, E, F, I, L, NL*
1991-93: estimates for P, UK

BOX 3: Global assessment of capital profitability.

1. Measuring macroeconomic profitability.

From a macroeconomic point of view, the profitability of fixed capital is equal to the profit rate per unit of GDP (the unit profit rate) times the average productivity of capital (the inverse of the capital-output ratio). **The unit profit rate** is measured by the ratio of the net operating surplus to the value added at factor cost for the whole economy (or its manufacturing sector). Since the net operating surplus is defined as net domestic product (or value added) at factor cost minus the total wage cost of employees, the unit profit rate - the profit share - is thus the counterpart of the share of labour in value-added, which is also referred to by the term real unit labour cost.

(Box 3 cont.)

The average (apparent) **productivity of capital** is the ratio of the value-added to the net stock of capital, but the decomposition can be pushed further by breaking down this ratio into the product of the average (apparent) productivity of labour times the inverse of capital intensity.

(1) Profitability = Net operating surplus/ Capital stock

= Net operating surplus/ Value-added x Value-added/ Capital stock

(2) Productivity of capital = Value-added/ Capital stock

= Value-added/ employment x Employment/Capital stock

All these constituent elements are published in the national accounts statistics except for the capital stock which can be however approximated with these statistics by cumulating the difference between gross investment flows and depreciation flows. (For more details on the methodological aspects, see European Economy No 50, Study No 2, December 1991).

2. Interpreting profitability and its main components.

Wage moderation, i.e. a rate of growth of real wage compensation lower than the rate of growth of labour productivity, means a decrease in real unit labour costs, or an improvement in the profit share. While the profit share in value-added (or its counterpart, the labour share) appears to be the main determinant of profitability, and is often used as its crude proxy, it is clear from the definition and formulas given above that the capital output ratio also plays an important role in the variation of capital profitability: any increase in the capital output ratio, i.e. any decrease of the apparent capital productivity, does affect negatively the profitability of capital. Thus to take but a small sample of stylized cases, profitability won't improve

a) if the increase in the profit share due to wage moderation goes together with a similar increase in the capital output-ratio (a fall in capital productivity); such an increase in the capital-output ratio could result from a fall in labour productivity or an increase in the capital intensity of the production process;

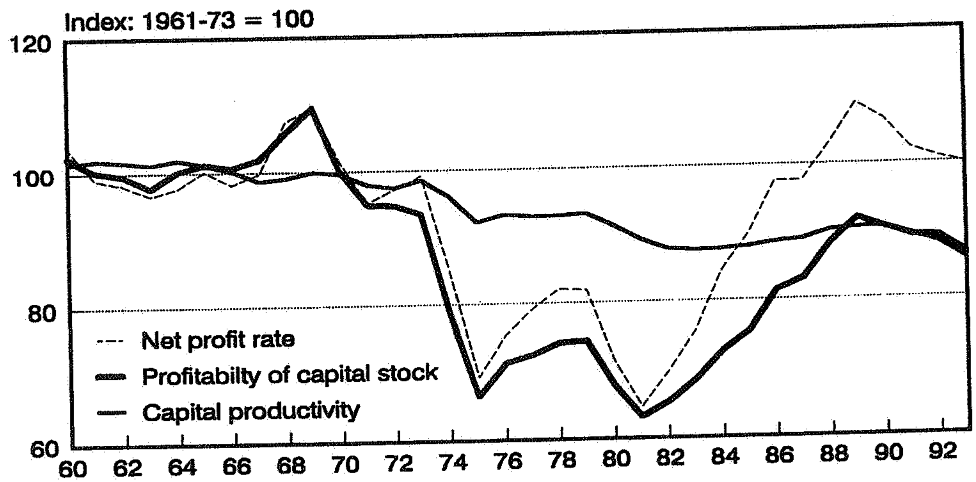
b) if, profit shares being stable, an increase in labour productivity comes only via an increase in capital intensity;

For example, as chart A shows, during the 1980s, the profit shares improved significantly in the Community, mainly due to wage moderation, making up for the losses registered in the second half of the seventies, and even exceeding the average level of 1961-1973. However, a significant part of this improvement in the profit share - shown by the gap registered between developments in the unit profit rate and the profitability rate - has been offset by the decline in apparent capital productivity which occurred from 1970 to

(Box 3 cont.)

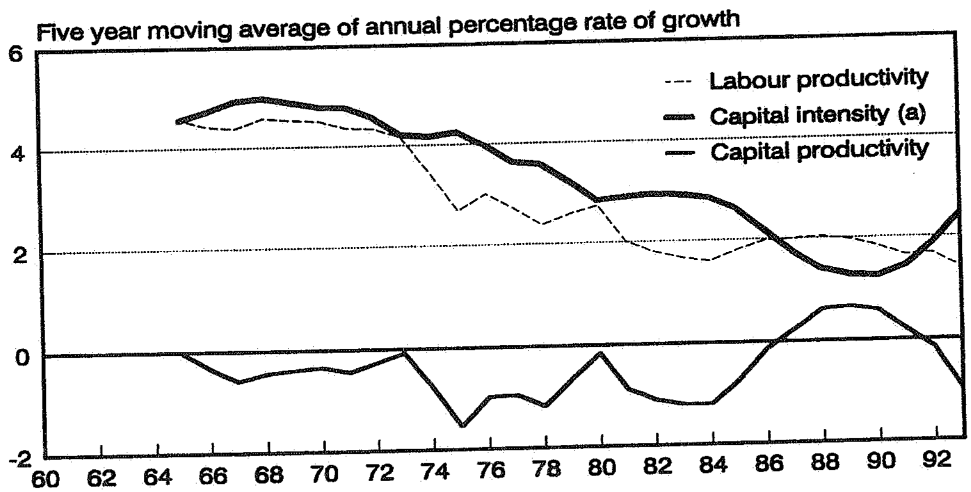
1984: only from 1985 to 1989 did capital productivity recover with the switch to a more labour-intensive production process (see chart B), but at a rather low rate as labour productivity growth was affected downwards by the reduction in capital intensity. As a consequence, the profitability of fixed capital for the Community remains significantly lower in comparison with its level of the "golden sixties", even for the peak reached in 1989.

Graph A: Profitability of capital stock



Source: Commission services

Graph B: Capital productivity



(a) Capital intensity = K/L

Source: Commission services

2.4.2 Structural reform: progress at Member State level

As part II of this report shows, progress has been achieved towards tackling structural obstacles to increased growth in output and employment at the Community level, notably through the internal market programme. This should, however, be accompanied by further progress at the level of individual Member States. There is already an increased recognition by Member States that structural rigidities affecting their national economies must be tackled. This is a welcome contrast with the past when they were frequently postponed, as the short-term costs outweighed the much greater long-term gains; in some cases e.g. Spain, structural reform is an important element of the convergence programmes. These structural reforms are geared to improve the functionning of markets and cover a wide spectrum of domains.

Reforms to improve the adaptability of labour markets and wage moderation

Measures are being pursued to increase work incentives in order to improve labour supply often through reform of social security systems. These measures include more stringent eligibility requirements for payment of pensions (increase in retirement age and/or qualifying period in France, Portugal, and Italy), reduced access to invalidity pensions (Netherlands) and a much closer integration of the taxation and welfare systems (Ireland and Denmark); unemployment benefit systems have been reformed (Denmark) and/or stricter rules governing payment of unemployment benefits have been enforced (Belgium and Spain). A much increased emphasis on improved training opportunities, particularly for the long-term unemployed, is evident in virtually all Member States.

Similarly, measures have or are being taken throughout the Community to improve the demand for labour such as greater access of employers and workers to part-time working, temporary contracts, job sharing, temporary leave for family/study purposes, legalisation of private employment agencies etc. The United Kingdom, in particular, undertook a major reform of the labour market in the 1980s. The high level of social security contributions in Member States is also considered to be depressing the demand for labour. This has led to the reduction of such charges for employers in certain categories in Belgium (with the consequential loss in revenues being funded through increased energy taxes), France and Spain.

In addition to these reforms, which will bear its fruits mainly in the medium to long term, Member States have more recently adressed the issue of wage moderation. Wage developments have been slow to respond to the economic downturn and the sharp rise in unemployment, thus dampening the prospects for recovery. Member States have, accordingly, taken several measures to promote improved wage moderation. This strategy, recommended by the Edinburgh European Council in December 1992, has led to a sharp reduction in public sector wage growth. This in turn is helping to reduce wage pressures generally. In most Member States (e.g. Italy, United Kingdom, Greece, Spain, Portugal, Germany, the Netherlands, Denmark), the rise in public sector wages in 1994 is currently projected to again remain at or below the rate of inflation. This improved public sector wage moderation is also sharply reducing the rate of growth of public consumption, thus facilitating the consolidation of budget deficits.

Labour market issues, from structural reform to wage moderation, have in some Member States been part of social pacts or agreements. This strategy has been particularly successful in Italy, where the abolition of the indexation of wages ("scala mobile") in 1992 has been followed in July 1993 by agreement that future wage developments must be consistent with agreed inflation targets. Similarly, in Germany, the social partners have agreed to an extended timetable for the equalisation of wages between the Eastern and Western Länder in key industrial sectors. Spain, Ireland and Portugal are all currently negotiating social pacts where the needs of employment, wage moderation and the consolidation of the public finances figure very prominently.

Increased competition

The implementation of the Single Market is the major initiative in the Community's history aimed at increasing competition. However, apart from the transposition of the required Community legislation into national legislation, Member States have also taken domestic initiatives to promote competition. These range from the privatisation programmes being followed in several Member States (Belgium, France, Ireland, Italy, Portugal), the abolition of state monopolies (Spain), the reduction or re-orientation of subsidies (Germany and Ireland) and lifting administrative and legal barriers to market entry (Greece). In many cases these measures have the additional benefit of improving the public finances of the countries concerned.

Fiscal consolidation and improving the structure of public expenditure and tax systems

Medium term strategies for fiscal consolidation constitute one of the main elements of the convergence programmes, as said above. Besides the positive effects stemming from the reduction of budget deficits, Member States have also attached importance to improving the structure of public expenditure and tax systems. In particular, a growth oriented pattern of public expenditure is being pursued since recession started to emerge.

Member States have attached priority to public investment in their spending plans in order to avoid a repetition of the experience of previous recessions when it was the first casualty of expenditure cutbacks. This strategy is meeting with a positive response and public investment in the Community has continued to escape the brunt of spending cuts. This in turn is offsetting the impact of the very sharp fall-off in private investment on total investment growth. The available budgetary plans for Member States for 1994 point to a broad continuation of this strategy and to greater emphasis on restraint in current expenditure. Several countries have also been pursuing tax reforms (e.g. Denmark and Greece) intended to simplify their tax systems, to reduce distortions and disincentives, and/or to improve the efficiency of tax collection.

Besides the priority to public instrument, measures to improve business investment feature strongly in all Member States strategies, particularly in relation to small and medium sized enterprises. These are largely concentrated on tax incentives or tax reductions for enterprises, loan subsidies for start-up businesses or measures to boost private housing demand and hence the construction industry. The newly created funds in

Portugal which are providing risk capital to firms are such an example. In the Netherlands, the new "industrial facility" is a similar initiative. In France, a major portion of the proceeds of the "Balladur bond" is being used to ease the cash-flow problems of SMEs arising from VAT payments. In addition, there is an increased emphasis throughout the Community on reducing or simplifying regulations and planning procedures affecting private investment.

2.5 Central bank independence

The Treaty on European Union distinguishes three phases in the process towards full independence of national central banks. In a first step, the ban on central bank financing of the public sector, which is an important element of central bank independence, will apply from 1 January 1994. To comply with this provision, Member States have to adopt the necessary measures already *ahead of* the start of stage II. Secondly, during stage II of EMU, Member States shall, as appropriate, start the process leading to the independence of central banks. Finally, at the latest at the date of the establishment of the European System of Central Banks (ESCB), national legislation including the statutes of its national central bank will have to be compatible with the Treaty and the Statute of the ESCB.

A number of Member States have recently taken measures to render their central banks more independent. Belgium, Italy and Portugal have adapted their central bank laws, primarily focussing on the prohibition of central bank financing of the public sector. France and Spain are in the process of major reforms of their central bank acts. In other countries internal discussions on the issue have started within the government/central bank. The main driving force behind these moves has been the greater credibility of the stability orientation and consequently the lowering of the interest rate risk premium in these countries.

The changes undertaken so far are encouraging in several respects. Firstly, the convergence in the institutional framework for economic and monetary policy mirrors a growing consensus on the role of monetary policy, paving the way for the closer coordination of national policies during Stage Two. Secondly, the fact that Member States adopt measures far ahead of the timetable required by the Treaty shows that Member States are not following a "minimalist approach" in the compliance with Treaty provisions. Although not at all required at this stage and despite the difficulties involved in designing at the present time a central bank law both suitable for the different institutional setups of Stages Two and Three, the changes in many respects already establish a high degree of compatibility with the Treaty.

The **Belgian** central bank law was amended in March 1993. In line with Art 104 of the Treaty, it completely abolishes central bank financing of the government; furthermore, the new act abolishes the censeur's veto right in the field of monetary policy, foreign exchange operations, the holding and management of official reserves and the promotion of the smooth operation of the payment systems, i.e. in the areas constituting the future tasks of the ESCB.

In **Greece**, according to a bill adopted in 1992, central bank financing of the government through its overdraft facility was halved; this overdraft facility is going to be abolished on 1 January 1994.

In **Spain**, the government submitted a draft law to Parliament at the end of 1992. Following the June 1993 general election, a new draft has been submitted according to constitutional rules, and the law is envisaged to enter into force on 1.1.1994. The draft law ensures full autonomy to the Banco de España and grants it sole responsibility for monetary policy.

In **France**, a new central bank law passed Parliament in July 1993; part of it was declared anti-constitutional by the Constitutional Council in August. The law was published as amended by the Constitutional Council. The Treaty having entered into force, the French government intends to submit the remaining parts of the law to Parliament. The law notably abolishes any central bank financing of the public sector; the Governor is appointed for a fixed term of six years.

In **Italy**, the central bank was granted sole responsibility for discount rate changes in February 1992 (Law no. 82 of 7 Feb 1992). In November 1993, Parliament passed a law abolishing any form of credit line of the government with the central bank.

In **Luxembourg**, the government is currently (mid-November 1993) in the process of putting before Parliament a major reform of the law relating to the Institut monétaire Luxembourgois. The draft would incorporate the Treaty provisions on central bank independence including central bank financing.

