

# COMMISSION OF THE EUROPEAN COMMUNITIES

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## THE ECONOMIC SITUATION IN THE COMMUNITY

Communication from the Commission to the Council  
(Economic and Financial Affairs) for its meeting on  
Monday 17th March 1980; first quarterly examination  
in accordance with Article 2 of the Council's  
Convergence Decision of 18th February 1974

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1. Results for 1979. In spite of the new oil shock, the performance of the Community economy in 1979 was in several respects favourable. Gross domestic product (GDP) is now estimated to have grown 3,3% in the Community as a whole, which is close to the original 3 1/2% objective envisaged in the autumn of 1978 in the Annual Report of that year, and thus somewhat higher than the 3,1% growth in the Annual Report adopted at the end of last year.
2. The cyclical upswing which begun in 1978, in part as a result of the concerted budget policy stimulus decided in July of that year, continued throughout 1979, and led to a stronger growth of private investment than in any year since 1973. Capacity utilisation in industry increased significantly. Employment grew by 0,9%, again the most positive result since 1973. Unemployment declined very slightly in the course of the year, with a more pronounced decline in male unemployment nearly offset by the increasing unemployment of women.
3. Money supply growth decelerated notably, from 12,7% in 1978 to 10,6% in 1979, with a large degree of fulfillment of national quantitative objectives. Some progress was also made in efforts to reduce public sector deficits. The aggregate deficit of all levels of government reduced only slightly from 4,0% of GDP in 1978 to 3,9% in 1979, but this latter figure is substantially lower than the 4,5% of GDP expected in the Annual Report of late 1978. Thus the fiscal stimulus imparted by policy ex ante in the course of 1978 helped strengthen economic activity in 1979, and ex post the faster growth saw these increased deficits in part paid back within a period of a year-and-a-half.
4. Intra-Community exchange-rate relations were more stable than in any year since 1972. The average change in the exchange-rates of Member States vis-à-vis the ECU in the year 1979 as a whole was 1,9%, compared to 5,2% in the average of the six preceding years. Thus it may approximately be said that the first year of operation of the European Monetary System (EMS) saw intra-European exchange-rate instability cut by nearly two-thirds compared to recent historical experience.

5. As regards external exchange-rate relations, the ECU appreciated in 1979 against both the US dollar and the Yen. However, the depreciation of the dollar against the ECU was fairly small; and the dollar's own effective exchange-rate remained nearly stable. This in turn reflects the much greater depreciation of the Yen, whose value against the ECU declined 30% in the course of 1979, which is matter for preoccupation from the point of view of international monetary instability in general, and of the low, excessively competitive value of the Yen now attained.

6. The oil price rise in 1979 (of nearly 50% in dollar terms, yearly average) was in part responsible for the deterioration in price performance. After the lowest rise in 1978 in seven years (6,9%), consumer prices rose on average in the Community in 1979 by 9%, with a 12,4% rise in the second half of the year (at an annual rate). All major components of the consumer price index accelerated (food, services, rent, manufactured goods and indirect taxes), albeit generally at rates far below that for energy.

7. The acceleration of inflation was not confined to the common impact of the oil price rise. There was a renewed tendency for inflation rates to diverge, with the gap between the least and most inflationary Member States increasing from 10% in the fourth quarter of 1978 to 17% in the fourth quarter of 1979 (consumer price data at annual rates); similarly the standard deviation of consumer price rises nearly doubled over the same period. The greater exchange-rate stability was not, therefore, underpinned by a better convergence of inflation.

8. The oil price escalation has led to coordinated steps to slow down world oil demand. For 1979 the community pledged to limit oil consumption to 500 million tons, 5% less than the original forecast and 2% less than the 1978 outturn. However, this target was not achieved, due in part to the severe weather in early 1979 and to precautionary stock-building. Gross inland consumption in 1979 is estimated to have reached 523 million tons, 4,6% above the target.

