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Annual Economic Review 1981-82

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1. Introduction and summary

The Annual Economic Review 1981-82 presents a detailed study of the Community's economic situation as 1982 approaches. The document, organized around the major areas of macro-economic analysis, discusses in turn and in depth economic cycles, the balance of payments, prices and costs, monetary and exchange rate policies, budgetary policies and employment. This year, special attention is paid to sectoral problems, the role and scale of subsidies and the different types of investment incentive in the Member States.

The Community's economic outturn was particularly poor in 1981. The recession which began in 1980 continued this year, and if there was evidence of something of a recovery, its pace was very moderate. Chapter 2 of this Review shows that the crisis now affecting Europe has many points of similarity with the crises of 1974-75. The relative magnitude of the 1973 and 1979/80 oil shocks is similar and the length of the recession, one year, appreciably the same. However, the present recession, if less sharp than the first, has been followed by an upturn far less vigorous than that of 1976.

The other major industrialized countries of the OECD area have by contrast suffered less severely than the European Community from the rise in the price of energy products. Taking the annual average, the growth of GDP in real terms in the United States has been positive this year, and growth in Japan remained steady, mainly due to the strength of her exports. The Community is therefore in a relatively more difficult position than the other major industrialized countries, especially since in 1981 little progress was made in correcting its external disequilibrium, in particular its balance of payments on current account, while Japan and the United States recorded a definite current account improvement. The Community suffered a substantial deterioration in its terms of trade which was not offset to any extent by an improvement in its trade balance in volume terms. Faced with a heavy current account deficit, it was compelled to encourage net inflows of long term capital, by public borrowing in particular, and to put up with some loss of reserves. Chapter 3 examines in detail the adjustment of the Community's external balance to the oil shock and the structural features of its balance of payments.

The year now drawing to a close saw the persistence of a high average inflation rate in the Community. The upward movement of prices is likely to slacken next year, but it seems more stubborn today than after the first oil shock. The Member States have endeavoured to encourage the free play of competition in order to hold inflation in check; systems of price control have often been relaxed and even dismantled. At the same time, and unlike the sequel to the first oil shock, the energy price rise was promptly passed on in costs in order to encourage the productive apparatus to adjust to the high cost of energy and to avoid the perpetuation of artificial situations as regards the relative prices of different sources of energy. On the other hand, Chapter 4 shows that the spread of inflation rates between Member States, after improving from 1976 to 1979, has again widened in the last two years. The upward movement of wage costs, which had accelerated in 1980, slowed down this year, but income distribution remains biased towards wages and salaries.

In the area of exchange rates, Europe went through a particularly troubled period in 1981. The substantial rise of the dollar and the yen and the consequent depreciation of the European currencies were accompanied by strains within the European Monetary System. The scale of the resources available within the exchange rate mechanism allowed the European currencies to weaken in an orderly fashion. The two realignments of the pivot rates this year, which reveal a healthy management of the system, have lessened, if not eliminated, the cost and price divergences between Member States. Chapter 5 examines these developments and the functioning of the European Monetary System in depth. It then goes on to deal with the problem of the rise in interest rates which, although partly a result of the rise in US interest rates, was mainly a response to the domestic constraints of monetary policy. Lastly, observation of the monetary aggregates reveals that the slowdown in monetary expansion in the Community, which began in 1979, ended this year, due to the large deviations in money supply growth from the initial forecasts, which occurred in several countries.

The public finance deficit in the Community grew in 1981 (see Chapter 6). The slackening of activity and its corollary, the slowdown in tax receipts, the size of the transfers paid to households, and the growing burden of the public debt, particularly heavy in certain Member States, have had the effect of widening the budget deficit. Thus the share of central

government receipts in Community GDP again increased in 1981, after advancing continually since 1972, so that the budget's redistributive function goes on expanding. In order to finance its deficit, central government made substantial calls on the non-monetary savings of the national financial markets (the depressed state of demand for long-term capital by the private sector was a help here) and on international capital in proportions which varied with the Member State. The majority of the Member States, however, made greater use of monetary financing to cover general government net borrowing. The upward movement of long-term interest rates, in 1981, though partly a result of the higher short term rates, also reflects the persistence of certain inflationary expectations and the growing demand for long-term sources of finance by the public sector.

Chapter 7 deals with employment and unemployment which today, with inflation, form the central concern of economic policy. The sharp rise in unemployment, since the beginning of last year, is a development difficult to bring under control. It stems from a combination of demographic and economic factors: the large numbers of young people who have joined the labour force while very few individuals are reaching retirement age, plus the small increase in job vacancies. This situation has resulted in substantial changes in the structure and nature of unemployment. The small number of job vacancies is a consequence of the economic recession, but it has deeper causes, among them the Community's competitive position, technological developments in equipment and the competition between the industrialized and developing countries in the traditional industrial sectors. The cost of this persistent and growing imbalance in the labour market is becoming extremely onerous for the Member States, both in terms of the direct cost for the government and, more generally, the social cost for the nation; the latter is admittedly more difficult to quantify, but it is certainly very significant today.

The oil shocks and the slowdown in growth have thrown into relief the importance of and necessity for the structural adjustment of the Community's productive apparatus. Chapter 8 analyses the adjustment of sectoral structures between the two oil shocks and points out that it is the energy, intermediate products and non-market services sectors which have

made the greatest contribution to growth while the capital goods sector shows some loss of dynamism. The sectors of the future, holding out good prospects for expansion, could replace certain declining industries, provided that their development is encouraged. The Community authorities possess specific means of helping the structural adjustment of the European economies, but their actions have up to now mainly concentrated on assisting the traditional sectors beset by serious adjustment crises.

Chapter 9 deals with subsidies, investment incentives and the taxation of energy. Production subsidies as a whole have increased significantly in the 1970s, with current transfers as a general rule outstripping investment aids. The scale of the transfers varies widely from one Member State to another, and so do the form they take and their distribution between recipient sectors. Special attention is given to investment incentives in their different forms - aids, loans, interest rate subsidies, the tax treatment of depreciation, etc.; they are also examined from the angle of the practices of Member States. The chapter also looks at energy taxation policy and the Community authorities' policy on subsidies.

The Economic Review 1981-82 as a whole is an in-depth study of the outturn and the economic problems today faced by the Community. In the Fifth Medium-Term Economic Policy Programme (1981-85) submitted to the Council in July, the Commission agrees that the projections for the next few years, assuming no change in policy, do not point to a return to the high growth rates enjoyed by Europe up to the early seventies. The results and the indicative forecasts made in the framework of the Fifth Programme and reproduced below are an eloquent illustration of this:

Fifth Medium-Term Programme - Base Projection

Average annual variations in % except where otherwise indicated

	1973/60	1980/73	1985/80	1985/81
GDP	4,6	2,2	1,9	2,5
GDP price	4,9	10,4	8,1	7,7
Investment	5,4	0,7	1,1	2,1
Employment	0,2	0,0	-0,2	0,0
Purchasing power of per capita wage	5,0	2,0	0,8	1,0
(Corrected) wage share in GDP	0,2	0,0	-1,1	-1,4
End-of-period balance of goods and services (GDP percentage points)	0,4	-1,4		-0,2

The projections for the period 1985 do not, strictly speaking, represent forecasts. A 2 1/2 % growth rate over the next four years will probably be insufficient to bring down unemployment. This is why the Community's main task is to devise and accept an economic strategy which will permit an appreciably better performance than the one described in the base projection.

2. Economic Cycles in the World and Europe

The industrialised countries of the OECD area as a whole probably reached the bottom of the second oil-shock recession early in 1981. But the pace of the recovery in the second half of 1981 is generally expected to be sluggish. While output and world trade should accelerate somewhat during 1982, their growth seems likely to be only modest. The Community economies have experienced a deeper and more prolonged recession than the other major industrialised economies and they are lagging behind in the recovery; after remaining flat in the first half of 1981, activity started to pick up again gradually from about the middle of the year. Community gross domestic product is expected to fall by 0,5 % in 1981 and to rise by 2,0 % in 1982. Unemployment will continue to rise throughout most of this period. The 1980-81 recession has not been quite as severe as that experienced in 1974-75 after the first oil-shock, but evidence from business surveys and elsewhere suggests that the upturn on this occasion will not be nearly as brisk as in the previous cycle. Progress on containing inflation has been threatened and uncertainties about growth prospects increased by the large depreciation of Community currencies against the dollar in the first half of 1981 and by the rise in interest rates. Estimates are presented from simulation studies of the likely impact of these developments on the Community economy.

2.1. World economic trends and outlook

Output in the industrialised countries of the OECD area probably reached the bottom of the current recession near the beginning of 1981, after declining during the middle quarters of 1980. In the United States the fall in output in the spring of 1980 was sharp but shortlived and was followed by three quarters of accelerating growth. However, in the second quarter of 1981 expansion in the USA was checked by the tightness of monetary policy and high interest rates which held back investment and consumer durables demand. Output in the United States is expected to resume its growth towards the end of this year and it should strengthen gradually during 1982.

There was no fall in output in Japan during 1980, the weakness of domestic demand having been offset by a strong export performance. During 1981 consumers' expenditure and investment have become more buoyant, and the gradual acceleration of output is expected to continue into 1982.

The economies of Europe (including the EC economies which are described in more detail below) experienced a longer period of recession than did the other major industrialised countries. Output started to fall in the spring of 1980 and through the winter and spring of 1981 remained relatively flat and depressed. It was not until about the middle of the year that a tentative recovery appeared to begin. The main components of domestic demand have shown little buoyancy throughout 1981, and while the recovery in Europe is expected to gather some momentum during 1982 the pace of expansion will be only modest.

For the economies of the OECD area as a whole, year-on-year growth in gross domestic product is put at about 1,3% in 1981 and some 2,3% in 1982. By the second half of 1982 the OECD economies should be expanding at an annual rate of about 3 1/2% (see Table 2.1).

The volume of world trade is expected to be at much the same level in 1981 as in the previous year. World trade fell back in the second half of 1980 as the recession-hit OECD economies cut back their imports and demand from the other zones of the world grew less strongly. After a period of stagnation in the first half of 1981 a gradual recovery is thought to have begun which should be consolidated during 1982. Strong demand for imports by the OPEC countries is continuing to provide some offset to weakness elsewhere. By contrast the non-oil developing countries, faced with the need to finance continuously large balance of payments deficits, and the 'other' group of countries (mainly the centrally-planned economies) have shown weaker import growth in 1981, and the modest strengthening expected for them in 1982 remains uncertain.

Part of the recent weakness in world trade has been due to the sharp falls in the consumption and import of oil which occurred in 1980 and 1981. Oil consumption in the OECD area fell by 7 1/2 % in 1980 and is forecast to fall by at least 5 % in 1981. This is a larger fall in demand than can be explained by the recession alone, and is clearly a response to the large hike in relative oil prices over the last three years. World trade in goods other than crude oil rose by some 5 % in 1980 and is expected to rise by 2 % in 1981 and 6 % in 1982, and is thus noticeably stronger than the figures for total world trade given in Table 2.1.

