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Part 2: Country section

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CONTENTS

BELGIUM

Buoyant domestic demand but decelerating export activity

Real GDP increased by 2.8% after reaching 3% in 1997. Economic activity was particularly buoyant in the first half of 1998, real output increasing by 3¾% on an annual basis as against the second half of 1997; however in the second half of the year activity decelerated. A slowdown in exports reflected weaker external demand and the nominal appreciation of European currencies. The leading indicator published by the Central Bank suggests that economic confidence has been falling since the fourth quarter of 1997, particularly in the manufacturing sector; in contrast, it remained at satisfactory levels in the domestic trade and construction sectors.

Table 1

Belgium: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	1.6	1.3	3.0	2.8	2.5	2.7
Private consumption	1.5	1.8	2.1	3.0	2.2	2.2
Gross fixed investment	1.0	0.5	5.4	5.4	4.6	5.5
Domestic demand	1.3	1.3	2.2	3.2	2.6	2.6
Exports (1)	4.1	2.2	7.1	5.3	4.4	4.8
Imports (1)	3.8	2.2	6.3	5.9	4.7	4.8
Employment growth	-0.1	0.4	0.4	1.3	1.0	1.0
Unemployment rate (% of civilian labour force) (2)	8.2	9.7	9.2	8.3	7.7	7.1
Nominal compensation per head (3)	5.3	1.5	2.9	2.2	2.7	2.7
Inflation (4)	2.8	2.3	1.8	1.1	1.4	1.5
Current account balance (% of GDP)	2.5	4.0	4.6	5.1	5.1	5.1
Nominal short-term rate of interest (level) (5)	7.9	3.2	3.4	3.6	:	:
Real effective exchange rate (6)	2.9	-2.7	-4.7	0.3	1.1	:
Government budget deficit / surplus(% of GDP)	-5.8	-3.2	-2.0	-1.3	-1.2	-1.0
Primary balance (% of GDP)	4.4	5.3	5.9	6.2	6.0	5.8

Notes:
(1) goods and services; (2) harmonized Eurostat definition; (3) total economy; (4) private consumption deflator; (5) money market rate; (6) unit labour costs, total economy, relative to IC-20; a positive (negative) sign indicates an appreciation (depreciation).

Source: Autumn 1998 Economic forecasts - Commission services.

Private consumption was particularly dynamic in 1998, especially in the first half of the year. On an annual basis, consumer spending accelerated from 2.1% in 1997 to an estimated 3% in 1998. This upswing was mainly due to a marked improvement in consumer confidence since the end of 1997, and a more than 2% rise in real disposable income in 1998 stemming from strong employment creation and a moderate rise in real wages. Other factors also contributed to the buoyancy of private consumption in 1998, namely the biannual motor show at the beginning of the year, which led to very high growth rates for new car registrations, and the fall in energy prices, which brought about a slowdown in overall inflation relative to the price index used to adjust wages and social transfers (the "health index"[1]).

Business investment is estimated to have increased by about 5% in 1998. The climate for investment has been favourable in recent years due to a rise in profitability, a low level of interest rates, and dynamism of exports. After a decline in residential construction registered between mid-1995 and mid-1996 - following a fall in real disposable income - this type of expenditure expanded by 4% in 1998, benefiting from low mortgage rates and the strength of disposable income.

Export growth declined gradually from the third quarter of 1997. Exports of goods and services decelerated from 5.9% in 1997 to 5.3% in 1998 due to the combined effect of lower foreign demand and the nominal effective appreciation of the BEF. Belgian exports to Europe and North America remained dynamic in the first half of 1998, whereas exports to Asia showed a marked decline. Imports of goods and services accelerated in 1998, from 5.1% in 1997 to 5.9%, reflecting the strengthening of domestic demand; external trade made a slightly negative contribution to growth in 1998 of around 0.2 percentage points of GDP.

The fall in commodity prices and the nominal appreciation of European currencies, significantly improved the terms of trade and contributed to the decline in inflation to about 1%. In addition, the world-wide flight to quality in financial markets led to capital inflows, reducing nominal long-term interest rates to low levels. Due to the increase in labour force participation, reduction in unemployment only partly reflected the extent of job creation. Nonetheless, the standardised unemployment rate fell from 9.3% at the beginning of 1997 to 8.8% in mid-1998, standing below the EU average. The claimant-based national definition of unemployment also fell in 1998.

In 1999, real GDP is expected to increase by about 2½%. Domestic demand should continue to expand, reflecting the current strength of private consumption. Conversely, weak foreign demand is likely to have an adverse impact on export growth; however, the accumulated gain in price-competitiveness registered in recent years will only be partially offset by the nominal appreciation of the currency, allowing Belgium to maintain an adequate level of international competitiveness.

Continuing budgetary consolidation aimed at reducing the level of the public debt.

After a strong budgetary consolidation effort in the 1980s – the primary balance[2] improved by over 9 percentage points of GDP from 1981 to 1987 - in the 1990s, the process of budgetary consolidation was renewed within the framework of two convergence programmes. In particular, the second convergence programme, covering the period 1997-2000, aimed at furthering the process of fiscal adjustment, and at approaching a position of budgetary equilibrium in the medium term. The intermediate target of budgetary policy was to keep a high primary surplus (close to

[1] The health index is the CPI excluding tobacco, alcohol and fuel products.

[2] General government net lending/borrowing excluding interest payments [adjusted for the cycle as a percentage of trend output.]

6% of GDP, which - even under less favourable macroeconomic conditions - should secure a reduction in the high debt to GDP ratio at a satisfactory pace.

Table 2

Belgium: Developments in Public Finances 1993-2002

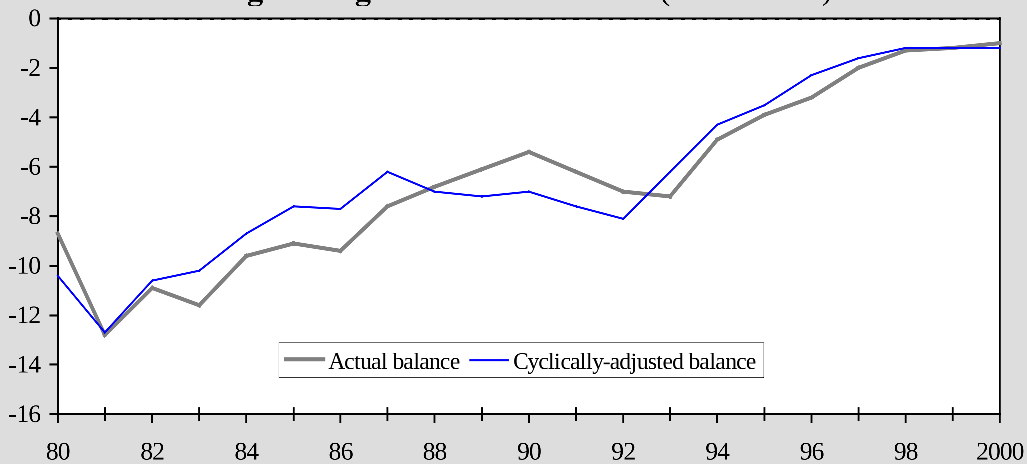
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-7.2	-3.2	-2.0	-1.3	-1.2	-1.0		
- Current receipts	48.7	49.7	49.8	49.7	49.2	48.7		
- Total expenditure	55.9	52.7	51.7	51.0	50.4	49.7		
of which: - Interest payments	10.7	8.5	7.9	7.5	7.1	6.8		
- Investment	1.6	1.1	1.4	1.4	1.5	1.4		
Primary surplus/deficit	3.5	5.3	5.9	6.2	6.0	5.8		
Government debt	135.2	126.8	121.9	117.2	113.7	110.1		
Real GDP growth**	-1.5	1.3	3.0	2.8	2.5	2.7		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-1.9	-1.6	-1.3	-1.0	-0.7	-0.3
Government debt			122.1	117.5	114.5	112.2	109.6	106.8
Real GDP growth**			3.0	2.9	2.4	2.3	2.3	2.3

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998.

Source: Commission services and Stability programme of Belgium.

Graph 1: Belgium - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

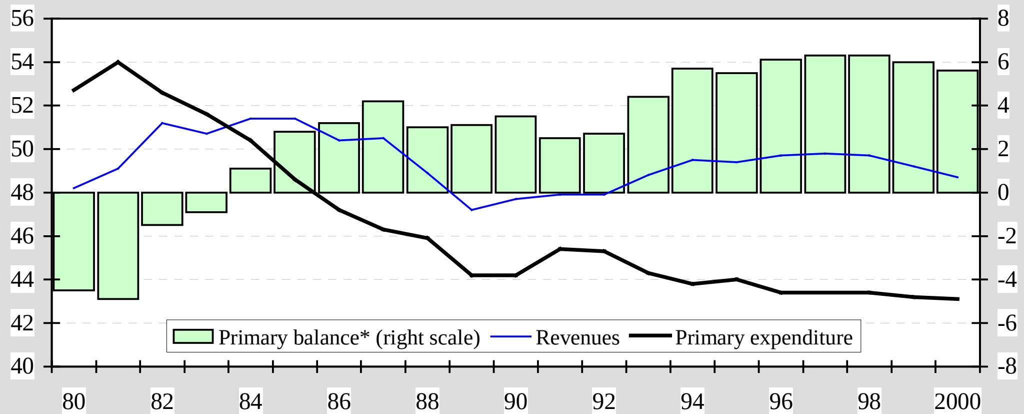
The improvement in the budgetary situation has been the result of both significant discretionary measures and the reduction in the implicit interest rate on the debt. The discretionary measures adopted between 1992 and 1998 totalled approximately 7 percentage points of GDP, of which, about two-thirds affected government revenue. Social expenditure declined by only about ½ of a percentage point of GDP, while since the 1980s, the burden of adjustment fell particularly on public investment, which now represents only 1½% of GDP. The implicit interest rate on the debt declined by nearly 250 basis points between 1992 and 1998. The cyclically adjusted deficit fell from 8.1% in 1992 to an estimated 1.2% in 1998.

The estimated actual deficit of 1.3% of GDP in 1998 is about two years in advance of the targets set in the second convergence programme. The general government deficit is expected to be marginally reduced to 1.2% of GDP in 1999.

The government debt to GDP ratio fell by about 18 percentage points of GDP between 1993 and 1998 (reaching 117.2% of GDP), about half of this improvement resulting from keeping a high primary surplus throughout the period, and the other half from financial operations and the statistical adjustment between the deficit and variations in the stock of debt.

In January 1999 a stability programme was presented by Belgium, covering the period 1999 to 2002; the intermediate objective of the programme is a primary surplus stable at the level of 6% of GDP over the period; under the assumption that real GDP growth will be close to its trend from 1999 to 2002, the Belgium authorities expect the general government deficit to fall to 0.3% of GDP at the end of the period. The debt ratio is expected to decline further to 106.8% of GDP in 2002. In its evaluation of the Belgium stability programme the Commission will assess whether the programme is in line with the requirements of the Stability and Growth Pact.

Graph 2: Belgium - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



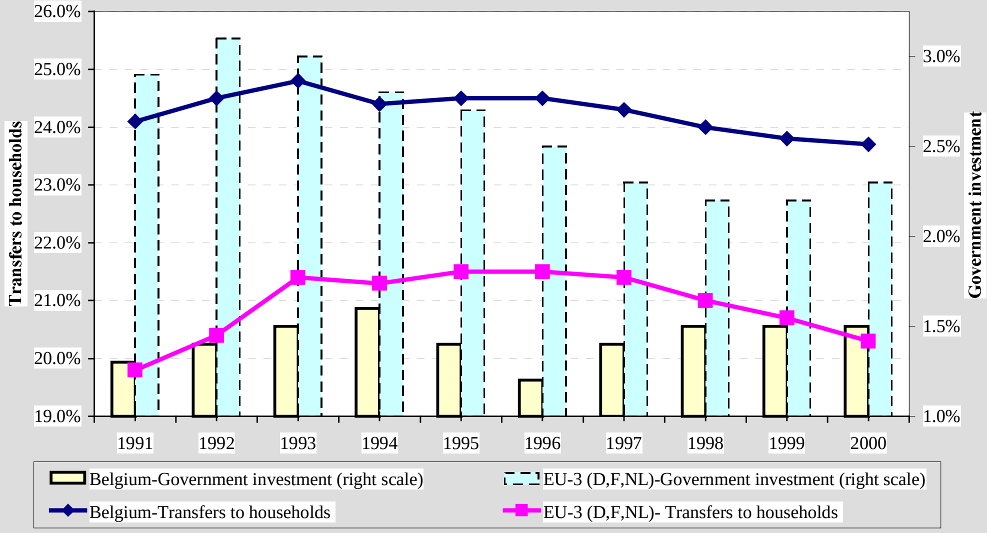
*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

The exchange rate policy – based on an informal link between the BEF and the DM since June 1990 - together with the progressive and sustained reduction in the deficit allowed Belgium to benefit fully from the general easing in monetary conditions since 1994. The interest rate differentials between the BEF and DM narrowed at both ends of the maturity spectrum. In addition, an active policy of debt management has also contributed to the reduction in the weight of interest charges. The average maturity of public debt was lengthened and a considerable amount of outstanding long-term debt was rolled-over at lower interest rates.

Further progress on labour market needed

In Belgium, the employment policy was recently restated in the National Action Plan for Employment. This plan is the result of a co-ordination effort between the Federal government, Regions and Communities, which have all specific responsibilities in this area. Social partners also play an important role in securing wage moderation -within the framework of the law on "employment and competitiveness"- and in the actual implementation of labour policy. In the interprofessional agreement for the period 1999-2000 social partners made firm commitments both in terms of job creation and vocational training, conditional on the government's pledge to reduce employers' social security contributions further.

Graph 3: Belgium - Transfers to households and government investment (as % of GDP)



Source :Autumn 1998 Economic Forecasts - Commission services.

An important pillar of the Belgian strategy to foster employment creation is the phased reduction in employers' social security contributions to the average level in the three main trading partners of Belgium (i.e. D, F, and the NL). Employers' contributions are to be reduced by a total of over BEF 100 billion in the next 6 years (starting in mid-1999), representing an estimated reduction in average labour cost of 3.4%. The other major axis of employment policy refers to "active" measures, which aim to improve the employability of the labour force through better training and guidance. The main policy initiative in this area is the "*Plan d'accompagnement des chômeurs*", which is to be strengthened. As a result, the apparent employment elasticity to real growth has increased in recent years. However, adding older unemployed and other people in special unemployment-related programmes to the national definition, it is estimated that a broader unemployment measure still represents about one-quarter of the labour force. Therefore and despite the progress made in 1998, the degree of under-utilisation of labour resources in Belgium remains very high.

The period of wage moderation initiated in 1994 has been crucial to improve firms' competitiveness and foster job creation. However, the process of wage formation could be made more flexible, and the incentives of the welfare system redressed in favour of labour force participation in order to facilitate the process of job creation, particularly for low-skilled workers.

There is also scope to improve competition in product markets, especially in the service sector, where employment gains are potentially higher. In particular, entry conditions in the distribution sector could be relaxed, as current administrative procedures to license new shops are cumbersome - effectively acting as barriers to entry - whereas shop opening hours could be made more flexible.

DENMARK

"Soft landing" after four years of strong growth

Following four years of annual output growth of more than 3%, real GDP growth in 1998 is estimated at 2½%. Economic activity in 1998 was dampened, in particular, by a large-scale industrial conflict that broke out in Spring and affected roughly one fifth of the employed labour force. Furthermore, the lingering international economic crisis impacted negatively on growth mainly via lower growth of export markets, although Denmark was spared from any large impact as its economic links with countries at the centre of the crisis remains low.

Domestic demand was the driving force behind growth in 1998, as in previous years. Private consumption was the main contributor to domestic demand, bolstered by high and accelerating wage increases in combination with rapid employment expansion, leading to higher disposable income. In addition, increased job security and a surge in housing prices – and thus in households' wealth - acted to lower the savings rate. Private capital formation also was strong. Continued high capacity utilisation and low interest rates made for strong investment in equipment. Equally, the sharp rise in housing prices and the fall in interest rates over recent years boosted housing investment. On the other hand, following the completion of several large projects, infrastructure investments are now in decline tending *per se* to reduce capital formation.

Table 1

Denmark: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	2.0	3.4	3.3	2.4	1.9	2.1
Private consumption	2.5	2.2	3.6	3.0	1.9	2.1
Gross fixed investment	1.5	7.8	10.4	4.9	3.5	3.5
Domestic demand	2.0	3.2	4.5	3.4	2.1	2.1
Exports (1)	4.3	4.1	4.3	1.2	3.1	4.9
Imports (1)	4.7	3.7	7.6	3.6	3.7	4.9
Employment growth	-0.4	1.3	2.3	1.9	0.6	0.7
Unemployment rate (% of civilian labour force) (2)	8.5	6.8	5.5	4.2	4.0	3.7
Nominal compensation per head (3)	3.6	3.1	3.8	4.2	4.7	4.7
Inflation (4)	2.0	2.5	2.2	1.9	2.4	2.2
Current account balance (% of GDP)	1.4	1.2	0.3	-0.9	-0.6	-0.4
Nominal short-term rate of interest (level) (5)	9.1	3.9	3.7	4.2	:	:
Real effective exchange rate (6)	0.7	-1.1	-1.3	3.8	4.1	:
Government budget deficit / surplus(% of GDP)	-2.3	-0.7	0.5	1.3	2.7	3.0
Primary balance (% of GDP)	4.8	5.9	6.6	6.7	7.6	7.5

Notes:
(1) - (6) see Table 1 for Belgium.

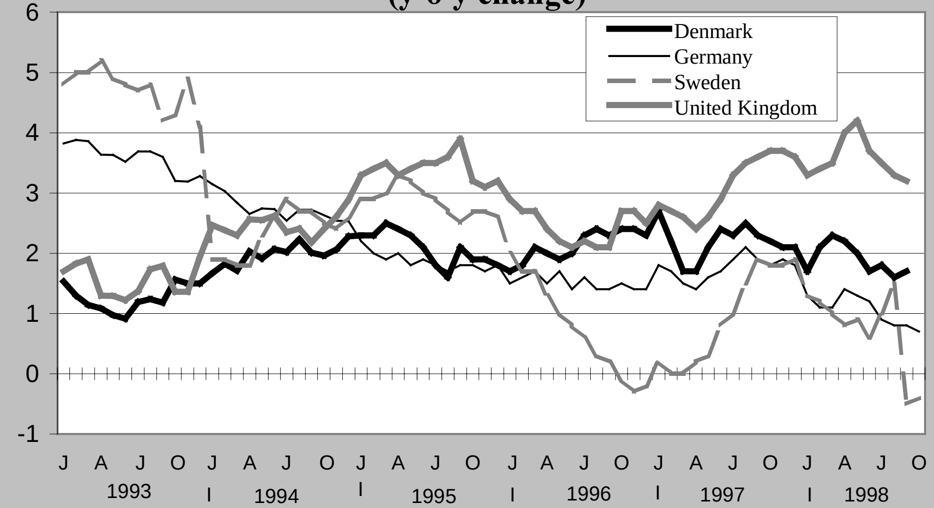
Source: Autumn 1998 Economic forecasts - Commission services.

Denmark is at an advanced point in the business cycle and domestic demand has been rising faster than in most trading partner countries. This was the main reason behind the weakening of the current account. The balance of trade in goods was the principal locus of the deterioration in the current account mainly because (i) merchandise imports were boosted by buoyant domestic demand, (ii) merchandise exports were lowered by the labour market conflict and (iii) Denmark lost market shares due to a strong appreciation of the effective exchange rate and unit labour costs rising above those of the main trading partners.

Partly owing to falling prices of commodities and foodstuff, the rise in consumer prices remained fairly low at just under two percent. However, in comparison with the main trading partners, except for the United Kingdom the CPI showed a higher growth rate. Domestic inflationary pressures seem to be better captured by the rate of underlying inflation, which excludes imports, energy, food, rents, indirect taxes and government controlled prices, and which shows an increase from 1.3% in January to just under 3% by the end of the year.

Employment grew by almost 2% in 1998, continuing its trend from the previous year. Wage developments reflect the increasing tightness in the Danish labour market. In 1998, nominal wages rose by over 4%, corresponding to real wage gains of more than 2%, well above wage increases in Germany, Denmark's main trading partner. Notwithstanding the traditionally high cyclical responsiveness of the labour force, the strong employment growth reduced unemployment by almost 1½ p.p. to some 6½% (national definition). In the harmonised (Eurostat) definition, the unemployment rate stood even lower at some 4½%. Unemployment has been roughly halved over a period of 5 years. Various estimates indicate that actual unemployment has fallen below the level of structural unemployment.

Graph 1. Consumer price index of main trading partners (y-o-y change)



Source: Eurostat

Denmark has decided not to participate in the single currency from the start of the third stage of EMU. However, Denmark has committed itself to follow a policy of keeping the krone stable relative to the euro. In fact, the krone has been increasingly stable within the ERM since 1982 and its bilateral central rate against the DEM has been unchanged since 1987. As of 1 January 1999, Denmark participates in the ERM2 with an agreed fluctuation margin of ±2¼%. On several occasions, the Danish authorities have demonstrated their strong determination to defend the currency peg. They did so successfully in Spring 1998, and again in September 1998 in connection with the global financial turmoil.

The economic outlook for 1999 is for a further deceleration of output growth to below 2%. External demand will continue to be weak due to the fragile international environment and further losses in international competitiveness. In addition, a tighter budgetary policy is expected to curb domestic demand. In particular, a tax reform decided in Spring 1998 is likely to restrain both consumption and housing construction (see below). Furthermore, government investment is estimated to fall as a number of large infrastructure projects have been completed. These dampening effects are likely to be partially offset by low commodity prices and continued favourable monetary conditions.

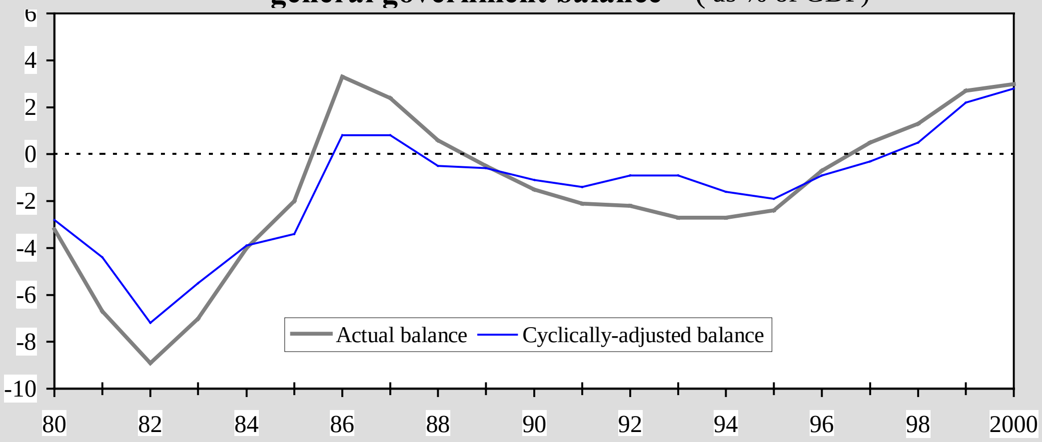
The current account is expected to stabilise in 1999, as a net result of the deceleration in domestic demand and the expected slowdown in export growth. As for prices, higher energy taxes are likely to lead to a slight acceleration of consumer price inflation. Employment will continue to grow, while unemployment should further decline. Wage growth will remain high at some 4½% or above, as the labour market will continue to be tight. Labour market measures announced in 1998 could result in a welcome increase in labour supply.

Public finance in the medium term

The budgetary position of Denmark has considerably improved over recent years. This owes much to the strong economic activity since 1994 but is also due to discretionary measures improving the structural position of government finances. In fact, perhaps more than in most other Community countries, in Denmark budgetary policy has been utilised for the purpose of stabilising the economy. In particular, following the counter-cyclical stimulus in 1994, against a background of increasing economic buoyancy budgetary policy has tightened from 1995 onwards. As a result, the general government balance improved from -2.7% of GDP in 1993, when it hit its trough, to a surplus of over 1% of GDP in 1998. Similarly, the gross debt ratio came down from its peak of 81.3% of GDP in 1993 to less than 60% of GDP in 1998.

Budgetary policy between 1994-98 has been embedded in the framework of tax reform and structural reform of the labour market. Although the tax reform has led to a significant shift in the composition of revenues from income taxes to social security contributions and energy taxes, its impact on total revenues was small. The revenue-to-GDP ratio changed only slightly from 59.9% in 1993 to an estimated 58.8% in 1998. By contrast, expenditure dropped markedly from 62.1% of GDP in 1993 to 57.6% of GDP in 1998. This may be attributed in large part to a decline in government transfers, in particular for unemployment benefits and labour market schemes.

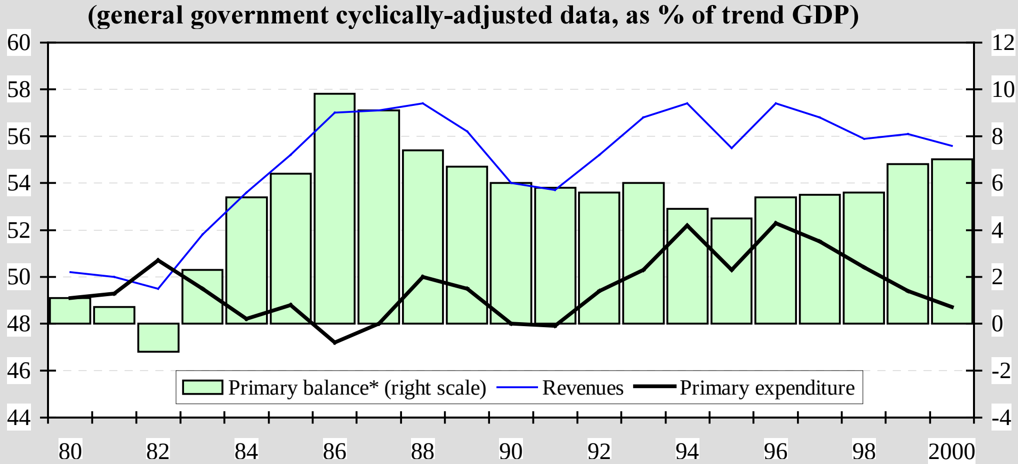
Graph 2: Denmark - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

Notwithstanding this overall favourable outcome, actual expenditure has regularly overshot budgetary targets due mainly to overruns at regional and local government levels. The higher expenditure has, however, been offset by higher-than-anticipated revenues largely owing to stronger-than-expected output growth. Additionally, lower interest payments contributed to the extent of almost 2 p.p. to the expenditure decline between 1993 and 1998. The primary balance improved by more than 2 p.p. during this period. Throughout the 1990s, the primary balance has shown sizeable surpluses.

Graph 3: Denmark - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

In October 1998, Denmark has presented its Convergence Programme in accordance with the provisions of the Stability and Growth Pact. The programme is based on the medium-term plan "Denmark 2005 - towards new results" and foresees a substantial further improvement of government finances over the programme horizon (1998-2005). The government balance is expected to improve to a surplus of 2.6% of GDP in 2001 and further to 3.5% of GDP in 2005. At the same time, the debt ratio should decline to 49% of GDP in 2001 and to 37% of GDP in 2005. With Denmark already fulfilling the requirements of the Stability and Growth Pact, namely "a medium-term budgetary balance of close to balance or in surplus", the additional improvement in the government balance will widen the margin for the potential use of discretionary counter-cyclical budgetary policy. Denmark's non-participation in the single currency and the high cyclical sensitivity of government finances might indeed call for such a wider safety margin.

The strategy of budgetary consolidation follows that of past years, namely a significant reduction in primary expenditure which is only partially offset by a moderate easing in the tax burden. Tax reform and structural reforms of the labour market will play a central role for the achievement of the programme's objectives. The tax reform, which was decided in Spring 1998 ('Whitsun' package), will be phased in over the period up to 2002 and will reduce the rates of personal income taxes for the lowest income bracket, increase the allowance threshold for the medium income tax bracket and lower corporate taxation. A broadening of the tax base, notably by reducing the tax value of deductible interest payments, an increase in energy taxes and a change in the system of taxation of pension fund holdings should help secure broadly neutrality of the reform in terms of tax revenue. The tax reform is expected to rein in consumer spending and residential construction in the near term, improve savings incentives in the longer term and diminish distortions in the present tax system.

The expenditure savings envisaged in the convergence programme will mainly derive from the planned reforms of the labour market. However, labour market reform also represents an aim in itself as bottlenecks on the labour market can only be overcome by a further increase in labour force flexibility. The reform measures seek to reduce skill losses from unemployment by shortening the period of unemployment after which compulsory activation is to be applied; increase work incentives by reducing the unemployment benefit period from 5 to 4 years, while persons aged between 50 and 54 years, which up to now have been able to receive unemployment benefits for 10 years, will become subject to the general scheme; and to make the labour exchange more effective by various administrative improvements. Overall, these reforms go into the right direction by easing tensions in the Danish labour market. However, disincentives mechanism in the Danish labour market will persist, such as the high effective replacement ratio especially for low-skilled workers.

