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## REPORT ON THE PRESENT ECONOMIC SITUATION AND THE MEDIUM-TERM OUTLOOK

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(Working paper by Commission departments)

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R E P O R T

ON THE PRESENT ECONOMIC SITUATION AND THE MEDIUM-TERM OUTLOOK

INTRODUCTION

1. In accordance with the mandate given by the Council on 14 March 1977, the Commission, with the help of the Economic Policy Committee, initiated a series of analyses dealing in particular with employment, investment, external payments and, more generally, the conditions governing growth. For this purpose, the Commission also drew on the work of the Study Group on Medium-Term Economic Assessments.

The present Commission staff report, drawn up after discussion in the Economic Policy Committee, offers a tentative preliminary synthesis of these analyses, concluding with suggestions as to points that should be considered for action by the Community and the member countries over the next two or three years, bearing in mind the most recent assessment of the situation.

I. ANALYSIS OF THE SITUATION

2. The Community is at present in a phase of slow growth; the recovery has not had the lasting vigour that might have been hoped for after the 1975 recession. Community GDP increased by about 4.5 % in 1976, and for 1977 and 1978 the figure is likely to be in the 3 - 3.5 % range.

The rate of capacity utilization is still low, averaging 80 % in industry, with appreciable differences between industries. The steady rise in the labour force and the insufficient rate of growth have lifted unemployment to a very high level (over 5 %), and this could well rise even further over the next few years if the outlook for growth does not improve.

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Women and young people under the age of 25 are particularly affected by the deterioration of the labour market.

3. Private investment showed only a very slight recovery in 1976, and this has not been confirmed since. In addition, growth in the volume of public investment has been very low, and, indeed, has been negative in some countries, with policy options being made more and more often in favour of social transfers (unemployment) and economic transfers (aids to industry).

4. Following a deficit of \$ 8 000 million in 1976, the Community's current balance of payments could move back towards equilibrium in 1977, with a reduction in the divergences between countries at the same time. In 1978, this trend is likely to continue and could even result in a surplus, which would be undesirable from the point of view of world equilibrium and would reflect the under-utilization of capacity.

5. Inflationary pressures have weakened, though to too limited an extent. After a standstill period in late 1976 and early 1977, the tendency for inflation rates to slow down and their divergences to narrow could well revive in the second half of the year.

## II. ACHIEVEMENT OF THE FOURTH PROGRAMME AND THE PROBLEMS INVOLVED

6. In view of the present outlook, serious doubts arise on the successful achievement of the Fourth Programme not only by 1980, but even beyond. The seriousness of the problems with which the Community has to contend, particularly in order to absorb the structural consequences of persistent inflation and the rise in the price of oil, and the difficulties in implementing the necessary policies seem to have been underestimated. The persistent weakness of investment limits the scope for future growth and consequently for job creation. The Community is thus in danger of getting bogged down in a state of steady equilibrium at a point of underemployment, with all the economic and political implications entailed and still without solving the problems of inflation, public finance and the allocation of resources.

The dangers inherent in recent developments

7. The extent of the leeway to be made up in relation to the Fourth Programme can be illustrated by a few particularly telling figures. In order to reach the growth target, which would enable the unemployment rate to be brought down to between 3 and 4 % in 1980, the Community's gross product over the next three years would have to increase by about 5.5 % a year. On the basis of the present outlook, a growth rate of between 3.5 % and 4 % for the whole of the period seems more plausible, unless there is a substantial change in economic policies pursued and an improvement in the social consensus.

8. As far as investment is concerned, the recent trend and the outlook are worrying. In 1977, the share of investment in GDP will probably be under 21 %, whereas, according to the Fourth Programme, it is supposed to reach about 23 % by 1980. To do so, the annual growth rate of investment by volume over the next three years would have to reach at least 7 %.

The last three-year period in which such investment performances were achieved goes back to the years 1968, 1969 and 1970, a period in which growth averaged 5.5 %, but at that time firms were operating a good deal nearer capacity than they are today, while taxation and "parafiscal" charges and the wages/profits ratio were more favourable to firms.

