SM/94/120

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May 12, 1994

To: Members of the Executive Board

From: The Acting Secretary

Subject: European Union - Common Policies and Recent Institutional Developments

Attached for consideration by the Executive Directors is a paper on common policies and recent institutional developments of the European Union. Topics for discussion appear on pages 28-31.

This subject, together with a supplement containing annexes (to be issued shortly), will be discussed in a seminar tentatively scheduled for Monday, June 6, 1994.

Mr. D. McDonald (ext. 38862) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

European Union: Common Policies and Recent Institutional Developments

Prepared by the European I Department, the Policy Development and Review Department, the Research Department and the Office in Europe

Approved by Massimo Russo

May 11, 1994

Contents

I. Introduction

During the most recent biennial review of surveillance and subsequent follow up discussions, Executive Directors underlined the importance of monitoring important regional developments. 1/ The Interim Committee, in its April 1993 Declaration, supported "the steps agreed by the Executive Board to strengthen surveillance, including regional developments." Against this background, the present paper focusses on important institutional and policy developments at the level of the European Union (EU) associated with the coming into force of the Treaty on European Union (hereafter the Maastricht Treaty), with the completion of the internal market program, and with developments in relations between the EU and neighboring countries. It is based, inter alia, on the discussions of a mission which visited the European Monetary Institute (EMI) and the European Commission in January. 2/

Section II covers coordination and surveillance activities of the EU. The discussion highlights two important aspects of recent developments. First, with the ratification of the Maastricht Treaty, the formal institutional setting for surveillance has been strengthened. Second, there has been a notable expansion of emphasis on indicators outside the standard financial framework. This reflects, inter alia, a growing awareness that deep-rooted structural problems, especially in labor markets, have the potential to threaten the process of economic and monetary integration.

Section III focuses on EU policies that promote market integration. Two aspects of these policies are examined. First, there is a discussion of steps to strengthen the legal and institutional framework for the internal market, focusing on the single market program and competition policies and on the recent reforms of the Common Agricultural Policy (CAP). Particular emphasis is placed on the domestic aspects of these policies. This complements the increasing attention to structural policies in macroeconomic surveillance. Moreover, the forthcoming comprehensive paper on trade issues will examine the international aspects in some detail. The second topic is the efforts to broaden effective participation in the integrated European market. The EU's Structural Funds are intended to promote the integration of weaker areas in the EU and have recently been augmented with a view to facilitating the transition to EMU. 3/ There has also been significant progress in expanding the geographical coverage of the single European market. In the case of the EFTA countries (excluding Switzerland), the

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1/ See Statement by the Managing Director on Certain Aspects of Surveillance (Buff/93/14, 4/9/93).

2/ The mission team consisted of Messrs. Artus (head), Griffiths, and McDonald (EU1); Adams and Harmsen (PDR); Rosenblatt (PAR) and Laxton (RES).

3/ Enlargement of the structural funds was an important part of the packages agreed to secure passage of the Single European Act in 1986--which paved the way for the Internal Market Program--and the Maastricht Treaty.

creation of the European Economic Area (EEA) has effectively accomplished this; enlargement of the EU to include some of these countries, which could come as early as the beginning of 1995, would consolidate this achievement. For the countries in transition in central and eastern Europe, the process of integration will be more gradual, but the EU is committed to eventual membership for these countries.

II. Coordination and Surveillance of Macroeconomic Policies

EU member states have long recognized that their economic policies are a matter of common concern, and multilateral surveillance within the EU has evolved steadily over the years. 1/ The goal of achieving an economic and monetary union (EMU), at the latest by 1999, has been accompanied by a marked increase in the attention paid to policy interaction and spillover. This reflects two considerations. First, achievement of a substantial degree of macroeconomic convergence is seen as critical to provide a sound basis for monetary union. Thus the Maastricht Treaty established criteria on performance in the areas of public finances, inflation, interest rates and exchange rates, by which the readiness of countries to participate in the union will be assessed. 2/ Second, there are concerns to ensure that policies at a national level continue to be consistent with the smooth operation of the single monetary policy, once EMU is established.

Against this background, the Maastricht Treaty gives significant prominence to the surveillance functions that are to be exercised by EU institutions: requiring the adoption of broad guidelines on economic policy that would provide the framework for surveillance by the Council of Ministers; providing for an excessive deficit procedure, also exercised by the Council, that would be directed at correcting "gross errors" in the public finances of member states; calling for an annual report from the Commission on the operation of the internal market; and establishing the European Monetary Institute (EMI) to strengthen coordination of monetary policies and cooperation among national central banks, with a view to achieving price stability and preparing the way for EMU.

1/ See Annex III of SM/92/129, Supplement 1 (6/29/92).
2/ The statistical criteria by which convergence is to be judged are: consumer price inflation should not exceed that of the three best performing EU member states by more than 1½ percentage points; the long-term interest rate on government bonds is not to exceed by more than 2 percentage points that of the three member states with the lowest inflation; the general government budget deficit should not exceed 3 percent of GDP and the gross debt of general government should not be larger than 60 percent of GDP; and a country should have respected the "normal" fluctuation margins of the ERM for two years without severe tensions and without devaluing on its own initiative. For further detail, see SM/92/129 (6/26/92).

The meeting of the European Council in December 1993, the first after the ratification of the Maastricht Treaty, underlined the political prominence that would be given to the enlarged scope of surveillance activities. At that meeting, against the background of concerns about the high and still rising unemployment, the Heads of State and Government endorsed an action plan, under the banner, "Growth, Competitiveness and Employment," comprising a general framework for the policies to be pursued by Member States, specific actions at the union level, and monitoring procedures. The plan reflected the broad economic policy guidelines, adopted in line with the treaty's requirements, and a Commission white paper addressing the unemployment problem, both of which will be discussed below. To monitor implementation of this plan, the European Council at its meeting each December will discuss: a summary report from the Commission; a report from the Council of Ministers on the lessons from national employment policies implemented under the strategy as well as on any new proposals; a report from the Council of Ministers on the implementation of the broad policy guidelines; the annual report of the Commission on the operation of the internal market; and a statement from the Commission on progress in developing trans-European infrastructure networks.

The surveillance activities highlighted by the European Council are those of governmental institutions--the Council of Ministers, supported by the Commission--with limited attention given to the activities of the EMI. This in large part reflects the independence of monetary institutions under the treaty. At its December meeting, the European Council appointed the head of the EMI, enabling him to begin the process of organization building when the institute came into being in January 1994.

1. Surveillance by the Council of Ministers

a. Broad economic guidelines

The central focus of surveillance by the Council of Ministers will be the broad economic guidelines, the first set of which was adopted by the Council in December 1993. 1/ These will provide the basis for multilateral surveillance as well as the framework for the review of convergence programs submitted by individual member states. 2/

The guidelines, which aim to encourage short-term recovery and put in place the conditions for an improvement in economic performance over the

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1/ The guidelines are reprinted in Annex I. See also the Commission's paper, "Framework for the Broad Economic Policy Guidelines," which was adopted by the Commission in November 1993 and has been reprinted in European Economy, No. 55, 1993.

2/ Over the past two years, all members other than Luxembourg have submitted a convergence program; these programs have varied considerably in the degree to which policy proposals have been elaborated.

medium term, have four broad components: price and exchange rate stability; the achievement of sound public finances; the generation of employment; and the integration of markets. In the area of prices and exchange rates, the guidelines specify a 1996 target of 2-3 percent inflation, as a step toward price stability, and underline the importance of exchange rate stability for the operation of the integrated European market. Regarding the public finances, they stress that the restoration of confidence requires that countries avoid any further deterioration of their budgets in 1994 and begin to address the process of consolidation, aiming for a fiscal position that is close to balance by the year 2000, and with most countries satisfying the Maastricht deficit criterion of 3 percent by 1996. In the case of countries with particularly serious fiscal positions--and especially those with high and rising public debt ratios--there is a need for immediate and strong fiscal measures. Where fiscal positions are not as critical and economic conditions continue to be weak, the emphasis should be on credible medium-term consolidation strategies, supported by the announcement now of measures that would take effect as recovery strengthens. In the labor market, attention is focused on the need for wage moderation, reductions in the indirect cost of labor, and training and other measures to improve the functioning of the labor market. Finally, the guidelines stress the importance of measures that foster the realization of the full benefits of the internal market.

