COMMISSION OF THE EUROPEAN COMMUNITIES

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THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the Council in accordance with Article 2 of the Convergence Decision of 18th February 1974)

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1. Recent economic performance in the Community

The slow-down in economic activity in 1980, with GDP growing 1,3% in the EC as a whole, was approximately as foreseen by the Council in in December of last year. Output peaked in the first quarter of 1980, but declined thereafter. However, private consumption was probably beginning to grow again in real terms by the end of the year, while the EC business surveys showed first signs that the sharp deterioration in business sentiment may have been arrested.

There was hardly any increase in employment in 1980, while the labour force continued to expand rather rapidly. The result was a sharp rise in unemployment: the average rate for the year was 6,0%, and by the beginning of 1981 had passed 7,0%. Over the last twelve months the unemployment rate increased most in Denmark and the Netherlands (up by about one half) and the United Kingdom (up by two-thirds). The additional cost to the national exchequers of the rise in unemployment amounts for the Community as a whole to some 0,15% of GDP for 1980 compared to 1979.

The deterioration in inflation performance which had begun in 1979 was accentuated in 1980; the increase in consumer prices in the Community on average reached 12,1% in 1980, compared to the low point of 7,3% in 1978. Divergence between consumer price rises of Member States also widened to twice the average for the seventies as a whole (the standard deviation rose to 5,6%). However, a somewhat better performance was evident in the second half of the year, especially in the United Kingdom where the annual rate had fallen to below double figures.

The Community's current account deficit in 1980, expressed as a percentage of GDP, was the largest ever recorded. In contrast with 1979, there was some improvement in 1980 in export in relation to import volume. However, this was more than offset by a terms of trade deterioration (2,8%) considerably larger than that in 1979 (although this was still very much smaller than that suffered in 1974 after the first oil-price shock).

Exchange-rates developments in the EMS in 1980 were limited to movements permitted by unchanged central rates. However, the UK pound appreciated 15% against the ECU in the course of the year, and the Yen 24%. The US dollar was on a declining trend against the ECU until mid-year, but has since recovered substantially.

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2. Outlook for 1981

The present cycle is now seen as being sharper and deeper than anticipated. The starting point, the high level of activity in early 1980 has been again revised upwards, with the steeper fall later in 1980 then carrying a heavier recessionary momentum over into 1981. Domestic private demand (consumption, stockbuilding and investment) wholly accounts for the more pronounced cyclical profile. Foreign demand has stayed on the expected path, while government consumption in volume terms is still expected to grow slightly in 1981. Thus the revised forecasts prepared by the Commission's services in February suggest that the upturn in activity may be delayed until the third quarter of 1981, two quarters later than earlier expected. GDP growth at an annual rate of about 2% is now expected in the second half of 1981 and into 1982. The year on year growth of GDP for 1981 for the Community as a whole is revised down from + 0,6% in the Annual Economic Report to - 0,6%.

Employment could fall by nearly 1%, and by the end of the year the unemployment rate could be above 7 1/2% (1) and still rising.

A significant slowdown in consumer prices can be expected during the course of 1981, as the effect of more moderate wage settlements in the first half of the year is reinforced by some rebound of productivity in the second half. Although consumer prices for 1981 as a whole could be up by around 10 1/2% on 1980 (Table 1), the annual rate in the second half of the year could, at 8,2%, be 4 1/2 points lower than in the second half of 1980. Divergence of inflation rates should also lessen somewhat, with the standard deviation of consumer prices increases falling back to 4,6%.

The Community's balance of payments current account is likely to change little during the course of 1981 and for the year as a whole could be slightly worse than the high deficit recorded in 1980. A further worsening of the terms of trade in 1981 will slightly more than offset an improvement in volume movements.

3. Policy issues

The Council is required (according to the 1974 Convergence Decision) to deliberate in March as regards possible adjustments to the economic

(1) Seasonally adjusted figure.

policy guidelines adopted in the Annual Report in December.

At the time the Council concluded that the policy mix should give priority to the reduction in inflation, savings in oil imports, and the pursuit of the other necessary structural changes in the Community economy, and be only moderately supportive in terms of cyclical demand management. The weaker economic outlook cannot imply an easier way out of the constraints. While the evolving situation calls for technical adjustments to some financial policies, the fundamental line of policy - to reduce inflation and push ahead with structural adaptation - has to be pursued with even greater urgency.