9. Bearing in mind the increase in the labour force, there is a danger that sluggish growth and the weakness of productive investment, if they persist for too long, will lead to a steady worsening of the employment situation, so that in 1980 the unemployment rate could be appreciably higher than today. What is more, the deterioration of productive capacity and the persistent heavy influx of new job-seekers on the labour market would even jeopardize the prospects for a return to full employment in the first years of the next decade, and would hamper the necessary structural adjustments.

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10. Faced with this situation and with the fear of a resurgence of inflationary pressures, an exacerbation of certain countries' balance of payments problems and an erosion of confidence caused by the size of public deficits, there is a great temptation to accept the unfavourable outlook for growth and to try to offset its adverse effects through specific measures, particularly with regard to employment. Serious reservations must be formulated with regard to such an approach.

A slow rate of growth cannot generate the investment flows needed to restore and develop productive capacity in the medium term. This is an essential requirement, particularly in order to ensure a sufficient level of job creation, prevent the development of bottlenecks and maintain the Community's competitive capacity.

The changes deemed essential or desirable in the international division of labour can only be carried out smoothly in a context of rapid growth, as experience over the last twenty years has shown. Otherwise, there is a danger of greater recourse to protectionist measures, already insidiously gaining ground, and this would endanger the efforts made since the war to promote free trade.

Problems connected with income distribution and the way in which the deterioration in the terms of trade is allocated are undoubtedly harder to overcome in a climate of mediocre growth. In particular, the wage restraint achieved in most member countries could well disappear if unemployment were to persist while living standards rose only slightly.

Specific measures aimed at reducing unemployment (work sharing, artificial reduction of the labour force) have relatively limited effects on employment and may entail considerable costs if they are applied too generally, or in ways that cannot subsequently be reviewed. Nonetheless, they can help to palliate the most serious difficulties pending a return to an adequate level of growth.

Outline of a strategy

11. Consequently, the Community must continue with the option it chose in adopting the Fourth Programme, namely that only sustained and stable growth over a long period is capable of solving the problems facing the Community, particularly the elimination of unemployment and the maintenance of competitiveness.

The key feature of the present situation is insufficient demand, which entails the under-utilization of factors of production and, in particular, high cyclical unemployment. This insufficient level of demand originates primarily within the Community. The public authorities are induced to pursue restrictive policies because of constraints imposed by the persistence of inflation, international payments problems and the limited scope of budgetary measures.

It is important, therefore, that coordinated action at Community level be initiated to attenuate these constraints, so as to allow reflationary measures to be taken. These reflationary measures should concentrate on investment, firstly because investment is a means of immediate support for final demand, but primarily because investment must in the long term make it possible to build up a sufficient stock of capital to ensure full employment for a labour force which will continue to grow rapidly for a number of years.

However, with most firms now running well below capacity, this cannot be envisaged without more general support for demand, which also implies some stimulus to consumption. This should be achieved through a lower savings ratio or through tax concessions rather than through too high a rise in wages: efforts to control cost must be continued, since they are necessary for controlling inflation and improving the situation of firms.

The emphasis of the measures and the proportions in which the various instruments are combined must depend on the situation peculiar to each country and be part of a joint and concerted Community operation.

Whatever efforts are made along these lines, the restoration of full employment can only be gradual and should therefore be accompanied by the development of back-up policies for employment.

Tentative suggestions on the strategy which has just been briefly outlined are presented in part three of this document.

### III. POLICY GUIDELINES

#### The conditions for non-inflationary recovery

12. A strategy intended to restore sustained and lasting growth can only be successful if the authorities continue to implement resolute and effective counter-inflation policies.

13. The present inflation in the Community owes less to demand-pull than to cost-push, linked particularly to rigidities in the economic system, the effects of indexation schemes, whether de jure or de facto, and the continuing existence of previous inflationary effects. Policies which might accelerate cost and price increases must therefore be avoided; it is for this reason that recovery based on a policy of indiscriminate demand stimulation must be ruled out. Selective measures should be used, some of which will be defined below, but when they are being implemented, the productive capacity actually available in the benefiting sectors must be studied carefully to avoid the rapid appearance of bottlenecks. The very low rate of current production capacity utilisation actually conceals situations which vary according to industry, some of them being close to the upper limit.

