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ANNUAL REPORT ON THE ECONOMIC SITUATION IN THE COMMUNITY

drawn up in accordance with Article 4 of the Decision of 18 February 1974 of the Council of the European Communities on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community.

(Commission proposal to the Council)

ANNUAL REPORT ON THE ECONOMIC SITUATION IN THE COMMUNITY

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to the Council Decision of 18 February 1974 (1) on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community, and in particular Article 4 thereof,

Having regard to the proposal from the Commission,

Having regard to the Opinion of the European Parliament and of the Economic and Social Committee,

HEREBY ADOPTS THIS ANNUAL REPORT ON THE ECONOMIC SITUATION IN THE COMMUNITY, LAYING DOWN FOR 1975 THE GUIDELINES TO BE FOLLOWED BY EACH MEMBER STATE IN ITS ECONOMIC POLICY :

(1) OJ No L 63, 5 March 1974, p. 16.

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FOREWORD

Under Article 4 of its Decision of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community, the Council, acting on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, must, at the end of the third quarter, adopt an annual report on the economic situation in the Community and must set economic policy guidelines to be followed by the Member States in the following year. Once the report has been adopted by the Council, the governments must bring it to the attention of their national Parliaments so that it may be taken into account in budget debates.

The guidelines contained in this report may have to be adjusted to take account of the trend of economic development when the Council carries out its subsequent examinations of the economic situation.

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I. CURRENT SITUATION

Disruptive effects of inflation

The main feature of the economic situation so far in 1974 has been the growing impact of inflation : the strains on the raw materials markets, particularly the oil market; the appearance of external deficits which are difficult to live with and which carry the danger of a restriction of world trade; the disorganization of the capital markets; growing difficulty for enterprises to determine their production costs, and consequently the failure to realize investment plans and for employment prospects to live up to expectations; the regrettable delays in infrastructure investment; the increased social strains as a result of disparities in the distribution of income and wealth; the spreading of inflationary expectations; the increasingly marked differences between trends in the various countries and industries of the Community; the deterioration in the possibility for growth in the Community as a whole, as a result of the uneven distribution of resources; finally, the appearance of the risk of the continuing existence at the same time of inflation and unemployment.

A. International background

World economic downswing

Even before the spectacular upsurge of oil prices in autumn 1973, world economic growth had been slowing down, particularly on account of the difficulties which arose in the supply situation of certain basic products.

Since then the trends in the principal non-member countries of Community have not been uniform. In the USA, during the first half of 1974 the gross national product fell in real terms. In Japan output also fell in the first quarter, but has since recovered slightly. The slowdown in expansion was much less marked in the other industrialised countries. Several of them, such as Canada and Sweden, even recorded a slight acceleration in economic activity during the first quarter of the year.

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Impact of the increase in oil prices

The huge increase in the price of oil added substantial further pressure to world inflation. It has led to a serious deterioration in the balance of payments of most oil-importing countries, while the incomes of the oil-producing countries will grow by about $ 60 000 million in 1974 as a whole.

Lull in the upward movement of world prices

The upward movement in the prices of raw materials other than oil, which had also been very rapid ever since the beginning of 1972, has now come to a halt. Weakening industrial demand, improved supply positions in response to the high prices, and, in agriculture, as a result of the better harvests in 1973, and high interest rates, caused the world market prices of certain commodities to fall. The largest reductions have been recorded for non-ferrous metals, especially copper.

In the industrialized countries the export prices of manufactured products have also risen sharply. World trade has therefore continued to increase at an extremely lively pace in value terms. However, growth in real terms has eased to the extent that, in 1974 as a whole, the volume of world imports will probably not be more than 5½ % higher than in 1973.

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World trade

(% change on the preceding year, on the basis of imports)

	value[1]	volume
1969	14	10½
1970	14½	9
1971	11½	6½
1972	17	8½
1973	37	13
1974[2]	38	5½

1) In dollars

2) Estimates by the Commission's departments.

B. The situation in the Community

Maintenance of activity

As a whole economic activity in the Community continued at a high level. In 1974 real gross product should grow by about 2½ % (compared with 5.6 % in 1973). Balance of payments disequilibria and the strains on prices have become more marked in recent months.

The growth in the volume of exports to non-member countries has slowed down. As a result of the acceleration in the rise in export prices the expansion of exports in value terms nevertheless continues to be rapid.

Intra-Community trade was given fresh stimulus by the second 20 % cut in customs tariffs between the six original Community countries and the three new members which took effect on 1 January 1974. In the Federal Republic of Germany, which was already strongly in surplus, exports increased more rapidly than imports. In Italy, and, to a lesser extent, France, the United Kingdom and Denmark, on the other hand, the growth of imports was not balanced by the increase in exports.

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Greater differences in demand trends

While overall domestic demand in money terms remained buoyant, in volume it tended to fall. Although capital expenditure by industry is still growing somewhat faster in 1974 compared with 1973, a certain reluctance to invest has become apparent. Enterprises are concentrating their investment on rationalization measures designed to check rising costs. At the same time, uncertainty with regards to the movement of world prices, credit restrictions and, in particular, the rise in interest rates, have made for a cautious approach in the management of stocks of raw materials. Furthermore, the growth of private and public expenditure on construction slowed down distinctly in most countries. In the Federal Republic of Germany and the United Kingdom expenditure on gross fixed capital formation is declining in real terms, while it is increasing at a sustained pace in Italy, France and Belgium.