9. Outlook for 1980. The beginning of the new year saw further major oil price rises which may mean an average increase for 1980 of some 60% (in dollar terms). This has been taken into account in revised economic

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forecasts prepared by the Commission services, which now suggest 1,2% growth for the year as a whole. While the 1980 growth rate anticipated in the recent Annual Report was 2%, it is also to be borne in mind that the level of activity at the end of 1979 was somewhat higher than expected. As a result the downward revision of the level of activity for 1980 is only -0,4%.

10. These figures suggest that the economy may be more resilient to the new oil shock than had been feared. While the oil price rises are a major set-back, especially for price inflation and the balance of payments, the impact on the business cycle is far from clear. The latest recorded output figures still show a firmly rising trend. Leading indicators (notably business surveys) suggest a turning-point for the Community as a whole, but the range between Member States is wide (between France for which little change in business sentiment is yet apparent, and the United Kingdom where the outlook has clearly deteriorated substantially). If the economy is to remain relatively buoyant, this would be due to a preparedness of households to continue to reduce their savings, and for the company sector not to reduce stocks and to maintain their investment plans. This would in turn depend on a combination of financial and confidence factors, where the condition of the European economy is certainly now better placed than after the 1973 oil shock.

11. However, the prospects for employment have worsened with unemployment expected to increase from an average 5,6% in 1979 to 6,4% in 1980 for the Community as a whole, and with the increases concentrated in Denmark, France, Italy and the United Kingdom.

12. The outlook for inflation is worse than was envisaged in the Annual Report. The forecast for 1980 has been revised upwards 2 points to 11,3% for the Community as a whole and a further divergence of performance between Member States is expected, with the highest rates of inflation, between 15 and 20%, in Ireland, Italy, and the United Kingdom.

13. The balance of payments current accounts have also clearly suffered from the oil price rise, with the Community's total deficit for 1980 now revised upwards from 4 to 14 billion ECU. The financing of these deficits should not pose major problems for the four larger Member States: Germany in particular is expected to account for half of the Community total. However, some of the smaller Member States are now facing overriding balance of payments constraints, notably Denmark and Ireland.

14. Policy for the period ahead. The Annual Report argued that priority had to be given in 1980 to alleviating the inflation and energy constraints, and to proceeding with other more widespread improvements in economic structures in many Member States. This implied continuing with policies to control money supply growth strictly, to stabilise or cut public deficits (according to Member State), to improve resource allocation in public and private sectors and to prevent the oil price rises from leading to further inflation through resisting compensatory rises in nominal incomes. A more active cyclical policy could only be envisaged for a later stage if positive results as regards inflation were assured and if economic activity were clearly found to be weakening significantly.

15. The economic situation has indeed evolved since last autumn (as outlined above). But the changes amount, on the other hand, to higher inflation, a still more acute energy constraint, and worse balance of payments situations; and, on the other hand, stronger recent trends in real output and greater uncertainty in this respect for 1980 and the trends that may lead into 1981.

16. In this situation the Commission judges that it is not appropriate to change the basic stance of macroeconomic policy in the Community (and therefore does not propose a change in the guidelines adopted by the Council in December 1979). Certain objectives of policy have to be implemented with even greater urgency and force. This concerns notably:

17. Energy Policy (in all Member States and at the Community level). Efforts to produce alternative supplies and economise in consumption more have to be increased.

18. Budgetary policy. In many Member States severe public finance policies have to be pursued as an unconditional necessity, so as to reduce the strain of deficits on the non-inflationary financing of the economy, and to improve resource allocation in favour of productive investment (this applies notably to Denmark, Ireland, Italy, the Netherlands, Belgium and the United Kingdom). In these cases there is little or no room, for the time being, for counter-cyclical flexibility in budget policy. Without a basically sound economic structure and a background of reasonably stable price expectations, a 'flexible' budgetary policy risks aggravating inflation without improving employment prospects.

19. Monetary policy. The maintenance or reassertion of firm control over the monetary aggregates in the recent conditions of rising inflation has naturally led to higher nominal interest rates. However, for the Community as a whole this has only just enabled real short-term interest rates to become positive again at the end of 1979, while long-term rates remain on average slightly negative. Where real rates of interest are highest (Denmark, Belgium, Netherlands) there are recognized policy needs to reduce public sector and balance of payments deficits. In general, an easing of interest rates can only be expected when inflation trends are seen to be improving, which is not yet the case. However, the trend in interest rates should be carefully controlled so as to avoid an unduly severe impact on economic activity.