The support of consumption cannot be envisaged on the basis of a policy of excessive wage expansion; use should rather be made of tax relief measures. In particular, where the progressivity of income tax has become distinctly distorted as a result of inflation, there would be a case for adjusting the tax scales. Personal savings may also be at too high a level, and action here should be investigated.

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The growth of liquidity and the appropriate matching of public sector borrowing requirements to the macro-economic financial balances must be severely controlled. In particular, liquidity creation should be kept within predetermined limits in order to contain inflationary expectations. Targets should be fixed and their publication considered in order to exercise an effect on the two sides of industry.

14. It is not sufficient that the division between wages and profits necessary for investment is achieved progressively but this adjustment must also be carried out at the lowest possible level of inflation. In this connection the ways in which incomes are formed, and in which indexation schemes are applied, particularly in connection with indirect taxes, the impact of changes in the terms of trade, and public service charges should all be reviewed. The restraint required from the trade unions is compensated for in the possibility of a more sustained activity represented by a higher level of employment and eventually by a more rapid increase in real incomes. In addition, it must be accompanied, with varying intensity from country to country, by a policy for reducing income inequalities, which will itself be instrumental in combating inflation.

The upturn in activity is partly reflected by increased employment, and partly by the mobilisation of productivity reserves; in the present situation the latter is a major factor in curbing inflation.

Costs and prices cannot be stabilized in countries particularly affected unless exchange rates are also stabilized. This, however, would seem to be facilitated at the moment by the current structure of relative costs following the devaluations of recent years. Countries concerned must ensure that there are no new price rises to jeopardize their competitiveness. This action should lead to a convergence in cost and price trends in the Community to a satisfactory level.

Finally, the reduction of inflationary pressures can be achieved lastingly only if the structural actions laid down in the Fourth Medium-Term Economic Policy Programme are effectively implemented. We refer here in particular to the competition policy intended to strengthen the control of concentration and to eliminate artificial advantages. Community initiatives along these lines should be introduced rapidly.

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International payments problems

15. The outlook for growth in the Community has been damaged by the emergence or persistence of serious international payments problems which affect the economies and conduct of economic policies of Member States in varying degrees.

The main problems are :

- the persistent OPEC current surplus and the imbalance in the distribution of the counterpart deficits and capital flows
- the maintenance of wide divergences in Member States' external positions.

16. The current OPEC surplus is tending to force savings and investment out of equilibrium in the world economy as a whole; this is inhibiting world growth because it is stifling real demand and tending to distort productive systems. In addition, the imbalance in the distribution of oil deficits encourages the countries with the most precarious external positions to pursue cautious domestic demand management policies in order to improve their balance of payments.

17. The size of the OPEC surplus or its counterpart in the form of a net oil deficit in the Community should not be considered as a term which is "given" and cannot be changed, and the member countries must make every effort to reduce it as quickly as possible.

Firstly, the efforts to reduce dependence on external sources of energy, which were begun during the oil crisis, must be pursued and intensified.

The second report on the achievement of the Community's energy policy objectives for 1985 indicates that a reasonable level of dependence on oil imports will not be achieved unless there is vigilant maintenance of energy saving measures and vigorous development of alternative sources.

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This objective must become a matter of priority in all the Member States. Use of heavy fuel in electrical power stations must be restricted, in particular by implementing an appropriate energy pricing policy, encouraging the construction of new power stations which burn solid fuels, and using coal in existing power stations.

The carrying out of nuclear power programmes must be pursued with greater resolution in most of the member countries than has so far been the case.

Energy production from sources within the Community must be facilitated, a genuine strategy on coal supplies must be established, intra-Community energy trading must be increased, and the Community must improve its relations with both suppliers and other consumers.

In all these areas, the Community should lend its full support to the Member States, so that the many difficulties involved can be rapidly surmounted.

Secondly, every effort must be made to overcome the obstacles which might curb the expansion of OPEC countries' imports, while preparing the economies of member countries to face the consequences of the industrialisation of OPEC.

In any case, whatever the efforts made, the OPEC surplus will remain large for several years to come and cannot be eliminated as quickly as had originally been anticipated.