Although incomes have been adjusted in line with constantly rising prices, the stimuli given to the level of activity by private consumption are relatively slight in most countries. In the United Kingdom private consumption could even fall slightly in volume. As regards the other countries, private consumption growth is slowest in Ireland, the Netherlands and the Federal Republic of Germany. Factors behind this have been the stabilization of the numbers in employment, and the increase in the propensity to save due in part to the uncertain economic outlook and to the deferment of purchases of private cars.

Tendency for industrial production to stabilize

Following a vigorous recovery during the early months of the year, industrial production in the Community as a whole has tended to stabilize since the spring. While some industries, such as iron and steel, chemicals and electrical engineering, are still experiencing quite rapid growth, activity in several other sectors, for example construction, motor vehicles and textiles, is slowing down distinctly. Whereas certain Member States, such as France and Italy, have still recorded considerable increases, others, especially the Federal

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Republic of Germany, have experienced a phase of general stagnation since the spring. In the case of some products, particularly beef, supply far outstripped demand, while shortages appeared on other markets, such as for sugar.

Disparities in the labour market

As a whole, the level of employment remained high, but considerable disparities have appeared. The number of unfilled vacancies fell, and, at the same time, unemployment rose in most member countries. The difficulties which have arisen on the employment market stem essentially from the varying effects of the higher price of oil and of inflation in general on the various sectors of economic activity. While the demand for skilled labour remained high in the basic industries and in the capital goods industries, labour requirements declined in the consumer goods industries, especially in the motor industry, and in construction.

Strong upsurge of prices

The most serious disequilibria affected prices and balances of payments. Several factors - in particular the recent increases in world market prices, rising labour costs, the depreciation of certain currencies, lower productivity increases, the inelasticity of supply, together with the self-perpetuating tendency of inflation - helped to push prices up even faster. Consumer prices have risen by between 15 and 20 % on a year-to-year basis in four member countries, the United Kingdom, Ireland, Italy and Denmark; by between 10 and 15 % in France, Belgium and Luxembourg; by slightly less than 10 % in the Netherlands and by 7 % in the Federal Republic of Germany.

Accentuation of external disequilibria

The balances of payments on current account have been affected by the higher oil prices and the differences between the rates of inflation and the changes in relative exchange rates. Despite the Federal Republic of Germany's record surplus, the Community's trade deficit has increased sharply. The external deficits of France,

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Denmark, and in particular the United Kingdom and Italy, have worsened considerably. However, as a result mainly of the lull on the world raw material markets, including the oil market, in recent months, some signs of improvement have recently appeared in the external accounts of some of these countries. In total, the deficit in the balance of payments on current account of all the Member States in their trade with non-member countries could amount to some $ 20 000 million in 1974 (1973 : about + $ 1 000 million).

After falling considerably at the end of last year and at the beginning of 1974, the gold and foreign exchange reserves held by the monetary authorities have since stabilized throughout the Community, even in those countries which have recorded large external deficits, except Italy and Denmark. This trend does not reflect the balance of payments difficulties. Several Member States borrowed abroad to finance their deficits. Changes in exchange rates were an important factor too. The German mark, for instance, which appreciated in value by almost 10 % [1] between January and May, has depreciated noticeably since then. The other currencies taking part in the Community joint float followed a similar, though less marked, trend. After leaving the "snake" in January, the French franc depreciated; in May it had lost 4.5 % [1] of its value, compared with January 1974, and despite a recovery since mid-July, it was finally some 6 % down on the other currencies taking part in the Community joint float. The Italian lira recorded a weakening in the first half of the year but since then it has been steady. There has been no significant change in the value of sterling and the Irish pound.

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(1) Value weighted according to foreign trade structure.

C. <u>An assessment of economic policies</u>

To organize the fight against inflation at Community level, the Council has adopted a series of resolutions. The resolutions of 5 December 1972 and 28 June 1973, the results of which were analysed in the last annual report,[1] were followed by the resolution of 17 December 1973[2]. This year, the Council has examined the economic situation in the Community on several occasions and on 4 July adopted a decision adjusting the economic policy guidelines for 1974.

Monetary restrictions

The acceleration of inflation led the authorities of most Member States to adopt increasingly restrictive monetary policies, which resulted in dwindling liquidity and high interest rate levels. However, the severity of the restrictions continued to show marked differences. For example, since spring, restrictions have been eased to some extent in the United Kingdom, Ireland, the Fed.Rep.of Germany and Denmark, while the opposite line was followed in France, Belgium and Italy, where restrictions were further tightened.

In recent months, the rate of expansion of the money supply has slowed down in most member countries. Since 1973, however, except in Italy, a widespread and significant divergence has been noted between the increase in the stock of near-money and that of the narrowly defined money supply (M1), probably as a result of the preference shown by savers for time rather than sight deposits, - on which little or no interest is paid - or long-term investments.

These changes reflect a more rational management of assets in an inflationary situation and do not imply any change in spending patterns. In the middle of the year, the year-to-year increase in the money and near-money supply (M2) was still over 20 % in Italy, the United Kingdom, Ireland and the Netherlands; it was running at about 15 % in France and Belgium, but at less than 10 % in the Federal Rep. of Germany and Denmark.

Interest rates reached record levels in certain member countries; in some of these countries, short-term rates were higher than long-term rates. This situation may explain in part the fact that savers are increasingly reluctant to invest in long-term assets. In these circumstances, real investment must to a large extent be financed by short-term borrowing. In most countries, the remuneration of financial saving is at present lower than the rate of monetary depreciation.