In **Portugal** a major reform of the Central Bank law took place in October 1990. The Bank of Portugal was granted formally the sole responsibility for the implementation of monetary and exchange rate policy. Credit to the government was formally forbidden, although some exceptions still persist, e.g. primary market purchases of government bonds are still possible, although under very restrictive conditions. The credit line for the Government was abolished at the end of 1992.

Apart from these initiatives, all Member States are currently in the process of adjusting national practices and legislation to the requirements of the prohibition of central bank financing of the public sector and to the prohibition of privileged access of the public sector to financial institutions.

PART TWO

Assessment of the implementation of Community law regarding the internal market

1. INTRODUCTION

The 1st January 1993 marked the beginning of a new stage in the development of the Internal Market. The objective set out in Article 8A of the Treaty, as amended by the Single European Act, has largely been achieved, except for the removal of identity controls on persons at all the internal borders. By the deadline, 95% of the basic legislative programme foreseen in the Commission's 1985 White Paper had been adopted by the Council. In certain sectors, not covered by the 1985 White Paper programme, notably energy and telecommunications services, considerable work has still to be undertaken to create a Single Market.

Firms can now operate in an environment that allows them to trade in products and services and fosters closer integration of co-operation and hence of the industrial fabric.

This has been achieved through progress in the following fields:

- Harmonisation of technical rules as provided for in the White Paper has now been completed; initially confined to specific limited areas, it was extented to cover entire sectors such as agriculture and food products, pharmaceutical products and motor vehicles. Harmonisation of essential product safety requirements, backed up by a policy of certification, and the general provisions on product safety and liability for defective products mean that all manufactured products marketed in the Community are now covered.

- The measures have been adopted to permit public contracts to open to competition from firms in other Member States, irrespective of whether such contracts are awarded by public authorities or public services and are intended for the purchase of supplies, the purchase of services or the carrying-out of work. The relevant directives include provisions on appeal procedures allowing national courts to review matters.

- Freedom to provide services will soon become a reality, where this is not the case already, with the gradual entry into force of the directives and regulations adopted on transport, financial services, telecommunications, recognition of diplomas, and the equivalence of professional qualifications. A final decision paving the way for the liberalisation of road cabotage was adopted in October.

- Since it is not enough simply to provide for freedom of movement and since firms must also be in a position to derive full benefit from it through corporate restructuring and the restructuring of their business strategies, the proposals on company law, company taxation, and industrial and intellectual property formed an integral part of the programme. The relevant objectives have been only partially achieved since, although most of the harmonisation measures relating to industrial and intellectual property have been adopted and although certain forms of double taxation have been eliminated, the key proposals are still before the Council, i.e. those relating to the European company statute, the establishment of a trade marks office and the complete elimination of taxation at source on interest and royalty payments and taking into account of losses suffered abroad.

- Such measures relating to the opening-up of markets to flows of products, services and capital from other Member States have been made irreversible by the elimination of all administrative checks at intra-Community frontiers. The abolition on 1 January 1993 of the single administrative document in intra-Community trade and the entry into force of a series of provisions reorganising tax, veterinary, plant-health, health, safety and statistical controls have made it possible to do away with checks at frontiers.

- Freedom of movement for individuals properly speaking has not yet become a reality. Individuals also benefit from the dismantling of customs and tax controls at internal frontiers, and Community nationals may now work in any other Member State thanks to recognition of their diplomas and qualifications and may reside in any other Member State regardless of any economic activity. Despite this, checks on persons are still carried out at internal borders although these have already been lightened. As underlined at the recent Schengen ministerial meeting on the 18th of October 1993, these controls shall be abolished by 1st of February 1994.

2. FUNCTIONING OF THE SINGLE MARKET

2.1 Implementation and Transposition of Community Legislation

Of the 282 White Paper measures, 264 have been adopted by the Council (95%). The transposition in the national legislations is proceeding: 261 White Paper measures have entered into force (90%), of which 219 require national transposition measures. 85% of the total number of necessary transposition measures have been taken. 110- of the 218 measures have been transposed in all 12 member states, 28 in 11 member states, 21 in 10 member states, 62 in 9 or fewer (of which 21 in 5 or fewer) member states.

An analysis by member state shows that Denmark has taken 94% of the necessary transposition measures, followed by UK (90%), Italy and Belgium (89%). Most delays in transposition are in Ireland (80%), Germany (78%) and Greece (75%). When broken down by sector, it emerges that transposition has been completed or is above average in the areas of freedom of movement of capital, in elimination of physical frontiers (various controls and controls on persons), in financial services (excluding insurance), in elimination of technical barriers, company taxation, VAT and excise duties.

When analysing the rate of transposition it is important to bear in mind the fact that certain items of legislation will only enter into force in 1994 and 1995. This fact can influence the speed with which measures are transposed, to the extent that Member States accord lower priority to those measures which are scheduled to come into effect at a later date. Nevertheless, the Commission remains concerned with the extent of delays in the following areas:

- company law: With the exception of the European Economic Interest Grouping just 60% of the necesary national transposition measures concerning the 5 Community legislative acts have been taken.

- intellectual and industrial property: the delays in transposition are concentrated on the directives on legal protection of registered marks and on protection of computer programmmes which only entered into force since the beginning of the year. Further difficulties in transposition are caused by the complex and technical nature of legislation in this field. The level of transposition comes to 61%. In addition, the Convention on the Community Patent has not yet been ratified by all member states to enable its entry into force.

- public procurement: only 62% of the necessary transposition measures have been taken. In respect of two directives in the excluded sectors, relating to works and supplies, and legal remedies, transposition measures have been taken in 6 and 3 member states respectively. In addition, the directive on services which entered into force on 1st July 1993 has been transposed so far in only 3 member states.

- financial services: while the transposition of measures in the banking and investment services sectors is above average (90% and 87% respectively), the level of transposition in the insurance sector is 73%, where there are important delays in transposition by Greece, Spain and Luxembourg.

- free movement of labour and professions: 75% of the necessary transposition measures have been taken. The first general directive on the mutual recognition of professional qualifications has been transposed correctly in 8 member states. With regard to the directives on right of residence, important delays in transposition persist, in particular, in France and Germany.

It is still too early to draw general conclusions about the practical operation of the single market mainly because, taking account of the periods for transposition, economic operators and citizens have not had the time to take advantage or experience the effects of the new rules. The Commission has, however, received only a limited number of complaints concerning possible deficiencies in the legislation. Although some measures to accompany the abolition of border controls on goods have not yet entered into force (transfer of wastes, repatriation of cultural goods, sales of explosives etc), any difficulties experienced in the interim are being dealt with through closer administrative cooperation between the authorities of the member states and with the Commission.

Apart from inevitable teething problems which have either already been resolved or are in the process of resolution, the "transitional" VAT system has performed well and has facilitated the free circulation of products. Nevertheless, economic operators have drawn attention to difficulties relating to specific provisions of the specialised regimes. This has been the case ,notably, with respect to the requirement for firms with a level of turnover in another Member State in excess of a certain threshold to appoint a fiscal representative. These difficulties have been examined by the *Comité d'Ecoute des entreprises,* established by the Commission. In a number of cases, these problems have already been effectively tackled. On the whole, the experience with the operation of the "transitional" VAT system has been largely positive. The Commission will make further proposals for appropriate simplification as required. Moreover a full report will be prepared by the Commission on the working of the transitional VAT regime which will be presented to the Council at the end of 1994 together with proposals for the adoption of a definitive VAT regime, which will allow a further reduction in the administrative burden on businesses in the Community.

2.2 Making the Single Market work

The work of building the Single Market did not end with the opening of the internal frontiers on 1st January 1993. The Commission is determined to ensure and reinforce progressively the effectiveness of the Single Market. This task is the subject of the preparation of a strategic programme by the Commission, based on its working document (COM(93)256) of June 2nd 1993). It takes into account proposed actions set out in its Communication of 2nd December 1992 (SEC(92)2277) in reponse to the Sutherland Report "the Internal Market after 1992: Meeting the Challenge".

The proper functioning of the Single Market is the basis for the improvement of living conditions of the Community's citizens. The objectives outlined in the strategic programme are clearly approached from this perspective. These objectives are:

- to respond to the expectations of citizens,

- to ensure a competitive environment for enterprise and to ensure that consumers and enterprises will be able to take an active part in the functioning of the internal market and take advantage of the possiblities that the internal market offers them,

- to ensure in the Single Market the impetus for economic and social development.

To fulfil these objectives precise lines of action for an effective application of the regulations and a dynamic development of the internal market are presented in the working document attached to the above-mentioned communication.

For an effective application:

- The instruments of control with respect to Community obligations as laid down in the Treaty of Rome will be fully exploited to prevent new obstacles to trade. The extension to the services sector of the notification mechanism for new technical rules in the field of goods is under consideration.

- The effective application of the Single Market regulations in all member states requires the full transposition of Community legislation, the monitoring of the conformity of national transposition measures and the monitoring of the convergent implementation of these rules in all member states, based on clear interpretations to be provided by the Commission. A satisfactory framework for control has to be set up to assure the member states that surveillance of the functioning of the regulations is being carried out. An improved access to justice and judicial cooperation will create real confidence in the Single Market whilst individuals and enterprises should be aware of proper and effective means of redress in case of violations of their rights. Consideration should be given to the promotion of training of lawyers in Communty law, to better transparency of possible sanctions and to effective enforcement of judgements between member states (the Brussels convention).

- Initiatives for the organisation of partnership with the member states are envisaged in the fields of administrative cooperation between the member states and between the member states and the Commission, in order to ensure the effective application of Community law and to create an atmosphere of mutual confidence.This includes improvement of early warning systems for dangerous goods, the introduction of early warning systems in the services sector, improvement of the administrative infrastructure, training for officials, exchange programmes - some are already in operation - and setting up data transmission networks between administrations.

- The transparency of Community actions also requires formal and informal consolidation of Community legislation. A communication on consolidation requirements in the Internal Market field will be published shortly. Furthermore, the Commission intends to improve information on and circulation of information in the Single Market, also by using already existing networks as the Euro Info Centres.

For a dynamic development

The dynamic development of the Internal Market has to be placed in the context of many Community activities, in particular the initiatives for the promotion of economic growth, competitiveness and employment. It should be also borne in mind that the further development of the Internal Market has to be accomplished by strengthening social and economic cohesion, social policy, environment and research policy, as well as actions to ensure that the interests and rights of consumers are fully taken into account as the internal market evolves. These objectives are also in compliance with the results of the European Council at Copenhagen.

The current discussion of the Strategic Programme and the White Paper on competitivity, growth and employment are closely linked. The White Paper will outline future policy on the Internal Market and refer to the Strategic Programme which will set out the actions to be carried out. At the European Council on 10th December 1993 the broad policy outline, contained in the White Paper, will be discussed. The formal presentation of the Strategic Programme will take place at the meeting of the Internal Market Council on 16th December 1993.

Additionally the dynamic development of the Internal Market relies also on the pursuit of many current actions. Measures are under way, for example, in the fields of intellectual property and of protection of personal data, on standardisation policy. In particular, in recognition of the importance of SMEs potential for growth and employment creation, the Council has adopted a multi-annual programme to assist SMEs to rise to the challenges and opportunities inherent in the internal market. On the occasion of the first SME Council on November 11 1993, it issued a Resolution calling for a second generation of Community actions to cater for the needs and interests of SMEs.

Community policies which interact with the Internal Market:

New initiatives are envisaged by the Commission as a means of ensuring that the full economic and industrial benefits of the Single Market are realised. These measures are in particular intended to:

- improve the tax environment for enterprises so as to eliminate obstacles to cooperation and cross-border activities:
- promote quality in European industry:
- develop an integrated approach to trans-European networks in the fields of energy, transport, telecommunications and telematics networks:
- special actions to assist SMEs to take full advantage of the benefits of a single market.

In addition, the Commission is examining ways in which the interrelationships between other Community policies and the Internal Market can be developed and improved with a view to ensuring the proper functioning of the Internal Market, and the effective realisation of other Community objectives. In particular:

- a vigilant application of competition policy safeguards must prevent the liberalisation generated by the Internal Market programme from being undermined by anticompetitive practices on the part of economic operators or governments:
- the effective management of the Community's external frontiers and a dynamic commercial policy are essential if individuals and firms are to feel confident and secure in the absence of internal frontiers and if the growth of illiberal and protectionist reactions is to be avoided:
- environment policy and the Internal Market must be coordinated so that the objectives of sustainable economic development and of guaranteeing the "four freedoms" are met and so that potential conflicts are resolved on the basis of a coherent approach.

After having undertaken wide consultations with all concerned parties the Commission intends to adopt the definitive version of the strategic programme and to present it to the Council and Parliament before the end of 1993.

3. ELEMENTS FOR A PRELIMINARY ASSESSMENT OF THE ECONOMIC IMPACT OF THE INTERNAL MARKET PROGRAMME

3.1 Introduction

The Community has scored an outstanding success in constructing the legislative framework necessary for the functioning of the internal market. During the course of this process, the Member States have demonstrated a commitment to the objective of a single market which has firmly established the credibility of this framework in the eyes of economic operators throughout the Community. The conviction that an Internal Market was in the making, and that it would herald significant new commercial opportunities, has prompted enterprises in many sectors to implement new investment and sales strategies. The pages which follow document actions undertaken by Community and third country enterprises to gear up in anticipation of the single market. Nevertheless, these anticipation effects represent only the first chapter in the Internal Market story. The full range of economic benefits will only be realised once the new legislative framework is firmly embedded, and once economic operators have had sufficient time to take full advantage of efficiency improvements and new commercial openings.

The current recession, which cannot be attributed to the restructuring contingent on internal market completion, has nevertheless obscured the benefits which were expected to flow from this process. In this respect, it is important to emphasise that progress towards the realisation of an Internal Market will strengthen the underlying competitive strengths of the industrial and services sectors concerned, and thereby provide the best guarantee for sustainable recovery once macroeconomic conditions improve. Furthermore, the Internal Market has acted as a brake on any temptation on the part of Member States to renationalise certain elements of economic, monetary or commercial policy. Any misguided return to "go-it -alone" policies would have proved counterproductive for economic operators and the Member States concerned.