Reduced demand for oil together with rising non-OPEC output led to the emergence of a substantial surplus in oil supplies during the first half of 1981 and to downward pressure on oil prices. Members of OPEC meeting at the end of May settled for an effective freeze on the official prices set at Bali the preceding December, and they were unable to agree on a unified pricing system at their meeting in August. In practice oil prices in dollars have fallen as premia have been eroded. Although some of the OPEC countries have decided on reductions in output levels, the glut of oil supplies seems likely to persist for at least the next few months. Because of the price rises that took place at the end of 1980, the average dollar export price of crude oil in 1981 is expected to be some 10 1/2% higher than in 1980. The forecasts presented here for 1982 are based on the assumption of a further 4 1/2% rise next year.

The large increases in the price of oil in 1979 and 1980 continued to dominate developments in the pattern of payments balances in 1980 and 1981. The current account surplus of the OPEC countries which had risen to nearly USD 70 000 million in 1979 rose to USD 120 000 million in 1980. The surplus is expected to decline in 1981 and 1982 but only at a relatively slow pace so that substantial deficits will remain to be financed by oil importing countries for some years to come.

The main burden of the oil price increases was reflected in the current account positions of the industrial OECD group whose combined current account deteriorated by USD 80 000 million in the two years 1979 and 1980. Within this group, however, there have been substantial differences in current account positions; the current balances of Canada and the United States actually improved while there was a very sharp deterioration in the current balances of the Community, Japan and the smaller OECD countries. Although the deterioration in the developing countries' current balance was less than for the industrial countries, this was due largely to the fact that this group of countries was already in substantial deficit prior to the latest oil price increases due partly to their difficulties in adjusting to the previous oil price rises of 1973 and 1974.

After the previous round of substantial oil price rises in 1973-4 the resulting OPEC surplus had been halved by 1975 and was reduced to some USD 4 000 million by 1978. This time the surpluses are not expected to fall quite as rapidly. Thus the outlook for payments balances suggests that a more balanced pattern of world current balances will only emerge relatively slowly. The aggregate current account balance of the OECD countries will improve this year by about USD 28 000 million mainly because of improvements in the current balances of Japan and the Community. The oil importing developing countries will have a further substantial increase in the level of their current deficit.

In 1982 the current account of the United States is expected to deteriorate significantly and the Japanese current account will continue to improve whilst a further improvement in the Community's deficit is foreseen. Both the smaller other OECD countries and the non-oil developing countries will continue to incur very substantial deficits, with a slight further worsening likely for the latter group, so that the problems of financing their deficits may prove increasingly difficult. The OPEC surplus will decline by about USD 24 000 million this year and a decline of about USD 22 000 million is expected next year, so that by 1982 the OPEC surplus will have declined by almost 40% from its peak in 1980. The weakness of OPEC exports of oil is a major factor leading to a reduction in the OPEC surplus, but the relatively slower decline in the OPEC surplus compared with the years after the 1973 oil price increases is due to a less rapid expansion in the volume of OPEC imports than in the earlier episode, and to a slower recouping by the industrial countries of the terms of trade loss.

2.2 Economic outlook for the Community

The real gross domestic product of the Community, which had been declining since the second quarter of 1980, stayed relatively flat during the first half of 1981 and then probably started to turn upwards at about the middle of the year. As yet indications are that the recovery will be very sluggish.

Real personal disposable income has been squeezed and private consumption has fallen or been stagnant in most countries. Governments anxious to contain their budget deficits have been increasing their consumption expenditures only very slowly. Fixed investment has been falling since mid-1980 and stockbuilding has become progressively weaker. In response to the developments in world markets Community exports dropped sharply in the second half of 1980, but have shown a marked recovery since then. Community imports, however, have been much weaker and so there has been a positive contribution to Community output from the real foreign balance. Between the first quarter of 1980 and the second quarter of 1981 gross domestic product in the Community is estimated to have fallen in real terms by over 2%. This sharp fall in output has been accompanied by a very rapid expansion of unemployment in the Community which by the middle of 1981 had reached over 9 million.

The prospects for output in the remainder of 1981 and for 1982 are most uncertain and give no cause for optimism. As part of their anti-inflationary policies some governments in the Community are attempting to follow strict monetary and fiscal policies, thus giving little or no stimulus to economic activity. Interest rates in Europe are higher than they would have been because of the very high rates induced by monetary policy in the United States. These are likely to hold back the usual cyclical recovery in business fixed investment, stockbuilding and consumer spending on durable goods. Additional uncertainties are introduced by the massive depreciation of Community currencies relative to the US dollar which occurred during the twelve months up to August 1981. The net effect of this factor may not be to depress output in the Community, as the gain in the Community's competitiveness should allow an expansion of exports to the rest of the world and should restrain the shares of third countries in domestic markets within the Community. But this currency depreciation has given a boost to inflation in the Community and may hold back domestic demand through its restraining effect on private consumption.

Further evidence that a recovery is under way but that it is proceeding only weakly comes from the Commission's business surveys. The balance of industrialists in the Community expecting output to decline over the next year began to narrow in the first quarter of 1981 (see Graph 2.2), but as compared with previous recoveries this retreat from pessimism seems much less pronounced.

The latest forecasts for the Community show real gross domestic product falling by 0,5% in 1981 compared with the previous year, and then rising by 2,0% in 1982. After only a small increase in the second half of 1981 output is expected to gradually accelerate, with all the components of domestic demand gathering speed, albeit gently. With world demand gradually picking up Community exports should move ahead faster, but the volume of imports will also move ahead. By the second half of 1982 Community gross domestic product should be growing at an annual rate of almost 3 %. The expected weakness of the recovery implies that unemployment in the Community will probably continue to rise at least until the middle of 1982, by which stage the number unemployed could be over 9 1/2 million. Thereafter the rise in unemployment should only be small but no decline can be expected during the forecast period. (See Tables 2.3 and 2.4 for details of forecasts).

Inflation in the Community (as measured by the year-on-year rise in the private consumption implicit deflator) now seems likely to be only a little lower in 1981 than it was in 1980 (11,6% compared with 11,9%). The steady slowing in the rate of price increase which had been achieved during 1980, was reversed in the first half of 1981 as the impact on import costs of the depreciation against the dollar began to be reflected in domestic prices. The prices of Community imports of goods are estimated to have risen at an annual rate of almost 22 % in the first half of 1981, compared with only 9 % in the previous half year. The rate of increase of import prices will continue to be high in the second half of 1981, but during 1982 it should slow to below 9 %, especially if, as expected, the Community currencies regain some part of their depreciation against the dollar. Although a part of the renewed acceleration in domestic inflation this year will automatically be reflected in increased wage costs, the weakness of the labour markets may limit the extent to which wages react. Part of the terms of trade loss experienced this year is therefore likely to be absorbed by some reduction in real personal incomes, and so the boost to inflation from the currency depreciation may not be perpetuated. Some slowing down in domestic inflation is therefore to be looked for in 1982, and the year-on-year increase in the private consumption deflator could slow to some 10,5 %.

The Community's deficit on current account narrowed in the second half of 1980 and the first few months of 1981 as imports fell back more sharply than exports. The appreciation of the dollar has added substantially to the Community's import costs, and so in the middle of the year the improvement in the Community's trade and current balance slowed. But, helped by the improved competitiveness of Community exports on world markets, the volume of exports has been rising throughout the year, while the volume of imports has remained weak. For 1981 as a whole the current account deficit is expected to be some USD 30 100 million or over USD 9 000 million narrower than in 1980 (although measured in ECU the Community's deficit will have changed only a little). In 1982 the Community's terms of trade loss should be much less than in 1981, and while the volume of imports should start to rise again quite briskly the volume of exports should rise even faster as Community exporters make further gains in their shares of more buoyant export markets. A further improvement in the Community's current deficit to about USD 24 800 million is therefore expected.

2.3 Comparison of the post-oil-shock cycles

There are a number of similarities between the recessionary experiences of the Community economies in the wake of the two sets of major oil price rises in 1973 and in 1979-80. In this section common features and differences between the two recessions are examined, and the reasons why the recovery from the present recession seems likely to be more gradual than occurred in 1975-76 are explored.

The relative sizes of the oil shocks to the Community economies in the two episodes were of similar order. The extra cost on Community oil imports which the increases in oil prices implied (with no change in the volume of oil imports) represented in both cases approximately 3 % of Community gross domestic product. However, the oil price rises in 1973 were all concentrated in the final four months of the year. In the second episode a series of increases were spread over the period from the end of 1978 to the end of 1980. The impact of these latter increases was therefore more diffuse, and they may have been a little easier to absorb.

Furthermore in 1973-74 the oil price rises were preceded by very substantial rises in the prices of non-oil commodities which also added appreciably to the Community's import costs. Commodity price increases in 1979-80 were not nearly as strong. In addition in 1974 the effects of oil and other commodity price rises in dollars were exacerbated by a weakening of the Community currencies against the US dollar, while especially in 1979 exchange rate movements slightly offset the dollar price rises. So taken as a whole, the size of the external shock in 1974 was larger and more concentrated than in 1979-80 (see Table 2.5).

Although there have been no more oil price increases in dollar terms since the end of 1980, the external shock in the present cycle has been amplified and extended by the strong appreciation of the dollar since the autumn of 1980. The calculations in Table 2.5 suggest that the contribution to the rise in Community import prices in 1981 from dollar-priced oil and other commodities becoming more expensive in terms of Community currencies is of the same order as that felt from the increases in the dollar price of oil in 1980. But the depreciation of the Community currencies, while adding substantially to import costs, at the same time improves the competitiveness of Community exporters in world markets.

Graph 2.1 shows the quarterly paths of gross domestic product and its main components for the total of the four largest Community countries during the two cycles from 1973 to 1977 and from 1979 to 1982. The figures are actual recorded values until the first quarter of 1981 and are Commission forecasts thereafter. The two cycles have been superimposed and have been made to coincide in the quarters at which gross domestic product peaked before the falls in output, the third quarter of 1974 and the first quarter of 1980.

As can be seen both peak quarters were followed by a half year of sharp falls in gross domestic product followed by a further half year of relative stagnation. The shapes of the two cycles in the four quarters following the peaks are remarkably similar, but the present recession appears to have been not quite so steep as in 1974-75 (GDP fell by 2,6 % between 1974 3 and 1975 1, and by 1,9 % between 1980 1 and 1980 3). Of course the experience of individual countries has varied, and in particular the United Kingdom has seen a much sharper recession in the last two years than in the earlier period. This means that in the other three major Community countries the latest recession has been noticeably less extreme than in 1974-75.

The graphs also illustrate that both fixed investment and stockbuilding had up to the first quarter of 1981 fallen by less than in the comparable period of the earlier cycle. It would appear that enterprises have reacted less sharply to the latest round of oil price rises and boost to inflation. In part this may be because their cash flows have been less severely squeezed by increases in their other costs. Non-oil commodity prices showed much larger increases and wage costs reacted more markedly in the earlier cycle. It may also be that the knowledge and experience gained by enterprises during the first cycle have helped to reassure them that very dramatic changes to their plans were not necessary on this occasion. Finally business confidence and stability might have been helped by the generally tighter monetary and fiscal policies followed in member countries which have had greater - albeit still very limited - success in moderating the secondary impact of the oil shock on labour costs.

