Europaudvalget 2000-01
EUU Alm.del Bilag 1128
Offentligt

UDENRIGSMINISTERIET

EUROPAUDVALGET
Alm. del - bilag 1129 (offentligt)

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Bilag	Journalnummer	Kontor	
1	400.C.2-0	EU-sekr.	27. april 2001

Til underretning for Folketingets Europaudvalg vedlægges Kommissionens henstilling med henblik på de overordnede økonomisk-politiske retningslinjer for 2001 for medlemsstaterne og Fællesskabet.

Notat vedrørende dagsordenspunkt 2 på rådsmøde (økonomi- og finansministre) den 7. maj 2001 til brug for Europaudvalgets møde onsdag den 2. maj 2001.

EN

ECFIN/228/01

COMMISSION OF THE EUROPEAN COMMUNITIES
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 25 April 2001
ECFIN/228/01-EN

COMMISSION RECOMMENDATION

for the 2001 Broad Guidelines of the Economic Policies of the Member States and the Community

EN

drawn up in conformity with Article 99(2) of the Treaty establishing the European Community

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I. GENERAL ECONOMIC POLICY GUIDELINES

1. INTRODUCTION

A year ago, in Lisbon, the European Union set itself a new strategic goal for the next decade: *"to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable growth with more and better jobs and greater social cohesion"*. The 2000 Broad Economic Policy Guidelines (BEPGs) set out a comprehensive policy strategy to fulfil this ambition. This strategy consists of sound macroeconomic policies and comprehensive economic reforms on labour, product and capital markets. These policies should sustain robust economic growth in the short term, strengthen the basis for future growth in the medium term and enhance the capacity to cope effectively with longer-term structural changes, including the impact of population ageing.

The 2001 BEPGs confirm the existing policy strategy and extend it further in the light of the results of the Stockholm European Council (23-24 March 2001). These include the integration of the promotion of sustainable development, which is done through the various relevant parts of the document. They have been drawn up against the background of the examination of the implementation of the 2000 BEPGs and the assessment of the economic situation and outlook as presented in the Commission's Spring 2001 Economic Forecasts.

Section 2 starts with a discussion of the economic background to these guidelines and concludes by identifying the main policy challenges in the short, medium and longer term. Section 3 then describes the general policy recommendations which are applicable to all Member States and the Community. Within the overall strategy, policy priorities differ somewhat across Member States due to differences in economic performance, prospects, structures and institutions. Taking due account of them, Part II presents the country-specific economic policy guidelines.

2. MAIN PRIORITIES AND POLICY REQUIREMENTS

2.1. Recent and prospective economic developments

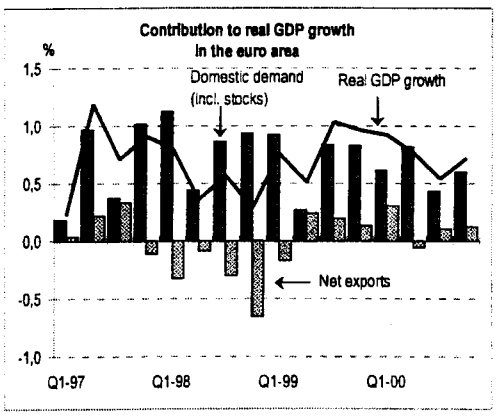
A markedly less favourable external economic environment — Since early summer 2000, when the previous guidelines were adopted by the Council, the global economic environment has become distinctively less supportive on the back of a number of inter-related forces. While the global slowdown is generally expected to be relatively short lived, the risks of a less favourable outcome are considerable.

Firstly, throughout the summer oil prices increased and reached new highs in the autumn. Although they have retreated from their late 2000 peak and slowing global demand reduces the risk of a renewed price hike, oil prices remain relatively high and continue to exhibit a high degree of volatility. Secondly, and more importantly, economic activity in the United States and Japan have experienced an unexpectedly steep fall-off over recent months. In the United States, some adjustment towards a more sustainable growth path was both expected and desirable, as it could effectively lead to a correction of important imbalances that had built up during

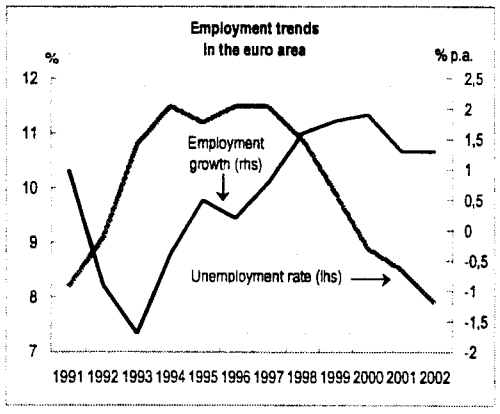
the expansion. Expectations centre on a quick (V-shaped) recovery in the second half of 2001 based *inter alia* on a judicious use of the available room for policy manoeuvre. However, the outlook remains subject to considerable uncertainties and a more severe and protracted downturn cannot be excluded. In Japan, the fragile recovery is faltering and the economy remains vulnerable to shocks. The deteriorating external environment is already affecting growth in a number of emerging market economies, mainly through a deceleration of exports. Thirdly, a pronounced correction has taken place on global equity markets, especially technology stocks, reflecting a downward shift in investors' perception of long-term profit growth.

Growth in the euro area is holding up rather well — On balance, the second year of Economic and Monetary Union was a successful one. In the euro area, economic growth was the strongest and unemployment fell to the lowest level for a decade. Headline inflation accelerated but underlying inflation stayed well below 2 per cent. Nevertheless, the growth momentum has been dented, firstly by the negative shock imparted by rising oil prices and, subsequently, by the downturn in global demand. In addition, the oil price hike in combination with a weakening euro entailed a pick-up in headline inflation that reached its peak in November 2000.

Looking forward, despite the global cyclical downturn which mitigates prospects, the euro area looks set to continue to enjoy in 2001-2002 relatively solid economic growth of about 2¾ per cent and continued job creation in a context of receding inflationary pressures. Strongly improved macroeconomic fundamentals, including sustained wage moderation, and supportive policies have fostered a favourable investment climate and steady employment creation. They have engendered a virtuous growth circle that is firmly rooted in domestic demand. While having come down, business and consumer confidence remain close to their historically high levels as they continue to be supported by the increased dynamism of the economy. High capacity utilisation, favourable financing conditions and strong profitability support investment demand, while rising disposable income, fostered by productivity gains, higher employment and tax relief, continues to underpin consumer demand.



Source: Commission services.



Source: Commission services.

Furthermore, the large internal market coupled with the single currency provides a strong and stable base for domestic growth with less exposure to exchange-rate fluctuations. The coming introduction of euro notes and coins on 1 January 2002 will give further impetus to economic integration and will turn the euro into a reality in daily life and make monetary union more visible. Moreover, thanks to progress with economic reforms, the euro area's resilience to external disturbances has been fortified. As a consequence, even if external downside risks were to materialise – in particular if the US economy would not quickly return to solid growth – the above factors will help to mitigate the impact on the euro area.

The non-euro-area Member States – After robust economic growth and job creation in 2000, Denmark, Sweden, and the United Kingdom are being affected by the adverse developments in the world economy. As a result, economic growth is expected to slow to a more moderate pace. The close trade links with the euro area and continuing healthy domestic demand position them well to weather the deteriorating external environment. Inflation in these countries remains subdued at or below the level recorded in the euro area.

2.2. Key challenges ahead

Looking ahead, the EU and the euro area face a number of key challenges in the short-, medium-, and longer-term. A successful response to these challenges will depend on appropriate policy action being taken now.

The short-term challenge: preserving the expansion in growth and jobs — The immediate task ahead is to maintain strong economic performance in a context of less supportive global economic conditions. The euro area will have to rely increasingly on its own strengths.

Policies must therefore aim at maintaining and further enhancing internal growth dynamics by pursuing stability-oriented macro-economic policies and comprehensive structural reforms. This will underpin business and consumer confidence whilst increasing the scope for a monetary policy stance supportive of domestic-led growth in the euro area. A stronger euro coupled with more expansionary domestic monetary conditions would contribute to a smooth adjustment of world imbalances while supporting domestic demand and reducing external price pressures.

In particular, budgetary policies should continue to be geared to the achievement of public finances close to balance or in surplus and wage moderation needs to be sustained. Preserving the hard-won macroeconomic stability and extending it into the future is essential. Pressures to increase government expenditure and reduce taxes are on the rise as budgetary positions have improved to their best levels for many years and in some cases for decades. Some wage pressures have arisen sparked by emerging labour market bottlenecks and demands for compensation for the recent increase in headline inflation and past moderation.

Yet, Economic and Monetary Union implies an important regime change that entails additional responsibilities for all major policy actors in making it a success. The single monetary policy can not be tailored to the needs of individual Member States and the exchange rate can no longer be used to restore lost

competitiveness, resulting from a delay in structural change or an inappropriate macroeconomic policy mix.

Governments and Social Partners therefore bear responsibility in contributing to a balanced macroeconomic policy mix both at Member State and euro-area level.

More generally, there is a need to further increase the resilience of the economy through a judicious combination of structural reforms. More flexible and open markets will enhance the capacity to deal with change and help minimise any lasting impact of shocks. They will also foster a positive interaction between structural improvements in the economy and entail benefits in terms of macroeconomic performance. In addition, structural reforms can have a positive impact in the short term through downward pressure on prices.

The medium-term challenge: improving the basis for future growth and employment — The growth performance since 1997 has to be seen in a context of a cyclical recovery where slack could be used up. While potential output growth may well have improved over recent years as a result of productivity gains fostered by improved market functioning and new information and communication technologies, it is still considered to be insufficient to sustain growth rates of around 3 per cent over an extended period of time. Sustaining the expansion will therefore hinge on a permanent increase in the speed limit of economic growth.

Policies should concentrate on creating the right conditions for the efficient use of productive and natural resources and for their enhancement over time, including investment in education and training. In particular, they should contribute to improved market functioning by addressing market imperfections or failure due to the existence of externalities, market power, imperfect information or the regulatory environment.

Particular importance attaches to making substantial inroads into the present under-utilisation of human resources. Registered unemployment in the euro area is still unacceptably high and labour force participation and employment rates are low, especially for older workers and women, and far from the targets agreed in Lisbon and Stockholm. An increase in the level of participation in the labour market, especially for groups that are underrepresented or disadvantaged is also key to social inclusion. The mutual reinforcement of economic and social policies is a fundamental strategy leading to the mobilisation of the full potential of jobs available.

To promote an increase in the labour supply, it is necessary to make sure that the regulatory framework encourages people to enter into or remain in the labour market. In particular, tax and benefit schemes should be further reformed to strengthen financial incentives for people to take up or stay in a job. A switch to focused active policies is needed to enhance the opportunities of unemployed and inactive persons. Active labour market policies promote also social inclusion. The more efficient use of the European labour force as a whole should also be achieved through measures to support labour mobility between Member States, particularly with a view to tackling skills bottlenecks. Moreover, life-long learning should be fostered with a view to encouraging participation in the labour market.

An increase in labour supply will have to be accompanied by capacity-enhancing investment. This implies creating a business

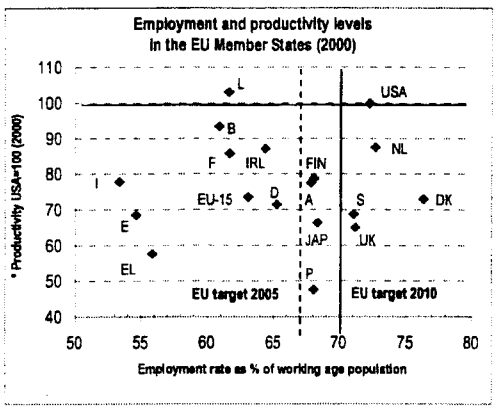
environment conducive to investment, supported by adequate public infrastructure and a modern and efficient public administration. Well-functioning, competitive and integrated product and capital markets will contribute by making sure that resources are put to their best possible use. In this context, there is a need to enhance competition in goods and services markets and, in particular, in utilities and financial services. To this end, action at Community level should focus on completing the internal market, especially in the service sector. Member States, for their part, should see to an effective implementation of the internal market legislation and encourage greater competition.

A central element in the Lisbon strategy is the recognition of the necessity to foster entrepreneurship and innovation in the EU, both of which are fundamental pre-conditions for increasing Europe's potential for growth and, subsequently, its competitiveness, wealth and job creation. Strengthening entrepreneurship and innovation constitutes a key challenge for all Member States.

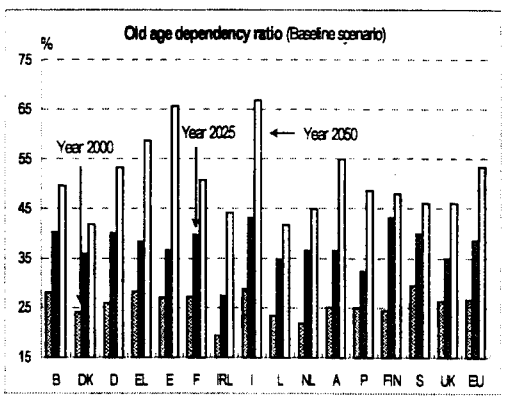
The promotion of competition within the internal market finds its logical complement in increased competition at world level. The European Union should therefore continue to adopt a common commercial policy that favours open world trade and press for a new multilateral trade round within the context of the WTO.

The maintenance of productivity growth and competitiveness over time and in a global context will require constant structural change. Europe's transition towards a knowledge-based economy is progressing but shortcomings remain in the relationship between industry and science and the level of private investment in R&D, such that commercialisation of the research effort remains weak. In addition, the supply of qualified ICT personnel and trained researchers is insufficient.

The longer-term challenge: preparing for the impact of ageing populations — The need for sound macroeconomic policies and comprehensive economic reforms is amplified by the challenge posed by ageing populations that is visible on the horizon. On present trends, the EU's working age population will fall by approximately 40 million people and the old age dependency ratio will about double between 2015 and 2050.



Source: Commission services. * Productivity is GDP per person employed.
Note: Employment rates for L, USA & JAP are for 1999. NL is provisional data



Source: Commission services.
Note: Old age dependency ratio is defined as persons aged over 65 as a percentage of the population aged 20-64.

Tentative calculations point to increased expenditures on public pensions of the order of 3-5 per cent of GDP over the period from 2010 to 2050. In addition, expenditure on health care and care for the elderly is expected to increase substantially. The ageing population will thus have considerable consequences for the long-term sustainability of public finances taking into account the need for universal adequate pensions. Even though it will still take a number of years before the impact will be clearly felt, governments should act already now and make full use of the current favourable overall economic situation to ensure the quality, adequacy and fiscal sustainability of pensions, health care and long-term care for the elderly. To this end, the current arrangements should be reviewed and, where appropriate, be reformed. Structural improvements in public finances should be achieved to prepare for the coming financial burdens imposed by ageing populations on public finances.

Beyond the immediate financial impact, the ageing of populations has wider implications for economic growth, as a result of the shrinking of the potential workforce and of potentially important effects on the level of aggregate savings. High standards of living will have increasingly to be supported through increases in labour productivity and by raising the employment rate. In addition, a reduced inflow of young, newly-educated persons into the labour force is likely to hamper skill renewal and thus the take-up of new technology. Increasing new-technology proficiency among young people and fostering adult learning could help to counteract the effects of ageing on skill levels.

Member States should develop comprehensive strategies for addressing the economic challenge posed by ageing populations. They should be presented in conjunction with the stability and convergence programmes and be examined in the context of multilateral surveillance.

Ensuring close policy-co-ordination – Close co-ordination among policy actors, including beforehand information exchange, will be instrumental in framing and implementing mutually supportive policy responses to these challenges. The effectiveness and efficiency of their policy actions will be enhanced by taking proper account of spill-over effects that become more important as integration intensifies.

This is particular true for the euro-area Member States. To deal with these challenges and to exploit the full potential of EMU, the authorities of the euro-area Member States are urged to closely co-ordinate their economic policies in the Eurogroup.

