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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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I. Introduction

In December, the Council adopted the Annual Economic Report for 1983-84 proposed by the Commission. The Report included an analysis of the conditions for a sustainable economic recovery in Europe, based on information available in October.

In the light of developments in the intervening months, more precise, and indeed more encouraging estimates and forecasts can now be given for 1983 and 1984 even though uncertainties remain. Signs of recovery are increasingly numerous. The present estimate for real GDP growth in the Community in 1983 is better than expected at 0,9% (revised upwards from 0,5% forecast in the Annual Report), and the most recent forecast for 1984 is 2% (revised upwards from 1,5%).

The improvement in economic performance and outlook is due both to internal Community factors and to external factors.

- The staggered introduction of adjustment policies is now having a more favourable impact to the extent that the Member States whose corrective policies are most advanced exercise a positive cyclical influence on the economies of their partners. Further, within the Community, the trend in the Member States is now increasingly convergent; imbalances are being corrected in most countries on external account, budget positions and inflation.
- Outside the Community, the main external factor in the upward revision of forecasts of activity is the improvement in world trade, to which the US has made a substantial contribution. However, the future development of US interest rates, like that of the US dollar, is still problematic, dependent as it is on the main macroeconomic policy choices of the US authorities. What is more, the financial situation of a number of developing countries is still giving cause for concern at a time when their participation in the recovery of world trade is essential.

Despite the brighter cyclical outlook, there are still some clouds of uncertainty on the Community horizon. Accumulating imbalances in the situations of the major institutional sectors - in public finance, for example, or in the trend of companies' net incomes, which has long been too weak - make it necessary in many Member States to continue applying adjustment policies that have little margin for stimulating aggregate demand. The improvement now emerging is encouraging for this approach.

The unemployment situation continues to be seriously worrying. Unemployment again increased in 1983, though significantly less rapidly than in 1982. Even if the recovery were to be confirmed in 1984, there would still be a slight increase in the average level of unemployment, which could reach 11% of the labour force as against 10,6% in 1983. It should be noted, however, that the unemployment rate, on average for 1984, should be lower than that for 1983 in the Federal Republic of Germany and the United Kingdom.

The task of the Member States' macro-economic policies against this background will be to organize conditions in which the improvement in economic performance and outlook can be consolidated into a balanced recovery of activity.

II. Outlook for activity in 1984

a) Better results at the end of 1983.

In the closing months of 1983, business surveys recorded a pronounced improvement in the economic climate in the Community. In the fourth quarter, capacity utilization increased in almost all the Member States, and the Community share-price index continued to rise, with increases recorded in every country except Italy.

Outturns in the closing months of 1983 were in general better than expected: annual results for Belgium, the Federal Republic of Germany, Greece, France, the Netherlands and the United Kingdom were slightly up

on the October forecasts. Real GDP growth on average for the Community was 0,8% in 1983, compared with the earlier estimate of 0,5%. The most marked improvement occurred in Germany, where real GDP expanded at an annual rate of 5,3% during the fourth quarter, and in the United Kingdom, where the annual rate of growth has been 2% or 3% for the past two years.

The improvement in the Community's growth rate in 1983 was mainly the result of the trends in consumption and stockbuilding in the UK and Germany, the countries where the recovery is already under way. As growth was boosted by domestic demand, the rate of expansion of import volume also increased somewhat, but the increase in world trade stimulated exports, so that the balance on goods and services also made a slight positive contribution to growth.

The major increase in US imports (+25% at an annual rate in the second half of 1983) underpinned world trade and helped to produce the expansion at an annual rate of 6,6% in the second half of 1983, up from 2,5% in the first half.

Volume of imports

	<u>1982</u>	<u>1983</u>	<u>1984(1)</u>
EC	+2,4%	+1,7%	+3,5%
USA	+1,3%	+12,1%	+14,7%
OECD	+1,0%	+3,8%	+6,6%
World	-0,1%	+1,7%	+5,0%

(1) Forecasts.

b) The factors of dynamism in 1984

Signs that activity will continue to improve in 1984 are increasingly apparent:

- There is a steady improvement in the opinions of businessmen in the Community on the outlook for Community output; optimism is strongest in Germany and the UK, but there is a more uncertain trend in France and Italy.
- Investment intentions in manufacturing for this year are encouraging: they imply an increase for the Community as a whole, both nominally (10%) and in volume terms (4,7%), after a nominal increase of 3% and a volume decline of 3% in 1983. The outlook for increased industrial investment is particularly good in Denmark and the Netherlands, but substantial growth may also be achieved in France and the UK.