While business spending has so far not fallen so sharply during the present cycle, consumption expenditures by the private sector and by government have shown a weaker development relative to the earlier recession. The picture for private consumption is confused by the more erratic quarter-to-quarter movements in this aggregate in recent years. But it appears that while nominal wage increases have risen less strongly during this cycle (a factor which in the short term at least would tend to reduce real incomes and depress consumption) there has been no marked tendency for savings ratios to rise in the way they did in 1974 and 1975. Government consumption has been rising more slowly in this cycle because of the much tighter fiscal stance of most governments.

On the foreign trade side there are also contrasts between the two cycles. While the fall in output in the European economies has been only slightly less this time than in the earlier recession, in the developed economies of the OECD area as a whole the recent recession has been noticeably less severe. In the United States it has been of shorter duration, and Japan has this time avoided any actual fall in GDP. The hiatus in world trade at the end of 1974 and early in 1975 when import volumes by almost all the developed countries fell very dramatically served to intensify the recession and to transmit it from one country to the next. In the latest episode world trade has indeed fallen but not by as much. Community imports have not declined as sharply as before because there has generally been no sharp fall in stocks.

In 1975 the half year of stagnation in output was followed by a period of rapid recovery. The reasons given above to explain the smaller fall in output during the present cycle (less dramatic shifts in the behaviour of enterprises and tighter fiscal policies) would also tend to suggest that the upswing will be more moderate. Since stockbuilding has not been cut back so markedly there cannot be so pronounced a positive impact on growth from the resumption of additions to stocks. The cyclical decline in fixed investment, although shallower than in 1975, could continue for several more quarters (until the beginning of 1982) before turning upwards. If interest rates continue at or near their present high level there is a risk that this recovery will be held back even longer. Consumption expenditures also seem likely to rise much more slowly during the coming quarters, since the growth of real incomes is expected to be small and savings ratios should remain relatively stable.

Evidence from the EC business surveys tends to support the conclusion that while a recovery in output is on the way it will be only gradual. The balance of industrialists expecting production to fall was more extreme at the trough in 1975, but in the three quarters which followed there was a sharp improvement in production expectations which was soon translated with a lag of about two quarters into a rapid rise in industrial production. Production expectations appear to have reached their lowest point in the present cycle already in August 1980, and since then there has been a steady but slow improvement in prospects as seen by industrialists (see graph 2.2). However, in the most recent survey (September 1981) there still remains a small majority expecting further falls in their output.

2.4 Impact of recent movements in exchange rates and interest rates

The exchange rates of all the Community countries have fallen sharply against the dollar in recent months and short-term interest rates have risen partly to prevent even further falls in European exchange rates. Longer-term interest rates have also increased, this perhaps reflecting to some extent the upward revisions to inflationary expectations that have occurred because of exchange rate changes. The Commission's forecasts given above take into account these exchange rate and interest rate changes in addition to the many other factors influencing the development of

the Community economies. In this section the analysis that lies behind the forecast is examined in some detail. Quantitative estimates of the effects on the Community economy of step changes in exchange rates and interest rates have been made using the Commission's economic models and other economic evidence. The exchange rate changes and interest rate changes have been examined separately to aid understanding. The calculations also assume that any particular change is maintained over the whole simulation period. The results are therefore not forecasts of what is likely to happen but more building blocks to be used in the construction of a particular forecast.

By August 1981 the ECU had depreciated by almost 28 % compared with its average value against the dollar in 1980. The effects of this depreciation on the Community economy if sustained will depend on the reaction of commodity prices, the price elasticity of exports and the influence of any rise in inflation on wages and real demand. Most commodities are priced in dollars and thus in the short term an appreciation of the dollar will result in a deterioration in the Community's terms of trade, since the prices in dollar terms of the Community's exports of mainly manufactured goods will fall relative to the prices of imports of primary products and of manufactured goods from countries with strong currencies. However, over time the terms of trade should recover part of the loss, since the dollar prices of commodities should adjust downwards and find a new equilibrium in world markets. In the calculations presented in Table 2.6, showing possible effects of a sustained 20 % devaluation of the ECU from the first quarter of 1981, it has been assumed that over a two year period oil prices fall by 5 % in dollar terms compared with what they would otherwise have been and that other raw material prices fall by 10 %. For food the situation is more complex because of the Common Agricultural Policy which should keep down the prices of Community food products in dollars. It has thus been assumed that world food prices fall by 5 % and Community food prices by 12 % in dollar terms.

Model-based calculations suggest these commodity price changes will raise Community import prices in ECU by around 9 per cent in the first year and raise domestic prices by around 1 per cent. Even after assuming a substantial increase in EC export prices to the rest of the world and some reduction in world dollar prices, the gain in price competitiveness of the Community is likely to be in excess of 10 per cent. Although it is well known that the effect of such relative price changes on the volume of exports is spread over a number of years most

econometric work indicates that at least 30-40 per cent of the full effect occurs within the first one and half years. The results therefore indicate a substantial increase in the volume of exports of goods and services and thus in total output in 1981 and 1982. Because of multiplier effects the increases in output in 1981 and 1982 would be a good deal higher than indicated were it not for the reductions in domestic demand, in particular private consumption, which arise from the upturn in inflation.

The effects of recent interest rate changes are next examined separately. Nominal long-term interest rates within the Community were by August 1981 on average more than 1 per cent above the average for 1980. Nominal short-term interest rates within the Community on average were about 3 percentage points higher than the average for 1980 whilst short-term US interest rates were some 3 1/2 percentage points higher. Since inflation has generally slowed, both in the United States and in the Community countries, the rise in real rates of interest (measured relative to current rates of inflation rather than the difficult-to-observe expected rates) has been even more substantial. The likely effects of the present US monetary and fiscal policy are of course matters of considerable uncertainty and dispute. In the short term, at least, they are likely to depress US output (mainly via a reduction in investment and stockbuilding) and reduce inflation. The rises in European interest rates will work in the same direction within the Community, although the reductions in inflation may be less powerful because they are not in general associated with a major change in the perceived conduct of domestic monetary policy, and are therefore less likely to reduce inflationary expectations. The Commission calculations suggest that if the rise in interest rates which has occurred is maintained it will depress Community gross domestic product by some 0,4 % in the first year and by 0,7 % in the second year, mainly through its impact on investment. There could be some very slight tendency for inflation to be restrained. It is worth noting that some of the rise in interest rates has probably occurred because the rise in the dollar has raised inflationary expectations. Thus some of the rise in long-term interest rates can be thought of as implicitly offsetting those increases in demand arising from the fall in real interest rates in the exchange rate simulation.

The rise in world interest rates could if maintained have perhaps more far-reaching consequences than those given in Table 2.6 because of the effects on debt interest payments of developing countries. In the very short term however these effects will to some extent be offset by the increases in real income of developing countries arising from the terms of trade gain of primary commodities associated with the rise in the dollar.

The combined effects of the exchange rate and interest rate changes are presented in the final two columns of Table 2.6. In the second year after the changes the level of Community gross domestic product would be about 1,1 % higher than it would otherwise have been, and the growth rate in that year would be some 0,6 % higher. The expansionary effect on the volume of exports appears to be more substantial than the restraining influence on the domestic components of demand. The level of consumer prices in the second year would be some 2,3 % higher as a result of the changes, that is the inflation rate in that year would be some 1,4 % higher since 0,9 % of the increase would already have taken place in the first year.

These simulations therefore suggest that the net effects of the changes in exchange rates and interest rates which have been seen recently could, if maintained, be to give some boost to real growth in the Community over a two year period. This higher output would be accompanied by faster price inflation which could in turn lead to greater instability in foreign exchange and domestic markets adding greatly to uncertainty about prospects. But the forecasts presented earlier in this chapter are based on the assumption of some partial recovery of the Community currencies against the dollar in 1982 and of some relaxation in interest rates. If these forecasts are realised then the effects given in these simulations will be reduced.

Production expectations as a leading indicator of the business cycle

The EC business surveys ⁽¹⁾ provide monthly data on industrialists' assessments of the most important variables relating to their enterprises. This information may be used to monitor the business cycle. The results for certain questions, in particular that on the expected trend of production in the months ahead, display leading characteristics. The Table shows that, for the Community as a whole, the turning-points in the production expectations series have led those of detrended industrial production ⁽²⁾, by an average of 6 to 7 months for cyclical troughs and peaks, respectively. There is some irregularity in the length of these leads, but on no occasion did the turning-point in expectations lag that in the index for the Community as a whole.

In the case of the present cycle, the low-point in industrialists' opinions on production expectations was reached in August 1980. Information from the industrial production index shows that industrial activity flattened out in the first half of 1981. While an upward turn in the index should soon become apparent it is not yet possible to date this turning-point. However, it seems that the length of the lead given by the survey data on production indications will on this occasion have been at the longer end of the range of 1 to 10 months seen in relation to the last three troughs of the Community business cycles.

As regards the four largest Member States, the long length of leading information given for Germany, Italy and the United Kingdom is rather similar, with average leads of between 3 and 7 months for their troughs and peaks. The averages for France are also within this range, but there are some instances in this case in which the production expectations of industrialists did not lead the cyclical turning-point.

The Graph also shows the results of industrialists' opinions on their order-book levels, as well as their production expectations. Turning-points in opinions on order-books also tend to lead the production cycle, but by less than the opinions on production expectations; sometimes the turning-points in order-books are coincident with those of recorded activity, but even in this event the information from the surveys is available about two months before the industrial production index and has the further quality of giving a smoother profile of trends.

(1) Details of the questions, the method of quantification of results, and time-series data are published in European Economy, Supplement B - "Economic prospects - business survey results".

(2) The de-trending and identification of turning-points is carried out according to the method of the National Bureau of Economic Research (NBER), New York, in which the trend is estimated by means of a long-term moving average, adjusted to conform more closely to the original data, and turning-points are selected in series of deviations of the original data from the trend. For a detailed explanation of the method, see G. Bry and C. Boschan, "Cyclical Analysis of Time Series : Selected Procedures and Computer Programs", New York, NBER, 1971.

