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ANNUAL ECONOMIC REPORT 1981-82

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1. Foreword

The Commission's proposed "Annual Economic Report" for 1981-82 is submitted to the Community institutions in accordance with the Council's 1974 Decision (1) for attainment of a high degree of convergence of economic policies of Member States. The Council is required in the fourth quarter of each year - on proposal of the Commission and after consulting Parliament and the Economic and Social Committee - to adopt an annual report on the economic situation in the Community and to set economic policy guidelines to be followed by each Member State.

As in previous years the Commission has also prepared, as a separate background document to the "Annual Economic Report", an "Annual Economic Review" which contains a more detailed factual analysis of economic trends and the outlook for the year ahead. This second document is submitted to the Council, Parliament and Economic and Social Committee for information.

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(1) Article 4 of Decision 74/120/EEC of 18 February 1974, amended by Decision 75/787/EEC of 18 December 1975.

2. Retrospect and prospects

(i) 1981 : digesting the second oil shock with an unstable dollar

It now seems likely that the volume of output will have been at best of the same order of magnitude in 1981 as in 1980, compared to the increase of 0,6 % forecast by the Commission a year ago in the last Annual Report (see Table 1). The recession lasted two quarters longer than expected.

The most conspicuous contributing factor to these differences between forecast and out-turn has been the strong appreciation of the US dollar and the related rise in world-wide interest rates. The hypothesis behind last year's forecasts included some appreciation of the US dollar against the ECU, but the 34 % increase that has occurred in the twelve months to September 1981 was very much greater than expected. Interest rate declines had been expected for 1981.

As a result the Community's import prices are likely to rise even faster in 1981 than in 1980 (16 1/2 % against 14 1/2 %), and its terms of trade loss will be greater too (4 % against 3 %). In these respects, the dollar revaluation in 1981 was on the same scale as the second oil shock in 1980 (although in other respects they are quite different, for example in demand and competitivity effects).

The oil price in 1981 stabilised around \$ 35 on average, which is broadly what had been supposed in the forecasts of a year ago. The exchange rate movements have not entirely prevented the Community from benefitting from the stabilisation of the oil price : a weaker dollar would probably also have weakened pressures to stabilise the nominal oil price.

Following from the fast rising import prices, consumer prices are now forecast to grow considerably faster in 1981 than originally expected (11,3 %, compared to 9,7 %) in spite of the fact that wage incomes have accelerated only a little. Thus there was no overall progress in reducing inflation in 1981. The squeeze on household incomes resulted in a low level of private savings, as well as a slight fall in the real level of private consumption compared to the 2 % gain that had been expected. Investment and stockbuilding performance also were weaker than expected, influenced no doubt by the very high interest rates.

Table 1

The Community economy 1960-82

	GDP volume growth	Productivity growth	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government financial deficits	Savings ratio of households	Monetary supply growth M2/M3	Unemployed in labour force
	% (3)	% (4)	% (3)	% (3)	% GDP	% GDP	%	% (5)	%
1960-69	5,0	4,8	3,4	8,4	0,4	-0,4		8,0	2,1
1970-79	3,3	2,9	8,8	13,0	0,1	-2,4	13,8	13,8	3,8
1979	3,4	2,6	9,6	10,6	-0,5	-3,6	17,1	11,9	5,4
1980	1,1	0,9	11,8	13,4	-1,4	-3,5	16,3	10,5	6,0
1981 last Report (1)	(0,6)	(0,9)	(9,7)	(10,3)	(-1,2)	(-3,9)	(16,9)	(9,0)	(6,8)
" this Report	-0,5	0,8	11,3	11,5	-1,2	-4,4	16,2	11,2	7,8
1982 (2)	2,0	2,1	10,4	10,8	-0,9	-4,1	16,1	9,9	8,5
half years									
1981 I	-0,2	1,3	12,1	:	-1,3	:	:	:	7,4
1981 II (2)	1,1	2,3	11,1	:	-1,2	:	:	:	8,2
1982 I (2)	2,2	2,0	10,8	:	-1,0	:	:	:	8,5
1982 II (2)	2,7	2,2	9,8	:	-0,9	:	:	:	8,6

(1) of 15 October 1980
(2) Forecasts of the Commission staff on the basis of present or anticipated policies
(3) % change over previous period
(4) Per occupied person, whole economy.
(5) End of period over twelve months earlier

However, the massive improvement in the Community's international price competitivity saw some compensating switch in demand with exports to non-EC markets now likely to increase 4 1/2 % for 1981 as a whole, compared to the 2 1/2 % expected a year ago. In spite of the worse terms of trade, the current account deficit for 1981 will remain at a similar level as in 1980.

The lower rate of activity, and accelerating labour supply, has also raised the level of unemployment, but the 7,8 % rate now estimated for 1981 as a whole exceeds the earlier forecast of 6,8 % by a wider margin than might have been expected from historical output-employment relationships.

As regards policy performance, it now seems likely that money supply will have grown 11 % on average in the Community as a whole, compared to the 9 % rate forecast for 1981 in the last Annual Report. While Germany has kept within its target range, other countries are tending to exceed the rates of growth projected in the last Annual Report.

For budgetary policy, the postponed recovery has meant automatic tendencies for deficits to rise, with weaker tax increases and higher expenditures - typically for unemployment compensation and interest rates. While it is estimated that these influences could have added about 1 1/2 % of GDP to the size of budget deficits, governments took steps to limit this rise through restrictive action amounting to about 1 % of GDP, the average deficit thus reaching 4,4 % of GDP, compared to the 3,9 % expected in the last Annual Report.

The European Monetary System has continued to function satisfactorily in 1980-81 in as much as exchange rate variability has remained substantially lower than in the last decade (see Table 2). The two realignments in central rates agreed on 22 March and 4 October 1981 (see Table 3) confirmed the ability of the system to make orderly adjustments in accordance with fundamental economic criteria, while preventing erratic or irrational exchange rate movements.

Table 2

Indicators of convergence and divergence in the Community 1960-82

	GDP per head of total population (c.v.)		Consumer prices % change (s.d.)	GDP deflator % change (s.d.)	Exchange rate changes (mean)		Net borrowing of general government % of GDP (s.d.)	Money supply % change (s.d.)
	PPP	EXCH			EC-10	EMS		
1960-70	12,4	18,8	1,4	1,7	1,1	1,0	1,9	3,3
1970-80	14,6	26,4	3,6	4,3	4,0	3,7	3,7	5,1
1979	15,7	29,5	4,8	4,9	2,7	1,8	3,7	5,4
1980	15,2	23,6	6,2	6,2	4,6	2,4	3,9	4,9
1981	15,3	20,9 (2)	6,0	6,1	3,2 (1)	2,1 (1)	4,4	3,9
1982(forecast)	15,8	"	5,5	5,6	..	..	4,4	3,8

Abbreviations:

c.v. = coefficient of variation (standard deviation divided by mean).
s.d. . = standard deviation,
mean = mean change on previous year of currencies against the ECU.
PPP = purchasing power parity.
EXCH = current market of exchange.

(1) First half of year.
(2) At mid-1981 exchange rates.

Source: Commission services

However, the convergence of economic fundamentals has been much weaker, and in fact seriously inadequate. The divergence in inflation rates (as measured by the standard deviation of consumer price rises) has risen in 1980 and 1981 to an even higher level than experienced in 1975-76 after the first oil shock. Budgetary policies have become increasingly divergent (as also indicated in Table 2 by the standard deviation of Government deficits as a share of GDP) in 1980 and 1981, compared to the average for the past decade, and even more so compared to the nineteen-sixties. While structural differences in budgets between countries are to be expected, major differences in the response of budgetary policy to a shock such as the oil price increases are difficult to reconcile with the objectives of exchange rate stability in the EMS. Differences in the degree of absorption of the first oil shock in real wage levels have still persisted.

(ii) 1982 : Prospects for recovery

There are three major points to bear in mind about the outlook for the year ahead : the nature of the cyclical recovery that is likely to develop between now and mid-1982, the nature of the major risks that hang over this view of the short-term future, and the nature of the medium-term path of development which the Community economy may be on by the end of 1982.

A certain cyclical recovery seems now to be beginning. The Community's surveys of business opinion suggest this, although the speed of the upturn still seems likely to be moderate. Taking 1982 as à whole over 1981, GDP should rise about 2 %, with a somewhat faster rate building up in the course of the year (2 1/2 % - 3 %). Exports are expected to be the most dynamic demand component (+ 6 %), with domestic demand growing only 1 1/2 %. Consumer price rises should decelerate to about 10 1/2 % for the year as a whole, and the balance of payments current deficit narrow to 0,9 % of GDP. Money supply expansion may decelerate somewhat, while public deficits are expected on the basis of budget plans known to date to narrow on average slightly to 4,1 % of GDP. Unemployment is expected to stabilise in the second half of 1982 at a level of about 8 1/2 %.

Of the many assumptions that have to be made in any forecast, three external factors are of evident importance and unpredictability: the price of oil, and the interest rate and exchange rate of the dollar. For the price of oil, it seems tenable to assume that in the course of 1982 its dollar rate will not rise more than that of the oil-exporters' import prices. For interest

Table 3

Exchange rate realignments in the European Monetary System in 1981

	Revaluation (+) or devaluation (-) of bilateral central rates		Changes in effective exchange rates implied in central rate changes (2)	
	22 March 1981	4 October 1981	22 March 1981	4 October 1981
DM	0	+5,5	+1,4	+5,9
HFL	0	+5,5	+0,6	+3,7
DKR	0	0	+0,9	-2,5
FB/LUX	0	0	+0,6	-1,8
IRL	0	0	+0,6	-1,4
FF	0	-3	+1,8	-4,5
LIT	-6	-3	-6,0	-4,6
(UKL)(1)	(+22,7)	(-9,9)	-	-

(1) The UK pound is included in the ECU, but not in the exchange rate mechanism of the EMS. For technical reasons, the pound is attributed a notional central rate in the system, and at each of the two realignments this rate was brought into line with the market rate of the pound against a reference currency prevailing on the day before the realignments (on 22 March, HFL, and on 4 October, DKR).