The main factor in the consolidation of the recovery in 1984 will probably be investment. After declining in real terms for the past three years, gross fixed capital formation in the Community should expand by a little over 2% on average during the year. This figure takes account of growth of between 3,5% and 7% in annual terms in five Member States (Belgium, Denmark, Germany, Italy and the UK) in the second half-year. Last year's considerable increase in firms' market capitalization will help to boost investment this year. At the same time, further disinflation should make for a slight increase in households' real disposable incomes, so that real private consumption could expand by an average of 1,1% in the Community in 1984 compared with 0,9% in 1983.

The development of the Community's trade balance is also expected to contribute to recovery. Forecasts of world trade point to a substantial expansion of import flows in 1984 (+5% in volume). An increase in Japan's import capacity is expected to reinforce the stimulus afforded by the expansion of US imports. As the industrialized countries import more, this should in turn allow the developing countries to increase their own imports. The Community's trade balance could therefore make a net contribution to growth equal to about 0,6 points of GDP.

However, there are other factors, less favourable to growth, to be taken into account. The dollar prices of raw materials other than oil are rising, sometimes substantially. If the dollar remains strong, the Community's terms of trade might deteriorate slightly this year. On the other hand, the trend of raw material prices will help to restore the external positions of the developing countries, whose trade deficits and current account deficits should contract further on average in 1984, after the improvement begun in 1983.

Another factor affecting growth in Europe is the development of real interest rates. These rates are high at the moment, and in view of the uncertain prospect of a decline they could be a factor inhibiting investment. However, the risk is limited by the improved returns on capital, which encourage investment.

c) Trend in unemployment

Unemployment continued to rise in 1983, although more slowly than in 1982. At the end of January 1984, the number (not seasonally adjusted) of unemployed in the Community reached 12,9 million, 600,000 more than at the end of January 1983. It seems, however, that during 1983 there was a slowing of the increase in unemployment followed by some stabilization of the unemployment rate. In 1984, taking account of the likely development of the labour force, the recovery of activity will not yet bring a

reduction in the rate of unemployment overall, though the trend should be more favourable towards the end of the year. This outlook for the Community as a whole is the result of prospects which differ somewhat among the Member States. Thus in the Federal Republic of Germany and the United Kingdom a reduction in unemployment is likely, the first since 1979.

III. International uncertainty

The key question now is whether the European recovery combined with US expansion will result in lasting economic growth for the industrialized countries and, by extension, the developing countries.

A balanced mix of fiscal and monetary policy is a condition for the sustainability of the recovery. From this point of view, the situation in the United States is a source of problems: in 1983, a sizeable deficit (which looks set to persist) in combination with a far from accommodating monetary policy, produced a renewed rise in US interest rates and further appreciation of the dollar. The expectation in US markets that the monetary authorities will not relax their restrictive stance is maintaining pressure on interest rates. As inflation has declined, real interest rates in the USA have now become extremely high.

Although US budget deficits have probably had a substantial favourable short-run effect on the recovery in the USA, they will prevent the balanced, and thus lasting, development of US growth if they persist over the medium term, by creating imbalances in monetary and financial markets and by crowding out the private sector. In consequence, if no corrective measures are taken, there is a risk of unbalanced and thus fragile growth followed by a new phase of stagnation.

Capital movements into dollars have been encouraged by vigorous US growth, high interest rates and the rise in the US stock market. However,

the substantial widening of the trade deficit, the declining competitiveness of US firms and the outlook for continuing high real interest rates (and hence high borrowing costs) now seem likely to inhibit activity in the US.

As long as no steps are taken to correct US budget deficits, it is difficult to foresee a relaxation of pressure on interest rates. The future development of the dollar will be determined by the interplay of two opposing forces: the high yield obtainable on dollar investments, which supports the dollar, and the increase in the external deficit combined with the expectation of renewed inflation and perhaps a slowdown in activity, which can work in the opposite direction.

The uncertainties could be greatly reduced if action were under way to remedy the US budget deficit, and if economic policies were better coordinated among the major industrialized trading partners. A better mix of macro-economic policies in the US would give the Community a wider margin of manoeuvre for monetary and financial policies.