The following paragraphs try to bring together some preliminary indicators which suggest that, even at this early stage in the process, the enabling legislation of the Internal Market programme is beginning to makes its influence felt in certain sectors of the EC economy. For a number of reasons, it is too early to attempt a global assessment of the economic impact of the Internal Market.

- Firstly, much Internal Market legislation is only beginning to make its effects felt. Indeed, in many areas (e.g., insurance, public procurement) important elements of the legislative framework will only enter into force over the coming months.

- Appropriate complementary measures, such as Trans-European Networks and actions to help SMEs, must be put in place if the full potential of the internal market is to be realised.

- Economic operators have to become accustomed to the new framework, and to adapt their activities accordingly.

A fundamental precondition for a wholehearted private-sector response to the Internal Market programme is that the legislative framework be seen to work, and enjoy full credibility in the eyes of economic operators. The forthcoming Strategic Programme on the functioning of the Internal Market is intended to ensure that the effectiveness of this legislative framework be sustained and further developed by tackling the issues raised above. In particular, the Strategic Programme aims to improve the Community capacity to ensure implementation and enforcement, to develop appropriate flanking measures, and to deepen private sector understanding and familiarity with the Internal Market framework.

It would be premature to attempt a full-scale economic analysis of the impact of the Internal Market programme at this stage. Nevertheless, the following text tries to bring together some early indications that the Internal Market programme has stimulated certain economic processes which, over the longer-term, will contribute to a strengthening of economic performance in the Community. Much of the evidence is related to the anticipatory response of the private sector to the Internal Market programme, for example cross-border investment activity. Information on the ex-post benefits which flow from the removal of internal border controls, the elimination of technical barriers, and other elements of the Internal Market programme which took effect on January 1, 1993, remains scanty and largely anecdotal for the time being. In addition, it is extremely difficult to extricate the effects of the Internal Market programme from other forces which are operating simultaneously on the EC economy.

These issues will be tackled in greater detail and on the basis of a fully worked out methodology in the wide-ranging study of the impact of the Internal Market which the Commission is preparing for 1996. This analysis will not focus only on the business dynamics linked to the realisation of the Internal Market , but it will also take into account the effect of Internal Market completion on other Community objectives, such as the achievement of sustainable and non-inflationary growth respecting the environment, and the contribution to regional cohesion.[1)]

The Internal Market Programme is best understood as a supply-side initiative, designed to improve the structural soundness of the EC economies and to enhance the attractiveness of the EC as a base for industrial and service activities. This objective is to be achieved through the removal of legal and administrative obstacles which have traditionally denied many EC firms the possibility of corporate development through expansion on to partner country markets. The primary effects of Internal Market completion will manifest themselves in the form of new commercial opportunities for

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1) Parameters as laid down in Council Resolution of December 7, 1992. OJ C 334, 18.12.92.

individual companies, operating in sectors where hidden trade barriers were most prevalent. It is the capacity of individual companies to perceive new openings which have been created by the Internal Market, and their ability to capitalise on them which will drive forward the process of market integration and unleash the wider economic benefits described in the Cecchini report. In this respect, the Internal Market programme can be seen as a facilitator - it creates a framework conducive to corporate development, but it requires an appropriate response from industry and services before the promise of the Internal Market can be transformed into an improved business and economic performance.

The effects of the Internal Market programme will unfold over a number of stages.

- Initially, the Internal Market programme leads to a reduction in trade costs, and opens up access to previously sheltered sectors of the Member State markets. In turn, this should lead to the establishment of a number of new markets based on geographic proximity, similar cultural traditions and economic structures. Firms can then develop new or improved products to better serve these new markets.

- One striking feature of the Internal Market process has been the way in which many companies have tried to anticipate the effects of Internal Market completion by adapting their operations proactively. The effects of these strategic responses on market structures will be a major determinant of the influence of the Internal Market on intra-EC trade and investment.

- By facilitating increased economic interpenetration, the Internal Market should then increase competitive discipline in those sectors characterised by a high incidence of non-tariff barriers. Given the changing complexion of competition and trade, many companies will react by revising or overhauling their activities and strategies.

- Ultimately, the reshuffling of market structures and business strategies may be reflected in a strengthening of the competitive position of individual companies or sectors.

At this early stage of the process, the immediate cost savings linked to barrier removal are becoming apparent. In addition, there is evidence that some companies are actively gearing up in preparation for the emerging single market. Finally, those sectors where Internal Market legislation has been in place for some time (e.g., some elements of technical legislation) are witnessing an evolution of intra-EC trade and a strengthening in cross-border competition which may be traced back to the completion of the single market.

3.2 Reduction in trade costs and removal of access barriers

The most visible result of the Internal Market Programme to date has been the dismantling of administrative formalities on cross-border shipment of goods. A recent survey of 156 Euro-Info Centres confirms that the abolition of frontier controls on vehicles and cross-border shipments of goods has signficantly increased the facility with which companies can bring their product to markets in other EC countries.[2)] This development has reduced the need for many smaller companies to rely on the services of export agents when selling their products in other EC Member States. In addition, the abolition of border controls has speeded up delivery times for products, with a consequent reduction in transport costs. Estimates, provided by companies which engage in cross-border shipments, of the savings resulting from the removal of border delays are of the order of 3-4% of expenditure on international road transport. The savings will be significantly higher for short distance shipments across frontiers.

The removal of technical trade barriers is widely seen as one of the most significant benefits to be derived from the Internal Market programme.[3)] However, it is impossible to provide an overall estimate of the savings that will result from the eradication of needless technical adaptation and duplication of conformity assessment costs. The savings which will flow from the emergence of common EC technical specifications and testing procedures will vary from product to product, as a function of the technical discrepancies which previously existed, and the cost structures of the products concerned. However, it can confidently be asserted that the potential savings will be sizeable for many sectors. In addition, by cutting out the need for product redesign and adaptation to match separate national requirements products can be brought to the market more quickly. These time savings could represent a significant benefit for products where product development costs are high, and product life-cycles are short.[4)] However, it may take some time before common technical specifications come into widespread use, and before test results, certification procedures, and conformity marks provided in one Member State are accepted without reservation in another. The EIC survey underlined continued scope for improvement with respect to mutual recognition of national tests and certificates, and of CE-marked goods coming from other Member States.

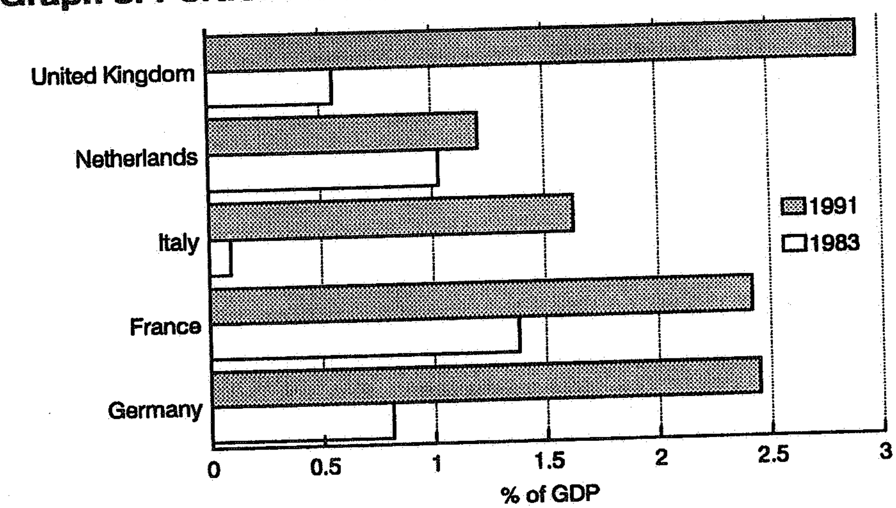
EC public procurement legislation heralds a potentially dramatic shake-up of markets which have long been shielded from competitive pressures. However, this legislation has only recently come into effect for supplies, works (January 1993) and services (July 1993), and has yet to enter into force as far as public utilities are concerned (July 1994). It will take some time before the effects of this legislation on cross-border public procurement can be properly assessed. This point is clearly underscored in the EIC survey which notes that SMEs continue to encounter administrative obstacles, unrealistic deadlines, and difficulties in obtaining contracts and supporting documentation.

Controls on capital movements have, in the past, served to hamper cross-border investment in physical and financial assets, thereby denying investors opportunities to earn the highest return on their funds or preventing them from constructing preferred portfolios. Capital controls also constituted one of the most formidable obstacles to the

2) EC Commission, Projet Euro-Info Centre (1993): EIC - Single Market Questionnaire: Results.
3) EUROPEAN Observatory for SMEs (1993): First Annual Report.
4) For instance, it has been estimated that a reduction in one month in the time needed to bring a new automobile model to market could generate gains of 30 million Ecus for the manufacturer.

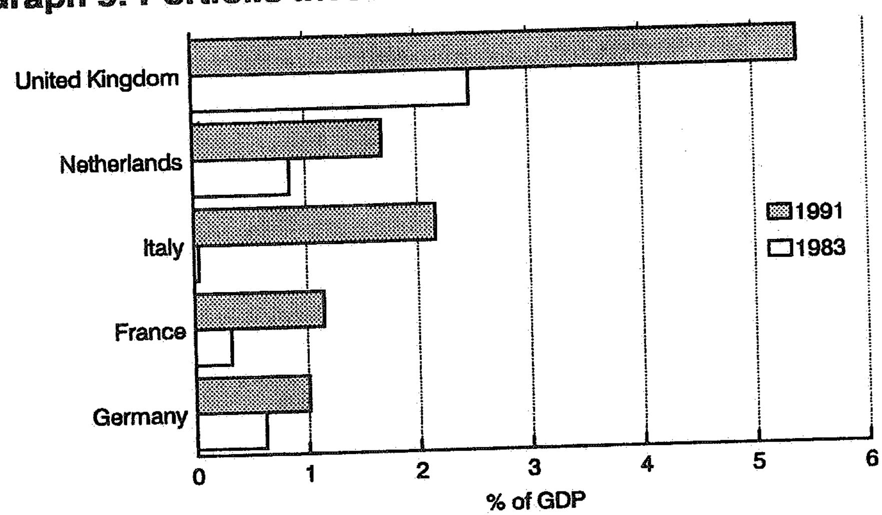
cross-border provision of financial services, as financial institutions could not transfer liquidity from one area of operations to another at short notice. Since the abolition of frontier controls, capital market integration has been significantly intensified. Graphs 8 & 9 illustrate the increase in flows of portfolio investment between individual Member States and other countries. These charts illustrate a sharp increase in portfolio investment into and out of all Member States examined. Taken together, this evidence suggests that the Internal Market programme has been accompanied by, and has contributed to, a qualitative increase in the degree of EC capital market integration.

Graph 8: Portfolio Investment from other EC countries



Source: Data is based on non-harmonised national data supplied to EUROSTAT

Graph 9: Portfolio Investment in other EC countries



Source: Data is based on non-harmonised national data supplied to EUROSTAT

3.3 Anticipation effects - Foreign Direct Investment

Many companies have moved quickly to gear up for the new opportunities and challenges implicit in the Internal Market. In particular, the completion of the Internal Market is making it progressively more profitable for companies to serve partner country markets, and is making it increasingly worthwhile for firms to organise their activities on an EC-wide basis. Companies are therefore looking further afield when taking locational and investment decisions. Foreign Direct Investment (FDI) can act as one vehicle for company expansion on partner country markets. FDI can take the form of a cross-border transfer of capital through which an investing enterprise creates a new foreign company, gains control (fully or partly) of an already existing entreprise, or develops the business of an already affiliated foreign company. FDI therefore involves managerial say over productive activities in another country.[5] The completion of the Internal Market encourages companies in one Member State to invest in partner countries in order to take advantage of location-specific advantages, to internalise assets of an acquired company, or to gain a foothold on the partner country market. Foreign direct investment has increased in tandem with the programme for the completion of the Internal Market. This trend has been common to all EC Member States.

This FDI was oriented heavily towards those sectors most directly concerned by the Internal Market legislation. The services sectors, in particular, were characterised by a sweeping restructuring of their international operations. In absolute terms, there has been a marked increase in FDI in the finance and banking sectors. However, FDI has been even higher in other service sectors when expressed as a proportion of value added in that sector. The relative importance of FDI in services vis-à-vis industrial products can be explained by the need for service providers to be close to their customers, and by the fact that the Internal Market has had a relatively more pronounced liberalising effect in these industries.

It is also interesting to note that non-EC companies have stepped up their investment in the EC. In large part, this development attests to an established worldwide trend towards globalised production. Nevertheless, the Internal Market Programme - by enhancing the profitability of investment projects - has encouraged foreign investors to step up foreign direct investment in the EC. The success of the Internal Market in attracting foreign investors is confirmed by business surveys and by trade associations in the US and Japan. (JETRO, US ITC). Extra-EC FDI into the EC has also been concentrated in those industries and services sectors which are most affected by the Internal Market Programme.

FDI can take a number of specific forms. One subset of intra-EC Foreign Direct Investment which has received considerable attention in recent years consists of mergers, acquisitions and other forms of alliance. In some cases, these alliances have been conceived of as a defensive step to consolidate positions on national markets before the

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5) The OECD uses a threshold of 10% of the voting power of the affiliated company in order to duistinguish investment designed to yield significant say in the management of an enterprise from portfolio investment.

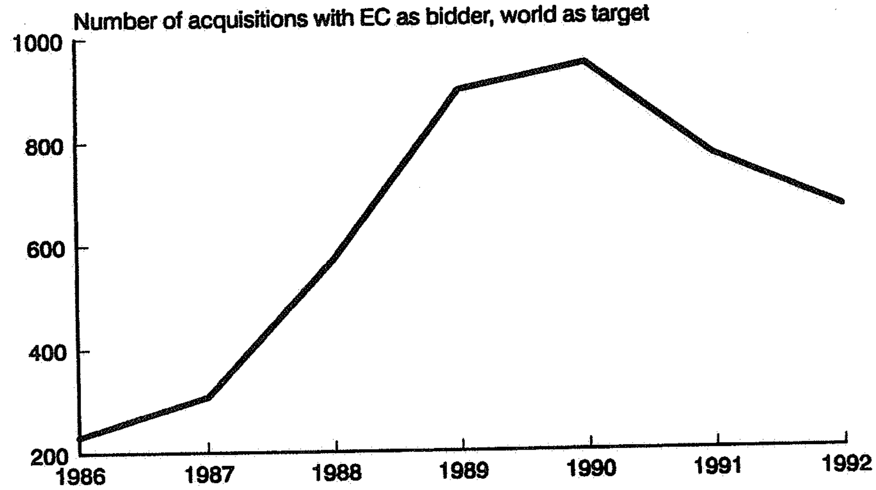
arrival of new competitors established in partner countries. However, the surge in the number of cross-border mergers and acquisitions in the latter half of the 1980s testifies to a growing tendency for many firms to conceive of their operations on a pan-European scale. Mergers, acquisitions and alliances are viewed as a means of acquiring an established foothold in partner country markets, of internalising assets which enhance the firms corporate strengths, and of ensuring that its products have access to appropriate distribution networks.