(2) Against currencies participating in the exchange rate mechanism of the EMS.

rates and exchange rates the outlook may be more uncertain. The dollar rates in both cases seem considerably higher than should be expected on a medium-term basis, but it is impossible to know when and how fast adjustments may take place. The technical assumptions underlying the Commission's forecasts include only a very partial regaining of ground of the ECU against the dollar in 1982, with some easing of US interest rates setting in from the beginning of the year. The sharp weakening of the dollar in late September is a reminder of how quickly the international monetary scenario can change. Indeed, it is possible that both the oil price and the dollar could prove weaker than now expected for 1982, in which case the Community's balance of payments deficit could reduce faster, and the recovery of domestic demand prove stronger.

Beyond the cyclical recovery phase over the next twelve months, assuming that further damaging shocks can be avoided, lies the question whether the Community economy will have moved on onto a growth trajectory that would be both sustainable and sufficiently strong to absorb unemployment. The answer is by no means clear. The last cyclical recovery (1978-79) broke down after two years of 3 1/2 % growth and had managed just to stabilise the unemployment level over that period. While the immediate cause of the breakdown was the second oil shock, it was also true that physical capacity utilisation was high in many industries, due to serious under-investment. The evidence gives a rather clear warning that the cyclical recovery phase will have to be accompanied by fundamental changes in the structural performance of the European economy and requires considerable action on the part of the social partners if it is to lead to a reduction in unemployment.

3. An outline of economic policy for the Community

Guidelines for economic policy in the Community for the period ahead may be defined under three headings:

(i) immediate issues of policy that relate to the international monetary environment and follow from the EMS realignment of 4 October 1981. Beyond questions of continuous management of monetary policy, this concerns decisions fixing budgets and, in several cases, domestic monetary policy objectives for 1982, and, generally, negotiations over pay for the next contract period;

(ii) how the framework of institutions and ground rules for economic policy need to be improved, notably in order to reverse tendencies for the economies of Member States to diverge in their financial policies and cost performance;

(iii) how the Community should tackle over a period of years its fundamental needs for higher levels of investment and competitive employment creation.

3.(i) Immediate issues of policy management following the October EMS realignment

The realignment of EMS central rates of 4 October was an act of sound management of the system. While the divergences that caused it need to be combatted more effectively, the adjustment was fully in conformity with the rules of the system; participating countries remain well shielded as between themselves from erratic or overshooting exchange rate movements. For the period immediately ahead, economic policy needs to be adapted in two ways:

(a) the Community needs to fix on a strategy capable of navigating successfully through an extremely unsettled international monetary environment,

(b) domestic policies for 1982 need to be set to make a success of the exchange rate changes, and to set the Community onto a firmer recovery path in the course of the next year.

The most favourable international scenario for the months ahead, from the US as well as the European point of view, would be one in which US interest rates declined substantially against a background of decelerating inflation, the dollar's exchange rate gradually moved back to a less high level, and economic activity in the US remained buoyant. In this case, European interest rates could also decline, while the Community could make rapid progress in reducing its balance of payments deficit with a boost to export-oriented industry.

A less favourable scenario would be one in which the dollar weakened sharply while US interest rates remained high alongside a weakening in economic activity. In the very recent past, some trends have been more of this kind. If this scenario deepened, the Community would need, and perhaps would have an opportunity, to disconnect its monetary conditions from those prevailing in the US. In particular, the Community might wish to dampen an unduly sharp dollar exchange rate fall with a reduction in European interest rates, opening up - at least for the low-inflation countries in Europe - an interest rate differential vis à vis the United States with lower rates in Europe. If combined with a moderate hardening of European exchange rates, this interest rate decline could be compatible with improved price stabilisation and a continued strengthening export performance in world markets. Thus in the second scenario also, there is a possible short-run strategy for Europe that could lead to a strengthening economic recovery.

The Community should also be making constructive suggestions to its major partners in the industrialised world for a more cooperative management of the major international monetary variables.

To make a successful strategy for 1982 requires that domestic policies be set in the Community in a way that supports these elements of external policy and is also coherent as between Member States in the light of the EMS realignment and the need for better convergence.

To do this in practise is a highly complex matter, and one that necessarily involves controversial issues. The key decisions are being made in the set of draft budgets for 1982 some of which are already before national parliaments, in fixing targets for domestic monetary aggregates for 1982 in the course of the autumn in some of the larger Member States, and in the forthcoming negotiation of principal wage contracts for the period ahead - in some cases annual as in Germany, in some cases for up to three years as in Italy. The complexity follows from the fact that in the optimal Community policy these three main decision-making variables - budgets, money, and incomes - have to be set consistently inter se within countries as well as between countries. Moreover there are several types of institutions involved in these three domains, and understandably so (the following section returns to institutional questions).

The first particularity of the outlook for 1982 is the acute interrelationship between budget and monetary policy. The sensitivity of interest rates to budget policy variables is almost certainly much stronger now than at any time in the past. A budget policy allowing the deficit to rise is likely now to be relatively heavily offset in its stimulative effects on economic activity by increasing interest rates; conversely budget policy action to reduce deficits is likely to be considerably offset in its contractionary effects by falling interest rates. Moreover this seems to hold for all Member States, ranging from Germany whose economy is the least disequilibrated, through France whose budget deficit has been the lowest in the Community in recent times, to the several countries whose deficits are now around or in excess of 10 % of GDP.

The second particularity is the need to follow through the EMS realignment with internal policy adjustments. For revaluing countries, stabilisation policy is strengthened, the prospects for interest reductions are improved and thence should follow a support for the real economy. The devaluing countries should exploit the opportunity now to make a more rapid external adjustment, which requires that they intensify efforts to avoid cost increases, that budgetary policy be controlled more strictly, and that monetary policy be managed so as to maintain durably the new central rates.

In the present circumstances, the probable reduction in the German budget deficit could contribute significantly to a reduction in German interest rates, which are exceptionally high in real terms (+7 % for short-term rates). The size of the impact on interest rates, while difficult to quantify, could be especially important because of the international monetary context already discussed. A marked recovery in international market confidence in the capacity of the German economy to adjust successfully to the energy shock and competition in world markets would make possible a movement back towards \$/DM interest rate differentials that reflect relative inflation performance.

The German money market is a fulcrum between international monetary conditions and those prevailing domestically within most Member States, and notably those in EMS countries. If German interest rates decline substantially, the rates in most Member States should be able to follow. In this way a rigorous German budgetary policy may be seen as leading to overall financial conditions favourable to the business upswing and employment in the rest of Europe; it can fit positively into a concerted strategy for the Community.

But for this to be the case there are still further conditions to be fulfilled:

(i) avoidance of 'overkill' in public finance stabilisation, and
(ii) convergence in the approach of all Member States, which means consistent, but not identical policy adjustments.

The danger of 'overkill' lies in creating recessionary circles of cause and effect between budgetary action which reduces demand and thence a weaker level of activity which automatically increases the budget deficit again, so leading to a new round of restrictive action in order to adhere to fixed targets for the budget balance. Almost invariably action to reduce budget deficits will have some demand contractionary effect, but this may be offset by monetary and external demand effects. The risks of a recession are great when the budgetary action is excessively heavy in relation to the desired interest rate reduction, or when it is accompanied by a serious overvaluation of the exchange rate, or cost increases that make the economy uncompetitive. Thus judgements on whether restrictive budget policy actions are 'deflationary' are not simple. Much depends on the monetary context, and on whether the social partners support or defy policies of stabilisation and adjustment in their income settlements. The United Kingdom is the major example of a Member State which has experienced a more serious recession since the second oil shock compared to the first, and this seems to be due to the combination of rigorous financial policies with a preparedness to let the Pound float outside the EMS and the fact that employers and trade unions did not adapt quickly to the financial stabilisation policies.

Convergence in the approach of Member States towards budgetary policy is necessary if all are to benefit from the interest rate reductions that are desired. If not, the benefits will be at best unevenly distributed, and worse the whole strategy risks being destabilised, inter alia through creating renewed exchange rate tensions. In the case of the Netherlands, the proposed 1982 budget would appear to be rather convergent on the German strategy as regards the budget balance, although taxation and public expenditure levels remains very much higher in the Dutch case. In 1981 seriously divergent trends were seen in Belgium, Denmark, Ireland and Italy as budget deficits attained levels that were fundamentally out of line with policy either in Germany or the average of the Community. In 1982 budget policy should in these countries at least begin to return towards more average Community magnitudes. The draft budgets so far published are hardly more than first steps in this direction. In no circumstances should the governments let these levels be surpassed, as in fact happened in 1981 in relation to the initially targeted levels. On the contrary, the realignment now makes it possible to envisage more ambitious budget consolidation targets. France is in a particular situation: in 1980 it was the only country to have a negligible budget balance. Since then its deficit has been increasing quite rapidly, but the draft 1982 budget deficit remains below the Community average as a share of GDP. If the balance of payments and inflation were in a similarly relatively favourable condition, this policy would be without serious risks. Since this is not the case, as the realignment has underlined, the government must control very carefully the extent of its budget policy change. Moreover, the realignment now permits exports to take over some of the demand stimulus initially envisaged for the 1982 budget.

Within the structure of budgets adopted for 1982, a common priority for all Member States is to find room for necessary expenditure on employment programmes and for the stimulation of investment. In order to respect overall financial constraints, this will require changes in existing programmes of current public expenditure. Important changes can be made without weakening vital public services. For example, the demographic changes at present underway mean that resources should be shifted from schooling to vocational training as the 'bulge generation' advances. However, social security budgets need to be examined with a view to containing their growth, re-examining their methods of financing and re-inforcing the efficiency of their coverage.