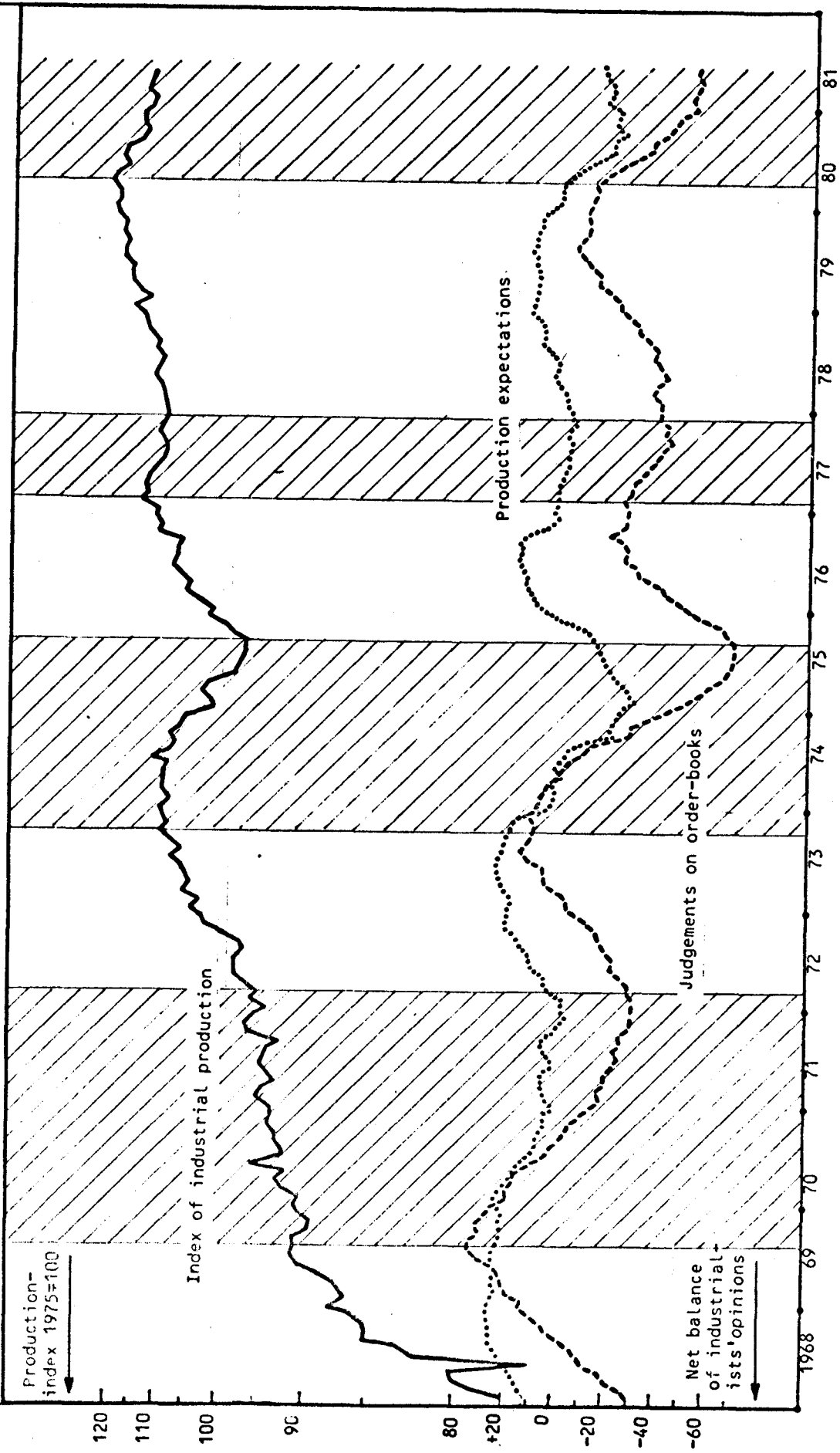
Table Cyclical turning-points 1968-81					
Recorded Industrial Production (1)		Production Expectations of Enterprises		Lead (-) or lag (+) (2) in number of months	
Trough	Peak	Trough	Peak	Trough	Peak
<u>European Community</u>					
	69-5		68-12		- 5
71-12		71-11		- 1	
	73-9		73-6		- 3
75-8		75-1		- 7	
	77-1		76-8		- 5
78-8		77-10		- 10	
	79-12		78-12		-12
		80-9			
			Average	- 6	- 7
<u>Federal Republic of Germany</u>					
	70-4		68-12		- 4
71-12		71-11		- 1	
	73-8		73-3		- 5
75-7		75-2		- 5	
	77-3		76-1		-14
78-3		77-9		- 6	
	79-7		79-1		- 6
		81-2			
			Average	- 4	- 7
<u>France</u>					
71-5		70-9		- 8	
	74-8		73-3		-17
75-5		75-6		+ 1	
	76-9		76-6		- 3
77-12		77-8		- 4	
	79-7		79-11		+ 4
		81-3			
			Average	- 4	- 5
<u>Italy</u>					
	69-7		69-5		- 2
71-7		71-5		- 2	
	74-4		73-6		-10
75-5		75-2		- 3	
	76-12		76-9		- 3
78-8		77-7		-13	
	80-2		79-8		- 6
		81-5			
			Average	- 6	- 5
<u>United Kingdom (3)</u>					
	69-6		68-12		- 6
72-2		71-6		- 8	
	73-6		73-3		- 3
75-8		75-6		- 2	
	79-6		79-5		- 1
		80-9			
			Average	- 5	- 3

(1) Turning-points of production de-trended by the NBER method.

(2) Turning-point in production expectations in relation to industrial production.

(3) Results available for the United Kingdom before 1974 relate to the value rather than the volume of expected production, but an adjustment based on expected price developments has been made in order to obtain broad comparability with the subsequent data.

Graph European Community - Index of industrial production and business survey indicators - production expectations
and state of order-books, all seasonally adjusted; shaded areas indicate recession periods.



The convergence of economic cycles in the EC and OECD.

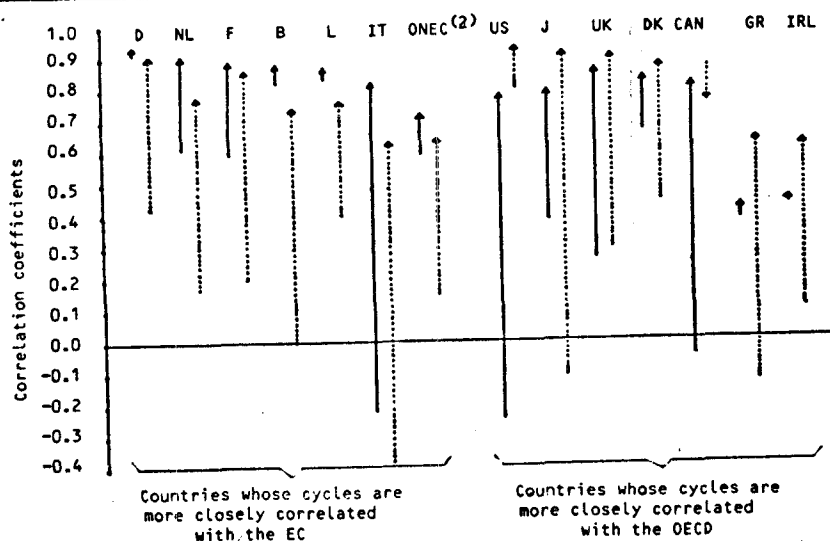
While it is obvious enough that Europe has been experiencing a generalised recession over the past year, it is not self-evident whether this convergence of economic cycles is true more within Europe compared to the industrialised world as a whole (OECD), and whether these tendencies have been becoming more strong with time or not.

The Chart shows that in comparing the period 1971-80 with 1961-70, there has been a much more powerful convergence of cycles in the last decade both within the Community and the OECD area (the upward pointed arrows indicating the extent of the increase in the correlation coefficients of each country's growth pattern on the two areas). This certainly in good part reflects the two cycles in the 'seventies that were led by massive oil price shocks. Thus the world-wide cycle has become much more dominant.

In separating countries into two categories, those most closely following respectively the Community and OECD's growth patterns, the 'seventies showed the original six Member States and the group of non-EC European countries to be more closely linked to the Community's economic cycles. In addition to the generally increased cyclical convergence among these countries, the most striking change between the two periods is that Italy joined this group in the 'seventies, whereas its cyclical movements were uncorrelated with the Community in the previous decade. The group of countries most closely correlated with the OECD cycle includes the U.S., Japan and the four newer Member States of the Community: UK, Ireland, Denmark and Greece. These Community countries saw, in general, a stronger convergence on the Community's cycle in the 'seventies, but not to a higher degree than their convergence on the OECD cycle.

This analysis of correlation coefficients, while having the merit of simplicity, does contain some problems of statistical bias to the extent that the larger countries may contribute heavily to the movement of the OECD total, and are present or absent from the Community total as the case may be. To cross-check the findings a more sophisticated statistical technique (principal components analysis) has also been used. In the present application the matrix of bilateral correlation coefficients between individual countries' growth patterns in the two successive decades were analysed (e.g. Germany's growth pattern in the 'seventies was correlated .9 on France, the UK was correlated .8 on the U.S., etc.). In scanning the complete

Chart : Correlation of economic growth rates (GDP or GNP) in the 1960's and 1970's.
Change in correlation coefficients from the levels observed in the period 1961-1970 to those (1) observed in 1971-1980, of regions or countries vis-à-vis the OECD as a whole (...·) or the EC (—→)



- (1) The direction of change is indicated by the arrows, the position of the arrowhead indicating the level of correlation observed in the 1970's and the base of the arrow being the correlation obtaining in the 1960's.
(2) Other Europe, excluding EC.

set of correlation coefficients the technique identifies a notional growth pattern that explains the maximum percentage variance in all countries' growth patterns; and then a second growth pattern that explains the next largest percentage of the variance. The results broadly confirm the findings already reported (see Table). Thus in the 'sixties the same group of the original "six" and other non-EC European countries find themselves to be the most significant cyclically convergent group : in the 'seventies this group is joined by Italy (and, curiously, Canada), and the whole group's mutual convergence is of a much higher order too. In the 'seventies the group consisting of the US, Japan, the UK, Ireland, Denmark and Greece is also confirmed as the second most important set of cyclically convergent economies.

Table : Principal components of annual GDP growth rates 1961-70 and 1971-80 (2)

(Factor loadings on major economic growth patterns in the OECD area)

<u>Predominant growth pattern</u>		<u>Secondary growth pattern</u>	
<u>1961-1970</u>	<u>1971-1980</u>	<u>1961-1970</u>	<u>1971-1980</u>
B	,85	B	,95
D	,83	NL	,89
DK	,76	I	,88
F	,74	ONEC(1)	,84
NL	,67	F	,79
ONEC(1)	,53	Canada	,70
		D	,67
		J	,82
		I	,64
		IRL	,61
		GR	,93
		USA	,86
		J	,83
		UK	,75
		DK	,71
		IRL	,66

Proportion of total variance of OECD growth rates explained by the above growth patterns.

34,3%

62,2%

21,8%

14,4%

(1) OECD Europe, excluding EC.

(2) For a description of the technique, see O'Muircheartaigh and Payne (eds.), "Exploring Data Structures" (vol. A, pp. 89-124), John Wiley and Sons, London 1977.