*
* *

The policy strategy both at macro and microeconomic level to deal effectively with these key challenges is set out in more detail in the next section. Its main components are to:

(i) ensure growth- and stability-oriented macroeconomic policies;

(ii) improve the quality and sustainability of public finances;

(iii) invigorate labour markets;

(iv) ensure efficient product (goods and services) markets;

(v) promote the efficiency and integration of the EU financial services market;

(vi) encourage entrepreneurship;

(vii) foster the knowledge-based economy; and

(viii) enhance environmental sustainability.

3. POLICY RECOMMENDATIONS

3.1. *Ensure growth and stability-oriented macroeconomic policies*

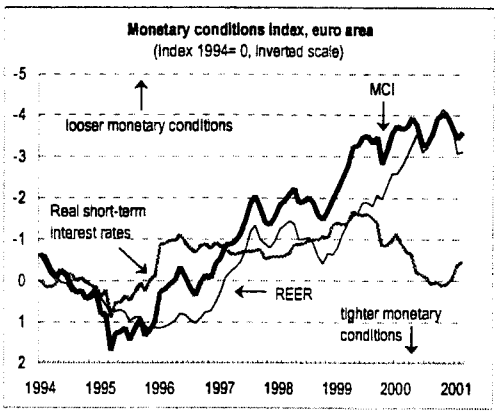
The conduct of macro-economic policy plays a key role in promoting growth and employment and in preserving price stability. Over the short term, it should ensure the continuation of the economic expansion and the full realisation of the current growth potential. Over the medium term, it should contribute to the establishment of the framework conditions ensuring adequate levels of saving and investment so as to position the economy on a sustained, higher, non-inflationary, growth and employment path.

In the **euro area**, *following buoyant economic activity in 2000, growth is expected to slow down somewhat but to remain fairly robust and above the potential rate in 2001-2002 whilst inflation should ease. An appropriate and tension-free macroeconomic policy approach consists of the following ingredients.*

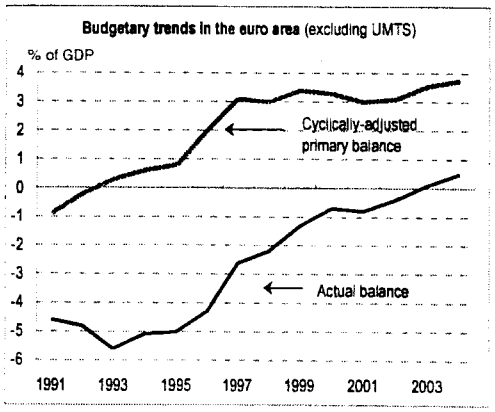
The single monetary policy is committed to maintain price stability in the euro area as a whole, and without prejudice to this objective, to support the general economic policies in the Community.

Sound budgetary positions, in line with the Stability and Growth Pact, provide the necessary scope for the full working of the automatic stabilisers without the risk of breaching the 3 per cent of GDP limit for the general government budget deficit. They also have favourable effects on interest rates and contribute to the crowding-in of private investment, to the further reduction in the government debt to GDP ratio and, by increasing the credibility of the budgetary framework of EMU, to a strengthening of investors' confidence.

As a general principle, it is important that budgetary policies be guided by the need to avoid pro-cyclical stances, which lead to exacerbated swings in economic activity, unsustainable structural balances and burden the single monetary policy. To this end, cyclically-adjusted budget balances are used as an additional tool when assessing budgetary positions. A 'minimum' budgetary position of close to balance or in surplus has been reached in several Member States and is within reach in the others. It is now time to anchor these results by ensuring that cyclically-adjusted budgetary positions move towards, or remain in, balance or surplus in the coming years. Where appropriate, further fiscal consolidation would create additional room for manoeuvre for cyclical stabilisation, to cope with unexpected budgetary developments, to put government debt on a more rapidly descending trajectory and to prepare for the budgetary challenges associated with population ageing. Based on the latest 2000/01



Source: Commission services. The MCI is based on Unit labour costs. REER is the real effective exchange rate



Source: Commission services

updates of the stability programmes, following a slight deterioration in 2001, the underlying budgetary position in the euro area as a whole is set to improve gradually to a balanced position in 2003.

General government net lending(+)/borrowing(-)
in the updated stability- and convergence programmes
(% of GDP, excluding UMTS)

	Date[1]	2000	2001	2002	2003	2004
			Stability programmes			
B	12/00	-0.1	0.2	0.3	0.5	0.6[2]
D	10/00	-1.0	-1½	-1.0	-½	0.0
EL	12/00	-0.8	0.5	1.5	2.0	2.0
E	01/01	-0.3	0.0	0.2	0.3	0.3
F	12/00	-1.4	-1.0	-0.6	-0.4	0.2[3]
IRL	12/00	4.7	4.3	3.8	4.6	:
I	12/00	-1.3	-0.8	-0.5	0.0	0.3
L	12/00	3.0	2.6	2.5	2.5	:
NL	09/00	1.0	0.7	0.6[4]	1.1[4]	1.9[4]
A	12/00	-1.8	-0.75	0.0	0.0	0.0
P	01/01	-1.9	-1.1	-0.7	-0.3	0.0
FIN	09/00	4.5	4.7	4.4	4.5	4.9
Euro area		-0.7	-0.6	-0.3	0.1	0.4
			Convergence programmes			
DK	12/00	2.7	2.8	2.6	2.6	2.7[5]
S	11/00	3.4	3.5	2.0	2.0	:
UK[6]	12/00	1.1	0.6	-0.1	-0.9	-1.0[7]
EU-15		-0.2	-0.2	-0.1	0.0	0.2

1) Date of adoption.
2) Government surplus of 0.7% of GDP projected for 2005.
3) Government deficit 0.5% of GDP in 2004 projected in more prudent growth scenario.
4) Favourable scenario, with margin available used for debt reduction; in the cautious scenario, with margin available used for debt reduction, the government surplus is projected to be 0.3% of GDP in 2002 and in 2003 and 0.6% in 2004.
5) Government surplus of 2.9% of GDP projected for 2005.
6) Financial years.
7) A government deficit of 1.1% of GDP is projected for 2005-06.
Source: National programmes and Commission services.

The euro area Member States should ensure that their budgetary policies support the price-stability orientation of the single monetary policy. In this context, they should stand ready to use budgetary policies to contribute to domestic price stability and to take into account both the euro-area dimension and the national implications of the single monetary policy in conducting their budgetary policies.

In general, Member States should:

i. meet, as a rule, and in keeping with last year's commitment, budgetary positions of close to balance or in surplus in 2001 so as to achieve a sufficient margin to cope with the impact of adverse cyclical fluctuations; ensure a rigorous execution of their budgets so as to prevent slippage from the stability programme targets;

ii. prepare budgets for 2002 in keeping with the need to preserve budgetary positions close to balance or in surplus and to avoid pro-cyclical fiscal policies; where appropriate, further strengthen public finances, especially with a view to securing their long-term sustainability; and

iii. be ready, in those Member States were overheating risks and inflationary pressures prevail, to tighten budgetary policy with a view to contributing to an appropriate macroeconomic policy mix at national level.

Wage developments in euro-area Member States should reflect different economic and employment situations. Governments can create the right framework conditions that facilitate the wage negotiations by Social Partners. From a macroeconomic perspective, it is necessary to set nominal wage increases consistent with price stability and job creation; this implies taking due account of the ECB's price stability objective whilst ensuring that real wage increases do not exceed productivity growth.

In the ***non-euro-area Member States****, monetary policies aim at price stability. In Denmark, monetary policy pursues this objective through supporting a fixed-exchange rate policy toward the euro in the framework of ERM2. In Sweden and the United Kingdom monetary policies directly target inflation. Their successful achievement will help create the conditions for exchange rate stability.*

The non-euro area Member States shall also maintain sound budgetary positions in accordance with the Stability and Growth Pact. In general, they should:

i. maintain budgetary positions in surplus in 2001 and thereby a sufficient margin to cope with the impact of adverse cyclical fluctuations; ensure a rigorous execution of their budgets so as to prevent slippage from the convergence programme targets; and

ii. prepare budgets for 2002 in keeping with the need to preserve budgetary positions in balance or surplus and to avoid pro-cyclical fiscal policies; where appropriate, further strengthen public finances, especially with a view to secure their long-term sustainability.

Wage developments in non-euro area Member States should also reflect different economic and employment situations. From a macroeconomic perspective, it is necessary to set nominal wage increases consistent with price stability and job creation; this implies taking due account of the price stability objective of the national central bank whilst ensuring that real wage increases do not exceed productivity growth.

3.2. Improve the quality and sustainability of public finances

Member States must sustain sound budgetary positions while at the same time improving the quality and sustainability of public finances in line with the report endorsed by the Stockholm European Council. This will ensure that public finances maximise their contribution to growth and employment and the achievement of the objectives agreed in Lisbon and Stockholm, including social cohesion. An appropriate balance and sequencing have to be drawn between running down public debt, cutting taxes and financing public investment in key areas. To this end Member States should:

i. pursue efforts to make tax and benefit systems more employment friendly, including by reducing the tax burden, especially on low-wage labour, within continued fiscal consolidation, and by improving the efficiency of tax systems (see also Section 3.3);

ii. redirect public expenditures towards physical and human capital accumulation;

iii. enhance the efficiency of public spending by institutional and structural reforms; in particular introduce or enhance the mechanisms that help control spending;

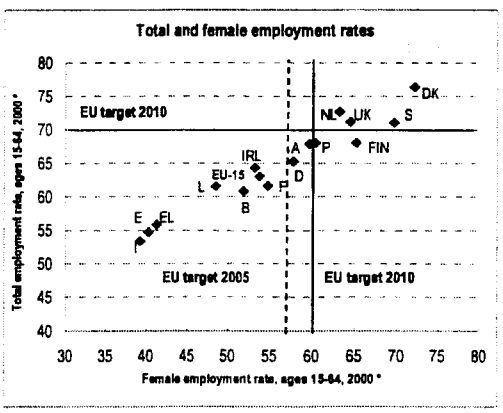
iv. improve the long-term sustainability of public finances by pursuing a three-pronged strategy. Over and above actions to raise employment rates, this will require a fast reduction in government debt and further reforms of the pension system. Measures to put pensions on a sounder footing should include moves towards a greater reliance on funding so as to achieve a better balance between the different pillars within the pension

systems in those countries which have not yet achieved that; and

v. pursue tax co-ordination further so as to avoid harmful tax competition and implement effectively the Council agreement of November 2000 on the tax package.

3.3. Invigorate labour markets

The strong employment performance of recent years continued during 2000. This has been due in large part to the favourable macroeconomic conditions, but labour market developments also strongly suggest a reduction in structural unemployment thanks to reforms and policies to improve the functioning of labour markets implemented over the past decade, in particular in the context of the European Employment Strategy. The pick-up in wage growth has been limited given the sharp fall in unemployment, while long-term unemployment has fallen by even more than the overall rate. Nevertheless, there remains ample scope for further progress. In particular, the EU is facing four challenges. Firstly, signs of recruitment difficulties and skill shortages have emerged in a number of Member States, which suggests that the EU may now be approaching the limits of rapid cyclical employment growth. Secondly, unemployment is still unacceptably high with large differences across Member States and regions. Thirdly, further large reductions in unemployment and a substantial increase in labour supply will be needed to hit the employment targets of 70 per cent overall employment rate and of 60 per cent for women by 2010 as agreed by the Lisbon European Council, including the intermediate targets of 67 per cent and 57 per cent respectively by January 2005, as well as 50 per cent for older workers by 2010, agreed at the Stockholm European Council. Fourthly, as reaffirmed at the Stockholm European Council, the aim should be to create better jobs as well as more jobs, notably via improved education, life-long learning and a better reconciliation of working and personal life.



Source: Commission services.
* L is 1999, NL is provisional data.

To meet these challenges, Member States should take advantage of the favourable macroeconomic conditions to make the necessary structural improvements in labour markets and move towards the goal of full employment. Member States should by the end of 2002 meet the targets set in the Employment Guidelines. They should, in particular, take the following measures:

i. promote increased participation in the labour market, especially among women and older workers, notably by pursuing equal opportunities, ensure provision of care facilities for children and other dependants, reforming early retirement schemes and through life-long learning. Similarly, the participation of disabled people, ethnic minorities and migrants should be promoted. Other relevant measures, including pension reforms, are mentioned under public finances;

ii. on the basis of past reviews, reform tax and benefit systems to make work pay. Reforms should reduce labour taxes for low-paid workers, reduce high marginal effective tax rates and address incentive

effects, duration, eligibility and enforcement of benefit schemes;

iii. **encourage wage formation processes** that better take into account productivity and local labour market conditions;

iv. bring down obstacles to labour mobility within and between Member States, inter alia through the mutual recognition of qualifications, improving portability of pensions by promptly adopting and implementing the directive on occupational pension funds, improving access to European-wide information on job vacancies and learning opportunities in Member States in the context of developing the new European labour markets;

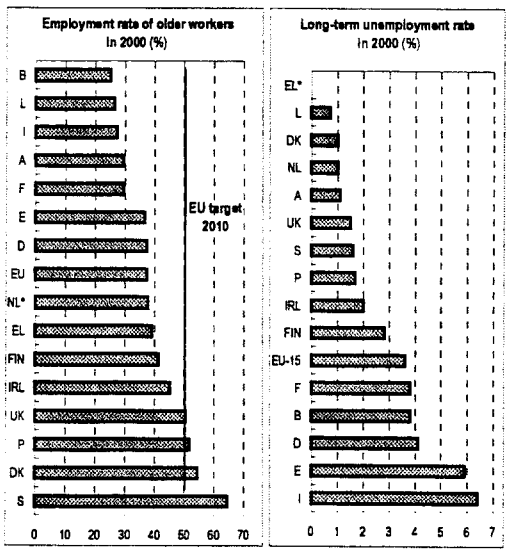
v. facilitate occupational labour mobility by improving, together with the Social Partners, education, training and life-long learning in order to reduce early school leaving and preparing for a successful transition to the knowledge-based economy;

vi. ensure the efficiency of active labour market policies and target these towards those individuals most prone to the risk of long-term unemployment; ensure that benefit systems are complemented by effective assistance for job-seekers to enhance their employability and their job opportunities;

vii. promote, together with the Social Partners, more flexible work organisation, including working-time arrangements, and reform the existing regulatory, contractual and legal framework, inter alia, on hiring and firing restrictions and on part-time work, with a view to combining greater flexibility with security; ensure that any reductions in overall working time do not lead to increases in unit labour costs, and that future labour supply needs are taken fully into account; and

viii. pursue policy aiming to reduce gender pay differences due to *de facto* discrimination.

Employment situation: older workers and long-term unemployment in EU Member States

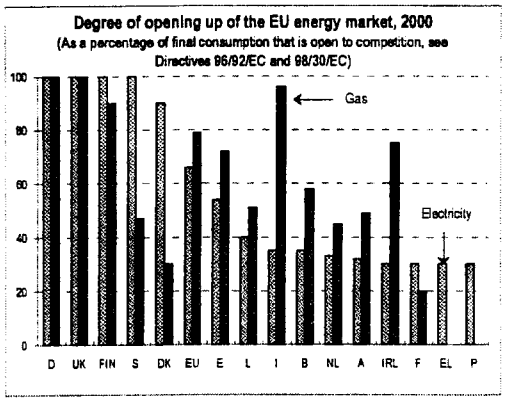


Source: Commission services. * For older workers, NL is provisional data. For Long-term unemployment rate, no data available for EL.

On 19th January 2001, the Council adopted, in accordance with Treaty Article 128, detailed guidelines for employment policies for the year 2001, consistent with the above-mentioned priorities, as well as Member State specific recommendations. In pursuing labour market reforms, Member States should vigorously implement the Employment Guidelines and recommendations addressed to them.