Four features of the guidelines are notable. First, while they underscore the contribution macroeconomic policies can make to recovery, by boosting confidence and by fostering fiscal and wage developments that make room for a substantial reduction in short-term interest rates, the guidelines focus to a large extent on medium-term issues.

Second, within the four broad policy areas, greater emphasis is given to fiscal and especially to labor market issues. In deference to the role of the EMI, the guidelines avoid specific advice on monetary issues. Similarly, internal market issues are touched on only briefly in view of the greater powers of the EU in this area and, as a consequence, the lesser need for indicative guidelines.

Third, compared with the previous bases for surveillance, not only are the guidelines more broad ranging, but they also, in some areas, have quite specific goals. These reflect the quantified stipulations of the Maastricht Treaty on convergence of inflation and financial indicators. The goals in the area of the labor market are more general, reflecting that the formal debate of these issues in union institutions is more recent, as well as the complexity of the issues.

Fourth, while the guidelines provide a more comprehensive and transparent basis for surveillance than in the past, they give relatively little attention to the specific policy needs of individual member states. A limited shift in this direction is that, while stressing the need for fiscal consolidation in all EU countries, the guidelines make a distinction between countries with critical fiscal situations and others. This plays an important role in balancing the need to make important progress in fiscal consolidation and the concern to avoid weakening the economic recovery.

Considered from the perspective of the EU as a whole, the guidelines appear well suited to the current economic situation. In particular, the recommendations on fiscal consolidation are quite similar to the position taken by the staff in Article IV discussions and the WEO. Fiscal consolidation is an essential underpinning to a meaningful economic recovery, both to strengthen confidence in policymakers and to provide room for the investment that will be needed to sustain the recovery. In countries with less critical fiscal positions, transparent and credible plans would, in the staff's view, be adequate to restore confidence, with early implementation as the recovery takes hold being sufficient to ensure that investment is not crowded out. In countries with large deficits and high debt ratios, however, which are also countries that in the past have been unable to follow through on consolidation plans, it is unlikely that confidence can be restored without substantial up-front measures. Such measures may initially weaken demand, but these effects are likely to be temporary and soon offset as economic agents come to understand that the authorities are determined to tackle the imbalances.

The guidelines will be revisited each summer with a view, inter alia, to influencing the budgetary decision of member states. In this context, Commission representatives indicated that future guidelines may pay greater attention to shorter-term issues and be more concrete concerning individual countries, with the current guidelines continuing to provide the medium-term orientation. Although a greater degree of specificity may be desirable in the future if the efforts to enhance surveillance are to yield their full potential, it should be recognized that the policies on which the guidelines focus remain the responsibility of national authorities. Thus, the effectiveness of the guidelines--and of Community surveillance more generally--will ultimately depend on the willingness of members to take appropriate policy decisions in what may sometimes be difficult circumstances. Prior to monetary union, the principal sanction at the disposal of the EU is publication of the recommendations of the Council of Ministers, which can be done on the basis of a qualified majority. The threat that countries that fail to follow sufficiently prudent macroeconomic policies will be excluded from EMU is likely, however, to represent the most important disciplining instrument. 1/

Surveillance will not depend on the general policy guidelines alone. Other surveillance exercises specifically address each of the four policy areas mentioned above. The exercises related to monetary policy and the internal market will be discussed below in sections II.2 and III.1, in the

1/ Once EMU has been achieved, the excessive deficit procedure will give the Council a wider range of sanctions to address problems in the fiscal area.

context of the work of the EMI and the EU's policies to integrate markets. The central focus of the guidelines, the public finances and the labor market, are addressed in two other exercises of the Council of Ministers--the excessive deficit procedure and the annual report to the European Council on the implementation of national employment policies. These are discussed next.

b. Excessive deficit procedure

The excessive deficit procedure has been established by the Maastricht Treaty to identify "gross errors" in the public finances of member states as reflected in "excessive" fiscal deficits or government debt ratios. The reference values for these assessments are the fiscal convergence criteria specified in a protocol to the treaty: 3 percent of GDP for the general government deficit and 60 percent for the government debt ratio. Under the treaty, the Commission is to prepare a report in those instances where the reference values are exceeded, except in specific cases where deviations are judged to be temporary or are already well on the way to correction. 1/ The report is to be made in the context of the medium-term economic and budgetary outlook of the member, and taking into account whether fiscal deficits exceed government investment expenditure.

In those cases where the Commission judges that a member has an "excessive" fiscal deficit, the Commission is required to address an opinion to this effect to the Council of Ministers. It is the responsibility of the Council to decide--acting by qualified majority and based on its overall assessment of the situation--whether an "excessive" fiscal imbalance does in fact exist. While the treaty makes no allowance for sanctions to be applied in the case of "excessive deficits" incurred during stage II of EMU--and relies on encouraging members to avoid excessive deficits--the Council, acting by qualified majority, may make its recommendations public in the event that a member does not respond satisfactorily.

The role of the excessive deficit criteria was widely debated in the negotiation of the treaty and in subsequent discussions. This debate has since receded and the focus has turned to implementation. Secondary legislation was passed by the Council in late 1993 specifying the precise definition and coverage of the fiscal variables to be used for the excessive deficit procedure and the modalities for reporting required data to the

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1/ The Commission may choose not to prepare a report if it judges that the deficit has declined substantially and continuously and reached a level close to the reference value or its deviation from the reference is temporary, exceptional, and small. Similarly, if the debt ratio is sufficiently diminishing and declining toward the reference value at a satisfactory pace, the Commission may choose not to make a report.

Commission. 1/ The first exercise is now under way, with countries having already supplied the needed data to the Commission. 2/

Given the widespread weakness of fiscal positions in the EU, there are likely to be a rather large number of reports under the excessive deficit procedure in 1994--the Commission staff indicated that the Commission would probably apply a strict interpretation of the treaty in this regard. This raises interesting issues concerning the next steps--Commission opinions as to whether the deficits are excessive and the decision of the Council of Ministers whether to declare that a member had an excessive deficit. Some strategic considerations may surface at these stages. For example, there may be concerns that finding a large number of countries to have excessive deficits could water down the impact on national policymakers especially in countries with the most egregious fiscal errors. The Council is also likely to be conscious that a finding of excessive deficit, if it became public knowledge, could cause difficulties for the country concerned in the financial markets, if only one or two countries were singled out.

Generally speaking, however, it would seem important to be seen to adhere closely to the intent of the treaty; doing otherwise might create undesirable precedents and could also raise doubts about the credibility of the surveillance process more generally. The intent of the treaty is not, of course, that there be a mechanical interpretation of the reference criteria in assessing fiscal positions. This is evident in the treaty's instructions, summarized earlier, as to what factors the Commission should take into account in preparing its reports. In this context it will be important that the process is seen to make realistic assessments of budgetary prospects, with regard both to the impact of any envisaged measures and to the cyclical outlook. Particularly difficult questions are likely to emerge in judging how quickly high-debt countries should be reducing their debt toward the reference level and how to take account of differences across countries in factors such as demographic profiles and private saving rates.

c. Strategy to reduce unemployment

In June 1993, the European Council invited the Commission to draw up a medium term economic strategy, that would address the EU's unemployment problem--an unemployment rate rising to 12 percent in 1994, with the prospect of little subsequent decline in the absence of policy measures. The resulting Commission white paper, "Growth, Competitiveness and Employment: The Challenges and Ways Forward into the 21st Century," was

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1/ This was accompanied by legislation needed to give effect to the prohibitions on central bank lending to government and on privileged access by the government to any financial institution.

2/ The secondary legislation specified reporting deadlines of March 1 and September 1 every year.

discussed at the December 1993 meeting of the European Council. At that meeting, Heads of State and Government agreed on an action plan to reduce unemployment, using the white paper proposals as its reference framework. As noted earlier, progress under the action plan will be examined annually by the European Council at its December meeting. The white paper's proposals were also a key input into the broad policy guidelines that were recently adopted.

The white paper refrains from making specific analyses of the situation of individual countries or formulating country-specific proposals. This reflects the limited direct role of the EU in the labor market policies of its member states, but perhaps also that the formal debate within the EU is still relatively young, and as a result there has been less time to forge a consensus on goals and policy priorities.