To exploit the profitable potential of enlarged market opportunities, many firms' strategic response has been to expand. Completion of the internal market gives large industrial and financial groups both the opportunity and the incentive to engage in increased direct investment and foreign acquisitions within the Community in order to achieve a scale comensurate with the enlarged markets upon which they operate. As evidence of this, Graph 10 shows that between 1986 and 1992, total transborder acquisitions (controlling stake obtained) in manufacturing grew from 231 to 666, with a peak of 947 in 1990. Meanwhile, total transborder acquisitions in all sectors grew from 436 in 1986 to 1162 in 1992, peaking at 1722 in 1992.

One can also usefully analyse acquisitions within the EC by international enterprises taking into account their origin - Community, or international non-Community. Before 1986, less than 25% of the total number of transborder operations recorded were carried out by EC enterprises. Between 1989 and 1992, however, such operations have continually accounted for over 60% of total acquisitions in all sectors (cf.graph 11). This provides clear indication as to the extent of the pan-Europeanisation process within EC firms.

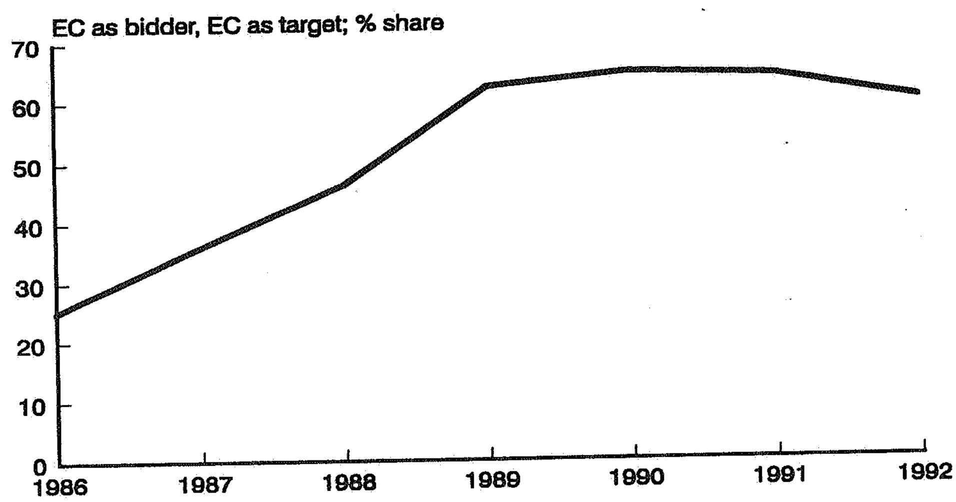
This picture of increasing merger and acquisition activities inside the Community after the start of the internal market programme is repeated when we look at the development of both transborder and intra-border acquisitions after 1986. These grew spectacularly between 1987 and 1989. (table 12). According to management surveys, these operations have frequently been due to the implementation of the internal market and to increasing economic globalisation. All sectors have seen relatively similar increases in the number of concentrations, although the increase was more rapid in industry where these operations rose by almost 300% than in services where mergers and acquisitions increased by 200%. Moreover, the subsequent slight decline in acquisitions between 1989 and 1992 has affected industry (-15%) less than services (-23%). This slowdown probably reflects both the worldwide recession and the fact that many of the production rationalisation possibilities sparked by the internal market programme have now been exploited. Most M&A activity is between enterprises of the same nationality even though their importance declined from 85% in 1987 to 66% in 1990. Activity in services tends to be more national in nature in services than in industry. In the same way, Community-level activity is higher in services than is true for international-level activity.

Graph 10: Total cross-border acquisitions- manufacturing



Source: AMDATA

Graph 11: Share of total cross-border acquisitions



Source: AMDATA

Table 12: Mergers and acquisitions inside the Community market by type of operation and by sector, 1987-1992

Country	National Operations		Community Operations		International Operations		Total Operations	
	Number	%	Number	%	Number	%	Number	%
Industry								
1987	878	82.0	104	10.8	69	7.2	960	100
1988	985	71.0	257	18.5	146	10.5	1388	100
1989	1766	65.1	538	19.8	410	15.1	2714	100
1990	1648	61.5	574	21.4	457	17.1	2679	100
1991	1787	68.0	457	17.4	383	14.6	2627	100
1992	1573	68.2	365	15.8	367	15.9	2305	100
Services								
1987	923	87.2	74	7.0	61	5.8	1058	100
1988	1092	83.5	143	10.9	73	5.6	1308	100
1989	1717	72.4	402	17.0	252	10.6	2371	100
1990	1624	69.6	433	18.6	277	11.9	2334	100
1991	1533	75.7	283	14.0	208	10.3	2024	100
1992	1343	73.9	248	13.6	227	12.5	1818	100
Total								
1987	1868	85.3	187	8.5	135	6.2	2190	100
1988	2382	78.7	420	13.9	225	7.4	3027	100
1989	3811	69.1	1021	18.4	689	12.4	5541	100
1990	3606	66.1	1066	19.5	783	14.4	5455	100
1991	3631	72.0	797	15.8	616	12.2	5044	100
1992	3247	71.3	651	14.3	655	14.4	4553	100

Source: AMDATA

Mergers and acquisitions have been used as a vehicle for entry to partner country markets in sectors such as banking where access to an existing retail network is crucial for commercial success. Table 13 provides a breakdown of those cross-border mergers and alliances between financial institutions between 1987-93 which were reported in the financial press. The pro-competition effect of the Internal Market in financial and banking services has been mirrored in the insurance sectors. In most EC countries, the market share of foreign firms in terms of premiums written has been on the increase. By accentuating competition, domestic incumbent firms will be placed under pressure to adopt more cost-efficient practices, as well as to speed up the introduction of new products in response to consumer demands. However, strong defensive behaviour on the part of national incumbents could also offset the effects of increased foreign presence by providing domestic firms with a bulwark against increased cross-border competition. The trend towards smaller numbers of companies on insurance markets is a widely reported trend. The impact of these developments on the degree of competition will require detailed and sophisticated observation and analysis within the framework of existing competences, with a view to assessing the implications for the degree of competition on relevant markets.

Table 13: Cross-border alliances between financial institutions, 1987-93
(by country of origin of target and initiating companies).

Target country's country

Initiating co's country	F	D	UK	E	I	NL	P	B	Others	Total
France	..	6	18	19	10	2	7	5	7	74
Germany	10	..	5	9	5	2	1	2	1	35
UK	7	4	..	6	9	2	2	2	4	36
Spain	7	6	4	..	3	2	7	4	-	33
Italy	10	4	3	8	..	-	1	-	1	27
Netherlands	5	2	5	4	1	..	1	4	2	24
Portugal	1	-	-	3	-	-	..	-	-	4
Belgium	2	-	-	-	-	2	-	..	4	8
Others	2	-	4	-	-	-	-	-	..	6
Total	44	22	39	49	28	10	19	17	19	247

Source: Bank of England Quarterly Bulletin: August 1993.

In addition to cross-border investment and establishment, the Internal Market has elicited other strategic and organisational responses from firms. Individual companies have abandoned their traditional segmentation of the EC market into separate national divisions, upgraded product development and introduced quality management systems, and overhauled packaging, marketing and distribution systems. Prior to the Internal Market programme, firms maintained subsidiaries in various Member States at great expense, with separate registered offices and increased administrative and tax costs. Facilitated by more flexible and less costly transportation costs, corporations have tended to replace multiple regional or national locations by Euro-centralised production and distribution networks with more destinations. These developments have not yet been analysed systematically. Nevertheless, they represent a potentially significant category of reactions to the Internal Market programme.

3.4 Changes in intra-EC trade and competition

The success of the Internal Market hinges on the extent to which it succeeds in stimulating intra-EC trade and thereby providing a shot-in-the-arm to cross-border competition. Through this mechanism, the Internal Market programme will unleash new dynamics which may result in a strengthening of the industrial and services tissue of the EC economy. The Internal Market has to be seen in the context of the increasing globalisation of the world economy for markets, production and finance. It should be seen as contributing to this process, and as a way of preparing Community firms for international competition. It would be inaccurate to interpret this process as a form of retrenchment on the Community market. The growth in intra-Community trade represents, therefore, an indicator of the increasingly international outlook of previously national-oriented firms, and does not constitute a handicap to, or an alternative for the participation of Community firms on world markets.

Table 14 gives the share of each Member State's total exports and imports which are accounted for by intra-EC trade over a number of years. For both exports and imports, the period between 1980 and 1990 registered a significant increase in this share for the nine countries which comprised the EC in 1980, except for Ireland where the share has generally been much higher anyway. On average, intra-EC trade was approximately 11 points higher for imports in 1990 than in 1980, and nearly 10 points higher for exports. However, for exports, this development took place between 1985 and 1990 which suggests that the liberalising effects of Internal Market legislation were beginning to filter through. For Greece, Spain and Portugal the combined effects of accession and deepening of economic integration through the Internal Market programme has led to spectacular increases in the export and import shares of 10-20 percentage points between 1985 and 1990.

Table 14: Share of Intra-EC Trade in total trade in percent
Imports and exports by Member States

	Country	1980		1985		1990		1992	
		Import	**Export**	**Import**	**Export**	**Import**	**Export**	**Import**	**Export**
original six Member States	**B/L**	61.6	73.2	68.6	70.2	70.7	75.1	71.2	74.8
	F	52.0	55.4	59.4	53.7	64.9	62.7	65.7	63.1
	D	49.4	51.1	53.1	49.7	54.3	54.3	54.7	54.1
	I	46.2	51.6	47.1	48.2	57.4	58.2	58.8	57.7
	NL	54.7	73.5	55.8	74.7	59.9	76.5	58.8	75.4
1st enlargement	**DK**	50.3	51.6	50.7	44.8	53.8	52.1	55.4	54.5
	IRE	75.3	76.0	71.7	68.9	70.8	74.8	71.9	74.2
	UK	40.9	45.0	47.3	48.8	51.0	52.6	50.7	55.5
2nd & 3rd enlargement	**GR**	40.9	48.2	48.1	54.2	64.1	64.0	62.8	64.2
	P	45.3	58.6	45.9	62.5	69.1	73.5	73.6	74.8
	E	31.3	52.2	37.9	53.3	59.1	65.0	60.3	66.3
	EC	49.2	55.7	53.4	54.9	58.8	61.0	59.3	61.3

Source: EUROSTAT. The former system of statistics collection based on customs declarations at intra-Community frontiers was replaced on January 1, 1993 by INTRASTAT. For structural reasons, INTRASTAT results for the first quarter of 1993 cannot be compared with statistics collected under the former system.

All sectors are affected by the opening up of markets due to the 1992 programme, but a certain number of manufacturing sectors have been more protected by non-tariff barriers than others due to a differences in standards, importance of frontier formalities, limited access to public procurement, and differences in VAT and excise regimes. Forty manufacturing sectors out of the 120 sectors which make up manufacturing industry were identified as being most sensitive to the removal of non-tariff barriers. For the forty sectors which are expected to be most affected and to benefit most from internal market completion (high-tech industries, mechanical and electrical engineering and transport goods industries), exports to the EC market increased enormously between 1979 and 1992 when compared against exports to non-EC countries.

The reciprocal tendency for companies in the various Member States to enter into each others markets in the quest for new market outlets should lead to keener competition on national markets in the sectors affected by the removal of non-tariff barriers. In particular, intra-EC trade may be leading to lower levels of concentration in national markets for products such as medical and surgical equipment, machine tools, electrical machinery, consumer electronics, and transmission equipment). Imports from other Member States in these sectors now account for an increased share of domestic consumption, which also amounts to greater competitive pressure on domestic producers. In order to evaluate the final impact of the Internal Market Programme on market structures at national level, it would be necessary to take into account a range of other factors, including any defensive reactions by domestic producers to increased cross-border competition. It will also be necessary to allow sufficient time for the new market structures to settle down before making any definitive pronouncements on the impact of the Internal Market Programme on the degree of competition in previously sheltered sectors of national markets. These considerations could form a central part of the 1996 study on the impact of the Internal Market.

In certain services industries, the increased competition induced by Internal Market liberalisation has had significant effects. One notable example is the case of air passenger transport. The introduction of fifth freedom rights (the freedom to pick up passengers in one Member State on an outward journey and to carry them to a third country, or to collect passengers in a third country on the return leg of a homeward journey) and consecutive cabotage has triggered a round of fare competition on a number of intra-EC routes.

Although the internal market has not yet reached its full potential, its credibility and irrevocability have exerted profound effects on business behaviour. On average, econometric calculations made by the Commission services show that the contribution of integration to economic growth, powered largely by significant anticipation effects, has accounted for around 0.4% per year during the period 1986-92.

4. CONCLUSIONS

The basic legislative framework underpinning the Internal Market is now almost fully in place. Over 90% of the White Paper measures are in force and the level of transposition of adopted directives into the laws of the Member States amounts to over 84%. The success of the introduction of the legislative programme by 1st January 1993, in accordance with the timescale laid down in the Single Act, has exceeded most initial expectations. The Commission's proposal to draw up a strategic programme is intended to ensure the smooth functioning of the Single Market based on this framework. The Commission has no ambition to embark upon a second legislative programme comparable to the 1985 White Paper.

As far as it can be judged until now, the Single Market is operating properly without major difficulties - apart from transitional problems particularly for small and medium sized enterprises earlier this year.

It is too early to assess the full economic impact of the Internal Market, as firms have not yet had sufficient time to adjust to the new legislation and the process of transposition of measures into national laws is still continuing. Even though it will be some time before the effects of Internal Market legislation fully come on stream, it is already evident that this legislation has been the catalyst for a thorough shake-up of key industry and services sectors. By injecting a new dynamism into lethargic sectors, the Internal Market may pave the way for improved competitiveness on the part of individual EC companies. It is this qualitative shift in the degree of cross-border competition which will be the greatest legacy of the Internal Market. In turn, this structural change in the EC economy may act as the dynamo for further development of many EC industry and service sectors.The Commission will launch a large-scale study in 1994 with a view to completion by 1996 to analyse the full effect of the legislative programme.

