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THE ECONOMIC 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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(Communication to the ECOFIN Council of 15 March 1982, in accordance with Article 2 of the Convergence Decision of 18 February 1974)

The Economic Situation in the Community

The first two sections of this communication give an account of recent developments in the European economy together with revised forecasts for 1982. The latter suggest a slow recovery in economic activity during this year. The associated policy recommendations are set out in section three. These forecasts and recommendations rely upon relatively hopeful assumptions for world economic conditions (for example an end to the US recession in mid-year and no new upward movement of interest rates).

However, there is a serious possibility of a frankly worse turn of events, for example of world monetary conditions that could abort the cyclical recovery process in Europe. A closer examination of action which could be undertaken would then become necessary. This is considered in section four.

1. Economic trends and prospects.

The economic situation at the end of 1981 and in early 1982 has been evolving somewhat more than one might deduce from the flat trend of industrial production and the steep rise in unemployment. Processes of cyclical and balance of payments adjustment are in motion in most countries. Business prospects have been gradually improving according to the European Community opinion surveys of industrialists.

However, the fragility of the recovery phase is illustrated by the new Commission forecasts which suggest only 1.6 % GDP growth in 1982 as a whole. This implies a quarterly profile of low growth from the end of 1981 to mid-1982. By end-1982 growth is projected to reach a 2 1/2 % annual rate.

Underlying the cyclical profile for both 1981 and 1982 is a relatively buoyant export volume growth, which has been stimulated as a necessary adjustment to the second oil shock and was further boosted by the strong depreciation of European currencies last year. For 1982 the outlook is for a slight growth of private consumption in volume terms, a less strongly negative evolution of investment (than in 1981), and a positive turn to the stock-building cycle.

The most striking change in 1981 was the 16,4 % reduction in the volume of petroleum imports, following the significant reduction already achieved in 1980. With rising production in the Community of oil and nuclear electricity, the Community's dependence on imported oil for its total energy requirements made a sharp step down from 45 % in 1980 to 39 1/2 % in 1981.

The balance of payments current account of the Community overall turned out better in 1981 than expected last autumn. The deficit is now estimated to have declined from 1.3 % of GDP in 1980 to 0,8 % in 1981, and to further decline to 0,4 % in 1982. Germany is moving rapidly back towards equilibrium, the UK and the Netherlands are in surplus, but France and most of smaller Member States remain in substantial deficit.

Little progress was made in reducing inflation in 1981, with an EC average consumer price rise of 11.4 %. With the recent weakening of commodity prices, and some deceleration in the growth of nominal incomes, the achievements in 1982 should be more substantial in this respect, and the objective should be to lower inflation below the 10.6 % now foreseen by the Commission. Divergences between countries seem likely to remain worringly wide, with consumer price increases of over 20 % in the last twelve months in Greece and Ireland, and only a little less in Italy.

Total employment in 1981 is estimated to have fallen by nearly 1 1/2 %, and with the substantial growth of the labour force, the unemployment rate rose by nearly one-third. The rate of growth of unemployment had up to the end of 1981 shown no sign of slowing down, with an average monthly increase of 180.000 persons. If the expected business upturn materialises, this rate of growth of unemployment will slow, with the absolute level possibly stabilising in some countries towards the end of 1982, with the aid also of special labour market measures.

2. Policy developments

Monetary policy in the Community in recent months has been overshadowed by financial developments in the United States. Short-term interest rates fell sharply there with onset of recession towards the end of 1981, but in the new year US rates hardened again.

In the Community the monetary authorities have been seeking to obtain a more gradual but steady lowering of interest rates. By mid-February average short-term rates had declined to a little over 14 %, which maintains a real interest rate margin of about 3 %; with the expected decline in the inflation rate in 1982, these rates remain very high for a low-point in the business cycle. The ECU/US dollar exchange rate has been sensitive to these changing interest rate differentials. Thus the dollar was weaker in the last months of 1981, but has strengthened again sharply in early 1982, notwithstanding substantial European central bank intervention selling dollars.

Money supply in the Community as a whole has kept to a rather steady rate of about 10 1/2 %. Slower monetary growth was achieved in several Member States in 1981 (including Germany and the UK), but somewhat faster growth than expected was seen in France, Italy and especially Greece.