Table 2.1

World output, foreign trade and EC export markets

(% change over previous period, seasonally adjusted annual rate)

	1977	1978	1979	1980	1981 ³		1982 ³		1983		1984		1985	
					I	II	I	II	I	II	I	II		
GDP/GNP, OECD total	3,7	3,8	3,2	1,2	1,3	2,3	2,3	1,1	-0,3	2,3	0,9	2,4	3,4	3,4
Imports of goods (volume)														
World	5,2	6,9	7,0	1,9	0,5	4,3	4,3	2,2	-3,5	1,5	2,6	4,6	5,8	5,8
EC-10 ¹	1,9	5,8	10,6	2,0	-3,7	4,3	4,3	3,5	-7,6	-3,4	0,2	5,1	7,2	7,2
World excluding EC	7,1	7,6	5,0	1,9	2,9	4,4	4,4	1,2	-1,2	4,3	3,9	4,4	5,0	5,0
of which :														
OECD excluding EC	7,2	7,2	6,5	-2,1	1,1	3,4	3,4	-3,2	-6,0	4,0	2,5	3,2	4,5	4,5
OPEC	14,5	5,0	-12,0	11,5	13,0	14,6	14,6	8,4	6,5	14,5	16,5	15,0	13,0	13,0
Other developing countries	6,5	8,0	11,0	5,9	3,8	4,0	4,0	5,9	4,1	3,6	3,4	3,8	5,1	5,1
Other countries	3,0	10,0	2,0	3,4	1,2	2,0	2,0	4,4	2,4	0,3	1,6	2,8	1,7	1,7
EC export markets ²														
Intra markets	4,1	6,2	10,4	2,0	-3,6	4,2	4,2							
Extra markets	5,4	4,5	4,0	4,3	2,7	4,8	4,8							
Total	4,7	5,4	7,4	3,1	-0,7	4,5	4,5							
Exports of goods, EC total ¹	5,1	5,0	7,4	2,5	2,2	5,8	5,8							

¹ Including intra-EC trade² Imports by the various markets weighted together according to their share in EC exports of goods³ Forecasts

Source : OECD, IMF and Commission services

Table 2.2

Balance of payments on current account

(000 million dollars, seasonally adjusted annual rate)

	1977	1978	1979	1980	1981 ²	1980		1981 ²		1982 ²		1982 ²					
						I		II		I		II		I		II	
EC-10	1,2	14,6	-10,9	-39,3	-30,1	-24,8	-41,2	-37,3	-30,1	-30,1	-30,1	-26,4	-23,2				
USA	-14,2	-14,5	1,6	3,5	4,5	-8,0	-5,0	12,1	8,7	0,2	0,2	-12,0	-4,0				
Canada	-4,1	-4,3	-4,2	-1,6	-1,8	-1,5	-3,6	0,4	-2,4	-1,2	-1,2	-1,0	-2,0				
Japan	10,9	16,5	-8,8	-10,7	3,9	10,5	-17,6	-3,8	2,6	5,2	8,0	12,8					
Other OECD	-17,0	-2,7	-5,5	-22,9	-19,5	-17,2	-22,1	-23,7	-23,0	-16,0	-15,0	-19,4					
OECD, total	-23,2	9,6	-27,8	-71,0	-43,0	-41,0	-89,5	-52,3	-44,2	-41,9	-46,4	-35,8					
OPEC	29,0	4,0	66,0	120,0	95,9	74,3											
Other developing countries	-12,0	-23,0	-39,0	-52,0	-64,8	-65,8											
Other countries	-8,0	-9,0	-4,0	4,0	2,1	3,5											
World	-14,2	-18,4	-4,8	1,0	-9,8	-29,0											

1 Including errors and omissions

2 Forecasts

Source : OECD, IMF and Commission services

Table 2.3
Demand, output and external balance, EC-10 total

	1977	1978	1979	1980	1981 (2)	1982 (2)	1980		1981 (2)		1982 (2)	
							I	II	I	II	I	II
Private consumption	2,3	4,0	3,4	1,5	-0,3	1,1	0,1		-0,7	0,1	1,2	2,0
Government consumption	1,1	3,7	2,8	2,4	1,5	1,0	2,1		2,4	-0,6	1,5	1,6
Gross fixed capital formation	0,9	3,0	3,8	1,8	-3,7	-0,8	-3,7		-3,3	-4,6	-0,3	2,2
Stockbuilding (as % of GDP)	1,2	0,8	1,8	1,0	-0,2	0,6	0,5		-0,4	0,0	0,4	0,8
Domestic demand	1,7	3,4	4,3	1,2	-1,9	1,5	-2,3		-2,4	-0,1	1,7	2,9
Exports (goods and services)	5,0	4,8	6,2	2,5	2,3	5,7	-5,3		5,8	3,4	6,2	7,3
Imports (goods and services)	2,4	5,5	10,1	2,6	-3,0	4,2	-5,8		-3,1	0,3	4,9	7,0
Gross domestic product at market prices	2,3	3,2	3,4	1,1	-0,5	2,0	-2,4		-0,2	1,1	2,2	2,7
Industrial production	2,4	2,4	4,9	-0,9	-2,8	2,9	-9,1		-0,8	-0,1	3,8	4,1
Unemployment rate (1)	5,2	5,4	5,4	6,0	7,8	8,5	6,4		7,4	8,2	8,5	8,6
Trade balance (fob/cif)	- 0,5	0,0	- 1,2	-2,6	-2,1	-1,8	-2,5		-2,2	-2,0	-1,8	-1,9
Current balance	0,1	0,7	- 0,5	- 1,4	-1,2	-0,9	-1,3		-1,3	-1,2	-1,0	-0,9

as % of GDP

(1) Unemployment as % of civilian active population.
(2) Forecasts.

Source : Eurostat and Commission services

Table 2.4
Rates of growth of demand and output, 1970-1982

		B	DK	D	GR	F	IRL	I	L	NL	UK	EC-10
Private consumption	1970-79 (1)	3,9	2,3	3,6	3,6	4,5	2,9	3,4	4,4	3,9	2,4	3,6
	1980	1,8	-4,1	1,7	-0,3	1,7	-0,6	4,4	1,8	-0,9	0,7	1,5
	1981 (2)	-1,8	-1,7	-1,3	0,3	1,9	-0,2	-0,1	0,7	-3,4	-0,6	-0,3
	1982 (2)	-1,2	1,8	1,0	1,0	3,2	-0,8	1,2	0,0	-1,0	-0,3	1,1
Government consumption	1970-79 (1)	4,3	4,4	2,9	6,7	3,3	6,1	3,2	3,4	3,1	2,6	3,2
	1980	1,6	5,2	2,6	-0,4	2,8	4,0	2,0	2,1	1,5	2,0	2,4
	1981 (2)	1,1	3,2	1,5	2,0	2,1	0,1	1,7	1,4	1,1	1,0	1,5
	1982 (2)	0,0	2,5	0,0	2,4	2,7	0,0	2,0	1,2	-0,6	0,7	1,0
Gross fixed capital formation	1971-79 (1)	2,7	1,3	3,0	3,5	2,7	6,4	0,5	4,0	1,9	0,8	2,1
	1980	5,6	-13,7	3,7	-8,3	0,8	-9,8	10,0	2,0	-2,6	-2,0	1,8
	1981 (2)	-4,4	-15,2	-3,8	-3,6	-3,0	6,0	-0,7	-0,8	-7,0	-5,0	-3,7
	1982 (2)	-1,3	4,6	-2,1	1,4	0,7	3,7	-3,3	0,2	-1,8	0,9	-0,8
Change in stocks (as % of GDP)	1970-79 (1)	0,8	0,7	0,9	4,8	1,5	1,1	2,0	2,2	1,2	0,8	1,2
	1980	0,2	-0,1	1,4	4,0	1,5	-1,7	3,4	1,1	0,4	-1,7	1,0
	1981 (2)	0,2	-0,3	0,5	4,1	-0,1	0,1	0,7	0,6	-0,5	-2,2	-0,2
	1982 (2)	0,4	0,1	1,0	3,9	0,7	0,9	1,1	0,6	0,2	-0,4	0,6
Domestic demand	1970-79 (1)	3,6	2,4	3,3	5,3	3,8	4,0	3,0	4,0	3,1	2,2	3,2
	1980	1,8	-4,5	1,7	0,0	1,4	-4,6	6,9	4,3	-0,9	-2,5	1,2
	1981 (2)	-1,8	-3,1	-2,3	-0,2	-0,7	3,0	-2,7	-0,2	-4,2	-1,5	-1,9
	1982 (2)	-0,8	2,8	0,7	1,4	3,4	1,2	0,9	0,2	-0,4	1,8	1,5
Exports (goods & services)	1970-79 (1)	6,1	5,1	6,4	10,9	9,5	7,8	8,1	3,5	6,6	4,5	6,7
	1980	3,9	5,9	5,7	8,6	3,4	4,9	-4,3	-1,3	1,8	0,5	2,5
	1981 (2)	-2,1	3,3	6,4	3,6	4,9	1,4	3,6	-9,8	1,0	-4,5	2,3
	1982 (2)	4,4	5,5	8,4	8,0	5,9	8,5	7,0	3,6	4,3	1,5	5,7
Imports (goods & services)	1970-79 (1)	6,3	4,0	7,2	8,3	8,3	7,5	7,0	5,0	5,7	4,4	6,4
	1980	2,8	-7,2	5,1	-2,5	5,5	-4,8	7,9	3,0	-0,8	-3,3	2,6
	1981 (2)	-3,5	-6,0	-0,3	-1,0	-0,9	3,5	-7,1	-6,7	-4,5	-5,3	-3,0
	1982 (2)	2,7	4,9	3,6	2,6	7,7	3,9	3,8	4,4	2,4	3,7	4,2
Gross domestic product at market prices	1970-79 (1)	3,5	2,8	3,2	5,4	4,0	3,8	3,3	2,8	3,5	2,2	3,3
	1980	2,4	-0,2	1,9	1,7	1,3	0,9	4,0	0,4	0,5	-3,0	1,1
	1981 (2)	-1,0	0,0	-0,3	0,4	0,5	1,7	-0,3	-3,3	-1,1	-2,0	-0,5
	1982 (2)	0,2	3,0	2,2	2,1	3,0	3,6	1,8	-0,3	0,9	1,4	2,0

(1) Annual average.

(2) Forecast.

Source: Eurostat and Commission Services.

2

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Table 2.5

Influence of oil and other commodity prices on the Community's import prices and terms of trade (percentage changes)

	1973	1974	1975	1976	1977	1978	1979	1980	1981 ⁽⁷⁾
<u>Contribution to change in implicit import price deflator (1):</u>									
1. Crude oil price in US dollars	1,1	14,1	1,0	0,7	1,9	0,2	4,4	7,8	1,5
2. Other commodity prices in US dollars (2)	6,7	3,6	-1,0	0,7	1,4	0,3	1,5	1,3	-0,4
3. Effect of \$/ECU exchange rate on above prices	-2,7	1,1	-0,9	2,9	-0,5	-2,7	-2,0	-0,5	6,9
4. Other import prices (1) (3) (4)	7,5	17,5	5,4	7,7	5,6	3,2	7,1	6,3	8,3
5. Total change in implicit import price deflator (in ECU) (1) (3)	12,6	36,3	4,5	12,0	8,4	1,0	11,0	14,9	16,3
6. Change in implicit export price deflator (in ECU) (1) (3)	8,7	23,2	7,7	9,6	8,3	4,0	9,7	11,7	11,8
7. Change in terms of trade (1) (3) (5)	-3,5	-9,6	3,1	-2,1	-0,1	3,0	-1,2	-2,7	-3,9
8. Effect of terms of trade on real domestic income (6)	-0,9	-2,6	0,8	-0,6	-0,0	0,9	-0,4	-0,8	-1,2

(1) Goods and services.

(2) Imports of food and raw materials (SITC 0-2,4) from outside the Community for which the dollar prices are assumed to move in line with UN price index for primary commodities excluding crude petroleum.

(3) Including intra-Community trade.

(4) Including small changes in implicit deflator due to changes in trade structure.

(5) Percentage change in ratio of implicit export price deflator (line 6) to implicit import price deflator (line 5).

(6) Difference between exports deflated by change in import prices and same exports deflated by change in export prices as percentage of GDP in first period.

(7) Forecast.

Sources : Eurostat and Commission staff.