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[1] OJ No C107, 8 December 1973, p.l.

[2] OJ No C116, 29 December 1973, p. 22

Action in the budgetary field

In public finance, the size of budgets has increased substantially as a result of the faster rise in prices and costs. Among those countries obliged by their external disequilibria to employ budgetary policy to curb domestic demand, France and Denmark will record substantial surpluses. Italy will reduce its deficit appreciably in relation to forecasts made at the beginning of the year. In the United Kingdom, on the other hand, the improvement in the balances by comparison with the previous financial year, is likely to be far less substantial than originally envisaged. In Ireland, the budget will exert a stimulatory influence. Among the countries which are not subjected to balance of payments constraints and which want, moreover, to maintain the level of their economic activity, in the Federal Republic of Germany will have a budget deficit well in excess of initial forecasts. The deficit will worsen to a more limited extent in the Netherlands, while in Belgium it will correspond to predictions.

Recourse to other instruments

In employment, the disruption caused by the oil crisis brought several Member States (Fed. Rep. of Germany, Denmark, France and Belgium) to restrict immigration of workers from non-member countries.

Certain Member States, in particular Italy, Denmark, the Netherlands and Belgium, temporarily strengthened their price policies. Most commercial policy measures taken concerned trade in petroleum products. These measures were often taken at national level and ran counter to common policies. Nevertheless, it should be noted that an improved system of generalized preferences has been applied in favour of developing countries and that the second 20 % cut was made in customs tariffs between the original member countries of the Community and the three new member countries; both measures had effect from 1 January 1974.

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In general, the coordination of economic policy at Community level has continued to be inadequate. The measures taken succeeded in halting the intensification of inflationary pressures only in certain countries, i.e. Federal Republic of Germany and the Netherlands; in other countries, the upward movement of prices continued throughout the first half of 1974 at an accelerating pace.

Limited success of anti-inflationary action.

II. OUTLOOK FOR 1975

A. Outlook for the world economy

Poor outlook for world trade

Economic activity in the United States and Japan should, from the autumn of 1974 onwards, recover slightly from its relatively low level in the first half of the year. In the other industrialized non-member countries, by contrast, there is little reason to expect any appreciable change in the tendency towards relatively modest growth. On the whole, no more than a slight increase in the imports of the industrialized countries should be expected from the end of 1974 onwards, even on the most favourable assumptions.

In the short run, it is unlikely that the oil-producing countries will be able to spend more than an insignificant part of their substantial revenue. However, from 1975 onwards, they may be expected to expand their purchasing more rapidly. By contrast, the other developing countries, faced with a higher oil bill, and probably a variation in their terms of trade with the industrialized countries, will often have difficulty in maintaining the present volume of their imports. Consequently, the expansion in the volume of world trade in 1975 may be expected to show only a slight acceleration in relation to 1974.

B. Outlook for economic trends in the Community

Provided that an appropriate economic policy is pursued throughout the Community, it may be hoped that existing disequilibria will be attenuated in 1975 and that conditions for the growth of Member States' economies will gradually improve.

Maintaining the flow of exports

World economic trends, as outlined above, point to scarcely any acceleration in exports to non member countries. In view of

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the less rapid rise in prices, however, the growth in the value of export sales will be somewhat more moderate. Although, on the whole, the competitive position of Community countries on external markets is unlikely to show much improvement, certain countries - particularly the United Kingdom and Italy - may nevertheless be able to benefit, from the depreciation of their currencies in recent years.

Modest recovery in domestic demand

The expansion of domestic demand could become somewhat more buoyant in most member countries, especially if the expected slowdown in the upward movement of prices encourages real growth. Gross fixed capital formation may recover in certain Community countries in which it was relatively low in 1974, in particular, in the Federal Republic of Germany and the Netherlands. Residential construction, however, is not expected to progress significantly - at least in the first half of the year - since demand in this sector often seems to recover only after an appreciable improvement in financing conditions.

The expansion of private consumption may accelerate slightly in real terms, mainly as a result of the developments expected in the Fed.Rep.of Germany.

Slight increase in the growth rate

In these circumstances, an increase in real gross domestic product of approximately 3 ½ % from 1974 to 1975, as against 2 ½% from 1973 to 1974, may reasonably be expected for the Community as a whole. Growth rates of member countries will generally be close to this average figure; however, growth will be lower in Italy and the United Kingdom while France should record above-average results. These trends should be accompanied by somewhat larger productivity increases, with the result that the employment level and the unemployment rate will be approximately stable for the Community as a whole. In employment, structural difficulties will persist, especially in Ireland, Italy, the United Kingdom and the Netherlands.

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Persistence of disquieting inflation rates

A slight deceleration in the upward movement of prices could well be recorded; however, inflation rates will continue to give cause for concern. Furthermore, disparities within the Community will persist; prices will climb at the slowest rate in the Federal Republic of Germany and Luxembourg, while in Ireland, the United Kingdom, Italy and Denmark, the year-to-year average inflation rate is likely to be well above 10 %.

Alleviation of external disequilibria

An improvement in the current balance of payments with non-member countries may be expected, mainly as a result of an improvement in the Community's terms of trade. In particular, this reflects the less unfavourable trend predicted for those countries which, like Italy, the United Kingdom and France, recorded substantial deficits in 1974. The surplus of the Federal Republic of Germany will fall somewhat, but will nevertheless continue to be considerable..