Lasting growth in the industrialized countries would be an enormous help to the developing economies. Increased demand for their exports could combine with an improvement in their terms of trade to lead to a gradual improvement in their external accounts. The burden of their debt would be lightened if interest rates began to fall again.

IV. Improved economic convergence

a) Outturns more convergent

Disinflation is continuing: inflation rates fell in all the

Member States in 1983, and are expected to fall further in 1984 in all but three. This reduction in inflation should, as in 1983, continue to go in tandem with a reduction in inflation differentials. The average inflation rate of 6,2% in 1983 masked a range of performance (with one country excluded) stretching from 2,7% to 14,5%. In 1984, inflation rates should be in the range 3,1% to 10% (with one country again excluded), and the average rate should be down to 5,2%. The continued slowdown in inflation is thus likely to be accompanied by a further narrowing in the dispersion of performance among Member States. It is also noteworthy that, along with this development, unit labour costs in industry should again decelerate, rising by only 3% on average.

The budget deficit on average for the Community, which rose from 5,4% of GDP in 1982 to 5,7% in 1983, could decline in 1984 for the first time since 1980, and amount to 5,2%; however, the deficit as a percentage of GDP may increase slightly in Greece, France and the Netherlands.

External accounts will continue to improve: the Community's visible trade surplus as a percentage of GDP will rise by three tenths of a point to 0,9% of GDP this year, and the current account will return to surplus, to the extent of 0,3% of GDP. Visible trade and current accounts should improve in all the Member States in 1984, with the possible exception of Greece and the United Kingdom.

b) Favourable desynchronisation of economic cycles in the Community

Community averages for the development of macro-economic aggregates mask differences in the cyclical situations of the Member States, mainly due to the desynchronised introduction of stabilization measures and the varying severity of the imbalances requiring correction.

Real consumption by households began to lose momentum as early as 1981 in Germany, Ireland, Luxembourg and the Netherlands, but not significantly until 1983 in Belgium, France and Italy. In 1984, real consumption might remain stable or even decline a little in some Community countries. The improvement in the outlook for investment this year, on the other hand, seems to be a general feature of most of the Member States.

The improved economic outlook is the successful result of efforts made in all the Member States, even though some made an earlier start than others, and the methods used were not everywhere the same. The two countries that introduced adjustment policies earliest, Germany and the United Kingdom, are also the two where the economic upswing is furthest advanced.

The other Member States can, through the increase in export demand, turn to their advantage the position of those economies further advanced in the cycle to pursue their own adjustment policies. In 1984, the contribution of the balance on goods and services to real GDP growth is expected to exceed that of growth in Belgium, France, Ireland and Luxembourg.

c) Convergence of economic policies

The day-today working of the European Monetary System provides clear evidence of the advantages of belonging to a stable currency area in a particularly unstable global monetary environment. This increases both

the attractiveness of the EMS and the support it gives to economic policy coordination. There is increasingly broad consensus in the Community on the stance of economic policy.

There is now a number of points in common in the policy stance in the Member States.

- Priority is given to reducing structural budget deficits through measures seeking to limit the expansion of public expenditure. At the same time, the Member States are doing their best to contain or even reduce the share of compulsory levies in GDP.
- Monetary policy stances are being kept non-inflationary, and the channelling of savings into investment is being encouraged.
- Further efforts are being made to eliminate rigidity, so as to improve the flexibility of markets and the adaptability of the European economies.
- The Member States have recognized the importance of innovation and investment in trading sectors; restructuring in productive sectors is intended to improve the productivity of both capital and labour.
- Wages policies have been reorganized to slow down the increase in labour costs and restore profitability. It has gradually become accepted in all the Member States that wage negotiations must take account of the productivity constraint and the aim of disinflation.

V. Conclusions

The development of the Community economy in 1984 should show an improvement compared with 1983. For the first time since 1979, the Community is engaged in the process of recovery, underpinned both by the first fruits of the adjustment policies which have been followed and by a strong recovery in world trade, set fair to re-attain its past rate of growth. The recovery in the Community is likely to be marked by a strong pick-up in investment, a further slowdown in inflation and increased convergence of economic performance.

Despite these prospects, the likely trend in unemployment in the Community as a whole in 1984 remains very worrying. Even if its rate of increase is clearly slowing down, unemployment could reach 11% of the labour force on average for 1984. Some improvement, nonetheless, can already be observed in some Member States (Federal Republic of Germany, United Kingdom).