In setting monetary targets for 1982, there is scope for improving the degree of prior consultation within the Community, before the central banks decide their policies in full conformity with their national institutional positions. In 1981, it seems likely that many central banks, with the exception of the Bundesbank, will overshoot their targeted rates of monetary or credit expansion, or the rates forecast by the Commission in last year's Annual Economic Review. For 1982 the monetary aggregates must be controlled within limits that will favour a distinct lowering of the rate of inflation, which in turn would aid the lowering of nominal interest rates without endangering the new EMS central rates.

There is a consensus in the Community over the need to act urgently and decisively to reduce unemployment.The right financial strategy will help. Direct labour market measures need to be intensified within this financial strategy, and these are further discussed below. The experience of Germany after the first oil shock, and of Japan more recently, both show how a rapid and major adaptation of labour costs to the needs of a new situation can enable major economic difficulties to be overcome. In the present situation, Europe has become much more competitive because of the combination of exchange rate changes externally against the dollar and yen, and internally within the EMS. This presents an enormous opportunity for European industry, and employment creation. But it is precisely in the next pay negotiations that the social partners will have to decide whether to confirm this improved competitive potential, and at the same time help inflation and interest rates to come down; to do so requires accepting real pay increases substantially below the growth of productivity until the economy is returned to a radically higher investment and growth performance.

3. (ii) Overcoming obstacles to a better convergence of monetary and budgetary policies and incomes.

A combination of convergence in nominal exchange rates, but divergence in budgetary, price and cost developments, has developed over the past two years. These contradictions can be sustained for some time, but only at the cost of increasing economic distortions, such as widening balance of payments, inbalances and rising real interest rates in countries with high budget deficits or attempts to control capital movements. But at some stage they must be offset by exchange rate changes, as recent experience confirmed.

The lack of balanced progress in stabilisation policy already led the Commission, in its Communication of 1 July to argue in favour of accelerated programmes of economic adjustment in several countries, with the emphasis on urgently required public finance and income stabilisation measures. This general Communication was followed up with a Communication on the principles of indexation, and two Recommendations on economic policy in Belgium and Italy.

There is considerable agreement on the need to support common monetary stabilisation efforts with convergence in budgetary policy and income trends. This being so, it is necessary to give greater attention to how institutional or even managerial factors affect the reactions of the economy to events that can induce the divergence process, notably the reactions of (a) employers and employees to a price shock in their pay negotiations; (b) the monetary authorities to demands for increased credit; and (c) the budgetary authorities to tendencies for results to deviate from initial plans.

As regards pay, the systems prevailing in the Community range from those in which the wage bargain is fixed in nominal terms for at least a year; to those in which an indexation mechanism automatically passes prices through into wages within as little as two months delay.

On the issue of indexation the Annual Report adopted by the Council last year indicates the high degree of consensus among governments on the need to avoid passing through the oil price increases into incomes. Some countries accustomed to indexation have taken some steps to limit its automatic pass-through of oil prices and indirect tax increases (Netherlands, Denmark). But in other countries existing practices have not changed (see the Commission's Recommendations to Belgium and Italy). Therefore the Commission followed up on the concern expressed by the European Council in March with a general Communication that concludes on four main points:

(i) Where the principle of wage indexation is accepted, the regulation index should exclude the impact of factors outside corporate control (terms of trade, indirect taxation etc.);

(ii) wage adjustments should only be made with delay, and not more than twice a year;

(iii) where the inflation rate is appreciably above the Community average, the aim should be to limit indexation to an agreed rate, for example to the Community average inflation rate;

(iv) a simple and temporary technique for adapting to an inflationary shock could be to forego entirely a certain number of indexation adjustments.

The urgency of action along these lines is now intensified following the EMS realignment.

As regards monetary policy, the range of policy reactions is between the case in which the monetary authorities commit themselves to nominal targets, and are expected to act to adhere to them, and the case in which the monetary authorities could - on past performance - be more expected to supply relief to enterprises in difficulty or financing to the government where market conditions become difficult. Problems of divergent monetary policy have so far been relatively limited to the extent that the members of the EMS who were before members of the Snake have accepted the required monetary discipline. Thus the problems among these countries are more often those arising from the combination of effective monetary control and ineffective efforts at pay moderation and budgetary control. But there are also examples in the Community where the operating responsibilities of the monetary authorities need to be clarified, for example in Greece. In Italy certain reforms are now being implemented. Moreover in the period ahead there is the need to prevent the erosion of monetary disciplines maintained until now (France).

As regards budgetary policy, the factors leading to divergent results are the most complex. The variables here are (a) the speed with which the essential statistics become available (b) the managerial capacity of the budget system to control over-runs, (c) the legislative procedures for control and adjustment, and (d) the willingness of the political authority to mark out clearly its budgetary objectives and give credibility to them. In practise over the past year, a major issue has been that of judging when the so-called "automatic stabilisers" needed to be resisted with offsetting expenditure cuts or legislative changes. The normative qualities of this term need correcting for countries whose starting position is one of serious financial disequilibrium, for example, countries with very large public deficits (Belgium, Denmark, Italy, Ireland). The presumption should rather be that economies with high public deficits are prone to being gravely destabilised, especially when large deficits are associated with high inflation or high real interest rates. The dangers inherent in the "automatic destabilisers", and notably the speed and ease with which a budgetary deficit have been seen recently to slide out of control up to enormous magnitudes, underlines the priority that several countries need give to reforming their systems of budget control. Indeed the four countries mentioned, whose public deficits have now reached, or are close to, 10 % of GDP, are now massively out of line with the average of the Community.

3. (iii) The challenge of building up investment and employment

The rise in the rate of unemployment to 8% is now the most dramatic of the Community's economic problems. The weakness of its investment performance, which has fallen about 2 % as a share of GDP in the years since the first oil shock, compared to the five years preceding it, and the rise in the rate of demographic increase in the labour force to nearly 1 % per year, points to the magnitude of the task of creating new jobs for a large fraction of those now unemployed. These problems are at the core of the proposed fifth medium term programme for 1981-1985 which the Commission sent to the Council in July(1).

The reduction of unemployment in the Community cannot satisfactorily be achieved without a massive renewal and expansion of the stock of productive capital. While relatively high rates of interest over a medium-term period may induce some helpful substitution of labour for capital, the strategy that the Community should follow still requires investment in new equipment. The only industrial strategy that can go with a weak investment performance is one which consists of down-grading productivity, technological quality and income levels relative to international competitors; this is not a strategy upon which the Community wishes to converge.

The challenge of building-up employment and investment involves the use of several instruments of policy and several indirect prerequisites of success, because of the importance of a favourable climate for investment for the success of such a strategy(2).

A first fundamental factor, the cost of labour in relation to that of competitors, has been considerably transformed over the past year as a result of the depreciation of the ECU against the dollar and the yen. Thus the Community's average unit labour costs (relative to its competitors, expressed in dollars) is likely to decline 14 1/2 % in 1981, as against increases of 14 % for the US and 10 1/2 % for Japan (see Table 14). The Community must for the time being take the opportunity to achieve a rapid balance of payments adjustment. To this end, the increased competitivity of the Community's producers must be translated into a rapid expansion of sales to regain lost market shares

(1) The complete texts and related analyses are published in European Economy N° 9, July 1981

(2) See foreword to the Vth Programme, and Energy and Research documents

Community and on third markets. Increased sales must now assure a build-up in the volume of profits, and then lead on to a new wave of investment to increase capacity and employment. This full cycle of results takes several years to build up.

A second fundamental factor is the cost and availability of capital. To achieve a reduction on average in the rate of interest is of vital importance for stimulating investment, but this cannot be done simply nor by decree. As regards very high real rates of interest, for example of the order of 5 to 9 % in some countries (notably Belgium, Denmark, Germany and the Netherlands), compared to the long-term average of about 2 1/2 %, these must be reduced substantially for a strong investment performance to take root. Relief from such very high real rates should in the first instance come from an adjustment to more normal international monetary conditions, but for some Community countries it will require stronger action to reduce budget deficits.

However, unduly low or even negative real rates of interest cannot be a sound prescription for investment and growth. Savings performance needs to be strengthened, and increased resources must be channelled into risk-bearing private uses - compared to government bonds which at present dominate many capital markets.

Governments should be examining the case for adapting rules governing business taxation, capital markets, and aids affecting investment and savings. The inflationary environment in addition creates serious problems for adequate capital cost evaluation and efficiency of incentive schemes and tax regimes. For example, where profitability is low or even negative and the prospects are depressed, the value of any investment incentive is correspondingly weakened, especially those of depreciation allowances. As inflation has increased, the incentive value of depreciation allowances has declined. Moreover, inflation and low profitability have tended to reduce the availability of risk capital required for increasing employment. Policy towards investment aids is too complex a subject, and too varied between countries, to allow simple generalisations. Two propositions, nonetheless, would seem to hold. Firstly, given the present priority need to induce a massive new build-up of investment, the level of financial incentive towards capital formation and innovation should be maintained in real terms if not increased. But secondly, experience has shown that multiple systems of aids directed at different policy objectives can become contradictory and cost-ineffective. Economies in obtaining better value for money in investment aids remains a promising pursuit for the authorities concerned.

The reduction of unemployment must come essentially from job creation in new growth industries and service sectors. In many of the newest and promising industries - microelectronics for example - the Community's world position is not as strong as it should be. To build up its new industrial base the enterprises, governments and Community have to work together in a comprehensive strategy, involving research and development, corporate organisation, commercial and public procurement policies. There are already examples of success, with the Airbus winning back substantial world market shares in its segment of the aerospace industry. The Community must give the highest priority to stimulating the capacity of European industry to become a major world force in the principal advanced technologies of the decades ahead.