The process of the completion of the Single Market has strengthened the mutually profitable economic and commercial links between the member states. This has been reflected in a steady increase in the proportion of intra EC-trade as a component of industrial and services output, and a Europeanisation of company corporate and investment strategies to allow firms to take advantage of newly accessible commercial opportunities in other member states. However, the Internal Market programme is not being constructed in an economic vacuum. The current recession, which has been provoked by forces unrelated to the completion of the Internal Market, has overshadowed the process of adaptation to the emerging single market framework. The depressed state of EC markets obscures the potential market openings created by the Internal Market. In addition, many, particularly small and medium sized, companies do not have the resources or are wary of positioning themselves in order to take advantage of opportunities which lie around the corner. However, there are strong reasons to believe that the restructuring and investment undertaken during the late 1980s in anticipation of the internal market have helped to mitigate some of the effects of the current downturn. Looking forward, the single market will provide added impetus to the development of individual companies once economic recovery gets underway.

The widening of the scope for exchange rate divergences has prompted concerns that increased "exchange rate-risk" could dissuade companies from engaging in cross-border trade and investment. While "exchange rate risk" does introduce an added degree of uncertainty to transactions denominated in partner currencies, the impact on intra-EC trade and investment may be clearly offset through the use of hedging techniques.These, however, remain expensive, mainly for SMEs. Furthermore, exhange rate stability, based on sound economic convergence, remains an essential component of the Internal Market, and it represents a prerequisite if the progress in liberalising capital markets and financial services is to be safeguarded. From the point of view of the Internal Market, it is to be hoped that the macroeconomic conditions which are needed to sustain a high degree of exchange rate stability can be restored at the earliest possible date.

Against this background the further reinforcement of an already well-established Single Market - as outlined in the strategic programme - is of major importance to counteract any negative tendencies. Maintenance of a stable and properly working Single Market will provide the basis for the realisation of the second step of the European Monetary Union. The widening of exchange rate fluctuation bands has increased the risk of sudden competitive depreciations . The introduction of a single currency would remove this risk, as well as the nuisance and costs caused by the coexistence of several currencies in an integrated economic zone. The objective of a single currency remains a logical development of the largely achieved Internal Market programme.

Annex to Part I

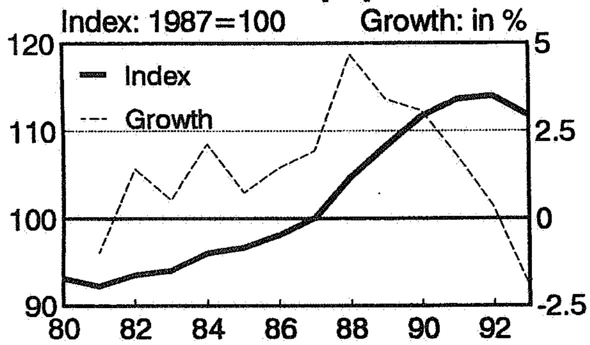
Charts by Member State

(1980 - 1993)

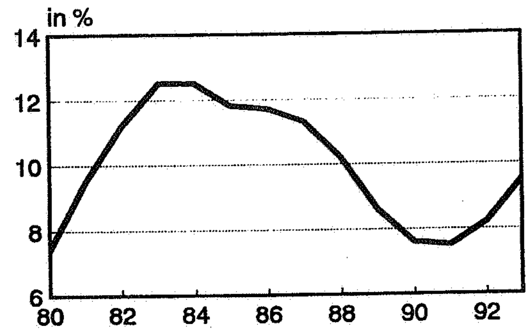
- Real GDP/head of population
- Unemployment rate
- Inflation
- Balance of current transactions
- Net borrowing requirement (general government)
- Long term interest rate
- Real unit labour costs

Belgium

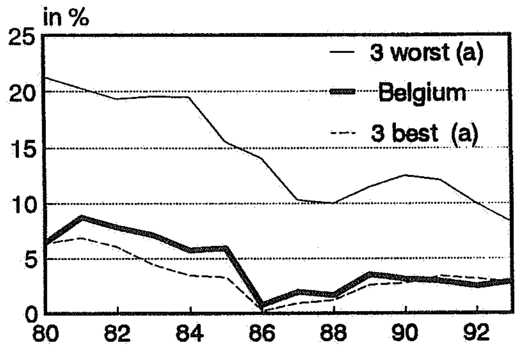
Real GDP/head of population



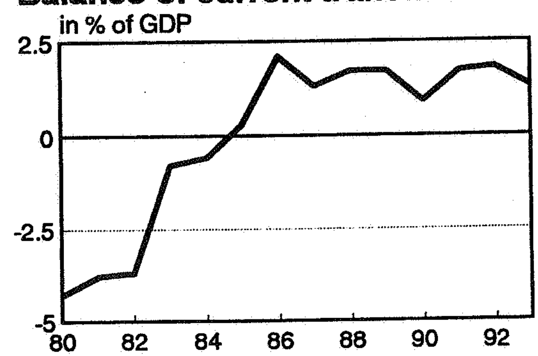
Unemployment rate



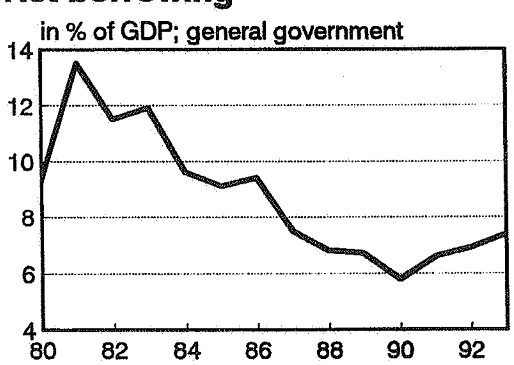
Inflation



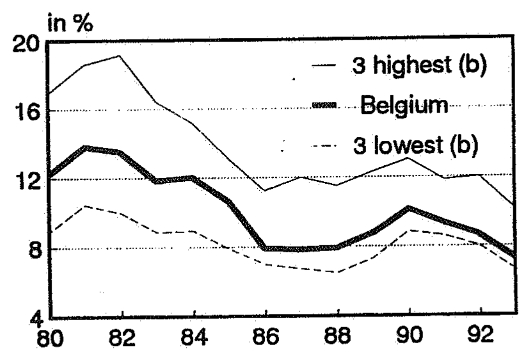
Balance of current transactions



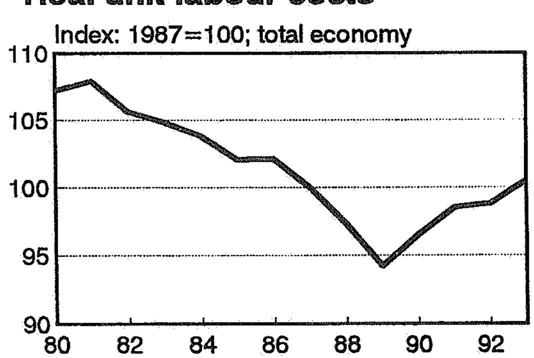
Net borrowing



Long term interest rate



Real unit labour costs

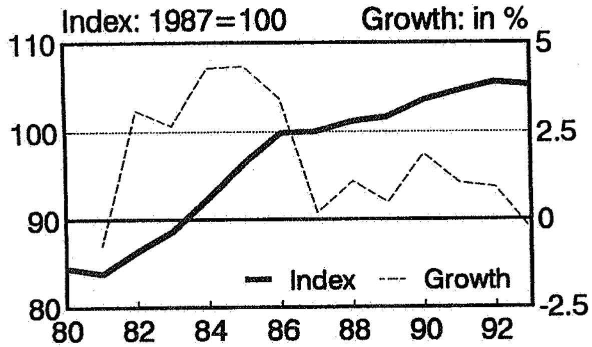


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

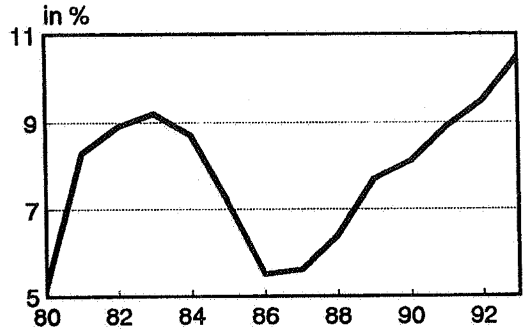
Source: Commission services, economic forecasts (Autumn 1993)

Denmark

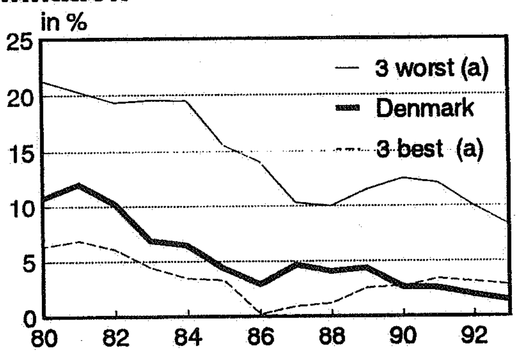
Real GDP/head of population



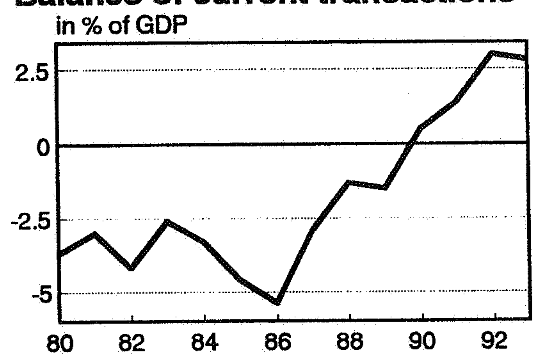
Unemployment rate



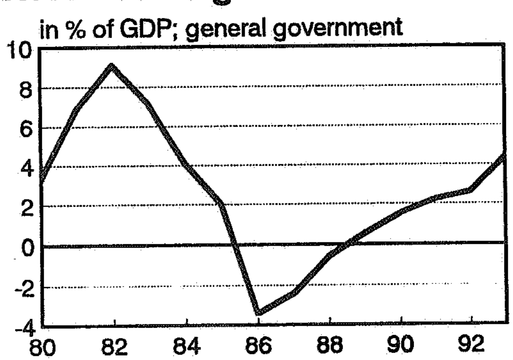
Inflation



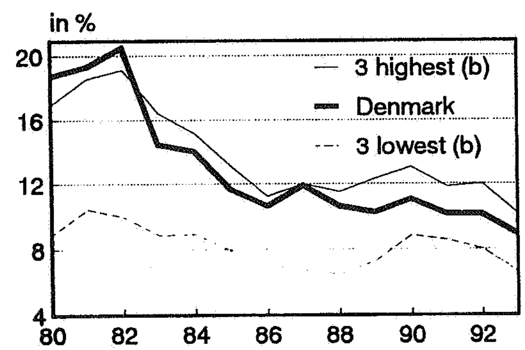
Balance of current transactions



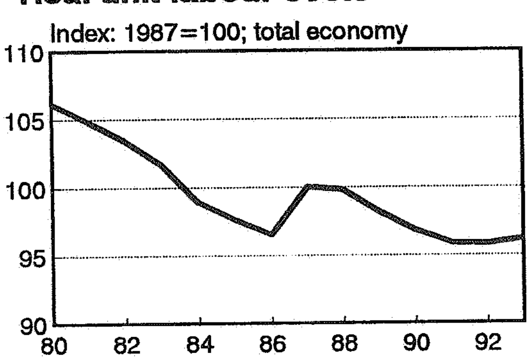
Net borrowing



Long term interest rate



Real unit labour costs



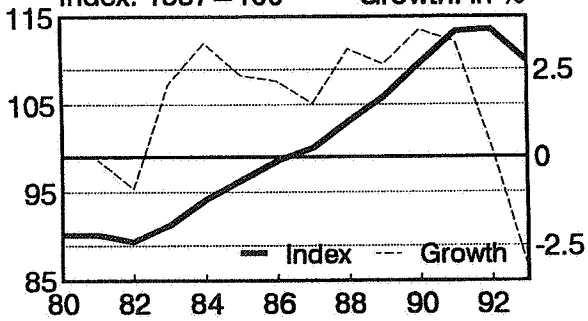
(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

Source: Commission services, economic forecasts (Autumn 1993)