3.4. Ensure efficient product (goods and services) markets

The creation of the Internal Market and the launch of the euro have fostered competition in EU product markets. This has had a moderating effect on inflation levels and has been a factor in the convergence of price levels between Member States with clear benefits for consumers. Competition has also led to a rationalisation of production, which has contributed to improving the competitive strength of European companies. However, the internal market for services is still hampered by existing barriers, creating obstacles to cross-border activities. The liberalisation of the telecommunications and to a lesser extent of the energy sector has started to give positive results. The Commission has proposed full liberalisation of electricity and gas for all consumers by 1st January 2005. Similarly, the opening up of the European economy to world trade has exposed European companies to international competition, which has contributed to increasing the efficiency of European product markets. The European Union continues to be committed to trade liberalisation, and to opening a new trade round within the WTO. While significant progress has been made in the functioning of European product markets, a number of areas remain where further efforts are needed. Member States should:



Source: Commission services.

i. fully implement the Internal Market:

- cut the internal market legislation transposition deficits to less than 1.5 per cent before the 2002 Spring European Council;
- eliminate technical barriers to trade;
- create an effectively functioning internal market in services by removing regulatory and other constraints on cross-border activities between Member States and market entry; and
- further open up the public procurement market and bring it on-line by 2003.

ii. reinforce competition while ensuring the delivery of real benefits to consumers:

- accelerate the liberalisation of the network industries (energy, railway, air transport and postal services sectors) while taking account of universal service obligations, and security of supply requirements;
- ensure adequate capacity and effectiveness of the competition and regulatory authorities; and
- reduce the overall level of State aid in relation to GDP by 2003 and redirect it away from ad hoc and sectoral aids; increase the transparency of State aid policies.

3.5. Promote the efficiency and integration of the EU financial services market

The EU financial system is integrating progressively under the influence of globalisation, deregulation, technological advances and the introduction of the euro. The efficiency gains from financial integration will be reflected in an improved allocation and lower cost of capital, with beneficial effects on growth and employment creation in the EU economy. However, the remaining obstacles to financial integration prevent potential benefits from being fully reaped. Among the more important of these obstacles is the absence of a harmonised regulatory framework for the Union, which prevents effective cross-border competition. Progress in harmonising EU financial regulation has been made through a range of actions taken under the Financial Services Action Plan (FSAP). Implementation of the Risk Capital Action Plan (RCAP) should enhance the availability of adequate financing opportunities for innovative SMEs, whose flexibility and growth potential make them important sources of economic growth and employment. However, progress towards a truly single market for financial services is, at present, too slow. In this respect, it is necessary to:

i. ensure that the approach in respect of securities markets proposed by the Committee of Wise Men on the Regulation of European Securities Markets as endorsed in the Stockholm European Council Resolution is operational from the beginning of 2002;

ii. step up efforts by all relevant parties - the Council, the Parliament and the Commission - to ensure full implementation of the FSAP by 2005 at the latest, and in particular to implement key steps for achieving an integrated securities market by the end of 2003, including notably the priorities set out in the report of the Committee of Wise Men on the Regulation of European Securities Markets;

iii. increase, in addition to implementing the FSAP and particularly in respect of risk capital markets, efforts towards a well-functioning risk capital market by 2003 through implementation of the RCAP, in particular with regard to easing quantitative constraints on institutional investment in equity capital, easing bankruptcy law and developing a fiscal framework more conducive to investment and entrepreneurship; and

iv. deal effectively with the challenges arising in the field of prudential supervision as a result of increasing cross-border and cross-sector linkages between financial markets and intermediaries; in this respect, Member States should take the necessary measures to further improve cross-sector and cross-border co-operation among supervisory and other relevant authorities.

3.6. Encourage entrepreneurship

Entrepreneurship is a fundamental precondition for increasing the EU's potential for growth, competitiveness and job creation. A more favourable environment for business needs to be created in Europe. Businesses and citizens need a regulatory and fiscal environment which is clear, simple, effective and workable in a rapidly changing global market place. Measures to improve the efficiency of the public sector and to limit red tape have been introduced in order to reduce the administrative burden on enterprises. Nevertheless, there is scope for significant further action. European SMEs still consider lack of access to finance

an obstacle to start-ups as well as a problem limiting companies' growth potential. Member States should:

i. create a business-friendly environment:

- further reduce the administrative burden and barriers for business by introducing simpler and more transparent procedures, one-stop shops for company start-ups and by simplifying business tax systems;

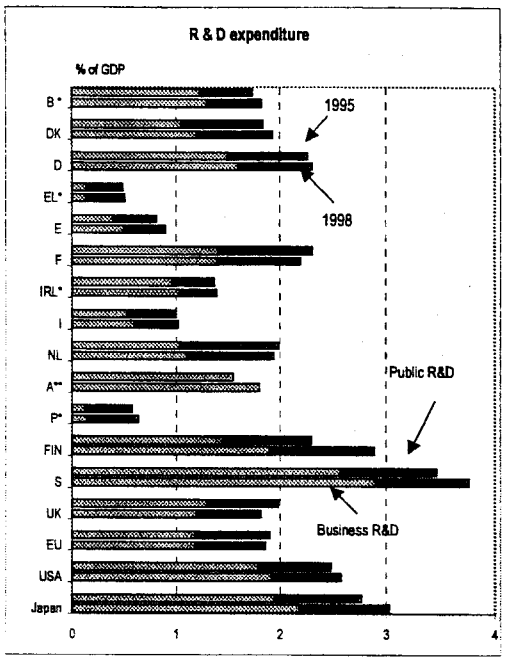
- increase the efficiency of public services, inter alia through benchmarking and the increased use of public tendering, while ensuring that public and private entities compete on a level playing field when public sector bodies or public–private partnerships are supplying market goods or services; and

- simplify and ensure a more uniform application of VAT systems.

ii. encourage risk-taking through improving access to finance especially for SMEs (see also Section 3.5).

3.7. Foster the knowledge-based economy

The European Union's transition to the knowledge-based economy is advancing, but it should be speeded up if the Lisbon strategic goal is to be achieved. Business and citizens need to be encouraged to seize the opportunities offered by the knowledge-based economy. In spite of recent progress in ICT diffusion, the EU continues to lag behind the United States in areas such as research and development, investment in new technology, and internet penetration. It is of high importance that the guidance provided by the Stockholm European Council to accelerate economic



Source: Commission services.
Note: * Data for 1997, ** no breakdown available for Austria.

reforms is brought into life within the agreed period. Increased investments in human capital, R&D and ICT are required in order to strengthen European competitiveness. The establishment of competitive product markets (see Section 3.4) and well-functioning capital markets (see Section 3.5) contribute to a business climate supportive of innovation and risk-taking that will encourage investment. In the area of R&D, the main challenge is to raise private sector involvement contributing to a better commercialisation of R&D results and to the establishment of the European Research Area. To facilitate the transition to the knowledge-based economy, it is necessary to:

i. stimulate R&D and innovation:

- provide adequate incentives for business to engage in R&D, *inter alia* by strengthening intellectual property rights and establishing a legal basis for a Community patent before the end of 2001;

- improve ties between university and business leading to knowledge transfer and a better commercialisation of R&D results;

- enhance collaboration on research and innovation across Europe *inter alia* by stimulating networks of centres of excellence combining business and academic partners and by promoting mobility of researchers, and through reinforced co-ordination of national research and innovation policies and programmes; and

- ensure sufficient public funding for R&D and establish clear and consistent priorities for public research.

ii. promote access and use of ICT:

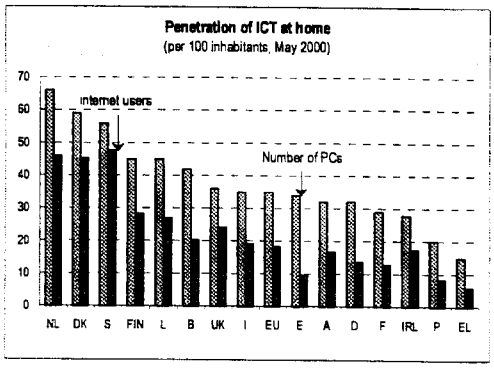
- implement the unbundling of the 'local loop' in order to help bring about a substantial reduction in the costs of using the internet;

- ensure a better and more widespread use of internet in schools and complete the necessary training of all teachers by the end of 2002;

- strengthen the regulatory framework for e-commerce (by implementing the electronic signature directive and by adopting in 2001 the proposals on copyright, distance marketing, VAT and electronic invoicing); and

- stimulate internet use in public administrations.

iii. strengthen education and training efforts, both private and public, in order to increase the supply of trained researchers, to increase the number of highly qualified ICT personnel, and to improve the basic ICT skills of the population.



Source: EITO, Commission services.

3.8. Enhance environmental sustainability

The Stockholm European Council has asked to integrate the promotion of sustainable development into the Broad Economic Policy Guidelines. Sustainable Development is a concept that goes beyond a purely economic assessment and strives for improvements in the quality of life by promoting coherent policy actions based on an overarching assessment of their economic, social and environmental dimensions. In doing so, it takes a long-term view, looking at the welfare of both present and future generations. This section focuses on the integration of environmental aspects into economic policy, in particular the use of market-based instruments, as a means of promoting sustainable development.

Member States should make increased use of market-based instruments in pursuit of environmental objectives, as they are often the most efficient means to curb pollution since they lead to the internalisation of external costs in prices. They are therefore a way to implement the polluter-pays-principle. Furthermore, they provide flexibility to industry to reduce pollution in

a cost effective way, as well as encouraging technological innovation. Gradual but steady and credible changes in the level and structure of tax rates until external costs are fully reflected in prices would minimize structural adjustment problems and support adaptation and innovative solutions by firms. This approach would also minimise the need for exemptions for those firms or sectors that are most affected. Such exemptions often reduce the environmental effectiveness of the measure, distort the tax structure and are difficult to remove at a later date. Establishing a framework for the use of market-based instruments at Community level could help avoid such distortions and underpin the internal market.

Therefore, it is necessary to:

i. introduce and strengthen market-based policies like taxation, user and polluter charges, insurance/liability schemes and tradable emission rights;

ii. reduce sectoral subsidies and tax exemptions and other measures which have a negative environmental impact;

iii. intensify the use of economic instruments to curb greenhouse gas emissions and fulfil the requirements of the Kyoto Protocol; and

iv. agree on an appropriate framework for energy taxation at the European level.

II. COUNTRY-SPECIFIC ECONOMIC POLICY GUIDELINES

1. BELGIUM

The economy expanded by about 4 per cent in 2000 and real GDP is expected to increase at around 3 per cent in 2001 and 2002. Private consumption, which increased rapidly in 2000, will remain sustained in both years supported by higher household disposable income and increasing employment. Rather dynamic investment should also continue to boost domestic demand. The external sector, however, is expected to turn less supportive of activity in 2001 and 2002. Consumer price inflation, measured by the harmonised index is projected to decelerate from 2.7 per cent in 2000 to just below 2 per cent in 2001 and further down in 2002. Employment should continue to increase in both years supported by still robust activity and the effect of active employment measures implemented in recent years.

Taking into account the still very high government debt ratio, and the need to prepare for future challenges resulting from the ageing population, budgetary consolidation remains a priority. The labour market is still characterised by a low employment rate, in particular among the older workers, while regional divergences in labour market performance are still too marked. Lack of competition in specific sectors, the excessive regulatory burden on enterprises, and the need to raise the efficiency of the public sector are also important policy challenges.

Budgetary policy

Acceleration in activity in 2000 resulted in more positive budgetary results than expected: instead of a government deficit projected at 1 per cent of GDP, a zero balance in the general government accounts was achieved. The 2000 updated stability programme projects a 0.2 per cent of GDP government surplus in 2001 increasing slightly to 0.3 per cent of GDP in 2002. The budgetary strategy planned in the 2000 update for the period to 2005 relies on the achievement of large government primary surpluses, reaching more than 6 per cent of GDP per year. Control on real primary expenditure is expected to be the main factor of adjustment, following a non-explicit norm of increase at 1.5 per cent per year in real terms for Entity I (federal government and social security). The government debt ratio is projected to be reduced from 110.6 per cent of GDP in 2000 to 101.4 per cent of GDP in 2002. In view of the above, and considering that Belgium is a member of the euro area, budgetary policy should aim to:

i. achieve a budgetary surplus of 0.2 per cent of GDP as projected for 2001 in the 2000 update of the stability programme, even in the event of slower real GDP growth than projected;

ii. in the framework of the budget for 2002, contain firmly the annual increase in primary expenditure within the 1.5 per cent limit, in real terms, in Entity I, thus allowing the achievement of the government balance objectives, in particular a primary surplus above 6 per cent of GDP.

iii. in 2002 and beyond allocate the budgetary margins, as defined in the 2000 update of the stability programme, in a

way consistent with the limit of 1.5 per cent growth of real expenditure; allocate all additional budgetary revenues which might result from better than expected real GDP growth to debt reduction; and

iv. prepare for the budgetary implications of population ageing by timely reforming the pension system and by identifying, in the next update of the stability programme, budgetary resources to be allocated annually to the "Ageing Fund".

Labour markets

Labour market conditions in Belgium continued to improve in 2000 bringing unemployment down to 7 per cent. The government is moving toward the implementation of an "active welfare state" characterised, among other things, by a gradual shift from passive policies to a preventive and more active approach to labour market issues. Initiatives have been undertaken to combat unemployment traps. Yet, benefit dependency remains relatively high for some segments of the labour market. The ageing population and the emerging signs of bottlenecks in hiring workers point to a need for further measures aimed at mobilising the non-occupied potential labour force, thereby increasing employment and participation rates. This is one of the main challenges facing the Belgian labour market, which is characterised by a relatively low overall employment rate (60.9 per cent), and in particular for older workers (only 24 per cent for those aged 55-64). The persistence of considerable geographical disparities in unemployment rates points to inadequate labour mobility and insufficient wage flexibility. Although the tax burden on labour in Belgium remains among the highest in the EU, tax cuts, as envisaged by the new Fiscal Reform Plan, are expected to gradually reduce taxation on labour in the years ahead. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Belgium should be to:

i. on the basis of past reviews, reform further tax and benefit systems to make work pay, in particular, to create adequate incentives for older people to continue to work or re-enter the labour market and to revise the higher benefits and the special status exempting older unemployed people (aged over 50) from active job search;

ii. address the main obstacles to labour mobility and encourage Social Partners to allow wage-setting mechanisms to better take into account productivity and local labour market conditions, while preserving wage moderation; and

iii. continue to enhance, together with the Social Partners, labour market flexibility by further relaxing conditions for fixed term and temporary contracts and increasing working-time flexibility, while ensuring that any reduction in working time has no adverse impact on unit labour costs and labour supply.

Product markets and the knowledge-based economy

Belgium is a small open economy, with strong competition on goods markets, which has contributed to a relatively high labour productivity in the manufacturing sector and relatively low prices for a country with its standard of living. The liberalisation process in the telecommunications sector is progressing well and several measures have

been taken to stimulate the knowledge economy. However, problems of competition persist in some services sectors. The liberalisation in the energy sector is less advanced. Efforts to reduce the regulatory burden on business and to reform the public administration have been announced but only few measures have been taken. In view of the above, the main priorities for Belgium should be to:

i. increase competition in transport and distribution of gas and electricity and set up independent transportation network managers in these sectors in order to ensure non-discriminatory access; ensure that the planned reform of the railways will increase efficiency and quality of service and reduce the need for operating subsidies;

ii. increase the transparency of the links between the public and private sectors at the local and provincial level, especially the role of municipalities and their associations ("intercommunale / intercommunaal") in different sectors such as energy or banking, in order to avoid distortions of competition and conflicts of interest; and

iii. take measures to reduce and simplify the administrative burden on business.

Capital markets

Capital markets in Belgium continue to develop. The equity market has become more integrated internationally with the merger of the Brussels, Paris and Amsterdam stock exchanges in 2000. Similarly, the banking system has been transformed by a series of cross-border as well as domestic mergers and acquisitions in recent years. The risk capital market has experienced strong growth, characterised by a high level of venture capital investment relative to GDP but also a substantial degree of public-sector intervention. Nevertheless, further development of the risk capital market would be desirable, in particular of the private as opposed to the public venture capital market. Efficiency in the financial system should benefit from a proposed set of legislative actions to improve corporate governance. In view of the above, the main priorities for Belgium should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws; and

ii. ensure that supervisory arrangements across sectors and across borders are keeping pace with developments in the financial system.