In industrial policy the Community has to make up what individual Member States alone cannot achieve by comparison with the United States and Japan. The exploitation of Europe's continental dimension should not necessarily rely on public intervention at the Community level. However, all the Community's relevant policy responsibilities should be turned to facilitating this process. First the openess of the internal market needs further to be improved. Secondly, the use of state aids must be controlled to prevent segmentation of the market and national discrimination. Thirdly, the Community should act whenever necessary to stimulate the formation of an advanced European industrial capacity. Fourthly, the Community's own financing possibilities should continue to build up support for investment and structural adaptation in the areas of accepted Community priorities. This concerns both loan funds and the structural funds of the Community budget whose policies are at present under review. The Community should furthermore encourage the development of small and medium-sized enterprises, in part by facilitating their access to Community finance through the technique of global loans to the appropriate financial intermediaries.

Many detailed initiatives are now being taken in Member States to help the process of small scale employment creation. This welcome trend should take account of the contribution that different types of enterprises, including cooperatives, can make in creating jobs, particularly through the exploitation of local economic potential, thereby opening up important scope for more flexible adaptation of the economy to meet market opportunities.

The needs for a stronger Community energy policy provide a vital component of the strategy for building up investment and employment. A comprehensive outline of what could now be done has been proposed recently in a Commission Communication "The Development of an Energy Strategy for the Community"(COM(81)540, 23 September 1981). Five main priorities for action by the Community are suggested:

(i) ensuring an adequate level of investment both in alternatives to oil and in the more rational use of energy. Forecasts for energy-related investment suggest that its volume will rise from around 1,6 % of GDP now to 2,2 % on average for the present decade, which would represent 9 - 10 % of total investment, implying expenditure of some 500 billion ECUs. The Commission has doubts whether these forecasts can be achieved without new action within the Community. But even if they were achieved, the level of energy investment would still only amount to about half the relative effort of the United States and two-thirds that of Japan (in all cases measured in the basis of energy investment as a share of GDP).

(ii) the development of a common approach to energy price and taxation. In the latter field the Commission has made more detailed proposals in a Communication on the "Taxation of Oil Products" (COM(81)511, 9 September 1981), suggesting principles for a coordinated approach involving the setting of target zones for tax pressure on the main oil products, and principles for the elimination of exemptions, subsidies or reduced rates for specific users. A constructive use of energy tax instruments could be one of the most powerful possible policy actions to induce the economy to make employment-intensive investment.

(iii) the establishment of credible measures for sub-crisis management for oil supply in the Community.

(iv) the reinforcement of common policies in the fields of research, development and technological demonstration.

(v) the further development of common initiatives in external energy relations, especially in relation to the developing world.

It will take time for the fundamental economic remedies to unemployment to build up their effects.

However, a start has been made in the Community towards building up recognition of the scope for a common and constructive approach, notably at the joint Council meeting of Finance and Social ministers in June of this year. The conclusions of the Presidency at that meeting accorded with the views of the Commission that a comprehensive policy response is required to the twin challenges of reducing inflation and unemployment. There is agreement for example on the need to pursue employment expansion in areas of technological innovation and the energy sector, and small scale job creation. The financial burden placed on employers by particular methods of financing social security needs to be reviewed, and a more transparent and coherent analysis is needed of the impact of public expenditure on employment and growth. There is also agreement on the need for direct actions to ease unemployment.

With regard to the particularly acute problem of youth unemployment, the Commission has carried the debate a step further in proposing a common objective in its foreword to the fifth medium-term programme: setting up over the five years ahead machinery and arrangements to ensure that, on leaving school, all young people obtain either a paid job or access to a vocational training course or both together. The Council is invited to adopt this objective and :

(i) to compare national experiences in this field;

(ii) require national programmes be submitted to the Community by a given date;

(iii) decide on partial funding for such schemes from the European Social Fund;

(iv) provide for the examination of results achieved at regular intervals.

The adaptation of working time can also help ease the problem of unemployment, while matching social demands for more flexible work arrangements - for example part-time work, early retirement etc. However, great care has to be taken to avoid changes in working conditions that could risk significantly increasing hourly labour or capital costs, and to avoid sharply deviating trends as between Member States especially in ways which would risk affecting competitive conditions.

4. Economic policy in the Member States

The economic situation has deteriorated in Belgium in 1981 : the fall in the level of economic activity and employment has been accompanied by an acceleration of consumer price inflation and a deterioration in the current account of the balance of payments.

The Commission of the European Communities considered this situation one of great concern and, on 22 July 1981, addressed a recommendation to the Belgian government which advocated corrective measures to be taken in the monetary, budgetary and revenue fields.

Guidelines were adopted by the belgian authorities, at the beginning of the month of August 1981, in establishing the central government budget for 1982, which effectively took account of the limit for 1982, on the current account budget deficit of 200 billion FB, requested by the Commission. The arrangements should make it possible to reduce the borrowing requirement of general government, as a percentage of gross domestic product, from 15,5 % in 1982 to 13,5 % in 1982.

The most recent information concerning the execution of the 1981 Budget suggests that net borrowing will be significantly above the provisional estimates made in the middle of the year. In other respects the guidelines adopted by the belgian authorities have led to an increase in the burden of taxation and less restraint on expenditure than the Commission recommendation suggested.

Under these conditions, the management of the budget in 1982, if it is to adhere to the limits and priorities indicated above, will have to aim at strictly containing expenditure, and to be implemented with sufficient flexibility to permit compensatory adjustments within the overall budget.

In other respects, political events have not made it possible to follow through the dialogue established with the social partners concerning income moderation and the possible relaxation of the indexation of certain incomes, as suggested by the Commission.

It is in the interests of a lasting improvement in the employment situation, that a renewal of negotiations should rapidly lead to concrete results.

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Reinforcing Belgium competitive position, a primary factor for a recovery in growth, is principally determined as much by the restructuring of productive potential, requiring strong investment growth, as by a lowering of costs relative to major competitors. The adjustment of the central rates of the European monetary system, decided on 4 October 1981, does not diminish the fact that the essential adjustments must take place within the Belgian economy.

Table 4

Belgium: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households	Money supply growth M2 H[3]
	%[2]	%	%	%[2]	%[2]	% GDP	% GDP	%	%
1960-1969	4,8	4,0	2,2	3,2	7,6	+ 0,2	- 1,5	13,0	8,2
1970-1979	3,4	3,1	4,9	6,5	12,3	+ 0,4	- 4,3	16,8	12,2
1979	2,3	1,4	8,6	3,9	6,0	- 2,9	- 6,8	14,8	6,0
1980	2,4	2,6	9,3	6,4	8,8	- 5,2	- 9,1	15,6	2,7
1981 (1)	- 1,0	1,4	11,6	7,5	8,8	- 7,2	-12,4	16,1	6,1

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 End of year. Up to 1978: 'money stock and financial assets with a maturity of less than one year with mainly money-creating institutions'; since 1979: 'harmonized M2' (M2 H).

In 1980 and 1981 Denmark succeeded in cutting the current account deficit appreciably despite the pronounced deterioration in the terms of trade and the heavier costs of servicing the external debt. The improvement reflects a gain in competitive edge, but it was achieved at the cost of a slackening of domestic demand, notably private consumption and residential construction. Economic activity therefore slowed down, pushing unemployment in 1981 to 8,2 % of the labour force.

The outlook for 1982 indicates a distinct upturn in economic activity (the year-on-year growth of GDP could well be 3 %) and confirms the need to continue with a tight financial policy as envisaged by the multi-annual programme adopted at the end of 1979. Budgetary policy must come to grips with various problems that give cause for concern namely the increase in expenditure made to combat unemployment, the upsurge in public debt interest and the sluggishness of tax receipts associated with slack economic activity. The central government borrowing requirement, which has increased from DKR 17 900 million in 1980 to DKR 31 900 million in 1981, i.e. from 4,8 % to 7,9 % respectively of gross domestic product, is likely, according to the draft budget, to reach DKR 39 900 million, or 8,8 % of GDP. A deficit of this size is becoming more and more difficult to finance, and the resulting cost of debt servicing will tend increasingly to aggravate the budget situation. A possible further increase in the budget deficit would seriously endanger the restoration of external equilibrium. The authorities should strictly respect the expenditure targets adopted under the multi-annuel programme and do their utmost while implementing the 1982 budget so as to avoid an increase in the presently forecast deficit even if economic conditions should be worse than foreseen.

The need to finance greater public sector borrowing requirements and to attract foreign capital in order to cover the current account deficit, means that monetary policy has singularly little room for manoeuvre. In line

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with its present stance, it should continue to keep the growth of domestic liquidity under strict control, and to maintain interest rates a a relatively high level.

As a result of the changes made since 1979 in the indexation system, and the moderation of demands by management and unions, the increase in nominal incomes has been slowed down somewhat. This trend must be maintained in the future : otherwise the authorities could well be obliged to apply more restrictive policies, in the interests of internal and external stability.

Table 5

Denmark: main economic aggregates, 1960-1981[1]

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households [3]	Money supply growth M2 [4]
	% [2]	%	%	% [2]	% [2]	% GDP	% GDP	%	%
1960-1969	5,1	3,8	1,2	5,3	10,2	- 2,0	(1,4)	:	10,1
1970-1979	2,8	2,2	3,3	9,4	11,6	- 2,8	(- 0,9)	21,3	11,0
1979	3,0	2,4	5,3	9,6	9,1	- 4,5	- 3,3	21,8	9,9
1980	- 0,2	- 0,0	6,2	11,9	9,0	- 3,8	- 6,1	22,8	10,9
1981 (1)	0,0	1,1	8,2	11,2	9,9	- 3,3	- 9,8	24,6	9,3

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 Private sector.
4 End of year.