Control of domestic monetary aggregates and exchange rates within the European Monetary System has on the whole been satisfactory. However, monetary policy in Europe has been and is still confronted with the need for a concerted reaction to the very high and volatile interest rates prevailing in the United States, and to the appreciation of the exchange rates of the dollar and yen.

The appreciation of the Yen appears to be justified in the light of Japan's trading performance. With respect to the United States'monetary policy, Europe is much affected by both interest and exchange rate movements.

If European interest rates now moved further up on average towards United States levels, it is quite likely that as a result there would be no cyclical recovery in Europe this year. On the other hand, a further substantial depreciation of European currencies against the dollar could risk causing a new acceleration of inflation in the Community, through the increase in import prices in European currencies. Moreover, erratic swings in either exchange rates or interest rates are costly to the economy through the uncertainty that they introduce.

In view of its large current account deficit on the balance of payments, the Community should be prepared to accept higher dollar exchange rates than prevailed in 1980 on average. The inevitability of this deficit in the short-run means that its financing should be carefully prepared. This in itself should pose no insuperable problems; the Community has for its part in February renewed and expanded its own recycling facility. Experience confirms how quickly conditions may change as between EMS currencies and the main floating exchange rates, and Europe should not make fundamental changes in its domestic monetary policies in response to volatile exchange rate movements. The United States authorities for their part could contribute to the international interest by managing their budgetary-monetary policy mix and the techniques of monetary policy with a

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view to reducing the level of interest rates consistent with a stable evolution of money supply.

Within the Community, Member States must match the difficulties of transatlantic monetary conditions with intensified cooperation as regards interest rate adjustments, intervention policy and official capital movements. In addition to full use of the mechanisms of the European Monetary System, there would seem now to be opportunities for adjustments of United Kingdom monetary policy as regards interest rates and criteria of exchange rate management.

Apart from the increase in unemployment a consequence of the weaker level of activity in 1981 is some increase in budget deficits over what had been forecast in the Annual Report. However, the structural weaknesses in parts of the European economy are such that a full play of the 'automatic stabilisers' cannot be risked in all countries. In particular, countries with the highest deficits (Belgium, Ireland, Italy) should act to prevent increases. Further increases in these countries' deficits cannot provide any sustainable increase in economic activity; on the contrary, increased deficits - whether spontaneous or discretionary - are likely to cause swift and significant interest rate increases. Among these countries, Italy has made progress in 1980 in reducing the borrowing of general government to well under 10% of GDP, and this should be conserved in 1981. In the case of Ireland the projection of a reduced deficit is also significant, particularly in view of the increased spending on public investment. In other countries, some increase in budget deficits should be permitted to support activity; indeed the 'automatic stabilisers' should be allowed to operate fully in countries with the least high deficits. However, even in these cases, priority must be given to restructuring expenditure to improve productive potential.

Extensive structural problems have to be overcome to achieve higher trend rates of growth and employment. Policy must intensify efforts to improve productive potential by redirecting budgetary resources from subsidies that are supporting uneconomic or non-priority activities, into aiding public or private investment. The investment ratio has declined from 23% of GDP in 1970 to 21% in 1979 in the Community as a whole. Meanwhile, over the same period it seems that (subject to difficulties of statistical measurement) investment grants remained static at 1% of GDP, whereas subsidies

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(notably operating subsidies, excluding tax expenditures) rose from 1,8% of GDP to 2,6%, with particularly large increases recorded in the Benelux countries, Ireland and Italy. Justifications for higher or more rapid fiscal depreciation allowances exist in the accelerated obsolescence of existing capital stock due to the higher energy prices, and in the need to achieve fundamental improvement in industrial competitivity vis-à-vis third countries. The Commission for its part is following these principles in areas of Community responsibility, having recently proposed a reduction of state aids to steel,[1] an increase in producers' financial co-responsibility for surplus agricultural production,[2] and a strengthening in Community loan instruments for financing investment[3].

Progress is being made in reducing the Community's dependence on imported oil. The share of imported oil in gross inland consumption of primary energy fell from 47,6% in 1979 to 44,2% in 1980, and is expected to fall further to 42,1% in 1981. The volume of net oil imports dropped 10,7% in 1980 and should further fall 5% or more in 1981.