There is nevertheless, in broad terms, a clear statement in the white paper of what should and should not be done. Concerning the latter, the paper resists policies of demand expansion or protectionism. Instead it advocates a strategy with three elements. First, fiscal consolidation is seen as critical both to bolster confidence and provide the resources to finance the increase in investment that will be necessary. The Commission envisages that fiscal consolidation would go considerably beyond the reference values in the treaty, with a deficit below 1 percent of GDP reached on average in the EU by the end of the century.

Second, the white paper calls for increased wage restraint, recommending that real wage growth be held below the rate of growth of labor productivity, by encouraging employed workers to restrain their wage demands in the interests of unemployed workers, and providing example through moderation in public sector pay awards. The resulting increase in the profit share would also stimulate investment.

Third, as an antidote to the past reliance on passive labor market measures, including welfare and benefit payments, a wide range of active labor market measures is proposed, addressed particularly at increased employment among the less skilled. Tax measures feature prominently. The central proposal is a reduction in non-wage labor costs of 1-2 percent of GDP targeted on less skilled workers. In addition, tax and benefit systems should be more closely integrated, possibly by means of a negative income tax. Fiscal incentives might also be used to encourage job creation in newly emerging sectors, including household services, care services, and environmental protection, that might provide significant opportunities for less skilled workers. To complement the tax measures, the strategy calls for improvements in education, training and public employment services, and for greater flexibility in the labor market, including in working hours. The latter, it is argued, would let many workers choose shorter work-weeks, raising the number of jobs for any level of output. The white paper, however, rejects the use of legislation to impose a mandatory shortening of the working week.

The Commission staff has illustrated the quantitative effects of the white paper's measures in a supplementary analysis. 1/ In the absence of policy measures--the base line scenario--a weak economic recovery would leave the unemployment rate at above 12 percent by the end of the decade. In contrast, the first alternative scenario envisages a sharp reduction in the average fiscal deficit in the EU to below 1 percent of GDP by 2000, combined with a moderation of wage growth to ½ percentage point less than productivity growth. By the end of the decade, thanks to a strong investment-led recovery, the unemployment rate would have fallen to 7½ percent.

A second scenario assumes that solidarity reduces wage growth further to one percentage point below productivity growth, producing an additional 1½ percentage point decline in unemployment by the year 2000, with higher investment allowing gains in employment without slowing the rise in labor productivity. A third scenario, that envisages, in addition, targeted cuts in social security taxes, increased training, new jobs in the service sector, and a socially acceptable degree of increased flexibility, assumes that the unemployment rate falls another 1½ percentage points, with output unchanged from the second scenario and the rate of wage increase moderating even more in line with lower productivity growth. Thus, full implementation of the policy strategy could reduce the unemployment rate to 4½ percent for the first time since the mid-1970s. This would be the result of structural changes and fully compatible with price stability.

While the white paper's strategy is ambitious and wide-ranging, it falls somewhat short in convincing the reader that the menu of proposed policy measures will be adequate. In part, this may reflect that the white paper does not address the specifics of country situations. More generally, however, doubts about the strategy reflect the optimistic assumptions on which it seems to be based, assumptions that are evident in the illustrative quantitative scenarios discussed above.

Taking the first two scenarios, the case that a substantial fiscal consolidation would support a stronger recovery over the medium term is convincing and the assumed wage moderation would undoubtedly result in a significant boost in the demand for labor. However, the extent to which reductions in unemployment rely on these factors is striking. While substantial budget cuts are desirable, one wonders whether it is prudent to count on them to the extent envisaged, given the difficulties that will be faced in legislating the necessary expenditure reductions. It is also not clear what would produce the wage moderation that is assumed. Pointing out that real wages grew less than productivity in the 1980s--as is done in the white paper--is not reassuring given that the share of labor income in EU economies, which in the early 1980s was relatively high, is now significantly lower even than that of the 1960s. Furthermore, the real wage

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1/ "Scenarios to the Year 2000" in European Economy, No. 55, 1993.

moderation of the 1980s occurred in an environment in which the decline in unemployment was much smaller than envisaged in the scenarios. More critically, an improved investment climate does not directly address the problem of long-term unemployment among the unskilled workers and those whose skills have become obsolete owing to structural change. Thus, it is likely that the supply of skilled labor would become fully utilized before the rate of unemployment fell to 6 percent, raising questions as to whether the expected wage moderation was credible. Indeed, the attention paid to insider-outsider problems in analyses of European labor markets suggests that wage pressures could emerge even before the supply of skilled labor became fully utilized. 1/

The active labor market measures promoted by the white paper, and which are the basis of the third scenario produced by the Commission staff, do address directly the problem of unemployment among the unskilled. Many of the proposed measures however are akin to subsidies and, given the scale of the problem, the costs of financing these measures could be substantial. In particular, the gap between the marginal product of the less skilled and the legal or contractual minimum wage may be large as a result of recent and ongoing changes in technology and in trade with developing and transition economies. The financing for the proposed measures may therefore not be easy to secure, especially given that the strategy already includes a large fiscal consolidation. Moreover, the nature of the financing is likely to have an impact on the outcome. Spending to correct labor market distortions and imperfections would be more likely to bear fruit if financed by cuts in other expenditure. If however financing were provided through revenue measures, one would have to consider the disincentive effects. The white paper notes in particular the case for an environmental tax but also offers higher VAT or taxes on financial capital as alternatives. While these raise difficult questions of incidence, the mobility of capital suggests that much of the increase in taxes would ultimately be borne by labor.

The issues raised above, and the analyses in a number of Article IV consultations and the WEO, suggest that the strategy may need to encompass, to a greater extent than at present is envisaged, measures that directly attack distortions in the labor market, and particularly those distortions that price unskilled labor out of the market. A number of studies point to the high level of minimum wages and the generosity of welfare benefits as important elements of the unemployment problem in Europe. 2/ Among the remedies suggested are: reform of the unemployment benefit system that

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1/ The insider-outsider question is analyzed in D. Coe and T. Krueger(1990), "Why is unemployment so high at full capacity? The persistence of unemployment, the natural rate, and potential output in the Federal Republic of Germany," IMF WP/90/101.

2/ See for example, R. Moghadam (1994), "Why is Unemployment in France so High?" IMF, forthcoming working paper, and R. Layard, S. Nickell and R. Jackman, (1991) Unemployment: Macroeconomic Performance and the Labor Market, Oxford University Press.

encourages the unemployed to seek work or retraining; limiting the duration of unemployment benefits and ensuring that recipients are engaged in active job search; making willingness to accept training places a condition for receiving benefits; and reducing minimum wages to tackle, inter alia, the problem of unemployment of young and unskilled workers.

Measures such as those just described received relatively little attention in the white paper, reflecting the concern not to dilute the European labor market model, which emphasizes the importance of a secure safety net and moderation in wage differentials. However, over the longer run, the interests of those who are presently unemployed or in unskilled occupations are likely to be served better by policies that promote growth and employment through labor market flexibility, adequately supported by education and training and more effectively targeted income support mechanisms, than by labor market regulation.

2. European Monetary Institute

The EMI was established at the beginning of 1994, replacing the Committee of EC Central Bank Governors. It will itself be replaced by the European Central Bank (ECB), when monetary union is realized. Although the institute is a precursor to the ECB, it will not itself be responsible for conducting monetary policy, which will remain the responsibility of national central banks during stage II of EMU. Reflecting the intention for the future ECB to be formally independent, the EMI may not take instructions from EU institutions or the governments of member states.

The EMI has three broad goals in the area of coordination and surveillance. First, it is charged with making the necessary technical and institutional arrangements to prepare for the future ECB. This will involve, inter alia, preparing the instruments and procedures necessary for carrying out a community-wide monetary policy in stage III, promoting the efficiency of cross-border payments, facilitating the use of the ECU, and furthering the harmonization of the rules and practices governing the collection, compilation, and distribution of statistics in the monetary area. These activities will take place against the background of considerable uncertainty about a range of issues, including the number of member states that will participate in stage III and the timing of the transition. In addition, there are technical hurdles associated with the need to agree on--and harmonize--monetary operating procedures for stage III, in a situation in which there are important differences among national central banks in procedures and instruments, such as for example the role of mandatory reserve requirements. Most significantly, however, the EMI will need to foster a smooth transition to an EU-wide monetary policy in stage III even though monetary policy decision making will continue to be the responsibility of national central banks until the end of stage II.