The Federal Republic of Germany enjoys relatively favourable conditions for a return to external and internal economic equilibrium and for economic growth, permitting, after some time, a reversal of the falling trend in employment. Whereas in the past there was a marked deterioration in both the external position and the public sector accounts, with the deficits of both general and the Federal Government well above planned levels, significant improvements are now underway. As a consequence, there should be greater room for manoeuvre from now on, as the balance of payments can be expected to strengthen considerably, and make the major contribution to a rate of growth averaging over 2% in 1982 but which is foreseen to increase as the year goes on. These developments should reinforce the foundations already laid for the medium term improvement of economic growth and employment conditions.

On the external side the significant depreciation of the DM to mid 1981 has strengthened the price competitiveness of German industry and a strong export performance in 1982 is expected (a volume increase of 8 1/2%), the principal factor pulling the German economy out of the present recession. The recent strengthening of the DM, reflected in the realignment of EMS central rates and firmness against the US dollar will help to reduce the cost of oil and other imports; as a result, inflationary pressures are expected to abate in 1982 (to well below 5%) and the deficit on the current account of the balance of payments is forecast to fall from DM 24 billion in 1981 to DM 7 billion in 1982 and could move into balance towards the end of the year.

To boost confidence and to avoid excessive competition for scarce funds in the domestic capital markets, the Government has taken measures to reduce the public sector deficit.

These measures are designed to reduce the net borrowing requirement of the Federal Government for 1982 to DM 26 1/2 billion, compared with a likely outturn for 1981 of DM 34 billion. This improvement in the Federal

Government's borrowing requirement is mainly brought about by cuts in expenditure, together with cuts in tax allowances, subsidies and transfers. A modest increase in taxation is also proposed. While this budget policy stance is appropriate, the adjustment in the short term should not proceed too quickly; furthermore, the above adjustments to the stance of budgetary policy should be in accordance with the new margin for manoeuvre for monetary policy opened up by the recent appreciation of the DM. In the present circumstances, a reduction in the borrowing requirement of the general Government from 4 % of GDP in 1981 to 3 1/4 % of GDP in 1982 can be envisaged.

The improved performance by the public sector and on the external side should give the Bundesbank more scope for reducing interest rates, whilst maintaining a steady growth of the money supply in concordance with the evolution of potential output and a further reduction in the rate of inflation. This would have a favourable impact upon capital markets in Europe and improve the overall investment climate. The prospects for lower interest rates would be significantly better if recent government decisions with regard to wage increases in the public sector could be adopted as a general guideline by the two sides of industry for the next round of wage negotiations.

The fundamental disruptions caused by the second oil shock suggest that the trend rate of growth which can eventually be expected is likely to be modest by past standards with unemployment remaining at relatively high levels, partly because of a continuing unfavourable demographic trend in the next few years.

Although the Federal Republic shares these problems with other countries of the European Community, the longer term performance with regard to growth and inflation is still likely to be better than elsewhere and this could well lead to a greater divergence in some respects between Community countries. Nonetheless, an improved growth performance for Germany would clearly be beneficial for Europe as well and this underlines the importance of continuing to grapple with the longer term problems of the German economy. Thus the energy bill is likely to remain a considerable constraint

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for some time to come. Further diversification of sources of energy to reduce dependence on foreign supplies, especially of oil, is therefore of the utmost importance. The authorities should ensure a clear and stable environment for business and increase their efforts to remove uncertainties related to future energy investment. Energy saving should be further promoted, but mainly in those fields where incentives are necessary to foster technical developments to be carried on by market forces once they have entered a profit earning stage.

The necessary adjustments to the industrial structure depend upon new investment to ensure that the capital stock is productive, profitable and flexible. Analysis of the latest trends in the German capital stock suggests that there is insufficient potential for economic growth and employment in the years ahead, and underline the necessity for a rapid adjustment both quantitatively and qualitatively. To bring about the substantial growth in fixed investment required to enlarge and restructure the capital stock, the main impulse should come from improved supply conditions. The principal task of economy policy should be to improve the general regulatory framework of the economy so that it favours the allocation of resources to investment. In particular, it is important to remove obstacles which in various areas inhibit the undertaking of new projects. In certain cases, however, namely where investment entails high risks but substantial external benefits, there is a case for special structural policy measures to encourage such expenditure by industries which are likely to contribute to growth in the future. There is also a need to improve the general conditions for investment by small and medium sized companies, since these are very important as vehicles for adjustment but are often handicapped in undertaking new developments.

Table 6

Germany: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households	Money supply growth M2[3]
	%[2]	%	%	%[2]	%[2]	% GDP	% GDP	%	%
1960-69	5,2	4,3	0,9	2,6	7,6	+0,8	+0,7	10,8	10,6
1970-79	3,2	3,6	2,5	5,3	9,5	+0,9	-1,4	13,8	10,1
1979	4,4	2,9	3,4	4,2	5,5	-0,7	-3,0	13,1	6,0
1980	1,9	1,0	3,3	5,4	6,5	-2,0	-3,5	13,3	6,2
1981 (1)	-0,3	0,7	4,7	5,8	5,6	-1,5	-4,0	14,1	5,4

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 End of year.
Note: Figures of the first 4 columns are on an ESA basis up to 1979.

In Greece, the priority basis for the thrust of economic policy must be the new constraints resulting from the rapid change of the external conditions affecting the country's development. These constraints exclude any return to rapid rates of growth of consumption and will impose a moderate trend of economic growth, of which exports and investment should constitute the principal elements.

In order to achieve this objective, short term economic policy must take on a more restrictive stance in spite of the delay in the revival of domestic demand. In 1981 the growth rate will be very low, whereas for 1982 it is improbable that it will exceed 2 %. Although the rate of inflation is declining slowly it will remain excessively high in 1982 and will probably be in excess of 20 %. In these conditions, it seems necessary not only to maintain the rigour of the incomes policy but also to accompany it with firm action to lower the economy's liquidity ratio by taking action both on the public deficit and on the availability of credit to enterprises. In order to achieve this, it will be essential to reverse the deteriorating trend of the current balance of the general government and public enterprises, not only by reducing the rate of growth of expenditure but also by fighting tax evasion, by reducing the delay that has occurred in the adjustment of certain public sector prices, and by an overall increase in the tax burden. This strict management of the current operations of the public sector should provide some leeway to continue and perhaps even increase the budgetary effort in favour of investment. In fact, this effort appears even more necessary when one considers that the strict credit policy involving high interest rates, which is required for other reasons, is likely to produce an opposite effect. In short, the attempt should be made in 1982 to reduce the growth of the money supply to below 20 %, which is considerably below the nominal increase of the gross domestic product. In order to achieve this, the borrowing requirement of general government should be stabilised at around 4 % of the gross domestic product and the deficit of the other public accounts - commercial accounts and accounts of public enterprises which are automatically financed by the Central Bank - should be considerably reduced.

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In the longer run, economic policy should take as a priority objective the elimination of inflation and its distorting effects. This means that the efforts made to contain it in the short term should be extended to a permanent action combining voluntary limits on the nominal growth of incomes with budgetary restrictions, credit limitations and the stabilizing of savings. This anti-inflationary policy, which ultimately aims at re-establishing the conditions for a rational allocation of the factors of production, does not rule out the application of a structural policy which, in order to meet the needs of rapid change, will have to be particularly active. The essential objective, which is imposed both by the external constraint and regional imbalances, must be to hasten the development, the sectoral diversification, and the geographical diffusion of industry and to take advantage of all the growth potential that it offers. Such a policy must include, to begin with determined efforts to establish, during this initial phase, the required elements of infrastructure : in the field of energy, firstly, where the forecast rapid increase of consumption will require the intensive exploitation of national resources, but also in the field of transport and urban infrastructure. In addition it must include the continuation of the efforts undertaken within the framework of the regional policy to affect sectoral development which, however, should basically be determined by market forces.
The logical corollary of a policy consisting of utilising the budget in order to promote investment activity should be the phasing-out of the selective administrative fixing of interest rates applied to enterprises until now, in favour of a system of uniform market rates, which the Central Bank would influence only by using classical intervention.

Table 7

Greece : main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance (3)	Savings ratio of households	Money supply growth M2/M3
	% 2	%	%	% 2	% 2	% GDP	% GDP	%	%
1960-69	:	:	:	:	:	:	:	:	17,7
1970-79	5,1	4,7	:	13,1	:	- 2,8	:	:	23,4
1979	3,8	2,7	1,9	19,0	21,2	- 2,9	:	22,6	18,4
1980	1,7	0,3	2,8	24,9	16,6	- 2,4	- 3,1	20,7	24,7
1981 (1)	0,4	0,0	3,3	24,1	22,5	- 2,8	- 3,9	19,4	31,7

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.

3 Gross saving of general government + balance of capital account of central government budget.

In France, the primary objective of the new economic policy is the reduction of unemployment, with the diminution of inequalities of income as a secondary objective. These objectives, are to be attained by seeking to reconcile a deliberate increase in the rate of economic growth with a significant reduction in the rate of inflation.

In the short term, this policy involves the use of support measures to assist the recovery which is beginning. The first measures, taken in early-summer 1981, consisted mainly of increases in low wages and certain social benefits, assistance to help firms cope with the increase in their costs due to the difficult economic situation, and a relaxation of credit conditions. As a result, and despite the increase in the tax burden - particularly on high incomes - imposed by the supplementary Budget of July, the public sector financial situation will deteriorate, in 1981, to a greater extent than was previously considered acceptable, and which could be equivalent to just over two percent of gross domestic product. As a further result, the growth of the money supply will reach 13 % during the year.

The policy foreseen for 1982 will seek to combine the continuation of the expansionary stance - directed, however, towards investment rather than consumption - with an exceptionally large effort to reduce inflation, an objective which has become even more important since the monetary realignment of 4 October 1981. Indeed, on the one hand, as the 1982 Budget of the central Government includes a massive increase in expenditure related to measures which stimulate, directly or indirectly, employment, and as the overall tax burden will remain unchanged despite the tax increases on wealth and the highest incomes, the potential deficit is larger than that of 1981, even allowing for the postponement of some expenditure. On the other hand, an increase in social security contributions is foreseen as a means of partly offsetting the strong growth of social security benefits and the availability of credit to firms will be maintained within limits that are compatible with the objective of a significant reduction in the liquidity ratio of the economy.