Budgetary policy ended up in 1981 less tight than originally planned. The aggregate net borrowing of government as a whole thus rose quite significantly from 3,6 % of GDP in 1980 to 5,0 % in 1981 (with all the reserve with which such a weighted mean should be interpreted). The only country to have reduced its public government borrowing as a share of GDP was the UK. The levels of government borrowing were highest in Belgium, Denmark, Greece, Ireland and Italy.

Budget policy adjustments have been in preparation in several countries in early 1982, in Belgium and Ireland as well as Italy in a restrictive direction, in Germany with measures to stimulate investment and aid employment; in the UK the 1982-83 budget will be published in March against a background of approximate achievement of budget policy objectives for the past year.

On present plans and forecasts it is expected that government borrowing will be reduced slightly in 1982 to 4.7 % of GDP (from 5.0 % in 1981) for the Community as a whole, with increases expected though in France, Greece and Denmark.

The growth of nominal wage incomes per capita decelerated on average in 1981 to 11.7 %, compared to 13.4 % in 1980. Taking into account price rises, this gave in 1981 a very slight gain in purchasing power. A further deceleration is forecast for 1982 in nominal wage incomes per capita (10.1 %), approximately in line with deceleration of prices. Negotiations have been under way in several countries in line with the Commission's communication (of July 1981) on the principles for indexation in the Community. In Italy these have not yet resulted in an adjustment of the prevailing system; in Belgium the government has just decided to limit pay increases in 1982 through a temporary limitation of indexation. The Netherlands made some such adjustments in 1981. In France a voluntary incomes policy is under negotiation.

In the face of the dramatic increase in unemployment in the course of 1980 and 1981, Member States have been taking measures aimed at reducing the disequilibrium in the labour market. Several countries have been adapting their policies for school-leavers along the lines envisaged by the Commission(1), the UK, Denmark and France in particular envisaging training or employment opportunities for all 16 - 18 year olds (2); Germany's very extensive apprenticeship schemes are covering a still increasing proportion of young people.

An intensification of work sharing schemes through early retirement (which is already an important feature in Belgium and Denmark and which plays a certain role in the UK) is now envisaged in France and is to be examined in Germany. In France a reduction of the weekly working time is also under way, together with an expansion of public sector employment and other measures. The Dutch government envisages an employment creation programme costing about 1 % of GDP but details are still being debated.

(1) Foreward to the Fifth Medium-Term Programme (para 7.2.2)

(2) 16 - 25 year olds in Denmark

3. Policy for reinforcing a recovery in economic activity

The prerequisite of an effective European economic policy is that a sufficient internal coherence between Member States is achieved. This does not mean identical performance or policies, as the controlled adaptability of exchange rate parities in the EMS has shown. However, it does mean, for example in the present situation, that countries which have moved into financially vulnerable situations act decisively to remedy this; and that countries with strong balance of payments positions do not pursue so prudent financial policies as to impede the recovery of high deficit countries. Divergences of this kind risk undermining the cyclical recovery process.

Several Member States, especially Belgium, have been preparing stabilisation policies, and in these cases bold action in the areas of public finance and costs provides the best prospects for a renewal of employment creating growth. Belgium has in particular announced measures to limit pay indexation, a measure all the more urgently needed, following the devaluation of the Belgian franc (and to a lesser degree the Danish krone) on 21st February. The Belgian devaluation corresponded to a need for an exceptionally deep adjustment, and must be followed through with the domestic budget and income measures. In general the essential Community interest is that Member States concentrate on thorough domestic public finance and cost stabilisation measures in good time, rather than wait until the failure to limit internal disequilibrium has to be ratified by exchange rate changes. The Community must guard in any case against a drift towards a pattern of competitive devaluation. Action to turn the trend in extremely high inflation rates (Ireland, Greece and Italy) and/or extremely high public deficits (Denmark, Greece, Ireland, Italy) is now urgently required.

Some countries have been able to create a certain room for manoeuvre :

thus Germany has recently taken measures aimed at stimulating investment and employment over the medium-run. Meanwhile domestic demand remains in the short-run stagnant in this country, and seems likely to remain so in 1982, as also in the UK. The policy strategy in these countries aiming indirectly at reducing interest rates must be encouraged, notably in Germany. For the time being, these countries should avoid any restrictive budget policy action in 1982. Moreover monetary policy should typically aim at the higher end of target ranges for monetary expansion.

As a more general proposition in the Community, budgetary measures may partially compensate for the effects of high interest rates either through increased investment aids as in Germany and France, or through such measures as a reduction of the value added tax on construction activity as in Belgium.