2. DENMARK

Following economic growth of close to 3 per cent in 2000, mainly boosted by dynamic investment and strong external demand, the economic expansion is expected to slow somewhat to slightly above 2 per cent in 2001. Whereas growth in both private and government consumption is expected to recover after the weak performance last year, this development is likely to be more than counterbalanced by a much lower rise in investment. Although growth in export markets is assumed to slow in 2001, the unusually strong rise in imports in 2000 – partly linked to the high import intensity of equipment investment and exports – is likely to fade away. Thus, the growth contribution of net exports is expected to strengthen in 2001. In 2002 economic activity is projected to accelerate to close to 2½ per cent, primarily as a result of a sustained revival of private consumption.

The growth potential of the Danish economy could be improved by properly addressing the following key challenges: labour supply constraints which, if eased, would also help avoiding that bottlenecks in some sectors spark a renewed pick-up in pay rises. Competition in several important sectors remains inadequate and, given the size of the public sector, it is important to attain a high level of efficiency in this sector. Also, effective restraint of real growth in government consumption is necessary, in particular in view of the budgetary impact of the ageing population.

Budgetary policy

In 2000, the general government surplus was 2.4 per cent of GDP, higher than expected at the time of the adoption of the budget bill. According to the government's estimates, the budget surplus should increase to 2.9 per cent of GDP in 2001 and decline somewhat to 2.6 per cent of GDP in 2002. The 2000 update of the Danish convergence programme by and large maintains the strategy of moderately declining ratios of primary expenditure and taxes to GDP. However, in 2001, both ratios are expected to increase slightly as a result of government consumption rising noticeably above the target of a real increase of 1 per cent annually and a tax rise by local and regional governments, clearly going beyond the non-binding agreements with central government. In the longer term, projections indicate that Danish general government finances have a capacity to cope with the financial burden of the ageing population. In view of the above, budgetary policy should aim to:

i. strictly limit the real increase in government consumption in 2001 to the budgeted rise of 1.9 per cent;

ii. ensure, in the framework of the budget for 2002, that primary expenditure falls to a level that is no more than the 49.5 per cent of GDP as specified in the 2000 update of the convergence programme, allowing a reduction in the tax burden while maintaining a budget surplus of around 2.5 per cent of GDP; and

iii. hold back real growth in government consumption also in the medium term so that the tax burden can decline up to 2005 in line with the government's projections in the updated convergence programme, without jeopardising the

capacity of Danish public finances to cater adequately for the ageing population. In particular, more binding commitments from lower levels of government should be sought, while respecting the autonomy of local governments, in order to achieve this.

Labour markets

The Danish labour market performance is one of the best in the Union, including the highest employment rate of over 76 per cent, a relatively low unemployment rate of 4.7 per cent and a good record in active labour market policies. In addition, the eligibility criteria for benefits have been tightened in order to increase effective labour supply, inter alia, recently through the reform of the early retirement schemes in 1996 and 1999, and the reform of disability pension scheme, to be implemented in 2003. However, labour supply has stagnated in recent years, and it will be curtailed by some recent measures, notably, the one-week increase in annual holidays for the private sector, agreed in 2000. Labour supply constraints are expected to persist, both in the short and longer term, despite efforts to increase the labour supply of immigrants. A further expansion in labour supply could be encouraged via tax and benefit reforms, to make the underlying tax-benefit structure more favourable for employment. In view of the above, while vigorously implementing all the Employment Recommendations, the main priority for Denmark should be to:

i. reduce further the overall fiscal pressure on labour over the coming years, especially through lowering high marginal effective tax rates on low and medium wage earners, and reform benefit systems to make work pay.

Product markets and the knowledge-based economy

The Danish economy is less exposed to international competition than other small Member States. This may be one reason why competition is insufficient in a number of product markets and why consumer price levels are relatively high. Over the recent period, Denmark has seen noticeable improvements in opening up public procurement and in raising the efficiency of public services provision. Competition policy has also been strengthened, introducing merger control and the enforcement of Articles 81 and 82 of the Treaty. Despite R&D expenditures that are above the EU average, Denmark does not measure up to the other Nordic Member States, in part owing to lower business R&D spending and a poorer commercialisation record. A new business policy strategy has been designed to better R&D performance in Denmark. In view of the above, the main priorities for Denmark should be to:

i. strengthen enforcement of competition rules in those industries where competition has been found to be inadequate; and

ii. enhance conditions for competition in public procurement, and heighten competitive pressures in public services provision at the local level through benchmarking and increased use of public tendering.

Capital markets

Capital markets in Denmark have been developing under the influence of government policies focused on strengthening financial supervision, improving competitive conditions for financial companies and increasing market transparency. To promote the development of the equity market, Denmark has eased the quantitative restrictions placed on equity holdings of pension funds, thus allowing for investments up to 70 per cent in equity under a "prudent man" principle. Denmark has improved the tax treatment of employee ownership schemes and reformed investment fund regulations by introducing "small cap" investment funds (special innovation funds which specialise in small and innovative companies). Investment in risk capital has doubled since 1998 but remains small when compared to other markets. Therefore, continued efforts to develop the risk capital market would be desirable. Financial-sector regulations are to be gathered in a single legislative framework and supervisory arrangements are to be streamlined. With increased merger activity of large financial institutions in the Nordic region, Danish supervisors have signed a co-operation agreement with their Finnish and Swedish (and Norwegian) counterparts to ensure efficient financial supervision of such cross-border institutions. In view of the above, the main priority for Denmark should be to:

i. develop further the risk capital market by establishing a fiscal framework that is conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.

3. GERMANY

Following an extraordinary export boom in 2000, economic growth in Germany looks set to decelerate somewhat in the near term, mainly because slower growth in the world economy will reduce export expansion. Stronger domestic demand is projected to compensate partly for the falling external contribution to growth and will become the main economic driving force. Private consumption, after being restraint last year by rising import prices and the surge in oil bills, will benefit from a reversal of these developments. An additional boost should come from employment growth and the implementation of the third step of the income tax reform on 1 January 2001. At the same time equipment investment is expected to remain robust as a result of a high rate of capacity utilisation. According to the projections of the Commission services, GDP growth is therefore likely to decline to some 2¼ per cent in 2001, while 2002 should see a slight pick-up to just over 2½ per cent. These growth rates should continue to result in higher employment.

Although the economic situation in Germany has substantially improved compared to the 1990s, Germany has not yet generated a strong endogenous growth process and, as a result, the economy remains vulnerable to external shocks. The positive effects of the recent reforms of income and corporate taxation notwithstanding, economic dynamism appears to be held back by rigidities, in particular in the labour market. While overall wage moderation has improved Germany's competitiveness in recent years, unit labour costs remain relatively high in the "New Länder", where the unemployment rate attains twice the national average and which are, as a consequence, dependent on large transfers from the West. Tax and benefit systems contribute to the general unemployment problem, as relatively high marginal income taxes and the simultaneous loss of social assistance payments can leave low-income earners in an unemployment trap. There is a risk that without reforms in the labour market and of the transfer mechanisms growth rates in Germany will remain subdued.

Budgetary policy

Last year, Germany achieved its consolidation target, as the deficit net of UMTS proceeds fell to 1.0 per cent of GDP (1.5 per cent surplus with UMTS). In addition, due to the UMTS proceeds significant progress was made in accelerating debt reduction. According to the 2000 update of the German stability programme, the government deficit should fall gradually to zero by the year 2004. About half of the adjustment burden is based on budgetary improvements in Länder and communes. Deficit reduction should be achieved mainly by reducing expenditures, while the tax burden should fall. The updated stability programme foresees, however, a temporary increase in the deficit to 1½ per cent of GDP in 2001 as a result of the tax reform. The long-term sustainability of public finances will be improved by the pension reform which is under way. Long-term budgetary risks remain, however, because health care and dependency payment schemes are not yet appropriately dealing with the consequences of population ageing. In view of the above, and considering that Germany is a member of the euro area, budgetary policy should aim to:

i. attain a general government deficit of 1½ per cent of GDP in 2001; to this end,

growth of government expenditure in 2001 should respect the projections set in the framework of the November 2000 "Finanzplanungsrat";

ii. when preparing the budget for 2002, maintain the planned reduction in the general government deficit to 1 per cent of GDP, even if economic growth in 2001-02 should turn out lower than projected in the updated stability programme of October 2000, so as to ensure that the medium-term target of a balanced budget by 2004 can be met; in the event of higher than projected tax revenues these should be used to reduce the deficit below the targeted level;

iii. reinforce from 2001 onwards the co-ordination of budgetary policy among the various levels of government by strengthening the role of the "Finanzplanungsrat" and, eventually, in the framework of a national stability pact; and

iv. in order to secure the longer-term sustainability of government finances continue the implementation of the pension reform and start in 2001 the elaboration of reforms of the health care sector and of dependency insurance, particularly of long-term care for the elderly.

Labour markets

The labour market situation in Germany continued to improve in 2000. Employment growth accelerated, with job creation increasing at a pace not witnessed in the last decade, and unemployment fell to 8.1 per cent. However, the overall improvement has still not reached the eastern part of the country, where employment decreased even further and unemployment remained fairly stable at 16.7 per cent. Significant measures were taken to reduce the tax burden on labour in the recent tax reform. While the pension reform package has not yet passed the second chamber, pension contributions were marginally reduced in 2000. However, the combined effects of tax and benefit systems can still result in disincentives to work. The German labour market is characterised by a relatively high degree of regulation. Active labour market programmes (ALMPs), especially in the eastern part of the country, appear to be inefficient in terms of reintegration into the labour market and tend to be incorrectly used as an instrument of social policy. The strong regional dimension of unemployment demonstrates the need for further action to enhance mobility and the adaptability of wages. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Germany should be to:

i. target ALMPs better towards those groups most prone to the risk of long-term unemployment and ensure that training better matches the demands of the labour market. Improve the efficiency of ALMPs, in particular in the New Länder. Continue to encourage the wage formation process to better take into account productivity and local labour market conditions;

ii. complement the income tax reform with further reforms of the tax and benefit system to make work pay. Further steps should be taken to reduce the still-high level of non-wage labour costs, in particular for low wage labour; and

iii. take measures, where appropriate in the framework of the "Alliance for Jobs", to make work contracts and work organisation more flexible and to improve the conditions for life-long learning.

Product markets and the knowledge-based economy

German product markets are open to international competition. Productivity levels are around the EU average but relative price levels are somewhat above what one would expect for a country with its standard of living. Germany has taken several measures to improve the functioning of its product markets, resulting in a better environment for business. In particular, some progress has been made in improving the framework for competition in the professions and handicrafts trade. Furthermore, the tax reform, the streamlining of business support mechanisms and the liberalisation of the telecommunications sector have started to have a positive impact. The electricity market has also been liberalised and a system of negotiated third party access to the electricity grid has been put into place. However, there are still large regional differences in access fees. The gas Directive has not yet been fully implemented into German legislation, thus hampering the introduction of competition. State aids are declining gradually, but levels remain above the EU average. Public procurement rules are still not sufficiently applied by some public authorities. Economic growth in the new Länder has been held back by an underdeveloped business services sector and a lack of innovative capacity, amongst other factors. ICT penetration is rising rapidly and measures have been taken to prevent a digital divide from appearing. A serious shortage of IT personnel has emerged. In view of the above, the main priorities for Germany should be to:

i. reform the higher education system and reduce shortages of IT personnel through education and training;

ii. reinforce competition in product markets by ensuring an increased opening-up of public procurement, continuing the policy of gradual reductions in State aid, and continuing to decrease the regulations for the professions and handicrafts trade; and

iii. reduce the large regional differences in the fees for the use of local electricity distribution networks; create a sector-specific regulatory authority for energy.

Capital markets

In Germany, several actions have been taken to improve the functioning of the regulatory framework for capital markets. In particular, the Fourth Financial Market Promotion Act (Finanzmarktförderungsgesetz) will be tabled as a draft in June 2001 and implemented in 2002. It proposes measures to deregulate stock market law, improve rules on stock market manipulation, and to provide greater legal certainty for futures. Furthermore, Germany has announced a reform of its financial services regulation by creating a single federal agency for the supervision of the banking, insurance and securities sector in order to meet the challenges of the ongoing integration of financial markets. Actions have been taken to rationalise and simplify programmes which aim to make risk capital available to SMEs and start-ups. More generally, the reform of the corporate tax system as well as the proposed reform of the

pension system should further promote capital markets, and a law has been tabled on take over bids. An expert commission has been created to draw up a code of good practice in the field of corporate governance, and a law was introduced to facilitate the introduction of registered shares (Namensaktien). In view of the above, the main priority for Germany should be to:

i. further develop the risk capital market by continuing efforts to establish a fiscal and regulatory framework more conducive to investment and entrepreneurship.

4. GREECE

Economic activity was buoyant in Greece in 2000 and is expected to accelerate in 2001 and 2002, real GDP rising by around 4.8 per cent in 2002. Strong domestic demand will be supported mainly by investment; investment in construction in particular, is expected to accelerate in view of the preparation for the Olympic Games in 2004. Moreover, lower interest rates, brought by participation in the euro area, should boost activity. The external current balance is expected to deteriorate further under the impact of fast increasing imports induced by strong domestic demand and of slowing export markets for goods. Consumer prices accelerated in 2000 and reached 4.2 per cent in December. In line with moderating import prices, inflation is expected to decelerate in 2001 and 2002; however, there are serious risks of overheating in a context of buoyant activity and easing monetary conditions. The acceleration in economic activity will contribute to improve gradually the labour market situation; still, the rate of unemployment is expected to remain high.

Inflation risks might persist in 2001, requiring appropriate stabilizing policy measures. In such a context, budgetary policy will be an important available economic instrument in order to contain inflationary pressures. Wage developments will also be crucial in this respect. Continuing budgetary consolidation efforts are also needed to lower the high level of the government debt ratio and to prepare for long term challenges resulting from the ageing population. Structural reform in the labour, product and capital markets remain priority areas with a view to increasing productivity, facilitating job creation and improving the external competitiveness of the economy.

Budgetary policy

In 2000, the general government deficit was reduced to 0.9 per cent of GDP from 1.8 per cent of GDP in 1999. The 2000 stability programme projects the general government balance to turn into a surplus equal to 0.5 per cent of GDP in 2001 and to 1.5 per cent of GDP in the following year; the budgetary projections included in the programme are based on high real GDP growth assumptions of around 5 per cent in both years. The budgetary strategy is centred on achieving high government primary surpluses reaching about 7 per cent of GDP in 2001 and 2002, while fully benefiting from lower interest payments following the decline in interest rates and in the debt ratio. However, the programme provides for a significant reduction in general government current primary expenditure only in 2002. In view of the above, and considering that Greece is a member of the euro area, budgetary policy should aim to:

i. ensure that the budgetary target of a surplus of 0.5 per cent of GDP set for 2001 is met and be ready to tighten the budgetary implementation in 2001 should inflationary pressures persist;

ii. maintain in the budget for 2002 a budgetary stance clearly oriented towards price stability; to this end, respect the government primary surplus objective of 7 per cent of GDP mainly through fast retrenchment in government current primary expenditure applying clear and binding norms;

iii. pursue the reform of the public sector in order to reduce its size in the medium-term with a view to improving the competitiveness of the economy and to

alleviating the burden on public finances; and

iv. accelerate the implementation of the reform of the social security sector in order to ensure the viability of the system; in particular, initiate in 2001 the reform of the pension system needed to address the challenges resulting from the ageing population.