Structural reforms

Apart from the structural policy measures outlined in the Convergence Programme the Danish government has embarked on a number of other structural reforms which seek to improve the functioning of product and factor markets.

Table 2

Denmark: Developments in Public Finances 1993-2002
(as percentage of GDP)

Outturn and forecasts [a]	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-2.7	-0.7	0.5	1.3	2.7	3.0		
- Current receipts	59.9	60.5	59.6	58.8	59.1	58.6		
- Total expenditure	62.1	61.4	59.4	57.6	56.5	55.7		
of which: - Interest payments	7.3	6.6	6.1	5.4	4.9	4.6		
- Investment	1.7	2.0	2.0	1.8	1.8	1.8		
Primary surplus/deficit	4.5	5.9	6.6	6.7	7.6	7.5		
Government debt	81.3	68.4	64.1	58.8	54.3	49.8		
Real GDP growth [b]	1.3	3.4	3.3	2.4	1.9	2.1		
Convergence programme [c]			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			0.5	1.1	2.5	2.8	2.6	d)
Government debt			64.1	59.0	56.0	51.0	49.0	e)
Real GDP growth [b]			3.3	2.6	1.7	2.0	2.0	f)

a) Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
b) Annual % change.
c) Submitted in October 1998.
d) Government surplus of 3.5% of GDP as average for 2002-2005.
e) Government debt of 37.0% of GDP as average for 2002-2005.
f) Real GDP growth 2.2% of GDP as average for 2002-2005.

Source: Commission services and convergence programme of Denmark.

In the framework of the budget proposal for 1999, additional reform measures are envisaged to increase labour supply by raising the effective retirement age. The reform focuses on the early retirement scheme and provides that private pension rights would be more extensively offset from public pension payments in the case of early retirement. It is expected that this measure will raise the effective retirement age from currently 62 years closer to the statutory retirement age which, at the same time, is lowered by the reform from 67 to 65 years.

Danish housing standards are rather high by international comparison, although this has been accomplished through large subsidies both directly and indirectly via the tax system. Mobility in the housing market is low and prices are high both in real estate and in the rented segment of the market. Reforms have come gradually over recent years. In 1987, 1994 and, most recently, in 1998 changes were made both by reducing the tax value of deductible interest payments and by decreasing direct interest support to house owners. Some effects of the 1998 reform could already be seen in the third quarter of 1998, when prices started to stabilise, discontinuing the strong upward trend.

In the area of energy a first step towards liberalisation was taken at the beginning of 1998. End users with an annual consumption over 100 GWH were allowed to choose their supplier. However, at present, there are only 6 enterprises that can exercise this right. For other end users, technical and regulatory obstacles persist.

GERMANY

Satisfactory economic growth in 1998

The improvement in the economic situation that had appeared during 1997 continued in 1998, when the Gross Domestic Product increased by about 2¾%, the highest rate of economic growth since the end of the "reunification boom". Although a 2¾% growth rate is not *per se* very high (only about half a point above the long-term trend), it represents a welcome improvement from the rather depressed post-1992 period. Furthermore, German growth rates of the end of the 1990s are driven downward by a long slump in the construction sector, which is due to structural, not to cyclical reasons.

Table 1

Germany: Macroeconomic and Financial Developments
(annual percentage change unless otherwise indicated)

	1992-95	1996	1997	1998	1999	2000
GDP growth	1.2	1.3	2.2	2.8	2.2	2.6
Private consumption	1.9	2.1	0.5	1.7	2.5	2.3
Gross fixed investment	0.3	-1.2	0.1	1.8	3.1	3.9
Domestic demand	1.4	0.7	1.4	2.7	2.5	2.5
Exports (1)	2.2	5.1	11.1	6.5	3.6	5.4
Imports (1)	2.6	2.9	8.1	6.3	4.8	5.4
Employment growth	-1.1	-1.3	-1.3	0.1	0.2	0.6
Unemployment rate (% of civilian labour force) (2)	7.8	8.9	10.0	9.7	9.3	8.9
Nominal compensation per head (3)	5.6	2.5	1.9	1.7	2.6	2.7
Inflation (4)	3.4	1.7	1.7	1.0	1.1	1.5
Current account balance (% of GDP)	-1.2	-1.0	-0.6	0.2	0.3	0.4
Nominal short-term rate of interest (level) (5)	6.6	3.3	3.3	3.5	:	:
Real effective exchange rate (6)	4.4	-4.1	-8.1	-1.5	1.0	:
Government budget deficit / surplus(% of GDP)	-2.9	-3.4	-2.7	-2.6	-2.3	-2.1
Primary balance (% of GDP)	0.6	0.3	1.1	1.1	1.3	1.5

Notes:
(1) - (6) see Table 1 for Belgium .

Source: Autumn 1998 Economic forecasts - Commission services.

From 1996 to 1997, the need to reestablish competitiveness, which had been hurt in 1995 by large wage increases (+4.6% on an hourly basis) and by a marked revaluation of the DEM (+5.4% in nominal effective terms) led to a deceleration in wages growth. This phenomenon, coupled with a bad labour market situation (unemployment jumped from 9.4% to 11.4% from 1995 to 1997) constrained households' expenditure. As a result, private consumption grew at a meagre 1.0% rate from 1996 to 1997, compared with a 1.7% rate for GDP as a whole. By 1998, however, the stabilisation of the labour market, signs of a acceleration in wages, albeit very limited, and a decline in inflation, bolstered households' real disposable income. Furthermore, consumer confidence improved markedly during the year, so that the rising propensity to consume amplified the positive income effect. By the third quarter of 1998, the saving rate fell to 11.8% (s.a.), which, if maintained in Q4, would mark by far the lowest half-yearly level since the reunification. This allowed private consumption to accelerate markedly: by the third quarter of 1998, it had risen by a 2.2% rate, year-on-year, compared with only 0.5%, on average, for 1997.

During 1998, exports decelerated sharply from the very strong growth of 11.1% the previous year. The effects of the Asian and of the Russian crisis gradually made themselves felt. Imports, too, decelerated, but not as quickly, so that the net foreign growth contribution shrank over the year, becoming negative in the third quarter.

The worsened international growth prospects led to a steady deterioration of the business confidence indicator. Nevertheless, equipment investment grew strongly in 1998, doubling the previous year's growth rate, as enterprises responded positively to a higher rate of capacity utilisation and good overall profitability. The better investment climate, however, was not sufficient to end the long slump in the construction sector: structures investment declined strongly for the fourth year running. Nevertheless, first signs of a pick-up in orders and an improvement in confidence appeared in the construction sector by the second half of the year. Overall, the recovery of private consumption and in stockbuilding were strong enough to overcome the decline in other domestic components, so that domestic demand as a whole accelerated.

The year 1998 brought some improvement in the labour market situation, as a six-year employment slump drew to an end. By the end of 1998, the seasonally-adjusted unemployment rate was some 1.3 points below previous-year levels. Part of the improvement, however, particularly in the new Länder, was due to an expansion of active labour market policies. Employment, too, picked up during the year.

Inflation fell to remarkable lows during the year: in November, the year-on-year rate of increase of the consumer price index was 0.7%. Corrected for statistical biases[1], consumer prices were practically stable, despite an increase in the normal VAT rate by one percentage point in April. The disinflation process was driven largely by decreases in the prices of imported goods, notably energy products and raw materials, and continued wage moderation.

In 1999, the effects of the international financial turbulence will lead to a deceleration in GDP growth. The slowdown, however, is expected to be temporary. The recovery of domestic demand and the good economic fundamentals are more important, in the medium term, than external factors, provided that the European environment remains favourable. It has to be considered that only a fairly modest share of Germany's exports are directed towards the countries directly affected by the crisis; therefore, even though world growth is bound to slow down somewhat, no recession should ensue, also thanks to the easing in monetary policy and to the low prices for oil and commodities that have been a byproduct of the crisis. The marked recovery in world stock prices at the end of 1998 and the beginning of 1999 seems to corroborate this relatively benign outlook.

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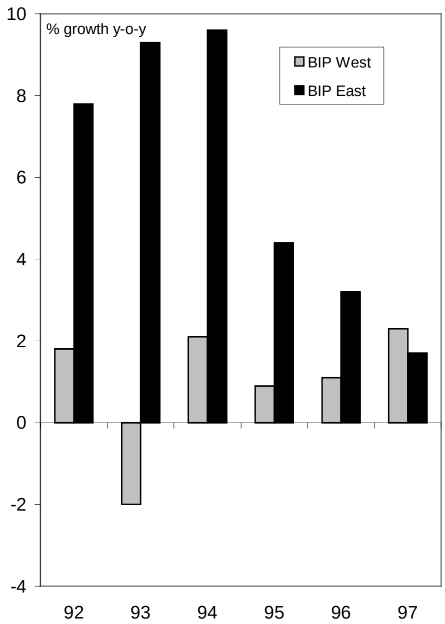
[1] According to a Deutsche Bundesbank study, the Consumer Price Index, owing to various biases, may overstate actual inflation by up to ¾% annually. Such a figure is not far from the estimate for the USA given by the Boskin Commission.

The outlook for the new Länder shows some signs of improvement

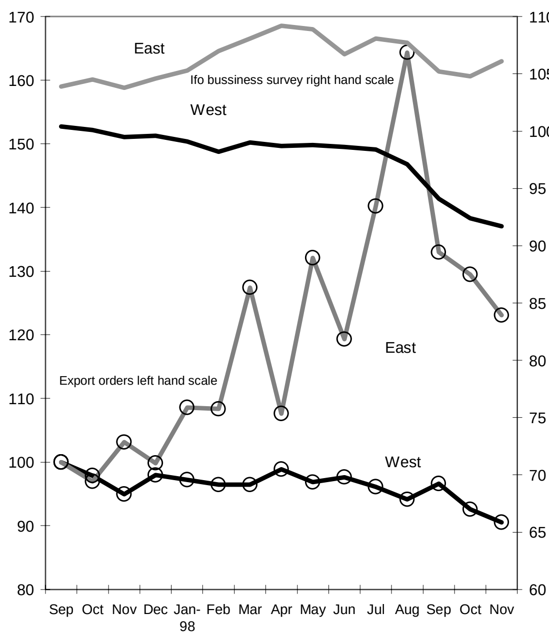
The outlook in East Germany has been getting better in 1998, after a few years in which the catching-up process had been slowing down or even reversing (*see graph)*. In 1997, as GDP growth in the East fell behind that of the West for the first time since reunification, pessimism about the region's long-term prospects spread. It was pointed out, not without reason, that the development process, besides being too dependent on tax subsidies, had hinged too much on the construction and service sectors to the detriment of manufacturing, which is essential for longer term development. No doubt the region's excessive focus on construction will continue to hamper development in the coming years; nevertheless, some signs of improvement appeared in other sectors. Industry, the sector that has suffered most by the Ostmark/DM conversion, which implied a strong revaluation of the currency, on top of the galloping wage increases of the early years, seems to show some dynamism; despite the slowdown in GDP growth, manufacturing production continues to grow much faster there than in the West. The most encouraging sign of improvement, however, is the following: Eastern businesses are finally starting to overcome their virtual absence from export markets. Orders from abroad have been growing much faster than those directed to West German enterprises, although of course from a much lower level: s.a. data for the first three quarters of 1998 show foreign orders to the new Länder growing by over 27%, compared with a growth of only 3% for Western German businesses. Given Germany's export orientation, such a development is very encouraging. Business confidence in the region, perhaps as a result, seems to be more upbeat than in the West: the ifo business confidence indicator has been performing much better in the new Länder than in the old.

Graph 1. GDP growth in the east has slowed down in recent years...



Source : Deutsche Bundesbank.

...but export orders and business confidence have improved markedly in 1998



Source : Deutsche Bundesbank , IFO.

Public finances in perspective

The 1990s were characterised, as far as public finances are concerned, by the huge task of financing reunification, which required annual transfers to the new Länder of the order of 4% of GDP. Up to 1994/1995, sharply rising expenditure was covered through an increase in revenues. By 1995, public expenditure as a share on GDP surpassed 50%, compared with little more than 48% in 1991, whilst the share of current receipts grew from 44.8% to 46.6%. From 1991 to 1994, the government deficit declined somewhat, decreasing from 3.1% to 2.4%; given, however, that economic growth was slowing down sharply, the structural improvement of the deficit was much larger.

Table 2

Germany: Developments in Public Finances 1993-2002

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-3.2	-3.4	-2.7	-2.6	-2.3	-2.1		
- Current receipts	46.3	45.9	45.4	44.8	44.8	44.5		
- Total expenditure	49.9	49.5	48.2	47.5	47.2	46.7		
of which: - Interest payments	3.3	3.7	3.7	3.7	3.6	3.6		
- Investment	2.7	2.2	1.9	1.8	1.8	1.9		
Primary surplus/deficit	0.1	0.3	1.1	1.1	1.3	1.5		
Government debt	48.0	60.8	61.5	61.3	61.0	60.7		
Real GDP growth**	-1.2	1.3	2.2	2.8	2.2	2.6		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-2.7	-2½	-2.0	-2.0	-1½	-1.0
Government debt			61.5	61.0	61.0	61.0	60½	59½
Real GDP growth**			2.2	3.0	2.0	2½	2½	2½

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in January 1999.

Source: Commission services and Stability programme of Germany.

In 1995, however, the deficit increased both in actual and in cyclically-adjusted terms. The government therefore set about reducing the deficit by reining in expenditure: its share in GDP consequently dropped by over 2½ points from 1995 to 1998. This reduction in outlays was so strong that it could offset a concomitant fall in the revenue ratio of around 2 points, due in part to unexpected tax shortfalls[2]. As a result, in the 1995-1998 period, the general government deficit declined markedly in both actual and cyclically-adjusted terms. In particular, information, which became available after the Autumn 1998 forecast of the Commission services, point to a stronger than projected decline in the deficit in 1998, now expected to lie close to 2% of GDP.

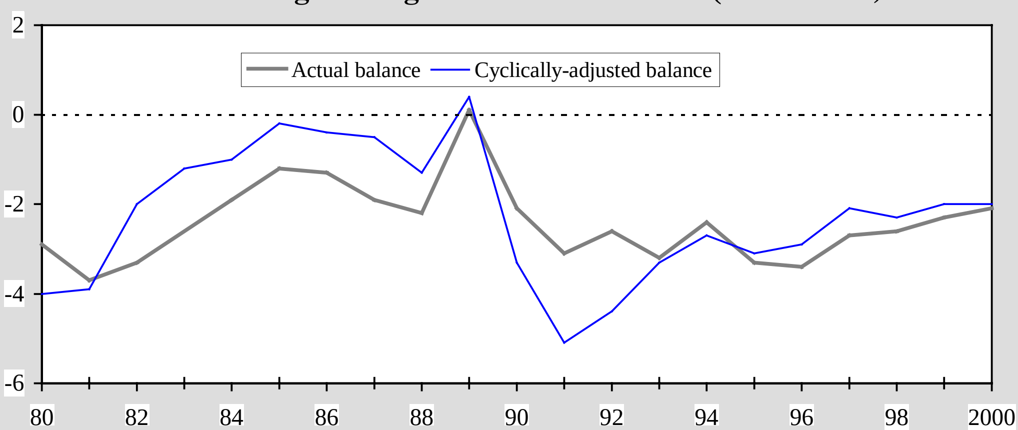
2 It must be kept in mind, however, that part of the decline in the tax and in the expenditure, however, was determined by a reform in children’s allowances, previously paid out as transfers and from 1996 on, for the greater part, as a tax reduction. This reform decreases, at unchanged levels of the entitlement, both the tax and the expenditure ratio by over half a point of GDP).

The consolidation has largely centred on a reduction of public consumption. Its share on GDP is currently well below that of 1991; from 1995 to 1998, it shrank by close to 1 percentage point, partly due to low wage increases in the public administration. Public transfers declined less rapidly: those directed to enterprises and to the rest of the world fell markedly, but transfers to households, which are far larger, were reduced much less quickly. The consolidation effort was also aided by the reduction in market interest rates, which allowed interest payments to decline slightly (as a share of GDP) since 1995, despite an increase in the government debt ratio. The expenditure item that was most affected, in relative terms, by the consolidation effort was government investment. It contracted by about one third from 1992 to 1998, reaching approximately 2% of GDP; this share is lower than in most European countries.

Current receipts, as a share of GDP, have been falling since 1994. All categories of tax revenue were affected, but the trend was somewhat stronger in direct taxes. Rate cuts recently reinforced this phenomenon (most recently, the cut in the Solidarity surcharge). The share of indirect taxes on GDP has been decreasing, too, despite a VAT hike in 1998.

The reduction in current receipts went far beyond the original intention of the government, as in recent years tax revenue has increasingly fallen behind expectations. Nonetheless, a gradual reduction of the tax burden was in line with government policy. In contrast, social security contributions claimed a rising share of GDP: by 1997, they had reached 20.1% of GDP, as compared to 18.0% in 1991. However, given the government's corrective action - the rise in the VAT rate was utilised to finance a cut in pension contribution rates, and the new government is planning to reduce them further in 1999 - social security contributions should decline again in the near term.

Graph 2: Germany - Actual and cyclically-adjusted general government balance * (as % of GDP)

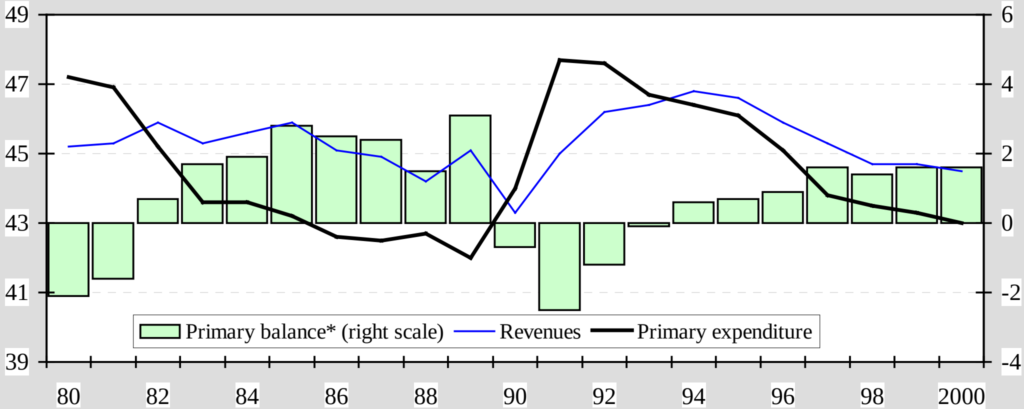


1980-1990: West Germany only. *Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

By now, sizeable improvements have been made in the structural equilibrium of public finances compared with the early 1990s; nevertheless, a further reduction of the deficit is desirable. The budget has not yet reached the medium term objective of being close to balance or in surplus, set by the Stability and Growth Pact.

Furthermore, preliminary information on the 1999 federal budget suggests that the federal deficit will not be limited to the level planned in the draft budget which was first presented by the outgoing Kohl cabinet. On the one hand, some budgetary risks have materialised, notably revenue shortfalls due to weaker economic growth and higher expenditure through the likely granting of special financial support to some Länder. On the other, the implementation of the first step of the tax reform, initiated by the new government, might not be fully revenue-neutral; in particular, proceeds from a hike in energy taxes might not be sufficient to cover the planned 0.8 point reduction in social security contributions, and a new fiscal treatment of jobs paying up to DEM 630 per month is set to be more onerous to the treasury.

Graph 3: Germany - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



1980-90: West Germany only. *Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

The 1999 budget must also prepare the ground for the burdens that are likely to arise later on. For instance, spending on public investment, currently very low, might well have to rise if a suitable level of infrastructure is to be preserved; civil servants' salaries, which have been contained in recent years, might catch up more with those in the private sector; budgetary risks concerning ex-postal workers' pensions might materialise; finally, given the rapidly rising numbers of pensioners, the issue of the reform of the pension system is bound to become ever more pressing. The new coalition has rejected the previous government's reform blueprint, which would have gradually cut the average pension.

Budgetary policy will not only have to address these needs, but also needs to reconcile the requirements of the Stability and Growth Pact with the objectives set by the new government, namely to reduce non-wage labour costs to support growth, create a more transparent, equitable and efficient tax system and help defend the environment. The tax reform, important parts of which have already been presented to Parliament, is seen as a major instrument in attaining those objectives. The reform will take place in three stages, the first already in 1999, then in 2000 and in 2002; it provides for a gradual reduction in income tax rates, for individuals and corporations. The loss in revenue will be largely offset by the elimination of many tax exemptions, particularly for businesses; but substantial overall net tax relief is provided, particularly in 2002. The environmental orientation of the reform consists of a hike in taxes on energy, the proceeds of which will be utilised, starting already in 1999, to reduce non-wage labour costs.

The debt ratio has been climbing, but should now be on a declining path

The government debt to GDP ratio has risen during the 1990s, following the decision to finance a large part of the reunification through borrowing. The ratio amounted to 41.5% in 1991, significantly less than the European average which was then around 57%. By 1994, the ratio had climbed almost nine points to 50.4%. In 1995, the government assumed the debts of the Treuhandanstalt (the public entity charged with the restructuring and privatisation of GDR enterprises and assets, which had been running a substantial deficit but was not statistically included in the government sector) and of some other entities, amounting to, in all, almost 7% of GDP. The ratio passed the 60% mark in 1996. It peaked in 1997 at 61.5%; from 1998 on a gradual decline is expected. It should also be noted that the strong deflationary process of recent years has slowed down the reduction in the debt ratio.

The German government presented its Stability Programme as required by the Stability and Growth Pact at the beginning of 1999. The programme foresees a decline in the deficit ratio from 2% of GDP in 1999 to 1% of GDP in 2002. Over the same period, the debt ratio is expected to decline from 61% of GDP in 1999 to 59½ % of GDP in 2002. The Commission and the Council will assess whether the programme is in line with the requirements of the Stability and Growth Pact.

Structural reforms

In the past few years a number of structural reforms have been carried out in Germany, with the objective of opening markets and making them more efficient.

In January 1996, faced with mounting unemployment, the federal government presented an “action plan for investment and jobs”, followed by a “programme for more growth and employment”. It identified several hindrances to job creation, notably rigidities in the labour and certain product markets and the excessive weight of taxes and social contributions; the public spending/GDP ratio was planned to be eventually reduced to the pre-unification level. In the following years, the fiscal burden was reduced: the Solidarity surcharge was cut by 2 points, the wealth tax and the Business Capital Tax were abolished. The Kohl government also implemented labour market and social security measures, *e.g.* a 20% reduction in mandatory sick pay, the gradual raising of the ceiling for non-application of employment-protection statutes from 5 to 10 employees, the prolongation of the duration of fixed-term work contracts from 18 to 24 months, reforms in the pension system such as a gradual increase of pension age, and so on. Several measures to obtain savings in the health sector, in which high expenditure growth was observed in 1996 (partly owing to the second stage of the introduction of long-term nursing care), were also taken. However, the new governing coalition intends to reverse some of these measures, *e.g.* the pension reform and the cut in sick pay.

Much attention was also devoted to the opening up of markets to more competition. On 1 January 1998 the monopoly on the telephone service was abolished; further liberalisation was introduced also in the postal sector, in utilities and in the transport sector. The federal government strongly reduced its holdings in corporations in recent years; in the recent past, besides numerous sales of direct holdings in companies, an important step towards privatisation was made with the stock market quotation of Lufthansa AG and Telekom AG. The Antitrust law was updated in May 1998; long administrative procedures that hampered investments were shortened and simplified; the regulation of the artisans' sector was updated; already in 1996, the regulations on shops opening times were eased. Many initiatives were also taken with the aim of improving the functioning of the financial market, *e.g.* in order to ease access to risk capital by start-ups and for innovative enterprises.

The new Schröder government is committed to strengthening and modernising the German economy. Apart from the tax reform, an important element of its strategy is a new "Alliance for employment" among social partners and the government, which will give more emphasis to the creation of more training positions for young people. This action will also be complemented by modernising the activity of the State and by improving regulation.

GREECE

Economic developments and policies in a new exchange rate regime

Economic growth has been on an accelerating path since recovery began in 1994 and in 1998 real GDP growth is likely to have reached 3.4%. This acceleration in activity was mainly the result of strong investment growth, in both the public and private sectors, while private consumption has been expanding by 2.2% per year since 1996. Net exports also improved and the current account balance did not deteriorate. Gross domestic product is forecast to continue growing by 3.5% in 1999, above the EU average, mainly driven by domestic demand.

Table 1

Greece: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	0.9	2.6	3.2	3.4	3.5	3.8
Private consumption	1.8	2.3	2.5	1.8	1.8	2.0
Gross fixed investment	1.3	9.4	9.6	9.8	11.2	11.7
Domestic demand	1.3	3.4	3.4	3.0	3.7	4.1
Exports (1)	2.2	0.0	5.3	7.9	5.2	6.2
Imports (1)	3.3	4.0	5.3	4.6	5.0	6.1
Employment growth	0.8	0.7	-0.5	0.2	0.8	0.9
Unemployment rate (% of civilian labour force) (2)	8.0	9.6	9.6	9.4	9.1	8.9
Nominal compensation per head (3)	14.0	11.5	11.0	6.5	4.5	4.1
Inflation (4)	14.8	8.5	5.5	4.8	2.9	2.4
Current account balance (% of GDP)	-2.7	-2.6	-2.6	-2.4	-2.3	-2.3
Nominal short-term rate of interest (level) (5)	21.8	13.8	12.8	14.1	:	:
Real effective exchange rate (6)	2.3	5.9	3.4	-3.6	-0.8	:
Government budget deficit / surplus(% of GDP)	-12.5	-7.5	-4.0	-2.4	-2.1	-1.9
Primary balance (% of GDP)	-0.6	4.5	5.6	6.7	6.9	6.8

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

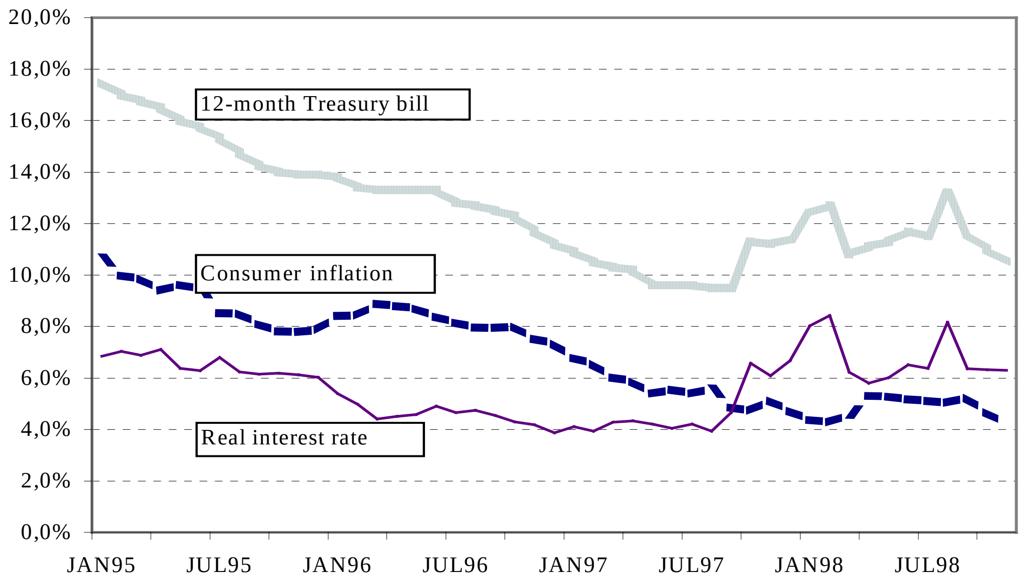
The labour market did not fully benefit from the acceleration of activity in 1998. Employment, after declining by 0.5% in 1997, rose marginally by an estimated 0.2% in 1998; this may be partly explained by large flows of immigrant workers from neighbouring countries working in the black economy. The unemployment rate decreased though, to 9.4% of the labour force.

In 1998, the major event in Greece, as regards economic policy, was the decision to join the ERM in March 1998; on this occasion the drachma was devalued by 12.1% against the ECU and accompanying measures had to be adopted in order to offset the impact of the devaluation on inflation and public finance.