There is also now a strong case at a time of declining petroleum prices for adjusting energy consumption taxes upwards, so as to maintain the right energy price message to consumers and investors. The oil importing countries must not repeat the mistake of the mid-nineteen seventies, when acceptance of a short-term energy price weakness led eventually to the great costs of the second oil shock. Extra consumption tax revenues can easily be offset in useful public finance adjustments of other kinds, be it for employment or investment expenditures or tax reductions.

Employment measures will continue to warrant a rising share of public expenditure. Specific measures aimed at improving the situation on labour markets have been described in other Commission communications. From an economic point of view, care should be taken to avoid introducing any new labour market rigidities impedeing the redeployment of labour when a stronger demand arises. The adjustment of working time in its many forms (working week, year, life time) should also contribute to reducing unemployment. This needs to be negotiated by the social partners in ways which take account of the competitive position of firms.

In addition to the need for convergence of policies in fundamental respects, there are technical possibilities for strengthening the European Monetary System which are currently being examined in the appropriate Community fora. Decisions in this field are expected to be taken soon.

4. Risks and contingencies

Against a background of uncertain cyclical recovery, the most clear-cut risk for 1982 is that negative impulses may be communicated across to the European economy from the United States as a result of the particular stance of policies there. For example it is possible that a cyclical upturn in the US combines with a rising federal budget deficit to cause upward pressure on interest rates beyond present levels.

The fact that interest rates in Europe in 1981, at the trough of the recession, were even higher than in 1979 and 1980, is probably the most important explanation of the failure of cyclical recovery to get under way last year. In the typical cycle of the past decade, short-term interest rates fell 5 - 6 % from peak to trough. A renewed rise in interest rates could well tip the balance of influences against an upturn.

It is also possible that world trade growth could weaken again in 1982, reflecting difficulties in other regions of the world, including Eastern Europe and parts of the developing world.

Thus for a number of reasons it is possible that the economic recovery in Europe in 1982 might abort. Action to forestall this contingency is therefore imperative.

First, the depressive influences of high interest rates may be combining with a weakening propensity to invest that reflected industrialists' perceptions of increasing world-wide trade restrictions; these two factors may be dampening, if not stultifying the motor forces that normally drive the business upswing.

Secondly, on the policy side, the major industrialised economies may be making some miscalculations over the costs of insufficient policy coordination, both as between the branches of government responsible for budgetary, monetary and trade policies, and as between the major regional centres of policy-making in North America, Japan and Europe. As regards the United States the problems of reconciling the objectives of monetary and budgetary policy are evident. For both Europe and Japan the resultant pressures on the dollar's exchange rate, unabated by any policy position in the US, have caused problems. In Europe the inflationary influences of devaluation have required continued tight financial policies. In Japan a reluctance to follow US interest rates has contributed to a weaker exchange rate and a faster balance of payments adjustment than might otherwise have occurred or been desired. The prospect now of a further round of monetary tensions, originating in the US budget/monetary policy mix is having a profoundly unsettling impact. Whether or not apprehensions turn out to be founded, the impact of the uncertainty is adverse on business expectations and on attempts of policy-makers to set, adhere to and explain publicly their strategies.

In Europe a third consecutive year of fast-rising unemployment should not be met just by resolve to wait for the present orientations or policy to deliver desirable results. Two broad policy responses should be considered.

(i) The most constructive approach would be for the major industrialised countries and regions to work together, on a time-scale adapted to the mid-year June summit, to produce an international cooperative solution. This could mean achieving a more generalised concern in monetary policy for interest rate and exchange rate movements, a more balanced set of domestic policy mixes, and a relaxation of trade policy tensions that could be confirmed by an agreement removing present disputes. On the US side this could mean reducing the budget deficit and introducing international considerations into the management of monetary policy. In Japan this could mean conversely a less restrictive stance or even a budgetary stimulus in an evolving policy mix which assured a sound internal-external balance in the economy. For Europe policy could aim at an easing of interest rates and at strengthening economic activity without trade tensions.

ii). If an agreement with its principal partners proves impossible to achieve, the Community should examine which policies would permit it to protect its own interests. These policies should be determined at the appropriate time and could for example aim at a concerted reduction of European interest rates, together with the introduction of the necessary measures to contain the secondary effects of such action.

5. Conclusions

(a) The economic upswing in Europe is still uncertain and is probably being hampered by the high interest rates; unemployment is still rising fast. However the balance of payments is improving on the whole quite fast.