However, much more progress must be achieved before the Community could consider its macroeconomic policy to be no longer constrained by energy market factors. Energy production and savings must be boosted by every possible means. Obstacles such as delays in investing in nuclear power, or failure to make timely adjustments to energy consumption taxes so as to sustain the 'price message', will ultimately exact an extremely high price in living standards. Several countries are relatively well endowed in hydrocarbon resources (Netherlands, United Kingdom) or have reasonable chances of becoming much more self-sufficient (Ireland, Denmark); France is making particularly rapid progress with other energy forms. Belgium, Germany and Italy - while making efforts in certain areas of energy production or saving - need urgently to strengthen major features of their national energy programmes, or their implementation. Examples of below-average taxation of energy consumption include heating oil in general as between forms of hydrocarbon consumption, and, as between Member States in relation to the Community average, heating oil in Germany, Belgium and the United Kingdom, petrol in Germany and Luxembourg and diesel oil in Italy and Luxembourg.

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(1) COM (81) 71 final

(2) COM (81) 50 final

(3) COM (80) 670 final

The further deterioration in the labour market situation should be appraised as a function of its different forms and causes.

The expected reduction of employment in 1981 could be corrected progressively with the recovery in the second half of 1981. The speed of this recovery depends on the response of social partners to the need for higher investment and structural change. Particular consideration should in this context be given to the need to take full account of the deterioration of employment prospects and to generate new jobs. Defensive measures and subsidies would impede the process of reallocation as much as aggressive wage policies. With little productivity growth and further losses in 1981 on the terms of trade, there is almost no scope for significant real income gains in the Community and even the need to accept a real income loss in some countries.

In some countries strong efforts are currently being made to moderate the growth of nominal incomes, and the Benelux countries in particular are improving their competitive positions as a result of combining a low inflation rate with stable exchange rates within the EMS. In other countries it is urgent that more efforts be made to reduce the trend of growth in nominal incomes, notably in Ireland and Italy. Moreover, the substantial increase in structural unemployment emphasizes the need for wage contracts to allow for the quicker adjusments of incomes between countries, sectors and firms where competitivity and profits have been reduced.

Part of the trend increase in unemployment reflects the longer periods of search between jobs, facilitated by unemployment and social security benefits. However, the weak growth performance since 1973 increased the number of unemployed. Among the unemployed certain groups are in a particularly vulnerable position: young people without sufficient training, women looking for part-time jobs and older people approaching their pension-age. To aid these groups and to alleviate unemployment in general it is vital that Member States assure sufficient resources for expanded vocational training and retraining, undertake supplementary efforts to help the record supply of young people into their first employment, improve programmes of apprenticeships (as offered in Germany) and promote pre-pension schemes and the creation of part-time jobs.

An old phenomenon has attracted new interest: the growing size of unrecorded and unobserved employment which seems to have been spreading rapidly in many industrialised countries.

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The multiple and continued efforts to remedy the unemployment situation in Community countries have shown some results. More has to be done, but no general and quick panacea is available. The responsibility for employment creation lies as much with those who decide the conditions of employment at the enterprise level as with governments in their macroeconomic and structural policies at the national and Community level.

4. Conclusions

The European and other non-oil producing countries are now undergoing the new readjustment process due to the second oil price shock - whose impact on growth, prices and the balance of payments is similar to that of the first shock in 1973-74. The difficult task of governments, trade unions, employers and households lies in the need to avoid the policy errors and mistaken reactions that followed in 1974 and 1975. The consequences of the second heavy transfer of resources in favour of OPEC have to be accepted. This implies priorities for reducing the growth of nominal labour costs and for restructuring the productive potential of our economies through accelerated investment and energy substitution and savings. The scope for global policy actions in the Community is very limited mainly because the high budgetary deficits after the first oil shock could not be reduced during the modest recovery period 1976-79, and because present inflation rates and inflationary expectations in most countries are still excessive. The limited policy contributions of governments could be widened if progress in countering inflation becomes more evident and if the structural policy efforts make rapid progress. Only in this way is it possible for Member States to help each other through having a coherent, collective programme for economic recovery and improvement in the employment situation.

This programme of policy coordination implies for the Community:

- maintenance of the generally convergent monetary and budgetary policy orientations approved in December 1980 ar ' progress in strengthening the European Monetary System;
- stronger cooperation between the Community and the United States in monetary and exchange rate policies;
- limited scope for demand stimulatory actions through a qualified acceptance of automatic budget stabilisers, but more support for investment, a quicker restructuring and energy substitution policy, and improved labour retraining and mobility schemes.