Labour markets

After a fall in employment in 1999 despite rapid economic activity, employment grew by 1.2 per cent in 2000 allowing a fall in the unemployment rate. Despite this positive development, the labour market in Greece is still characterised by a low employment rate (55.4 per cent in 2000), a high unemployment rate, and a strong degree of labour market segmentation evidenced by high female and youth unemployment. A number of recent measures have aimed at improving the labour market situation, including changes to some taxes and benefits, and the adoption of a second wide-ranging package of labour market measures. Moreover, implementation of active labour market programmes and the modernisation of the Public Employment Service is continuing. Despite recent measures, the labour market still displays a number of rigidities including: complex and heavy regulation; insufficient decentralisation of wage bargaining; and important distortions to labour market incentives emerging from the tax and benefit system. Moreover the educational system seems to equip people inadequately for the labour force. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Greece should be to:

i. ensure the full implementation of recent labour market reform packages, and further build upon these efforts by loosening restrictive employment protection legislation in particular;

ii. eliminate major distortions arising from labour taxes and pension entitlements, thus improving incentives to work, in particular in the formal sector;

iii. ensure that wages better take into account productivity and local labour market conditions, in particular by making opt-outs included in the territorial employment pacts a practical possibility; and

iv. increase investment in and improve educational and training systems in order to enhance the skills of the labour force.

Product markets and the knowledge-based economy

Greece is relatively little integrated in EU product markets, not least due to its geographical position. Labour productivity is improving but remains below the EU average. Price levels are below the EU average, but somewhat higher than what one would expect for a country with its standard of living. Reforms in the product markets continue but remain relatively slow. Progress has been made in completing the regulatory and institutional framework for the opening up of network industries, but the pace of liberalisation remains slow, in particular in gas and sea transport. During 2000, privatisation of state-owned companies continued, but with somehow less vigour than in previous years, and some measures were taken to foster start-ups. The transposition record of internal

market legislation remained the poorest in the EU and only modest progress was made in improving the business environment. Despite a rapid increase in ICT spending and penetration in recent years, Greece is still a relative latecomer in the development of the knowledge-based society. In view of the above, the main priorities for Greece should be to:

i. continue to reduce the regulatory and administrative burden on business, enhance the performance of the public administration and improve the coherence of the corporate taxation system;

ii. take additional measures to increase R&D spending;

iii. continue to promote the wider diffusion of ICT and the use of e-commerce;

iv. improve the transposition record of internal market legislation, particularly in the area of public procurement; and

v. speed up the announced liberalisation of the gas and sea transport sectors and reinforce competition in already liberalised utilities.

Capital markets

Capital markets in Greece continue to develop rapidly, assisted by improvements in the regulatory framework and in market infrastructure. More specifically, development of the risk capital market has been facilitated by the creation of a new equity market for SMEs, by the creation of a Fund to foster early-stage investment in SMEs and by further tax relief on capital gains. Nevertheless, further development of the risk capital market would be desirable. Privatisation is enhancing competition in the domestic banking sector. Changes in the structure of the banking system and the process of financial integration with the rest of the EU means that co-operation between supervisors across sectors and across borders is increasingly important. In view of the above, the main priorities for Greece should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework that is conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws; and

ii. ensure that supervisory arrangements across sectors and across borders are keeping pace with developments in the financial system.

5. SPAIN

GDP growth maintained a robust pace in 2000, but with a clearly decelerating path in the second half of the year due to the slowdown of domestic demand partially offset by a positive external contribution. Prospects for 2001 and 2002 point to weaker but more balanced growth. In 2001 domestic demand is expected to decelerate further with a modest narrowing of the external deficit, and lower inflation. In 2002, GDP growth is forecast to recover slightly, mainly due to private consumption benefiting from an increase in real disposable income, caused by more favourable price developments, and steady job creation.

Although unemployment continued to decline in 2000, labour market problems remain. The share of fixed-term contracts represents almost one third of total employment. Wide regional disparities in unemployment persist. In addition, price developments in 2000 were worse than expected, due both to the behaviour of more volatile items (energy and unprocessed food) and to an acceleration in underlying inflation. Fiscal consolidation is expected to continue over the medium term as projected in the 2001 updated stability programme, but more decisive steps are needed in order to cope with the budgetary consequences of ageing. Finally, economic policy must take into account the need to foster the knowledge-based society so as to improve the medium-term prospects of the Spanish economy.

Budgetary policy

In 2000 the general government accounts registered a deficit of 0.3 per cent of GDP, 0.9 percentage points lower than in 1999. According to the 2001 updated stability programme, the general government sector is expected to be in balance in 2001 and to reach a surplus of 0.3 per cent of GDP by 2004. The fiscal strategy outlined in the update is similar to the two previous programmes. It relies on restrained growth of primary current expenditure, enabling higher public investment and, after 2002, a reduction in the tax burden. Given Spain's particularly exposed demographic profile and the implied adverse budgetary consequences of ageing, the sustainability of public finances is a matter of concern. As a result, and considering that Spain is a member of the euro area, budgetary policy should aim to:

i. achieve a budgetary position of balance for 2001 as set in the updated stability programme, especially through primary current expenditure restraint. Moreover, there should be a readiness to tighten fiscal policy further to counterbalance additional inflationary pressures;

ii. prepare the 2002 budget considering the 2001 updated stability programme target as a minimum, carrying forward any better than expected results in 2001 and taking into account the need to counteract inflationary pressures. Additionally, ensure that the fiscal reform envisaged for 2002 is supply-side-oriented and does not jeopardise the stability programme budgetary objectives; and

iii. increase the public pension fund reserve created in the 2000 Budget Law to at least 1 per cent of GDP by 2004, as envisaged in the latest updated stability programme. Additionally, legislate already in 2001 for a comprehensive overhaul of the public pension system to ensure its future viability.

Labour markets

Labour market performance has improved markedly in Spain over recent years, with strong employment growth and a sharp drop in unemployment, from 24 per cent in 1994 to 14 per cent in 2000. Nevertheless, the country still suffers from very high structural unemployment with severe regional disparities, and a low employment rate, especially among women (40.3 per cent in 2000). Key structural problems include the failure of labour costs to adjust to productivity and local labour market conditions, and low labour mobility, partly owing to housing market rigidities and the operation of certain regional benefit schemes. Recent proposals for reforms of employment contracts would seem to go some way towards addressing rigidities in this area, although the experience of previous reforms suggests that much will depend on implementation. While expenditure on active labour market policies has grown substantially in recent years, less attention seems to be devoted to ensuring the efficiency of such measures, which can play an important role in further reducing long-term unemployment. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Spain should be to:

i. encourage reform of wage formation in order to better take into account productivity and local labour market conditions, and diminish obstacles to labour mobility, inter alia through improvements to the functioning of the housing market and regional benefit schemes;

ii. increase investment in and improve education and training, and ensure that active labour market measures are efficient and tailored to the needs of those most prone to the risk of long-term unemployment and to the demands of the labour market; and

iii. take steps to ensure, with the Social Partners, an appropriate balance between flexibility and security, by means of the effective implementation of recently approved employment contract reforms, with a view to early progress in terms of a reduced share of fixed-term contracts, greater use of the part-time contract and a higher share of female employment.

Product markets and the knowledge-based economy

Although Spain's integration into the European goods markets has constantly increased in the 1990s, the openness of the Spanish economy is still less than that of other large Member States. Similarly, labour productivity is relatively low. In 2000, Spain has taken several measures to improve the functioning of its product markets. The transposition of internal market legislation and the liberalisation of the telecommunications and energy markets have been speeded up; the Community rules on public procurement have been implemented more effectively and the level of State aid has been reduced. Further measures have been taken to reduce the relatively high administrative burden on businesses, especially SMEs. To tackle the problem of the low level of R&D expenditure, a three-year National R&D and Innovation Plan has been launched. However, public expenditure on education is also relatively low compared to other EU countries and internet penetration is the second lowest in the EU. In view of the above, the main priorities for Spain should be to:

i. take measures to increase the basic ICT skills of the population and to increase the supply of highly qualified research and ICT personnel; and

ii. continue the implementation of the plan to simplify the regulatory framework for SMEs.

Capital markets

Capital markets in Spain have been characterised by a significant privatisation programme and regulatory measures to enhance transparency. Market efficiency is being improved by the consolidation of several national securities clearing and settlement systems. Consolidation is also underway in the banking sector, which has resulted in increased profitability and has fostered the use of more advanced technology. The risk capital market is expanding due to favourable tax measures and the creation of the Nuevo Mercado but remains underdeveloped, particularly with regard to early stage investment. Therefore, measures to further develop this market would be desirable. In view of the above, the main priority for Spain should be to:

i. develop further the risk capital market by further easing constraints on institutional investors which may limit their investment in equity capital, and by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.

6. FRANCE

Despite some deceleration resulting from weaker external demand, economic activity in France is expected to remain sustained: real GDP growth is currently projected to reach slightly less than 3 per cent in both 2001 and 2002. In both years, strong domestic demand should continue to be the main factor underpinning the robust trend in activity which started three years ago; the negative effects on household purchasing power which stemmed from the past surge in oil prices will progressively fade away; at the same time, the tax reductions planned for 2001 and 2002 will contribute to an acceleration in private consumption. In such a context of favourable demand prospects, productive investment is expected to remain dynamic. Expanding economic activity will continue to have a high job content thus enabling the unemployment rate to pursue its rapid decline.

Although unemployment has sharply declined in the course of 2000, it remains high and wage and price developments have remained moderate until now. However shortages are gradually emerging in the labour market. Moreover, the rate of capacity utilisation in the manufacturing sector has reached a high level by historical standards. Whilst these developments do not seem to constrain production as yet, they represent a potential risk calling for appropriate policy measures; the sustainability of the current economic expansion relies on improved supply side conditions, including higher labour market participation, a more favourable environment for investment and increased competition. Furthermore, the current macroeconomic situation provides an opportunity to eliminate the general government deficit at a faster pace: this would be particularly appropriate in order to prepare for future budgetary challenges stemming notably from the ageing population.

Budgetary policy

In 2000, the general government deficit was reduced by 0.3 percentage point to 1.3 per cent of GDP, below the targeted deficit for that year. According to the 2000 updated stability programme, further reductions in the deficit ratio are to be pursued in 2001 and beyond. The public finances are expected to come to balance or a surplus in 2004 at the latest. The French budgetary strategy is based on a tight control of government spending in real terms; about half of the margins created by such restraint are projected to be allocated to reducing the government deficit and the remaining to tax relief. In a longer term perspective, government finances will face an increasing burden stemming from ageing of population. A public pension reserve fund was created in 1999 in order to partly cushion the budgetary impact of ageing population. In view of the above, and considering that France is a member of the euro area, budgetary policy should aim to:

i. achieve in 2001 a general government deficit of 1 per cent of GDP (excluding UMTS receipts) as targeted in the 2000 updated stability programme; to this aim, ensure that the increase in real government expenditure will not exceed the projected 1.8 per cent in 2001;

ii. in the framework of the budget for 2002, contain government expenditures in real terms within the 1.6 limit in order to secure the achievement of the 0.6 per cent government deficit target set in the 2000 updated stability programme; and

iii. allocate in 2002 and beyond, as a matter of priority any additional available margin to strengthen the budgetary position in order to prepare for long term challenges, notably the burden for public finances which will result from ageing of population; also in view to secure the long term sustainability of government finances start without delay, the undertaking of a comprehensive reform of the pension system.

Labour markets

Recent developments in the French labour market continue to be impressive: in 2000 employment grew strongly by 2 per cent contributing to a marked reduction in the unemployment rate to 9.5 per cent. Wage developments have also been moderate, despite concerns about emerging labour shortages in some sectors and professions, which are likely to be exacerbated by the reduction of working time. Despite good recent performance, the unemployment rate is still high and the employment rate is relatively low, especially for older workers (29 per cent in 2000). There is also a need to increase labour supply, in particular of unskilled workers and older workers. High levels of structural unemployment are due in part to remaining disincentives to work resulting from the tax and benefit system despite recent measures to reduce inactivity traps, and relatively strict labour market regulation. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for France should be to:

i. consolidate recent reforms of the tax and benefit system by improving the incentives for older workers to remain in work, and by removing the remaining disincentives to take up part-time and full-time work. In this context, particular attention should be paid to early retirement schemes and income guarantee schemes, in particular for unskilled and low-paid workers;

ii. monitor closely the positive and negative effects of the implementation of the 35-hours working week legislation to continue to ensure that it does not generate any adverse medium-term effects on wage costs, labour supply and work organisation; and

iii. reform employment protection legislation to promote job creation.

Product markets and the knowledge-based economy

The French economy is open to international competition. Labour productivity is relatively high. Relative price levels remain somewhat above what one would expect for a country with its standard of living. Progress has been made in promoting entrepreneurship and State aids have been reduced. However, France's record in transposing the internal market directives is the second worst in the EU and network industries are being liberalised slowly. Moreover, despite recent progress, the administrative burden on business remains relatively high. Recently, France has adopted a decree which should open further public procurement and increase its transparency. Finally, ICT penetration is rising rapidly and measures have been taken to prevent digital divide from appearing. In view of the above, the main priorities for France should be to:

i. accelerate the liberalisation process in the network industries, especially in the gas and electricity sectors;

ii. speed up transposition and implementation of internal market directives;

iii. continue the reduction of ad hoc State aids; and

iv. continue efforts to reduce the administrative burden on business by simplifying procedures and developing new means of electronic communication with the public authorities.

Capital markets

Capital markets in France continue to develop with the equity market, in particular, expanding both in terms of companies listed and market capitalisation. The equity market is further benefiting from the creation of long-term savings plans, while market efficiency is being enhanced by greater transparency and improvements in investor protection. Moreover, the equity market has become more integrated internationally due to the merger between Paris, Amsterdam and Brussels stock exchanges. More specifically, risk capital investment has benefited from a series of measures taken in recent years but venture capital investments remained slightly below the EU average in 1999. Nevertheless, further development of the risk capital market would be desirable. Privatisation of the banking sector is continuing, with the State divesting its share in the last publicly owned bank, the Hervet Bank. Changes are also underway in the supervisory framework, as reflected in the forthcoming merger of the securities regulatory authorities and increased co-operation between banking and insurance supervisors. In view of the above, the main priorities for France should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws; and

ii. continue to streamline supervisory arrangements across sectors and across borders to ensure that they keep pace with developments in the financial system.

7. IRELAND

After very high growth in 2000, with the level of output considerably above potential, a slowing in growth is expected in 2001-2002 with labour and other capacity constraints becoming more evident. The slowdown in the US economy and the effects of foot and mouth disease are additional factors contributing to the slowing in growth. Lower export market growth and a higher real exchange rate, coupled with an expansionary budget for 2001 are expected to increase the relative contribution of domestic demand to growth. After a sharp increase in inflation in the course of 2000, the inflation outlook is for a moderate decline in 2001-2002: while some factors that impacted significantly on inflation in 2000 are expected to unwind, domestically-generated inflation is expected to remain relatively high.

High growth since the mid-1990s has virtually brought full employment. The task now is to maintain good, sustainable growth by containing inflationary pressures and tackling labour and infrastructure constraints. In particular, the contribution of fiscal policy to achieving these goals without threatening economic stability is a major challenge. Given that the basic pay rises for 2001-2002 in the recently re-negotiated national agreement have been revised upwards in response to higher than expected inflation and that drift over and above these provisions is likely in a tight labour market, avoiding a wage-price spiral constitutes another challenge. The contribution of further measures to increase competition in some sectors and more business R&D expenditure to strengthening the supply-side are also key policy issues.

Budgetary policy

In 2000, due to a strongly growing economy the surplus is estimated to have been 4.5 per cent of GDP, 1.2 percentage points higher than originally expected. The 2000 update of the stability programme for the period 2001-2003 projects high surpluses of 4.2 per cent of GDP on average and a further decline in the debt ratio to less than one quarter of GDP by 2003. The public finances are sound and the recent decision to make an annual contribution of 1 per cent of GNP to the National Pensions Reserve Fund until 2055 further enhances their long-term sustainability. However, in its meeting of 12 February, the ECOFIN Council considered budgetary plans for 2001 inappropriately expansionary and thus inconsistent with the 2000 BEPGs, and issued a recommendation to Ireland to end this inconsistency. In view of the above, and considering that Ireland is a member of the euro area, budgetary policy should aim to:

i. remove the inconsistency with the 2000 BEPGs, engendered by the budget plans for 2001, with countervailing budgetary measures during the current fiscal year;

ii. prepare a budget for 2002 that contributes to an orderly easing of the pace of demand;

iii. improve expenditure control, re-introducing from 2002 clear norms on spending aggregates; and

iv. continue to accord high priority to the National Development Plan for infrastructure and human capital investment, but subject to achieving and maintaining the stability objectives of fiscal policy.