In addition, the principle that the average growth, in 1982, of wages and salaries should not exceed the increase in prices, has been introduced and a temporary selective price freeze has been imposed with the aim of starting the process of deceleration.

This policy is expected to promote a vigorous recovery of domestic demand which, combined with the favourable development of external demand, should lead to real growth of gross domestic product amounting to 0,5 % in 1981 and to 3 % in 1982. This should be accompanied by a significant deceleration of inflation between the two years, with the aim being to reach an annual rate of 10 % in 1982.

There are, however, a number of uncertainties surrounding this action. Firstly, it is by no means certain that the expected improvement in the self-financing capacity of firms and the budgetary measures in favour of business investment, however important, will be sufficient to reverse the downward trend in investment by firms which could continue to be adversely affected by a very poor initial financial situation. Also, it is by no means certain that domestic supply, which has possibly been limited by the weak growth of productive capacity over recent years, will be able to grow in line with demand. There is, therefore, a risk that the external deficit will once again begin to grow and that inflationary pressures will remain stronger than expected. This risk would be even greater if anticipatory buying caused an unduly rapid recovery in consumption.

It seems, therefore, that the success of the present policies depends on the speed with which the counter-inflationary strategy is able to improve the financial situation of firms, thus favouring an increase in investment, and, at the same time, to moderate the growth of consumption. To achieve this, it will not only be necessary for the recently announced incomes policy to succeed (without, however, abandoning the principle of price freedom beyond the temporary exceptions already made), but also that the action taken to reduce the liquidity of the economy should extend to restricting the growth of the money supply in 1982 to about 13 %. This implies, on the one hand, in the framework of the chosen policies, that the control of public finance be sufficiently restrictive to limit the general government borrowing requirement to about 2,5 % of gross domestic product, in order to avoid subjecting firms to a "crowding-out" effect, and that appropriate measures be taken to stabilise a greater proportion of private savings.

Looking beyond the recovery foreseen for 1982, a return to faster rates of economic growth will depend on the ability of the economy to achieve a better adjustment to the external constraint, by ending the erosion by inflation of its competitiveness and by accelerating the necessary reorganisation of its productive capacities. The elimination of inflation requires that efforts are made to introduce a cautious monetary policy, to counter inflationary expectations, and to reform certain structures which enable firms to derive exceptional profits from their situation.

As for structural policy, its aims do not need to be fundamentally modified. Thus, the pursuit of energy-saving and substitution, which aims at reducing dependance on imported oil, should be continued, and even intensified, but without any major changes of direction. Similarly, industrial policy should, in the main, be based on market forces, in conformity with the competition policy of the Community. Any general measures in favour of investment or research, any specific measures designed to reorganise sectors in difficulty or to promote high technology sectors, and the new facilities provided to remedy financial deficiencies and to remove obstacles to the development of small and medium-sized firms, should all be contained within this framework.

At the same time, important efforts should be made in the area of professional training in order to achieve greater harmony between qualifications and expected future needs and, in so doing, to improve the prospects of developing competitive activities and, as a result, to increase the growth and the economic value of employment.

Essentially, a durable reversal of the trend of increasing unemployment is dependent on the success of all these measures. To the extent that action is taken to reduce unemployment directly - generally by various means of work-sharing - in order to reduce its social impact, an effort must be made to ensure that such measures do not lead - directly or indirectly - to a further increase in costs.

Table 8

France: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households	Money supply growth M2 [3]
	% [2]	%	%	% [2]	% [2]	% GDP	% GDP	%	%
1960-69	5,7	5,1	0,8	4,2	9,6	+ 0,3	+ 0,4	14,8	12,9
1970-79	4,0	3,2	3,3	8,6	13,5	- 0,3	- 0,2	17,9	15,4
1979	3,3	3,9	6,0	10,5	13,2	+ 0,1	- 0,8	16,7	14,4
1980	1,3	1,3	6,3	13,2	14,7	- 1,4	+ 0,4	14,8	9,7
1981 (1)	0,5	0,6	7,6	13,5	15,6	- 1,4	- 2,1	14,8	13,0

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 End of year.

In Ireland over the years the main thrust of economic policy has been toward the industrialisation of the economy, diversifying its structure away from agriculture and other traditional industries. To encourage this process successive governments have laid great emphasis on attracting foreign direct investment and undertaking publically sponsored infrastructure investment. The fruits of this policy have been evident in a rate of growth of Irish exports well in excess of the rate of growth of world trade. The openness of the Irish economy does however make it extremely vulnerable to downturns in world economic activity and to international inflationary developments such as occurred in the wake of the second oil shock. The ambitious public capital programme has always implied relatively large government deficits but the international recession coupled with discretionary government action has led to a significant widening of these deficits and to a serious imbalance on international payments. This situation has been aggravated by a relatively poor inflation performance which is affecting the economy's competitive position. The policy problems facing the authorities are the reduction of the balance of payments and governments deficits, the control of inflation and the maintenance of the Government's vigorous role in capital formation.

An essential condition for achieving an improvement in the external balance and for moderating domestic inflationary pressures is that monetary developments not be allowed to add excessively to the level of demand. To this end the monetary authorities have announced a limit of 15 % growth in private sector credit extended by licensed banks in the year to mid-February 1982. Given an expected rate of growth of nominal GDP in excess of 19 % in calender year 1981 this target seems consistent with the need to exert a measure of restraint on domestic demand. Success in meeting this target will however mainly depend on the effect of the large government deficit on credit creation and the attitude of the authorities to rising domestic interest rates. A ceiling on credit growth similar to that in force for 1981 would seem appropriate for 1982 when nominal GDP is expected to grow by about 21 %.

Until the first oil shock the public sector deficit was predominantly on account of capital expenditure undertaken by the public sector. In the most recent years however, a significant imbalance has emerged in the current account of the budget. This has resulted partly from the working of automatic stabilisers, partly from discretionary government action and partly from the level of pay settlements in the public sector. This overall deficit is not unrelated to the serious balance of payments imbalance, which is expected to reach 14,8 % of GDP in 1981. In addition, the demands of the current budget threaten to divert resources away from the capital budget. Moreover the build-up in debt concomitant with the deficits is reducing the government's room for manoeuvre in dealing with the current budget imbalance and is placing a heavy burden on future tax payers. A reversal in the trend to increased deficits, especially those on account of current items is overdue and requires firm government action which should include both expenditure reductions and tax increases. The corrective package introduced in July by the incoming government, after only one month in office, to prevent a further deterioration in the 1981 situation is an important step in this direction. This policy stance should be reinforced in 1982 so as to reduce the Exchequer Borrowing Requirement to below 13 % of GDP. At the same time the current budget deficit should fall to a level equivalent to approximately 6 % of GDP. This would be in line with the Government's commitment to eliminate the current budget deficit over a four year period.

The openness of the economy to high international inflation, the adverse movements in the terms of trade following the second oil price shock, the lack of sufficient moderation in wage bargaining and the deficit financing have led to an inflation rate performance far out of line with the Community average : the private consumption deflator is expected to increase by 20 % in 1981. If the economy is to maintain its competitive position it is essential that this rate of inflation is quickly moderated. This requires that domestic costs are held down. To this end, the government can have a major influence on the level of settlements in the coming payround through its attitude to the public sector where about one fifth of all employees are employed.

Table 9

Ireland: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households [3]	Money supply growth M3 [4]
	% [2]	%	%	% [2]	% [2]	% GDP	% GDP	%	%
1960-69	4,5	4,2	4,5	3,9	9,3	-1,9	-2,5	10,2	9,6
1970-79	3,8	3,7	7,1	12,8	18,1	-4,2	-6,3	19,5	18,3
1979	1,9	0,6	7,4	13,2	16,6	-10,1	-11,9	23,1	19,0
1980	0,9	-0,1	8,3	18,2	20,5	-8,3	-13,1	19,7	16,9
1981(1)	1,7	2,4	10,4	20,0	18,4	-14,8	-14,3	19,2	14,3

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 Private sector.
4 End of year.

Note: Figures in columns 1, 2, 5 and 6, are on ESA basis up to 1979.

ITALY

In Italy, economic policy is dominated by the determination to bring inflation under control. Rampant inflation over many years has not only been a permanent factor of short term instability and exchange rate volatility, but also of resource misallocation.

This anti-inflationary stance became more positive in 1981, and was supported by the Commission Recommendation of 1 July 1981 on the occasion of the Italian Government's recourse to the safeguard clause provided for in Article 109 of the Treaty. It has resulted in a tighter credit policy, in decisions of principle (not, however, fully implemented) to hold down the underlying public sector deficit, in a concerted attempt to stabilize consumer prices and in the opening of management-union negotiations to bring about changes in the wage indexation mechanism.

The monetary realignment of 4 October 1981 is a further reason why this new course of economic policy in all its aspects should be translated into action as quickly as possible. The cyclical background will be favourable : buoyant export demand, a moderate upturn in domestic demand and the probable confirmation of a slower movement of prices. Thus, after falling back slightly in 1981, gross domestic product is likely to register a rise of close on 2 % for 1982, while the rate of price rises is likely to fall spontaneously below 17 %. This is a propitious background for the definitive introduction of the proposed anti-inflation package which, within two years, should bring inflation down to close to the average rate prevailing in trading partner countries and at the same time keep the economy on its medium-term potential growth trend.