Table 1: Main Economic Aggregates, 1979-81

	1979	1980	1981		1979	1980	1981
	GDP volume, % change				Private consumption deflator, % change		
DK	3,5	-0,9	-0,1		9,5	11,0	9,0
D	4,6	2,0	-0,7		3,9	5,4	4,5
GR	3,8	1,4	2,4		17,7	24,5	21,5
F	3,2	1,8	0,5		10,5	13,5	11,8
IRL	1,9	0,8	1,8		12,2	18,2	16,0
I	5,0	3,8	-0,8		14,9	21,2	18,7
NL	2,2	0,2	-0,6		4,6	6,5	6,3
B	2,4	1,2	-0,7		3,5	6,3	6,2
L	3,6	0,4	-1,0		5,8	6,3	6,3
UK	1,3	-2,0	-2,0		12,2	16,1	11,0
EC	3,5	1,3	-0,6		8,9	12,1	10,4
	Unemployment rate, % of civilian labour force				Current account of balance of payments % GDP		
DK	5,3	6,2	7,6		-4,6	-4,1	-3,7
D	3,4	3,4	4,4		-0,7	-1,7	-1,6
GR(1)	(2,2)	(2,1)	(2,3)		-2,9	-2,6	-2,9
F	6,1	6,5	7,5		+0,1	-1,3	-1,8
IRL	7,9	8,9	10,9		-10,1	-8,3	-11,4
I	7,6	8,0	8,2		+1,6	-2,6	-1,4
NL	4,2	5,0	6,8		-1,4	-1,5	-0,9
B	8,6	9,3	10,7		-2,9	-5,6	-6,6
L	0,7	0,7	0,8		+28,7	+20,8	+18,0
UK	5,4	6,9	9,8		-0,9	+1,0	+0,3
EC	5,5	6,1	7,4		-0,5	-1,5	-1,6
	General government net lending (+) or borrowing (-), % GDP				Money supply, % change		
DK	-3,1	-4,6	-5,7	(M2)	9,9	10,9	8,7
D	-3,0	-3,5	-3,8	(M3)	6,0	6,2	4,5
GR	:	:	:		:	:	:
F	-0,8	-0,6	-1,8	(M2)	14,4	10,5	10,0
IRL	-11,9	-13,5	-11,7	(M3)	12,0	18,9	12,0
I	-9,4	-7,8	-8,4	(M2)	20,3	12,3	13,1
NL	-2,0	-2,8	-3,2	(M2)	7,6	5,8	6,5
B	-7,2	-9,4	-9,7	(M2H)	6,0	3,0	5,0
L	+0,1	-0,9	-2,1		:	:	:
UK	-3,3	-2,3	-2,2	(£M3)	12,7	19,5	10,2
EC	-3,6	-3,6	-4,0		11,2	10,1	8,2

(1) Not comparable with other countries.

Source: Commission services, based on information available to 24 February 1981.

ADDENDUM

to the Communication from the Commission to the Council;
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When, on 15 December 1980, the Council adopted the Annual Report on the economic situation in the Community (Decision 80/1265/EEC), it was agreed to fix the first economic policy guidelines for Greece at the first examination of the economic situation by the Council in 1981.

Accordingly, the Commission proposes that the Council approve the economic policy guidelines for Greece contained in the annex.

In Greece, the improvement in the current account balance was achieved in 1980 at the cost of a moderate decline in domestic demand and a controlled drop in the exchange rate; as a result, a more flexible economic policy was possible for 1981. The policy has two aims: first, to contain the upturn in consumption of which there were signs toward the end of 1980, while stimulating the recovery of investment which is essential if production structures are to adjust to the new external context; and second, to slow down prices - rising at an annual rate of 26% at the end of 1980 - in order to preserve the competitiveness of the economy which is likely, sooner or later, to be affected if the present rate of price rises persists.

These objectives are to be achieved by a package of measures concerning incomes, the budget and credit. As a complement to the adjustments made to the income tax rates and allowances to counteract fiscal drag, incomes policy has laid down, for the year, rules for the adaptation of wages designed simply to maintain purchasing power: this should help achieve the necessary slowdown in nominal pay rises and the moderation of private consumption. As for budgetary policy, it has provided for a substantial increase in public sector investment and an appreciably greater effort to assist certain categories of private investment. Lastly, monetary policy has considerably loosened the constraints on firms: for 1981, the increase in lending to the private sector is targeted to move roughly in parallel with the forecast increase in the value of gross domestic product; however, no immediate moves have been made to lower interest rates.

This package seems to achieve the best compromise possible between short-term constraints and medium-term necessities. Only during the first half-year will it be possible to assess whether the results achieved fully correspond to the objectives set as regards, in particular, slowing down price rises and limiting the increase in the external deficit. If they do not, certain elements of the current policy would have to be tightened up.