Price developments have been the main area of concern in recent years and throughout 1998. A significant and steady slowdown in inflation had been registered since 1994; nonetheless, on the entry of the drachma into the ERM, consumer inflation was still significantly above the EU average. It accelerated as a result of the devaluation: the inflation rate exceeded 5% during the six following months and only started decelerating again in October. However, several factors contributed to moderate the impact of the devaluation on inflation and to shorten its duration. Just after ERM entry the drachma re-appreciated significantly as a result of tight monetary and exchange rate policies in the new framework; moreover, the collective wage agreement in the private sector, signed in May, was undoubtedly viewed as progress towards wage moderation for at least a period of two years. International price developments also made a significant helpful contribution. In addition, the government decided in Autumn to lower indirect taxes on fuels. Finally, the renewed commitment to ensure participation of Greece in EMU by the year 2001, as affirmed in the new convergence programme[1], enhanced the credibility of the adjustment efforts.

In 1998, on average, the consumer price index increased by 4.8%. The target set for 1999 is to reduce the inflation rate to 2% by the end of the year. Prospects for further disinflation in the course of 1999 build primarily on the implementation of the 1998 wage agreement in the private sector and of the wage increase norm for the public sector, included in the 1999 Budget.

Graph 1: Real interest rates *(% change year-on-year, monthly data)*



Source: Commission services

[1] Within the framework of the Stability and Growth Pact, Greece presented an update of the Hellenic convergence programme (1998-2001) during the Summer 1998.

Real interest rates were steadily declining since 1995. In October 1997, the turmoil in the international financial markets, spreading into the Greek markets, led to a rise in nominal interest rates and real interest rates increased to levels similar to those prevailing in 1994, at the beginning of the current stabilisation phase. Real interest rates eased after the entry of the drachma into the ERM, with the exception of a temporary peak in summer 1998 reflecting the impact of the Russian markets turmoil. Nonetheless, the 12-month Treasury bill rate deflated by the consumer price index, which since end-1997 is market-determined through auction, was as high as 6%.

Budgetary policy stance aimed at balancing the policy mix

Table 2

Greece: Developments in Public Finances 1993-2001

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000	
Government surplus /deficit	-13.8	-7.5	-4.0	-2.4	-2.1	-1.9	
- Current receipts	35.0	38.0	38.9	39.0	39.0	38.7	
- Total expenditure	48.8	45.5	42.8	41.5	41.1	40.7	
of which: - Interest payments	12.8	12.0	9.6	9.2	9.0	8.8	
- Investment	3.3	3.4	3.4	3.6	3.9	4.2	
Primary surplus/deficit	-1.0	4.5	5.6	6.7	6.9	6.8	
Government debt	111.6	112.2	109.5	108.7	107.0	104.2	
Real GDP growth**	-1.6	2.6	3.2	3.4	3.5	3.8	
Convergence programme***			1997	1998	1999	2000	2001
Government surplus/deficit:			-4.0	-2.4	-2.1	-1.7	-0.8
Government debt			108.6	107.8	105.8	102.5	99.8
Real GDP growth**			3.5	3.5	3.7	3.9	4.5

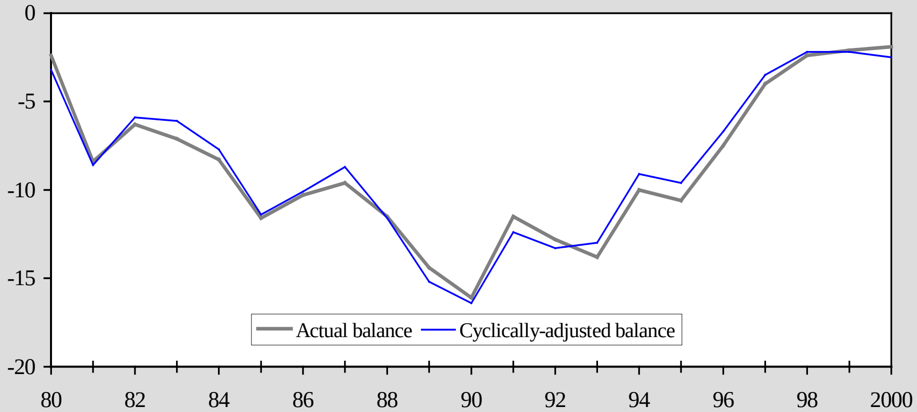
* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in September 1998.

Source: Commission services and convergence programme of Greece.

Large general government deficits and mounting public debt have been the features of the Greek economy until the early 1990s. Since 1994 uninterrupted, albeit slow, budgetary consolidation efforts have been undertaken. A significant part of the adjustment achieved from 1993 to 1997 is to be attributed to the decline in interest rates: the general government deficit was reduced by 9.8 percentage points of GDP - from 13.8% in 1993 to 4.0% of GDP in 1997 - of which 3.2 percentage points was the result of lower interest payments. However, in 1998, the adjustment relied basically on the implementation of saving measures, more particularly on the package of measures of permanent nature which was adopted since 1996, in particular the tax expenditure law, aiming at enhancing revenue and combating tax evasion. In March 1998, just after the entry into the ERM accompanying measures were adopted, mainly of a structural nature.

In fact, the devaluation implied additional costs for the 1998 budget initially estimated at close to 1% of GDP. These were mainly debt servicing costs, as the public external debt of Greece accounts for over 20% of the total, and also primary spending. The accompanying measures included the strict implementation of the wage norm for civil servants as announced with the 1998 budget; a cut in primary spending, mainly in transfers; a reduction in the investment budget deficit, resulting from cuts in investment spending and an increase in revenues under a more favourable

Graph 2: Greece - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

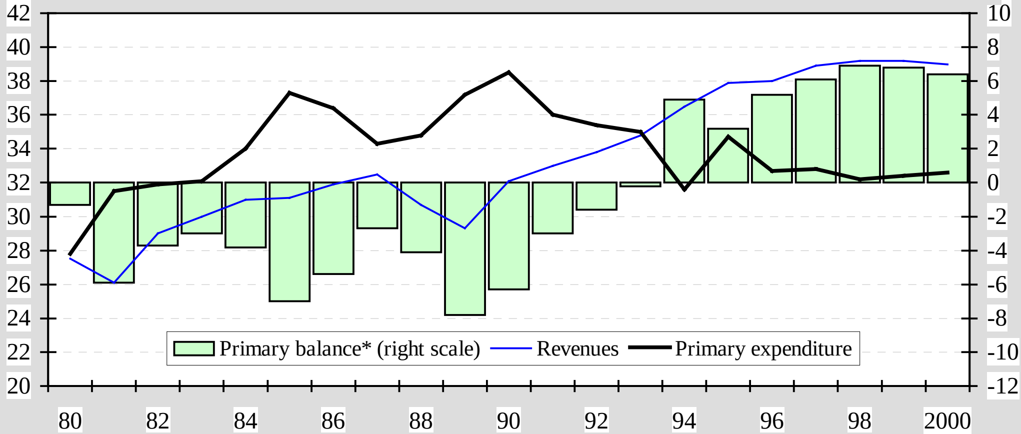
co-financing agreement with the EU Structural Funds; and the increase in social security contributions as a result of the implementation of the first stage of the social security system reform.
The general government deficit in 1998, as estimated when the State budget for 1999 was presented in November 1998, turned out to be better than targeted, i.e. 2.2% of GDP. This can partly be attributed to better than projected tax revenues and to a lower overrun in interest costs than estimated after the devaluation. The former reflects further progress in combating tax evasion and strong nominal GDP growth; the latter suggests the success of debt management operations and the appreciation of the drachma since the end of March. In addition, measures adopted in earlier years aimed at controlling spending in the wider public sector contributed to the containment of current primary expenditure.

In the period 1993-1997, the largest part of the progress in reducing the general government deficit resulted from discretionary tightening rather than the cyclical upturn; the actual deficit was reduced by 9.8 percentage points of GDP, to 4.0% of GDP in 1997, of which 0.3 percentage points were due to improved cyclical conditions and 9.5 percentage points to the reduction in the cyclically adjusted balance. In 1998, the actual deficit was reduced further by 1.6 percentage points of GDP while the cyclically adjusted balance improved by 1.3 percentage points of GDP, from 3.5% of GDP in 1997 to 2.2% of GDP.

The stock of debt was reduced by 2.7 percentage points of GDP in 1997. In 1998, the smaller than initially expected external debt valuation effect, due to the appreciation of the drachma since April, had also a positive impact on the estimated stock of debt. Combined with higher receipts from privatisation as a result of the extended plan announced in March, the debt ratio, according to the estimate included in the 1999 state budget, declined by some 4 percentage points of GDP instead of only 0.8% as initially expected. Still, the general government debt ratio is estimated at 105.5% of GDP.

Graph 3: Greece - Key budgetary variables

(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

Recognising the risks emanating from heavy indebtedness and the vulnerability of the Greek economy to external financial shocks, the Greek government presented a Budget for 1999 which targets a deficit for the general government of 1.9% of GDP instead of 2.1% of GDP set in the convergence programme.

Priority in speeding the implementation of structural reform

Structural issues have been generally considered as partly responsible for the poor economic performance of Greece. Low efficiency in the large public sector, labour market rigidities and a social security system favouring contribution evasion and fraud, are among the more often spelled out issues requiring policy intervention.

Segmentation, wage rigidity and low productivity are among the features of the Greek labour market. Illegal immigrants, estimated at above 400 000 or 10% of the labour force, willing to work for less than the minimum wage, have boosted production in the large black economy, while contributing to containing labour costs. After an intensive dialogue with social partners, the government reached an agreement in 1998 on the outline for a structural reform bill tabled before Parliament in July. The bill provides mainly for a more flexible use of working hours, the introduction of part-time work in the public sector, the legitimisation of private employment offices and the strengthening of the wage bargaining process at the local and company level, especially in areas of high unemployment.

The social security system in Greece is among the most generous and inequitable in Europe, due to low contributions and to large differences in pension benefits between pension funds. Early retirement for certain privileged groups and contribution evasion contribute to the non-viability of the system in the long run. The government has adopted a two-tier structural reform strategy. A first package of measures was introduced in July 1998 including the legitimisation of illegal foreign workers and the payment of their social security contributions; the merger of various complementary social security funds and the partial liberalisation of surplus fund management; measures to contain administrative costs and the widespread evasion of social security contributions.

The privatisation of public utilities companies, state-controlled banks and the restructuring of loss-making public corporations has been contemplated since the early 1990s. Action was delayed by interest group protests while it took time to put in place the appropriate legal framework. In March 1998, the government announced the details and the timetable of the privatisation plan for 1998 and 1999. It involves twelve public corporations and four state-controlled banks. The plan for 1998 has been broadly completed, with some exceptions mainly due to difficult market conditions. The flotation of Greek Telecommunications Company (OTE) shares on the Athens Stock Exchange, initiated in 1996, was increased by 14% in 1998, totalling 33% of the company's shares. OTE shares were also introduced in parallel on the New York Stock Exchange for the first time in October 1998. Three out of the four state-controlled banks have been privatised, but the sale of 51% of the shares of the most important, the Ionian Bank, was postponed in late August until 1999.

SPAIN

Strong and healthy economic growth

Economic activity in Spain strengthened markedly in 1997 and 1998. Whereas GDP went up by 1.7% on average in the period 1990-95 and by 2.4% in 1996 (see Table 1), it expanded by 3.5% and 3.8% in 1997 and 1998, almost one percentage point above the EU average. During the first half of 1998, GDP growth maintained its previous strong pace, growing by 3.9% on the year. Real GDP is estimated to have decelerated only slightly in the second half of 1998, as the initial impact of the international financial turmoil on the Spanish economy appears to have been relatively small.

Table 1

Spain: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	1.7	2.4	3.5	3.8	3.6	3.5
Private consumption	1.5	2.0	3.1	3.4	3.7	3.5
Gross fixed investment	0.4	1.3	5.1	8.8	8.0	8.5
Domestic demand	1.4	1.6	2.9	4.6	4.5	4.6
Exports (1)	8.9	10.6	14.8	9.8	7.0	8.3
Imports (1)	6.7	7.4	12.2	11.6	9.3	10.5
Employment growth	0.2	1.5	2.9	3.2	2.9	2.7
Unemployment rate (% of civilian labour force) (2)	20.2	22.2	20.8	18.9	17.2	15.7
Nominal compensation per head (3)	6.9	3.8	2.4	2.1	2.0	2.0
Inflation (4)	5.7	3.4	2.5	2.3	2.1	2.1
Current account balance (% of GDP)	-2.2	0.2	0.4	0.1	-0.4	-0.8
Nominal short-term rate of interest (level) (5)	11.8	7.5	5.4	4.3	:	:
Real effective exchange rate (6)	-0.9	2.2	-4.5	0.3	1.1	:
Government budget deficit / surplus(% of GDP)	-5.6	-4.7	-2.6	-2.1	-1.6	-1.3
Primary balance (% of GDP)	-0.9	0.4	1.8	2.1	2.3	2.5

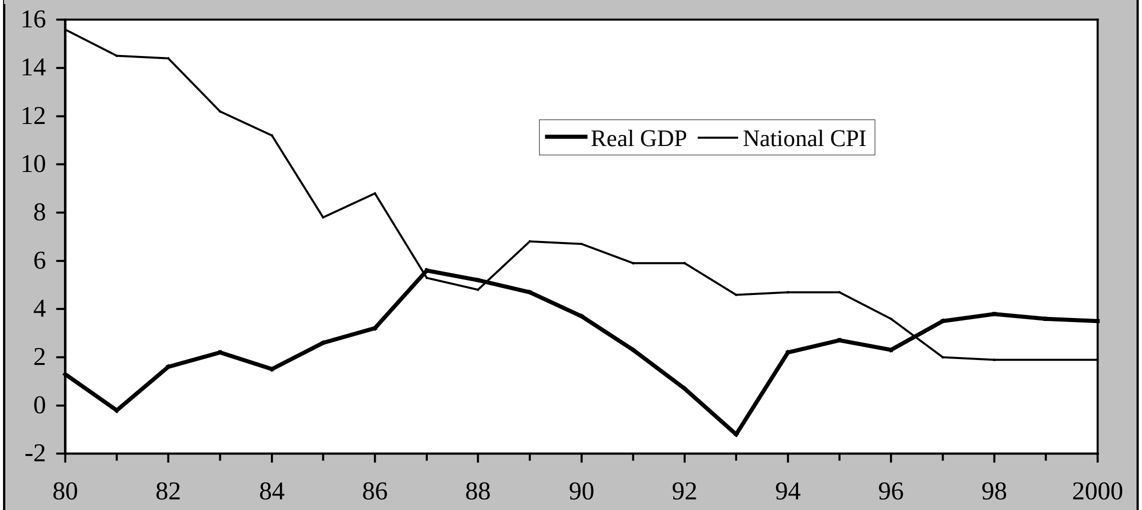
Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

In 1998, economic growth was characterised by vigorous domestic demand, mainly based on investment in equipment and private consumption, and a growing negative contribution from the external sector, as export growth decelerated more sharply than imports. These two features are expected to be accentuated in 1999 and 2000.

A number of favourable factors have supported domestic economic activity and are likely to continue having positive effects: i) the stable monetary framework provided by EMU along with budgetary consolidation, which boost domestic demand through stronger confidence and historically very low interest rates; ii) falling inflationary expectations and wage moderation, which support price stability and employment growth; iii) a number of labour market measures, which have improved the functioning of the labour market. In addition, the reform of the personal income tax, which will come into operation in 1999, is expected to raise households' disposable income. This should more than offset the international financial turmoil which started in August 1998 and could hit the Spanish economy through lower external demand and through its negative impact on the stock market, especially due to the exposure of Spanish investors in Latin America.

Graph 1: Spain - Growth and Inflation*



*Annual % change

Source: Autumn 1998 Economic Forecasts - Commission services.

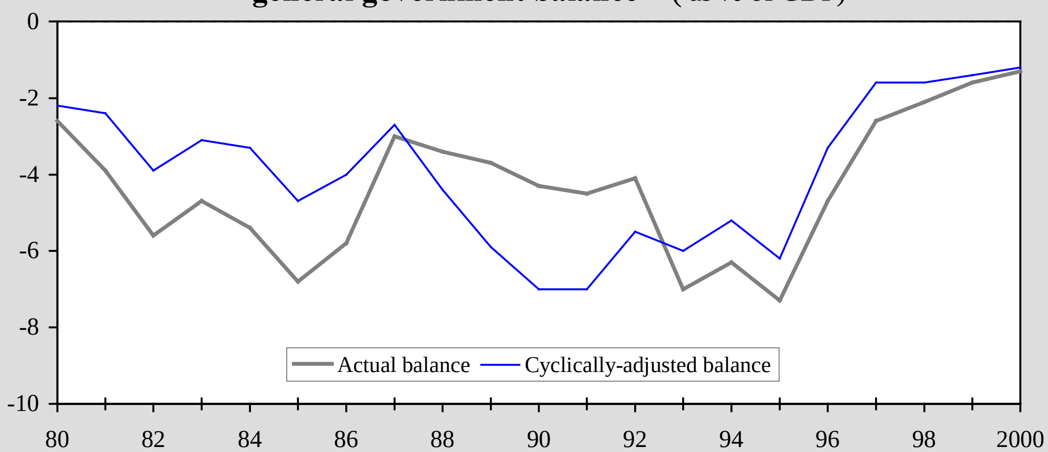
Private consumption is assessed to have risen by 3.4% in 1998, mainly supported by strong job creation and low interest rates. Gross fixed capital formation is estimated to have increased by 8.8% in 1998, after its poor performance in most of the 1990s. Investment in equipment will have been the most dynamic demand component, growing by 12.5%, boosted by strong demand.

Due both to the strength of domestic demand and the less dynamic external markets in 1998 and 1999, imports are expected to grow faster than exports. Thus, in contrast with the key role played by the external sector in 1997 in sustaining economic activity, from 1998 onwards a growing negative external contribution to GDP growth is expected. The balance on current account, which registered a surplus of 0.4% of GDP in 1997, is forecast to deteriorate gradually as the growing trade deficit will outweigh the continuing surpluses in the service balance.

Employment rose briskly in 1997 and 1998 (2.9% and 3.2%, national accounts concept) in line with strong economic growth and with low productivity growth (GDP per worker has been rising at a rate below 1% since 1995). In addition, the number of jobs on a permanent basis has been growing faster than total employment, in contrast with past experience, which can be seen as a positive outcome particularly from the labour market reform introduced in May 1997. As a result, the unemployment rate is foreseen to have fallen further to 18.9% in 1998 after 20.8% in 1997.

In contrast with Spanish past experience, continued economic growth has now been compatible with subdued inflation rates (see graph 1). Inflation (as measured by the consumer price index) has fallen to 1.8% in 1998, after 2% in 1997 and 3.6% in 1996. Low inflation results mainly from the following factors: i) a balanced policy mix; ii) the expectations of inflation convergence ahead of EMU, which have underpinned a lowering in wage increases; iii) structural reforms in goods and services markets as well as in the labour market which brought some prices down and have supported wage moderation; iv) low energy and commodity prices. Despite much progress, in some sectors (services, housing and medicine), price developments still show downward rigidity. This suggests the need to move forward with deregulation policies in these sectors in order to boost competition.

Graph 2: Spain - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

General government deficit on a clear downward path

The government accounts deteriorated significantly during the economic recession of the early 1990s and the deficit reached a peak of 7.3% of GDP in 1995 (see Graph 2). Since then, Spain has notably reduced its government deficit-to-GDP ratio. In the 1998 Commission autumn forecasts the 1998 deficit ratio was estimated at 2.1%, compared to 2.6% in 1997 and 4.7% in 1996. However, the latest data on State budgetary execution suggest that the deficit reduction in 1998 will have been greater than expected, leading to a general government deficit below 2.1% of GDP (latest official estimates point to a deficit of 1.9% of GDP).

The reduction in the general government deficit since 1996 was chiefly due to a number of budgetary consolidation measures which reduced much the cyclically adjusted deficit (see Graph 3). A second contribution came from the fall in debt service payments, mainly due to the sharp decrease in interest rates. Finally, strong economic growth in 1997 and 1998 also contributed to reduce the budgetary deficit.

Consolidation measures relied more on expenditure restrain than on revenue increases (see Table 2) and among the expenditure items, more on current expenditure than on investment[1]. The main point of budgetary consolidation was achieved in 1996 and 1997. In 1998 the deficit reduction continued but at a lower pace.

As to the government debt, the previous upward trend in the debt-to-GDP ratio was reversed in 1997. After having reached a peak of 70,2% in 1996, the debt ratio went down to 68.9% in 1997 and to 67.7% in 1998.

The government deficit is targeted to be cut further to 1.6% of GDP in 1999. The budget is based on current expenditure restraint and takes advantage of the relatively strong performance of the economy.

On the expenditure side and at State level, spending is set to grow at 3.8%, clearly below nominal GDP. On the revenue side, the rates of the special excise duty on hydrocarbons and the reference minimum wages for social security contributions will be raised. However, the chief measure is the reform of the personal income tax. The reform cuts the minimum and maximum marginal tax rates to 18% and 48%, from 20% and 56% respectively. In addition, it redefines the concept of taxable income, eliminates some fiscal allowances, and changes some deductions. Official estimates from the Spanish authorities set the total revenue effects at around 0.6 percentage points of GDP of lower direct taxes in the years 1999 and 2000 (the bulk of the effects is due to take place in 1999).

The Stability Programme for the years 1998-2002 (see Table 2) targets to reach a surplus (of 0.1% of GDP) in the general government balance by the year 2002.

The programme also targets to reduce the fiscal pressure (by 0.4 percentage points of GDP in the period 1999-2000) and to increase public investment during all the period.

In a framework of healthy – though decelerating – GDP growth and decreasing interest payments on the debt, the discretionary measures that underpin the deficit reduction throughout the covered period are based on primary expenditure cuts on the current side. As far as the debt is concerned, it is targeted to be lower than 60% at the end of the period.

The programme also intends to continue the structural reforms already implemented in the factors, goods and services markets and details the main measures targeted for the covered period.

These reforms are considered to have played an important role in increasing the output potential of the economy as well as its capacity to growth in a framework of low inflation and high employment creation.

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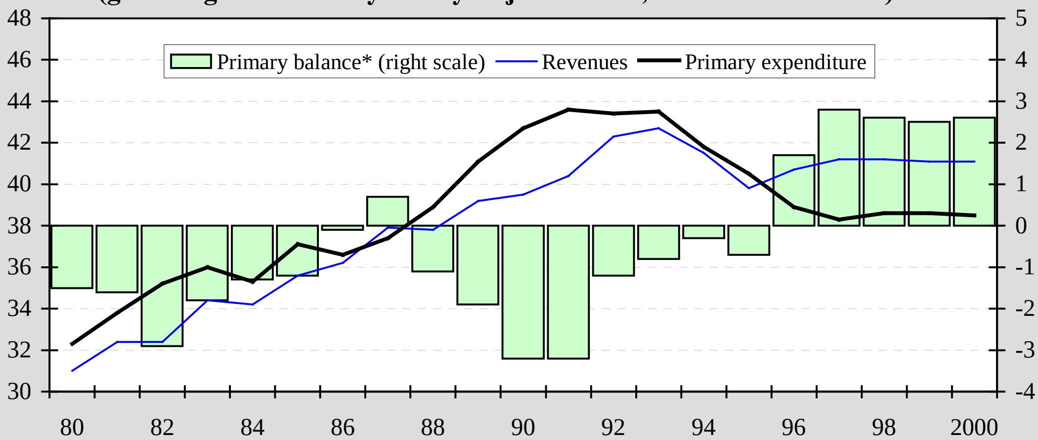
1 Spain satisfies the *golden rule* (a general government deficit lower than government investment expenditure since 1997.

The Commission services will assess whether the Spanish Stability Programme is compatible with the provisions of the Stability and Growth Pact.

Structural reforms: considerable progress but still further action needed

In the last few years, there have been a number of structural reforms addressed at liberalising the productive sectors of the economy, downsizing the state-owned sector and improving the taxation system, the management of the public administration and the working of the labour market.

Graph 3: Spain - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

With respect to productive sectors, one of the main measures undertaken refers to the telecommunications sector. In December 1998, with three nation-wide cable companies already in operation, this sector was completely liberalised, and a further increase in the supply of services and competition involving a reduction of prices is expected. Regarding the energy sector, the Spanish authorities adopted a step-by-step programme of liberalisation of electricity generation and distribution up to the year 2008, as well as a progressive freeing of choice of suppliers for users. As a result, electricity tariffs decreased by 3% in 1997 and by 3.6% in 1998, and a further cut is planned in 1999.

Additionally, one of the key pieces of the programme of structural reforms of the current government has been the privatisation programme. More than 20 privatisations have been carried out, the most notable being the sell-off of Endesa (electricity and gas supplier), which constituted the biggest sale of public shares on the Madrid Stock Exchange. However, a large number of liberalising measures need to be monitored and surveyed as they have been implemented in a progressive way (the energy sector) or they will need to be continued (the privatisation program). On the other hand, little progress has been made in areas like the professional associations, such as lawyers and doctors associations, which have the right to set prices and regulations hindering competition. Also in the housing sector, municipalities still control the allocation of land for housing. As that is one of their most important sources of revenue, the municipalities sometimes create an artificial shortage of land with consequent overpricing.

Another reform concerns taxation. In general, the aim has been to reduce the weight of direct taxes on labour and capital while increasing slightly some indirect taxes. The key reform is the new personal income tax approved at the end of 1998 which comes into operation in 1999. It reduces the fiscal burden on households by lowering minimum and maximum marginal rates and redefines the different taxable incomes.

As regards public finances, several structural reforms have already been implemented, which include: the public pension system, the health assistance system and transfers to Territorial governments. With respect to the public pension system, there was a reform of the social security system in 1997[2]. However, in the future, the long-term problem of the ageing population should continue to be considered when implementing new measures. In relation to the health assistance system, the existing mechanisms to control the growth of public health spending should be reinforced. Indeed, in the period 1990-97, expenditure on public health assistance, especially pharmaceutical products, rose much faster than other expenditure categories of the budget. Regarding budgetary consolidation at regional level, the government intends to complete the transfer of spending entitlements to Territorial entities (regional and local governments) by the year 2003. The envisaged increase in expenditure by Territorial governments should be accompanied by a continuation of the current Stability Pact with the regional governments aiming at the consolidation of their public finances.

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[2] This reform raised the minimum number of years for calculating the retirement pension (from 8 to 15 years) and separated the funding sources of social benefits by the year 2000 (contributory pensions should be funded only by social security contributions). In fact, according to the 1999 draft budget, this clarification will be implemented one year before schedule.

Table 2

Spain: Developments in Public Finances 1993-2002
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-7.0	-4.7	-2.6	-2.1	-1.6	-1.3		
- Current receipts	42.3	40.3	40.8	40.8	40.8	40.8		
- Total expenditure	49.3	44.9	43.3	42.9	42.4	42.1		
of which: - Interest payments	5.2	5.1	4.5	4.2	4.0	3.8		
- Investment	4.2	3.2	3.2	3.2	3.2	3.3		
Primary surplus/deficit	-1.8	0.4	1.8	2.1	2.3	2.5		
Government debt	60.0	70.1	68.9	67.7	66.0	63.6		
Real GDP growth**	-1.2	2.4	3.5	3.8	3.6	3.5		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-2.6	-1.9	-1.6	-1.0	-0.4	0.1
Government debt			68.9	67.4	66.4	64.3	61.9	59.3
Real GDP growth**			3.5	3.8	3.8	3.3	3.3	3.3

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998.

Source: Commission services and Stability programme of Spain.

Finally, regarding the labour market, two major reforms have been enacted. In May 1997, a new contract on a permanent basis was agreed between the employers' associations and the trade unions which the government then turned into law. This new contract implies lower unfair redundancy payments and a better specification of factors allowing for a fair lay-off. In order to promote this contract, the government also laid down substantial reductions of employers' social security contributions. Moreover, in November 1998, the government approved a new part-time contract to promote employment on a permanent basis[3].

3 In 1997, part-time employment in Spain represented only around 8% of total employment compared to 17% in EU15 and 15% in EU11.

FRANCE

Domestic demand buttresses growth without triggering inflationary pressures

The recovery that got under way in 1997 continued in 1998 as domestic demand became firmer in a world economy becoming gradually more uncertain. In that manner, investment underpinned a still very buoyant level of private consumption; this suggests overall GDP growth of 3.1% in 1998.The upturn owes a great deal to solid fundamentals and to rising levels of confidence among economic operators up to the middle of the year. Labour market developments, and in particular the steady rise in the numbers in employment (up 1.8%), were instrumental in boosting the momentum of growth, which also allowed unemployment to be trimmed back by more than one percentage point between mid-1997 and the end of 1998.

The high level of job creation, coupled with rising purchasing power (up 1.9%), boosted consumption sharply (up 3.6%), with sales of consumer durables (especially household appliances and cars) proving most buoyant. The savings ratio declined as a result of this higher propensity to spend on the part of households. At the same time, house purchases recovered in 1998; the number of unsold properties was at its lowest level since 1989, the property market climbed back to its peak of 1994, and both property prices and rents rose.