The second major task of the EMI is to strengthen cooperation among national central banks and the coordination of monetary policies, with the aim of ensuring price stability, and the third, closely related, is to monitor the operation of the EMS. 1/ These tasks are seen both in terms of a need for closer monetary cooperation during stage II, against the background of the turbulence in the ERM in 1992-93, and as a means of facilitating the eventual move to monetary union. Inter alia, national central banks will normally be expected to consult the EMI before taking decisions on the course of monetary policy as part of the process of ex-ante policy coordination.

The replacement of the Committee of Governors by the EMI has been an evolutionary step. Already in 1990, the former had in effect become the principal locus of surveillance in the monetary area, when its role was broadened to include the task, previously carried out by the EC's Monetary Committee, of preparing annual assessments of monetary issues to be used as inputs in policy making in member countries. While the EMI has not been conferred with more authority over national monetary policies than the Committee of Governors, its greater stature should facilitate its activities. Unlike the Committee of Governors, it has been formally established, by treaty, as an institution of the EU, it will have a much larger staff, and the need to prepare for EMU provides it additional status. Moreover, the head of the EMI will not be encumbered with the duties of managing a central bank, as was the Chairman of the Committee of Governors, and will thus have considerably more time to devote to the task of coordination and surveillance. These considerations should allow the EMI to play an important role in identifying emerging issues in a timely fashion, bringing together the parties involved in a more systematic manner than during the exchange rate crises of 1992 and 1993, and where appropriate making policy suggestions.

A number of factors make the task of the EMI more complex than was envisioned when it was conceived. In particular, monetary arrangements within the Community differ markedly from what was envisaged by those who drafted the treaty. The widening of the bands and the absence of two large EU countries from the ERM blurs an important focus of the coordination efforts in the system envisaged by the treaty. Furthermore, in terms of the preparations for EMU, five of the potential members--Italy, the United Kingdom and the three Nordic applicants, Norway, Finland and Sweden, are presently not pegging their exchange rates. While the treaty requires countries to observe the "normal" fluctuation margins of the ERM prior to the move to a common currency, it is no longer clear what is meant by this. Moreover, the recent experience has, for some, raised questions about whether this is the appropriate route to EMU. 2/

1/ In this role, it has assumed the functions of the European Monetary Cooperation Fund (EMCF) and, if requested by a national central bank, may manage its foreign exchange reserves.

2/ For discussion of this point see section III.2 of "Monetary Policy Issues Following the Widening of the ERM Bands", (SM/94/14, 1/12/94).

Given that the EMI has only been operating since the beginning of this year, the means through which it intends to fulfil its tasks are not yet clear. In its surveillance function, forging consensus will be the key to its success--its only sanction is to publicize its opinion and this requires unanimity.

III. Common Policies of the European Union

1. Internal market and competition policy

a. Internal market program

Until the mid-1980s, efforts at market integration in the EC were founded principally on reduction of tariffs and import quotas on intra-EC trade and on a common external tariff on imports from third countries. These measures, although supported to some extent by the Community's power under the Treaty of Rome to limit state aids and to tackle anti-competitive behavior, proved inadequate to realize the goal of a common market, owing to national authorities prerogatives in the area of regulating domestic markets, and the border controls associated with such regulation.

The Single European Act of 1986, by introducing weighted majority voting on most issues related to the freedom of movement of goods, services, capital and labor, opened the door to efforts to dismantle national barriers. In 1985, anticipating this act, the Community relaunched the drive to integrate markets, with the release of the white paper, "Completing the Internal Market," that gave birth to the Internal Market Program. Three important types of barrier to market integration were identified: <u>physical barriers</u> such as custom posts and passport checks at frontiers; <u>technical barriers</u> that result, inter alia, from product standards, regulation of services, inadequate cross-border recognition of professional and vocational qualifications and public procurement practices that favored national producers; and <u>fiscal barriers</u> due to differential rates of taxation in the community. The almost-300 initiatives set out in the white paper were intended to eliminate most of these barriers by the end of 1992. Although the original timetable was not observed fully, 93 percent of the white paper's measures had been adopted by the Council of Minsters by the end of 1992 and the process of transposition into national legislation was 85 percent complete. A few additional measures were adopted by the Council in 1993 and the rate of transposition increased to 87 percent (Table). Among the 17 measures awaiting Council action at the end of 1993 were directives on a European Company Statute, aspects of double taxation of companies, and protection of property rights in biotechnological inventions. The elimination of passport controls is also yet to be achieved. 1/

1/ The so-called Schengen group of countries (EU countries other than Denmark, Ireland and the United Kingdom) have agreed to abolish passport controls, but implementation has been delayed (see Annex II).

Table. Status of the 1985 Internal Market Program, end-1993

1985 White Paper Measures adopted by the Council

Ninety five per cent of the 282 measures have been adopted by the Council

Transposition into national legislation

87% of the national transposition measures have been completed

Above average transposition in: Denmark, UK, Italy, Portugal

Below average transposition in: Greece, France, Spain, Ireland

By industry national transposition is above average in:

(1) freedom of movement of capital
(2) elimination of physical frontiers
(3) financial services (excluding insurance)
(4) elimination of technical barriers
(5) company taxation
(6) VAT and excise duties

The Commission is concerned about the progress of transposition in the following areas:

(1) company law
(2) intellectual and industrial property
(3) public procurement
(4) insurance

The rate of adoption and transposition of legislation overstates somewhat the extent to which the original goals have been realized. Not all of the measures adopted have yet come into force. In air and road transport, cabotage (the right to offer services between two points in another country) will not be completely liberalized until 1997 and 1998, respectively. Some directives dealing with public procurement and insurance will not take effect until mid-1994, and a few countries have obtained derogations that will delay implementation for a number of years beyond this date. Moreover, the directives on public procurement apply only above specified monetary thresholds--ECU 5 million in the case of construction projects. Outside of the jurisdiction of the Council of Ministers and national parliaments, harmonization of technical standards by industry groups has not been progressing as quickly as had been hoped.

Notwithstanding these reservations, the extent to which the program has addressed barriers to market integration has represented a remarkable accomplishment. This is evidenced by the summary of measures presented in Annex II. Since many of the initiatives have only recently come into force and others are pending, it would be premature to attempt a quantitative assessment of the actual effects of the internal market program. 1/ However, ex-ante estimates, suggested that the benefits would be substantial. 2/ The uptick in investment activity in Europe in the late 1980s and the marked expansion in mergers (especially in services) are taken as indications that anticipation effects have been significant. Surveys of businesses also suggest important benefits; for example, the removal of customs controls is estimated to have reduced the transportation cost for cross-border shipments in Europe by 3-4 percent.

b. Strategy for further market integration

Over the past two years there has been some ebbing in the momentum of the market integration process. In part, this may have reflected a natural stock taking as such a large undertaking reached its conclusion, but it may also have been due to an easing of pressure by the Commission against the background of difficulties with the ratification of the Treaty on European Union and concerns about subsidiarity on the part of member states. The Commission is now seeking to rebuild momentum and in December 1993 released

1/ The Commission is planning to publish a detailed review of the effects of the single market in 1996.

2/ The Commission staff in 1988 estimated that full implementation of the single market program would over a number of years yield static welfare benefits in the range of 4¼-6½ percent of GDP (see "The Economics of 1992", European Economy, March 1988). These estimates have been the subject of considerable debate. Some have regarded them as overly optimistic. Others have pointed out that they do not take account of dynamic benefits that could add significantly to the long-term growth rate. L.A. Winters provides a review of the debate in Trade Flows and Trade Policy after 1992, Cambridge University Press (1992).

a strategic paper entitled "Making the Most of the Internal Market." The strategy for the coming years has four components.