III. GUIDELINES FOR ECONOMIC POLICY

A. General guidelines

The struggle against inflation: a matter of priority

1. In view of the disappointing results achieved in recent years, the fight against inflation must once more be considered the priority objective of Community economic policy. An appreciable slowdown in the price upsurge is essential if a profound disruption of economic and social life is to be avoided. It would also contribute to the progressive improvement of balance of payments positions. More than in previous years, economic policies must be adapted to/the particular situations of various countries and sectors. There should be close coordination at Community level in drawing up these policies and backing must be provided in the form of active solidarity from Member States, so as not to worsen the employment situation.

Regulation of demand

2. All member countries must restrain the expansion of overall demand to keep it within limits compatible with the growth of productive capacity.

Since it would be advisable to avoid further affecting depressed industries, i.e., motor vehicles, textiles and, in certain member countries, building and tourism, action taken to curb the expansion of overall demand should - as far as possible - not cause any further deterioration in the level of activity in these sectors.

... bearing in mind the constraints imposed by the external situation

Demand regulation must take into account the constraints imposed on various countries by their external positions. Curbs on domestic demand are particularly necessary in those countries where resources must be channelled into exports in order to reduce a large external deficit. On the other hand, those countries enjoying substantial current balance of payments surpluses should see that domestic demand develops in such a way that the upward movement of costs and prices is held back by further productivity increases, while avoiding the imposition of further strains on the productive apparatus.

Strict budgetary policies

3. In public finance, the continuing efforts necessary to control inflation and improve current balance of payments positions will mean that most Member States in 1975 must adopt a budgetary policy aimed at avoiding any stimulation of domestic demand. An important exception to this guideline is the Federal Republic of Germany, which should maintain a moderately expansionary budgetary policy so as to reduce the external surplus. The other Member States should continue to follow a restrictive line; countries with structural budget deficits must take steps to limit them.

A rigorous approach is therefore essential in relation to expenditure, which should display only a minimal increase in volume terms in most countries. In that case, the necessity for further increases in taxes may become evident. However, since the fiscal burden is already very great in certain countries, a further increase might in these instances have inflationary consequences. The reduction in direct taxes in the Federal Republic of Germany and Denmark should have as a counterpart more moderate wage demands.

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Member States should ensure that restraint in the central government budget is supported by parallel efforts on the part of other public authorities.

Maintenance of monetary restrictions

4. Monetary policy must seek to prevent a continuation of inflation. This implies a strict limit on the increase in the money supply, especially in those countries with substantial balance of payments deficits.

This overall policy of restricting liquidity should be accompanied, in certain countries, by particularly energetic measures on lending to finance consumption or for speculative transactions.

Compatibility of interest rates

At the same time, monetary policy should help to assure the compatibility of interest rates within the Community and in relation to non-member countries. It is essential that levels should be comparatively higher in countries with large external deficits and which need to attract considerable sums from abroad. A policy of this kind is desirable, not only from the point of view of re-establishing balance of payments equilibria, but also because of its restrictive effects on the internal business situation.

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Financing deficits

The Community countries having, henceforth, to obtain substantial funds so as to cover their overall external deficit, their action would be more effective if they adopted a common position - especially by issuing Community loans. Further, member countries could jointly establish the necessary machinery to attract long-term funds, particularly from the oil-producing countries.

Closer cooperation between central banks is needed to supervise the operation of the Euromarket, in view, on the one hand, of its importance for the financing of external deficits and, on the other, the growing wariness created by the difficulties recently experienced by certain credit institutions. It would be desirable to extend this cooperation to the principal non-member countries.

Encouragement of saving

Saving should be encouraged not only by making interest rates more attractive but also by specific measures designed to benefit savers in the least well-off economic categories.

The fight against inflation will undoubtedly be greatly facilitated if exchange rate relations within the Community, and with the main trading partners, remain relatively stable.

Equitable distribution of sacrifices

5. The new burden resulting from the rise in the prices of petroleum products will affect standards of living. In countries with substantial balance of payments deficits, a temporary halt in the rise of the purchasing power of households is inevitable. Nevertheless, it is important that the sacrifices to be made should be fairly distributed among the various groups of the population and, above all, that special protection be afforded to the least well-off social categories. Since the situation varies greatly from one country to another, it is important that the Member States hardest hit should be able to rely on the active solidarity of their partners.

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The social injustices brought about by inflation - to the detriment of the . . saver in particular - together with the economic disequilibria which cause numerous difficulties for business firms, are liable to lead to serious upheavals. In these circumstances, it is in the interests of the two sides of industry to cooperate to contain inflationary tendencies and repair the damage caused to the economy - especially in the form of accentuated distortions in the trend of incomes, losses or deferred investments, and the deterioration of competitive positions. There is an urgent need to bring home to the public the consequences of inflation - in particular its social costs - and to organize a broad programme of public information on the subject.

Social welfare and the maintenance of employment

6. The member countries in which unemployment benefits are relatively limited should examine the possibilities of easing the conditions under which benefits are granted and increasing the amounts concerned. The danger for employment resulting from persistent inflation is such that absolute priority should be given to this type of social transfer over other types of transfers from the central government budget. The solution to problems of structural unemployment, which exists in certain sectors or regions, should be sought through specific actions concerning the work-forces in question and not by global stimulatory measures which would inevitably be a further impetus to inflationary trends. The facilities for readapting the labour force should be improved.