18. In the Fourth Medium-Term Economic Policy Programme the external equilibrium objective (1) set was to achieve a surplus of some 0.5% to 1% of GDP in order to promote the maintenance or the acceleration of transfers, particularly to developing countries. This guideline, which corresponds to equilibrium or to a slight deficit on current account should remain a medium-term objective, but, as emphasized in the Programme "is conditional since it presupposes a fairly strong deterioration in the balance of payments position in some countries outside the Community". Another condition set out explicitly and not achieved was that "the OPEC countries should record a current account equilibrium with the industrialised countries by 1980".

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(1) Goods, services and factor incomes

The Programme added that "if this does not come about, the Community would have to tolerate an even higher deficit so as to maintain the priority given to growth and full employment".

Since the conditions laid down have not yet been fulfilled, the Community should not attempt at present to achieve equilibrium much less a surplus on current account, especially as it is still far from its objectives on growth and employment; rather it should follow the guidelines laid down by the Fourth Programme and accept that the process of bringing its balance of payments back into equilibrium will extend over a longer period, which means accepting a deficit for in any case the next two or three years.

19. If the Community were, in fact, to seek the achievement of a surplus at all costs, this would mean in effect that Community problems were being solved primarily by forcing other industrialised countries, the East European countries and the non-oil developing countries heavily into debt. This solution raises a number of difficulties, particularly the concentration of debt among predetermined groups of countries, which have reached, in some respects, the limit of their solvency. It is probable that this distribution of deficits and the corresponding indebtedness will not be accepted and that it will give rise to defensive reactions in the form of beggar-my-neighbour devaluations with the attendant danger of further twists to the inflationary spiral and recourse to protectionist measures. Furthermore, given the foreseeable trend of United States oil imports, that country could well run up a heavy external deficit between now and 1980. Any attempt by the USA to cut back or eliminate altogether this potential deficit could have important consequences, particularly in the area of exchange rates, growth and inflation.

In this context, it should be noted that too large a degree of laxity in the United States' policy on oil imports constitutes a threat, because of the very high pressure it would put on oil resources and prices.

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20. The Community's acceptance of an external deficit presupposes that such a deficit is financed by adequate and stable means which will alleviate the difficulties involved for the deficit countries. More balanced use of the various forms of financing should be sought, with the emphasis shifting from private funding to financing by the IMF and the Community. For the latter case, existing instruments should be strengthened and new kinds of facilities introduced. These means of financing should ensure that the inevitable external deficits can coexist with exchange rate developments reflecting divergences in costs and prices.

The Community's increased external deficit must not lead to a slowing down in aid to the poorest developing countries; on the contrary, this aid must be maintained and indeed increased.

21. Tolerating a deficit will also help to ward off the danger of a spread of protectionism, which the Community must oppose energetically. There must be joint action to support the resistance of each country to internal pressures and to dissuade other areas from following this course. If, in some cases, defensive measures against dumping or other unfair practices became inevitable, a temporary and reversible Community solution should be preferred to the disorderly adoption of national measures which could well be more lasting in character.

22. The maintenance of an external deficit over the next few years and the gradual return, in a longer-term perspective, to equilibrium or a surplus on current account for the Community as a whole must be accompanied by the restoration of equilibrium within the Community. To this extent, the Fourth Programme's recommendation that cyclical trends be kept out of phase is still necessary and expansion efforts must be greatest in the countries whose balances of payments are currently satisfactory.

23. Nevertheless, given the interdependence of European economies, the support action recommended must be general and coordinated. It is the scale and nature of the measures which must vary. It must be realized that while the Federal Republic of Germany has an important role to play in this plan, and also as regards private consumption, it cannot act alone. The German economy is particularly dependent on its exports, which, in 1976, represented 26.5% of GNP and over 50% of the added value of the agricultural and industrial sectors.

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Furthermore, exports are of particular importance for the expansion of investment, because they are concentrated on a number of large industries which play a major role in this connection.

#### Recovery through investment

24. A sustained and lasting improvement in investment by firms requires the fulfilment of certain conditions as regards the climate of confidence, profits and demand.