(1) Legislative framework

The first element of the strategy is the completion and further development of the legal basis for the integrated market. In addition to ensuring that the outstanding white paper measures are enacted by the Council of Ministers, there will be a need to identify new measures warranted by changing circumstances and emerging needs. However, the principal legislative challenge relates to sectors that were not effectively covered by the original program, in particular, energy and telecommunications. In these sectors, substantial price differences across countries underline the costs of fragmented markets. However, as the competitive model is seen to be inappropriate--to some extent, this is due to technical factors on the supply side but also reflects social goals such as universal access--a simple strategy of deregulation is judged inadequate. Reaching an agreement on the optimal degree of government regulation is complicated by the substantial revenues that are earned by the public sector in providing these services in some countries.

The efforts to introduce a greater element of competition in energy are proving particularly difficult, with a 1992 Commission proposal meeting great opposition both in the Council of Ministers and in the European Parliament (see Annex II). In telecommunications, where technological change is pushing deregulation, agreement has been reached in principle on liberalization of voice telephony by 1998. As regards postal services, it is likely that any common policy will be defined in terms of the minimum universal service and the reservation of monopoly rights in specific areas to finance this.

A second area were the single market program had significant gaps was in the area of taxation. 1/ There were important proposals for the harmonization of indirect taxes and, after long debate, directives setting out minimum rates for VAT and certain excises were put in place in time for the dismantling of frontier controls in January 1993. There was, however, little attention given in the 1985 white paper to direct taxation, reflecting the considerable debate as to the need for a common policy. In particular, there is no consensus on the extent to which market integration requires harmonization and the recent focus on subsidiarity has reinforced the position of those resisting harmonization. Moreover, developing legislation is particularly difficult given that taxation is one of the few economic policy areas still subject to the requirement of unanimous agreement.

1/ There is a comprehensive presentation of the issues in this area in "Tax Harmonization in the European Community", IMF, Occasional Paper, No. 94.

The case for a common policy is based on the danger of tax competition, and the inefficiencies in the allocation of resources that might result from important differences in tax rates. Those who oppose harmonization underline, inter alia, the need to retain flexibility in fiscal instruments for macroeconomic policy purposes and because preferences for government services are likely to differ across countries. The case for a common policy is strongest where factors are relatively mobile. Not surprisingly, pressure for action has been greatest in the area of taxation of interest income and the harmonization of withholding taxes, but even here it has not been possible to make progress. There has also been considerable discussion of harmonization in the area of corporate taxes, most recently in the 1992 report of the Ruding Committee, which recommended a minimum corporate tax rate of 30 percent, but this was met by a cautious response from the Council of Ministers and the Commission.

(2) Monitoring implementation of internal market legislation

The second component of the strategy entails putting in place administrative and information systems to facilitate monitoring the implementation of EU legislation. The goal will be to promote conformity in the transposition of EU directives into national law, to ensure that internal market legislation is enforced, and to prevent the emergence of new barriers to market integration. These systems would be supported by legal actions against member states that fail to enforce EU law as well as by measures that facilitate access of individuals and companies to redress in national courts.

(3) Infrastructure networks

The third element of the strategy is the implementation of supporting measures in transportation and information infrastructures. To this end, the EU is addressing the tasks assigned to it in the Maastricht Treaty concerning trans-European networks (TENs)--establishing guidelines and master plans, identifying projects of common interest, and supporting member states through feasibility studies, loan guarantees, and interest rate subsidies. Information systems will also need to be attuned to providing individuals and enterprises with the information necessary to benefit from the internal market.

(4) Competition policy

The fourth element of the strategy is to make effective use of the tools of competition policy--the powers under the Treaty of Rome and the new instruments of merger control--to ensure that new barriers to competition do not emerge as a result of state aids or anti-competitive practices.

Since the mid-1980s, the Commission, which is charged with vetting state aids to ensure that they do not distort competition, has promoted greater transparency, inter alia, through the regular reports on state aids that it has been issuing since 1989. These reports have documented the steady, albeit gradual, decline in state aids in the EU, which have fallen from 4 percent of GDP in 1981 to 2 percent in 1990. The Commission is confident of its ability to ensure a continuation of the downward trend, but the current situation in the airline and steel sectors underlines the difficult circumstances often surrounding its decisions. While there may be some attractions to a macro approach to reducing subsidies--specifying economy-wide targets--the Commission sees, in practice, little scope for getting away from a case by case approach. The Commission's jurisdiction only applies where subsidies are distorting trade between member states. Moreover, subsidies are allowed under certain circumstances and following specified guidelines, in particular, for research and development, small- and medium-sized enterprises, industrial restructuring, and regional support. The process of reducing subsidies may need to entail a tightening of policies in these areas.

The second important focus of competition policy is limiting anti-competitive behavior in the markets. The Commission has used its powers to break up commercial and public monopolies and also attaches priority to challenging cartels and vertical restraints on trade such as exclusive dealer relationships. 1/ It is also encouraging national courts to apply EU competition rules more frequently in the belief that antitrust action through national courts can be quicker than at a European level. The powers under the Treaty of Rome can in circumstances be used as a substitute for legislation and, thus, it is possible that in areas where legislation is difficult to forge, e.g. the energy sector, the Commission will bring action in the courts to encourage greater competition.

Unusual price dispersion is one factor that may indicate the presence of market barriers. However, the Commission staff noted that price dispersion is normal even in well integrated markets. Price dispersion within the EU had been declining but some differences in technical standards would continue to be an obstacle to price convergence for some time, e.g., the effect of different broadcast standards on the market for televisions.

The third weapon of competition policy is merger control. In 1989, in response to the increase in cross-border mergers after the initiation of the internal market program, the Council of Ministers passed a regulation that gave the Commission the power to investigate mergers before they could take place. This regulation took effect in 1990 and through the end of 1993 the Commission had considered 175 mergers, prohibiting one and clearing eight others with conditions attached. Only relatively large mergers fall within

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1/ The exemption given the automobile companies has been particularly controversial in this respect. The Commission has however required that, twice a year, automobile companies publish list prices by market and it will remove the protection from parallel imports where price divergence of more than 12 percent are recorded with another EU market. In all cases, consumers are allowed to purchase automobiles directly in another member state.

the Commission's competence--those in which two of the companies concerned have a turnover of at least ECU 250 million within the EU and the companies in aggregate have a worldwide turnover of ECU 5 billion. There has been some consideration given to reducing these thresholds. One of the benefits would be to free more companies from having to seek approval of separate national regulatory agencies. However, the proposed extension of Commission competence did not command sufficient support and the issue has been deferred. 1/

2. Common agricultural policy 2/

External trade and budgetary issues have been to the fore in the debate on the CAP. However, the agricultural regime has also resulted in significant distortion in consumer choice and in the allocation of factors across markets. 3/ A reform of the CAP, adopted in May 1992, is currently being implemented. The immediate objective is to make production incentives more responsive to demand conditions so as to reduce, if not eliminate, excess production. This would make it possible to bring the cost of agricultural support under control and avoid trade frictions with other exporters of temperate zone products. It would also represent an important contribution to market integration in the EU.

Prior to the current reform, the CAP relied chiefly on market price support that was virtually open ended. It was enforced through intervention purchases of excess supply and through border protection that included export subsidies to bridge the gap between prices in the EU and the generally much lower level in the world market. This became untenable as the annual growth of output averaged 2 percent, outstripping demand growth of ½ percent.

Under the reformed system, intervention and border protection are maintained. However, the 1992 reforms constitute a major break with the past by introducing direct payments, thereby allowing substantial reductions in support prices and hastening the reallocation of resources from agriculture to other sectors. Specifically, support is being largely, but not entirely, decoupled from output in the case of cereals, with the support price lowered to somewhat above the current world market level and farmers receiving a flat payment per hectare under cultivation provided they participate in a set-aside scheme. The support prices for beef and veal are

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1/ Data are difficult to assemble, but with the exception of the aerospace and steel sectors, increases in indicators of concentration have been relatively small since the initiation of the internal market program.

2/ The material here is supplemented by a more detailed discussion in Annex III.

3/ Currently, agriculture accounts for 3 percent of GDP in the EU, but 6 percent of employment. Thus, productivity evaluated at market prices is considerably below that in other sectors, despite artificially elevated prices.

also being lowered significantly, with compensation to farmers in the form of larger direct payments through various premiums. 1/ The dampening effects on supply are, however, likely to be offset in part by lower prices for cereal feedstuffs. For oilseeds, the Commission representatives noted that prices were now fully determined by market forces, following an agreement with the United States.