Prices policy

7. According to the situation in their respective countries, Member States should pursue active prices policies, based above all on the machinery of effective competition. In the absence of such competition, it is to be feared that price reductions on world markets may lead to the establishment of inflationary profits. If these are to be absorbed, it is essential that, in every member country, demand must not be allowed to exert excessive pressure on productive resources. Markets must once more become buyers' markets and firms must adapt themselves to new market conditions by basing their trading strategy on expanding the volume of sales rather than on increasing profit margins.

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In certain member countries, distribution circuits need to be rationalized and regulations governing the display of prices more strictly enforced.

Cooperation by the social partners

8. The social disparities brought about by inflation and the economic disequilibria which are the root cause of business difficulties threaten to result in serious disturbances. It is, in these circumstances, in the interest of the social partners to cooperate in the control of inflationary tendencies and to repair the damage which has been caused to economies, in the form particularly of growing distortions in the distribution of income, investment delays and deterioration in competitive positions. It is urgent that all should become aware of the disastrous consequences of inflation and, in particular, of its cost in social terms.

9. Economic growth will probably continue in 1975 in the Community as a whole, but major factors of uncertainty are nevertheless present in the economic outlook. Public investment programmes suitable for immediate implementation should be prepared in case it might be possible, in certain countries, to bring the upward movement of prices rapidly under control by restrictive measures combined with an autonomous slowdown in activity. In this field, the initiative lies principally with the Federal Republic of Germany and the Benelux countries, which are the least affected by constraints arising from their external positions. In any case, the Community must remain extremely vigilant and must reinforce cooperation between the member countries, none of these being in a position to withstand a long recession.

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B. Guidelines for the individual countries

In Denmark the slowdown in economic activity, which began in spring will probably become more marked in the months ahead. However, the delayed effects of the steep climb of wages and prices are likely to be reflected in continuing inflationary tendencies, especially as the subsidy granted to enterprises to limit the rise in costs will be cut by half between now and the end of the year. The current balance of payments deficit will probably remain high.

Short-term economic policy must therefore continue to be aimed principally at improving the internal and external equilibrium conditions. To this end, the measures already taken to limit the growth of domestic demand should be kept in force.

In the budgetary field, steps should be taken to ensure that the surplus in the central government budget for 1975-76 is not less than the surplus for the present financial year. The effects of the income tax reform planned for the beginning of 1975 and which will probably cut direct taxes by some Dkr 10 000 million, should be offset by an increase in indirect taxation and cuts in planned expenditure. In addition, major efforts must be made to limit the increase in local authority spending. In this connection, care should be taken to prevent the lifting of the freeze on public building from triggering off too sharp a recovery of spending in this sector.

Monetary policy will have to be kept tight until the rise in prices and costs has slowed down distinctly and as long as the balance of payment situation continues to be precarious. In particular the growth of domestic liquidity which has been gradually losing momentum since the end of 1973 must continue to be kept under strict control. Strict ceilings should be applied to lending in the months ahead.

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An active incomes policy, written into the framework of the tax reform would improve the economic outlook and ease inflationary strains. It would make it easier to channel resources into exports and would thereby help to cut out the balance of payments deficit.

In the Federal Republic of Germany, where external surpluses are very high, a recovery of domestic demand in the coming months would clearly be welcome. However, it should not come in the way of further progress in lowering the rate of inflation. The abolition of the counter-cyclical surcharge, the increase in pensions and war victims' allowances, the latest wage increases under certain collective agreements and the large deficits in the public authority budgets will all be factors sustaining demand. The entry into force of the tax reform on 1 January 1975 will also provide fresh impetus. Nevertheless, certain cautious and temporary measures are clearly necessary to ensure that in the immediate future output grows at 3 to 4 % in line with the average increase in capacity. The announcement by the Federal Government on 11 September that, together with the Länder, it will allocate DM 900 million to public works contracts for the improvement of the infrastructure which are ready to be put to tender is a move in this direction.

In view of the heavy burden that the tax reform will place on the budget, the tightest possible limits should be imposed on the increase in public authority spending in 1975. For the Federal Government and the Länder, this increase, allowing for the effects of the tax reform should not exceed 12.5 % so that their total borrowing requirement will not be more than DM 12 000 million higher than in 1974. The necessary savings should be made primarily on current expenditure, in particular, by restraining public service salary rises and by exercising a cautious recruitment policy. The large budget deficits which are likely will have to be financed from the capital market.

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Monetary policy must remain tight in the coming months and ensure a limited growth of the liquidity. Should it later become apparent that the growth factors are too weak to achieve an economic growth rate in 1975 in line with the objective set out above, the authorities should, take additional reflationary measures, in particular by easing monetary policy.

In France, the level of employment and the capacity utilization rate have remained high. Prices are likely to go on rising rapidly in the months ahead. The trade balance will remain in deficit despite the appreciable increase in exports.

Inflationary pressures and the deterioration in the external position are therefore the main problems that short-term economic policy will have to tackle. In order to lower the rate of inflation to any substantial degree without increasing unemployment excessively or jeopardizing future growth, there will have to a distinct tempering of wage claims. In addition, the authorities will have to press on with their policy aimed at curbing the impetus from domestic demand.

In the field of public finance with a central budget surplus in 1974 of some FF 9 000 million, the increase in central government spending in 1975 will have to be kept at a much lower rate than that currently expected for the growth of gross domestic product in money terms (14 1/2%) and a budget surplus will have to be maintained. Although the financial situation of the local authorities does not, on the whole, seem likely to deteriorate, they will also have to be cautious in their spending.