Investment in plant and machinery, which was somewhat hesitant in 1997, reflecting business uncertainty about future demand, bounced back significantly in the first part of 1998 as demand expectations improved. This resurgence was helped by high levels of company profitability, by a self-financing ratio that was still above 100% and by a less restrictive monetary and financial stance. Business investment in building and construction, which had adversely affected overall investment since 1992, began to pick up in early 1998 (net growth in non-residential building permits) and should gradually gather momentum. In total, business investment is estimated to have increased by 6% in 1998.

France was not left unscathed by the serious deterioration in the world economy in 1998. Its multiple manifestations (Asian crisis, turmoil on world financial markets, falling dollar) and knock-on effects (contagion, risks of deflation) imposed a burden on French growth by causing foreign trade to contract in the first half of the year and by curbing stockbuilding by firms in the second half. The result was a very sharp slowdown in exports under the twin impact of lower growth in world trade and a less favourable competitive position. The various crises started to affect trade at the end of 1997, with exports to Asia (excluding Japan) in the first half of 1998 down by 25% on the corresponding period in 1997. As a result, taking the average for the year, GDP growth was probably 0.3 percentage points lower in 1998 than it would otherwise have been.

In addition to more buoyant job creation (for a description of underlying explanations, see below the section about structural reforms), the current recovery is characterised by low inflation, which fell again in 1998 to a level substantially below 1% on an annual average basis. This fall essentially reflects a collapse in commodity and hence in import prices, coupled with the fact that the French franc's effective exchange rate remained high.

Table 1

France: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	1.3	1.6	2.3	3.1	2.6	2.8
Private consumption	1.4	2.0	0.9	3.6	2.7	2.4
Gross fixed investment	-0.5	-0.5	0.2	4.3	4.7	4.3
Domestic demand	1.0	0.9	0.9	3.8	3.0	2.7
Exports (1)	4.3	5.2	12.1	5.2	3.5	5.1
Imports (1)	3.0	3.0	7.7	7.5	5.0	4.9
Employment growth	0.0	0.2	0.2	1.3	1.1	0.8
Unemployment rate (% of civilian labour force) (2)	10.8	12.4	12.4	11.7	11.1	10.8
Nominal compensation per head (3)	3.5	2.9	2.1	2.5	2.4	2.5
Inflation (4)	2.4	1.8	1.1	0.6	1.2	1.4
Current account balance (% of GDP)	0.4	1.5	3.2	2.9	2.8	2.9
Nominal short-term rate of interest (level) (5)	8.6	3.9	3.5	3.6	:	:
Real effective exchange rate (6)	1.2	0.3	-5.0	0.7	1.2	:
Government budget deficit / surplus(% of GDP)	-4.0	-4.1	-3.0	-2.9	-2.3	-1.9
Primary balance (% of GDP)	-0.7	-0.3	0.6	0.6	1.1	1.4

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

Inflationary pressure should remain absent for some time since wage rises are currently slowing down against a background of significant gains in purchasing power, the downturn in unemployment not being sufficient for strains to appear. In addition, the fall in producer prices has not yet been passed on in full to consumer prices, and the outlook for the introduction of the 35-hour week is an additional moderating factor.

GDP growth is set to slow to 2.6% in 1999, with business activity continuing to be affected by the turmoil in the world economy over the New Year before picking up in the course of 1999. Growth should continue to be driven by consumer spending since all the determining factors are still relatively favourable. Business investment might though be slightly less robust in 1999, since companies in competitive markets might decide to postpone certain projects on account of the deteriorating demand prospects at the end of 1998. In contrast to previous cycles, it seems unlikely that stockbuilding will be much in excess of what has already taken place during the current cycle. The contribution of foreign trade to GDP growth is expected to remain negative in 1999, but to a lesser extent than in 1998. Nevertheless, movements in the terms of trade mean that the trade surplus should be similar to that in 1998.

Table 2

France: Developments in Public Finances 1993-2002

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000	2001	2002
Government surplus /deficit	-5.8	-4.1	-3.0	-2.9	-2.3	-1.9		
- Current receipts**	49.6	51.1	51.4	51.3	50.9	50.5		
- Total expenditure	55.4	55.2	54.4	54.1	53.2	52.4		
of which: - Interest payments	3.4	3.8	3.6	3.5	3.4	3.3		
- Investment	3.2	2.9	2.9	2.8	2.8	2.8		
Primary surplus/deficit	-2.4	-0.3	0.6	0.6	1.1	1.4		
Government debt	45.3	55.7	58.1	58.3	58.6	58.3		
Real GDP growth***	-1.3	1.6	2.3	3.1	2.6	2.8		
Stability programme****			1997	1998	1999	2000	2001	2002
Government surplus/deficit:				-2.9	-2.3			-0.8/-1.2
Government debt				58.2	58.7			57.2/58.4
Real GDP growth***					2.7/2.4	3.0/2.5 (average 2000-02)		

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** This line does not include the payment by France Télécom to central government of FRF 37.5 mrd (0.45 % of GDP) in 1997, which is recorded as capital receipts.
*** Annual % change.
**** Submitted in January 1999. The rates and ratios shown are, respectively, from the favourable and prudent scenarios.

Source: Commission services and Stability programme of France.

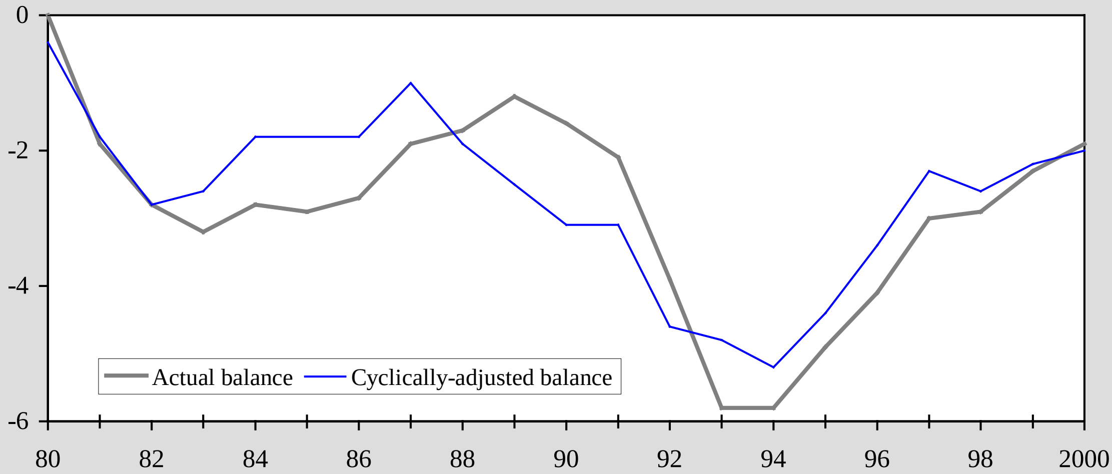
Improvement in public finances to resume

Since the general government deficit target of 3% of GDP was achieved in 1997, the rate of improvement slowed in 1998. While the deficit contracted on average by almost one percentage point per year between 1994 and 1997, in 1998 it declined by 0.1 percentage point of GDP. Indeed, the government's initial objective was merely to maintain the previous year's outturn, given that a one-off budgetary operation, which improved the deficit in 1997, has not been repeated[1]. The marginal improvement was thus the result of a favourable trend in tax revenue, mainly from indirect taxation, in the wake of the aforementioned buoyancy of domestic demand and reductions in interest payments. Nevertheless, the deficit should start to contract again in 1999: the Commission has forecast that it will fall to 2.3% of GDP.

[1] This refers to the extraordinary payment made by France Télécom to a central government fund of FRF 37.5 billion (0.45% of GDP).

The cyclically adjusted general government deficit, as calculated by the Commission, worsened in 1998 (see Graph 1). This setback is mainly due to the non-recurrence of the aforementioned exceptional operation. But, even if that transaction were disregarded, the cyclically adjusted deficit would improve by only 0.2 percentage points of GDP in 1998, compared with 0.6 percentage points in 1997 and 1 percentage point in 1996. In 1999, the adjusted deficit is expected to fall by 0.4 percentage points.

Graph 1: France - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

The budgetary consolidation which took place between 1994 and 1997 was essentially the result of discretionary measures focusing on higher taxes. The tax burden, as calculated by the Commission services, increased by more than two percentage points of GDP to 47.6% in 1997, one of the highest levels in the European Union.

The tax burden probably remained stable in 1998[2] despite a major change in the tax system. The bulk of the sickness insurance contribution was replaced by an increase in the rate of the general welfare contribution (CSG), which is levied on a broader income base.[3] The tax burden should fall about 0.2 percentage points of GDP in 1999. Under the State budget, about one third of the gains deriving from economic growth, reflected in the nominal increase in tax revenue, is to be allocated to reducing levels of taxation, with the remaining two thirds being used to cut the deficit and to boost real expenditure.

From 1993 to 1997, government current expenditure as a percentage of GDP has remained at a very high level, as higher spending by local authorities and, above all, higher social security spending offset efforts to bring State expenditure under control. In 1998, the government expenditure ratio was reduced, as State spending in real terms remained stable and social security spending grew slower than GDP. The 1999

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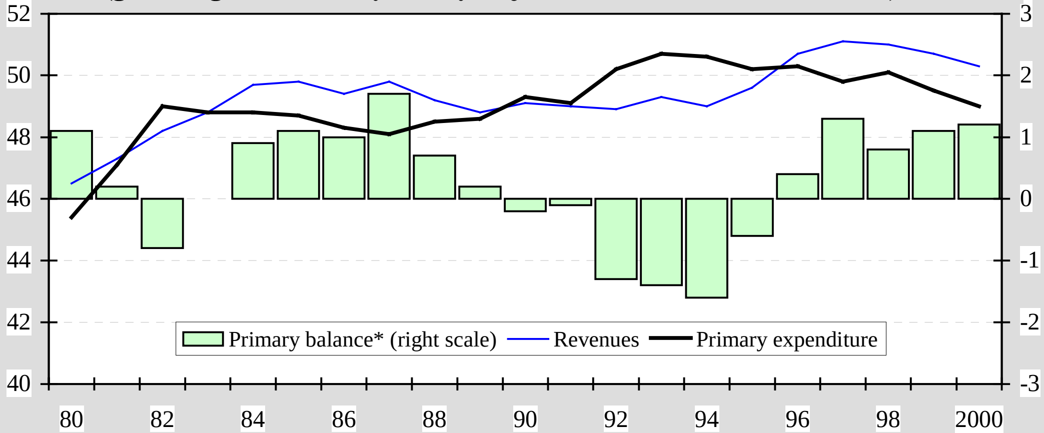
2 If imputed social contributions are excluded from the tax burden, it records a slight reduction.

3 In spite of its name, the CSG (*"cotisation sociale généralisée")* is treated as a direct tax in the national accounts and not as a social security contribution.

budget anticipates real growth of 1% for State expenditure. Against a background of very low inflation, it might be necessary to rein in central government expenditure during the year in order to meet that target given that, under the Finance Law, expenditure totals are expressed in nominal terms.

Graph 2: France - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

The social security system saw major overspending on health care in the first half of 1998 which was not fully absorbed by the year-end even though the Government took swift corrective action.[4] To ensure that the aim of a social security surplus in 1999 is met– which would be its first surplus of the decade – measures to fight against the repetition of the last year's overspending are needed. These measures are so more essential as the Constitutional Council invalidated the financial incentives and penalties to ensure compliance with expenditure ceilings, established by the Social Security Law for 1999.

Local authority accounts should also show a small surplus, in line with the trend since 1997.

The general government consolidated gross debt has grown continuously since the beginning of the 1980s, with the rate of increase actually accelerating between 1992 and 1996, when the ratio in terms of GDP increased by more than 15 percentage points. The primary surpluses recorded in 1997 and 1998 had a dampening effect on, but were not large enough to reverse, this upward trend. The debt ratio should remain below 60% of GDP but is expected to rise further in 1999, although it could start to decline in 2000 (see Table 2).

4 Action included a review of the list and prices of refundable drugs and a tax on certain categories of health-care professional.

Public finances: the medium-term outlook

The Stability Programme presented by the French Government in January 1999 identifies two alternative economic scenarios for the period 2000-02. Under the favourable scenario, real GDP growth is expected to amount to an average of 3% each year, whereas under the cautious scenario this would reach 2.5% per annum. The main distinguishing feature of the programme is that the projections for public expenditure remain the same under both scenarios, i.e. a cumulative increase of 3% in real terms over the period. While the cautious scenario foresees the deficit falling to 1.2% of GDP by 2002, the increased revenues entailed by the more optimistic growth scenario would result in a decline in the deficit to 0.8% of GDP in this year. Moreover, by the end of the period of the programme, the tax burden is expected to decline by between 0.5 and 0.8 percentage points of GDP, depending on the growth scenario. This progress in budgetary consolidation should also allow a reduction in the gross debt ratio. However, the reduction will be offset to some extent by the expected build up of assets in the pensions reserve fund, which the Government has recently established. Thus, depending on the respective growth scenario, the debt ratio is expected to fall to either 57.2% or 58.4% of GDP by the end of 2002.

In its assessment of the French Stability Programme, the Commission will examine the compatibility of the programme with the Stability and Growth Pact.

Reducing working hours: from incentives to legislation

The very substantial number of jobs created in 1998 tended to be taken up more rapidly than in previous cycles. A large proportion of them was non-standard jobs (temporary contracts, fixed-term contracts, etc.). This increased labour market activity stemmed from the reductions in social security contributions first made in 1992-93 to encourage part-time work and to reduce the cost of unskilled labour.

The impact of these new jobs showed up in a fall of 186 700 in the number of job seekers (down 6%) between June 1997 and November 1998. However, unemployment remains high at 11.5%, no doubt because some new entrants were attracted onto the labour market by the various forms of part-time employment on offer. The French Government, which since 1993 has been in favour of reducing working hours as a means of combating unemployment (Laws of 20 December 1993 and 11 June 1996, the latter being known as the de Robien Law), made it a central pillar of policy when in June 1998 it passed a framework law reducing the statutory working week. A 35-hour working week is to be introduced for private-sector companies with more than 20 employees as from 1 January 2000 and for other companies as from 1 January 2002. A system of incentives will also be introduced to help companies adapt in time. A second draft law will be presented to parliament at the end of 1999 with a view to resolving a number of outstanding issues involving the arrangements for facilitating the reduction in the working week (rules governing overtime, the reorganisation of working time, structural aid to replace the temporary system of financial incentives and compensation for those on the minimum wage).

The fact that this legislation is in two parts seemed necessary for the second draft law to take into account the preliminary negotiation between social partners at the firm and at the industry level. The downside of this is that it fosters a degree of uncertainty, which will probably have an impact on the speed of implementation of the 35-hour week and, consequently, on the rate of job creation.

The final impact on employment is very difficult to determine because a reduction in the statutory working week sets in motion a series of relatively complex interactions which alter the underlying economic relationships. Now, a compulsory and widespread working-time reduction may have undesirable effects if this reduction was to set in motion a deterioration of these economic equilibria. The factors that will determine whether the measure is successful are the size of the wage compensation that employees will be prepared to accept (this being without doubt the key variable on which success will depend), the hourly productivity gains that will result *per se* but that will also be required in order to offset any increase in unit labour costs, and the scale of the internal reorganisation that companies will have to carry out.

IRELAND

Continuation of strong growth into 1998 and beyond

The Irish economy continued to grow strongly in 1998 following GDP growth of 10.6% in 1997. Domestic demand continued to be the main motor of growth as both consumer and investor confidence were buoyed by falling interest rates and favourable employment prospects. Combined with the exceptionally strong growth in exports in 1998, GDP is estimated to have risen by 11.4%.

Table 1

Ireland: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	6.4	8.3	10.6	11.4	8.2	9.0
Private consumption	3.4	6.1	6.3	6.7	7.2	6.8
Gross fixed investment	3.5	13.6	10.9	11.6	12.8	11.2
Domestic demand	3.4	6.9	7.4	7.2	7.7	7.1
Exports (1)	11.7	11.8	16.9	18.9	12.1	13.5
Imports (1)	7.9	11.1	14.7	16.4	13.2	13.1
Employment growth	2.3	3.9	3.2	4.1	3.7	3.4
Unemployment rate (% of civilian labour force) (2)	14.3	11.6	10.1	8.7	7.4	6.2
Nominal compensation per head (3)	4.4	3.2	6.4	7.0	6.0	6.5
Inflation (4)	2.4	1.4	0.9	2.7	3.3	3.3
Current account balance (% of GDP)	3.1	4.7	4.1	3.6	2.6	2.0
Nominal short-term rate of interest (level) (5)	9.3	5.4	6.0	5.8	:	:
Real effective exchange rate (6)	-2.3	0.1	-0.3	-6.0	1.1	:
Government budget deficit / surplus(% of GDP)	-2.2	-0.4	0.9	2.1	3.4	4.6
Primary balance (% of GDP)	4.3	4.0	5.0	5.5	6.3	7.0

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

Private consumption is estimated to have increased by 6.8% in 1998, reflecting rising numbers in employment along with increased compensation per head and personal income tax cuts taking effect in April. The rise in consumer's expenditure is also thought to have been helped by a fall in the saving ratio, reflecting a further strengthening of consumer confidence. The favourable demand prospects and continued low interest rates also lie behind the strong growth of investment, with gross fixed capital formation estimated to have increased by 11.6%. In addition, the contribution of net exports increased substantially despite weaker growth in Ireland's export markets. This reflected the continued strong gains in market share of Irish exporters which is closely linked to the establishment of new FDI projects throughout the year.

The acceleration of domestic demand has benefited the more labour-intensive sectors of the economy leading to a much improved employment performance. In 1998 employment is forecast to have increased by 55 000 (+4.1%), while the unemployment rate is expected to have fallen below 10%. Employment growth should remain strong in both 1998 and 1999 but the decline in unemployment is expected to continue to be lower than the rise in employment as participation continues its long-term rise and inward migration continues.

Falling interest rates and further tax cuts point to sustained growth

The policy background of a substantial fall in interest rates in the run up to EMU and the further reductions in personal income tax in the 1999 budget (amounting to about 1% of GDP) is expected to contribute to further sustained growth. In particular, the components of domestic demand are expected to show an upturn in 1999 in response to the decline in interest rates and further tax reductions. At the same time the very strong contribution of net exports in 1998 is unlikely to be repeated, partly as the coming on stream of new productive capacity is expected to be lower. Nevertheless, export growth is expected to continue to outstrip the growth in Irish export markets as manufacturing competitiveness continues to allow exporters to make gains in market share in line with the previous years.

The growth of private consumption is expected to rise to about 7% in 1999, partly due to the boost to household disposable incomes from the expected reduction in mortgage interest payments. Along with a continued rise in wealth effects from the rise in house prices, rising compensation per head, further tax cuts and growth in employment, this is also expected to result in a further bolstering of consumer confidence and a substantial decline in the saving ratio. At the same time the favourable demand prospects and low interest rates should see a further increase in investment.

The recent strong growth of the Irish economy has begun to show signs of overheating. So far this has been most noticeable in the housing market, where house prices rose by 36.6% in the year to the third quarter of 1998 while private sector credit increased by 25.1% in the year to October. In addition, the tightening of the labour market has seen an upturn in earnings growth. This has been most apparent in the construction sector, where wages increased by almost 12.5% in the year to June 1998. There is also evidence of strongly rising wage settlements in the public sector where the public pay bill has increased by almost 10% on average in 1997 and 1998. Although this reflects some increase in numbers employed, the underlying increase in pay rates has increased by an average of about 7½% in each of these two years. In addition, industrial earnings showed a rise of 6.8% in the year to June 1998. However, these pressures were only marginally reflected in the inflation rate during 1998. Although the consumer price index (CPI) showed a significant increase during the first half of the year, this can be largely attributed to the effective depreciation of the exchange rate during the second half of 1997. Following the peak in the year-on-year increase in the CPI of 3.2% in August, however, the index fell consistently, with the CPI showing only a 2.1% increase in the twelve months to November. Nevertheless, there is evidence of a rise in domestically generated inflation, particularly in the case of the service sector, where prices rose by about 3½% over the first 11 months of

1998. Looking to 1999, with the extreme openness of the economy and generally low international inflation there is little prospect of externally driven inflation. However, it is expected that the sustained period of strong growth will see the emergence of more widespread capacity constraints resulting in more tangible inflationary pressures as non-traded prices continue to rise and have a more general impact on economy-wide price developments.

Further improvements in the labour market

The acceleration of domestic demand over recent years has benefited the more labour intensive sectors of the economy leading to a much improved employment performance. Since 1993 employment is estimated to have increased by an average of over 4% each year, while the unemployment rate has fallen from 15.7% to 7.4% in 1998. In addition, structural reform has focused on shifting the emphasis of labour market policies from passive to active measures. These have paid particular attention to the persistent problem of long-term unemployment which still accounts for almost half of the unemployed in Ireland. Partly as a result of these measures, the numbers of long-term unemployed have begun to fall. At the same time, efforts have been made in recent budgets to improve the outlook for employment through changes to the tax and benefit regimes. The net effect of these changes has been gradually to reduce the replacement ratio and the tax wedge, thereby increasing the incentives to labour supply and demand respectively.

Nevertheless, the sustained growth over recent years and the associated tightening of the labour market have begun to present new problems. There are also signs of skill shortages emerging in the economy, most notably in the construction and software sectors. While to some extent these appear to be alleviated by the rising inward migration, there has nevertheless been a discernible impact on earnings growth. Compensation per head of employees increased by over 6% in 1997 and short-term indicators for earnings across all sectors indicate further sharp increases throughout 1998. This increases the risk that a domestically generated inflationary process might take hold in the economy.

Public finances in perspective

The general government deficit has remained below 3% of GDP in every year since 1988 and since 1997 has moved into surplus. The continued strength of activity has had a profoundly beneficial impact on the public finances with tax revenues persistently growing well above the authorities' expectations.

The current healthy state of the public finances stems from the budgetary consolidation of the late 1980s. This was initially based on strong restraint of primary expenditure, complemented by reform of the tax system. Thus, in the period 1987 to 1992, primary expenditure as a percentage of GDP fell by 6.5 percentage points. Revenues remained relatively buoyant during this period as efforts were made to broaden the tax base. This resulted in the emergence of substantial primary surpluses averaging over 4% of GDP.

Since the early 1990s the acceleration in economic growth and strong growth in revenues, combined with the continued decline in interest costs as a percentage of GDP, has provided in an increased margin for manoeuvre for budgetary policy. This has allowed the authorities to focus more on the reform of the personal tax system, with the intention being to unwind some of the personal sector tax measures that had been imposed in the early 1980s as an initial response to the budgetary crisis. In particular, successive budgets have sought to alleviate taxation on labour in order to encourage the creation of employment. In part, this has contributed to the substantial decline in current revenues as a percentage of GDP in recent years.

Table 2

Ireland: Developments in Public Finances 1993-2001

(as percentage of GDP)

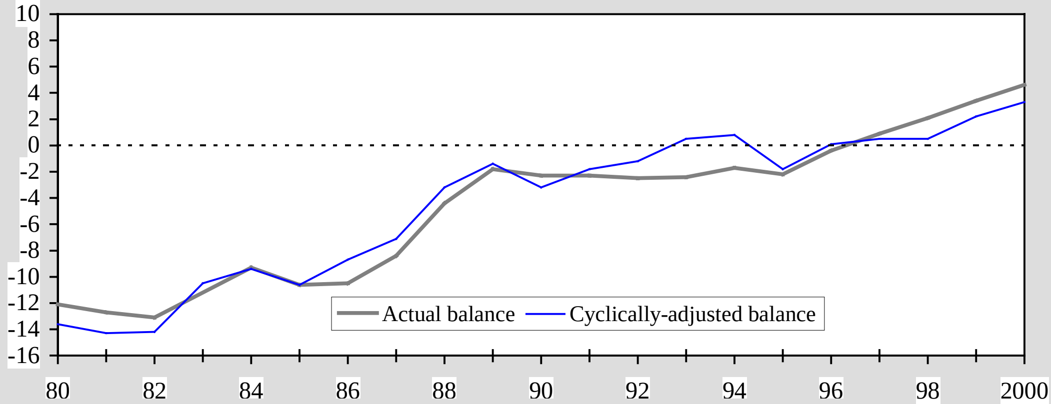
Outturn and forecasts *	1993	1996	1997	1998	1999	2000	
Government surplus /deficit	-2.4	-0.4	0.9	2.1	3.4	4.6	
- Current receipts	38.0	35.1	34.8	33.7	33.3	32.7	
- Total expenditure	40.3	35.0	33.4	31.6	29.9	28.1	
of which: - Interest payments	6.5	4.4	4.1	3.4	2.9	2.4	
- Investment	2.2	2.3	2.3	2.5	2.3	2.1	
Primary surplus/deficit	4.1	4.0	5.0	5.5	6.3	7.0	
Government debt	96.3	71.4	63.4	53.3	44.1	34.4	
Real GDP growth**	3.7	8.3	10.6	11.4	8.2	9.0	
Stability programme***			1997	1998	1999	2000	2001
Government surplus/deficit:			0.9	1.7/2.0	1.7	1.4	1.6
Government debt			61.3	59.0	52.0	47.0	43.0
Real GDP growth**			9.8	9.5	6.7	6.4	5.8

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998. GDP growth figures in the stability programme are on a semi-ESA95 basis (cf: ESA79 in the Commission's forecast) while historical government finance figures are on an ESA79 basis. In forecast years government finance figures are on an ESA95 basis and the GDP ratios use semi-ESA95 GDP figures incorporating 'exhaustiveness' revisions.

Source: Commission services and Irish Stability Programme 1998 to 2001.

However, the behaviour of the primary balance when adjusted for the cycle reveals something of a relaxation of policy during the recent period of strong growth. Whereas the period 1987 to 1993 showed a strong improvement in the structural primary balance, the period since then has shown something of a loosening in the primary balance, although this is offset by continued reductions in the interest component of the structural balance. Thus, the standard cyclical adjustment to budget balances implies that fiscal policy showed a modest tightening in 1998. However, this masks an underlying relaxation in the cyclically adjusted primary balance of 0.5% which was offset by the reduction in interest payments.

Graph 1: Ireland - Actual and cyclically-adjusted general government balance * (as % of GDP)

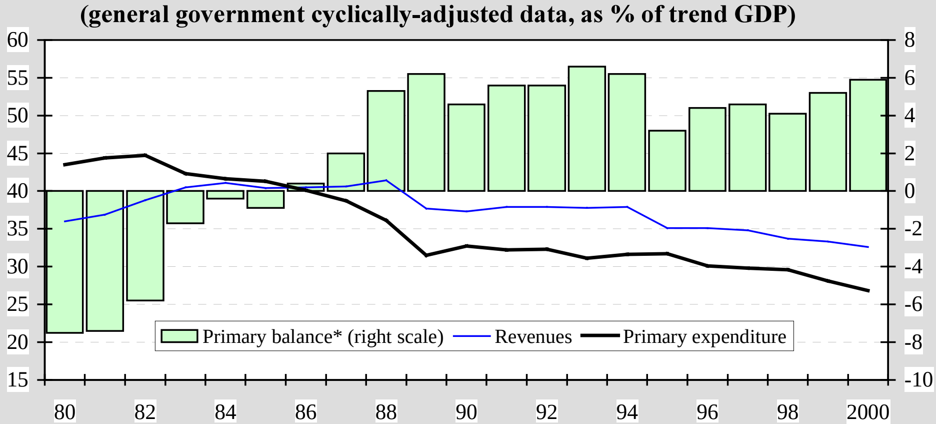


*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

Nevertheless, Ireland's budgetary consolidation policies have been remarkably successful, with the combined effect of consistent primary surpluses, strong growth and relatively low interest rates leading to a substantial decline in the debt ratio. The debt ratio has more than halved since 1987 and is expected to have fallen by about 10% of GDP in 1998 to 53.3%. Although estimates of expenditure show an overrun in 1998 when compared with the budget plans, this was more than offset by the strong revenue growth throughout the year. The official target of a budget surplus of 0.3% in 1998 was revised in the light of the continued strength of growth and the strong performance across all the main tax headings to an estimated outturn of 2.0% of GDP. The publication of the Irish Stability Programme 1999-2001 in December 1998 indicated that these favourable public finance trends are likely to continue over the medium term. The Stability Programme projected continued general government surpluses throughout the period to 2001 while the debt ratio is expected to fall by an average of 5 percentage points each year. This would allow Ireland to continue to be in compliance with the objectives of the Stability and Growth Pact.

Graph 2: Ireland - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

ITALY

Economic activity remained weak in 1998 but is expected to strengthen in 1999.

Economic growth in Italy revived mildly in 1997, driven by buoyant demand for cars and a modest rebound in exports. Real GDP increased by 1.5%, despite the deflationary impact of the huge budgetary correction which opened the way to Italy's EMU participation. However, the recovery failed to consolidate in 1998, owing to a slowdown in private consumption and unfavourable developments in external trade. In the light of latest information, GDP growth is likely to have posted in 1998 a similar rate of growth to 1997 (1.5%).