Germany

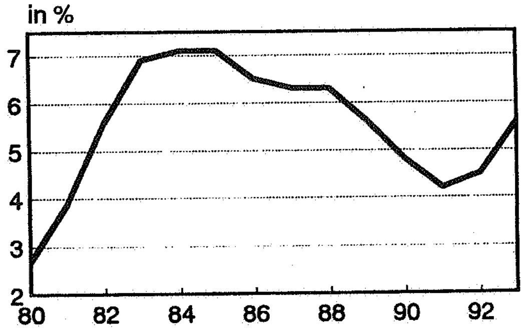
Real GDP/head of population

Index: 1987=100 Growth: in %



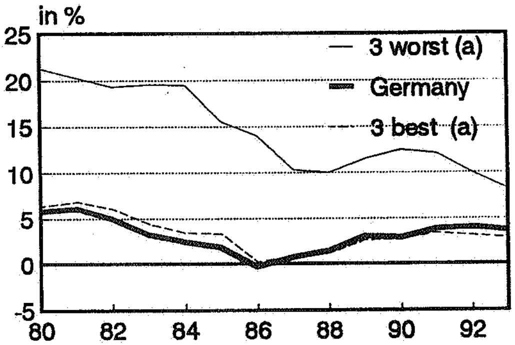
Unemployment rate

in %



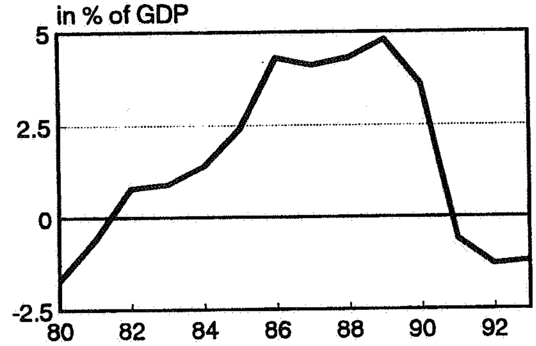
Inflation

in %



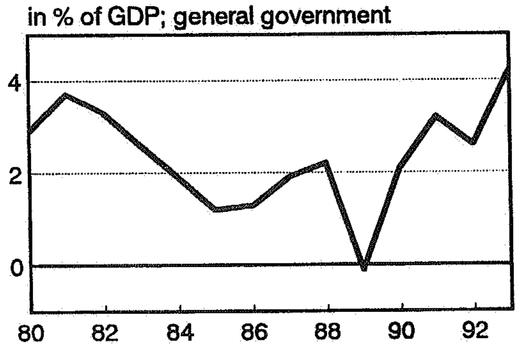
Balance of current transactions

in % of GDP



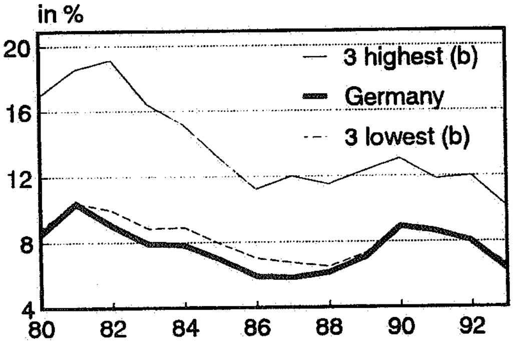
Net borrowing

in % of GDP; general government



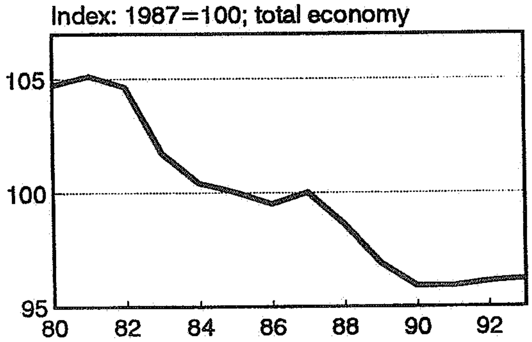
Long term interest rate

in %



Real unit labour costs

Index: 1987=100; total economy

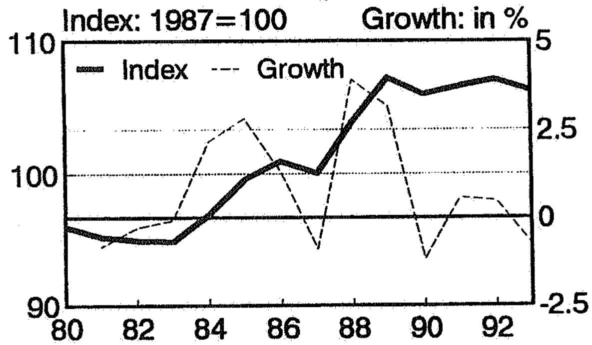


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

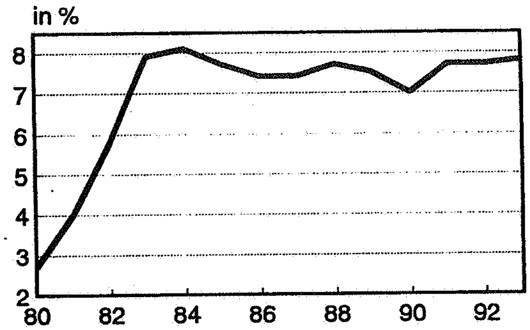
Source: Commission services, economic forecasts (Autumn 1993)

Greece

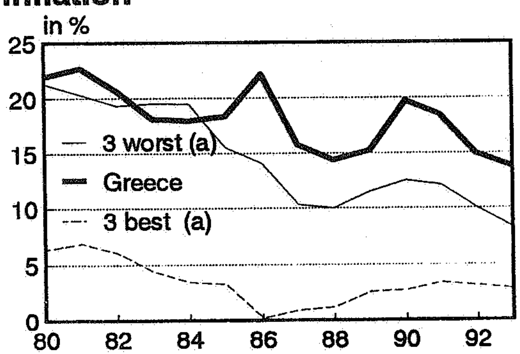
Real GDP/head of population



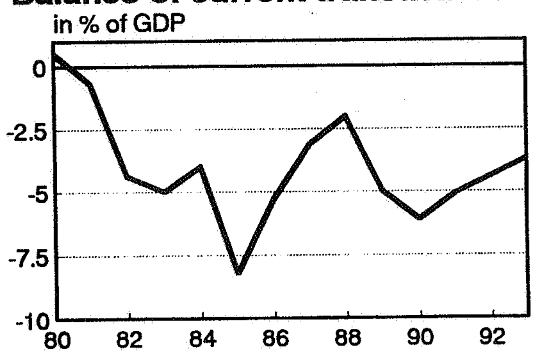
Unemployment rate



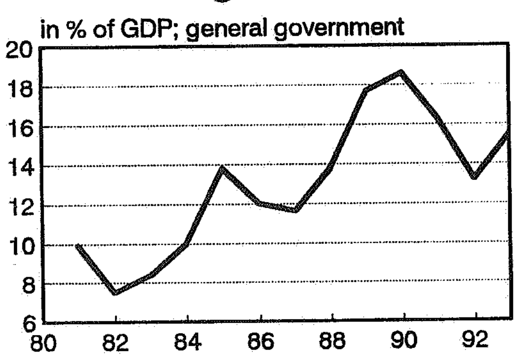
Inflation



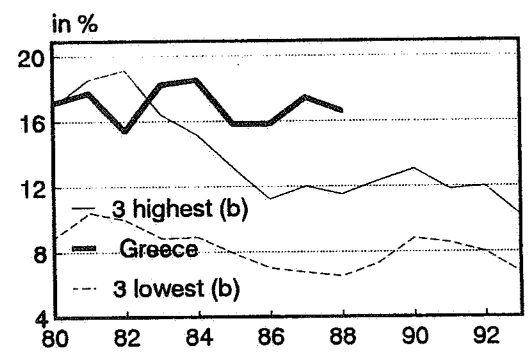
Balance of current transactions



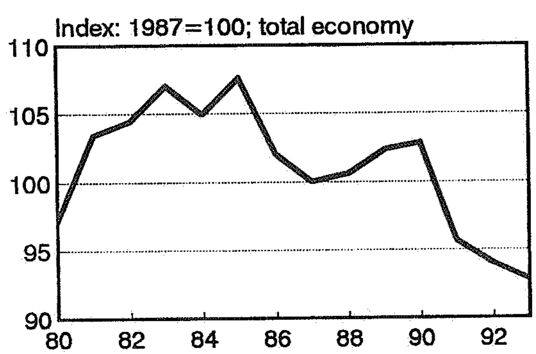
Net borrowing



Long term interest rate



Real unit labour costs



(a) Unweighted averages of the 3 best (worst) performing Member States
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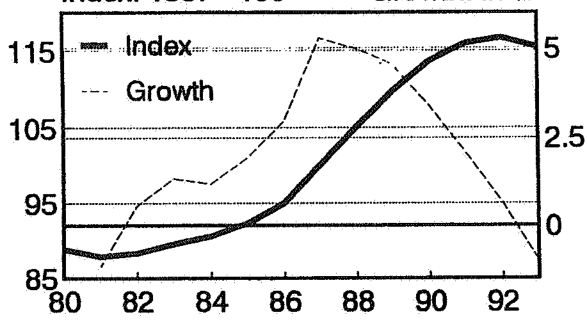
Source: Commission services, economic forecasts (Autumn 1993)

Spain

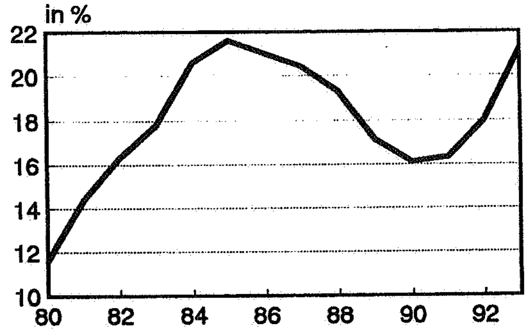
Real GDP/head of population

Index: 1987=100 Growth: in %



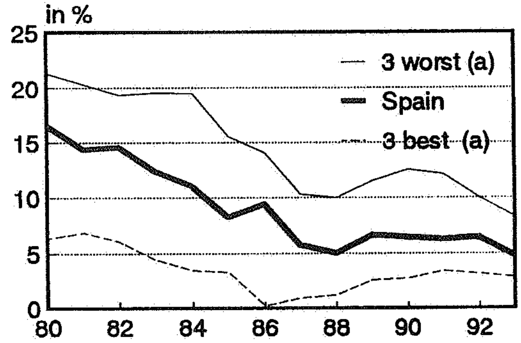
Unemployment rate

in %



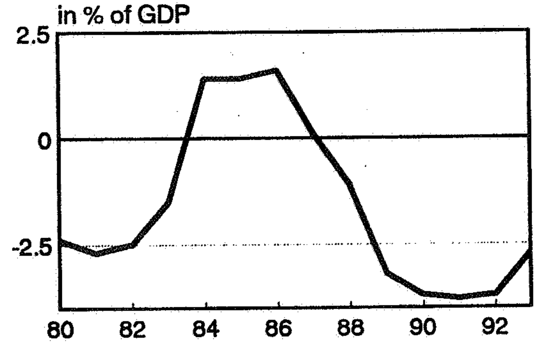
Inflation

in %



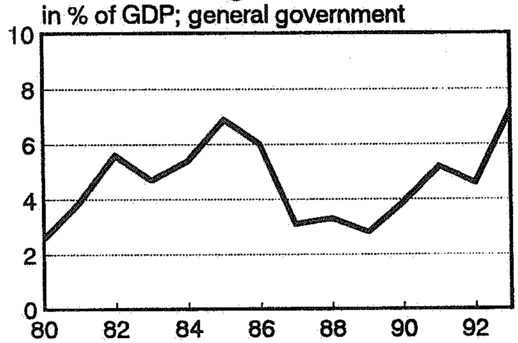
Balance of current transactions

in % of GDP



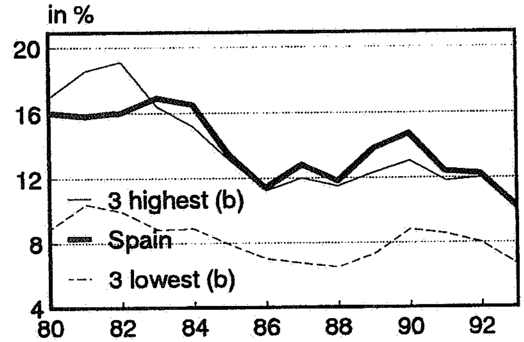
Net borrowing

in % of GDP; general government



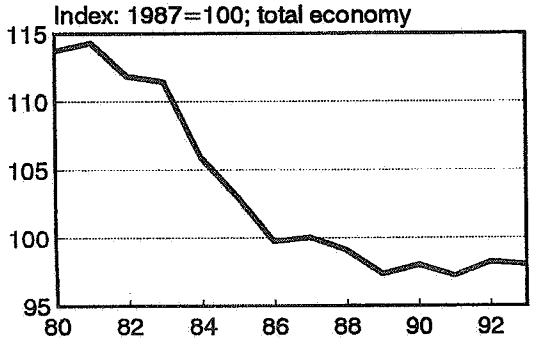
Long term interest rate

in %



Real unit labour costs

Index: 1987=100; total economy

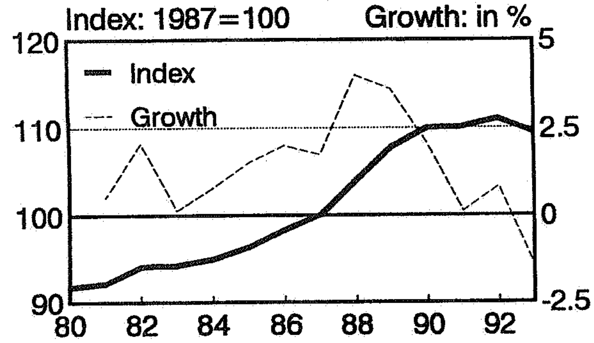


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

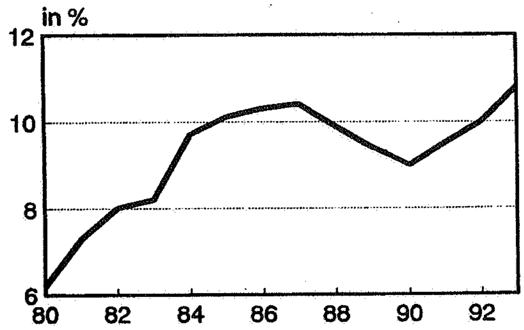
Source: Commission services, economic forecasts (Autumn 1993)