(b) Within the European Community, there are policy adjustments that can, and need to be made to strengthen a sustainable upswing. Stabilisation programmes remain still to be implemented as a matter of urgency in some countries and these are indispensable for improving employment. But in other countries whose financial condition is becoming sounder, budgetary policies should abstain from any restrictive impulse. Monetary policy should at present be aiming typically at the higher end of target ranges in countries with relatively low inflation. Budgets should notably support employment-related measures and aid investment, in part through measures anticipating general interest rate decline, and maintain the right energy price message through fiscal adjustments.

(c) Improvements to the European Monetary System, in particular a more extensive role for the ECU in private and public uses, are warranted as a contribution to rebuilding a more balanced and safe international monetary environment.

(d) The prospects for 1982 are still darkened by serious problems of imbalance budgetary-monetary-trade policy mix emerging in the industrialised countries, and notably the US. A set-back to the recovery in Europe in 1982, implying a third successive year of fast rising unemployment would have far-reaching implications. Policies would have to be reconsidered in fundamental ways, as regards the management of monetary policy in Europe in relation to the US, as regards the domestic mix of policies within Europe, and as regards the general balance of monetary, budgetary and trade policies in the industrialised world.

Table 1 - Main Economic Aggregates, 1980-82

	1980	1981	1982		1980	1981	1982
	GDP volume, % change				Private consumption deflator, % change		
DK	-0,2	-1,2	2,5		12,3	11,5	10,1
D	1,9	0,0	1,4		5,4	6,0	4,5
GR	1,6	-0,2	1,2		22,2	23,5	24,0
F	1,3	0,1	2,7		13,2	13,1	13,0
IRL	1,9	1,7	1,6		18,2	20,0	19,5
I	4,0	-0,8	1,5		20,3	19,2	16,5
NL	0,6	-1,1	0,8		6,9	6,7	5,0
B	2,4	-1,4	0,4		6,4	7,6	10,0
L	0,4	-3,0	0,1		7,7	8,1	12,0
UK	-1,4	-1,4	1,1		15,9	11,6	10,3
CE	1,4	-0,5	1,6		11,8	11,4	10,6
	Unemployment rate, % of civilian labour force				Current account of balance of payments % GDP		
DK	6,2	8,3	8,9		-3,4	-3,1	-2,9
D	3,4	4,8	6,6		-1,8	-1,2	0,2
GR	(2,8)	(3,1)	(3,4)		-0,9	-4,0	-3,0
F	6,5	7,8	8,5		-1,3	-1,4	-1,4
IRL	8,3	10,4	12,0		-8,4	-12,9	-9,3
I	8,0	8,9	9,7		-2,5	-2,1	-1,2
NL	4,9	7,5	9,7		-1,4	2,0	3,9
B	9,3	11,5	13,3		-5,2	-6,6	-3,9
L	0,7	1,0	1,3		22,2	19,7	(20)
UK	6,9	10,5	11,8		1,4	2,2	0,7
CE	6,1	7,9	9,1		-1,3	-0,8	-0,4
	General government net lending (+) or borrowing (-), % GDP (1)				Money supply, % change end of year (1) (2)		
DK (3)	-5,9	-10,7	-12,1	(M2)	10,9	10,1	13,0
D	-3,5	-4,5	-3,6	(M3)	6,2	5,0	4,9
GR	(-3,3)	(-6,3)	(-8,2)	(M3)	24,7	34,7	27,8
F	+0,4	-2,1	-3,1	(M2)	9,7	12,3	(13,0)
IRL	-12,8	-14,4 (4)	-12,3	(M3)	16,9	13,6	13,6
I	-7,8	-10,6	-10,3	(M3)	16,9	17,0	17,0
NL	-3,4	-4,1	-3,7	(M2)	3,6	6,3	8,8
B	-9,4	-13,3	-12,0	(M2)	2,7	5,1	(9,5)
L	-1,8	-3,3	-3,0		:	:	:
UK	-3,9	-2,3	-0,8	(£M3)	18,4	10,5	9,0
	-3,6	-5,0	-4,7		11,3	10,9	(9,9)

(1) The figures relate to calendar years except for the UK (financial years).
(2) end-year on end-year.
(3) Excluding losses on bonds issued below par: -2,9, -6,9 and -8,5% respectively.
(4) Excluding private sector participation in investments amounting to 112 mill. IRL.
Source: Commission services, based on information available up to 2 March 1982; the figures take provisionally into account the effects of the realignment of EMS parities on 21 February 1982.