Monetary policy must continue on a tight line. However, the gradual replacement of the credit policy by a tight control of the money supply might well prove more effective as an instrument for curbing demand.

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The policy of encouraging private saving should be continued. There is still a very good case for specific measures on prices, such as those which are actually envisaged in the introduction of a counter-cyclical tax on firms applying large increases to prices or wages, and also for measures to rationalize distribution circuits.

In Ireland, the pace of growth will probably accelerate slightly in the coming months as the budget for the current financial year adds momentum to consumer spending. Wages could rise even faster. The upsurge in domestic prices will remain strong although the rise in import prices will be more moderate. The current account deficit is likely to increase substantially.

Given these prospects, a very firm position will have to be adopted in applying economic policy in order to ease the inflationary pressures which at present are very heavy. An active incomes policy will have a major role to play in this respect.

In the budgetary field, the aim should be to see that the net borrowing requirement in 1975 is only slightly higher than that for the current financial year on an annual basis. The tendency for the budget deficit to grow, which has been very strong in recent years and particularly so in 1974, will have to be curbed, more especially as the net borrowing requirement is already considerable in relation to gross domestic product. A strict limitation of the growth of expenditure is required. As a result of the sharp rise in the number of civil servants and the heavy investment burden on the central government budget, it will probably be necessary to increase taxation.

At the same time, monetary policy will have to be tightened, although finance must be made available for priority investment projects.

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In Italy, priority must be given to bringing the current balance of payments progressively back into equilibrium. A strict credit and public finance policy is essential. To this end, the authorities adopted in summer a stabilization programme centering on large increases in indirect tax revenue, social security contributions and public service charges. The aim of these measures is in particular to moderate the growth of the purchasing power of private individuals.

In the coming months, resolute steps will have to be taken to bring the economy on to a sound basis and the close cooperation of the two sides of industry will be essential. The increase in central government spending in 1975 will have to be well below that of gross domestic product in money terms. The central government budget deficit must not be higher than in 1974. If further tax increases are to be avoided, virtually no latitude exists for increasing spending in real terms. Any new expenditure will have to be offset by savings in other fields; this could be done by reviewing budget priorities. The central government will have to make use of its supreme authority to ease the upward trend in the deficits of the other public bodies, local authorities, social welfare institutions, autonomous public enterprises.

Monetary policy must remain tight and selective at least until budgetary measures are clearly seen to be having their effects. It is important to make sure that the rate of expansion of credit is such, as was the case in the second quarter of 1974, as to remain within the Lit 22 400 000 million credit ceiling for April 1974-March 1975 contained in the commitments which the government entered into with the IMF, especially as the oil deficit at the end of this year could well prove to be lower than feared and since the recent rise in public enterprise charges will reduce their financing needs. In particular, the terms for private consumer credit should be tightened.

All these measures should facilitate the channelling of real resources into the export sector which could thus support the level of employment.

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In the Netherlands, where the first part of 1974 saw a recession in construction, growth could take a firmer hold. Because of the large degree of autonomy in energy supplies and the favourable effect this has on the production costs of much of Dutch industry, the competitive position and the growth outlook for exports continue to be favourable. As a result mainly of the measures taken at the beginning of 1974, the price upsurge has not been as strong as in most other Community countries. Nevertheless, with the price freeze being eased somewhat, the rate of increase in 1975 is likely to slow down comparatively little.

With the danger of a slump in activity obviated for the time being, the way must now be prepared for a gradual return to acceptable rates of price increases and employment policy must be strengthened in order to create a greater mobility of labour into the growth industries. In order to attain these two objectives - price stability and stimulation of employment - major investment efforts will be needed both in the private sector and in the public sector, and this will tend to reduce the structural surplus of the current balance of payments.

In the budgetary field of public finance there must be a return to comparatively neutral budget management. The central government budget for 1975 must be implemented in such a way that the net borrowing requirement is kept near to the medium-term public finance objectives, that is to say some Fl 2 000 million. To this end, expenditure should increase at a rate similar to gross domestic product in money terms, which means that there will still be room for increasing expenditure in real terms.

.../...

Monetary policy must see that the growth of domestic liquidity is kept within limits compatible with the capacity of the Dutch economy to absorb new investment without triggering inflationary pressures.

In Belgium, where demand-pull inflation has added to imported cost-push inflation, the growth rate continues to be buoyant. The external account surplus could fall further and give way to a deficit on the current balance. The priority objective of short-term economic policy must continue to be the moderation of the upsurge in prices and costs by reducing the strains on the productive apparatus in certain industries.

Efforts to moderate the impetus provided by public finance must therefore be pursued. In particular, strict priorities should be fixed in the field of current expenditure - as regards subsidies to enterprises and other recipients - so that the net borrowing requirement in 1975 is less than that of 1974. The raising of certain tax rates foreseen seems inevitable. In the same vein, the increase in the current expenditure of the local authorities which could result from the rapid rise in their own tax revenue and in transfers from the central government, should be kept as low as possible. Ways should be found for financing the substantial deficits of the public authorities without using monetary means and without borrowing abroad.

In the coming months, the authorities must maintain a restrictive line on monetary policy in order to curb the expansion of demand in money terms by slowing down the growth of liquidity. In particular, a close watch must be kept over the trend in building loans.