France

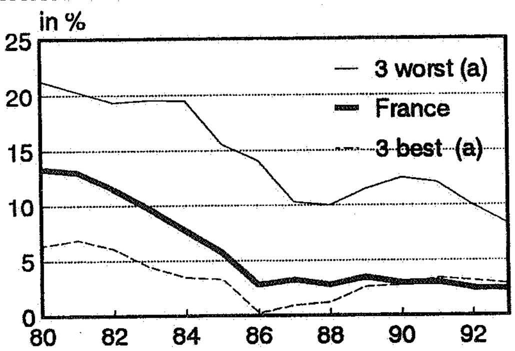
Real GDP/head of population



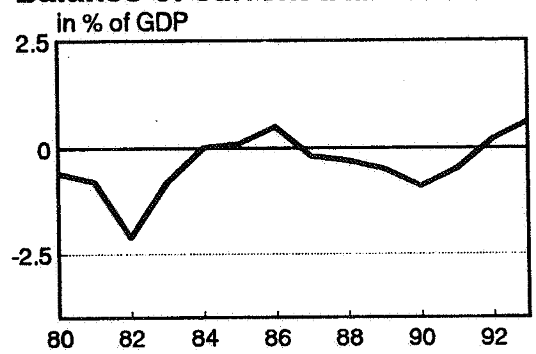
Unemployment rate



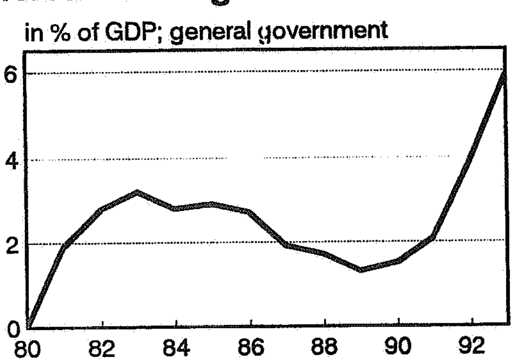
Inflation



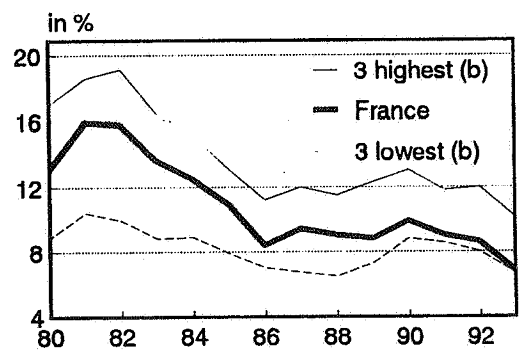
Balance of current transactions



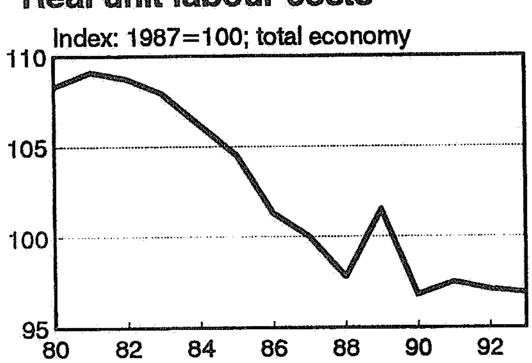
Net borrowing



Long term interest rate



Real unit labour costs

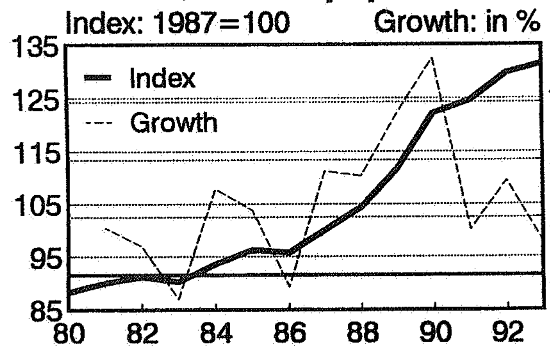


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

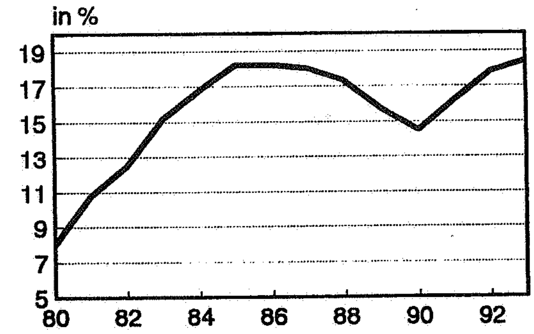
Source: Commission services, economic forecasts (Autumn 1993)

Ireland

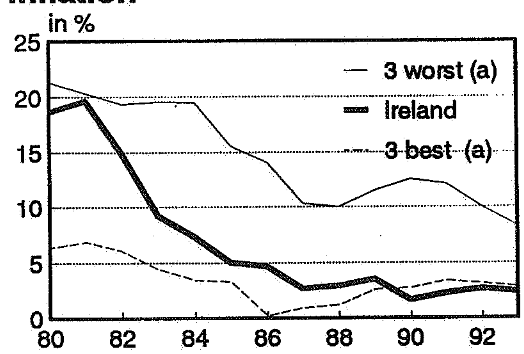
Real GDP/head of population



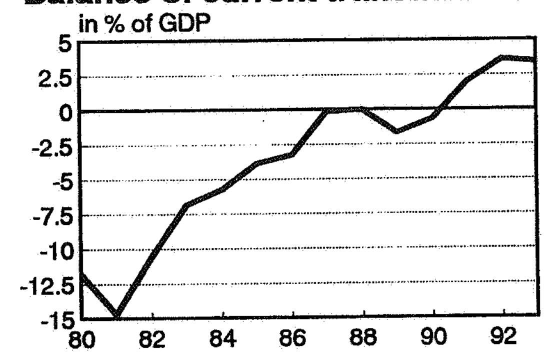
Unemployment rate



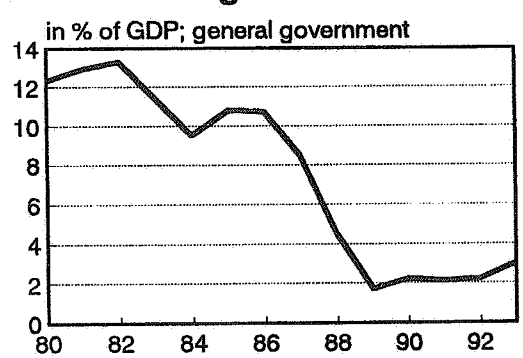
Inflation



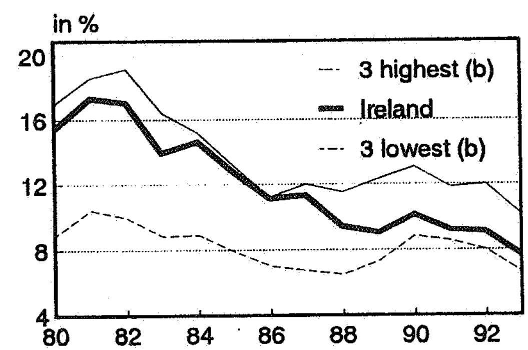
Balance of current transactions



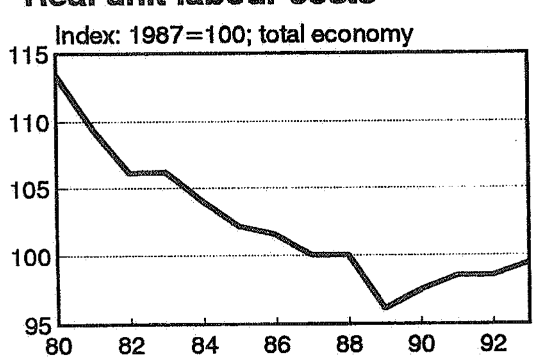
Net borrowing



Long term interest rate



Real unit labour costs

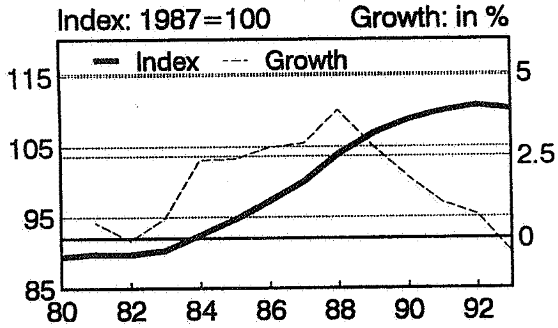


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

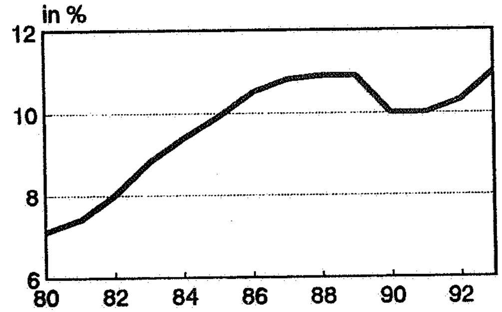
Source: Commission services, economic forecasts (Autumn 1993)

Italy

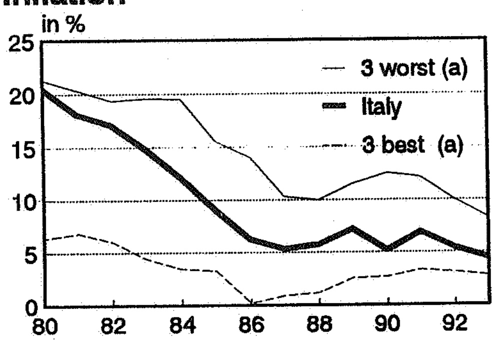
Real GDP/head of population



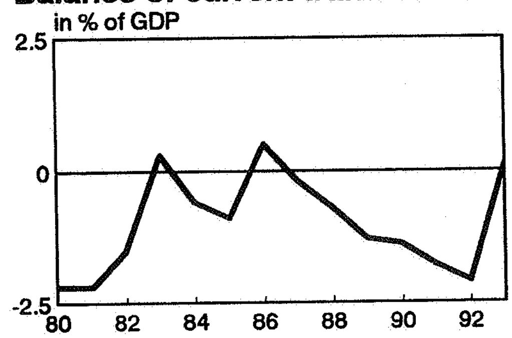
Unemployment rate



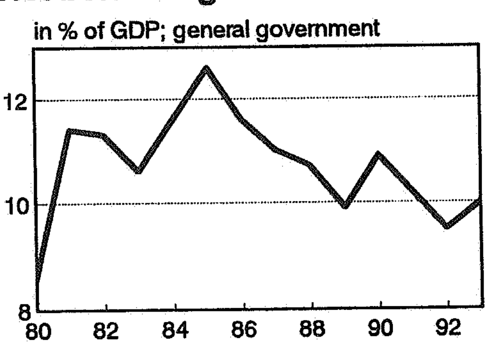
Inflation



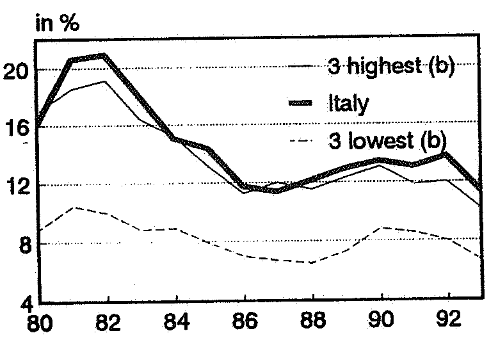
Balance of current transactions



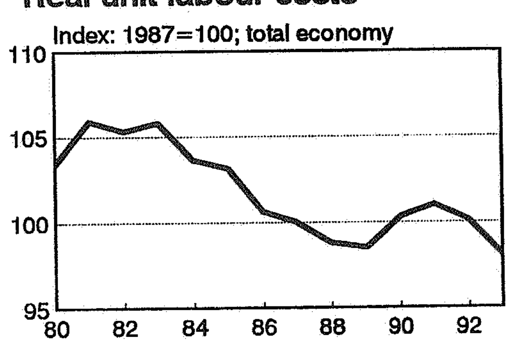
Net borrowing



Long term interest rate



Real unit labour costs

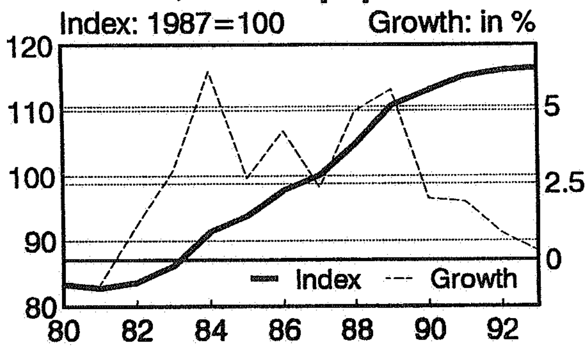


(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

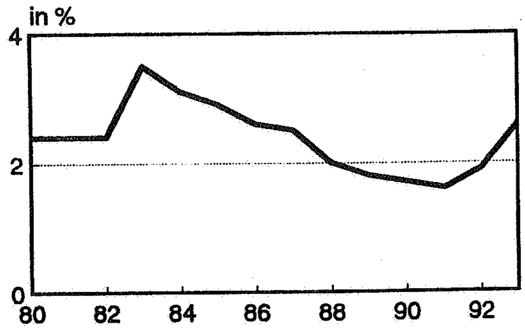
Source: Commission services, economic forecasts (Autumn 1993)

Luxembourg

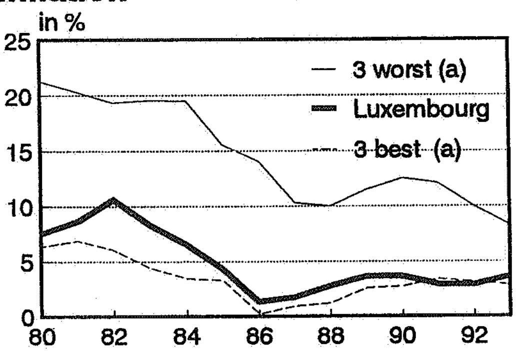
Real GDP/head of population



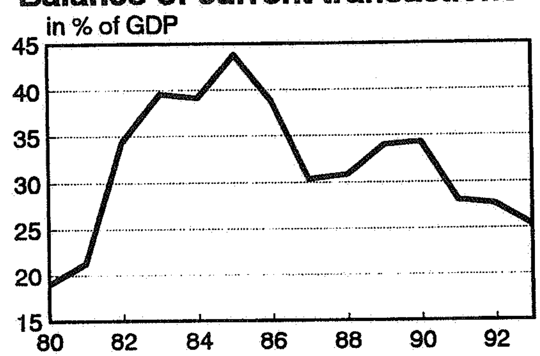
Unemployment rate



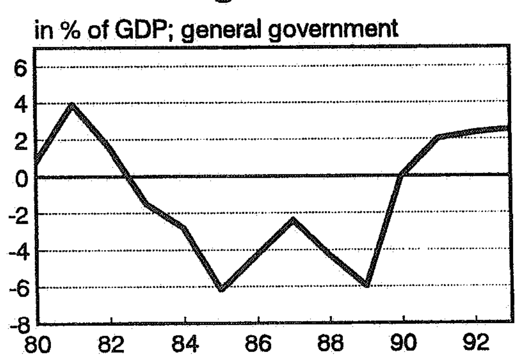
Inflation



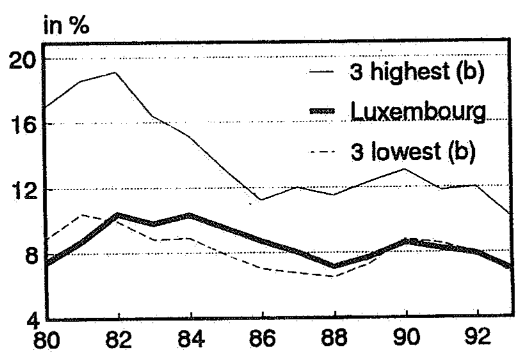
Balance of current transactions



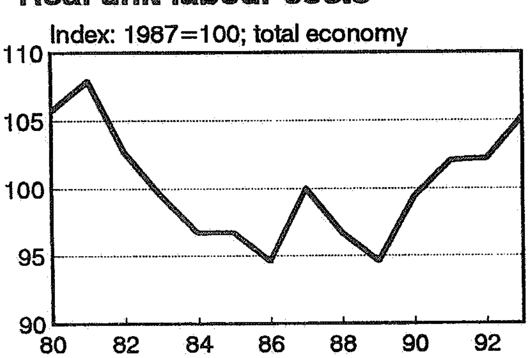
Net borrowing



Long term interest rate



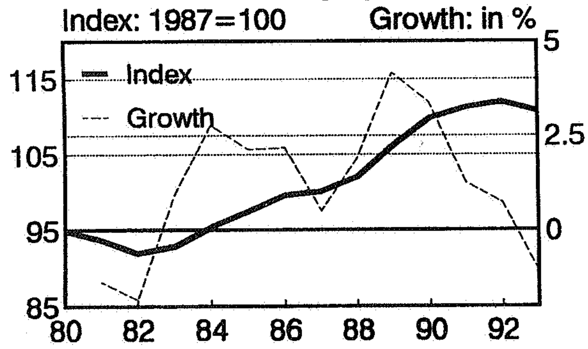
Real unit labour costs



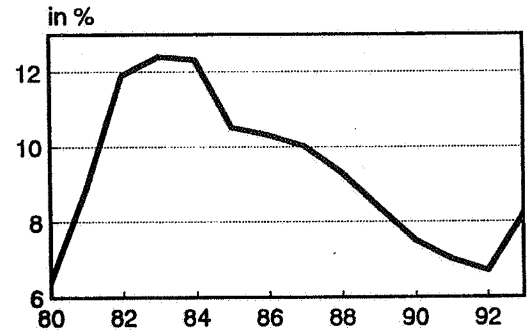
(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