Labour markets

The Irish labour market has continued to perform strongly with further gains in employment exceeding the growth of the labour force, leading to a persistent fall in the unemployment rate which is now 4.2 per cent. The employment rate of 64 per cent in 2000 exceeds the EU average. While the female employment rate, 53 per cent in 2000, has increased to around the EU average, it remains the 6th lowest in the Union. Against the background of an increasingly tight labour market, labour shortages are becoming more widespread and wage inflation is accelerating, constituting a significant risk of wage drift. Recent growth in the labour force, which is beginning to slow down, has been significantly due to continued robust growth in the working age population. The previously recorded strong growth in participation rates is diminishing and there remains scope for considerable further gains. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Ireland should be to:

i. promote wage developments that are consistent with the maintenance of price stability; and

ii. continue to focus measures on increasing the participation of women in the labour market.

Product markets and the knowledge-based economy

Ireland is well exposed to international competition. Labour productivity is well above the EU average and consumer prices are around the EU average. The regulatory burden on business is relatively low and the liberalisation process is advancing, in particular in the electricity and gas sectors. However, there is still insufficient competition in some product market sectors. More progress is also needed to privatise large state-owned incumbents and to transpose internal market legislation. Whilst Ireland is well advanced in terms of ICT production and internet penetration, public R&D expenditure is relatively low and business R&D spending is concentrated in foreign-owned firms. In view of the above, the main priorities for Ireland should be to:

i. take measures to introduce more competition into specific market segments; strengthen the application of competition policy economy-wide;

ii. introduce measures to continue the liberalisation of transport, electricity and gas sectors, and to reduce the market power of large state-owned incumbents in the network industries; and

iii. implement the government's plans for a substantial increase in R&D expenditure through programmes to support R&D in SMEs, to promote co-operative networks within industry and to develop the national and regional research infrastructure.

Capital markets

Evidence of on-going structural change in Ireland's capital markets has been seen in the decision of the Irish Stock Exchange to buy electronic trading technology from the Deutsche Börse and in the creation of a stock market for high technology shares (ITEQ). Privatisation of the banking sector is also proceeding. The government has taken

various measures to support the risk capital market, notably through the Seed and Venture Capital Measure of the EU Operational Programme for Industry. Nevertheless, there are still notable gaps in the provision of seed and early stage financing. There have been important changes made to the framework for regulation and supervision of financial markets. An Irish Financial Services Regulatory Authority (IFSRA) is to be established which will be responsible for prudential regulation of both the banking and insurance sectors and for consumer protection. A strategic review of the banking system has suggested that while concentration of the banking sector is not a problem, there should be a revision of the way of assessing proposed mergers to ensure that they are in the interests of customers and the economy generally. Finally, an Office of the Director of Corporate Enforcement has been established with the aim of improving standards of adherence to company law by active enforcement. In view of the above, the main priority for Ireland should be to:

i. develop further the risk capital market, particularly with a view to improving access to start-up and early-stage financing.

8. ITALY

The marked upswing recorded in 2000, with real GDP growth almost doubling on the year, is expected to slow in 2001, though with growth still well above the sluggish rates of the 1990s. The loss of momentum results mainly from a weakening external environment, especially in non-EU markets where Italy has a relatively large exposure. Domestic demand growth, particularly of private consumption, is also expected to weaken despite significant stimulus from tax cuts as the latter will be counterbalanced by a less buoyant performance of the labour market and a slow-down in expenditure on durable goods. Employment creation is forecast to continue at a somewhat slower rate. The unemployment rate should continue to fall. Lower oil prices and an assumed appreciation of the exchange rate will gradually reduce inflationary pressures in the course of the year 2001. The pace of economic expansion is expected to accelerate again in 2002, responding to a forecast recovery of the world economy.

The recent buoyancy of employment growth continues to conceal a wide regional disparity, with signs of labour shortage emerging in the North. In the South, despite sustained employment growth, the unemployment rate decreased only from 22 per cent in 1999 to 21 per cent in 2000. In addition, labour market regulation remains somewhat skewed towards employment protection of workers in permanent jobs in medium- and large-sized firms and the unemployment benefit system is the least generous and one of the most fragmented in the EU. The late development of the knowledge-based society and, linked to that, the relatively low involvement of business in R&D, may weaken or retard the medium- and long-term growth potential of the economy. Liberalisation of utilities has continued but a lack of competition in local public utilities might be a risk to the efficiency of the general economy. Finally, the still high public debt to GDP ratio tends to limit the share of growth-enhancing public expenditure, such as for education, R&D or investment in infrastructure.

Budgetary policy

The general government deficit in 2000 was 0.3 per cent of GDP, while the debt-to-GDP ratio fell to 110.2 per cent, well below the projected 112.1 per cent. Excluding receipts from UMTS licences, the deficit ratio was 1.5 per cent of GDP, lower than the previous year's outcome, but slightly higher than the revised target of 1.3 per cent. According to the December 2000 update of the stability programme, the budget balance to GDP ratio is projected to continue to improve in 2001 and 2002, to reach a balance in 2003. The debt ratio is expected to fall below 100 per cent of GDP by 2003. Within this framework, and considering the budgetary strategy of achieving a gradual reduction in the tax burden, controlling current primary expenditure will remain a key issue. As regards the future budgetary impact of an ageing population, Italy has taken a number of steps in recent years to reform the pension system, and a reassessment of the parameters of the system is scheduled to take place in 2001. In view of the above, and considering that Italy is a member of the euro area, budgetary policy should aim to:

i. achieve in 2001 a general government deficit of 0.8 per cent of GDP as targeted in the 2000 updated stability programme; ensure when preparing the budget for 2002 the respect of the steady path of deficit reduction in

order to achieve the medium-term objective of a balanced budget in 2003, by securing primary surpluses at the high levels projected in the programme;

ii. match any loss of revenue stemming from additional reductions of taxes and social security contributions with offsetting expenditure cuts; ensure in the formulation of the budget for 2002 a more comprehensive rationalisation of public spending, with a view to improving the supply-side conditions of the economy;

iii. strengthen the domestic stability pact, translating in a more rigorous way its provisions for the decentralised administrations, in order to ensure already in 2001 more effective control of current primary expenditure, in particular on healthcare; and

iv. take every opportunity to improve budgetary targets and accelerate the reduction of the high government debt ratio, also in order to prepare for long-term budgetary challenges from population ageing; also with a view to securing the long-term sustainability of government finances, proceed as scheduled to the reassessment of the parameters of the pension system in 2001 including further steps to promote the expansion of supplementary privately-funded pension schemes.

Labour markets

The Italian labour market situation improved substantially in 2000. Employment grew by almost 2 per cent (Italian labour force survey) and unemployment fell from 11.3 per cent to a still high 10.5 per cent. This is a result of higher economic growth and increased hiring flexibility, thanks to the progressive removal of many restrictions on the application of "atypical contracts" (fixed-term, temporary and part-time contracts). However, the Italian labour market is still characterised by a low employment rate, especially for women and older workers, and wide regional disparities in unemployment and productivity. The unemployment rate in the North is only 4.6 per cent compared to 8.2 per cent in the Centre and 21 per cent in the South. Higher wage differentiation can compensate productivity gaps across geographical areas. A higher degree of wage differentiation should be encouraged. Despite some recent measures, the unemployment benefit system remains fragmented and limited in scope, with different schemes and disparities in benefit conditions (level and duration). The still relatively low degree of protection of non-employed and "atypical workers" combines with stricter protection of workers in permanent jobs in medium and large firms, in maintaining the duality of the labour market. The tax wedge on labour costs has been reduced, especially that on low-paid workers but the overall tax burden remain high. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Italy should be to:

i. reinforce efforts to let wage developments better take into account productivity and local labour market conditions;

ii. continue to increase labour market flexibility by combining measures to improve social protection of the unemployed with an easing of job protection for employees on permanent contracts; and

iii. continue to bring down the tax burden on labour by gradually reducing tax and social security contributions. In particular, the reduction of the tax wedge on labour costs should be particularly targeted at the lowest end of the wage scale, thereby increasing the employment opportunities for low-skilled workers, while reducing the budgetary impact of the tax cuts and complying with the need for continued progress in public debt reduction.

Product markets and the knowledge-based economy

Italy is less integrated in European and international product markets than other large Member States. Price levels are below the EU average, except for energy products. Italy has made good progress in implementing internal market legislation, improving the businesses environment, streamlining regulation and reducing State aids. Liberalisation of utilities has continued, but competition in the local provision of utilities remains limited. Competition in some service sectors is also insufficient. While labour productivity in Italy is higher than the EU average and despite the rapid increase in ICT penetration, low R&D expenditures, by the business sector in particular, can contribute to explain the relatively poor innovative performance, as reflected by the large share of low-tech sectors in industrial production and export specialisation. These latter problems also have a strong regional dimension. In view of the above, the main priorities for Italy should be to:

i. promote business sector involvement in R&D and further encourage the wider diffusion of ICT and the use of e-commerce;

ii. ensure that the liberalisation process in the energy sector will lower prices for households and small business users who are still unable to choose their provider; ensure the competitive provision of utilities at the local level in the framework of the reform of local public services;

iii. reduce further the administrative burden for businesses and continue efforts to streamline regulations and administrative procedures; and

iv. increase competition and remove access restrictions in the area of professional services.

Capital markets

Capital markets in Italy are continuing to benefit from legal and regulatory reforms, the continuation of the privatisation process, and the restructuring and consolidation of the banking sector. New rules on mutual funds allow for the introduction of new products and facilitate new investment opportunities. The risk capital market has grown and should benefit from a proposed new law on bankruptcy and insolvency that encourages entrepreneurship. Plans to review the current tax regime for stock options and a more consistent application of the tax regime to different securities and to collective investment

schemes of different nationality should also favour the risk capital market. There has also been a broadening of the range of companies which can benefit from provisions which favour the equity financing of corporations. Nevertheless, the risk capital market remains one of the less developed in the EU. In view of the above, the main priority for Italy should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, and promoting a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.

9. LUXEMBOURG

Economic activity was particularly buoyant in Luxembourg in 1999 and 2000. Some deceleration in real GDP growth is to be expected in 2001 and 2002 to around 5 per cent per year. Still very dynamic activity will be sustained by strong domestic demand, particularly private and public consumption. As employment is projected to keep rising at rates around 4 per cent a year, the economy will continue to draw large numbers of cross-boarder workers. Wage increases accelerated in 2000 reaching 5 per cent as a result of the tightening of the labour market, the direct impact of acceleration in inflation on wages through the automatic indexation mechanism and a relatively high wage agreement in the public sector. Inflation is expected to decelerate from a peak of 3.8 per cent reached in 2000, in line with moderation in oil prices; however underlying inflation, which had accelerated in 2000, is likely to remain relatively high.

Economic performance was strong recently and public finances particularly sound. However, acceleration in wages and prices represents an important economic policy challenge; moreover, tensions which have recently emerged on the labour market also call for appropriate policies aimed at increasing the relatively low national participation and employment rates.

Budgetary policy

As a result of fast growing activity and employment, the surplus of the general government rose to 5.3 per cent of GDP in 2000; a decline to about 3-4 per cent of GDP is to be expected in 2001 and 2002 due to a large reduction in the income tax which will be implemented in these two years. Government expenditure is expected to continue to increase at a fast pace, although declining moderately in share of GDP; expenditure will be mainly devoted to investment in infrastructure and to supporting specific policy objectives, especially the development of the information society and research. In view of the above, and considering that Luxembourg is a member of the euro area, budgetary policy should aim to:

i. tighten budgetary conditions when executing the budget in 2001 and when preparing the budget for 2002 in order to counter inflationary pressures should they persist; and

ii. monitor closely the increase in government expenditures in order to safeguard the balance of public finances should real GDP growth falter as well as their sustainability in the long term taking account of the ageing population.

Labour markets

The overall performance of the Luxembourg labour market was good in 2000, due to a large extent to the availability of cross-border workers. The unemployment rate was very low at 2.2 per cent. Nevertheless, the labour market has been tightening in terms of accelerated wage increases and inflation pressures, and this underlines the need to exploit better the country's own labour potential. Low national employment rates, in particular for women (48 per cent) and older workers (26 per cent), reveal the significant reserve of own labour resources. Early withdrawal from the labour market has been encouraged by early retirement, pre-retirement and disability pension schemes. In view of the

above, while vigorously implementing all the Employment Recommendations, the main priority for Luxembourg should be to:

i. make further efforts to increase the national employment rate, especially for older workers by increasing the incentives in early retirement, pre-retirement and disability pension schemes to remain in employment, and for women by removing obstacles to their remaining in employment or re-entering the labour market.

Product markets and the knowledge-based economy

Luxembourg is a small open economy, very well exposed to international competition.

Productivity is high and, despite a recent increase, prices are not unduly high, except for electricity. Significant progress has been made to improve the transposition of internal market legislation, to reduce regional aids, to speed up the liberalisation of network industries, and to catch up to the most recent developments in ICT. However, different elements, including price regulation, continue to limit the degree of competition in product markets. In view of the above, the main priority for Luxembourg should be to:

i. implement the announced abolition of fixed and monitored prices.

10. NETHERLANDS

Strong macroeconomic performance was achieved in the Netherlands in recent years, culminating in a particularly buoyant 2000; economic activity is expected to decelerate somewhat in 2001 and 2002 mainly as a result of external developments, real GDP being still projected to grow by more then 3 per cent in both years. Strong domestic demand will continue to be the main factor of expansion, in particular, private consumption is expected to accelerate, boosted by a substantial rise in wages and employment, as well as the reduction in the tax burden resulting from the tax reform being implemented in 2001. Employment is expected continue to increase, resulting essentially from a higher activity rate. Inflation has significantly accelerated in 2000 as a result of a surge in import prices; under the mechanical effect of the increase in indirect taxes from the beginning of the year, but also as a result of endogenous pressures, inflation is expected to reach more than 4 per cent in 2001 and to remain around 3 per cent in 2002.

The substantial acceleration in wages since 1997 has brought fifteen years of wage moderation to an end; this resulted, in particular, in worsening external competitiveness following the very significant gains achieved during more than a decade. Taking into account the substantial tax cuts which have benefited the households disposable income especially in 2001, a key challenge is to ensure renewed wage moderation. Increasing tensions, emerging on the labour market raise the issue of new policy measures aimed at further fostering labour supply; this would imply more reform of passive benefits schemes aimed at increasing the activity rate. Moreover, improvement in labour productivity will be needed in order to restore the competitiveness of the economy as well as to prepare to face the challenge of the ageing population.

Budgetary policy

The general government balance turned into a surplus of 1 per cent of GDP in 1999 and of 2 per cent of GDP in 2000, including UMTS licences receipts equivalent to 0.7 per cent of GDP. The wide-ranging tax reform, which entered into force from 1 January 2001, will lead to a significant reduction in budgetary revenues from income tax and social security contributions which will be only partly compensated by an increase in several indirect taxes, among which the standard VAT rate from 17.5 per cent to 19 per cent. Therefore, in 2001, according to the 2000 updated stability programme, the government surplus is expected to be lowered to 0.7 per cent of GDP. The shift from direct taxation of labour income to indirect taxation is especially meant to reduce the tax wedge on income from labour and thus provide incentive to work. However, from a stabilisation point of view, the current budgetary stance in the Netherlands is raising concern, as inflationary pressures are mounting. In view of the above, and considering that the Netherlands is a member of the euro area, budgetary policy should aim to:

i. maintain strict control of government expenditure despite lower expected economic growth, in order to limit the reduction in the government surplus in 2001 (projected at 0.7 per cent of GDP in the 2000 update of the stability programme) and to contain inflationary pressures;

ii. prepare a budget for 2002 the stance of which is firmly oriented at limiting inflationary pressures, thus improving the budgetary outcome as against 2001. To this end, the budgetary margins as defined in the 2000 update of the stability programme should be allocated taking into consideration cyclical conditions as a matter of priority and ensure a clear improvement in the budgetary position; and

iii. with a view to secure long-term sustainability of public finances taking into account the ageing population, use available budgetary margins for accelerated debt reduction as a matter of priority from 2002.