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Table 2.6

Simulations of impact on Community (EC-4) of exchange rate and interest rate changes

(percentage differences from base)

	20 % devaluation of ECU against the dollar		Rise in interest rates (2)		Combined effect of devaluation and rise in interest rates	
	1981	1982	1981	1982	1981	1982
<u>Volumes</u>						
Private consumption	-0,9	-1,5	-0,1	-0,2	-0,8	-1,3
Gross fixed capital formation	0,2	1,8	-1,1	-2,7	-0,9	-0,9
Exports of goods and services (1)	3,2	5,0	-0,6	-0,9	2,6	4,1
Imports of goods and services (1)	-0,3	-1,4	-0,5	-0,8	-0,8	-2,2
Gross domestic product	0,9	1,8	-0,4	-0,7	0,5	1,1
<u>Implicit price deflators</u>						
Private consumption	1,0	2,5	-0,1	-0,2	0,9	2,3
Exports of goods and services (1)	5,0	6,0	-0,1	-0,2	4,9	5,8
Imports of goods and services (1)	9,5	10,0	0,0	0,0	9,5	10,0

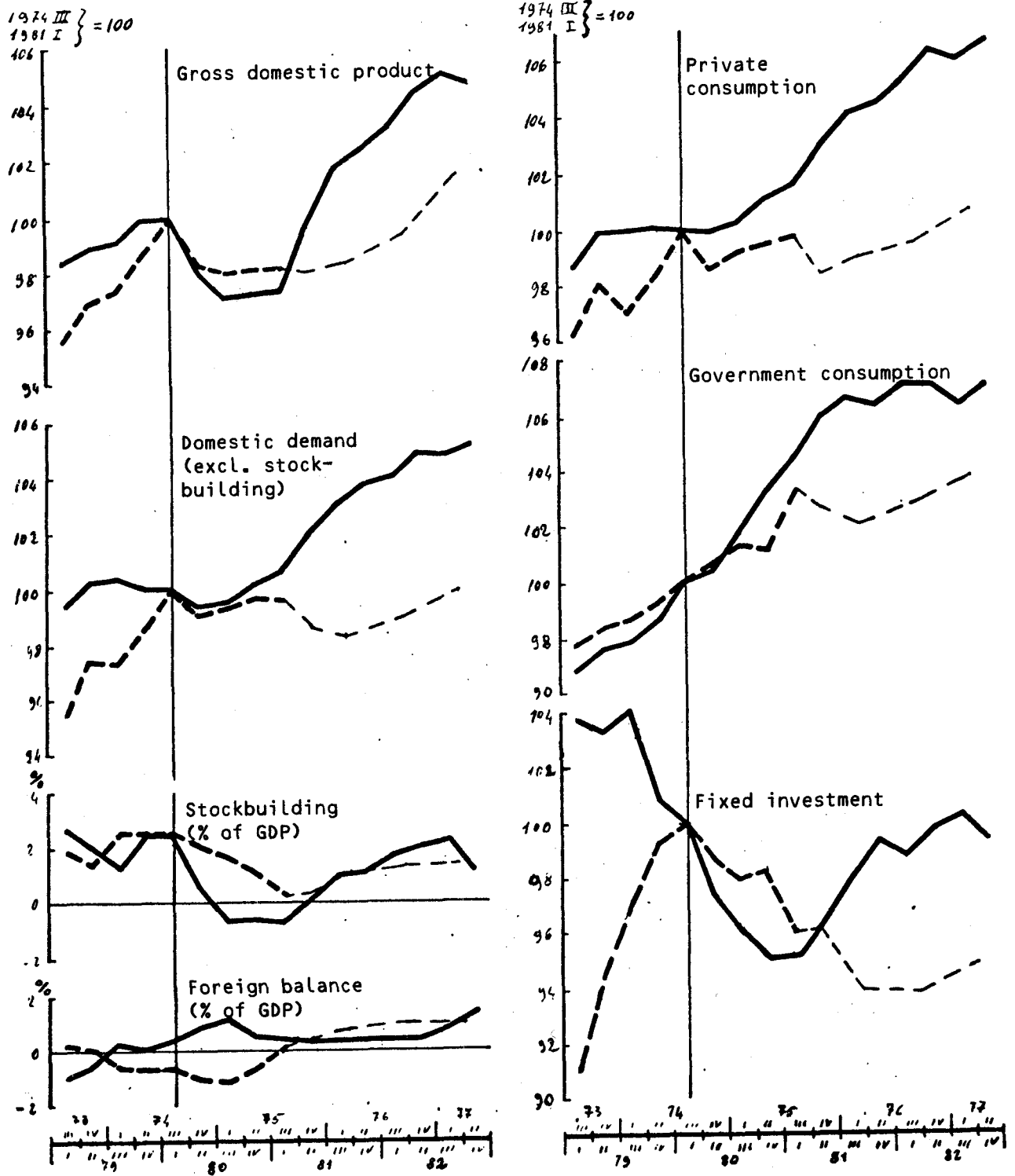
(1) Including intra-Community trade

(2) 3 percentage points increase in short-term rates and 1 percentage point increase in long-term rates

Source : Commission services

GRAPH 2.1

Comparison of cycles in 1973-77 and 1979-82 (EC-4)
(in volume terms)

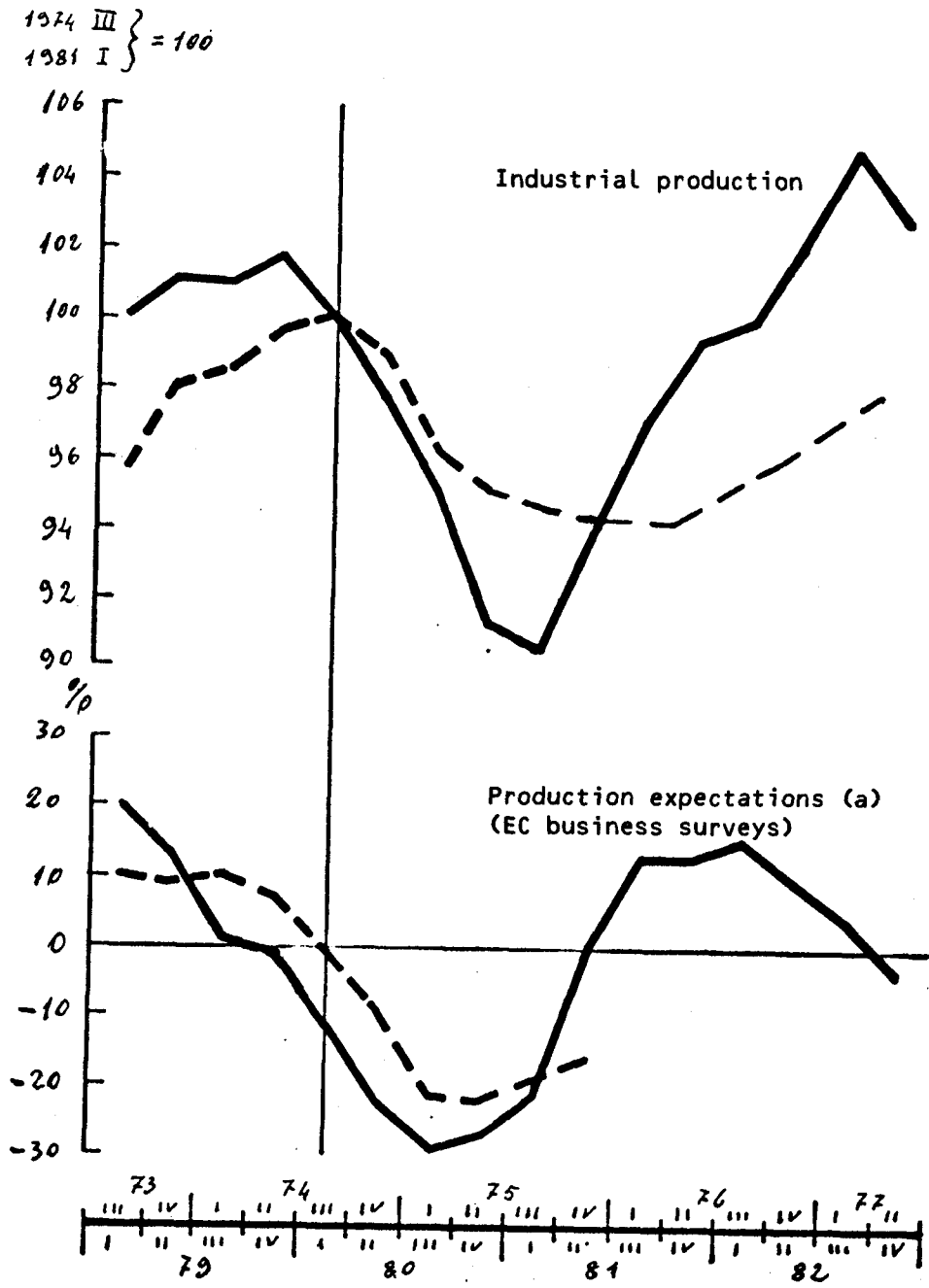


1973 III - 1977 II
1979 I - 1982 IV

actual
forecast

GRAPH 2.2

Cycles in industrial production and production expectations
(EC-10), 1973-77 and 1979-82



1973 III - 1977 II ———
1979 I - 1982 IV actual — — —
 forecast — — —

(a) Net balance: i.e. difference between the percentages of respondents giving positive and negative replies.

3. External performance : balance of payments

The adjustment of balances of payments to the most recent round of oil price increases has so far been relatively slow. This is particularly so for the Community which continues to experience a substantial current account deficit. This is due to a number of adverse factors not the least of which has been the very large appreciation of the US dollar which has prolonged the terms of trade deterioration initiated by the oil price increases of 1979 and 1980. The Community members, however, have had relatively little difficulty in financing their current deficits and the capital flows resulting from interest rate and exchange rate developments, although financing was largely by means of public sector external borrowing. Services continue to play an important role in Community countries' external transactions.

3.1 Adjusting to the oil price increases

Progress towards reducing the deficits induced by the oil price increases has been slower in the Community than in other major industrial countries. The increase in oil prices occurred at a time when the Community's current balance was already deteriorating due to a sharp rise in imports in 1979 which continued into 1980. The position was made worse as compared to 1973-4 by the very substantial difference in the performance of the German current account which, despite the quadrupling of the price of oil in late 1973, improved sharply in 1974 and largely accounted for the relatively modest effect of the 1973 oil price increase on the Community's current balance as a whole. In 1979, however, the non-oil trade balance in Germany was deteriorating slightly which, combined with the oil price increases and a continued deterioration in other items of the current account, pushed the German current account into a substantial deficit. Hence for the Community as a whole, the current account deteriorated by 23 000 million ECU in 1979 and by a further 19 000 million ECU in 1980 so that the current deficit was much larger than after the oil price increases of 1973-1974.

The Community's deficit is expected to remain sizeable for some years to come. So far as 1981 is concerned, it is expected that the deficit will decrease, although only very slightly. Both the Netherlands and the United Kingdom will be in surplus on current account. Among the other

member countries only Germany and Denmark will have a slightly improved position this year with modest declines in the size of their deficits while in Ireland and Belgium the current deficits will increase significantly. While forecasts for 1982 suggest some improvement, the deficit is still expected to remain very large. The German current account position will be substantially improved but some deterioration is expected in the French deficit. The deficits of the other Community members will remain broadly unchanged but the United Kingdom's surplus will decline sharply while that of the Netherlands will increase. Thus there has not yet been an overall recovery of the Community's external position in the first two years after the latest round of oil price increases.