Table 1

Italy: Macroeconomic and Financial Developments
(annual percentage change unless otherwise indicated)

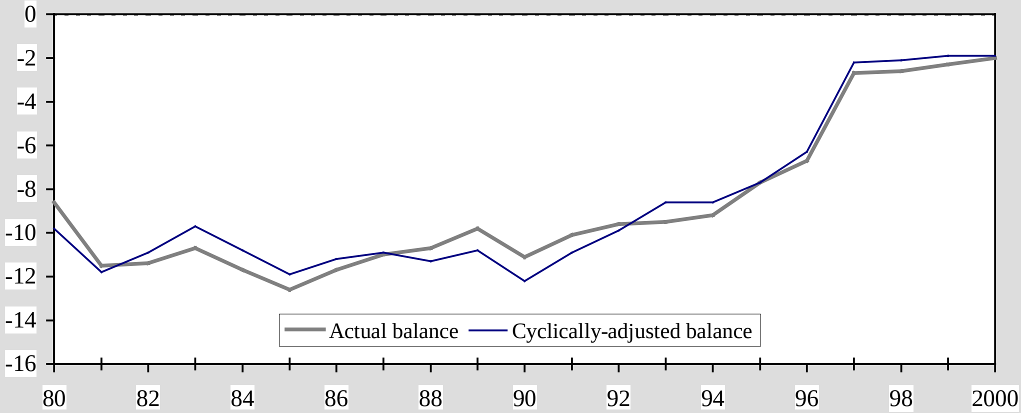
	1990-95	1996	1997	1998	1999	2000
GDP growth	1.3	0.7	1.5	1.7	2.1	2.5
Private consumption	0.9	1.2	2.4	1.2	1.8	2.2
Gross fixed investment	-0.6	0.4	0.6	3.3	5.4	6.7
Domestic demand	0.5	0.5	2.5	2.0	2.3	2.7
Exports (1)	7.6	-0.6	6.5	6.3	4.9	6.1
Imports (1)	4.4	-1.7	11.9	8.3	5.8	7.3
Employment growth	-0.7	0.0	-0.2	0.2	0.3	0.6
Unemployment rate (% of civilian labour force) (2)	10.1	12.0	12.1	12.0	11.9	11.6
Nominal compensation per head (3)	6.0	6.1	4.7	-0.5	2.9	2.8
Inflation (4)	5.8	4.3	2.5	2.2	2.0	1.9
Current account balance (% of GDP)	-0.2	3.4	2.9	3.1	3.1	3.0
Nominal short-term rate of interest (level) (5)	11.3	8.7	6.8	5.1	:	:
Real effective exchange rate (6)	-4.6	14.3	2.0	-2.8	1.2	:
Government budget deficit / surplus(% of GDP) 7)	-9.5	-6.7	-2.7	-2.6	-2.3	-2.0
Primary balance (% of GDP)	1.4	4.1	6.8	5.4	4.9	4.6

Notes:
(1) - (6) see Table 1 for Belgium. (7) Figures for 1999 and 2000 do not include the targeted budget corrections.

Source: Autumn 1998 Economic forecasts - Commission services.

Nonetheless, prospects for 1999 are more favourable. Despite the direct and indirect impact of the international crisis, domestic factors should keep the Italian economy on the way to a moderate recovery. Against the backdrop of lower interest rates and a less restrictive budgetary stance, both investment and consumption should revive. Tax incentives on house maintenance and a number of welfare enhancing and growth-fostering measures envisaged in the 1999 budget (including a recovery in public investment) should help sustain domestic demand. As a result, real GDP could grow by about 2% in 1999.

Graph 1: Italy - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

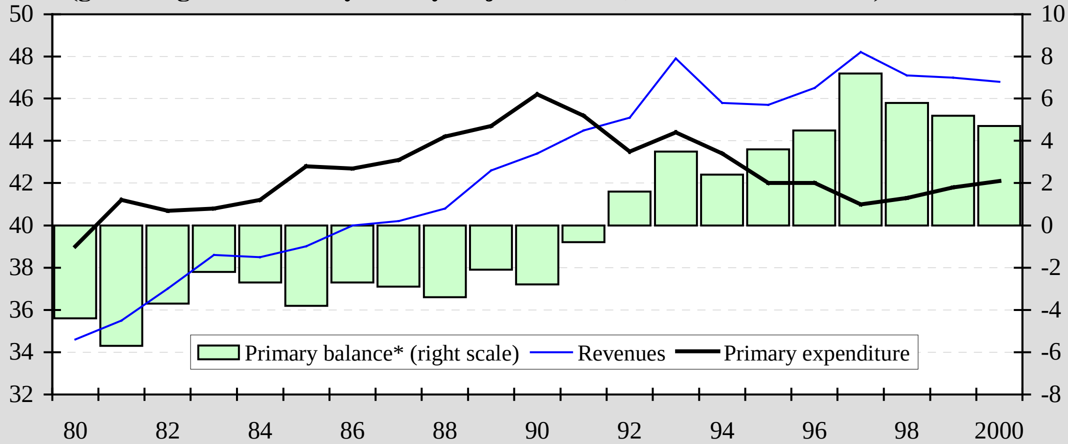
Source: Autumn 1998 Economic Forecasts - Commission services.

The evolution of private consumption in 1997 and 1998 was significantly influenced by the impact of the tax incentives to the car sector. Private consumption was the most dynamic demand component in 1997, when it increased by 2.4%, well above GDP growth. However, private consumption decelerated markedly when the effects of the incentives started to fade out, and its rate of growth almost halved in 1998. After having reduced their savings in order to benefit from the tax incentives to replace old cars, households seemed to have returned to a cautious consumption behaviour, in a context of persistent labour market weakness, subdued growth in real disposable income and increasing uncertainty affecting the world economy. Prospects are for a moderate revival in 1999, sustained by more favourable developments in real disposable income and helped by the tax incentives to house maintenance introduced in 1998, the effects of which should become more visible in 1999.

Fixed investment rose slowly in 1997 (+0.6%). This resulted from a gradual recovery of investment in equipment (+2.6% after –0.3% in 1996) and a contraction of investment in construction (-1.6%). Business fixed investment continued to expand in the beginning of 1998, while the expected recovery in investment in construction failed to materialise. As a result, the annual growth of fixed capital formation is likely to show only a modest acceleration with respect to the previous year (around 3%). Total investment is expected to revive in 1999 and 2000, thanks to a lower cost of capital, better demand prospects and the stimulus of specific policy measures. Investment in construction is expected to benefit from the tax incentives for house renovations and by the ongoing recovery in public investment.

The weak performance of net exports reduced GDP growth by almost one percentage point in 1997 and their contribution to growth remained sharply negative in 1998, as the effects of the Asian crisis added to the domestic factors which had been at work in the previous year. Despite some deceleration in the second half of 1998, in line with subdued domestic growth, import penetration remained high, while export growth suffered from the slowdown in world demand and from the competitiveness losses in some export markets. Owing to the favourable evolution in the terms of trade, however, there was only a marginal reduction in the trade surplus, which is expected to stay close to 2.5% of GDP in 1999.

Graph 2: Italy - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

Despite the slow pace of the economic recovery, labour market conditions improved gradually in 1998. The number of employed has increased by 0.5%-0.6% with respect to 1997. However, owing to a similar increase in the labour supply, the unemployment rate remained virtually stable at 12.2%. At a sectorial level, favourable trends characterised both the manufacturing sector and the services sector, whereas substantial employment losses were still recorded in agriculture and in the construction sector. The annual rate of growth of total employment is expected to improve only marginally in 1999, in line with the slight acceleration in GDP growth.

In 1996 and 1997 Italy achieved impressive results in terms of disinflation. Consumer price inflation fell from 5.6% in the beginning of 1996 to an annual average of 1.7% in 1997, the lowest rate in 30 years and well below the government target of 2.5%. Despite the increase in VAT rates in October 1997, consumer price inflation remained flat throughout 1998 and the annual average was 1.8%.

The thrust for rapid convergence, announced by the government and credibly backed by the action of the Bank of Italy, played a key role in the disinflation process. The adjustment was largely structural. The changes in the wage settlement mechanism introduced in 1993 ensured nominal wage moderation and declining unit labour costs, paving the way for the stabilisation of inflation expectations. Moreover, cyclical factors contributed to the rapid deceleration of price dynamics. In a context of slow growth and persistent slack in the labour market, cost and demand pressures remained very subdued. Furthermore, the downward trend in international commodity prices and declining prices for imported consumer and investment goods added to the deflationary impulses of domestic origin.

The decline of inflation was accompanied by a cautious relaxation of monetary policy. The Bank of Italy gradually cut official interest rates throughout 1997 and 1998, albeit leaving them higher than in other euro countries until late December 1998. The discount rate was reduced from 7.5% in early 1997 to 4% in late October 1998 and then to 3% in two further steps by the end of December. Meanwhile, consumer inflation had fallen to the historical low of 1.5% , whereas expectations, based on

Table 2

Italy: Developments in Public Finances 1993-2001

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000	
Government surplus /deficit	-9.5	-6.7	-2.7	-2.6	-2.3	-2.0	
- Current receipts	48.1	46.6	48.4	47.2	47.1	46.8	
- Total expenditure	57.6	53.3	51.0	49.9	49.4	48.8	
of which: - Interest payments	12.1	10.8	9.5	8.0	7.1	6.6	
- Investment	2.7	2.3	2.4	2.5	2.5	2.5	
Primary surplus/deficit	2.6	4.1	6.8	5.4	4.9	4.6	
Government debt	119.1	124.0	121.6	118.8	115.3	111.7	
Real GDP growth**	-1.2	0.7	1.5	1.7	2.1	2.5	
Stability programme***			1997	1998	1999	2000	2001
Government surplus/deficit:			-2.7	-2.6	-2.0	-1.5	-1.0
Government debt			121.6	118.2	114.6	110.9	107.0
Real GDP growth**			1.5	1.8	2.5	2.8	2.9

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.

** Annual % change.

*** Submitted in December 1998.

Source: Commission services and Stability programme of Italy.

current and projected cost dynamics, pointed to a further deceleration in the coming months.

Strong budgetary correction paved the way for Italy's participation in the euro

In 1997 Italy succeeded in meeting the ambitious targets set for budgetary consolidation, thus paving the way for its admission to the group of the first-wave participants in the euro. The general government deficit went down to 2.7% of GDP (undershooting the official objective of 3%), thanks to a budgetary correction amounting to 4% of GDP.

The unprecedented deficit reduction achieved in 1997 was the culmination of a process of budgetary consolidation which started in the late 1980s and continued throughout the first half of the 1990s, though with uneven intensity and results. The primary deficit was cancelled in 1991, turned into a surplus in 1992, and widened in the following years to reach 6.8% of GDP in 1997 (see Table 2). The improvement in the primary surplus was accompanied by a gradual reduction of interest payments, which fell from 11.4% of GDP in 1995 to 9.5% in 1997. Sustained budgetary consolidation, together with the revenues from privatisation, put the ratio of general government debt to GDP on a downward path. From a high of 124.9% in 1994 the debt/GDP ratio fell to 121.6% in 1997 and is forecasted to be 118.8% in 1998. It is now expected to follow a sustained downward path.

The important budgetary consolidation is the more remarkable as it was achieved in a period of low economic growth. Indeed, the deficit reduction was mostly based on discretionary measures and, to a lesser extent, on lower interest payments, whereas cyclical developments did not play any role. Moreover, the corrective measures were based more on expenditure cuts than on revenue increases, notwithstanding the one-off "eurotax" in 1997. Most of the adjustment was structural, and resulted from in-depth intervention in most areas of the economy related to the government budget, as detailed in the passage on structural reforms.

As for 1998, the general government deficit target had been set at 2.6% of GDP, with the primary surplus at 5.5% of GDP. This objective, based on assumptions of an acceleration of economic growth, reflected some relaxation of the consolidation efforts. Government receipts in terms of GDP were assumed to fall significantly with respect to the previous year, due to the expiration of the one-off levies (such as the "eurotax"), which was expected to be compensated by a sharp decline in the cost of debt servicing. On the other hand, current expenditures as a percentage of GDP were assumed to remain unchanged. Preliminary indications on budgetary developments in 1998 suggest that, also due to lower-than-expected growth, the deficit outcome will have somewhat departed from the 2.6% target. A likely undershooting of the primary surplus target, due to a significant shortfall in receipts and higher expenditure for health care and transfers to railways, is expected to have been partly offset by additional savings on interest payments.

The budgetary strategy for 1999-2001

The Stability Programme for 1999-2001, presented at the end of December 1998, sets a target of half a percentage point reduction in the deficit ratio for each of the next three years, to reach 1% of GDP in 2001. The Italian authorities intend to achieve this objective through a reduction of the same size in the cost of the debt servicing and a stabilisation of the primary surplus at 5.5% of GDP. While the primary surplus is projected to remain constant, there will be some re-balancing of different budget components. In particular, current expenditure is expected to decrease moderately, as a percentage of GDP. The government intends to increase instead fixed capital expenditure and reduce the tax burden. The debt to GDP ratio will decline by around three and a half percentage points each year, to reach a level of 107% in 2001.

The Stability Programme not only focuses on public finance consolidation, but underlines the issue of employment and economic development of Italy's southern regions. The government is committed to stimulate economic growth via a package of direct investments and tax incentives, which will cost 0.3% of GDP in 1999 and 0.4% of GDP in 2000 and will continue in following years.

As for the 1999 budget, the approved financial law takes explicitly into account the possibility of a more active use of budgetary policy. The authorities assess at 2.4% of GDP the 1999 deficit ratio in the absence of any correction. Hence a set of measures with a net impact 0.4% of GDP has been introduced in order to reach the target of 2% of GDP. However, since the budget also includes additional welfare expenditures, tax-breaks for poorest households and incentives to investment and employment, amounting to around 0.4% of GDP, the amount of extra revenues and savings is double the size of the deficit reduction.

The most relevant interventions on the expenditure side are the reduction of the borrowing of regions and local authorities, in the framework of a "domestic stability pact", and savings in various items of current expenditure (civil service, education, transfers to public enterprises, health care, purchase of goods and services). On the revenue side, lower tax revenues arising from the reimbursement of the "eurotax" and from tax breaks for housing and low-income households are projected to be more than compensated by the sale of claims of the national institute for social security (INPS) to uncollected social contributions. Expected revenues from the newly introduced "carbon tax" will be mainly used to fund a reduction of 0.82% of social security contributions paid by employers.

The Commission Services will assess whether the Italian Stability Programme is compatible with the provisions of the Stability and Growth Pact. In that framework, an assessement of the 1999 package will also be provided.

Extensive structural reforms have accompanied the process of fiscal consolidation

Since the early 1990s, budgetary consolidation has been accompanied by wide-ranging structural reform in most areas of the economy related to the government budget and this process gained further momentum in 1997-98.

The pension system, which had been the object of two comprehensive reforms in 1992 and 1995, aimed at ensuring the long-term balance of the system, was further revised in 1997. The transition period to a contribution-based regime was shortened and the eligibility criteria for early retirement were tightened. Public and private pension regimes were harmonised and pension contributions paid by self-employed were increased.

In 1997-98 the tax system was subject to its most important reform since the early 1970s, inspired by the principles of fiscal decentralisation, simplification, enlargement of the tax base and higher tax neutrality. The tax reform aims at easing both profit and labour taxation and tackles a number of distortions which had characterised the Italian tax system in the last decades. Although some provisions need to be somewhat fine-tuned, the measures introduced in the last two years reflect a noticeable effort of rationalisation and pave the way for efficiency gains, which will become fully visible in the medium and long run.

The State budget rules and procedures have been incisively reformed. The reform of the central government budget, approved in April 1997, has made the budget process more transparent while simplifying the budget structure and establishing a clearer relationship between spending targets and allocated resources. At the same time, significant progress has been achieved in the control of financial outflows from the central government and on the cash accounts of decentralised entities, thus allowing a better planning and a tighter control on the spending decisions of decentralised institutions.

The reform of the public administration, announced in 1990 and started in the following years, has also made decisive progress with the new legislation enforced in 1997-98 (Bassanini reform). This reform has linked the restructuring of the civil service to the process of decentralisation, by transferring several state functions to local governments, on the basis of the principle of subsidiarity.

The privatisation process accelerated markedly in 1997, when the sale of state-owned enterprises (including the energy conglomerate ENI, the telecoms utility Telecom and two major banks) reached 3% of GDP, thus contributing 1.5% of GDP to the reduction of the debt ratio. In 1998 the process slowed down, in a context of unfavourable conditions on the stock market. Nonetheless, the revenues from privatisation are assessed to have contributed a further 0.75% of GDP to the reduction of the debt.

All these reforms have set in motion a process of deep transformation of the Italian economy, although they need to be further developed or completed. The reforms of the tax system and of the State budget have to be fine-tuned and strictly monitored in the early stages of application. The legal framework for the reform of the public administration has been adopted, but its implementation, which is linked to the process of decentralisation, has only just started. Further interventions on the pension and on the health-care system are required, both for the short-term control of current expenditure and in a medium-term perspective, in order to deal with the problem of ageing population. The privatisation process must continue to help the reduction of the debt and to improve the functioning of the product and services markets.

As for the labour market, several steps have recently followed up the structural reforms started in the early 1990s. Many provisions of the “Pact for Employment” signed in September 1996 by the social partners and the government, have been turned into law in 1997 and 1998. All these measures aim at increasing labour and wage flexibility while favouring a gradual deregulation of the labour market. In particular, new categories of contracts have been adopted (e.g. part-time contracts, apprenticeship schemes, interim jobs), the State monopoly on job placement has been abolished, and a regional differentiation of labour contracts has been introduced to assist job creation in less developed areas. However, the labour market reform is also far from being completed and only marginal progress has been achieved so far in reducing high structural unemployment.

The social pact for growth and employment, signed just before the end of 1998 by the government, the employers and the unions, might provide a framework to enhance labour and wage flexibility. In this context, there are a number of crucial elements to be further defined, such as the contractual framework, the reform of the training system, the implementation of the draft legislation on the shortening of working time to 35 hours by 2001, the size and the distribution of the tax reductions to be introduced, the reform of unemployment subsidies. An appropriate solution to these issues could not only help reduce structural unemployment, but also remove some of the causes which restrained investment and growth in recent years.

LUXEMBOURG

Growth still high in 1998 but set to fall sharply in 1999

The Luxembourg economy was particularly buoyant in 1997, with real GNP growth of almost 4.8%. Private consumption grew by 2.5% and gross fixed capital formation, which is traditionally erratic in Luxembourg in view of the country's small size, increased by more than 14% in volume terms. This was due partly to the launch of a satellite and the purchase of two wide-bodied aircraft but also to an upturn in the construction industry. Exports of goods and services were also buoyant, growing by just under 6%, as were imports. With value added rising by 6.2% in volume terms, industry in general - and the steel industry in particular - helped significantly to secure this healthy performance.

Table 1

Luxembourg: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	4.9	3.0	4.8	4.2	3.8	4.3
Private consumption	2.9	1.9	2.5	3.0	2.9	2.8
Gross fixed investment	5.7	-1.7	14.1	6.1	5.0	5.2
Domestic demand	3.7	1.8	4.7	3.7	3.2	3.4
Exports (1)	4.4	2.3	6.0	6.2	5.6	6.5
Imports (1)	3.2	1.0	6.1	5.9	5.2	5.6
Employment growth	2.9	2.9	3.1	2.9	2.5	2.9
Unemployment rate (% of civilian labour force) (2)	2.4	3.0	2.6	2.4	2.3	2.2
Nominal compensation per head (3)	4.7	1.8	2.7	2.4	2.4	2.2
Inflation (4)	3.1	1.6	1.1	1.4	1.7	1.7
Current account balance (% of GDP)	22.1	16.3	14.1	14.1	14.7	15.7
Nominal short-term rate of interest (level) (5)	:	:	:	:	:	:
Real effective exchange rate (6)	:	:	:	:	:	:
Government budget deficit / surplus(% of GDP)	2.3	2.9	3.0	2.2	2.0	2.0
Primary balance (% of GDP)	2.7	3.2	3.4	2.6	2.4	2.4

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

The strong growth continued in 1998, to the extent that the forecast of 4.2% put forward by the Commission last October might even prove to be unduly cautious. The available statistics, which essentially concern the first half of the year, point to sustained levels of activity throughout the economy, particularly in industry, which recorded a 7% increase in the volume of production in the first half of the year, but also in services and the construction industry. Exports of goods actually increased by almost 20% in value terms during the first six months of the year. However, growth slowed during the second half of the year, particularly in industry, which is particularly dependent on external demand. Private consumption probably grew by more than 3%; investment, while not replicating the very high 1997 figure, probably increased by almost 6% and both exports and imports must have recorded much the same levels of growth as in the previous year.

Growth is expected to fall quite sharply in 1999 to around 3¾%. Domestic demand should slacken somewhat, especially as regards investment; exports should show a more pronounced decline. However, imports, which are fairly closely correlated to investment, particularly in plant and equipment, should also slow down, with the result that the contribution of foreign trade to GDP growth could remain higher than the deterioration in the world economy would initially suggest. Industry, which is very much export-oriented, is likely to feel the effects of the expected slowdown in the rest of the European Union, but the service sector, and in particular the financial industry, should remain buoyant. Growth is set to pick up again in 2000 as the effects of the recent turmoil recede.

Employment still rising sharply: inflation down

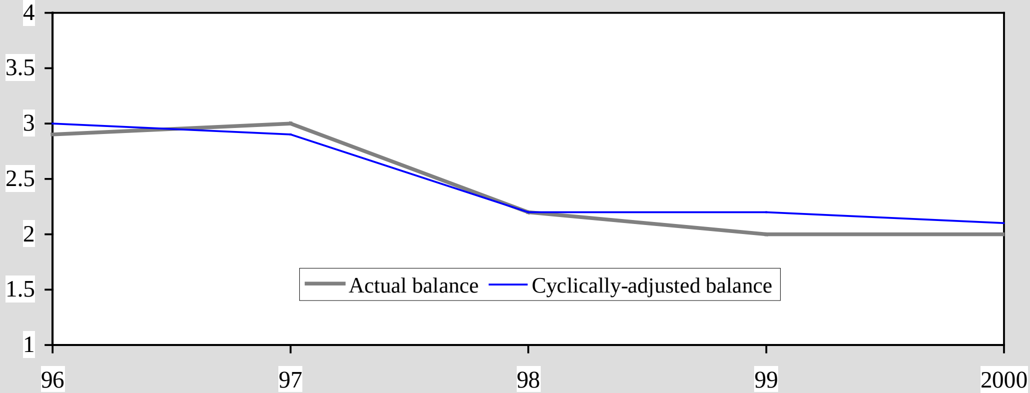
The strong growth in 1997 and 1998 has been reflected in a rapid increase in employment. Total employment grew by almost 3.1% in 1997 (with the number of wage a salary earners up by 3.4%); even though the number of Luxembourg residents in jobs increased by only 1.3% (since more than 70% of the new jobs were taken by frontier workers, the number of which rose by a further 8.1%), this figure is the highest since 1991. Nevertheless, unemployment continued to edge upwards, although it remains the lowest in the European Union. Growth in employment will doubtless prove to have been even stronger in 1998 than in 1997, and unemployment has started to dip slightly, partly in response to the substantial growth in employment but probably also as a result of the specific job-creation and training measures taken by the Luxembourg authorities.

As in many other Member States, inflation is at an historically low level, particularly as a result of declining oil prices. It was only 1.4% in 1997 and remained at around that level in 1998. The substantial pool of labour in the regions bordering Luxembourg meant that the rapid rise in employment did not exert any major pressure on wages. In fact, wage rises, which had registered 2.8% in 1997, actually slackened in 1998.

Public finances still particularly healthy

Luxembourg has recorded surpluses in its public finances since at least the beginning of the 1970s, with only a brief interruption between 1980 and 1982. The last two years did not buck the trend, with the general government surplus amounting to 3% of GDP in 1997 and to about 2% in 1998. Movements in the cyclically adjusted surplus very closely mirror movements in the actual surplus (see Graph 1).

Graph 1: Luxembourg - Actual and cyclically-adjusted general government balance * (as % of GDP)

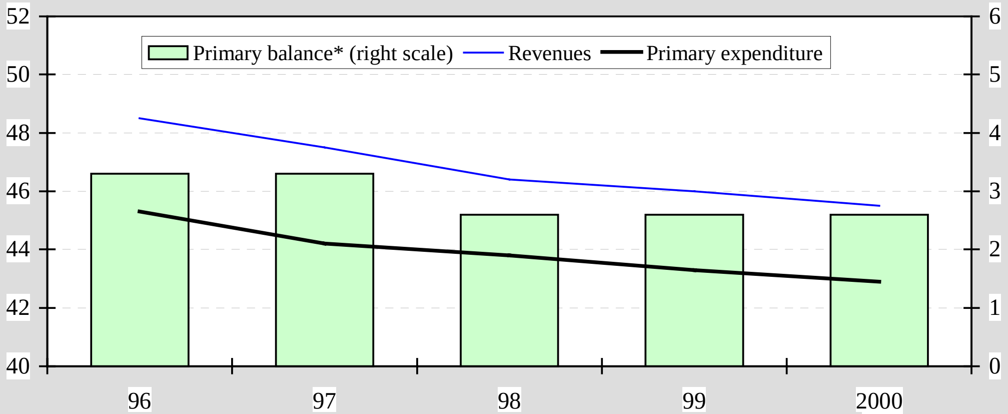


*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

As a result of the Luxembourg economy's strong performance, the weight of public revenue and spending in GDP has tended to decline in recent years. This trend should continue despite relatively high rates of increase (see Graph 2). Given the very low level of public debt, interest payments have on average amounted to less than ½% of GDP in recent years. By contrast, investment spending, at almost 5% of GDP, is the highest in the European Union and almost twice the average for the fifteen Member States (see Table 2).

Graph 2: Luxembourg - Key budgetary variables 1996-2000
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

The public debt, which fell to a low of 4.2% of GDP in 1991, has since registered a slow, autonomous increase, standing at 6.7% of GDP in 1997 and around 7.1% in 1998.

Table 2

Luxembourg: Developments in Public Finances 1993-2001
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000	
Government surplus /deficit	1.7	2.9	3.0	2.2	2.0	2.0	
- Current receipts	:	48.5	47.5	46.8	46.0	45.5	
- Total expenditure	:	45.6	44.5	44.5	44.0	43.5	
of which: - Interest payments	0.4	0.3	0.3	0.4	0.4	0.5	
- Investment	5.4	4.8	4.7	4.8	4.8	4.8	
Primary surplus/deficit	2.0	3.2	3.4	2.6	2.4	2.4	
Government debt	6.1	6.6	6.7	7.1	7.5	7.7	
Real GDP growth**	8.7	3.0	4.8	4.2	3.8	4.3	
Stability programme***			1997	1998	1999	2000	2001
Government surplus/deficit:			:	:	:	:	:
Government debt			:	:	:	:	:
Real GDP growth**			:	:	:	:	:

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** : not available.

Source: Commission services.

The particularly enviable public finance situation is not expected to change much in the years ahead. However, a rapid increase in spending, particularly on social security, could pose a problem in the longer term. In its evaluation of the Luxembourg stability programme the Commission will assess whether the programme is in line with the requirements of the Stability and Growth Pact

NETHERLANDS

Strong growth in 1998 underpinned by domestic demand

Since the 1993 recession which, unlike the situation in the neighbouring countries, merely resulted in a marked cyclical slowdown, the Netherlands has recorded five years of rapid expansion in which GDP growth averaged 3.2% per annum. GDP grew in real terms by 3.7% in 1997, accelerating slightly to 3.8% in 1998.

Employment increased by 2½% in 1998 in full-time equivalent terms. These substantial gains were reflected in a significant downturn in unemployment: the harmonised Eurostat unemployment rate, which was running at 7.1% on an annual average basis in 1994, fell to 3.7% in 1998.