Labour markets

Dutch labour market performance remained among the strongest in the EU. Employment growth registered 2.5 per cent in 2000. While unemployment fell further to 2.8 per cent, robust labour force participation growth has contributed to limiting the strains that arise from labour market tightness. A range of measures has been taken to improve work incentives, e.g. the tax reform 2001 and measures to promote the participation of women and older workers in the labour force. However, while official unemployment is very low, the proportion of inactive recipients of passive benefits – in disability, sickness, and unemployment schemes - is still high. Also employment in terms of full-time equivalents is relatively low. This points to an unexploited potential for further labour supply growth. In view of the above, while vigorously implementing all the Employment Recommendations, the main priority for the Netherlands should be to:

i. continue reforms of the tax and benefit system to make work pay. Reforms should focus on the still high marginal effective tax rates, especially at the lower end, and relatively lax eligibility rules, in particular to foster labour force participation among older workers and to facilitate the labour market re-integration of people receiving passive benefits, including those receiving disability benefits.

Product markets and the knowledge-based economy

The openness of the Dutch economy and the now well established process of structural and regulatory reforms have created generally well functioning product markets, which is reflected in relatively low price levels. Measures have been taken to strengthen competition policy and to encourage entrepreneurship. The telecommunications sector is fully liberalised, which has contributed to low prices and a high ICT penetration. The reform process is continuing, but a certain 'fatigue' is emerging, which may delay further liberalisation in areas such as energy, public transport and health care. There is a concern that the liberalised markets will still be dominated by the former monopolists. Moreover, the value of tenders published in the Official Journal as a percentage of GDP remains the second lowest in the EU. The development of the ICT producing sector and the knowledge economy in general is held back by a shortage of qualified personnel and associated with that a very low volume of local ICT research, which might also be reflected in a rather disappointing overall labour productivity

growth rate. In view of the above, the main priorities for the Netherlands should be to:

i. take measures to improve the climate for innovation and to stimulate further ICT penetration, and, in particular, increase the supply of qualified ICT personnel and trained researchers; and

ii. reinforce the level of competition by further opening up public procurement and by facilitating market entry in electricity, gas, cable networks and public transport.

Capital markets

Capital markets in the Netherlands continue to develop. The equity market has become more integrated internationally through the merger of the Amsterdam, Paris and Brussels stock exchanges. More specifically, the risk capital market has developed rapidly with substantial venture capital investment at all stages including the earliest stages. Although the banking sector is relatively concentrated, the degree of competition in the sector seems adequate. By the creation of the Council of Financial Supervisors, the three supervisors strengthen the existing co-operation on cross-sector aspects of supervision. In view of the above, the main priorities for the Netherlands should be to:

i. develop further the risk capital market by establishing a fiscal framework more conducive to investment and entrepreneurship; and

ii. ensure that supervisory arrangements across sectors and across borders are keeping pace with developments in the financial system.

11. AUSTRIA

Following output growth of more than 3 per cent in 2000, budgetary restraint and a slowdown in external demand are expected to dampen economic activity in 2001. Budgetary consolidation will not only affect private households and enterprises through mainly tax related measures but also curb public consumption. Consequently, domestic demand is expected to decelerate in 2001. In addition, exports are likely to see a downturn, particularly in 2001, in step with the economic development of Austria's main trading partners. As a result, output growth in 2001 is estimated to slow down to some 2½ per cent. In 2002, domestic demand is expected to recover somewhat, since the negative effects on household purchasing power stemming from tax increases should fade away, while the planned introduction of a new childcare allowance should provide some fiscal stimulus. In addition, private consumption should be underpinned by continued employment growth and a further decline in unemployment, thereby offsetting the projected further small slowdown in export growth. GDP growth in 2002 is thus projected to remain steady.

A favourable medium and long-term growth outlook for the Austrian economy hinges on improved supply-side conditions: increased competition as well as less regulation to strengthen entrepreneurship; liberalisation concerning public utilities and the retail and transport sectors; and higher labour market participation, in particular of older workers. Moreover, to secure a rapid transition into a knowledge based economy several issues need to be addressed, in particular spending on research and development, deficiencies in the university education system, and problems in technology diffusion. In addition, a high tax burden is likely to affect adversely the growth potential of the economy.

Budgetary policy

In 2000, the general government deficit dropped significantly to 1.1 per cent of GDP from 2.1 per cent in 1999. However, taking into account higher-than-expected output growth as well as one-off revenues (UMTS proceeds, real estate sales) the underlying budgetary position was little changed. By contrast, the budget plan for 2001 and the budget proposal of the government for 2002 imply significant budgetary restraint. By 2002, the general government position is planned to be in balance, although at the expense of a sharp rise in the already high tax burden. Tax increases are estimated to raise revenues by 0.9 per cent of GDP in 2001. Some spending increases are planned in 2002, most notably generous childcare allowances. In net terms, the overall reallocation of resources amounts to a cumulative € 3.6 billion or 1.6 per cent of GDP over the period 2001-02. More than half of the overall consolidation until 2002 stems from the revenue side. Despite the ongoing budgetary consolidation programme, public finances are not yet on a sustainable footing in the longer term. Spending pressure in the public pension system is bound to increase in spite of its recent reform. In addition, the health care system is in need of reform to contain the fast rise of health related expenditure. In view of the above, and given that Austria is a member of the euro area, budgetary policy should aim to:

i. ensure tight budgetary execution at all levels of government in both 2001 and 2002 in order to meet the targets of the December 2000 update of the stability

programme of respectively, 0.75 and 0 per cent of GDP; realise expenditure savings as planned in the stability programme, in particular in the area of administrative reform and the social security sector;

ii. in the following years reduce the high tax burden, in particular on labour, without however jeopardising the budgetary consolidation objectives; this will call for additional and permanent expenditure savings; and

iii. in view of long term challenges - notably resulting from population ageing - continue reforms in the pension system: in particular review already in 2001 benefit levels and reconsider access to invalidity pensions in order to increase the average retirement age; in the health care sector: take measures to counter the rising spending pressures.

Labour markets

The good performance of the Austrian labour market continued in 2000. Employment growth continued, although somewhat weaker than in 1999, and the unemployment rate fell further to 3.7 per cent. However, at 29 per cent the employment rate of older workers is very low. This is particularly problematic in view of the tightening labour market and, in particular, the challenge of population ageing. In 2000, a gradual increase in the early retirement age (by 18 months by 2002) was introduced, along with other measures to make early retirement less attractive. An income tax reform reduced the general tax burden on labour. In view of the above, while vigorously implementing all the Employment Recommendations, the main priority for Austria should be to:

i. further reform tax and benefit systems to increase incentives for older workers to remain active in the labour market, including measures to facilitate the labour market re-integration of people receiving invalidity pensions.

Product markets and the knowledge-based economy

Austria is less exposed to international competition than other small Member States. Labour productivity is just below the EU average. Progress has been made in transposing internal market legislation and measures to enhance entrepreneurship are in the pipeline. However, the share of public procurement open to competition is low and, despite encouraging plans to speed up their liberalisation, the telecommunications, gas, and electricity sectors are still characterised by relatively high prices and rigidities. However, the most recent legislation provides for full liberalisation of the electricity sector by October 2001, and of the gas sector by October 2002. Finally, the conditions for a rapid development of the knowledge economy are not yet fully in place, and Austria still exhibits low level of R&D and ICT expenditure, and a significant shortage of ICT skills. However, Austria has announced reforms in these fields. In view of the above, the main priorities for Austria should be to:

i. transpose the Community's public procurement directives and further open up public procurement to competition, in particular at the provincial level; and

ii. implement fully the announced reforms to promote the development of the knowledge economy and take measures to

increase the supply of ICT-skilled personnel.

Capital markets

Capital market development in Austria been evident in a consolidation of the banking sector, with an increase in concentration and a significant further reduction in state holdings. The stock exchange has formed an alliance with the Deutsche Börse, and the two exchanges have created NEWEX in co-operation with the relevant exchanges for the trading of Central and East European securities. A number of reforms have been carried out to improve the regulatory framework, including implementation of EU directives, and actions to combat money laundering. Related measures include allowing prospectuses in English for security issues, with prospectuses available on the Internet, and an extension of the scope of the exemption from the duty to publish prospectuses for euro securities. A series of fiscal measures have been implemented, or are planned, including the abolition of the stock exchange turnover tax, changes to the inheritance tax on shares, tax benefits under certain conditions for stock options, and a doubling of the allowance for the issue of employee shares. Despite benefiting from some of these reforms, the risk capital market remains relatively underdeveloped, particularly in relation to early stage financing. A draft law on the creation of a unified financial market supervisory authority was presented mid-April 2001, aiming at upgrading of supervision and coping with developments in the markets. In view of the above, the main priority for Austria should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship.

12. PORTUGAL

Economic growth in 2000 is estimated at 3.3 per cent, close to the rate registered in the year before. However, the composition of growth changed markedly, with lower domestic demand being roughly offset by an acceleration in export growth. Economic activity is likely to slow in 2001-02 to a growth rate of slightly above 2½ per cent. A number of factors are behind this slowdown, notably efforts of private sector agents to redress their balance sheets following the recent sharp rise in indebtedness, supply constraints in various service sectors and in construction, and lower external demand. Employment grew by 1.7 per cent in 2000 and the unemployment rate fell to 4.2 per cent. Consumer price inflation rose considerably in 2000 and into 2001 under the impact of a significant increase in import prices, high pay rises associated with a tight labour market, and some temporary country-specific factors such as an upsurge in prices for unprocessed food. Although price pressures are expected to ease in the course of this year, average inflation in 2001 is expected to rise to more than 3 per cent but to come down again below this level in 2002 .

The buoyancy of domestic demand in Portugal over recent years has led to the accumulation of a large external imbalance. Its correction is a prerequisite for Portugal to return to higher levels of growth on a sound footing. The necessary adjustment process towards more balanced growth needs to be supported by budgetary policy, through tight expenditure restraint. In addition, external competitiveness has suffered from high wage growth in combination with relatively low productivity gains. As a consequence, wage moderation as well as policies enhancing the productivity growth are required to improve the performance of the economy in the medium term.

Budgetary policy

In 2000, the general government deficit fell to 1.4 per cent of GDP (1.7 per cent of GDP excluding UMTS proceeds). According to the 2001 update of the stability programme, the deficit ratio is to be reduced to 1.1 per cent in 2001 and to 0.7 per cent in 2002. A balanced government position is envisaged in 2004. The tightening of the budgetary stance in 2001 is appropriate in view of the current excessive demand situation in the economy and is also necessary because government finances in Portugal have not yet reached a medium-term position close to balance. The government deficit reduction in 2001 is the result of a projected steep decline in the growth rate of primary current expenditure, which is only partly offset by the planned increase in government investment. Tax revenues are projected to rise as a result of the combined effect of additional gains in the efficiency of tax collection, a broadening of the tax base and a reduction of tax rates for lower income brackets. In order to meet expenditure plans, the updated stability programme foresees the strengthening of budgetary procedures, such as, *inter alia*, expenditure control mechanisms, in the framework of the envisaged Public Finance Consolidation Programme. In view of the above, and considering that Portugal is a member of the euro area, budgetary policy should aim to:

i. meet the 1.1 per cent of GDP deficit target for 2001, which calls for a strict adherence to the current primary expenditure plans; if needed, do not use the current expenditure amounts frozen

in the budget for 2001 to avoid cutting back government investment plans;

ii. prepare a budget for 2002 which aims at a faster decline in the deficit ratio than planned in the 2001 updated stability programme given that government finances in Portugal have not yet reached a medium-term position close to balance; such an acceleration of budgetary consolidation should be based on expenditure restraint rather than on tax increases; and

iii. underpin the process of budgetary consolidation by introducing already in 2001 additional measures in the area of health care to improve expenditure control and efficiency and by implementing expeditiously the enabling legislation required by the recently adopted social security law to strengthen the financial position of the social security sector in the light of the budgetary challenges of an ageing population.

Labour markets

The labour market situation remained favourable in Portugal with unemployment declining to around 4 per cent of the labour force in 2000. The employment rate rose slightly to 68 per cent and the employment rates of both women and older workers were well above the EU-average. In some regions and sectors there are now clear signs of labour shortages and the tightening labour market situation has also boosted nominal wage growth, reaching about 5½ per cent in 2000. These wage increases were only partly offset by productivity growth. In addition, the level of labour productivity is very low in Portugal, partly due to the low levels of educational attainment and vocational training. Two-thirds of the population aged 25 to 64 have only completed the primary education cycle. However, Portugal has increased spending on education substantially in recent years, and the shortfall in the education level is partly the result of a lack of schooling over past decades. Employment protection legislation for permanent contracts remained relatively strict. This is probably one of the most important causes of the rapid increase in fixed-term contracts in recent years. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Portugal should be to:

i. increase investments in and improve education and training systems in order to raise the employability, adaptability and productivity of the labour force; and

ii. enhance, together with Social Partners, labour market flexibility, in order to minimise the risk of segmentation between regular and atypical contracts.

Product markets and the knowledge-based economy

Portugal is less exposed to international competition than other small Member States. Relatively low levels of labour productivity limit the overall competitiveness of the Portuguese economy. Price levels are well below the EU average. Several measures have been taken to improve access to public procurement, reduce the administrative burden on business and reform the public administration. Numerous initiatives have also been launched to promote ICT diffusion. Nevertheless, Portugal's transition to the knowledge-based economy is still hampered by its weak research and innovation capacity,

partly related to deficiencies in the educational qualification of the workforce. Liberalisation in energy utilities is proceeding relatively slowly and State aids remain high. Finally, the rate of non-transposition of internal market legislation is still among the highest in the EU. In view of the above, the main priorities for Portugal should be to:

i. enhance efforts to raise the level of R&D investments, particularly by the business sector;

ii. further promote the diffusion of ICT, in particular by taking measures to increase the supply of skilled ICT personnel;

iii. sustain the progress made in containing State aids (particularly sector-specific ones);

iv. speed up and widen the liberalisation of energy sectors, particularly to the benefit of small business users and households; and

v. accelerate progress made in transposing internal market directives.

Capital markets

Capital markets in Portugal are undergoing rapid change, with the consolidation and conglomeration of financial institutions and the development of new financial products. The risk capital market has grown, although it remains among the least developed among the EU Member States. Initiatives - mainly based on public funding - have been undertaken to facilitate SMEs' access to finance but further measures to develop the risk capital market would be desirable. The regulatory framework has been reinforced by a tightening of the rules governing general provisions, capital adequacy and large exposures. The Bank of Portugal is also taking measures to strengthen the monitoring of banks' risk management processes and practices, and to enhance market discipline through more public disclosure. The creation of the National Council of Financial Supervisors should further reinforce the supervision process. In view of the above, the main priorities for Portugal should be to:

i. develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws; and

ii. ensure that supervisory arrangements across sectors and across borders are keeping pace with developments in the financial system.

13. FINLAND

Under the impact of a burgeoning export sector, output growth in 2000 amounted to 5.7 per cent. A normalisation of the external contribution to growth in 2001-02 is likely to result in a slowdown of economic activity to a more sustainable growth rate of around 4 per cent. Domestic demand is expected to hold steady bolstered by a pick-up in private consumption thanks to sizeable income tax cuts. Equipment investment should also perform well owing to still very high rates of capacity utilisation, while construction investment should be stimulated by high levels of migration towards growth centres. Although continued job creation will ensure that unemployment remains on a downward trend, the number of unemployed remains at a fairly high level, suggesting persistent structural problems in the labour market. Consumer prices surged last year, with an economic situation close to overheating being compounded by the oil price hike, but are expected to come down to a rate of just above 2 per cent in 2001 and to slow further in 2002.