The representatives of the Commission were confident that the reform was coherent and would attain its objectives. It was as yet too early for an assessment of the reform's impact. Not only would the implementation of some measures not be completed before the end of the marketing year 1995-96, but the adjustment to the changes that had been set in train might take several years longer. However, the fall in the production of cereals registered in 1993-94, the first year of the reform, was most encouraging. Moreover, simulations with different models supported the view that excess supply would largely disappear in this sector. This was expected to occur on the consideration that the lower institutional prices should encourage farmers to cut back on investment and on the use of expensive seed varieties and fertilizer which, in turn, would discourage research in yield improvement. 2/ Against that, however, the reforms had not addressed in a fundamental way the large excess supply of beef and milk.

The Commission representatives argued that the CAP would largely cease to pose problems in the coming years because the margin by which prices in the EU exceeded world market prices for temperate zone agricultural products was bound to narrow sharply, as a result of developments at home and abroad. 3/ As well as defusing trade tensions, the reform would constrain further the growth of CAP expenditure in the EU budget, by cutting the cost of export subsidies and market intervention. However, owing to the increased reliance on direct payments, total outlays on the CAP were unlikely to decline.

1/ To avert an escalation of the cost of this compensation, the number of animals eligible for the premiums may not exceed the size of herds in a reference period; there is also a restriction on the number of animals per forage area to discourage intensive breeding.

2/ They were likely to seek to control output by this means rather than by reducing the acreage, as the direct payment per hectare was only available for land under cultivation (with the acreage in the reference period as the maximum).

3/ This would happen under the combined impact of the sharp cuts in institutional prices being made under the reform and of a likely end, or even a partial reversal, of the decline in the relative level of world market prices recorded during the 1980s. The latter could be expected as the green revolution had largely run its course and purchasing power was rising in countries where the income elasticity of the demand for food was still high. At the same time, the sharp reduction in the volume of subsidized exports agreed in the Uruguay Round would exert upward pressure on prices in the world market.

Asked about future policy, the Commission representatives said that proposals for reducing the production of beef were to be submitted later this year. Corrective measures would sooner or later be taken to deal with the excess production of milk. 1/ There was no official position as to the approach that should be taken in the event that further changes in the CAP were needed after 1995, once the current reform was completed.

The staff views the reform as an important step in tackling agricultural surpluses in the EU. Clearly, substantive additional measures will be needed soon, especially in the beef and dairy sectors. More generally, the staff believes that the process of lessening reliance on price support in favor of direct payments should continue so as to reduce further the economic costs of the system. Indeed, as the system remains one of minimum prices and trade protection, it remains quite vulnerable to changes in technology or world prices. In the case of cereals, for example, while the margin of EU prices over world prices is being reduced considerably, surpluses might not decline to the extent planned should technological improvements proceed at a faster pace than envisaged. Similarly, should world prices be lower than assumed, the economic costs to the consumer would be greater than projected. The institutional arrangements needed for direct payments are costly but, as they are now in place, this consideration should not militate against greater emphasis on such payments.

The policy of reform could also suffer setbacks if there were significant changes in exchange rates within the EU and this was allowed to put upward pressure on prices. Uniformity of institutional prices--expressed in ECUs but applied in national currencies--is one of the foundations of the common market in agricultural products. To maintain this uniformity, institutional prices in national currencies need to be adjusted in line with exchange rate movements, with an appreciation giving rise to a reduction and a depreciation to an increase. It is tempting to raise the level of institutional prices (in ECUs) throughout the EU, and thus also to raise the level of protection, so as to spare member states with an appreciated currency the need for a politically difficult measure. 2/

1/ Further quota reductions have been decided, in principle, but specifics will depend on how the market situation evolves.

2/ For many years, member states could delay adjustment by resorting to so-called monetary compensatory amounts (MCAs), i.e., export levies and import subsidies or export subsidies and import levies, as the case might be. Moreover, the common price level was sometimes raised to accommodate member states with an appreciated currency; this became known as the switchover mechanism. At the start of 1993, as part of the completion of the internal market, the MCAs were abolished. When the ERM fluctuation band was widened in August 1993, the switchover mechanism became ineffective because it depends on changes in central parities. However, intramarginal fluctuations in exchange rates could no longer be assumed to be of no consequence for agricultural trade.

The Commission representatives explained that policy in this area was to avoid an upward drift of prices, as this would run counter to the objectives of the reform of the CAP. It had therefore been decided that, as long as exchange rate movements were small enough not to disrupt trade, institutional prices should remain unchanged in terms of national currencies. Specifically, there would be no change in the case of appreciations up to 3 percent or depreciations up to 2 percent. Beyond this range (referred to as the neutral margins), prices could be adjusted, but care would be taken not to adjust for short-lived changes. 1/

3. Structural funds

To facilitate the integration of markets and the achievement of the nominal convergence required for EMU, the EU assists lagging regions, which in a few cases encompass an entire member state, in their efforts to attain greater real convergence. Increasing resources are being devoted to this policy, which is referred to as social and economic cohesion and aims, in effect, at narrowing income differences within the Community. The Maastricht Treaty specifically adopts the dual objective of raising the level of economic development of the "least-favored" regions and reducing regional disparities. 2/ The assistance to the less prosperous regions is channeled through the EU's general budget and accounts for a significant part of its total appropriations--close to one-third in 1994. While the EU's budget is relatively modest in size--about 1¼ percent of the EU's GDP--structural fund payments are quite large for several less prosperous member states, in the range of 2½-3½ percent of GDP in 1992 for Greece, Ireland and Portugal.

Five priorities have been set for the assistance to member states. Most emphasis has been put on the development of regions that are lagging behind or are seriously affected by industrial decline. The other three objectives are: (i) facilitating the entry into the labor force of those who risk being excluded; (ii) helping workers adjust to industrial change; and (iii) promoting rural development. The corresponding appropriations are entered in the budget under a number of structural funds.

The appropriations for the general budget are drawn up on the basis of a multi-year framework, a so-called financial perspective. In December 1992, the resources to be committed under the Structural Funds was

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1/ The Commission may shift upward the central position of the neutral band; at the limit, this would yield 5 percent for appreciating currencies and leave no neutral margin for depreciating currencies.

2/ An indication of the magnitude of these disparities is afforded by the differences in per capita GDP (calculated at purchasing power parities) among the member states. In 1991-93, GDP in four countries was well below the EU average, excluding Germany's eastern Länder: Greece (47 percent of the EU average), Portugal (59 percent), Ireland (75 percent), and Spain (78 percent).

set at ECU 161 billion (at 1992 prices) for the period 1993-99, to which must be added ECU 15 billion for the Cohesion Fund. 1/ The corresponding appropriations are set to rise gradually, reaching in 1999 a level two-thirds higher in real terms than in 1992. Of these appropriations, three-quarters is for assistance to lagging regions, of which more than two-thirds will accrue to the four Cohesion Fund countries. 2/ Thus, the latter will receive a little over half of total structural fund appropriations.

The Commission staff has tentatively estimated that the contribution of the Structural Funds to economic growth in Greece, Ireland, Portugal and southern Spain was ½ percent or more a year in 1988-93 and could be in the range of ½-1 percent in 1994-99. They underline however that such calculations are subject to considerable uncertainty. They also point out that the estimates relate not just to the structural fund grants but the total investments they help finance. Indeed, no project is financed entirely by the Structural Funds; the recipients are required to cofinance, and additional resources have been harnessed within Community Support Frameworks in which, where possible, the European Investment Bank, national authorities (at different levels), and the private sector participate.

To ensure that the EU's structural policies succeed in enhancing investment, aid for regional development from the Structural Funds is extended on the condition that the projects concerned are additional to otherwise planned expenditure. Compliance is assessed by comparing past and planned public investment that satisfies the eligibility criteria for assistance. The test is passed if, in real terms, eligible investment, whether cofinanced or not by the EU, increases at least by the amount of EU transfers. For the programming period 1994-99, additionality has been given a macro-economic dimension by taking into account the overall circumstances in which the funding is taking place, including whether an unusual level of public infrastructural investment had been undertaken in the previous programming period and cyclical conditions. In the negotiations for the 1994-99 period, the Commission has included the prospects for nominal convergence in its assessment of the macroeconomic effects of the regional development plans. In some cases, it has been stressed that a greater reliance on private sector financing of infrastructure could alleviate the budgetary consequences of the use of structural funds.