In Luxembourg, the foreseeable increase in export demand should ensure that economic activity continues at a relatively buoyant pace in 1975. Prices will go on rising although more slowly. The manpower shortage should not be an insurmountable obstacle to the expected growth of output.

.../...

Caution still needs to be exercised in the field of public finance. There will have to be tight selectivity in the current spending of the central government and a closer watch kept over the operations of the investment fund so that expenditure increases more slowly than in 1974 and the budget closes with a surplus much the same as that forecast for 1974. Credit policy will have to remain tight.

In the United Kingdom, real gross domestic product will probably grow more slowly than production capacity. While the pace of price and cost increases should slacken somewhat, it may nevertheless remain very rapid. An improvement in the terms of trade and an easing of the pressure from domestic demand could well bring about an appreciable cut in the current balance of payments deficit in 1975, although it will still be comparatively large.

Economic policy must continue to be directed essentially at limiting the growth of domestic demand and in particular consumer expenditure in order to achieve a substantial and lasting reduction of the current payments deficit by curbing imports and transferring resources into exports. As there is little chance of improving purchasing power, it is important that the cooperation of both sides of industry be obtained to limit increases in prices and money incomes. Substantial progress in the fight against inflation is necessary to preserve a high level of employment in the longer term.

In view of these objectives, there seems to be very little room for manoeuvre for new reflationary measures either in the autumn budget or in the initial 1975/76 budget. At all events efforts will have to be made in 1975/76 to achieve a lower public authority net borrowing requirement than in the previous year.

.../...

To this end, the increase in current expenditure from 1974 to 1975 should be well below the increase currently forecast for gross domestic product in money terms.
The rise in current transfers to public corporations in 1975 should be limited.

The need to attain internal and external equilibrium will probably mean that a restrictive policy will have to be pursued covering both the money supply and interest rate levels. As regards the latter, the need to finance the current payments deficit and to retain international confidence in the pound will mean that rates will have to remain relatively high. Certain selective support measures in the housing sector might nevertheless be advisable.

CONCLUSION

In 1975 the Community will still be faced with serious problems of economic equilibrium. Inflation rates which have reached new record levels in most member countries will continue to cause concern. Certain Member States will have to strengthen their external positions which have suffered serious damage from the rise in the price of oil and from the particularly sharp upsurge in prices and costs.

There must therefore be no let-up in the struggle to overcome inflation throughout the Community, which should be carried out so as not to cause unnecessarily an increase in unemployment, but it must not be forgotten that the maintenance of inflationary trends endangers the level of employment and long-term growth. Special efforts must be made to change the structure of the economies of the member countries faced with the most serious internal and external disequilibria.

If the policy to combat inflation and gradually to wipe out the external deficits without causing a serious deterioration in the economic and social situation is to be a real success, all the social categories will have to cooperate actively; this means that there will have to be a fair distribution of the sacrifices and burdens.

The measures to be taken must be closely coordinated at Community level in order to smooth over the disparities between the Member States and the uncertainties which are a burden on economic and social development. They must have as their base the active solidarity of the partner countries.

PRODUCTION AND EMPLOYMENT

(% annual growth rates)

	Gross domestic product in real terms				Persons in paid employment			
	1966-1971	1972	1973	1974(1)	1966-1971	1972	1973	1974(1)
Denmark	4,6	5,1	3,8	2,0	1,4	2,0	0,4	-1,4
Germany	4,4	3,0	5,3	1,9	0,5	-0,3	0,7	-1,2
France	5,8	5,5	6,0	5,2	1,7	1,5	2,4	1,7
Ireland	4,4	3,2	6,0	3,5	0,8	-0,9	.	.
Italy	5,2	3,2	5,9	5,0	1,2	0,1	1,9	2,0
Netherlands	5,6	4,3	4,7	3,3	1,3	-0,7	0,1	-0,1
Belgium	4,7	5,2	5,7	4,0	1,2	0,5	1,1	0,7
Luxembourg	3,3	4,6	7,4	4,5	1,7	3,7	2,9	1,9
United Kingdom	2,2	2,3	5,6	-0,9	-0,8	-0,7	1,3	-1,1
Community 9	4,4	3,7	5,6	2,7	1,0	0,1	1,4	0,0

Source: SOEC

(1) Estimates by the Commission's departments.

CONSUMER PRICES

(% annual growth rates)

	1966-1971 (1)	1972	1973	1974 (2)
Denmark	6,3	6,6	9,3	14,2
Germany	2,9	5,5	6,9	7,3
France	4,5	6,2	7,3	12,5
Ireland	5,9	8,6	11,4	14,8
Italy	3,3	5,7	10,8	15,4
Netherlands	5,4	7,8	8,0	8,8
Belgium	3,6	5,5	7,0	10,0
Luxembourg	3,3	5,2	6,1	8,3
United Kingdom	5,4	7,1	9,2	14,4

Source; SOEC

[1] Average for the period

[2] January - June

3.