20. Incomes. The oil price levy on household incomes has been further, inescapably increased. While governments may alleviate the impact on the poorest and hardest-hit parts of the population, there can be no alternative for the population as a whole to accepting the loss of real income to oil producers so long as oil consumption habits are not changed. Special efforts have been evident in several Member States to limit the rise of nominal incomes as a result of the oil price rise, although in several instances the outcome of these efforts is not yet clear. In some countries, however, the acceleration of nominal income increases is particularly preoccupying (Ireland, Italy, United Kingdom).

21. Balance of payments. Member States in basically sound economic situations (for example Germany) should accept for the time being deficits on current account. Some Member States in the most exposed situations (for example Denmark and Ireland) need to take urgent action to reduce their deficits, especially through budget policy and income adjustments. The Community itself has available ample credit facilities to meet any foreseeable financing problems as regards its Member States.

22. It is more likely that financing problems could arise for non-oil producing developing countries. The Community should be prepared to support international efforts to assure sound and adequate financial recycling facilities.

Table : The Community economy 1978-80

	1978	1979	1980	1978	1979	1980	
	GDP volume, % change			private consumption deflator, % change			
DK	0,9	3,1	- 0,3	9,4	9,5	12,5	
D	3,2	4,4	2,1	2,6	4,1	5,0	
F	3,3	3,4	2,1	8,8	10,5	12,1	
IRL	6,1	3,2	1,4	7,9	13,2	15,5	
I	2,6	4,9	2,0	12,7	15,0	17,1	
NL	2,4	2,3	1,0	4,4	4,7	6,8	
B	2,6	3,0	1,9	4,5	4,5	6,9	
L	4,5	2,7	1,8	3,5	4,5	6,5	
UK	3,3	0,2	- 2,5	8,4	13,2	18,9	
EC	3,0	3,3	1,2	6,9	9,0	11,3	
	unemployment rate, % civilian working population			balance of payments current account, billion ECU			
DK	6,6	5,3	7,0	- 1,2	- 2,1	- 2,3	
D	3,9	3,4	3,5	7,4	- 2,7	- 6,9	
F	5,3	6,1	6,9	2,9	1,7	- 0,1	
IRL	8,7	7,9	7,8	- 0,3	- 1,1	- 1,3	
I	7,1	7,6	8,5	4,9	4,6	1,2	
NL	4,2	4,3	4,5	- 0,7	- 0,7	- 0,9	
B	8,3	8,7	9,2	- 1,2	- 1,6	- 2,2	
L	0,7	0,2	0,9	0,4	0,4	0,4	
UK	5,7	5,3	6,8	1,0	- 3,8	- 2,3	
EC	5,5	5,6	6,4	13,4	- 5,1	-14,2	
	public finance : general government deficit, % of GDP			money supply, % change			
DK	- 0,9	- 1,3	- 1,2	(M2)	6,7	9,9	9,0
D	- 2,8	- 3,0	- 2,6	(M3)	11,0	6,0	6,0
F	- 2,3	- 1,4	- 1,8	(M2)	12,2	13,5	12,0
IRL	-10,5	-13,2	-11,2	(M3)	28,7	19,0	13,0
I	-10,6	-10,5	-11,5	(M2)	22,8	20,0	20,0
NL	- 2,2	- 3,0	- 2,7	(M2)	4,2	6,0	8,0
B	- 6,0	- 6,8	- 7,5	(M2M)	9,5	6,5	6,5
L	3,3	2,7	1,2	:	:	:	:
UK	- 4,2	- 3,5	- 3,4	£M3	13,3	11,7	11,5
EC	- 4,0	- 3,9	- 4,0		12,7	10,7	10,4

Source: Commission services, based on information available up to 27th February 1980.  
Data for Ireland do not take into account the budget announced on 28th February.