Trends in 1984 will continue to be influenced by the high degree of uncertainty surrounding the international environment, especially because of the prospect that real interest rates will remain too high and because of the uncertain development of the dollar's exchange rate.

The essential tasks for 1984 must be those of consolidating the recovery movement, continuing to seek a more stable monetary and financial environment internationally, and maintaining open markets.

Internally, more convergent results and a better coherence of policies, at the same time as the desynchronisation of economic trends, must permit, especially in the countries which have not yet been able to complete their process of adjustment, the required follow-through of the stabilization policies and structural adaptation policies so far undertaken and thus allow an increasing degree of participation, on a solid base, in

the economic recovery. The economic guidelines agreed last December should thus be maintained. In this respect, it is important that measures to reduce structural disequilibria should be maintained and that signs of cyclical improvement should not be accompanied by a relaxation of the efforts undertaken to reinforce the capacity for innovation and to improve competitiveness. On this will depend a lasting improvement in employment.

MAIN ECONOMIC INDICATORS FOR THE EUROPEAN COMMUNITY, UNITED STATES AND JAPAN

TABLE 1 : GROSS DOMESTIC PRODUCT (PERCENT. CHANGE AT CONSTANT PRICES ON PRECEDING YEAR, EC, USA, JAPAN, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	3.2	2.5	3.1	-1.1	1.0	.0	1.3
DK	2.6	3.7	-4	-7	3.6	2.0	2.6
D	2.9	4.1	1.9	.2	-1.0	1.0	3.0
GR	4.8	3.7	1.6	-7	.0	.3	1.6
F	3.6	3.2	1.3	.2	1.7	.3	.6
IRL	4.3	3.4	3.7	1.6	1.2	.5	2.3
I	3.2	4.9	3.9	-2	-3	-1.3	2.2
IL	3.1	4.0	1.7	-1.8	-1.9	-2.4	-1.0
NL	3.6	2.4	.9	-1.6	-1.6	1.0	1.7
UK	2.2	1.6	-2.0	-2.0	2.4	3.2	2.5
EC	3.1	3.3	1.3	-4	.6	.8	2.0
USA	2.9	2.4	-3	2.3	-2.2	3.4	5.0
JAP	6.9	5.1	4.4	3.2	2.9	3.3	4.6

TABLE 2 : DEFLATOR OF PRIVATE CONSUMPTION (PERCENT. CHANGE ON PRECEDING YEAR, EC, USA, JAPAN, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	6.7	3.7	6.7	8.8	7.4	7.7	6.5
DK	9.8	10.4	10.2	11.9	10.5	6.7	5.3
D	5.1	4.2	5.4	5.6	5.3	3.0	3.3
GR	11.5	17.5	22.2	24.4	21.1	19.8	19.2
F	8.4	10.6	13.3	12.9	10.8	9.5	7.2
IRL	12.8	13.4	18.6	20.1	17.1	10.8	9.0
I	13.1	15.0	20.3	19.0	16.8	14.5	10.5
IL	6.3	5.8	7.7	7.7	10.0	8.4	7.7
NL	7.5	4.3	6.9	6.4	5.7	2.7	3.1
UK	12.3	13.2	16.4	11.0	8.3	5.4	5.5
EC	9.1	8.9	11.2	10.1	8.8	6.2	5.2
USA	6.1	9.0	10.5	8.9	5.8	3.9	5.1
JAP	7.7	3.5	7.0	4.5	2.9	1.4	1.4

TABLE 3 : NUMBER OF UNEMPLOYED AS PERCENTAGE OF THE CIVILIAN LABOUR FORCE (EC, USA, JAPAN, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	5.0	8.8	9.4	11.2	13.1	14.5	14.9
DK	3.3	6.1	7.0	9.2	9.9	10.5	10.8
D	2.5	3.4	3.4	4.7	6.8	8.4	7.8
GR	-	-	-	-	5.8	7.8	8.6
F	3.3	6.0	6.4	7.8	8.7	8.9	9.7
IRL	7.1	7.4	8.2	10.2	12.3	14.7	16.6
I	5.6	7.5	8.0	8.8	9.1	10.7	11.9
IL	.2	.7	.7	1.0	1.2	1.6	1.9
NL	3.0	5.7	6.5	9.4	12.7	15.4	16.8
UK	4.0	5.0	6.4	9.6	11.0	11.7	11.4
EC	3.8	5.3	5.9	7.8	9.5	10.6	11.0
USA	6.2	6.0	5.8	7.6	9.7	9.5	7.8
JAP	1.7	2.2	2.1	2.2	2.4	2.6	2.5