25. For the propensity to invest to increase, the present climate of doubt and uncertainty must improve. It must be possible for plans to be made in more stable conditions and against more stable horizons : stability as regards external policies with a firm rejection of protectionism and greater efforts to control erratic exchange rate movements; a firm statement of government's longer-term intentions on key policies such as energy and the environment; monetary and budgetary policies which comply with the objective of growth without inflation.

Improving the social consensus must also contribute to the climate of confidence; this consensus must be sought by putting into practice a whole series of reciprocal sacrifices and quid pro quo arrangements which will provide a basis for stable attitudes and behaviour and a steady and foreseeable pattern of developments.

The climate of confidence will, finally, be improved by implementing at Community level measures aimed at establishing sustained and lasting growth through coordination of economic policies along the lines set out in this document.

26. The trend of profitability and indebtedness in industry over recent years has certain implications likely to impede the growth of investment. There must firstly be continuing moderation in the rise in wage costs. It would also be desirable to look at measures to improve the conditions for external and internal financing of firms.

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In order to achieve consistency within the Community, there should be closer examination of a series of measures being looked at or planned in some member countries, such as :

- easing taxation of long-term capital gains, double taxation of dividends, improving depreciation allowances, etc.
- including the effects of inflation in the calculation and taxation of profits
- promoting the use of floating-rate loans or shortening the maturity of loans.

27. No proper recovery in investment will be achieved without an improvement in the present state of demand and in the outlook for demand and without a higher degree of capacity utilization. As has already been stressed, the result is that cautious demand support action is proving necessary on the consumption side, especially in certain countries, but intervention by the authorities who can help to stimulate investment through the budget, is also needed.

28. Budgetary action may help to boost investment in three main ways:

- promotion of private investment,
- capital transfers to public or semi-public enterprises and to firms in which the government has a holding,
- direct investment by the authorities.

All this action must be viewed on a medium-term basis, taking account of sectoral and regional requirements and the major considerations represented by changes in industrial structures so as to create lasting jobs, regional equilibrium, energy saving and the improvement of the environment.

The promotion of private investment is a possibility in the present context, but there may be doubts as to its effectiveness, its scale and how it is to be applied.

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Thinking along these lines is being pursued in several Member States, but a Community view is needed so as to ensure consistency among the options made and avoid distortions of competition. The Economic Policy Committee will pursue its studies in this area, in particular with regard to the consultations held on the draft Netherlands law on investment aid.

29. Government backing for public enterprises and firms in which the government has a holding has the advantage of allowing relatively rapid, controllable effects. Further, the element of risk inherent in investment linked to certain structural changes is sometimes so large that government aid or guarantee is necessary if new projects are to be carried out.

Here too, efforts are viewed on a medium-term basis and must be concentrated on sectors with a particular leeway to make up in the various member countries. Account must be taken, however, of the fact that room for manoeuvre varies from country to country. Finally, efforts should be concentrated on productive investment which meets demand, and distortions of competition within the Community should be avoided.

30. Carrying out new infrastructure work in the form of school-building, new hospitals, etc. requires a very long period of preparation. The authorities should therefore concentrate on implementing projects ready in the pipeline which may have been held over due to the long period of restraint in public investment. In this area too, the situation varies considerably from one Member State to another. Of these measures, some will have direct impact on the budget both as regards their direct financing and their subsequent management. In other cases, partial or total covering of operating costs by the users may be envisaged. It is to this latter type of operation that priority should be given. In this context, there is the problem of greater autonomy regarding public enterprises' charges and the fiscal capacity of local authorities in financing local infrastructure.

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The management of public budgets

31. The measures discussed earlier, as regards both investment and consumption, will have some impact on public finance, and some temporary deterioration of the public finance situation must be accepted. In point of fact, it should be emphasized that the redressing of government financial balances has been very rapid, indeed too rapid in most of the member countries. It is not a question of abandoning the medium-term goal of putting public finance on a sound footing, but simply sticking to the guidelines put forward in the Fourth Programme, which said that a return to budget equilibrium must be parallel to improving the employment situation and redressing the external balance. Too rapid a return, in the present circumstances, would have deflationary consequences. As soon as the effects of reflationary measures begin to make themselves felt, a reduction in the deficit would be appropriate. This would be largely automatic, with the swelling of revenue. The high level of savings by firms and households should make financing possible from long-term savings, without posing any risk of disequilibrium on the financial markets, even if in some cases improvements must be made to methods of collection and distribution. In any case, Ireland, Italy and the United Kingdom must observe the conditions set as part of the financial assistance granted by the Community and the IMF.