Netherlands

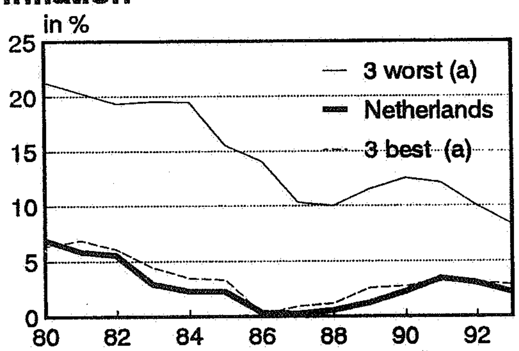
Real GDP/head of population



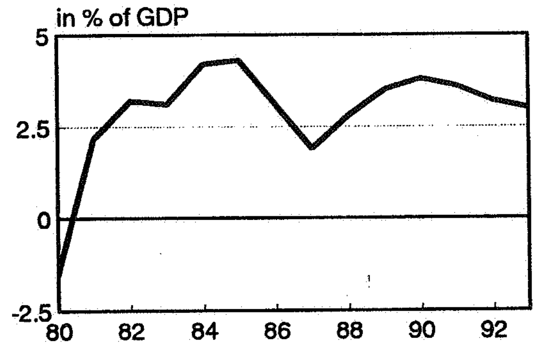
Unemployment rate



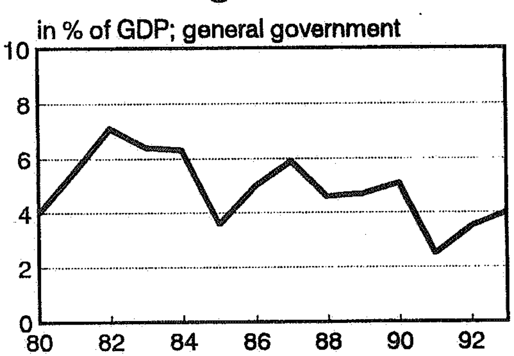
Inflation



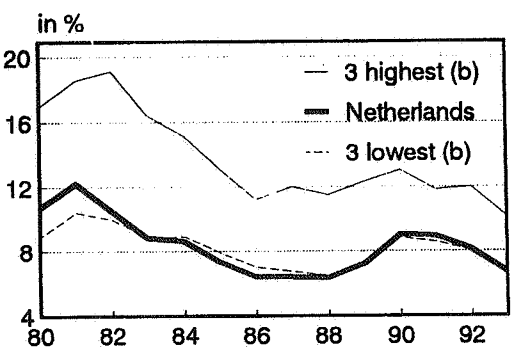
Balance of current transactions



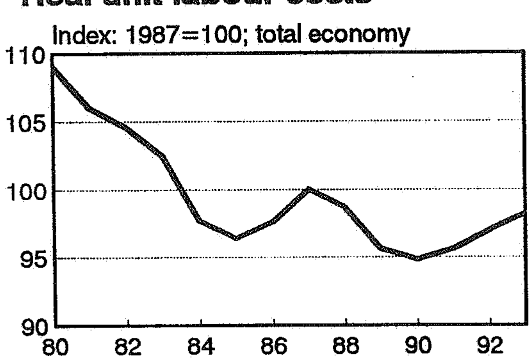
Net borrowing



Long term interest rate



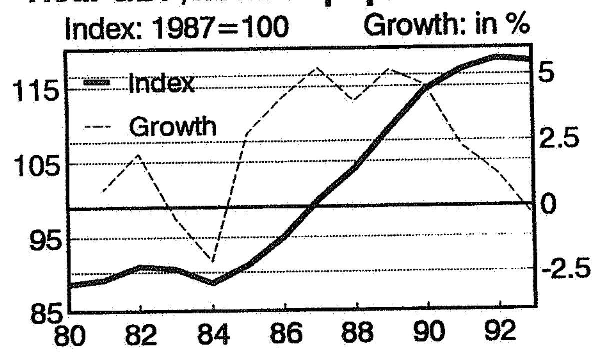
Real unit labour costs



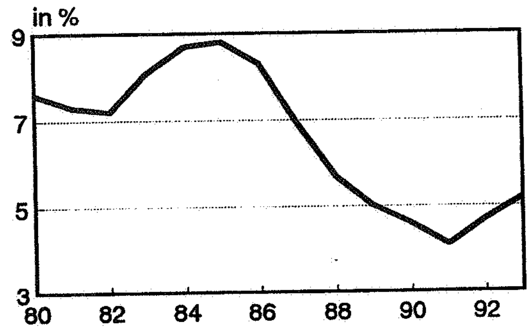
(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

Portugal

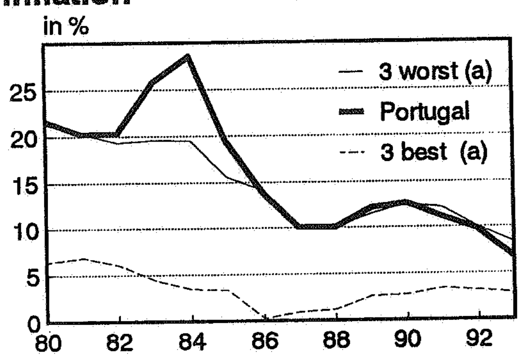
Real GDP/head of population



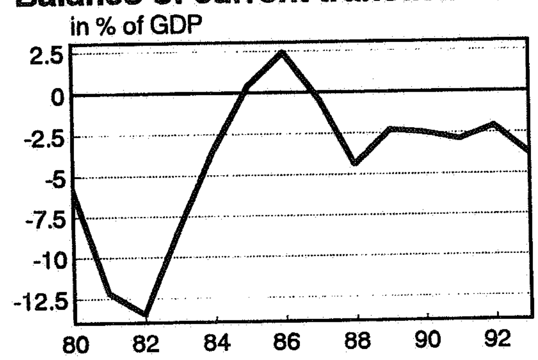
Unemployment rate



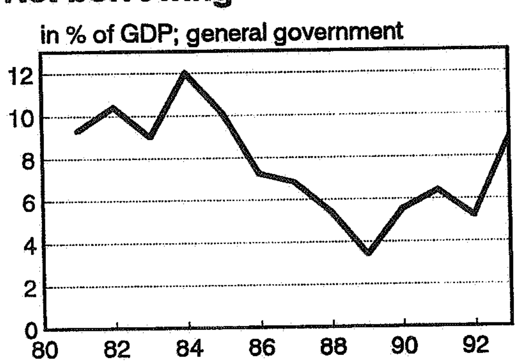
Inflation



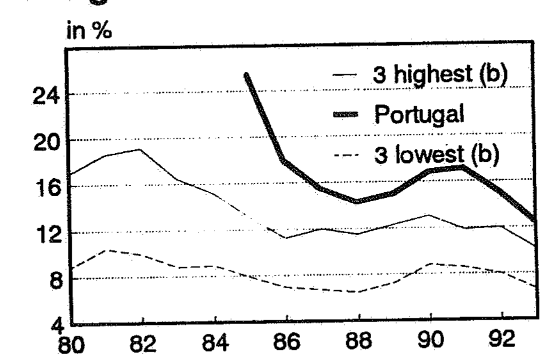
Balance of current transactions



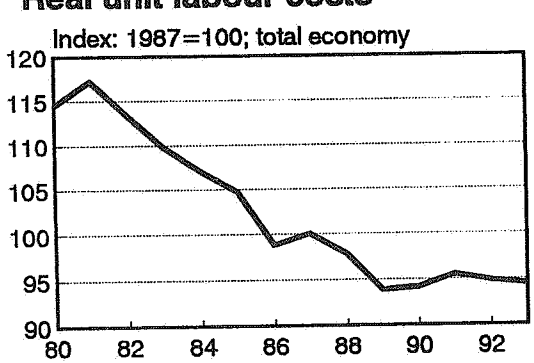
Net borrowing



Long term interest rate



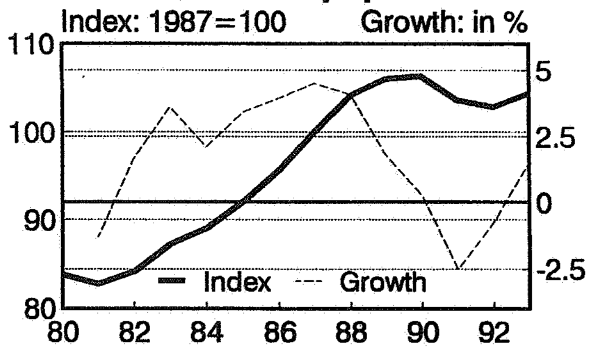
Real unit labour costs



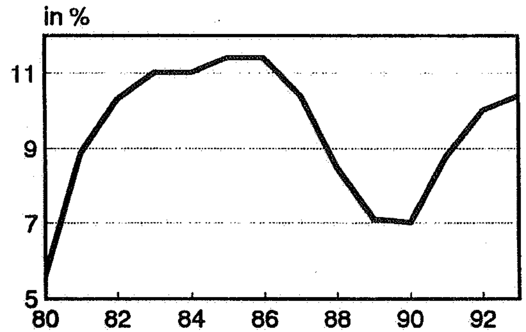
(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates

United Kingdom

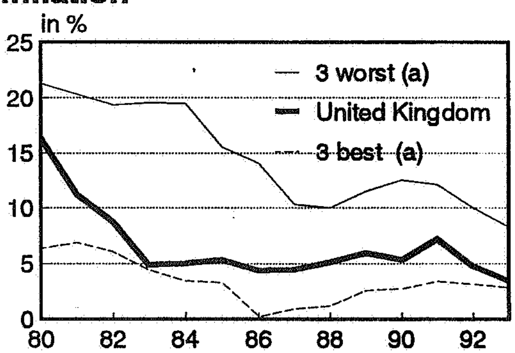
Real GDP/head of population



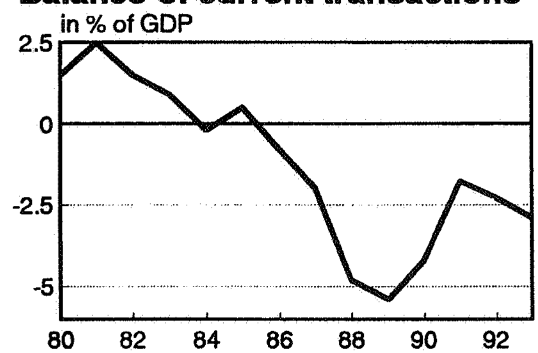
Unemployment rate



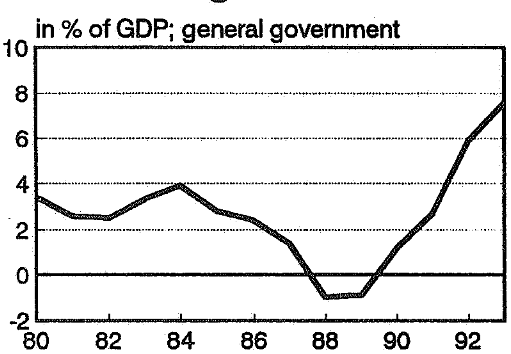
Inflation



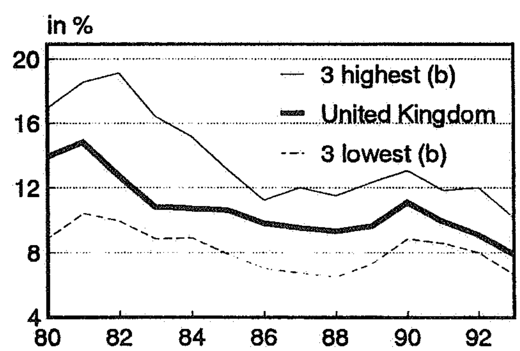
Balance of current transactions



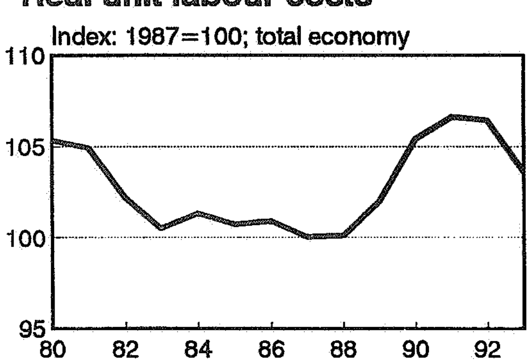
Net borrowing



Long term interest rate



Real unit labour costs



(a) Unweighted averages of the 3 best (worst) performing Member States
(b) Unweighted averages of the 3 highest (lowest) Member States (excl. GR and P) rates