Table 1

The Netherlands: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	2.4	3.1	3.6	3.8	2.7	3.0
Private consumption	2.5	2.7	3.0	3.7	3.0	2.7
Gross fixed investment	1.1	5.4	6.8	3.7	4.1	5.7
Domestic demand	1.9	3.0	3.6	3.8	3.0	3.2
Exports (1)	4.6	5.2	6.7	6.9	5.0	6.0
Imports (1)	3.7	5.3	7.1	7.3	5.8	6.8
Employment growth	0.9	2.0	2.6	2.5	1.8	2.0
Unemployment rate (% of civilian labour force) (2)	6.4	6.3	5.2	4.0	3.5	3.1
Nominal compensation per head (3)	3.4	1.8	2.1	3.0	4.2	3.8
Inflation (4)	2.5	1.6	2.0	2.2	2.3	2.3
Current account balance (% of GDP)	4.4	6.2	6.9	5.8	5.6	5.5
Nominal short-term rate of interest (level) (5)	7.3	3.0	3.3	3.4	:	:
Real effective exchange rate (6)	1.0	-2.6	-3.8	1.2	3.4	:
Government budget deficit / surplus(% of GDP)	-3.8	-2.0	-0.9	-1.4	-1.4	-0.6
Primary balance (% of GDP)	2.3	3.5	4.4	3.4	3.2	3.7

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

The main motor of growth in 1998 was domestic demand and, in particular, private consumption, which increased by 3.7% in volume terms over the year as a whole. Purchases of consumer durables, in particular, were exceptionally buoyant. As in previous years, the consumer boom was fuelled by substantial gains in employment, by the planned reduction in taxes and social security contributions and probably also by the increase in household wealth deriving from the rise in house prices and, until recently, stock exchange gains. The acceleration in the contractual rise in earnings, which since last year has again outpaced the consumer price index, also played a part.

Gross fixed capital formation grew by 3.7% over the year as a whole and therefore has not replicated the especially high rates of 1996 and 1997 (5.4% and 6.8% respectively) which, admittedly, were boosted by the completion of several major projects. Investment in plant and machinery, in particular, is not expected to increase by more than about 3%: the construction sector should be a bit more buoyant with a growth rate of around 4.3%.

Exports of goods and services did not decelerate significantly in 1998, mainly as a result of the resumption of pigmeat exports following the eradication of the swine fever epidemic which was a feature of 1997. However, a gradual slowdown occurred in the course of the year in response to developments in the world economy. In total, exports of goods and services are expected to grow by about 7% over the year as a whole. Imports of goods and services increased sharply during the first half of the year, reflecting the buoyancy of domestic demand, but thereafter growth tailed off slightly, resulting in a rate of around 7¼% for the year as a whole. Thus the contribution of external demand to GDP growth was slightly positive, in the region of 0.3%.

Wage restraint has been one of the key components of Dutch macroeconomic strategy in the last fifteen years. Since 1992, wages have increased, in both real and nominal terms, more slowly than those of the country's main competitors, thus improving competitiveness in spite of the long-term appreciation in the guilder. However, wages have increased faster in recent years in response to the sharp fall in unemployment. The result has been a reversal of the relative downward trend in wage costs observed previously in the Netherlands as compared with those in the neighbouring countries. Nevertheless, consumer price inflation has remained low, with the fall in import prices more than offsetting wage increases. Price inflation for 1998 as a whole should be just above the 2% mark.

The peak of the cycle was apparently reached in the first few months of 1998: quarter-on-quarter real GDP growth was virtually zero in the third quarter and industrial production declined by almost 2%. In addition, the consumer confidence indicator and, to a lesser extent, the producer confidence indicator have fallen sharply since the end of the summer. Dutch growth therefore seems likely to slowdown fairly significantly in 1999 to within the 2½-2¾% range; private consumption should grow by 3% or so and thus continue to act as an essential support for growth. In contrast, exports will be hit by the deterioration in the world economy. Employment should continue to rise, but at a more modest rate than in previous years (around 1.8%).

Dutch public finances within the framework of the stability programme

The Netherlands presented a stability programme for 1999-2002 in accordance with the requirements of the Stability and Growth Pact. This programme extends the main objectives of the second convergence programme (1995-98): a continued reduction in the general government deficit and in the GDP/public debt ratio, to take place in parallel with new reductions in taxes and social security contributions with a view to boosting growth and jobs. It is also planned to allocate additional resources to eradicate certain inefficiencies in the economy, mainly in the labour market and infrastructure.

Table 2

The Netherlands: Developments in Public Finances 1993-2002

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit a)	-3.2	-2.0	-0.9	-1.4	-1.4	-0.6		
- Current receipts	53.2	48.7	49.1	47.0	46.6	46.2		
- Total expenditure	56.4	50.7	50.0	48.3	47.9	46.8		
of which: - Interest payments	6.2	5.6	5.2	4.8	4.5	4.3		
- Investment	2.1	1.9	1.9	1.9	1.9	1.9		
Primary surplus/deficit	3.0	3.5	4.4	3.4	3.2	3.7		
Government debt	81.1	77.1	71.4	68.6	66.6	63.7		
Real GDP growth**	0.8	3.1	3.6	3.8	2.7	3.0		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-0.9	-1.3	-1.3			-1.1 [b)]
Government debt			71.4	68.6	66.4			64.5 [c)]
Real GDP growth**			3.6	4.0	2¼ [d)]	2¼ [d)]	2¼ [d)]	2¼ [d)]

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in November 1998.
'a) Not including for 1995 a net amount of 32.84 mrd NLG of exceptional expenditure related to the reform of the financing of the social housing societies.
b) Government deficit of 1.1% of GDP in 2002 is that projected in the base, cautious scenario; the alternative middle and favourable scenarios project a deficit of ¼% of GDP and a surplus of ¼% of GDP, respectively, in 2002.
c) Government debt ratio of 64.5% of GDP in 2002 is that projected in the base, cautious scenario; the alternative middle and favourable scenarios project a government debt ratio of 61¾% of GDP and 59% of GDP, respectively, in 2002.
d) Average annual growth in the four years 1999-2002 in the base, cautious scenario; alternative middle and favourable scenarios assume average growth of 2¾% and 3¼% per year respectively.

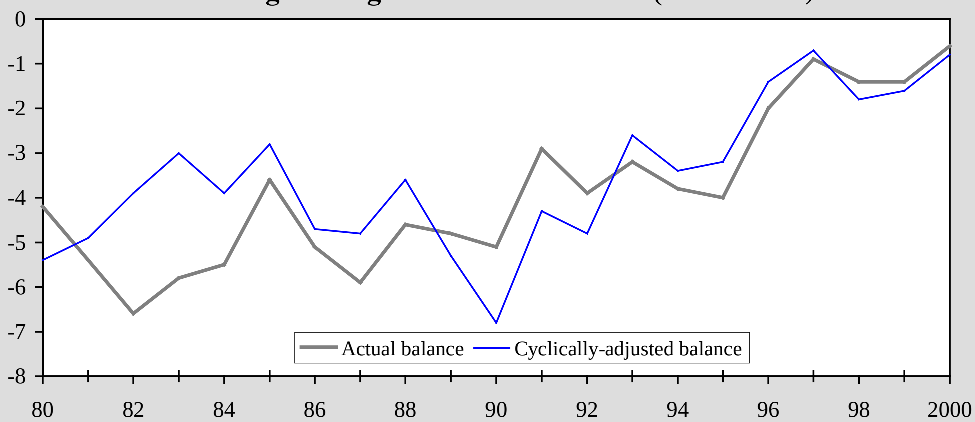
Source: Commission services and Stability programme of the Netherlands.

Thanks to this twin-track strategy, the general government deficit was reduced from 3.2% of GDP in 1993 to 1.4% in 1998 during implementation of the second convergence programme; in cyclically adjusted terms, the deficit came down from 3.4% of GDP to 1.8% over the same period. At the same time, taxes and social security contributions were reduced from 48.4% to 44.2% of GDP. This result was achieved by setting an annual expenditure reduction target of 0.7% in real terms. Accordingly, between 1993 and 1998 general government spending was cut back from

56.5% to 48.3% of GDP. As a result of this policy, the increase in personal disposable income outstripped that of earnings, thus contributing to the buoyancy of domestic demand. The taxation of labour was also reduced - particularly on the lowest-paid jobs - with the aim of expanding employment.

Under the stability programme, which is based on an agreement reached within the new coalition government in August 1998, the strategy of recent years is continued, albeit with some fine-tuning of priorities. The emphasis is on continuing to reduce the tax burden while also boosting spending in some sectors, such as education, vocational training, health care and infrastructure. The public expenditure target was eased considerably, with an annual real increase of 1½% authorised for 1999-2002.

Graph 1: The Netherlands - Actual and cyclically-adjusted general government balance * (as % of GDP)

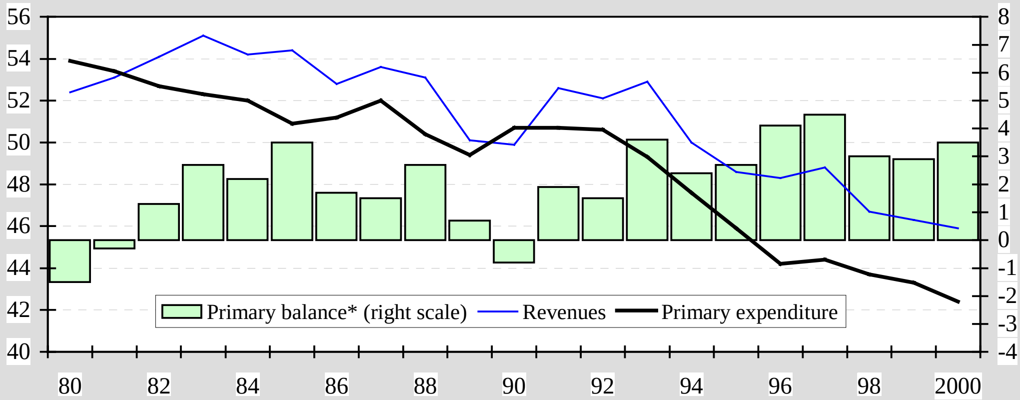


*Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

Against this background, the reduction in the general government deficit is likely to continue, but at a slower pace. The stability programme sets out three macroeconomic scenarios, projecting annual average GDP growth at 2¼%, 2¾% and 3½% respectively over the period. Depending on the scenario chosen, in 2002 the general government deficit should stand at 1% (conservative scenario), ¼% of GDP, or in the most favourable scenario, be transformed into a surplus of a ¼% of GDP. For reasons of prudence, the stability programme favours the conservative scenario which is based on slower growth than that in the macroeconomic results of recent years and would result in a modest adjustment in the public finances, since the deficit would only come down from 1.4% in 1998 to 1% in 2002. However, if economic growth developed according to recent trend, i.e. more or less in line with the middle scenario, the deficit would decline to ¼% of GDP in 2002.

The public debt, which was fluctuating within a narrow band around 80% of GDP at the beginning of the decade and which had fallen from 81.2% in 1993 to 68.6% in 1998, should fall, depending on the scenario chosen, to 64½%, 61¾% or 59% of GDP by 2002.

Graph 2: The Netherlands - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

The budget for 1999 was the first to implement the stability programme. The general government deficit should remain much the same as in 1998 (1.4% of GDP); Dutch budget policy will therefore continue to underpin growth in 1999. It should be noted that the stability programme lays down prudential rules for managing the variations in general government revenue which could result from unforeseen changes in activity, the aim being to ensure that the budget position is at all times consistent with the requirements of the Stability and Growth Pact.

Promoting competition and labour market reforms

The last few years have seen a number of important reforms concerning product markets, the labour market and the organisation of social security. Measures have been taken to enhance competition on product markets: a new competition law entered into force on 1 January 1998 and is designed to check on abuses of dominant positions and to examine the competition effects of company mergers. Plans are currently being drawn up or implemented for the introduction of competition in public transport, the utilities (electricity, gas, water), post and telecommunications and health care.

Various measures have also been taken to increase labour market flexibility and to reduce labour costs, particularly for unskilled workers. For example, employers' contributions have been cut for employees whose pay is no more than 115% of the minimum wage.

In recent years the Dutch social security system has undergone major reforms essentially designed to cut welfare costs against a background of deteriorating public finances. Another objective has been to make the system more efficient, so as to provide new job opportunities and increase the participation rates. Accordingly, the emphasis has gradually shifted from guaranteeing the unemployed an income to increasing the incentives for people to go back to work.

One of the most important reforms in this area concerns the disability scheme. At the beginning of the decade, the Netherlands had almost one million registered disabled, or almost one adult in seven. It is clear that the rules deciding entry to the disability scheme were used over many years as a means of absorbing part of the rise in unemployment.

Faced with this situation, the Dutch authorities launched a reform of the scheme in the early1990s which was designed to tighten the entry conditions, to discourage employers and workers from using it by introducing incentives and penalties, and to reduce the level of benefits. A major reform of the scheme took place with the entry into force in early 1998 of the so-called PEMBA law, which aims to tailor contributions to individual risk and to introduce a measure of competition by allowing employers to choose between the state scheme and private insurance. However, it is too early as yet to assess the impact of this reform.

Other major reforms were also carried through in the area of sick leave, the cost of which is far higher in the Netherlands than in most other European Union countries. The scheme was privatised in two stages and the state scheme covering sick leave was abolished.

Under the 1998 coalition agreement and the stability programme, an active investment policy is to be conducted over the next few years to improve the quality and efficiency of economic structures. The main emphasis will be on providing proper vocational training, and improving health-care infrastructure and infrastructure in general, including environmental protection. The competition monitoring policy launched in recent years is also to be continued.

AUSTRIA

Output growth driven by domestic factors

Over the past few years, economic developments in Austria have been decisively shaped by the single most important policy goal, i.e. first-round participation in the third stage of EMU. Budgetary consolidation, in particular, leading to a drastic reduction in the general government deficit between 1995-97, was strongly motivated by this objective. Despite the magnitude of the budgetary retrenchment, economic activity proved resilient, with GDP growth averaging only slightly less than trend growth. Buoyant exports, an easing of monetary conditions and traditional consumption-smoothing behaviour of Austrian households appear as the main factors behind this rather benign scenario.

Table 1

Austria: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

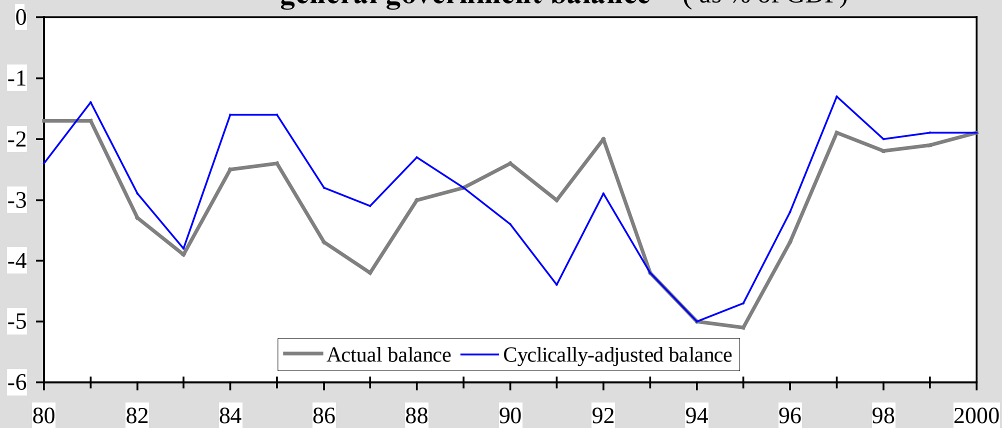
	1990-95	1996	1997	1998	1999	2000
GDP growth	2.3	2.0	2.5	3.2	2.8	3.0
Private consumption	2.5	2.0	0.7	1.8	2.3	2.4
Gross fixed investment	3.4	2.5	2.8	4.8	3.9	4.4
Domestic demand	2.6	1.7	1.8	2.1	2.6	2.9
Exports (1)	4.3	6.9	10.1	9.2	6.5	6.9
Imports (1)	5.0	6.3	8.7	7.3	6.3	6.8
Employment growth	0.6	-0.5	0.4	0.8	0.7	0.7
Unemployment rate (% of civilian labour force) (2)	3.6	4.3	4.4	4.4	4.3	4.2
Nominal compensation per head (3)	4.7	1.7	0.7	2.2	2.5	2.5
Inflation (4)	3.1	2.8	2.0	1.1	1.3	1.5
Current account balance (% of GDP)	-0.4	-1.9	-1.9	-1.9	-2.1	-2.2
Nominal short-term rate of interest (level) (5)	7.3	3.3	3.5	3.6	:	:
Real effective exchange rate (6)	1.8	-3.9	-4.8	0.1	0.4	:
Government budget deficit / surplus(% of GDP)	-3.6	-3.7	-1.9	-2.2	-2.1	-1.9
Primary balance (% of GDP)	0.6	0.6	2.1	1.7	1.8	1.9

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

The Austrian economy reached its growth peak in 1998. In line with the change in policy parameters, the driving force of the growth acceleration shifted from the external sector to domestic demand. In particular, growth of private consumption rose to 1.8% as compared to a weak 0.7% the year before. Despite a slight rebound in the household savings rate, which had fallen to an historical low of 8% in 1997, rising household income, underpinned by improving employment conditions and accelerating real wage growth, was the mainstay of the increase in consumer spending. Similarly, government consumption, in preceding years held down by budgetary consolidation, picked up by some 1½ % following a decline by almost 4% in 1997 (the latter figure being, however, artificially depressed by a statistical reclassification of activities). Growth of equipment investment peaked in 1998 at close to 7%, up from 4% in 1997, fuelled by, amongst other things, improving business confidence and the continued need for industrial restructuring. Construction investment stabilised at a growth rate of some 3%; in particular, the abolition of tax breaks on balance sheet provisions for renovation purposes introduced in 1997 continued to boost demand for small-scale construction enterprises.

Graph 1: Austria - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

During 1996/97 Austrian exports strongly benefited from the depreciation of the real effective exchange rate of the Schilling (which corrected the strong appreciation during preceding years) and a marked decline in relative unit labour costs. Although these two effects came to an end in 1998, the increasing growth momentum in Europe kept Austrian exports on a high-growth path. The continued strengthening of the economies of the neighbouring countries of Central and Eastern Europe, in particular, proved to be a boon to Austrian exports. As a result, while imports recorded fairly strong growth of 7%, in line with the acceleration of domestic demand and the firming of the Schilling, owing to export growth of more than 9% net exports contributed to output growth to the extent of almost 1 percentage point.

Over recent years, the current account showed a persistent deficit of around 2% of GDP. The most important reason for this was a sharply decreasing surplus in tourist net-revenues, resulting partially from a reduction in tourist receipts but also from rapidly increasing expenses of Austrian households for travelling and shopping abroad. The erosion of tourist net revenues bottomed out in 1998, thereby contributing to an improvement in the balance of trade in services. However, in view of a persistent large deficit in the balance of trade in goods the overall decline in the current account deficit remained limited.

Thanks mainly to wage moderation and increased competition in formerly protected sectors, such as agriculture or services, price inflation has been trending down ever since the early 1990s. As a result, in early 1998, on the eve of the decision on the start of the third stage of EMU, Austria was among the three EU Member States with the lowest level of inflation. This trend has been sustained throughout 1998, with a sharp fall in import prices further accentuating the dis-inflationary process. Real wages have been essentially flat since 1995, while productivity increases above trend made for a strong decline in real unit labour costs.

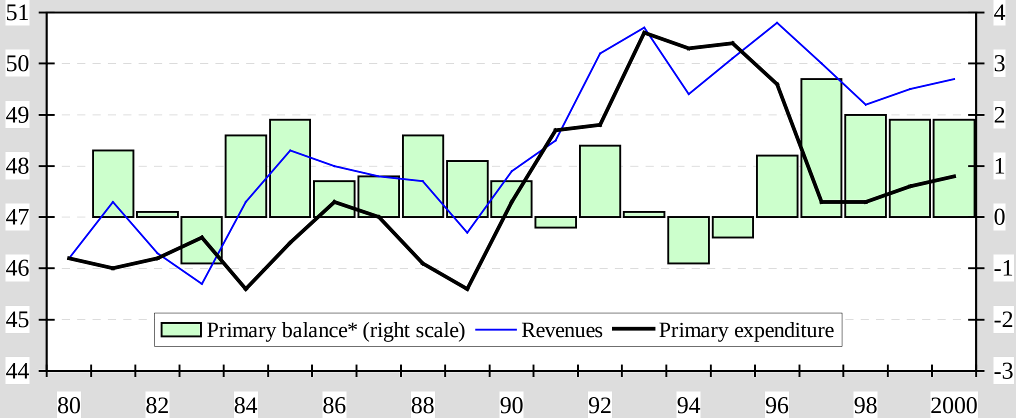
Overall employment fluctuations have been rather moderate in recent years, despite significant employment shifts on industry level. With the temporary acceleration in industrial restructuring and modernisation in the wake of EU membership drawing to an end, the strong output growth in 1998 resulted in an employment expansion of almost 1%. However, owing to the traditionally high elasticity of the labour supply in Austria, unemployment remained basically unchanged. The harmonised unemployment rate, though much lower than in most other Community countries, remained at an average of 4½ %. Moreover, the composition of the unemployed continued to deteriorate, with the already high share of unskilled and older workers rising further.

The outlook for 1999 is for a slowdown in the growth momentum which can be mainly attributed to the less favourable external environment. The lingering international economic crisis is expected to lower export market growth while an expected appreciation of the effective exchange rate will partially erode prior gains in international competitiveness. Barring a significant fall in business and consumer confidence, the growth slowdown should, however, prove limited as financial conditions should remain favourable and domestic demand should continue to bolster production. Inflationary pressures should remain moderate although, in view of an acceleration in wage growth and the closing of the output gap, prices are expected to edge up slightly. GDP growth above potential will have positive effects on employment. As in previous years, the decrease in unemployment will be dampened by a concomitant increase in labour supply.

Public finances in the medium term

As a result of the budgetary consolidation programme in 1996 and 1997, the general government deficit declined significantly from 5.1% of GDP in 1995 to below 2 % in 1997. The measures were predominantly centred on the expenditure side and comprised, *inter alia*, a reduction in government employment together with very low wage increases and a tightening of social benefits. Measures on the revenue side included rate hikes for some taxes (withholding tax, tobacco) and the abolition or suspension of tax exemptions. Owing to a rigorous execution of the consolidation package but also due to other factors such as a stronger-than-anticipated decline in interest rates, lower-than-projected deficits at the level of regional and local governments and higher-than-expected output growth, the deficit outcome in 1997 was significantly better than targeted.

Graph 2: Austria - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

The government debt ratio had reached almost 70% of GDP in 1996, following a succession of increases over a long period. The significant improvement in the primary balance in 1997 could for the first time break this long-term rise in the debt ratio. Thanks mainly to a number of additional 'asset related measures', such as privatisations and the moving off-budget of self-financing government enterprises, the debt ratio was even brought down by more than 5 p.p. to 64.3% of GDP.

For 1998, the target of the government's budgetary policy was to stabilise the deficit ratio at the achieved level of about 2 % of GDP. In fact, with some of the one-off measures included in the 1996/97 savings package ending, the deficit ratio increased even slightly in 1998. The government debt ratio remained roughly unchanged. The negative (i.e. debt-reducing) net contribution of the primary balance, interest payments and nominal GDP growth was offset by a positive (i.e. debt-increasing) contribution of the stock-flow adjustment, the latter being mainly caused by a revaluation of foreign currency denominated debt.

The federal budget proposal for 1999 was drafted together with the budget for 1998, repeating the practice of two-year budget proposals started for the budgets 1996/97. The budget plan is mainly an extrapolation of the 1998 budget, without significant discretionary changes in expenditure and revenue. A recently adopted reform in the area of family transfers will increase public spending by some 0.2% of GDP. This will be offset by an equivalent reduction in public consumption due mainly to continued tight control on government employment. On the back of output growth above potential and a decline in interest payments by 0.1% of GDP, the general government deficit ratio is expected to fall to slightly below 2.0% of GDP.

As for the year 2000, according to the no-policy-change extrapolations of the Commission services a further gentle decline in the deficit ratio is foreseen. These estimates incorporate the assumption that the reform in the area of family transfers will increase public spending by a further 0.3% of GDP from 2000 onwards, while interest payments should decline by 0.2% of GDP. A tax reform is planned to take effect in 2000. The main goal of the reform is to reduce the tax burden on labour and to redirect the tax base towards other sources. However, the details of the reform have yet to be decided. In particular, no information exists on whether the reform will be designed to be revenue-neutral or will provide a net tax relief.

Given that in the coming years the general government deficit is expected to fall only slowly and nominal GDP growth will decline, the further reduction in the debt-to-GDP ratio is likely to be moderate.

Table 2

Austria: Developments in Public Finances 1993-2002
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-4.2	-3.7	-1.9	-2.2	-2.1	-1.9		
- Current receipts	50.7	50.8	50.0	49.3	49.5	49.7		
- Total expenditure	55.0	54.5	51.9	51.5	51.7	51.5		
of which: - Interest payments	4.3	4.4	4.0	3.9	3.9	3.8		
- Investment	3.3	2.8	2.0	2.0	2.0	1.9		
Primary surplus/deficit	0.1	0.6	2.1	1.7	1.8	1.9		
Government debt	62.7	69.6	64.3	64.0	63.6	62.8		
Real GDP growth**	0.5	2.0	2.5	3.2	2.8	3.0		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-1.9	-2.2	-2.0	-1.7	-1.5	-1.4
Government debt			64.4	64.4	63.5	62.2	61.1	60.0
Real GDP growth**			2.5	3.3	2.8	2.6	2.1	2.2

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998.

Source: Commission services and Stability programme of Austria.

In the framework of the Stability and Growth Pact Austria submitted its Stability Programme at the end of 1998. The Stability Programme covers the period 1998-2002 and foresees a reduction of the government deficit ratio to 1.4% by 2002, while the debt ratio should be reduced to 60%. The deficit reduction will be achieved by a fall in the expenditure-to-GDP ratio which will be only partially offset by a decline in the revenue ratio. Primary expenditure and interest payments are expected to contribute to the decline in expenditure to roughly the same extent. The programme also contains a number of structural reforms aimed at gaining a better control on the dynamics of expenditure. According to calculations by the Commission services the medium-term target of 1.4% of GDP would be sufficient to prevent the deficit from overshooting the 3% of GDP reference value in normal cyclical downturns. However, the deficit target is to be considered as lacking ambition in view of the fact that it does not provide a safety margin to insure against unforeseen developments in economic activity and in public finances; would not permit the use of active budgetary policy such as counter-cyclical policy interventions; and does not provide for a swift decline in the debt ratio which would be warranted in view of future financial burdens arising from population ageing.

In the longer term, the consolidation of recent progress towards sounder public finances will hinge on the question whether, in the context of a predominantly pay-as-you-go financed system, social security pension expenditures can be kept under control. Recent measures have been important steps towards a reform of the system. However, their potential financial impact has been limited by long phasing-in periods and ceilings on the maximum effects on individual benefits. In the face of the ageing population the reforms will have to be taken further to ensure the longer-term viability of the system.

Structural Reforms

The need for structural reform increased sharply in the mid 1990s, when due to the membership of the European Economic Area in 1994 and of the European Union in 1995 market regulations had to be liberalised and many former protected industries were exposed to increased competition. In the meantime, noticeable progress has been achieved in modernising the regulatory framework and in improving the functioning and efficiency of markets. Nevertheless, an important agenda of unfinished business remains.

The budgetary consolidation programme 1996/97 included a number of measures aimed at containing government transfers to the public pension system, particularly by reducing incentives to early retirement. A more comprehensive pension reform package was agreed in late 1997. The principal measures of this reform comprise a further discouraging of early retirement, stricter eligibility criteria for disability pensions, and a strengthening of actuarial principles for benefits. Additionally, steps towards a harmonisation of special pension schemes, notably the scheme for civil servants, with the general scheme have been made. The reform also included measures aimed at improving the employability of older workers.

Notwithstanding a lower unemployment rate than in most other EU countries, Austrian labour market policy is confronted with structural problems such as long-term unemployment of unskilled or older workers. In the framework of the Austrian National Action Plan for Employment, the Austrian government addresses these issues by measures aimed at improving the qualification of the labour force, reducing the tax burden on labour, promoting new professions in the services sector and liberalising working time regulations. The objective of the Action Plan is to reduce the unemployment rate to 3½ % by 2002.

During recent years, important areas of structural reform have been the liberalisation of market regulations concerning shop-opening hours, trade regulations and the setting-up of business plants. Empirical evidence on the effect of the reform of shop-opening hours indicates that mainly shopping centres, large retail chains and centrally located smaller shops benefit from the more flexible opening hours. There is also evidence that as a result of this measure part-time and casual employment has risen in the retail sector. The effect on unemployment remains marginal though, as the new vacancies are mainly filled by persons previously not in the labour force (e.g. house wives, students). Another important step towards liberalisation of markets has been the reform of trade regulations by liberalising entry. With respect to the reform of regulations for the setting-up of business, emphasis has been put on simplifying and accelerating procedures and harmonising legislation on the level of the Länder. Future reform steps envisage a further simplification of regulations and a speeding-up of administrative procedures by implementing the principle of a “one-stop shop”, i.e. the setting-up of a business would require only one permission.

Entry to the telecommunication sector has been liberalised by 1 January 1998, leading to a substantial increase in competition. An independent regulatory authority, the *Telekom Control,* has been established and licences for the operation of telecommunication services have been put up for public sale. In 1998, about 30 licences for the operation of traditional telephone services have been sold and mobile telephone services are offered by 3 different companies.