The keynote of economic policy for 1982 must, and moreover can be, the resolute reduction of inflation; consequently, the crucial objectives

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are monetary strictness and the deceleration of costs. These objectives must be pursued simultaneously. Efforts must be made to bring down further the economy's liquidity ratio, by achieving both a further relative contraction in overall lending and a further reduction in the degree of liquidity of financial savings. The greatest problem will be to limit the public deficit - to a level of LIT 50 000 billion for the net borrowing of the public sector (broad definition) and to some 9 % of gross domestic product for the general government borrowing requirement - but this is essential if the credit constraints on firms are not to be unduly severe. The aim of budget management in 1982 must therefore be to free new resources and in particular to cut spending, for if budget volumes are left to develop spontaneously, this objective would be exceeded by far. But the long months of effort to break the vicious circle of price and cost increases must, on their side, also produce decisive results. This would be achieved if, as a result of the success of government steps designed to slow consumer price rises down further, moderation prevails in the renewal of the numerous and important pay agreements expiring at the end of 1981 and if, secondly, the parties concerned reach agreement in their efforts to make the rigid sliding scale mechanism more flexible.

Over and above, these short-term measures, if inflation is to be eliminated, permanent arrangements must be made in future to reduce sharply the extent to which liquidity is fed by the public sector deficit : in the past, the latter has been its main source. Two types of action are required : the former concerns the financing of the deficit, the latter the deficit itself. For the former, the Treasury's calls on the market must be limited by gradually transforming - this is now being done - the treasury into the role of banker of the public sector; further, stopping automatic interventions by the central bank at the auctions of public securities must lead to better control of the monetary base. As for the deficit itself, the need to check its growth implies an effort all the more energetic, since it will have to concentrate on the current balance. It would imply, in particular, a better control of the operating costs of public administration and public sector services, the requirement to bring into equilibrium certain public sector operations that are in structural deficit - the health service and pension fund, primarily - and changing the system of automatic transfers from central government tax receipts to regional and local authorities, and the re-introduction of taxes for their benefit.

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The other anti-inflationary moves which are necessary, such as the elimination of the rules and customs which fall heavily upon distribution and construction costs amongst others, relate to supply side policy, and, hence to all the measures suited to hastening the adjustment of structures of production to the requirements of a competitive economy.

The most necessary and urgent of these moves concerns energy, where, as a result of delays in introducing a systematic policy of saving and substitution, the situation is one of still extremely high dependence on imported oil. A vigorous effort will have to be made during the next few years towards conservation, the promotion of national sources of energy and nuclear production, and the conversion to coal. Other effects on the structural side will be necessary to help further the remodelling of industry, to bring about a shift in its centre of gravity from traditional manufacturing industries and heavy industry, often badly affected by international competition, towards high technology industries with a high value added content, which ought to develop a more necessarily favourable balance of trade. In addition, steps should be taken towards ensuring the better exploitation of agricultural and tourist potential. Lastly the strengthening of structures of production requires increased efforts to improve the environment within which enterprises operate. They should aim, in particular, at greater efficiency in public services, at a wider participation by the southern regions in the general effort towards adjusting structures of production, and at a more satisfactory matching of professional training to requirements.

Table 10

Italy: main economic aggregates, 1960-198 1

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households	Money supply growth M2
	% [2]	%	% (4)	% [2]	% [2]	% GDP	% GDP	%	% [3]
1960-69	5,9	6,3	5,5	3,5	10,3	+ 1,7	- 1,9	.	13,9
1970-79	3,3	2,5	5,6	13,2	17,8	+ 0,2	- 9,1	25,2	19,6
1979	5,0	4,0	7,5	14,9	17,9	+ 1,6	- 9,4	26,1	20,3
1980	4,0	3,0	8,0	21,2	22,0	- 2,5	- 7,8	24,3	12,0 (5)
1981(1)	- 0,3	- 0,6	8,6	19,5	19,3	- 2,3	- 9,0	23,5	3,2 (5)

Preliminary estimate of the Commission services on the basis of present or anticipated policies.
% change over previous period, annual rate.
(3) End of year

(4) SOEC definitions
(5) M3 = 1980 : 16,9
1981 : 17,5

In Luxembourg, gross domestic product fell by about 3 % in 1981 and could again decrease in 1982 entailing a worsening of the employment situation which until now has remained reasonable. As a result, industrial restructuring and the need to keep production costs as low as possible has become more urgent. In this regard, the application of the agreement concluded last May by the social partners, which, in particular, entails a more flexible application of the system of indexation, should make a significant contribution; this development seems especially opportune in view of the recent acceleration of the increase in consumer prices.

The stricter expenditure policy set out in the draft budget for 1982 should aim at securing a margin of manoeuvre necessary for industrial restructuring and should avoid an increase in the tax burden. That implies not exceeding the limit fixed for the net deficit in the States' budget (2,6 billion francs or 1,9 % of GDP).

Table 11

Luxembourg: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households	Money supply growth M2/M3
	%[2]	%	%	%[2]	%[2]	% GDP	% GDP	%	%
1960-1969	3,9	3,8	0,1	2,3	6,2	7,1	+ 1,7	:	:
1970-1979	3,1	1,6	0,2	6,6	10,4	18,5	+ 2,6	:	:
1979	3,6	2,5	0,7	4,9	6,2	28,7	+ 0,1	:	:
1980	0,4	- 0,6	0,7	6,3	8,2	22,8	- 1,3	:	:
1981 (1)	- 3,3	- 3,6	1,0	7,9	9,0	18,6	- 3,0	:	:

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.

For the Netherlands, the forecasts for 1982 show an improvement in the economic situation relative to that in most other Community countries. Output resumes an upward path, while the rate of inflation remains relatively moderate. The current balance of payments surplus, small in 1981, could reach about 2.2 % of GDP in 1982, largely as a result of an increase in the price of exported gas.

However, this encouraging trend hides a less favourable outlook for the medium term; official projections show a growth rate of only 1 % in GDP between 1981 and 1985.

The Dutch authorities are therefore concerned to consolidate the competitive position of the economy. The achievement of this objective depends on a change in industrial structure resulting, in particular, in a less intensive demand for energy, bearing in mind the levelling off of natural gas production in the 1980's.

It also rests on continued wage restraint both to reduce production costs and to ensure the profitability of the investments necessary to adapt the industrial structure.

The realignment of the central rates of the European Monetary System, agreed upon on the 4 October 1981, giving an effective appreciation of the guilder of 3,5 % against the members participating in the exchange rate mechanism, should contribute to this objective through holding down import costs, through the beneficial impact of the improvement of the terms of trade on real incomes and through the enhanced possibilities for a reduction in interest rates.

A final element of the strategy which seeks to support the competitive position is to stabilise the fiscal burden and to reduce the budget deficit. The 1982 draft State Budget, published in September, which shows a reduction in the General Government borrowing requirement from 7 3/4 % of national income in 1981 to 6 1/2 % in 1982, has been drawn up with this aim

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in mind. It contains substantial economies, notably on social welfare payments, civil servants pay and public health.

The implementation of budgetary and financial policies in 1982 should take account of the repercussions of the realignment on the 4 October. A reduction in the budget deficit, such as indicated above, does not eliminate the dangers of inflationary financing and maintains the tax burden in the Netherlands at one of the highest levels in Europe. The worsening unemployment situation may however require selective measures.

Table 12

Netherlands: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households [3]	Money supply growth M2 [4]
	% [2]	%	%	% [2]	% [2]	% GDP	% GDP	%	%
1960-1969	5,5	3,8	0,9	4,1	10,4	+ 0,5	- 0,6	:	8,7
1970-1979	3,5	3,0	3,0	7,5	11,7	+ 1,3	- 0,8	17,6	11,6
1979	2,2	0,4	4,1	4,4	7,8	- 1,3	- 3,7	14,5	7,6
1980	0,5	0,2	4,9	6,9	5,8	- 1,4	- 3,7	13,3	3,6
1981 (1)	- 1,1	0,4	7,3	7,5	4,3	+ 0,6	- 4,1	13,1	6,6

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 Private sector.
4 End of year.

The level of output in the United Kingdom economy is now showing signs of stabilising, with GDP having fallen by nearly 6% since the second half of 1979. Total Industrial output fell by over 14% between mid-1979 and mid-1981. Partly as a result of this fall there has been a rapid rise in the level of unemployment which now stands at more than 11% of the working population. On the other hand, there has been a marked fall in the underlying rate of inflation which has more or less halved since 1980.

The very modest recovery now in prospect, well below that anticipated for the Community as a whole, depends heavily on the reversal of the stock-building cycle but the recent depreciation of sterling will help sustain the momentum of any recovery by stimulating exports. Moreover, despite this depreciation the rate of inflation in 1982 can be expected to decline further, although it is likely to remain in double figures.

Since 1979 the thrust of the UK authorities' policy stance has been the control of domestic inflation. This end has been sought through monetary and fiscal control within the framework of a Medium Term Financial Strategy (MTFS) which requires that public expenditure and public sector borrowing, as a percentage of GDP, should be reduced over the medium term.

Although in adopting this strategy account was taken of the difficulties that it would bring in the shorter term, it is clear that the rise in unemployment has been far greater and longer lived than anticipated. As a consequence, in formulating policy two considerations must be kept in mind. On the one hand, there is the need to ensure the control of inflationary pressures and the stability of financial markets. On the other hand, a clear strategy should be implemented to improve the productive capacity of the economy and to alleviate the social costs of the adjustment process, particularly the difficulties on the labour market.

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Measures of the kind announced in June to increase youth employment and training are a step in this direction.

The present fiscal stance should ensure that the Public Sector Borrowing Requirement (PSBR) outturn for 1981-82 will be broadly in line with the MTFS figure of UKL 10 500 million, a substantial fall in a single year. Indeed, as a proportion of GDP, the PSBR in 1981-82 is likely to fall to 4,3%, compared to 6% in the previous financial year. The growth of sterling M3, however, is likely to be somewhat outside the target range of 6% - 10%.