32. Government action should be integrated into the medium-term planning of public finance. In certain cases, the will to act has been frustrated by the lack of properly-prepared plans. Article 6 of the Council Directive of 18 February 1974 on stability, growth and full employment (1) must therefore be effectively implemented.

Specific employment measures

33. The problem of unemployment will burden the economies of the Community for several years to come. Technical progress will probably continue at a rapid rate, which means that, as in the last twenty years, net job creation will accrue only at the end of a complex process of destruction and creation. A lasting

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(1) "Each Member State shall draw up public investment programmes covering a five-year period. Implementation of the programmes shall be in accordance with the requirements of current economic activity, within the framework of public expenditure".

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solution to the employment problem can be found only in sustained growth. Specific employment measures cannot provide a total solution, but they will help to alleviate difficulties during a transitional period. A number of measures can be envisaged in this area, aimed at :

- improving the matching of the supply of labour to the demand,
- helping to create additional jobs,
- distributing existing jobs in the best possible way.

The implementation of these measures must always be viewed in the light of other economic policy requirements. For example, large-scale job creation in the public sector poses financing and therefore distribution problems; any artificial change in the capital/labour ratio raises difficulties in respect of competitiveness; reducing the working week has varying effects depending on reciprocal arrangements accepted as regards incomes.

Rejecting measures of this type can, however, also lead to considerable economic costs, for example through the excessive protection (directly or indirectly) of jobs which are no longer economically justified.

In recent months, the member countries have variously been introducing some of these measures, without a sufficient effort having been made at Community level to appraise the problem or find less costly methods.

34. Sectoral and occupational mobility, and, more generally, the matching of supply and demand for labour will fall short of what is needed. Even before the crisis, many jobs could be filled only by very heavy immigration, at a time when unemployment was already beginning to rise. There are still many unfilled vacancies.

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Geographical mobility should be encouraged, for example by removal of premiums and by help with housing problems. But it would be a mistake to ignore certain real obstacles, particularly of a sociological nature. A policy aimed at correcting regional imbalances is still the best response to the very unequal territorial distribution of unemployment. As regards sectoral and occupational mobility, action must be taken in many directions : better vocational training and retraining during working life, expansion of employment services in order to better satisfy the requirements of job-seekers and employers, improvement of working conditions, and the up-grading of manual work.

Some of these measures involve significant burdens for companies and the necessary efforts must be undertaken at Community level to avoid the decline in the competitiveness of any individual country or of the Community as a whole.

35. Job creation is partly a function of the relative cost of capital and labour. Wage restraint is therefore an essential prerequisite; other factors, which may have affected this relationship to the detriment of labour and to the benefit of capital - for example policies of subsidizing investment or the system of financing social charges - are also highly relevant. More detailed studies are urgently needed on the influence of these different factors. These studies should also review the effectiveness of employment premiums and consider the case for linking investment premiums to the number of new jobs actually created.

Another important question is that of the future job-creation capacity of the tertiary sector and in particular of the public sector. Particular attention should be paid to whether it is possible for the public sector to offer training courses to young people with a view to their subsequent integration into the private sector.

36. Work-sharing measures (reduction of working hours, lowering of the retiring age, raising of the school leaving age) must be regarded with great caution : arrangements of this kind could well spread very rapidly. They are expensive and, where they are irreversible, make lasting inroads into productive potential. In some cases they can even be counter-productive. In any case, these measures should be applied only on a case-by-case basis and only where the problems of financing and redistribution that they pose for society as a whole are borne clearly in mind.

A reduction in working hours could also be envisaged for certain unpleasant trades or occupations. More generally, the long-term tendency observed for all workers might be anticipated. Some measures can be envisaged for overtime pay, particularly during the recovery. Different systems could be adopted such as compulsory compensation by days off or higher costs for companies. Care must, however, be taken to preserve the flexibility necessary for firms to operate properly.