At present, the Austrian authorities are discussing the reform of the electricity market, which has been exposed to a higher degree of competition as from 1999. The main problem is the implementation of EU regulations in a rather fragmented market, consisting of a central distribution system on the national level and various producers on the level of the Länder and municipalities. Additional issues are differing views on the extent of “stranded investment” which has important implications on the profitability of various electricity producers.

In order to reinforce market competition, the competition law is in the process of being reformed and an independent competition authority is planned to be established. Furthermore, the role of the state in the banking sector will be further reduced and there are plans to pursue the reform of the Viennese stock exchange, with a view to better integrating it with other European capital markets.

PORTUGAL

Strong economic growth leads to a marked decline in unemployment

In 1998, domestic demand-led growth in the Portuguese economy continued at a fast pace and remained, for the third year in a row, well above the EU average. In line with the buoyancy of the economy, employment continued to increase and the situation of the labour market became quite tight in several sectors. The unemployment rate reached its lowest level since 1992. The inflation differential vis-à-vis the other EMU participants trended upwards throughout the year.

Table 1

Portugal: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	2.2	3.2	3.7	4.2	3.4	3.6
Private consumption	3.2	2.5	2.9	3.6	3.4	3.4
Gross fixed investment	2.9	5.7	11.3	8.4	6.3	7.2
Domestic demand	3.3	2.8	4.7	4.7	4.0	3.9
Exports (1)	5.2	10.2	8.4	10.3	6.1	7.9
Imports (1)	7.4	7.5	10.4	10.4	7.1	7.7
Employment growth	-0.2	0.7	2.0	2.4	1.3	0.8
Unemployment rate (% of civilian labour force) (2)	5.5	7.3	6.8	5.7	5.1	4.7
Nominal compensation per head (3)	11.9	6.3	5.6	4.7	4.6	4.8
Inflation (4)	8.4	3.6	2.5	2.6	2.4	2.1
Current account balance (% of GDP)	-3.1	-5.1	-2.0	-2.1	-1.8	-2.0
Nominal short-term rate of interest (level) (5)	14.2	7.4	5.7	4.5	:	:
Real effective exchange rate (6)	4.8	2.0	0.4	0.8	2.2	:
Government budget deficit / surplus(% of GDP)	-5.3	-3.3	-2.5	-2.3	-2.0	-1.8
Primary balance (% of GDP)	1.7	1.5	1.8	1.2	1.1	1.1

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

In an environment of strong employment growth and low unemployment, private consumption continued to accelerate, as a result of the rise in households' real disposable income and a reduction of the savings rate, induced by sharply falling interest rates. Growth of construction investment decelerated slightly as the decrease in public works was not fully compensated by strong residential construction. Equipment investment expanded at a fast rate. The continued improvement of business confidence reflecting a more optimistic assessment of demand emerges as the main factor behind this expansion. In addition, better prospects about the rate of return due to the fall in interest rates as well as further restructuring efforts in the less healthy industrial sectors may have contributed to the strong growth of machinery investment. Export growth was very strong, in line with the acceleration of foreign markets, while import growth remained stable, leading to an improvement in the contribution of net external demand to GDP growth.

Due to the pick-up of the economy, improvements in the labour market were significant in 1998. Employment increased by 2.4% (1.7% in 1997), with particularly strong employment gains in low productivity sectors such as services. The unemployment rate decreased to close to 5½ %. Nominal wage growth implicit in collective agreements (excluding civil servants) amounted to 3.1%.

Inflation, as measured by the CPI growth rate, increased to 2.6% on average in 1998 (from 2.3% in 1997). Among the factors behind this acceleration were the increase in some food prices and strong demand for products and services related to the World Exhibition (EXPO'98). The inflation differential vis-à-vis the EU average has widened from the beginning of 1998.

In 1999, the expected deceleration of external demand should lead to a slowdown of economic activity. The end of temporary factors boosting economic activity, such as the EXPO'98 exhibition, and a deterioration in business and consumer confidence will act to dampen output growth. This will be partially offset by more expansionary monetary conditions stemming from the convergence of interest rates and low import prices. The net effect should be a deceleration of both domestic demand and output growth.

Private consumption is forecast to grow at a steady albeit decelerating rate in 1999 supported by a sustained increase in real disposable income, continued improvements on the labour market and lower interest rates. Investment is likely to decelerate slightly. While, in general, equipment investment growth should remain steady, machinery investment is expected to slow somewhat after the marked recent increase. Low increases of unit labour costs in the tradeables sector, attributable, in particular, to high productivity increases, will make for exports to increase above market growth.

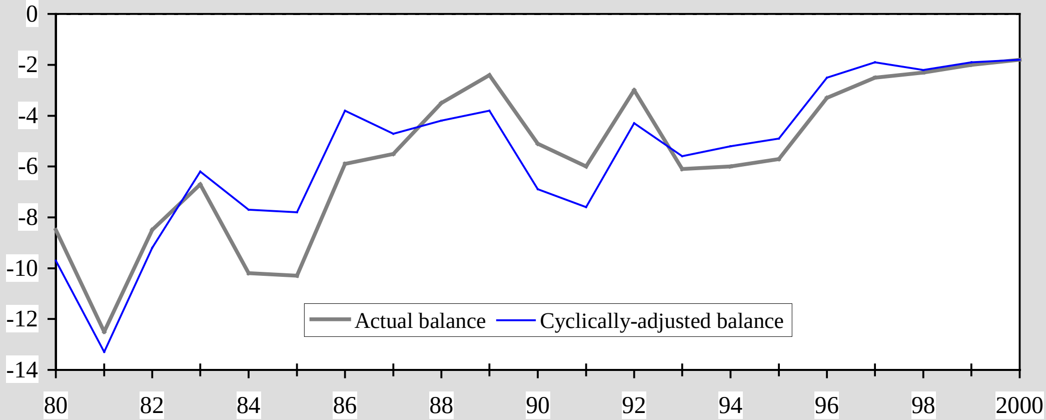
Inflation developments need to be monitored closely. A continued significant inflation differential vis-à-vis main trading partners could pose a risk to competitiveness and, eventually, lower employment growth. The regime change implied by the introduction of the euro should help reduce inflation expectation. Moreover, the fading out of some of the factors spurring inflation in 1998 coupled with decreasing import prices and continued wage moderation act to diminish inflationary pressures in 1999. The average inflation rate should nevertheless remain above 2%.

Substantial improvement in the public finances but recently largely growth-induced

After peaking in 1993, the general government deficit has since been set on a declining trend. This achievement has been mainly a result of two factors: a marked increase in tax revenues and a sharp reduction of interest expenditure.

The increase in tax revenues by 2% of GDP between 1993 and 1998 was mainly brought about by a substantial improvement in the effectiveness of tax administration, a tightening of tax expenditure and the favourable impact of the economic cycle. The fall in interest payments from 6.2% of GDP in 1995 to 3.5% in 1998 can be attributed to the decline in domestic interest rates together with the indirect impact of substantial privatisation proceeds on the stock of government debt.

Graph 1: Portugal - Actual and cyclically-adjusted general government balance * (as % of GDP)

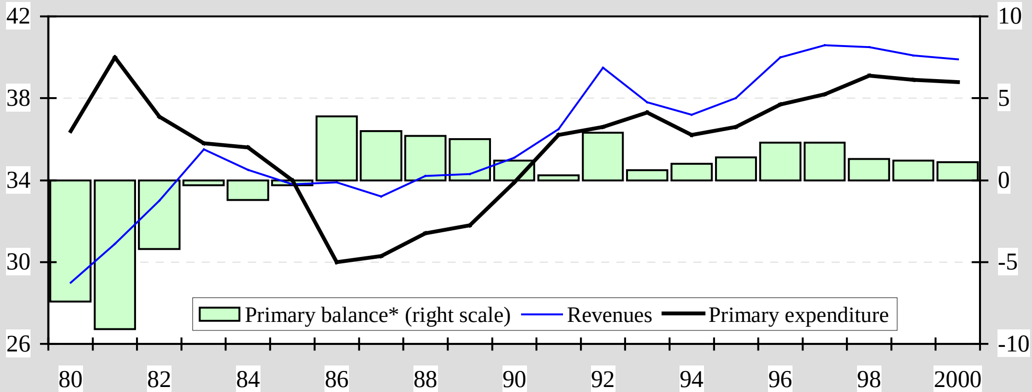


*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

The favourable impact of tax revenues and interest payments on the government balance was partially offset by a rise in primary expenditure from 37.7% of GDP in 1993 to 39.3% of GDP in 1998. Expenditure pressures in social areas and in the health sector, in particular, proved difficult to check. Moreover, in line with priorities of the government, public investment has slightly increased its share in GDP and since 1996 has exceeded government net borrowing. The overall result was an improvement in the primary surplus, from 0.1% of GDP in 1993 to 1.2% in 1998, resulting in a decline of the general government deficit from 6.1% in 1993 to 2.3% of GDP in 1998.

Graph 2: Portugal - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

After having peaked at around 66% of GDP in 1995, the general government debt ratio was reduced steadily to 57.4% in 1998. A strong and rising contribution from economic growth, increasing primary surpluses and large privatisation receipts were at the root of the debt decline.

In 1998, the general government deficit decreased to 2.3% of GDP, from 2.5% in 1997, with the budget outturn better than initially targeted (2.5% of GDP). Although current non-interest expenditures are expected to have risen above the budget target this should be offset by lower interest payments and better social security contributions. In fact, a marked reduction of interest payments due to the significant fall of interest rates contributed significantly to the deficit reduction. Public investment also should be below the initial budget.

The target for the general government deficit in 1999 is 2.0% of GDP. The budget plan follows the approach of previous budgets, i.e the deficit reduction is expected to derive from lower interest payments and an increase in taxes resulting from a more efficient tax administration. The general government debt ratio is further reduced.

In the framework of the Stability and Growth Pact Portugal submitted its Stability Programme at the end of 1998. The stability programme covers the period of 1999-2000 and foresees a reduction of the government deficit ratio to 0.8% by 2002, while the debt ratio should be reduced to 53.2%. The government expects the deficit reduction to be achieved by a decline in the expenditure-to-GDP ratio by 0.6% and a modest increase in the revenue ratio by 0.5%. Current expenditure is expected to remain broadly unchanged between 1999-2000 at 39.8% of GDP, with a decline in interest payments by 0.4% of GDP being offset by an equivalent increase in primary current expenditure. The increase in the revenue ratio is mainly attributable to the ongoing process of reform of the tax administration. The Commission and the Council will assess whether the programme is in line with the requirements of the Stability and Growth Pact.

Table 2

Portugal: Developments in Public Finances 1993-2002

(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-6.1	-3.3	-2.5	-2.3	-2.0	-1.8		
- Current receipts	37.9	40.0	40.6	40.4	40.0	39.8		
- Total expenditure	44.0	43.3	43.1	42.8	42.0	41.7		
of which: - Interest payments	6.2	4.8	4.3	3.5	3.1	2.9		
- Investment	4.0	4.1	4.2	4.1	4.2	4.4		
Primary surplus/deficit	0.1	1.5	1.8	1.2	1.1	1.1		
Government debt	63.1	64.9	61.5	57.4	55.3	53.7		
Real GDP growth**	-1.1	3.2	3.7	4.2	3.4	3.6		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:					-2.0	-1.5	-1.2	-0.8
Government debt			61.5	58.0	56.8	55.8	54.7	53.2
Real GDP growth**			3.8	4.2	3.5	3.2	3.2	3.3

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998.

Source: Commission services and Stability programme of Portugal.

Meeting the challenge of EMU participation implies a deepening of the ongoing process of structural reforms.

In certain areas the structural position of the Portuguese economy looks rather favourable. This is so particularly in the case of the labour market, characterised by a large degree of effective flexibility, which plays an important role in the comparatively low rate of unemployment.

In other areas, a number of structural reforms have been implemented. The privatisation programme has already strongly reduced or eliminated state ownership in sectors like the financial sector, basic industries, and, lately, public utilities. Increased competition, more innovation, better quality of services and more economic efficiency are some of the results achieved as a consequence of this privatisation process. The privatisation of public utilities and new regulatory frameworks and supervision bodies have also improved efficiency, contributing to lower prices and better coverage. Investment in infrastructures soared in recent years and the main obstacles to economic development in this area are being tackled.

However, there are other areas saddled by long-standing rigidities, which affect negatively the overall efficiency of the economy and enhance inflationary pressures. The rental market has been partially liberalised but rent controls remain in place for a significant proportion of both housing and non-housing premises, with huge allocation costs. The public administration must be modernised and become more efficient. Another domain is the National Heath Service were increased flexibility could not only improve the quality of the service offered but also check the rate of expenditure increase. New procedures and financing methods appear necessary in education and health while new forms of financing social security should be sought. The privatisation effort together with the creation of regulatory bodies needs to be completed. Continued efforts should also be made in order to improve the skills of the labour force.

FINLAND

Economy slowing down since mid-1998 from vigorous economic growth

Finland has been growing at a strong pace since the end of the economic recession of 1990-93. In the five years 1994 to 1998 GDP grew at an yearly average rate of 4.8% and in 1997 and 1998 it rose by 6% and by 5.1% respectively.

This strong economic growth has been led by external demand. The exports of goods and services contributed at an yearly average 3.5 percentage points to GDP growth between 1994 and 1998, which compares with 1.9 percentage point from private consumption and 1.8 percentage point from gross capital formation.

On the supply side, manufacturing has been growing at quite high rates, particularly the metal industry, whereas services have been recovering at a much slower pace and construction has not yet reached its pre-recession level.

Table 1

Finland: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

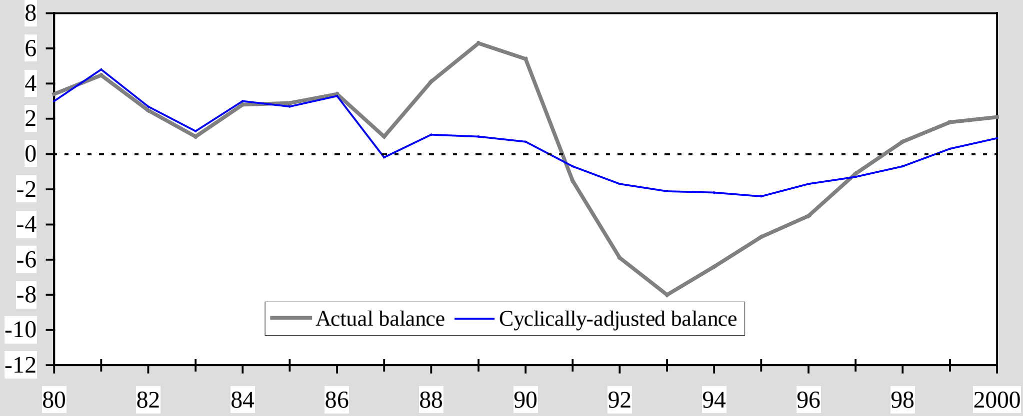
	1990-95	1996	1997	1998	1999	2000
GDP growth	-0.5	3.6	6.0	5.1	3.4	2.9
Private consumption	-0.9	3.5	3.3	4.1	3.8	2.2
Gross fixed investment	-8.9	7.8	12.2	8.5	5.9	6.5
Domestic demand	-2.6	2.3	5.5	5.1	3.8	3.3
Exports (1)	6.9	6.2	12.8	8.7	5.3	5.8
Imports (1)	1.3	4.6	10.5	9.7	7.2	7.6
Employment growth	-3.2	0.7	2.7	2.3	1.7	1.3
Unemployment rate (% of civilian labour force) (2)	12.2	15.3	13.1	11.6	10.4	9.5
Nominal compensation per head (3)	4.2	3.1	1.7	3.6	2.8	3.4
Inflation (4)	3.6	1.7	1.5	1.5	1.6	1.9
Current account balance (% of GDP)	-1.9	4.0	5.5	5.8	6.1	6.2
Nominal short-term rate of interest (level) (5)	9.9	3.6	3.2	3.6	:	:
Real effective exchange rate (6)	-3.6	-3.8	-5.7	-0.8	1.8	:
Government budget deficit / surplus(% of GDP)	-3.5	-3.5	-1.1	0.7	1.8	2.1
Primary balance (% of GDP)	-0.1	2.1	4.2	5.8	6.4	6.4

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

Another feature linked to the export-led growth has been the relatively high productivity advance: GDP per employed person has risen at an yearly average of 3.6% between 1994 and 1998. This has implied a relatively slow growth in employment, as compared to the buoyant development in economic activity (see Table 1).

Graph 1: Finland - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

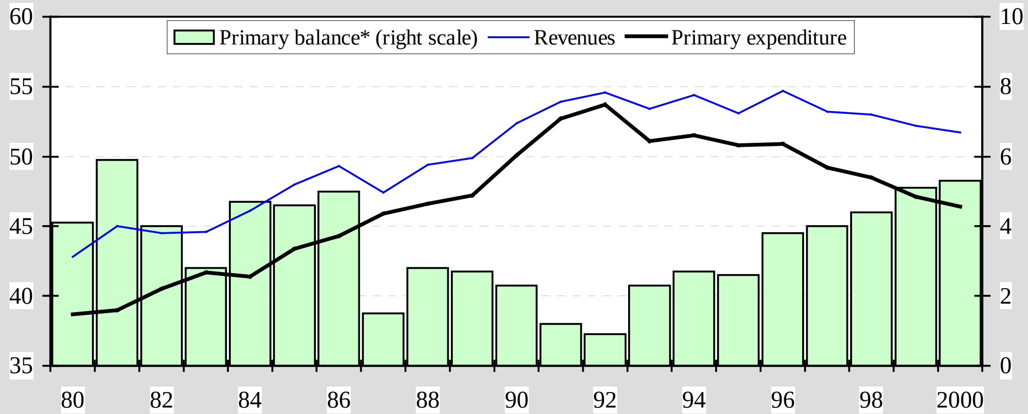
Economic growth became somewhat more balanced in 1998. Indeed, last year the contribution of domestic demand to GDP growth became clearly stronger than that of the exports of goods and services. This was mainly due to the acceleration in private consumption to 4.1% from 3.3% in 1997, whereas export growth slowed down to 8.7% from 12.8% in 1997 (see Table 1). The strength of private consumption in 1998 owes to the higher real gross disposable income and greater recourse to new credit by households, in a context of low interest rates and of sound household balance sheets. The higher disposable income in turn is mainly due to the higher wage increases in the first year of application of the new comprehensive wage agreement for 1998 and 1999, in a context of steady employment growth.

At the same time the slowdown in the world economy has had a major impact on Finnish exports. Indeed, since the summer of 1998 exports have been slowing down very markedly, as a result of the contagion of the Asian crisis and the effects of the recession in Russia. Moreover, investment has been decelerating as well, both in construction and in equipment. The lower growth in construction investment stems mainly from the phasing out of a number of state subsidies to housing production, because of cyclical and structural reasons. Lower investment in equipment follows the completion of a number of big projects in the forest industry.

After the summer of 1998, there was a marked deterioration in business sentiment, mainly in manufacturing and construction. Consumer confidence and private consumption were hit much less and might remain strong in 1999. This is because real disposable income is expected to grow at a rate close to that of 1998, employment continues to rise and interest rates are expected to remain at historically low levels. The growth in disposable income in turn is explained by wage and employment increases and low consumption prices, supported by the fall in import prices.

Employment has been increasing steadily since 1995, thus accommodating an increase in the labour force and a fall in unemployment. The unemployment rate fell from 17.4% in 1994 to 11.6% in 1998. Given the export-led characteristics of the Finnish economic recovery, the employment content of the economic recovery has been low,

Graph 2: Finland - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

especially in its initial stage. In 1998, with private consumption and services playing an increasing role in growth, productivity decelerated to 2.8% and employment rose by 2.3%. The same trend of a further deceleration in GDP and productivity growth is expected to take place in 1999.

Inflation in Finland has remained below 2% in every year since 1994, despite strong economic growth, and is expected to continue flat in the foreseeable future. The move towards a low inflation regime stemmed in the early 1990s from depressed demand and was afterwards reinforced by the effects of low food prices following the accession of Finland to the EU. Since then, however, low inflation has prevailed in Finland owing to more permanent factors, namely financial stability and wage moderation, in a context of continued slack in the labour market. The comprehensive wage round for 1998 and 1999 again provides for wage moderation until early 2000. Low import prices in 1998 and in 1999, as well monetary stability provided by the European Central Bank, will contribute to low price increases ahead in Finland.

Low inflation and steady budgetary consolidation allowed for a progressive reduction in interest rates. The differential with German rates has remained steadily below a half of a percentage point since mid 1996 for short-term interest rates and since early 1997 for the long-term rates. Low interest rates have boosted confidence and economic growth.

All in all, in a context of relatively sound fundamentals, the main uncertainties surrounding Finnish economic developments have to do with the international economy. Unless this deteriorates more than foreseen at the end of 1998, Finland will certainly still post a GDP growth of more than 3% in 1999. This should be accompanied by a further reduction in unemployment, as the impact of lower economic growth on job creation is partly offset by a GDP composition more prone to job creation. Moreover, inflation is expected to remain low, in the context of EMU and in the face of wage moderation and low import prices. Despite the slowdown in exports, the high surplus in the balance on current account could still widen, as imports are also decelerating and Finland is experiencing an improvement in the terms of trade.

General government accounts in surplus

With the 1990-93 recession the Finnish government accounts turned from a traditional surplus into a huge deficit, which amounted to 8.0% of GDP in 1993. Since then, the deficit has been shrinking fast and in 1998 the general government accounts shifted again into surplus (see Table 2).

Table 2

Finland: Developments in Public Finances 1993-2002
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000		
Government surplus /deficit	-8.0	-3.5	-1.1	0.7	1.8	2.1		
- Current receipts	53.8	54.8	53.2	52.9	52.1	51.6		
- Total expenditure	61.9	58.2	54.4	52.2	50.3	49.6		
of which: - Interest payments	4.6	5.6	5.3	5.0	4.6	4.3		
- Investment	2.8	2.8	2.8	2.7	2.5	2.5		
Primary surplus/deficit	-3.4	2.1	4.2	5.8	6.4	6.4		
Government debt	58.0	57.8	55.1	52.9	50.2	48.3		
Real GDP growth**	-1.2	3.6	6.0	5.1	3.4	2.9		
Stability programme***			1997	1998	1999	2000	2001	2002
Government surplus/deficit:			-1.1	1.1	2.4	2.2	2.1	2.3
Government debt			55.1	51.9	48.5	46.4	44.8	43.2
Real GDP growth**			6.0	5.5	4.0	2.7	2.6	2.6

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in September 1998.

Source: Commission services and Stability programme of Finland.

The improvement in the government balance since 1994 stems both from the strong economic growth and from a number of budgetary consolidation measures which have led to a steady increase in the cyclically adjusted primary balance since 1996. In 1997 and 1998 a fall in interest payments in percentage of GDP also helped to improve the government accounts.

The process of budgetary consolidation has been based on expenditure cuts rather than on an increase in tax revenue (see Graph 3). Indeed, the fall in expenditure has provided room for the tax burden to be reduced since 1996, without putting deficit reduction at risk.

The improvement in the general government financial position since 1995 is associated with a reduction in the central government deficit, while the financial position of other sub-sectors of general government has remained nearly unchanged. Nevertheless, the local governments have also carried a part of the adjustment burden, as approximately one third of the expenditure cuts in the central government accounts have consisted of reduced income transfers to the local governments. Faced with declining revenues, the local governments were forced to reduce their expenditures accordingly.

The central government accounts for the main bulk of general government gross debt: consolidated gross debt of all other sub-sectors of general government only accounts for 3% of GDP. In 1997 the central government debt ratio fell for the first time after six years of rapid increase.

Part of the central government debt is owned by the social security system (labour pension funds). Such debt constitutes an intra-government liability, and is not included in the definition of general government debt. The general government debt peaked in 1994 at 59.6% of GDP and has since declined. At the end of 1998, general government debt amounted to 53% of GDP.

Finland presented its Stability Programme in September 1998, which was examined by the EU Council in October 1998.As had become customary with Finland's Convergence programme and its updates, the Stability Programme was also drafted in connection with the budget proposal for the following year. With regard to 1999, the Programme is based on the same macroeconomic and public finances projections as the budget proposal. In contrast, for the period after 1999 no policy measures are proposed. The projections for the government finances in 2000-2002 presented in the programme are based on an assumption of unchanged policies (general elections will take place in Finland in March 1999).

The Ecofin Council, in its opinion of October 1998 on the Finnish Stability Programme considered thatthe underlying budgetary position corresponding to the surplus target of 2.3% of GDP in 2002 is sufficient to provide a safety margin against breaching the 3% of GDP deficit threshold as a result of normal cyclical fluctuations. In this sense the programme was assessed to meet the requirements of the Stability and Growth Pact. However, in view of the future effects of population ageing on the current surplus of the social security sector, the Council recommended a continued effort in order to improve further the government balance.

As to the general government debt, the Stability Programme projects a continued decline in the debt ratio over the forecast period to 43% in 2002. The debt reduction mainly results from primary surpluses on the government accounts.

Structural reforms most needed in the tax and benefit system

Finland has gone a long way in the liberalisation of the markets for goods, as is shown by its strength in the telecommunications sector. However, there is still a major problem with the labour market, what is reflected in its still high unemployment rate. Labour market rigidities show up in the high duality of the economy, with an underdevelopment in the area of personal services.

A key issue that hinders job creation in Finland concerns the tax and social security system. Despite some reforms in the last few years, direct taxes are still high and social security benefits remain generous in amount, duration and coverage. The combination of the two leads to high labour costs and replacement ratios which discourage job search and render unprofitable a number of service activities with a high job potential, especially of less skilled jobs. However, tackling social benefits cannot be limited only to unemployment benefits, otherwise the high substitutability between different social schemes could lead to a generalised shift between schemes without any major impact on labour and output supply.

The problems are greatest in the services sector, especially personal services. The sector suffered from the recession and its level of employment is still much lower than it was at the turn of the decade. While there are some historical and geographical reasons behind the underdevelopment of personal services in Finland, the tax and social security systems also play an important role. Besides the potential disincentives which high replacement ratios may create for people who potentially could run a small business, the high cost of labour contributes to the high prices of these services, which limits demand for them. Moreover, the low development of personal services appears to be a major reason behind low part-time work in Finland, particularly among women.

Another parallel obstacle to job creation concerns some aspects of the design of active labour market measures, particularly the access to the more generous earnings-related unemployment allowance, which also tends to raise the replacement ratios and so to discourage re-entry into the labour market

SWEDEN

Recent developments and prospects

After a relatively weak performance in 1996 and 1997 the Swedish economy began to pick up in 1998. Despite the weaker international background growth accelerated in the first half 1998 to 3% compared to the corresponding period in the previous year. Growth was led by the main components of domestic demand with both consumption and investment strengthening considerably. The external sector, however, deteriorated and made a negative contribution to growth. For the year as a whole growth is expected to reach 3% compared to 1.8% in 1997.

Table 1

Sweden: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	0.6	1.3	1.8	3.0	2.8	3.0
Private consumption	-0.2	1.3	2.0	2.9	2.5	2.2
Gross fixed investment	-4.0	3.7	-4.8	9.4	7.5	6.8
Domestic demand	-0.6	0.1	0.4	3.8	3.0	2.8
Exports (1)	5.9	6.1	12.8	6.6	5.9	6.8
Imports (1)	2.8	3.7	11.7	9.5	6.9	7.0
Employment growth	-1.7	-0.5	-1.1	1.1	1.2	1.2
Unemployment rate (% of civilian labour force) (2)	6.3	9.6	9.9	8.3	7.7	7.0
Nominal compensation per head (3)	5.6	6.5	4.0	3.5	3.8	4.1
Inflation (4)	5.6	1.2	2.2	1.3	1.8	2.2
Current account balance (% of GDP)	-1.6	1.5	2.1	1.5	1.3	1.6
Nominal short-term rate of interest (level) (5)	10.7	5.9	4.5	4.4	:	:
Real effective exchange rate (6)	-3.2	13.5	-4.1	-1.2	-3.5	:
Government budget deficit / surplus(% of GDP)	-5.7	-3.5	-0.8	0.9	1.4	2.3
Primary balance (% of GDP)	0.1	3.7	5.5	7.3	7.1	7.5

Notes:
(1) - (6) see Table 1 for Belgium.