TRADE BALANCES

(levels, in national currencies; '000 million units)

	1966-1971 (1)	1972	1973	1974 (2)
Denmark	-5,8	-5,0	-9,4	-8,3
Germany	+15,1	+20,3	+33,0	+29,7 (3)
France	-6,4	-4,5	-6,2	-16,5 (4)
Ireland	-0,17	-0,19	-0,27	-0,29
Italy		-420	-3267	-3941
Netherlands	-4,2	-1,4	-1,8	-1,3 (5)
Belgium) Luxembourg)	+1,1	+29,2	+17,6	-14,2 (5)
United Kingdom	-0,99	-1,39	-3,42	-3,58

Source: National statistics

[1] Average for period

[2] January - June, unless stated otherwise

[3] January - July

[4] January - May

[5] January - April

CENTRAL GOVERNMENT BUDGETS

(% increase)

	Expenditure			Revenue			Surplus/deficit (levels in national currencies; '000 million units)			As percentage of GNP at market prices in 1973		
	1972	1973	1974(1)	1972	1973	1974(1)	1972	1973	1974(1)	Expenditure	Rev.	Surplus, Deficit
Denmark[2]	14,1	10,6	24,5	16,1	16,8	19,0	+2,7	+5,5	+3,8	29,9	33,2	+3,3
Germany	11,8	11,9	14,0	12,0	14,4	9,0	-6,5	-2,2	-13,0	24,0	23,8	-0,2
France	9,9	11,0	15,0	12,1	11,6	18,0	+1,9	+4,8	+9,5	19,0	19,4	+0,4
Ireland	..	22,5	27,1	..	19,7	20,6	..	-0,21	-0,32	36,5	28,6	-7,9
Italy	6,4	36,0	27,5	6,0	12,4	20,5	-3382	-7731	-6400	28,0	18,4	-9,6
Netherlands	12,1	18,2	17,5	15,2	18,1	16,0	-0,9	-1,1	-2,0	26,8	26,1	-0,7
Belgium	17,6	13,3	16,0	13,0	17,1	18,5	-84,9	-81,8	-82,0	29,5	24,9	-4,6
Luxembourg	14,1	18,5	16,0	14,5	24,1	14,0	+1,0	+2,3	+2,2	24,3	27,6	+3,3
United Kingdom[2]	14,1	13,8	18,9	7,8	13,2	22,0	-1,83	-2,22	-1,86	37,7	34,5	-3,1

[1] Estimates by the Commission's departments.

[2] Financial years 1972/73, 1973/74, 1974/75

MONETARY SITUATION

	Money Supply[1] (% annual growth rate)						Short-term bank lending (% annual growth rate)			Interest rates: Short-term 4			Interest rates: Long-term		
	1972(2)		1973(2)		1974(3)		1972(2)	1973(2)	1974(3)	1972(2)	1973(2)	1974(3)	1972(2)	1973(2)	1974 (3)
	M_1	M_2	M_1	M_2	M_1	M_2									
Denmark	17,1	15,1	10,0	12,6	6,2	9,8	12,5	15,4	14,0	6,0	8,5	9,5	10,4	12,2	14,6
Germany	14,4	16,9	1,8	13,8	7,2	7,2	18,8	6,2	9,1	6,7	11,9	8,8	8,6	9,7	10,8
France	14,9	18,6	9,7	14,9	9,1	16,2	18,8	0,8	1,3	7,3	11,2	12,9	8,4	9,8	11,1
Ireland	16,0	18,2	7,1	25,7	4,5	23,3	33,7	22,9	25,1	7,6	13,5	12,3	10,3	13,5	14,8
Italy	17,3	18,2	23,5	23,4	20,6	22,5	19,5	17,2	28,5	6,1	8,2	18,0	7,5	7,4	8,7
Netherlands	17,6	11,9	-0,2	22,0	1,8	25,0	15,2	34,5	30,4	3,2	8,8	9,0	7,5	9,0	10,2
Belgo-Luxembourg Economic Union	14,2	17,5	7,8	14,4	9,5	14,6	20,2	19,5	18,7	3,7	7,2	9,6	7,2	7,8	8,8
United Kingdom	13,7	25,4	4,3	28,5	+1,5	20,5	57,1	11,5	33,8	6,3	9,5	9,6	9,6	12,5	14,2

[1] M_1: Money; M_2: Money and near-money

[2] December

[3] Most recent month for which figures are available

[4] Interest rate for call money; Denmark and Italy: official discount rate.

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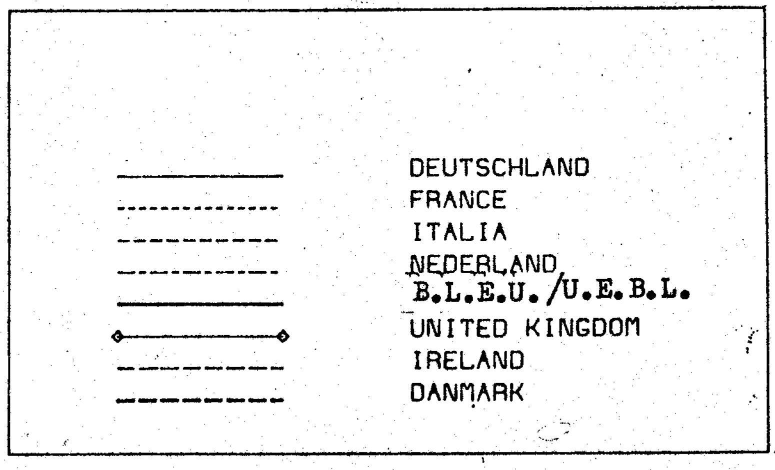

WEIGHTED APPRECIATION OR DEPRECIATION OF THE CURRENCIES OF MEMBER COUNTRIES IN %

(Reference period: "Smithsonian Agreement", December 1971; weighting according to the structure of foreign trade)