COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL
ON THE ECONOMIC POLICY TO BE FOLLOWED IN 1980 AND
ON THE PREPARATION OF PUBLIC BUDGETS FOR 1981

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Economic trends and prospects

Following a period with comparatively favourable growth performance (3.4 % on average for the years 1976 to 1979) a slowdown of economic activity is now underway in the Community. As a consequence mainly of the deflationary impact of the 1979/80 oil price increase (estimated at 150% from end 1978 to 1st July 1980) real gross domestic product of the Community is expected to decline from the first to the second half of 1980, but may for the year as a whole show an increase of about 1.5%.

The currently available data suggest that the expansionary forces may regain a certain strength in the course of 1981. Private consumption, which is likely to stagnate in most of 1980, should recover under the impact of the acceleration of real disposable incomes resulting from a slowdown of price increases realtive to nominal incomes. Moreover, the process of inventory adjustments, which exerts a highly deflationary impact in 1980, should come to an end and be succeeded in the second half of 1981 by a more normal rate of inventory formation. Exports, notably to the OPEC countries, should remain a factor of buoyancy both in 1980 and 1981. On the whole, the growth of gross domestic product is expected to exceed 2% in the second half of 1981 but the average increase over 1980 may amount to only 0.5 to 1%. These forecasts are, however, the aggregate result of relatively divergent growth performances within the Community, with United Kingdom expected to see a decline of GDP both in 1980 and 1981, whereas other Member States will experience more buoyant conditions.

Given that the slowdown of economic growth coincides with a relatively large, in part demographically determined, increase in the labour force, an extension of unemployment is unavoidable despite the fact that shortage of skilled labour remains in many branches.

The price increases for raw materials and fuels are now being reflected strongly on the retail price level; in some Member States, this has sparked off a new wave of compensatory income adjustments, whereas others have succeeded to some extent in stemming the secondary effects. For the Community as a whole, the deflator of private consumption is expected to rise by more than 12 % in 1980 (partly reflecting, however, increases in indirect taxes). In the course of next year, the rate of price increases should get back into single figures but may for the year on average (over 1980) remain above 10%. The difference between the lowest and the highest inflation rates should be reduced somewhat compared to the 15 percentage points expected for 1980, but the underlying rate of inflation would remain 5 points higher in Italy and the United Kingdom than the Community average, and 3 1/2 points higher in Ireland.

A high degree of divergence would seem likely to prevail in the field of general government borrowing requirements, expected to amount to close to 12% of GDP in Ireland and Italy and around 8% in Belgium, with the Community average exceeding 4%.

For the Community as a whole, the deficit on the current external account is expected to exceed 28 mrd ECU in 1980 and to decrease to some 22 mrd ECU in 1981 (including an estimated impact of the oil price increases decided in June 1980). Two countries (France and United Kingdom) are expected to see a sharp improvement in their current external balances, whereas, on present policies, the other countries would seem likely to experience only little change or (in the case of the Netherlands) a deterioration. The current external deficit of Germany is expected to amount to about half the total deficit for the Community both in 1980 and 1981; its financing is not expected to present major problems, whereas the deficits envisaged for Denmark (4% of GDP), Ireland (7 %) and Belgium (5%) are a source of preoccupation.

Policy issues for the Community

Once again the Community is confronted with the economic consequences of a major increase in the price of oil, creating new balance of payments disequilibria, acceleration of inflation, additional structural problems and real income loss for all citizens. Moreover, a surplus is expected to remain for several years on the current account of the balance of payment of the oil-exporting countries increasing thereby considerably the tasks to be solved by the international monetary and banking system.

In the opinion of the Commission, the Community is not necessarily condemned to an extended period of economic stagnation. However, a balanced economic growth and a strengthening of employment opportunities cannot be obtained at the present rates of inflation. A reduction in the rate of increase in prices and wages is therefore a main condition for a lasting improvement of economic prosepcts. Given, moreover, the gravity of supply constraints in the field of energy, the persistent shortage of skilled labour in key growth sectors and the obsolescence of parts of the capital stock, a temporary slow-down of the rate of expansion of economic activity seems unavoidable. Enterprises and consumers need some time to adjust to a new set of relative costs and prices and attempts to force through a stronger rise in demand would carry a heavy risk of acceleration of inflation, additional constraints on supply of oil and other raw materials and external financial difficulties.