The Commission representatives pointed to some simulation exercises which suggested that the obligation of the member states to cofinance

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1/ A Cohesion Fund, i.e., a special budget chapter, was created under the Maastricht Treaty to help the less prosperous member states--Greece, Ireland, Portugal, and (southern) Spain--achieve the degree of convergence required for EMU.

2/ The remaining two important beneficiaries of the assistance to lagging regions are Germany, with almost 13 percent (on account of the eastern Länder), and Italy with around 16 percent.

projects benefitting from the Structural Funds did not hamper the achievement of the Maastricht criteria in the fiscal area. Structural fund grants tended to account for most of the financing. Furthermore, faster real growth boosted tax revenue. Still, beneficiaries could conceivably face a budgetary problem. As the rate of EU cofinancing varied among categories of investment, a change in the structure of investment could require beneficiaries to put up more money in order to keep the assistance from the Structural Funds at its earlier level. 1/ For instance, as cofinancing was much lower for revenue-yielding projects than for infrastructure, a shift away from, say, roads toward telecommunications implied that the beneficiary needed to increase the relative size of its contribution. Also, after a period of exceptionally high public investment, a country might find it difficult to meet the requirement of additionality. However, it was hoped that the greater operational flexibility afforded by the new macroeconomic dimension to additionality would prevent major problems from arising.

4. Relations with non-member countries in Europe

a. Relations with European countries in transition

The EU has negotiated wide-ranging association agreements (Europe Agreements) with six formerly planned economies in central and eastern Europe--Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. 2/ The goal is the creation of a free-trade area (except for agricultural products) by 2003 and, ultimately, the accession of the associate countries to the EU. 3/ Thus, trade liberalization is to take the lead in the market integration process, and is the focus of the discussion below. As discussed in Annex IV, the agreements also have provisions dealing, inter alia, with movement of labor and capital, competition policy, and the approximation of legislation. To facilitate the integration process, the EU will continue to provide financial assistance under PHARE as well as loans through the European Investment Bank. In addition the EU may consider granting general macroeconomic support.

1/ Depending on the objective, the ceiling for the EU contribution is 75 percent or 50 percent of the total cost of a project. In the case of the Cohesion Fund, it is 80 percent or 85 percent, depending on the region.

2/ A Europe agreement is also being negotiated with Slovenia. Discussions with Croatia are suspended at present. Economic conditions in Albania are not judged ripe for an association agreement; instead, a more limited trade and cooperation agreement has been signed under which GSP benefits have been granted. Negotiations are underway with Estonia, Latvia, and Lithuania on free trade agreements that will replace existing trade agreements. The EU intends to conclude Europe Agreements with these countries as soon as the necessary conditions have been met.

3/ A commitment to eventual accession was made at the Copenhagen meeting of the European Council in June 1993.

The Association agreements with Czechoslovakia, Hungary and Poland, were signed in December 1991, and those with Romania and Bulgaria in November 1992 and March 1993 respectively. Pending ratification of the Europe Agreements, the trade provisions were incorporated in interim accords that took effect in 1992 for Czechoslovakia, Hungary and Poland and in 1993 for the other two countries. 1/ Under the agreements, trade liberalization is to proceed at a faster pace in the EU than in the association countries. At the meeting of the European Council in Copenhagen in June 1993, the EU, unilaterally, decided to accelerate the liberalization on its side; this will now be completed within 5 years of the effective dates of the agreements.

Trade liberalization has been particularly rapid for industrial products other than steel, clothing and textiles. Quantitative restrictions were eliminated immediately on the coming into effect of the interim agreements. Tariffs on the majority of these goods were also eliminated immediately, with the remainder to be phased out within three years--i.e., by end-1994 for agreements that came into force in 1992. 2/ For steel, quantitative restrictions were also abolished immediately and tariffs are being phased out over four years, i.e., by end-1995. For textiles and clothing, tariffs will be eliminated by end-1996 and quantitative restrictions by end-1997. Outside of industry, tariffs and quantitative restrictions on coal will be eliminated in 1994 in most EU countries, but Germany and Spain will be allowed to maintain restrictions for another four years. For agriculture, the agreements provide for levy reductions and tariff quota concessions, but the extent of liberalization is considerably less than in other areas. 3/

The Commission staff stressed that the pace of liberalization had been rapid. This had facilitated an increase of over 80 percent in the dollar value of EU imports from the association countries between 1989 and 1992; during the same period, imports of other European industrial countries from the association countries had increased at only half this pace and imports of industrial countries outside Europe had declined. While EU exports to the association countries had grown even faster than its imports--resulting in a surplus for the EU in this trade--this was not inappropriate given the need of the reforming economies to import capital.

1/ Following the dissolution of the Czech and Slovak Federal Republic, new agreements were negotiated with the successor states.

2/ Dates quoted below are for the interim agreements that came into effect in 1992; for the other agreements, the corresponding dates are, in almost all cases, one year later.

3/ While the association countries will benefit from much more favorable access to the EU's agricultural markets than other producers, important quotas and levies on agricultural goods will remain after the agreements have been fully implemented. Moreover, cereals have not been incorporated into the market liberalization.

The Commission staff acknowledged that sensitive industrial products represented a significant share of EU imports from the association countries. 1/ They noted however that, despite their less favorable treatment, imports of sensitive products had been growing as rapidly as overall trade. They also underlined that the remaining restrictions on industrial products were being phased out over the next few years, a process that had been advanced by one to two years by the decisions at the Copenhagen summit. Indeed, the timetable for the elimination of tariffs and quotas on textiles and clothing entailed a pace of liberalization more than twice as fast as under the Uruguay Round agreement. More generally, to illustrate the spirit in which the Europe agreements were being implemented, they explained that, in the case of tariff ceilings, complaints were being entertained only if the ceiling had been broken by a very large amount and only if the complaint were supported by several EU states.

The staff agreed that the pace of liberalization for most products had been impressive, as had been the increase in trade. There were however two areas of concern. First, there was a danger that the recent use of anti-dumping and safeguard clauses, particularly in the steel area, would create uncertainties as to the future stance of policies that could be an obstacle to investment in the reforming economies; the prospect of high unemployment in the EU for a number of years could reinforce any uncertainties. Second, the EU's relatively closed agricultural markets would remain an important constraint on exports of the association countries; even under restrictive access, agricultural goods accounted for 14 percent of association country exports to the EU in 1990-92.

The Commission representatives argued that safeguard and anti-dumping measures were used sparingly. The most important case had been the ceiling agreed on the imports of five categories of steel products from the Czech Republic and Slovakia; these accounted for a quarter of the Czechoslovak exports of base metals and products to the EU in 1992 and 4 percent of overall exports to the EU. 2/ Imports of these products from Czechoslovakia had tripled in volume terms between 1989 and 1992 and their unit value had fallen by almost one-quarter in ECU terms. This action had also to be seen against the background of the difficult ongoing adjustment in the EU's steel sector. In the case of agriculture, the Commission staff noted that the pace of liberalization was limited by the constraints posed by the CAP.

1/ In 1992, clothing, textile, and steel exports ranged from one quarter of manufactured exports to the EU for Czechoslovakia to almost one half in the case of Romania.

2/ Under this ceiling, exports of these products could rise by 1995 to a level that was on average 60 percent above the 1991 volume, but was still a little below the 1992 level. Additional information on safeguard and anti-dumping measures is presented in Annex IV.

b. EFTA countries

Since the late 1970s, trade in most industrial goods between the EU countries and the EFTA countries has been free of tariffs and quantitative restrictions. 1/ With the coming into effect of the EEA agreement in January 1994, six of the seven EFTA countries moved into an even closer economic relationship with the EU--while Switzerland had been party to the negotiations, the Swiss people rejected the treaty in a referendum in December 1992. The EEA in effect extended the geographical coverage of much of the EU's internal market--the most notable missing elements were that policies with respect to third countries were not harmonized and agricultural markets remained segregated.