In the U.S. and Japan there was a more immediate response to the oil price increases. Imports fell sharply in 1980 and this, combined with a very strong export performance, helped to counteract the deterioration in the terms of trade. The very strong export performance of both the U.S. and Japan may have owed something to the structure of the growth in world imports when there were substantial increases in the value of imports in Opec countries and in European countries, both within and outside the Community, but imports declined in the U.S., Japan and Canada. Undoubtedly also the increase in U.S. and Japanese exports is at least partly due to the lagged effects of the depreciation of their currencies in previous years.

In the Community, on the other hand, not only did imports continue to grow in 1980 but also the Community's export performance was relatively weak. Thus, for some years now, the Community's exports

have been growing in volume terms more slowly than its export markets so that the Community has been losing market share. This is in sharp contrast to the United States which has been gaining market shares over the past few years. Japan has had a somewhat variable performance with very sharp losses in market share in 1978 and 1979 and with a strong recovery in 1980 and 1981.

The slow adjustment by the Community of its external position is also due to a continuing deterioration of the terms of trade into 1981. Because the immediate effect of a depreciation is to alter the terms of trade unfavourably while the favourable real effects only result later, the recent depreciation of Community currencies against the dollar has had an unfavourable impact on the Community's current account. Thus while the U.S. and Japan are experiencing the favourable effects of the depreciation of their currencies in the period 1977 to 1979, the depreciation of Community currencies against the dollar in 1980 and 1981 has prolonged the terms of trade deterioration initiated by the oil price increases. Over the three years 1979 to 1981 the cumulative terms of trade loss for the Community amounted to 2.9 % of GDP and, although the relative terms of trade loss for the Community is less than that incurred by Japan, the Community's terms of trade continued to deteriorate this year while in both the U.S. and Japan there were no further terms of trade losses. This, combined with their much stronger real performance, enabled them to achieve the continued improvements in their balances of payments.

Within the Community the terms of trade loss relative to GDP has been very large for some of the smaller Community members (Ireland, Greece, BLEU and Denmark) and for Italy. For the other members there has been a loss equivalent to about 2% of GDP in the two years 1980 and 1981 except for the U.K. which had a slight terms of trade gain. One or two Community members have begun the process of offsetting the terms of trade loss of the past three years. Both Denmark and the Netherlands have had a very strong adjustment of net real exports amounting to a cumulative 7.9% of 1978 GDP in the case of Denmark and 4.8% of 1978 GDP in the Netherlands over the three years 1979 to 1981. Germany and Greece have also improved their net exports but not sufficiently to offset the terms of trade loss.

Overall, therefore, the pronounced movements in exchange rates have so far hindered the adjustment of the Community to the oil price increases. On the other hand the prospects for the coming years look somewhat better. While the appreciation of the U.S. dollar has had an immediate adverse impact on the Community's balance of payments, the Community's competitive position has improved. Its real net exports are thus expected to increase in 1982 while the terms of trade will stabilise.

3.2 Financing and reserves

The Community's current account deficit of 31,000 million ECU¹⁾ in 1980 was financed by inflows of capital of nearly 28,000 million ECU and by a fall in total reserves of 3,000 million ECU. The fall in reserves is explained wholly by a very sharp reduction of 11,000 million ECU in the reserves of Germany partially offset by reserve gains by all the other members. For Germany the net capital inflow was negligible and the current account deficit was wholly financed by the fall in reserves. This occurred despite substantial inflows of official capital both through direct official borrowing and other official inflows which were offset by large scale private sector outflows mostly associated with changing interest rate differentials on the DM vis-à-vis the USD and the changed outlook for the DM as a result of the current account deficit.

All the other member states, apart from the United Kingdom, had a positive inflow on capital account. However it should be noted that in many cases the favourable net capital position and increase in reserves resulted from large scale public sector foreign borrowing. Thus all Community members had official recourse to the international capital markets to finance their balance of payments and/or budgetary deficits with the

1) See footnote to table 3.3

exception of the Netherlands and the United Kingdom. While exact details of public sector external borrowing are not available it is clear that for Belgium, Denmark, Ireland and Germany public sector external borrowing was a dominant element in the net capital position of the balance of payments. In France and Italy, on the other hand, there appear to have been sizeable private sector inflows in addition to public sector borrowing mainly in the form of bank capital transactions.

The recourse to public sector external borrowing is in part a recognition of the fact that adjustment to the oil price increases cannot be immediate and that balance of payments deficits will have to be financed for a number of years. However, in some Member States the recourse to foreign borrowing is related not only to balance of payments financing but also to the need to finance domestic public sector deficits; recourse to domestic markets for financing these deficits would have disturbed domestic capital markets unduly. Thus in Belgium, Ireland, Greece and Germany official external borrowing was used to finance both fiscal deficits and external deficits. On the other hand, it must be recognised that recourse to official external borrowing, especially where this is denominated in foreign currency and the exchange risk is borne by the borrower may increase future balance of payments financing problems as a result of the need to service external debts. Thus in 1980 official external debt amounted to between 9 and 10 % of GDP in Belgium and Greece, over 16 % of GDP in Denmark and over 25 % of GDP in Ireland. As outstanding external debt increases, the pressures for policies of adjustment will increase also.

Despite the loss of exchange reserves during 1980 the total stock of reserves at the end of the year was greater than the previous year due largely to changes in the value of gold. Of the total stock of reserves at the end of 1980 over 70% was in the form of gold holdings. It should be noted that in table 3.4 gold has been valued at a market related price for each Community member whereas in the official reserve statements of the member states gold is valued according to national valuation methods. Nevertheless it is clear that gold is the largest component of Community reserves. Given the substantial

fluctuations in the price of gold there is a reluctance to give gold its full market value and there is a tendency to value gold conservatively. The fluctuations in the price of gold and the narrowness of gold markets relative to central bank stocks also make Central Banks reluctant to use gold actively as a reserve asset and gold reserves are now mainly used as asset backing for alternative forms of official balance of payments financing, e.g. direct government to government borrowing, and to maintain credit worthiness for official borrowing in the international capital markets. It should also be noted that a portion of the Community's gold stock has been partially monetised in the form of swaps against ECU which are in turn used for intra central bank settlements within the Community. The Community's holdings of currency assets amounted to over 66 000 million ECU at the end of 1980, of which the majority were held in dollar form. Nevertheless, other currencies accounted for about one sixth of this total and were relatively important in the cases of the U.K., Ireland and Italy.

3.3 Services and transfers

While the imports and exports of merchandise are generally the most important and largest items in the gross flows of payments underlying the current account balance, in terms of their contribution to the net balance, the services and transfers parts of the current account can have an important influence on the overall current account position. Thus the deterioration in the current account balance of the Community in 1980 was the result of a deterioration not only in the balance in merchandise trade but also in the services account. Although the gross flows of payments on services and transfers may be substantially smaller than those on merchandise trade account, their effect on the net balance of payments on current account can be equally important. The main components of the current account balances of the Community and the U.S. and Japan are given in table 3.5. Variations in the net balance of

services and transfers can be quite substantial (+ 0.4% of GDP) although, particularly at the time of structural shocks such as the rounds of oil price increases, the fluctuations are generally smaller than those of the trade account. Both the Community and the United States are net exporters of services. In the United States the favourable net balance on services has been growing to reach a massive 1.4 % of GDP in 1980, more than offsetting the negative balance on trade account even after the initial shock of the 1979 oil price increases. In the Community the net balance of services fell up to 1975 but has subsequently increased to 0.5 % of GDP. The Community, on the other hand, tends to have a substantial deficit in transfer payments which in absolute terms has been growing year by year and amounted to 0.8 % of GDP in 1980. Unlike the Community and the U.S., Japan has generally a deficit both on services and transfer payments which in 1980 amounted to 1.2 % of GDP.

Gross receipts and expenditure on external services for the Community amounted to 185,000 and 174,000 million ECU in 1980 or about 9 % of Community GDP. However the importance of trade in services to the balance of payments varies among the Community members. Table 3.6 indicates the size of gross external service flows relative to total trade in goods and services for the Community and the members. For the Community as a whole the service component of trade in goods and services amounted to 28% of exports and 26% of imports in 1980.

In Denmark and Belgium the importance of services in the current account has been growing with the ratio rising from 24 % to 35 % for exports and 25 % to over 33 % for imports in Belgium from 1970 to 1980 and from 27 % to 31 % for exports and 19 % and to 29 % for imports in Denmark. In Ireland, Italy and the U.K., on the other hand, the importance of services has declined particularly in Ireland where service exports and imports are now relatively small. The fall in the relative importance of services in Ireland is due to the sharp rise in Irish industrial goods exports as a result of the industrial development policy. The U.K. has an exceptionally high ratio of service exports and imports but these have been falling in relative terms over the last decade and exports and imports of services in 1980 amounted to about

33% and 30% of total exports and imports of goods and services, which for exports at least, is still above the Community average. In Germany, France and the Netherlands, exports of services have maintained their share of total exports of goods and services but in Germany the ratio of imports of services has been falling in recent years while in the Netherlands there appears to be an upward tendency.

The composition of trade in services for the Community members is given in table 3.7. In terms of gross flows the biggest service item is revenue from capital, i.e. interest, dividends and profits earned from or paid abroad. The Community is a net recipient on this account although the net balance is small relative to the gross flows. The flow of payments on this account is particularly large in the BLEU where the gross flows are of the same order of magnitude as those of France, Germany and the U.K. This is due to the role of the Luxembourg banks in the international money markets. Germany and France are the largest net recipients while the U.K.'s favourable net balance is tending to decline partly due to the growth in profits remitted by overseas oil companies operating in the North Sea, and to the increase in sterling investments by external holders, in particular in the oil producing countries.

The Community has a very substantial deficit on tourism which has been increasing in recent years. The deficit is due mainly to the large negative balance on this account for Germany which in 1980 amounted to approx. 10,000 million ECU or 1.7% of the German GDP. The German deficit on tourism has been growing in recent years and is a substantial factor in the deterioration of the overall German current account position; the deficit on tourism in 1980 more than offset the surplus on trade account. The two main net recipients on this account are France and Italy, particularly the latter.

Among the other service sectors the Community has a small net positive balance on transport services. These are concerned mainly with the transport of merchandise imports and exports and with civil aviation. In 1979 and 1980 Germany and the Netherlands were the largest net recipients although

in previous years Germany had a small deficit on this account while the Netherlands traditionally has a surplus. Since the major Greek shipping companies are not resident in Greece only their payments in Greece, mainly wages to seamen, are included in the balance of payments. Nevertheless this is an important item on the Greek balance of payments.

The Community also is in surplus on Government and other services. The latter include financial services and the provision of construction services abroad etc. The largest net recipient is the U.K. partly due to the earnings of the City which in 1980 amounted to 2,600 million ECU. France also is a substantial net earner on this account mainly due to the receipts from large scale foreign projects.