A thriving telecommunications equipment industry is the prime factor behind the strong performance of the Finnish economy in recent years. However, the very strong reliance on this industry for the overall evolution of the economy is not without risks. Evidently, in the short term any slowdown in the telecommunications sector would have an immediate impact on overall economic growth. In the medium term, the strong wage dynamics in this sector, which may be justified on grounds of rapid productivity growth, carry the risk of inappropriately high wage increases in other parts of the economy where productivity gains are much smaller. This could lead to competitiveness problems in these sectors and, eventually, to lower employment. In view of already strong geographical and skill mismatch this may further slow the pace of the decline in unemployment. The recent moderate wage agreements for 2001 and 2002 are therefore welcome, but wages continue to reflect insufficiently differences in productivity developments.

Budgetary policy

Much stronger than expected tax intake related to high output growth but also to some specific factors (e.g. exceptionally high capital gains taxes) in combination with tight expenditure control resulted in a general government surplus of an estimated 6.7 per cent of GDP in 2000. According to the updated stability programme, substantial albeit somewhat lower surpluses are also projected during the programme period covering the years 2001-04. The budgetary strategy is mainly built on reducing government expenditure in relation to GDP while at the same time alleviating somewhat the tax burden. The process of lowering income taxes, which is under way, is likely to improve work incentives but would have to be looked at in combination with benefit systems. Medium-term government surpluses of above 4 per cent of GDP appear feasible given the favourable economic conditions and justified by long-term concerns over the sustainability of public finances in view of a marked ageing of the population. Against a background of mounting spending pressures a tight grip on expenditure will be needed to achieve the envisaged surpluses. In view of the above, and considering that Finland is a member of the euro area, budgetary policy should aim to:

i. adhere to the expenditure targets set in the budget for 2001;

ii. maintain high government surpluses in 2001 and the following years through a reduction in government expenditure relative to GDP; and

iii. ensure the long-term sustainability of public finances in view of the future effects of population ageing on pensions and health care costs, to which Finland is particularly exposed; this requires the continuation of the policy of debt reduction but needs to be complemented by measures, to be adopted during the programme period, raising the low effective retirement age.

Labour markets

Finnish labour market performance in 2000 was mixed. In contrast with the brisk growth in GDP and employment, the unemployment rate declined slowly and remains disappointingly high at 9.8 per cent. Structural problems in the labour market are manifested in disproportionately high unemployment rates among low-skilled, older workers and in some regions. On the other hand, labour bottlenecks have emerged in other regions and in some sectors, notwithstanding ample labour mobility. The government's responses to labour market problems have focused strongly on the reduction of overall taxes on labour, including the announced further tax reductions in 2001 and 2002, and on the increase of active labour market programmes. However, progress has been sluggish so far regarding the objective of increasing the effective retirement age and addressing the incentive effects for low-wage earners. Despite large early activation programmes of the unemployed, the success rate in terms of reducing the flow into long-term unemployment is low. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Finland should be to:

i. strengthen efforts to reduce high marginal effective tax rates on low wage earners and to improve incentives in benefit, especially pension, schemes to take up a job offer and to stay in the labour force; and

ii. increase the efficiency of active labour market programmes and refocus them to the needs of those most prone to the risk of long-term unemployment.

Product markets and the knowledge-based economy

Despite Finland's peripheral location in the EU and its low population density, which creates natural barriers to competition, the openness of the Finnish economy has been increasing in recent years. Consumer price levels are above what one would expect for a country with its standard of living. Nevertheless, telecommunication and electricity prices are low, which may be due to the substantial progress that Finland has made in liberalising and deregulating these industries. In the retail distribution, construction, and media sectors, however, competition is insufficient. In addition, the share in GDP of public procurement that is published in the Official Journal is relatively low in spite of stricter than required regulations. The transition to the knowledge based-economy is well advanced in Finland, as indicated by relatively high expenditures on R&D and high ICT penetration. In view of the above, the main priorities for Finland should be to:

i. enhance compliance with regulations in public procurement, especially at the local

level, and increase transparency in the provision of public services in order to heighten private firms participation; and

ii. enhance competition in industries such as distribution, construction, and the media sector.

Capital markets

The capital markets in Finland are developing rapidly, with investment opportunities set to increase further due to new legislation allowing the establishment of mortgage banks and the issuance of mortgage bonds. Market development is benefiting from a more consistent tax treatment of investment earnings and from improvements in market infrastructure. The risk capital market is also developing, with the emergence of new growth, technology and SME funds but further efforts to develop the market would be desirable. Restructuring in the banking sector is continuing, notably with the merger of the Swedish-Finnish Nordea and the Danish Unibank to create the largest financial institution in the Nordic region. To ensure efficient financial supervision of such cross-border institutions, Finnish supervisors have signed a co-operation agreement with their Danish and Swedish counterparts. In view of the above, the main priority for Finland should be to:

i. develop further the risk capital market by establishing a fiscal framework more conducive to investment and entrepreneurship.

14. SWEDEN

Sweden has experienced a period of strong growth since 1998, with GDP increasing by more than 3.5 per cent each year. However, the deceleration in the world economy in 2001 results in weaker external demand and this coincides with an expected cyclical downturn in domestic demand, in particular private consumption. The sluggish developments in the stock market contribute to this slowdown. On the other hand, a rise in households' disposable income is expected, resulting from some further employment growth and also from the tax cuts implemented in 2001. Further, the build-up of the third generation telecommunications network should stimulate investment this year and next. All in all, this is expected to result in lower economic growth, of 2.7 per cent in 2001 and of 3.0 per cent in 2002.

Employment growth has been robust in recent years, which has contributed to a substantial fall in the unemployment rate. Wage and price developments have remained subdued and new wage agreements suggest that wage moderation will continue. This should contribute to keeping domestically generated inflationary pressures subdued in 2001 and 2002. Sweden's target of an employment ratio of 80 per cent by 2004 is most welcome. In order to achieve this target, a continuation of the strategy of lowering taxes and of diminishing the distortionary marginal effects arising from income-dependent benefits seems appropriate, as this provides better financial incentives for people to work. Furthermore, the scope and design of active labour market programmes would benefit from a review to ensure the provision of an adequate labour supply.

Budgetary policy

In 2000, the general government surplus rose markedly, by 2.2 percentage points, to 4 per cent of GDP, well above Sweden's projection of 3.4 per cent of GDP. According to the 2000 updated convergence programme, continued large surpluses in 2001 and 2002, of 3.5 per cent of GDP and 3.3 per cent of GDP, respectively, are expected on current policy. Swedish medium-term budgetary policy is two-fold and consists of; (i) nominal ceilings on central government expenditure set annually for three years ahead and (ii) a 2 per cent of GDP surplus target for general government on average over the business-cycle. The margin created by achieving higher surpluses than targeted has been used partly for tax relief and partly for debt reduction. The latter form an important part of Sweden's strategy for coping with the ageing of the population. In view of the above, budgetary policy should aim to:

i. achieve in 2001 a general government surplus consistent with the 2000 updated convergence programme projection of 3.5 per cent of GDP;

ii. continue with the strategy of lowering taxes for low and medium wage earners in 2002 while still attaining the medium-term surplus target of 2 per cent of GDP, taking into account the position in the business-cycle, and at the same time ensure adherence to the central government expenditure ceiling; and

iii. pursue the strategy of reducing public debt in the medium-term, as described in the 2000 updated convergence programme, by maintaining the government surplus target of 2 per cent of GDP over the cycle while implementing the strategy of further tax

cuts and tight expenditure control. This should place Sweden in a better position to cope with the burden on public finances stemming from the ageing of the population.

Labour markets

The Swedish labour market situation continued to improve strongly in 2000, bringing unemployment down to 5.9 per cent of the labour force. The overall employment rate and, in particular, the employment rates of women and of older workers, are among the highest in the Union. So far, there is no general shortage of labour, even if it has become increasingly difficult to recruit in some sectors or regions. Improved job placement, tightened eligibility criteria for unemployment insurance (in terms of occupational and geographical mobility), and a focus on life-long learning have facilitated matching in the recent upswing. However, various evaluations indicate inefficiencies, such as substantial displacement effects, in some of the active labour market programmes (ALMPs). Despite recent measures, the tax burden on labour remains high and benefit schemes contribute to high net replacement rates. In fact, Sweden has the highest tax burden in the Union on low wage earners. In view of the above, while vigorously implementing all the Employment Recommendations, the main priorities for Sweden should be to:

i. pursue reforms of tax and benefit systems to make work pay and, in particular, reduce the high tax burden on low-wage earners; and

ii. ensure the efficiency of the ALMPs and target them at those most prone to the risk of long-term unemployment, as well as to meet the demands of the labour market.

Product markets and the knowledge-based economy

In spite of Sweden's peripheral location in the EU and its low population density, which create natural barriers to competition, the openness of the Swedish economy has been increasing in recent years. Consumer price levels remain relatively high. However, considerable progress has been made in liberalising the telecommunication and electricity sectors, which has resulted in lower price levels in these sectors. Sweden also has an excellent record in transposing internal market directives and State aid is very low. Measures have been taken to introduce competition in public service provision and public procurement, but there is scope for further competition. Competition is also insufficient in retail distribution, pharmaceuticals, construction, and transport, and the high degree of State ownership is a perceived problem. Sweden has the highest total expenditure on R&D in the EU, but much of the R&D are carried out by large companies in a few industries. In view of the above, the main priorities for Sweden should be to:

i. enhance compliance with regulations on public procurement and enhance competition in public services provision at local levels; and

ii. increase competition in areas such as air transport and pharmaceuticals.

Capital markets

Capital-market development in Sweden has been characterised by consolidation, legislative and regulatory reform and growth in risk-capital investment. In particular, the introduction of a funded element in the pension system, where the individual himself can choose a fund manager, have increased the demand for investment services and increased the presence of foreign mutual fund companies on the Swedish market. The risk capital market has grown in recent years, with a diversification of investment beyond the high-tech sector. Measures have been taken to improve the climate for risk capital providers but further efforts to develop the market would seem desirable. The Financial Supervisory Authority has reorganised its activities to adapt to the growth of financial conglomerates and to develop an overall view of the risks in the financial sector. The Authority has signed a co-operation agreement with its counterparts in Denmark, Finland and Norway to ensure efficient financial supervision of cross-border institutions. In view of the above, the main priority for Sweden should be to:

i. develop further the risk capital market by establishing a fiscal framework that is more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.

15. UNITED KINGDOM

United Kingdom GDP rose by 3 per cent in 2000. The development of the economy is expected to remain favourable in 2001 and 2002 with growth at 2.7 per cent in 2001, returning to 3 per cent in 2002. Domestic demand is expected to remain strong, boosted by recent fiscal measures and plans for strong growth in public consumption and fixed investment. This is expected to offset a weakening of net exports resulting from the slow down in US growth. Inflation, current and expected, is benign with HICP inflation among the lowest in the EU. Despite a tight labour market with unemployment, at 5.2 per cent, at a twenty-five year low, wage pressures remain subdued. Unemployment could fall a little further as measures aimed at increasing the attractiveness of work take effect.

Unemployment is low but characterised by higher than average rates in particular groups and communities. The key issue is whether the active labour market policies implemented are sufficient to tackle the problems of social exclusion associated with remaining unemployment and inactivity. Another structural problem is the low, relative, level of UK productivity. While productivity growth has risen in recent quarters, it is too soon to establish that there has been a permanent rise in the rate. Again, government measures have been introduced to address this weakness. The challenge is that these measures actually translate into higher productivity.

Budgetary policy

The government surplus was 4.3 per cent of GDP in 2000 (1.9 per cent excluding UMTS receipts). The budget projections show a surplus of 1.7 per cent of GDP (excluding UMTS receipts) in financial year 2000-01; higher than the 1.1 per cent expected in the convergence programme update. Subsequently, a surplus of 0.5 per cent is projected in 2001-02 before the balance falls to a small deficit of 0.1 per cent in 2002-03 and deficits of around 1 per cent of GDP in 2003-04 and the following years. These figures are broadly the same as in the updated convergence programme. The projections are based on a cautious assumption of trend GDP growth of 2¼ per cent. Nevertheless the projected deficit, on current policies, of around 1 per cent of GDP over the period 2003-04 to 2005-06 is not close to balance. The extra loosening between 2000-01 and 2001-02, compared to the convergence programme update, is unlikely to compromise economic stability since inflation is low and the fundamentals of the economic outlook, incorporating budget measures, do not suggest demand pressures that are a cause for concern. Expenditure plans have allocated increased resources to public sector investment which has been low in recent years. It is planned to rise, net of depreciation and asset sales, from 0.8 per cent of GDP in 2000-01 to 1.7 per cent by 2003-04. The provision of long term forecasts of public finances in the convergence programme update shows them to be sustainable on current policies. In view of these developments, budgetary policy should aim to:

i. ensure that a general government surplus of at least 0.5 per cent of GDP is achieved in 2001-02 as projected in the 2001 budget;

ii. for the general government balance, ensure, in preparing the budget, that an outturn in 2002-03 is achieved that, as planned, is close to balance. In particular,

the expected ratio of public sector current expenditure to GDP should not exceed, in 2002-03, the 37.3 per cent of the Budget 2001 projections; and

iii. allow public investment, net of depreciation, to double, as planned, as a share of GDP, between 2000-01 and 2003-04 while, at the same time, ensuring that the terms of the Stability and Growth Pact continue to be respected.

Labour markets

Labour market performance in the UK remains among the strongest in the EU, with robust employment growth in recent years and unemployment at around a 20-year low (5.5 per cent in 2000). Long-term unemployment as a proportion of the total is among the lowest in the EU. The UK has continued to make further refinements to the tax and benefit system with a view to making work pay. The range of active labour market policies centred on the New Deal has been extended, notably with reinforced measures aimed at tackling problems of social exclusion associated with concentrated non-employment in deprived areas and the high share of jobless households. While overall unemployment has fallen, there has been little reduction in economic inactivity, and the number of people claiming sickness and disability benefits has risen substantially in the past few years. In view of the above, while vigorously implementing all the Employment Recommendations, the main priority for the United Kingdom should be to:

i. reinforce active measures targeted at those communities and individuals most prone to the risk of concentrated or long-term unemployment and inactivity, and reform passive benefit schemes to provide people who are able to work with the opportunities and incentives to do so.

Product markets and the knowledge-based economy

The United Kingdom is well advanced in terms of regulatory reform and liberalisation of the network industries. The economic environment is favourable to business and entrepreneurship with low levels of regulation. However, the UK's relatively low level of labour productivity remains a problem, despite some signs of stronger growth in 2000. This may reflect weak competition in certain sectors of the economy, declining business R&D as a percentage of GDP (up to 1999) and insufficient investment in the past, especially public investment. A number of measures have been taken to stimulate R&D and innovation. In view of the above, the main priorities for the United Kingdom should be to:

i. take measures to address the relatively low level of productivity, in particular by increasing competition in sectors such as retail banking services, car retailing and postal services and by increasing the supply of skilled ICT personnel; and

ii. ensure that the announced investment to improve the transport infrastructure and to improve the quality of public transport is delivered in practice and ensure that there is adequate co-ordination between different public bodies, regulators and private firms.

Capital markets

Financial markets in the UK remain the most developed in the EU. Nevertheless, development of the risk capital market is being fostered by efforts to increase equity flows to early-stage investment and by a number of fiscal and financial regulatory reforms. The replacement of the Minimum Funding Requirement with a long term scheme-specific funding standard will remove a potential obstacle to investment in risk capital. In addition, the government is promoting public-private partnerships to improve the supply of small scale and early-stage risk capital across the country. The creation of a single regulatory body – the Financial Services Authority – will further promote a level playing field among financial institutions, and actions to benefit consumers are underway. Measures are also planned or underway in the banking sector to improve competition and to benefit consumers, including legislation to open up access to payment systems and to oversee access charges, a review of self-regulatory codes, and a reform of the Treasury's objectives on promoting competition in financial services. In view of the above, the main priority for the United Kingdom should be to:

i. further ease constraints on pension funds which may limit their investment in risk capital.