After the commencement of negotiation on the EEA in 1990, five EFTA countries applied to join the EU--Austria, Finland, Norway, Sweden and Switzerland. Following the defeat of its EEA referendum, there has been no action on the Swiss application, but negotiations on EU membership for the other countries were concluded successfully in March 1994. The goal is that these countries accede to the EU in January 1995. 2/

While the EFTA applicants had accepted much of the EU's legislation as part of the EEA agreement, full EU membership will bring some important institutional changes, with implications for economic policies. Membership in the EU will entail participation in the CAP and the common fisheries policy, adoption of the EU's common commercial policy, contributing to the EU budget, the adaptation of regional policies in the applicant countries to EU rules, membership in EMS and the future monetary union, and the participation in EU decision making. Other issues not directly related to these institutional considerations were prominent in the discussions, most notably issues of the environment.

A full discussion of the agreements is beyond the scope of this paper, but some of the key points of negotiation can be noted here. The acceding countries will participate fully in the CAP on accession. As agricultural support is presently much higher in the EFTA countries, they will be allowed to provide national aids to farmers for a transitional period, financed in part by temporary relief from the full contribution of these countries to the EU budget. In a number of areas where the applicants apply tougher environmental standards than the EU, the applicants have been given a transitional period, during which the EU commits to reexamine its own standards. 3/ In the area of regional policies, agreements were reached allowing provision of national and EU aids to disadvantaged regions in the applicant countries, mostly sparsely populated arctic and mountain regions.

1/ Complete liberalization for sensitive industrial products was delayed until 1984.

2/ Referenda will be held in each of the applicant countries.

3/ The agreements require that the enforcement of tougher environmental standards by the acceding countries not lead to border controls.

The two most difficult issues were perhaps transalpine road transit through Austria and access to Norway's fishing grounds. The compromises reached late in negotiations were critical to the successful outcome with respect to these two countries.

While the accession agreements provide clear roadmaps for the integration of markets for goods and services, the dynamic effects resulting from the enlargement of institutions are more difficult to anticipate. First, if all four countries join, the balance between the large and small countries will change--two large countries and one small country will no longer be able to form a permanent blocking coalition on issues for which weighted majority voting applies--as will that between affluent and less affluent member states. Questions relating to the composition of the Commission and the weighting of the votes of member states in the Council will, however, be reopened in 1996, when they will be among the issues considered by an inter-governmental conference. Second, the accession of these countries could affect the timing of a future move to monetary union, given that commencement of stage III prior to 1999 requires that a majority of EU countries, including any new members, be judged ready to participate. 1/

IV. Topics for Discussion

1. Coordination and surveillance

The role of EU institutions in coordination and surveillance has gained in importance as attention has focused on the need to prepare the way for EMU. In particular, the Treaty on European Union has strengthened the institutional framework for surveillance, providing for the adoption of a set of economic guidelines for assessing the policies of member countries, instituting an excessive deficit procedure, and establishing the EMI. There has also been a notable broadening of the focus of surveillance beyond standard macro-financial indicators as policymakers have become increasingly concerned by structural problems in the labor markets.

While the new framework for the EU's surveillance has only recently been established, a number of policy recommendations have already emerged in the context of the first set of broad economic guidelines. One feature of the recommendations is the setting of specific goals for fiscal policy, drawing on the convergence criteria that were quantified in a protocol to the Maastricht Treaty. Thus, the guidelines envisage that, by 1996, most countries would be able to attain the convergence criterion for the general

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1/ It was agreed that, for an acceding country which had not been a member of the ERM for two years because of the timing of its accession, the record of exchange rate stability of the country's currency vis-à-vis ERM currencies during the relevant period of non-membership would be taken into account in deciding its eligibility of EMU.

government deficit of 3 percent of GDP. Moreover, in view of the need to make even greater room for investment, it is recommended that the process of consolidation continue beyond this in order to achieve a fiscal position that is close to balance by the year 2000. The guidelines also envisage that countries with critical fiscal positions, and especially those with high and rising government debt ratios, should take strong measures already in 1994, but that, for countries in a less critical situation, the formulation of medium-term consolidation programs, backed by the announcement of measures now to take effect as recovery takes hold, would represent a satisfactory start.

How do Directors assess these EU-wide goals against the background of an average general government deficit in the EU of 6¾ percent of GDP in 1993? Do they agree with the staff that, looking at it from the perspective of the EU as a whole, the strategy provides an appropriate balance between the need to make important progress on consolidation and the concern to avoid weakening the economic recovery?

With respect to the labor market, the EU's policy guidelines and a recent Commission white paper have emphasized a strategy for reducing unemployment that gives particular emphasis to three elements--fiscal consolidation, wage moderation based on solidarity, and active labor market measures that include reductions in employment taxes, especially for lower-paid workers, increased training and steps to foster labor intensive services. Concern to avoid diluting the European labor market model resulted in less emphasis on labor market deregulation and welfare reform. Directors may like to comment on this strategy and the staff's view that there is need for action over a broader range including measures to address adverse incentives resulting from minimum wage and other regulations and from overly-generous welfare benefits.

On monetary policy, as the EMI has only recently commenced operations, it is not yet evident how it will approach its tasks. Moreover, in contrast to the guidelines that have been provided for the surveillance of the Council, the EMI has a much less specific mandate. Its formal status in the Maastricht Treaty and the ability of its president to devote himself full time to its tasks suggest, however, that it will be in a stronger position to carry out surveillance functions than its predecessor, the Committee of EC Central Bank Governors. In this light, do Directors see the surveillance role of the EMI, combined with the widening of the fluctuation margins in the ERM and more effective surveillance of fiscal and structural policies, as providing sufficient institutional support for inflation convergence in the EU as well as an adequate bulwark against the re-emergence of tensions in European foreign exchanges?

Finally, in this area, Directors may wish to discuss any considerations they see arising out of the interaction of multilateral surveillance of EU institutions, with its expected emphasis on issues related to European economic and monetary integration, and the Fund's surveillance, exercised from a more global perspective.

2. Market integration

The paper has highlighted the impressive achievements of the EU to date and its continuing efforts in developing a more efficient internal market. A notable feature of the EU's experience has been the realization that eliminating tariffs and quantitative restrictions among EU countries, even supplemented by various tools of competition policy, was not sufficient to produce well integrated product and factor markets. Thus, from the mid-1980s, emphasis shifted to breaking down a whole range of barriers that resulted, inter alia, from the prerogatives of national governments in regulating domestic markets. Do Directors see this, combined with increased emphasis on tools of competition policy, as an important additional dimension to market integration, notable not least in that it improves access to EU markets for producers outside the EU as well as those within the EU? What weight would Directors attach to issues that have thus far proved difficult to resolve in the EU, issues such as competition in energy and harmonization of direct taxation?

Reflecting non-economic objectives, agriculture has for long been treated as a special case in the internal market. With increasing concerns over the efficiency and budgetary costs of the CAP, and conscious of the complications it has created in international trade negotiations, the EU has instituted a program of reform which significantly reduces the degree of protection, while attempting to satisfy noneconomic objectives through direct income supports. There are competing views on the extent to which reform needs to go in this area. One view stresses that the reforms underway, combined with supplementary measures in the beef and dairy sectors, will eliminate to a large extent the distortions in the system, while taking account adequately of non-economic objectives. An alternative view, while acknowledging the important progress that has been made already, underlines that the system is still one of minimum prices and trade protection, albeit with prices moving much closer to current world levels; in this view, the system is quite vulnerable to important changes in the world market environment. How would directors assess the reforms in light of these alternative perspectives?

The deepening of the internal market has been accompanied by the extension of its geographical coverage, with the coming into force of the EEA agreement. Further extension, albeit more slowly, is envisaged in the case of the European countries in transition, with trade liberalization taking the leading role. In light of the goal of the eventual full integration in the EU of the central and eastern European economies in transition, as well as the need to support their policies of reform, Directors may wish to assess the degree of trade liberalization provided for in the EU's association agreements with these countries, including the rapid market opening for most industrial products, the less liberal treatment of agriculture and whether safeguard and anti-dumping clauses are cause for concern.

Within the EU, there have been efforts to ensure that less affluent, and often geographically more remote, areas are better positioned to participate in the benefits of the market integration. To this end, the Internal Market Program and the Treaty on European Union have been accompanied by an enlargement of the EU's Structural Funds. Directors may wish to comment on the potential for conflict between fiscal consolidation and the requirement of additionality, i.e. national contributions to the funding of projects supported by the Structural Funds.