For 1982-83, the authorities present intentions are that the PSBR will fall somewhat in absolute terms, towards the trend value set out in the MTFS (3,2 % of GDP). Public finance plans should give greater priority to the following areas :

- to expand the special employment measures;
- to reduce the employers' National Insurance surcharge, thus lowering employment costs, or
- bring forward worthwhile investment projects.

Possible additional expenditure (or reduced income) corresponding to an increase in the PSBR beyond its trend value (3,2 % of GDP) should also be attributed to these sectors.

The proposed fall in the PSBR between 1981-82 and 1982-83 as a percentage of GDP should not be inconstent with a target growth rate of 5 - 9% for sterling M3 in 1982-83, though this might imply a higher interest rate structure than might otherwise be the case.

To reinforce the contribution which such a stance of fiscal policy can make towards reducing earnings growth, it is important that the authorities keep a firm grip on public sector pay rises. This would facilitate the overall control of public expenditure and increase the Government's ability to take steps, as outlined above, to deal with the current difficulties.

Although the recent marked downward movement in the value of sterling will have improved the competitiveness of UK industry, the main aim of economic policy is to reduce the rate of inflation; this suggests the need for exchange rate stability from now on. The UK authorities should therefore consider the possibility of adopting a target range for sterling. With the improved budgetary position and an underlying rate of cost and price inflation which no longer diverges greatly from that of the Community average, both the credibility of such a policy and the means for its implementation would be assisted by the adherence of sterling into the exchange rate mechanism of the European monetary system.

The fierce competitive pressures to which the UK has recently been subjected have undoubtedly provoked substantial improvements in efficiency. Nonetheless, much remains to be done to overcome the longer term structural difficulties of the British economy. In particular the UK still suffers from:

- relatively high levels of real wages, low labour productivity and low profitability;
- a low level of productive investment;
- an inadequately competitive production structure.

By reducing the growth of earnings in the longer term to or below the rates obtaining in other major industrialised countries, and by maintaining, and improving upon, the gains in productivity already made, the Uk should be able to increase significantly investment profitability both in absolute terms, and in comparison to other countries. At the same time there would be a strengthening in the competitiveness of UK exports.

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Greater investment profitability and improved export competitiveness should then provide the stimuli for the investment needed to increase labour productivity further and to effect the longer term changes in industrial structure. This inturn would lead to a longer term improvement in the UK growth and employment prospects.

However, this process requires a major change in the composition of national income, with a reduced labour share but increased profits. This itself would be a reflection of a necessary shift of resources away from consumption, which has risen rapidly over the last few years, towards investment and exports.

Table 13

United Kingdom: main economic aggregates, 1960-1981

	GDP volume growth	GDP volume growth per occupied person	Unemployed in labour force	Rise in consumer prices	Compensation per employee	Current account balance of payments	General government balance	Savings ratio of households [3]	Money supply growth M3 [4]
	% [2]	%	%	% [2]	% [2]	% GDP	% GDP	%	%
1960-69	3,1	1,8	1,8	3,5	6,1	-0,3	-1,0	8,1	5,2
1970-79	2,2	2,7	4,0	12,3	15,1	-0,9	-2,4	11,3	13,8
1979	0,9	0,4	5,3	12,5	15,7	-1,2	-3,3	14,1	12,7
1980	-1,4	0,4	6,9	15,5	19,6	1,2	-3,5	15,1	18,6
1981 (1)	-1,2	2,5	10,2	11,8	12,1	1,2	-2,2	13,0	11,5

1 Preliminary estimate of the Commission services on the basis of present or anticipated policies.
2 % change over previous period, annual rate.
3 UK national accounts basis.
4 Sterling M3.
In 1979 and 1980 the statistics concerning the money supply are distorted by the existence of the 'corset' controls and by their suppression in mid-1980. If these distorsions are corrected the growth rates would be about 14,6% in 1979 and in 1980.

Note : Figures up to 1979 are on an ESA basis unless otherwise stated.

5. Conclusions

The industrialized countries, almost without exception, have been hit by structural shifts in the world eocnomy; by the consequences of the two oil price shocks, interest rate and exchange rate instability and public budgets and balance of payments disequilibria. Industrialized and developing countries alike are in the throes of a painful and continuing adjustment crisis.

But some industrialized countries, such as the USA and in particular Japan, have been more successful in coping with the adjustment constraints of the seventies. From 1974 to 1980 the USA has increased total employment by 12 million persons, whereas for the Community, the increase was a mere 118 thousand. Because of her competitiveness and dynamic approach to exporting, Japan's economy has since 1976 grown by 5,3 % a year. Both the USA and Japan have recently been back in surplus on their current accounts (see Table 14).

On top of this adjustment crisis has come the recession caused by the second oil price rise and the dollar's instability. It has been more intractable for Europe and has inflicted more damage on the European economies than on Japan and the USA. In 1981, real gross domestic product for the Community as a whole will contract slightly. From early 1980 until today, the number of registered unemployed in the Community has climbed by some 3 million to over 9 million, over 8 % of the labour force. Successes in holding down inflation have remained modest, with cost and price trend divergences widening between the member countries. Balance of payments deficits and interest rates are at record levels.

The business cycle is now turning for the better in Europe. The challenge to the Community is to ensure that the moderate recovery now in prospect for 1982 is developed into a period of sustained growth and stability which creates new jobs and reduces unemployment in a climate of low inflation. But this export-led recovery remains fragile and depends on the optimal interaction of a favourable expansion of world trade, improved and sustained competitiveness in the Member States and declining interest rates. It should be reinforced domestically by improved corporate profitability, more effective incentive schemes and the easier availability of capital to encourage investment and facilitate the renewal and restructuring of productive capacity in Europe.

A better balance of payments performance would increase the scope for bringing down interest rates and easing monetary restraint. If the Community wishes to take advantage of expanding external demand, all tendencies toward greater protectionism should be firmly checked. To the extent that some possibilities exist for a selective support of demand, this must be used in areas where manpower and production facilities are available and where the direct impact on the balance of payments is slight.

The realignment of central rates in the EMS on 4 October is a new point of reference for the management of economic policy in the period ahead. In itself the realignment was a act of sound management, confirming that the system can adjust without letting loose erratic or overshooting exchange rate movements among participants. However, it also underlines the need for renewed and stronger efforts to achieve convergence in cost developments and in budgetary and domestic monetary policies. In addition, the realignment itself warrants internal policy adjustments, on the one hand for stricter policies for control of public deficits and costs in devaluing countries, and on the other hand for measures to support activity in revaluing countries, notably through an easing of interest rates. On the basis of better convergence and coordination of policy along these lines, the Community will be in a position to strengthen the EMS, which forms an essential element in the spectrum of policies required to turn the recovery into a period of sustained and stable grwoth.

The improved outlook and probable performance in 1982 fall far short of what is needed either to reverse the trend of unemployment and absorb the increased supply of labour, or to make good the economic weakness and policy errors which left Europe ill-defended against the major shock waves that have passed through the world economy.

The need is for more radical and fundamental changes in the macroeconomic management of public budgets, in sectoral adjustments and in the behaviour of social partners. Our experience within the Community and outside show that these enormous economic adjustments are possible, and indeed can be crowned with success as long as the fundamental economic policy choices are correctly set.

Table 14 Main economic indicators, EC, USA and Japan

		GDP/GNP volume (1)	Total employment	Unemployment	consumer price deflator	Relative unit labour costs (2)	Current account of balance of payments	Budget deficit (3)
		% change	% change	% labour force	% change	% change	% GDP	% GDP
EC	1974-78	2,1	-0,1	4,5	10,7	0,5	-0,1	-3,7
	1979	3,4	0,7	5,4	9,6	8,6	-0,5	-3,6
	1980	1,1	0,0	6,0	11,8	6,2	-1,4	-3,5
	1981 (4)	-0,5	-1,3	7,8	11,3	-14,5	-1,2	-4,4
USA	1974-78	2,5	2,0	6,9	7,3	-3,2	-0,3	-0,9
	1979	2,4	3,5	5,8	8,9	1,1	-0,8	+0,5
	1980	-0,2	0,3	7,1	10,2	1,5	+0,1	-1,2
	1981 (4)	1,9	1,5	7,4	8,4	14,0	+0,2	-0,8
Japan	1974-78	3,3	0,8	1,9	10,3	3,0	+0,5	-3,2
	1979	5,6	1,3	2,1	2,0	-14,2	-0,9	-4,7
	1980	4,1	1,0	2,0	7,1	-10,7	-1,0	-3,9
	1981 (4)	4,0	1,0	2,1	5,4	10,4	+0,3	-3,0

(1) EC : GDP; US and Japan : GNP

(2) unit labour costs in manufacturing expressed in $, relative to weighted average of 17 competitors

(3) Net lending (+) or borrowing (-) of general government, national accounts definitions

(4) Estimate

Source : Eurostat; National Accounts of OECD countries, Vol. II; estimates of Commission services

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(81) 596 final/2

Brussels, 9 November 1981

ANNUAL ECONOMIC REPORT 1981-82

COM(81) 596 final/2

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Proposal for a

COUNCIL DECISION

:ing the annual report on the economic situation in the Community
.aying down economic policy guidelines for 1982

:OUNCIL OF THE EUROPEAN COMMUNITIES,

ıg regard to the Treaty establishing the European Economic Community,

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

ıg regard to the proposal from the Commission,

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

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

ADOPTED THIS DECISION :

Article 1

Council hereby adopts the annual report on the economic situation in Community (1981), contained in section I of the Annex /point 2 of the : Report/, and lays down the guidelines to be followed by the Member es in economic policy for 1982, as contained in sections II, III and f the Annex /points 3, 4 and 5 of the draft Report/.

Article 2

Decision is adressed to the Member States.

at Brussels, 1981

For the Council

The President

OJ N° L 63, 5.3.1974, p. 16
OJ N° L 330, 24.12.1975, p. 52
OJ N°
OJ N°