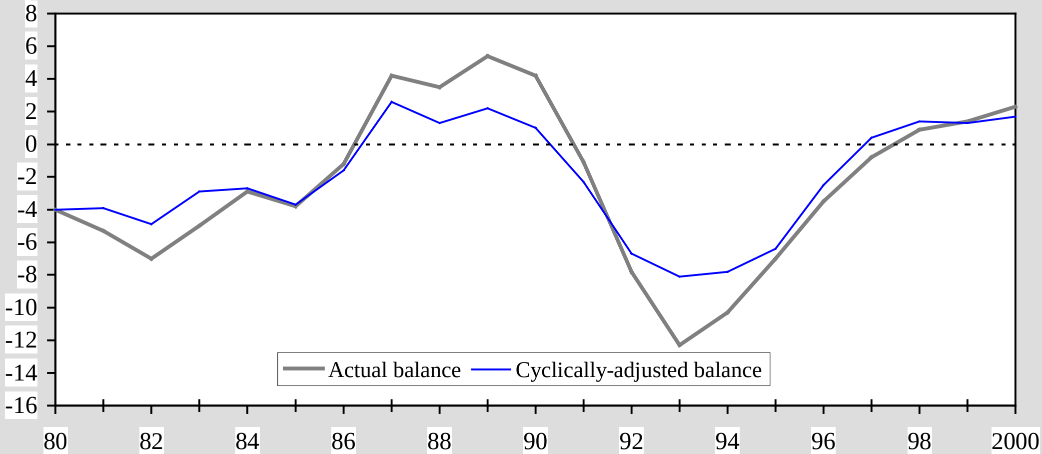
Source: Autumn 1998 Economic forecasts - Commission services.

Growth in the domestic components has been stimulated by increasing confidence in the economic outlook. By 1998 the programme of budgetary consolidation had successfully rectified the very large imbalances which had emerged in the downswing of the early 1990's and the outlook for the public finances had been significantly improved. Inflation was low and from the end of 1997 employment growth picked up and unemployment, partly due to government measures, began to decline. This more favourable domestic background stimulated both consumer and investor confidence.

Private consumption growth has been driven both by economic fundamentals and by pent up demand for durables which had accumulated over the previous years of more subdued domestic demand. In addition the easing of budgetary consolidation measures allowed real personal disposable income to grow for the first time in some years, which together with emerging strong employment growth formed a favourable background for private consumption growth. Thus in the first half 1998 private consumption grew by 2.5% and is expected to expand by 2.9% for the year.

The more positive developments in private consumption were matched by a reversal in the previous negative trend for public consumption. Under the fiscal consolidation programme public consumption, and in particular public employment, had been cut back significantly. However as budgetary adjustment eased, the public sector employment trend was reversed and in the first half 1998 a significant rise in public sector employment took place; public consumption grew by 2% in the first half and is expected to grow by 1.8% for the year as a whole.

Graph 1: Sweden - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

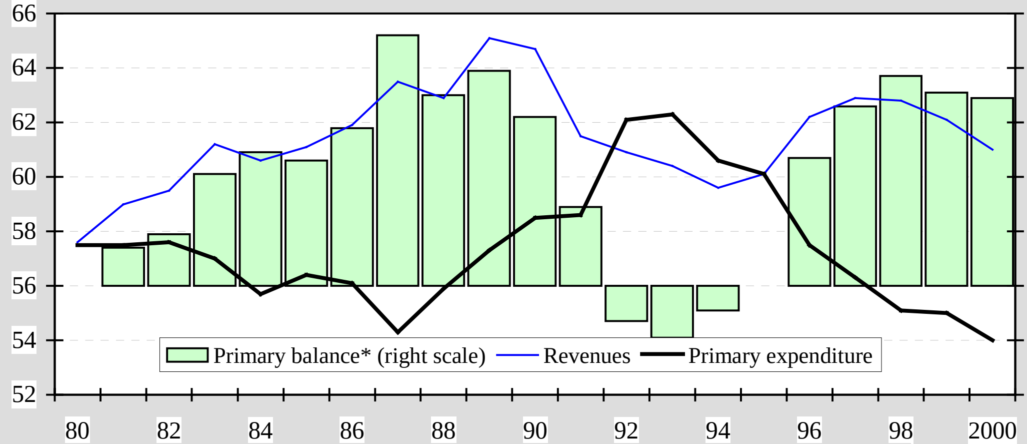
Source: Autumn 1998 Economic Forecasts - Commission services.

The strengthening of the economy has been accompanied by a surge in investment which grew by 9.6% in the first half of 1998. To some extent this may be explained by high capacity utilisation in manufacturing associated with strong export growth. However as export growth decelerates this should prove less of a stimulus to investment. Nevertheless the broadening of growth from being export led to stronger domestic demand growth also boosted investment. Thus investment in construction picked up in the first half 1998 (+4.7%) while residential investment turned positive for the first time since 1996. Overall total investment is expected to rise by 9.4% in 1998.

Export growth has been the main driving force of the Swedish economy in the current upswing, following the large devaluation in the autumn of 1992. Although export growth has fluctuated, it averaged 11.5% in the four years to 1997. The prospects for 1998 are less dynamic. The impact of the Asian crises was already seen by the 2nd quarter of 1998 when export growth fell to 2.6% compared to the same quarter in the previous year. Nevertheless for the year as a whole export growth is expected to reach 6.6% or about half the growth rate of 1997 (12.8%). Despite the unfavourable international background exports will be sustained by the fact the over 70% of Swedish exports go to Europe where market growth is expected to remain relatively sustained. The contribution of net trade to growth, however, will be negative as the strong domestic demand growth will maintain imports at a high level.

Despite stronger growth and capacity utilisation at a high level inflation has remained subdued in Sweden : indeed CPI inflation has fallen through 1998 to reach negative growth rates by the Autumn. To some extent CPI inflation is driven down by the impact of falling mortgage interest costs on the index and by developments in taxes but even so underlying inflation remains weak. The downward drift in inflation is due substantially to weak commodity and other import prices but is also aided by subdued domestic inflationary pressures including wage developments which, following recent wage agreements, are expected to remain relatively modest in the range 3½ - 4%. The weak inflationary outlook has enabled the Riksbank to ease interest rates thus creating a more favourable monetary background for domestic growth.

Graph 2: Sweden - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).
Source: Autumn 1998 Economic Forecasts - Commission services.

Despite the deterioration in the international envoirnment the prospects are for sustained growth in Sweden over the coming two years. Export growth will weaken in 1999 before recovering somewhat in 2000, but the main impetus to growth will come from domestic demand as consumption and investment continue to expand.

Private consumption will continue to grow as real incomes and employment increase although some continued modest decline in the saving ratio is foreseen. However consumption growth will slow somewhat as a modest rise in inflation, associated with the relatively strong growth, will cause real income growth to slow. Furthermore, the current upswing in consumption is partly due to replacement of consumer durables and this influence is likely to diminish over 1999 and 2000. Investment will also decelerate somewhat from the very high growth rate in 1998 as export growth slows. However construction investment is expected to grow in 1999 and remain sustained in 2000 in response to the strong growth in the domestic economy.

Overall, after a modest dip in 1999, GDP growth is forecast to recover to about 3% in the year 2000, well above the trend growth rate. This is expected to have some upward impact on inflation with modestly rising wages and prices. Nevertheless, inflation will remain relatively low and should not exceed 2.5% in terms of the private consumption deflator.

Public finances

Sweden’s public finances in recent years have been dominated by the efforts to rectify the very large imbalances that emerged in the recession of the early 1990s. By 1993 the deficit had peaked at over 12% of GDP. The consolidation programme, embodied in Sweden’s convergence programme of June 1995, set out to rectify the imbalances; its main objectives were to stabilise the debt ratio by 1996, to have a deficit less than 3% of GDP in 1997 and thus satisfy the budget criteria for EMU and to achieve a balanced budget by 1998. These objectives have been more than achieved; by 1996 the debt ratio was in decline; by 1997 the budget deficit was 0.8% of GDP and a surplus of nearly 1% of GDP is expected for 1998.

Table 2

Sweden: Developments in Public Finances 1993-2001
(as percentage of GDP)

Outturn and forecasts *	1993	1996	1997	1998	1999	2000	
Government surplus /deficit	-12.3	-3.5	-0.8	0.9	1.4	2.3	
- Current receipts	60.3	62.1	62.8	62.7	62.1	61.0	
- Total expenditure	72.6	65.6	63.6	61.8	60.7	58.7	
of which: - Interest payments	6.2	7.2	6.3	6.4	5.7	5.2	
- Investment	1.1	2.2	2.4	1.6	2.4	2.4	
Primary surplus/deficit	-6.1	3.7	5.5	7.3	7.1	7.5	
Government debt	76.0	77.2	76.9	74.0	69.5	63.8	
Real GDP growth**	-2.2	1.3	1.8	3.0	2.8	3.0	
Convergence programme***			1997	1998	1999	2000	2001
Government surplus/deficit:			-0.8	1.5	0.3	1.6	2.5
Government debt			76.6	74.2	71.4	66.7	58.0
Real GDP growth**			1.8	2.8	2.2	2.6	2.5

* Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
** Annual % change.
*** Submitted in December 1998.

Source: Commission services and convergence programme of Sweden.

This substantial improvement was achieved through both revenue and expenditure adjustment. Revenues grew from 60.3% of GDP in 1993 to 62.7% in 1998 while the expenditure ratio fell from 72.6% to 61.8%. The fall in expenditures was partly due to the ending of support for the banking system but was also due to a wide range of measures outlined in the consolidation programme. Similarly revenue growth was due both to tax adjustments and also to some unexpected buoyancy of taxation in particular corporation tax and revenues from capital gains.

As the budgetary position improved in 1997 the authorities set a new target for the public finances viz that a surplus equal to 2% of GDP would be achieved over the business cycle. In part this was a recognition of the high cyclical sensitivity of Swedish public finances owing to the large relative size of the public sector.

Nevertheless, despite the high cyclical sensitivity the deterioration of public finances in the early 1990s and the improvement in recent years have been mainly structural. The structural deficit peaked in 1993 at 8.1% of GDP and the structural balance was in surplus by 0.4% of GDP in 1997. However, the stronger growth expected over coming years adds a growing cyclical component to the expected surpluses and the adjustment effort eases with only modest structural adjustment in 1998-2000.

The debt ratio has been in decline since 1994. The decline is expected to accelerate in coming years as the primary surplus grows on the one hand and because of the impact of low interest rates on the other. Thus the interest costs of the debt peaked in 1996, and the primary balance moved into surplus in 1995. This surplus is expected to continue to grow to 1998 but as the adjustment effort eases will tend to stabilise over 1999-2000. On a cyclically adjusted basis the primary surplus peaks in 1998 before declining modestly in 1999 and 2000. The debt ratio however, should continue to decline year by year.

In December 1998 the Swedish government presented its new convergence programme for the period 1998 – 2001. On the basis of the macro economic scenario presented in the programme, the government balance is expected to remain in surplus throughout the programme period, rising from 1999 to attain 2.5% of GDP by 2001. The debt ratio will decline strongly and will fall below 60% of GDP by 2001. In its assessment of the Swedish convergence programme the Commission will evaluate whether the programme is in line with the requirements of the Stability and Growth Pact.

Structural Reforms

Over recent years there have been a number of significant structural reforms in the Swedish economy. In the late 1980’s financial markets were liberalised and in the early 1990’s there was a major tax reforms. In addition competition policy was reformed and on joining the Union Sweden undertook to meet the obligations of the single market. More recently a reform of the pension system has been agreed. However, in the recent past the main concentration of economic policy was to rectify the large scale imbalances that had emerged in the economy in the early 1990’s; namely the fiscal deficits and high unemployment. As indicated the fiscal deficits have been tackled and low inflation has achieved but high unemployment still remains. The main focus on policy with respect to unemployment is on education and training to increase employability. It remains to be seen whether, in combination with the upswing in the economy, this achieves a significant increase in employment and a lowering of unemployment (other than through government measures) or whether more significant reforms in the labour market might not be required to produce permanently lower unemployment.

UNITED KINGDOM

GDP growth is expected to slow sharply in 1999 but no recession

GDP grew by 3½% in 1997 and the economy is estimated to have been operating at around productive potential in that year. However, strong growth in domestic demand, particularly consumers' expenditure, together with the fear that such growth would fuel inflationary pressures, prompted rises in short-term interest rates. These were raised by 1¼% percentage points, to 7½%, between May 1997 and June of 1998. Sterling, on average in 1997, was much higher than its level typically seen in the period following its exit from the ERM (that is September 1992 to end 1996). This contributed further to a tight monetary stance. In addition, fiscal policy was tightened strongly in the July 1997 budget, to secure the government's budgetary objectives.

Economic growth continued to be strong up to and including the first quarter of 1998 when it grew by 3% at an annual rate. Strong growth in domestic demand more than accounted for this growth.

Table 1

United Kingdom: Macroeconomic and Financial Developments

(annual percentage change unless otherwise indicated)

	1990-95	1996	1997	1998	1999	2000
GDP growth	1.4	2.6	3.5	2.5	1.3	2.1
Private consumption	1.1	3.6	4.2	3.0	2.1	2.0
Gross fixed investment	-0.8	4.9	6.1	6.4	2.6	3.8
Domestic demand	0.8	3.0	3.9	3.6	1.8	2.4
Exports (1)	5.2	7.5	8.4	3.9	3.7	5.5
Imports (1)	2.6	9.1	9.5	7.3	5.0	6.3
Employment growth	-0.4	1.2	1.8	1.5	0.5	0.4
Unemployment rate (% of civilian labour force) (2)	9.1	8.2	7.0	6.3	6.2	6.2
Nominal compensation per head (3)	5.6	3.5	4.6	4.8	5.0	4.8
Inflation (4)	4.8	3.1	2.6	2.0	2.2	2.0
Current account balance (% of GDP)	-1.5	-0.1	1.0	0.2	-0.1	-0.4
Nominal short-term rate of interest (level) (5)	9.0	6.0	6.8	7.4	:	:
Real effective exchange rate (6)	-1.9	2.7	18.2	7.2	0.2	:
Government budget deficit / surplus(% of GDP)	-5.0	-4.7	-2.1	-0.1	0.1	-0.2
Primary balance (% of GDP)	-1.6	-1.0	1.5	3.3	3.4	2.9

Notes:
(1) - (6) see Table 1 for Belgium.

Source: Autumn 1998 Economic forecasts - Commission services.

However, growth has declined subsequently and in the third quarter of 1998, GDP growth fell to 1½% at an annual rate as consumers' expenditure growth slowed and net exports fell. Fixed investment growth, however, was strong.

The slowdown in GDP growth in 1998 was expected. It was also intended, since the growth rates of 1997 were unsustainable for an economy close to productive potential. The slowdown followed the tightening of fiscal policy and the monetary stance described above but other factors were also responsible. The fall in consumption growth was partly attributable to a reduction of the effect of 1997's large windfall payments to the personal sector from mutual financial institutions that were converting to bank status. Also, weak net exports resulted partly from the effects of weak economic performance in SE Asia on the UK. The UK has a larger proportion of its trade with these economies than the rest of the EU on average.

More recent data have shown falls in manufacturing output, reductions in growth of retail sales, flat underlying exports and survey responses which reveal pessimism in both manufacturing and service sectors. These indicators suggest that GDP growth in the final quarter of 1998 slowed further. For 1998 as a whole, GDP growth is expected to have been 2½%.

As might be expected from an economy that has been subjected to significant monetary and fiscal tightening and is slowing down rapidly, inflationary pressures are subdued helped by weak commodity prices. The government's 2½% inflation target for retail price inflation (less mortgage interest payments) has been met from August 1998 onwards. Other inflation indicators show even smaller rises and, in particular, inflation based on the HICP has been below 2% since May of 1998.

This background of subdued inflationary pressures, rapidly slowing economic growth and concerns about the economic effects of the turmoil in world financial markets prompted the Bank of England's Monetary Policy Committee to reduce the short term interest rate to 6% in January 1999 from its June 1998 peak of 7½%.

The slow down in growth is expected to continue into 1999. However, the easing of monetary policy and a fall in sterling from its recent peak should ensure a 'soft landing' - a recession is unlikely. Certainly net exports are forecast to fall further as a result of a slowdown in UK markets. Growth in household expenditure is expected to slow down to 2%. Equipment investment will be flat. However, rises in construction investment and government consumption – resulting from recent government expenditure plans – will partly offset these. GDP growth of 1.3% in 1999 is projected.

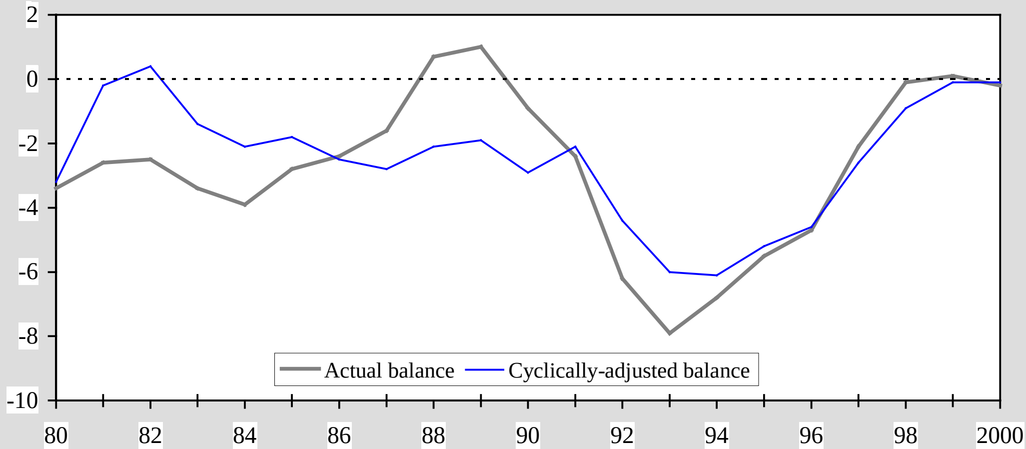
The government's inflation objective of 2½% should continue to be achieved although the introduction of a minimum wage in 1999 could, temporarily, introduce a small upward blip in inflation.

Interest rates are expected to fall further in 1999 and into 2000 as output falls below potential and inflation remains low. This will stimulate domestic demand growth. Also, export growth should recover as the depressing effects of the world crisis, particularly in Asia, and sterling's strength fade. GDP growth is expected to accelerate to 2.1% in 2000.

Public finances expected to remain close to balance

Since 1993, the public finances have improved dramatically as Graph 1 shows.

Graph 1: United Kingdom - Actual and cyclically-adjusted general government balance * (as % of GDP)



*Net lending (+), net borrowing (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

The general government deficit peaked at 7.9% of GDP in 1993. Substantial fiscal tightening in the 1993 and 1994 budgets accompanied by ongoing tight public expenditure control and a sustained economic recovery, resulted in a significant reduction in the deficit to 2.1% of GDP in 1997.

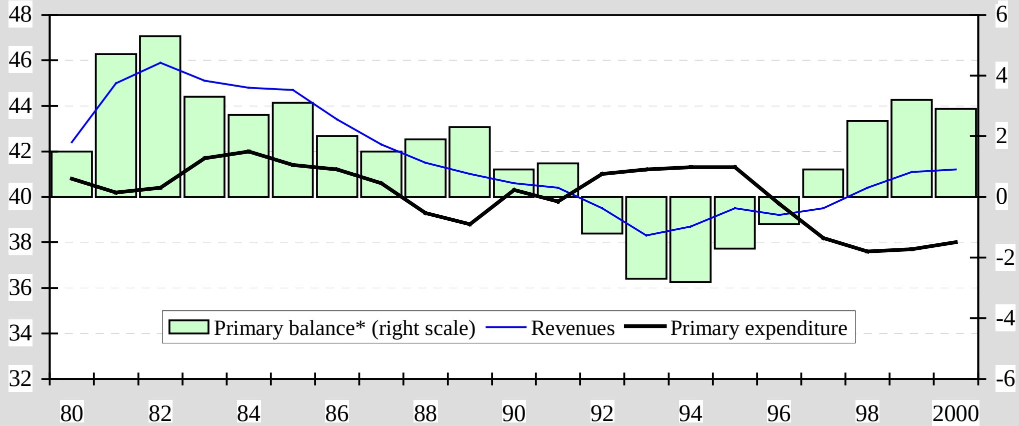
However, consolidation was less than might have been expected from the particularly tight budgets and expenditure plans. This was, in part, due to some disappointments on revenue returns such as VAT. In addition, in 1997, the economy was close to productive potential but the public finances were still a long way from balance in cyclically adjusted terms.

It was this background that prompted the newly elected Labour government, in its first budget of July 1997, and subsequently, to take measures to put the public finances on a stable and sustainable basis in both the short and long term

The government announced two rules for the public finances:

- the so called golden rule that the government borrows only to invest and not fund current expenditure. That is, the government current account must be in balance or surplus over the economic cycle.
- the sustainable investment rule: net public debt as a proportion of GDP must be held over the economic cycle at a stable and prudent level.

Graph 2: United Kingdom - Key budgetary variables
(general government cyclically-adjusted data, as % of trend GDP)



*Surplus (+) , deficit (-).

Source: Autumn 1998 Economic Forecasts - Commission services.

To make the rules operational, the new government announced, in the July 1997 budget, measures that in aggregate, tightened policy by around ¾% of GDP in a full year and pledged to continue the expenditure restraint exercised by the previous government to financial year 1998-99.

As a result of these measures, together with continued economic recovery and revenues that have been especially buoyant, the public finances have improved further The outturn for the general government finances in 1997-98 was a deficit of 0.6% of GDP. The finances continued to improve further into 1998.

In 1998 the government announced a broadly neutral budget and introduced two new major initiatives on the public finances. The first was the introduction of a legally binding mechanism – a Code for Fiscal Stability. This is designed to enhance accountability and transparency in the pursuit of public finance objectives. One practical aspect is that it involves the government publishing a wealth of material that is intended to facilitate the monitoring the public finances. It also requires the independent assessment of changes in major assumptions behind the public finance projections by the National Audit Office. The second was a comprehensive spending review that determined expenditure allocations, involving the major part of public expenditure, over the three years 1999-00 to 2001-02. The review implies real government expenditure growth of 2¾% a year on average - above previous, illustrative, projections and above trend GDP growth. The plans are intended to redress what were perceived to be years of neglect of the public services. In particular, within this, investment is planned to rise as a share of GDP while current spending's share remains constant.

Table 2

United Kingdom: Developments in Public Finances 1993-2003

(as percentage of GDP)

Outturn and forecasts [1]	1993	1996	1997	1998	1999	2000			
Government surplus /deficit	-7.9	-4.7	-2.1	-0.1	0.1	-0.2			
- Current receipts	38.6	40.0	40.4	41.4	42.2	42.1			
- Total expenditure	46.8	44.3	42.2	41.3	41.8	42.0			
of which: - Interest payments	3.2	3.7	3.5	3.4	3.3	3.1			
- Investment	2.1	1.5	1.3	1.2	1.3	1.4			
Primary surplus/deficit	-4.8	-1.0	1.5	3.3	3.4	2.9			
Government debt	48.6	54.7	53.5	51.5	49.9	48.5			
Real GDP growth [2]	2.3	2.6	3.5	2.5	1.3	2.1			
Convergence programme [3]			1997	1998	1999	2000	2001	2002	2003
Government surplus/deficit [4]			-0.6	0.8	-0.3	-0.3	-0.1	0.2	0.1
Government debt [4]			50.4	47.9	46.7	45.4	43.7	42.0	40.4
Real GDP growth [2) 4)]				2¼	1.0	2½	2¾	2½	2¼

1) Autumn 1998 Economic forecasts for the years 1998 , 1999 and 2000.
2) Annual % change.
3) Submitted in December 1998.
4) On a financial year basis 1997/98 to 2003/2004.

Source: Commission services and convergence programme of United Kingdom.

These announced policy measures and the macro-economic prospects will determine the outlook for the public finances over the next three years. The public finances are forecast to be close to balance in 1998 with a deficit of just 0.1% of GDP. They are expected to remain close to balance in 1999 and 2000. GDP growth, below trend in 1999, will put upward pressure on the deficit as will expenditure growth above that of GDP growth from 1999-00 onward. However, these are expected to be offset by revenue from the ongoing over-revalorisation of road fuel and tobacco duties and a reduction in interest payments as debt falls relative to GDP.

Gross debt, as a percentage of GDP, is expected to fall below 50% by the end of 1999.

The 1998 United Kingdom convergence programme projects the government finances as being close to balance over the period 2003-04 to fulfil the medium-term objective of the Stability and Growth Pact.

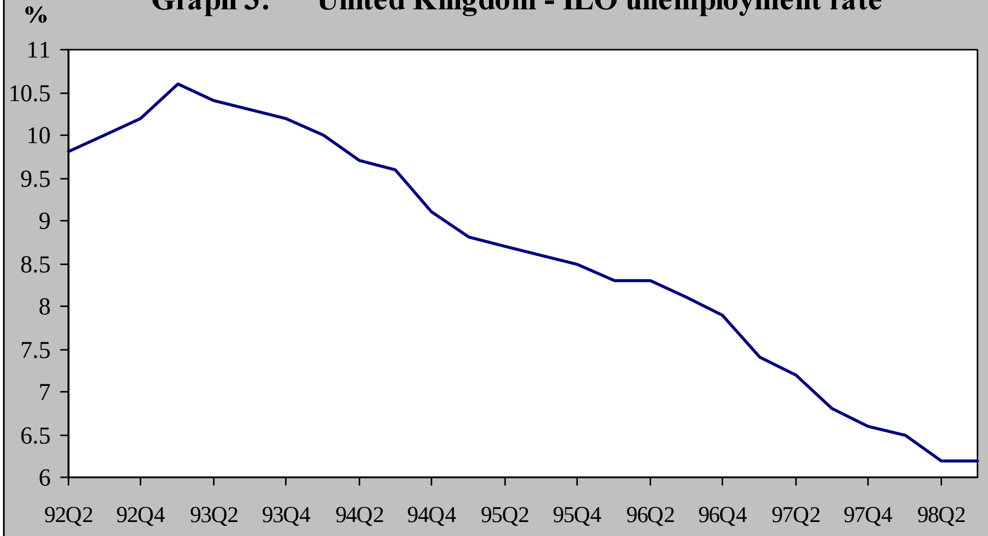
There are of course risks to the public finance projections. In particular, growth in 1999 and 2000 could be weaker than expected. This would put upward pressure on the deficit. Since the government’s objectives are in terms of the ‘economic cycle’, it would be expected to let the automatic stabilisers work in these circumstances.

In its assessment of the United Kingdom convergence programme the Commission will evaluate whether the programme is in line with the requirements of the Stability and Growth Pact.

Recent reforms are intended to secure macro-economic stability and increase employment opportunities

The UK economic recovery, which started in 1992, has now lasted 6½ years. It has been characterised by steady growth and an absence of major inflationary pressures. It has been accompanied by budgetary measures that have brought the public finances close to structural balance and a robust labour market where unemployment has fallen, Graph 3, and employment has risen.

Graph 3: United Kingdom - ILO unemployment rate



Source: Office for National Statistics.

The recovery has therefore been somewhat different from others that have ended with marked inflationary pressures and a sharp, policy induced, contraction.

Much of the benign aspects of the recovery can be associated with earlier reforms, both micro and macro, such as labour and product market reforms of the 1980s, budgetary consolidation since 1993 and the setting of monetary policy to achieve inflation targets since 1992.

Nevertheless, the current administration have introduced, recently, additional macro and micro-economic reforms to address remaining structural weaknesses.

Recent macro-economic reforms have been designed to help reduce macro-economic instability which, since the 1970s, has been associated with the UK's relatively slow growth. They include giving the Bank of England's Monetary Policy Committee responsibility to set interest rates to achieve the government's inflation target and reforms, such as the introduction, described earlier, of the Code for Fiscal Stability and the Comprehensive Spending Review that are intended to put the public finances on a sustainable and stable footing. Such reforms have been accompanied by the achievement of low inflation, and a lowering of inflation expectations, broadly balanced public finances and a reduced gap between UK and German long term interest rates from 1.2 percentage points in May 1997 to 40 basis points currently.

Micro-economic reforms have addressed several shortcomings and two important intentions are to increase employment opportunities and to improve the rate of economic growth, by raising productivity.

The UK has increased its employment rate over the last decade from 69.6% in 1987 to 73.6% in 1998 Q-3. This rate is higher than that of the EU on average. Nevertheless long-term unemployment remains a problem especially among males and particularly among youths. The UK participation rate, though higher than the EU average, has not risen since 1987 although the employment rate has increased.

Two important initiatives introduced by the government to improve the labour market performance are the "Welfare to Work" scheme and the introduction of measures to make work pay and so make it more attractive. The former focuses on improving the employability of groups detached from the labour market such as the young and long term unemployed, lone parents and disabled people. The latter includes a working families tax credit and the introduction of a minimum wage in 1999.

The level of UK labour productivity remains well below that of its major competitors. The government has noted that the UK has a much lower level of capital stock per worker than its competitors – a key determinant of labour productivity. It has taken, and proposed, a number of measures to try to reduce these gaps. They include a large planned increase in public sector investment, strengthening competition policy, enhancing skill levels and encouraging innovation and enterprise (the latter, in part, through the tax system).

Unlike the macro-economic reforms that have been associated quite rapidly with improvements in some aspects of performance, it will only be possible to judge, fully, the efficacy of these micro-economic measures in the medium and long term.