The Commission insists, in particular, upon the importance of the formulation and implementation of a vigorous energy policy as a support of growth. Such a policy, aimed notably at energy saving and increase of domestic energy production, should be accompanied by a strengthening of the structural base of the economy through an increase in the investment propensity and supply oriented policies.

The Community is now faced with the danger that strongly divergent price and wage movements may reduce its cohesion in a period with major challenges. The rates of price increases in member countries, which in April 1979 ranged from 3.3 to 13.9% over a year earlier, in April 1980 ranged from 6 to 22%. Ratios of public sector deficits to GDP are, in some countries, two to three times larger than the Community average. In some countries increases in relative unit labour costs have resulted in a deterioration of the external account in addition to the impact from the oil price increase. The diversity of price developments, budget balances and external balances is such that the general policy guidelines for the Community must be interpreted for each individual

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Member State in the light of its special situation and possibilities.

In the opinion of the Commission the need for a rapid reduction of the degree of divergency justifies a certain ranking of priorities in Member States' economic policy. In countries where general economic conditions as described above diverge significantly from the Community average, highest priority must be given to measures of adjustment. Such measures should reduce aggregate demand through reduction in government borrowing requirements, but should also remove factors of inflation and external disequilibrium operating on the supply side, such as productivity and cost conditions. Quick results are difficult to obtain in this field but all possibilities to dampen the price/wage spiral should be exploited. A higher degree of convergence of price/wage movements in the Community would in particular be facilitated if the rules of operation of the strong formal or informal indexation mechanisms, which exist in some Member States, were modified in such a way as to exclude the effect of external price shocks or other temporary factors like increases in indirect taxation, without reducing the level of protection of the lower income groups. Such measures of economic adjustment would partly improve the overall external position of the Community, and partly be reflected in the external accounts of other member countries, where fundamental conditions are more stable. The latter countries should be ready to accommodate the consequences, on their balance of payments, of adjustment policies corresponding to the general objective of reducing divergence within the Community.

A decline, recently started, of short-term interest rates would favour the possible recovery, which, on the basis of available evidence could start towards the end of 1980. Such a decline should be consistent with the money supply targets of Member States. As interest rates reflect expected rather than actual rates of infation, in addition to international interest-rate differentials, a decline in short-term rates could be the first sign of a change in price expectations and would at the same time assist the slow-down of price increases through a reduction of the financial burdens on the enterprise sector. Long-term rates on the whole are likely to decline more slowly than short-term rates although a major reduction of inflationary expectations could lead to a swift change also in this field.

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While the basic policy stance in most Member States appear appropriate in view of the circumstances, a certain flexibility may be required in the face of the uncertainties concerning cyclical developments over the coming year. A major recession could do considerable damage to the economy in terms both of real performance and of acceleration of cost pressures. In case the slowdown of economic growth over the coming months should prove more pronounced than hitherto foreseen, governments should therefore be prepared at least to accommodate the budgetary consequence of a loss of tax receipts.

To conclude there is, thus, no credible alternative to maintaining the present policy stance for the Community as a whole. A certain flexibility in demand management would, however, be called for if the slowdown of activity in 1980 and 1981 proved to be much more pronounced than now envisaged. Member States with high budget deficits and/or external financial problems should in any case pursue efforts to reduce imbalances without delay. More emphasis should be given in all countries to supply policies and, notably, policies to economise energy and reduce dependence upon imported oil.

Close surveillance and coordination of economic policy within the Community - notably of monetary policy in the framework of the EMS - remains a key element in stabilisation efforts and could contribute importantly to a slowdown of the rate of inflation and to a reduction of the degree of inflation divergence, necessary conditions for a strengthening of longer-run prospects for growth and employment.