TABLE 4 : BALANCE ON CURRENT ACCOUNT (PER CENT OF GDP, EC, USA, JAPAN, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	.4	-2.7	-4.7	-4.2	-3.6	-1.5	-1.5
DK	-2.9	-4.7	-3.7	-3.1	-4.1	-2.1	-1.9
D	.9	-8	-1.9	-1.0	.6	.7	1.0
GR	-2.8	-2.9	-9	-2	-3.9	-3.8	-4.3
F	.3	.0	-1.4	-1.4	-2.9	-1.7	-8
IRL	-4.2	-11.3	-9.9	-13.1	-8.4	-2.8	-1.3
I	-2	1.7	-2.4	-2.3	-1.6	-.2	-.1
IL	22.5	28.3	22.6	31.5	39.2	37.7	36.1
NL	1.3	-1.1	-1.5	2.2	2.7	3.3	3.9
UK	-.9	.0	1.6	2.6	2.0	.7	.6
EC	-.1	-.4	-1.3	-.5	-.5	-.1	.3
USA	.1	-.1	.3	.1	-.4	-1.4	-2.4
JAP	.8	-.8	-1.0	.5	.6	1.9	2.6

TABLE 5 : GENERAL GOVERNMENT LENDING OR BORROWING (-) AS PERCENTAGE OF GDP (EC, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	-4.2	-7.1	-9.1	-12.6	-11.6	-11.6	-10.9
DK	.0	-2.0	-3.6	-7.1	-9.2	-8.2	-6.9
D	-1.5	-2.8	-3.1	-3.9	-3.5	-3.0	-1.8
GR	-4.4	-4.8	-5.4	-10.6	-8.3	-9.2	-9.8
F	-.6	-.7	.3	-1.8	-2.6	-3.4	-3.5
IRL	-8.5	-11.9	-12.8	-15.8	-16.2	-13.4	-12.3
I	-8.6	-9.5	-8.4	-11.7	-11.9	-11.9	-11.9
IL	2.3	.7	-.8	-2.3	-1.4	-2.3	-.6
NL	-1.3	-4.3	-4.0	-5.2	-7.2	-6.6	-6.8
UK	-3.2	-3.2	-3.4	-2.7	-2.0	-3.5	-2.5
EC	-2.9	-3.6	-3.5	-5.4	-5.4	-5.7	-5.2

TABLE 6 : MONEY SUPPLY M2/M3 (PERCENTAGE CHANGE AT END OF YEAR ON TWELVE MONTHS EARLIER, EC, USA, JAPAN, 1970-1984)

	1970	1979	1980	1981	1982	1983	1984
	-						
	1979						
BE	10.9	6.0	2.7	6.6	5.9	5.5	6.7
DK	11.0	10.8	8.1	9.6	11.8	25.4	7.5
D	10.1	6.0	6.2	5.0	7.1	5.3	5.3
GR	23.3	18.4	24.7	34.3	31.5	20.0	21.3
F	15.4	14.4	9.7	11.4	10.8	8.8	6.0
IRL	18.2	19.0	16.9	17.4	12.9	7.5	11.4
I	19.6	20.3	12.0	16.0	17.2	14.4	14.2
IL	-	-	-	-	-	-	-
NL	11.6	7.6	3.6	5.2	7.6	10.3	10.0
UK	13.6	12.7	18.6	14.6	9.2	11.5	8.9
EC	13.9	11.9	10.5	10.8	10.7	9.8	8.6
USA	9.5	8.2	9.0	10.0	9.2	-	-
JAP	16.9	9.1	7.2	8.7	7.0	-	-

F, NL, USA: M2; D, GR, IRL: M3; B, DK: M2H; UK: STERLING M3 (FISCAL YEAR); I: M2 (68-79), M3 (80-84); JAP: M2 AND CD.

NOTE: ITALY: M2-GROWTH IN 1983 AND 1984 WAS 13.0 % AND 12.8 % RESPECTIVELY