The Community has a very large deficit on transfer payments which amounted to 16,000 million ECU or 0.8% of GDP in 1980. About one third of the deficit is due to private sector transfer payments of which the most important are the remittances of foreign workers, particularly from Germany and France, (although Ireland, Italy and Greece are net recipients on this account). The major part of the deficit relates to public or official transfers. These include bilateral aid, pensions, and other payments to international organisations including the Community. Payments to Community institutions, of course, while representing a net inflow or outflow for the individual members, do not affect the overall balance of payments of the Community, except in so far as expenditure or receipts are incurred outside.

Table 3.1

Current balances 1979 to 1982

'000 million ECU

	1979	1980	1981 (forecast)	1982 (forecast)
BLEU	- 1.5	- 3.7	- 5.8	- 5.9
DK	- 2.2	- 1.8	- 1.7	- 2.0
D	- 3.7	- 10.4	- 8.8	- 2.1
GR	- 0.8	- 0.7	- 1.0	- 1.1
F	+ 0.3	- 6.3	- 7.1	- 10.5
IRL	- 1.1	- 1.0	- 2.2	- 2.1
I	+ 3.9	- 7.1	- 7.1	- 4.9
NL	- 1.5	- 1.7	+ 0.7	+ 3.1
UK	- 2.6	+ 4.6	+ 5.3	+ 2.5
EC	- 9.2	- 28.1	- 27.7	- 23.0
USA	- 0.4	+ 2.5	+ 4.1	- 7.4
Japan	- 6.4	- 7.7	+ 3.6	+ 9.8

Source : Commission Services.

Table 3.2

Changes in the terms of trade and real adjustment 1979 to 1981

	Cumulative Terms of Trade Loss or gain as a % of 1978 GDP				Cumulative change in the real balance of goods and services ¹⁾ as a % of 1978 GDP			
	1979	1980	1981 (forecast)	1982 (forecast)	1979	1980	1981 (forecast)	1982 (forecast)
BLEU	0	- 2.3	- 5.5	- 6.4	- 1.0	- 0.6	+ 0.1	+ 1.0
DK	- 2.7	- 4.2	- 5.5	- 5.3	+ 1.2	+ 5.2	+ 7.9	+ 8.4
D	- 0.8	- 2.1	- 3.1	- 3.2	- 1.1	- 0.9	+ 1.0	+ 2.6
GR	- 2.9	- 7.3	- 12.3	- 16.9	- 0.8	+ 1.0	+ 1.8	+ 2.3
F	+ 0.1	- 2.1	- 1.6	- 4.1	- 0.7	- 1.1	- 1.3	- 0.2
IRL	- 4.9	- 9.5	- 17.6	- 17.2	- 4.8	+ 0.5	- 1.1	+ 1.3
I	- 0.4	- 3.3	- 5.6	- 6.1	- 1.2	- 4.4	- 1.5	- 0.7
NL	- 1.5	- 2.7	- 2.5	- 1.1	+ 0.8	+ 2.2	+ 4.8	+ 5.8
UK	+ 1.1	+ 2.9	+ 2.5	+ 2.0	- 2.3	- 1.2	- 0.9	- 1.6
EC	- 0.5	- 1.6	- 2.6	- 2.9	- 1.0	- 1.1	+ 0.3	+ 0.8
USA	- 0.2	- 1.4	- 1.1	- 1.3	+ 0.4	+ 1.3	+ 0.7	+ 0.2
Japan	- 2.1	- 5.1	- 4.9	- 5.1	- 0.9	+ 1.8	+ 3.1	+ 4.1

1) national accounts basis

Source : Commission estimates.

Table 3.3

Balance of payments financing 1980-1981

'000 million ECU

	Current balance	Non-monetary ¹⁾ capital	Banks	SDR allocation	Change in reserves ³⁾
1980					
BLEU	- 3.7	+ 1.5	+ 2.4	+ 0.1	+ 0.3
DK	- 1.8	+ 1.6	+ 0.3	+ 0.0	+ 0.1
D	- 10.4	+ 4.9	- 5.7	+ 0.2	- 11.0
GR	- 0.7	+ 0.7	+ 0.2	+ 0.0	+ 0.2
F	- 6.3	+ 5.5	+ 5.4	+ 0.2	+ 4.8
IRL ²⁾	- 1.0	+ 0.9	+ 0.6	+ 0.0	+ 0.5
I	- 8.6	+ 3.1	+ 6.2	+ 0.1	+ 0.8
NL	- 2.9	+ 0.4	+ 3.2	+ 0.1	+ 0.8
UK	+ 4.6	- 6.3	+ 2.1	+ 0.3	+ 0.7
EC	- 30.8	+ 12.3	+ 14.7	+ 1.0	- 2.8

1) includes errors and omissions

2) estimated

3) excluding gold valuation changes

Note : figures are on a transactions basis except for Italy and the Netherlands which are on a payments basis. This explains the discrepancy in the current balances of these two countries and hence in the E.C. total compared with those shown in table 3.1.

Source : Commission Services.

Table 3.4

Official reserves

'000 million ECU

	IMF Position and SDRs			Currency Assets			Gold			Total		
	1979	1980	1981	1979	1980	1981	1979	1980	1981	1979	1980	1981
	BLEU	0.9	1.0	1.2	1.7	2.7	4.0	10.4	19.5	18.3	13.0	23.2
DK	0.2	0.2	0.3	2.0	2.4	2.3	0.5	0.9	0.9	2.7	3.5	3.5
D	3.6	3.2	3.8	27.7	23.6	29.4	28.9	54.3	51.1	60.1	81.1	84.3
GR	-	0.1	0.1	0.6	0.8	0.6	0.9	1.7	1.7	1.6	2.6	2.4
F	1.0	1.5	2.1	6.6	10.5	10.2	24.8	46.7	43.9	32.5	58.7	56.2
IRL	0.1	0.1	0.2	1.4	1.9	1.8	0.1	0.2	0.2	1.6	2.2	2.2
I	0.6	1.1	1.4	8.4	9.5	7.8	20.2	38.0	35.8	29.3	48.6	45.0
NL	0.8	0.9	1.2	2.1	3.2	2.4	13.3	25.1	23.6	16.2	29.2	27.2
UK	0.9	1.4	2.3	11.7	12.4	12.7	5.5	10.7	10.1	18.1	24.5	25.1
EC	8.1	9.5	12.6	62.2	67.0	71.2	104.6	197.1	185.6	175.1	273.6	269.4

Note : 1979 and 1980, end December; 1981 end June.

Source : Commission Services.

Table 3.5

Components of the current balance¹⁾

	% of GDP			
	1970	1975	1979	1980
EC(10)				
Merchandise trade balance	+ 0.5	+ 0.6	- 0.5	- 1.2
Balance of services	+ 0.4	+ 0.2	+ 0.7	+ 0.5
Balance of transfers	- 0.6	- 0.8	- 0.8	- 0.8
Total current account	+ 0.3	0	- 0.6	- 1.5
USA				
Merchandise trade balance	+ 0.2	+ 0.6	- 1.3	- 1.0
Balance of services	+ 0.4	+ 0.9	+ 1.5	+ 1.4
Balance of transfers	- 0.3	- 0.3	- 0.2	- 0.3
Total current account	+ 0.3	+ 1.2	0	+ 0.1
Japan				
Merchandise trade balance	+ 1.9	+ 1.0	+ 0.2	+ 0.2
Balance of services	- 0.9	- 1.1	- 0.9	- 1.1
Balance of transfers	- 0.1	- 0.1	- 0.1	- 0.1
Total current account	+ 0.9	+ 0.1	- 0.8	- 1.0

1) balance of payments basis.

Source : Commission Services.

Table 3.6

Exports and imports of services 1970 - 1980 as % of total exports and imports of goods and services

	1970	1975	1978	1979	1980
BLEU exports	24.1	28.3	29.1	30.6	34.9
imports	25.0	27.2	27.3	29.1	33.2
DK exports	27.0	28.7	31.1	31.2	30.5
imports	19.3	21.5	25.4	26.6	29.4
D exports	20.2	19.8	20.4	20.1	20.6
imports	27.4	28.6	27.9	23.8	23.5
GR exports	44.3	44.6	49.3	48.8	51.1
imports	18.5	18.0	17.1	16.6	17.3
F exports	26.0	26.8	29.7	26.8	29.0
imports	25.4	26.2	26.3	23.2	24.0
IRL exports	29.6	21.9	19.4	12.1	:
imports	13.2	14.7	14.0	6.7	:
I exports	30.5	24.2	24.0	24.7	26.8
imports	26.2	23.0	20.8	19.6	19.7
NL exports	26.6	26.5	25.0	27.4	29.5
imports	23.0	24.5	24.3	27.0	29.3
UK exports	36.6	34.2	32.8	32.3	32.6
imports	32.0	27.1	26.5	27.4	30.0
EC ¹⁾ exports	27.0	25.9	26.2	26.0	28.0
imports	26.7	26.2	25.8	24.5	25.9

1) Gross : includes intra and extra.

Source : Commission Services.

Table 3.7

Services in the balance of payments 1980

'000 million ECU

	Transport		Tourism		Investment income		Labour income ²⁾		Government ³⁾		Other ⁴⁾		Total	
	+	-	+	-	+	-	+	-	+	-	+	-	+	-
BLEU	3.7	3.3	1.3	2.4	12.8	12.9	0.4	0.3	1.0	0.3	3.7	3.8	22.9	23.0
DK	1.9	1.6	1.0	1.2	0.7	2.0	:	:	0.1	0.1	1.6	0.8	5.3	5.7
D	7.8	4.6	4.8	15.0	9.5	8.2	1.7	2.7	4.5	1.2	7.9	10.1	36.2	41.8
GR	0.7	0.5	1.2	0.2	0.1	0.3	:	:	0.1	0.1	0.9	0.2	3.0	1.3
F	7.7	8.0	5.9	4.3	13.2	11.6	1.2	1.5	1.5	0.9	8.7	6.0	38.2	32.3
IRL	:	:	:	:	:	:	:	:	:	:	:	:	:	:
I	4.0	5.0	6.4	1.4	3.8	4.3	1.5	0.2	0.2	0.4	4.3	5.1	20.2	16.4
NL	7.1	5.3	1.2	3.3	7.4	7.6	0.4	0.3	0.3	0.3	4.0	3.6	20.4	20.4
UK	10.1	9.2	5.0	4.6	13.5	13.6	:	:	1.7	2.0	8.2	3.6	38.5	33.0
EC ¹⁾	43.1	37.5	26.7	32.3	61.1	60.6	:	:	9.4	5.3	39.2	33.1	184.7	173.9

1) Gross : includes intra and extra.

2) eg : frontier workers, etc.

3) Military, representational, etc.

4) Financial and other services.

Source : Commission Services.

Table 3.8

Transfers in the balance of payments 1980

'000 million ECU

	Private ²⁾		Public ³⁾		Total	
	+	-	+	-	+	-
BLEU	0.5	0.8	0.7	1.4	1.2	2.1
DK	0	0.1	0.7	0.6	0.7	0.7
D	0.5	4.7	4.1	9.5	4.6	14.2
GR	0.8	0	0	0	0.8	0
F	1.1	2.9	3.3	4.4	4.4	7.3
IRL	:	:	:	:	:	:
I	1.3	0.3	2.1	2.4	3.4	2.7
NL	0.3	0.8	1.9	2.2	2.1	3.0
UK	1.3	1.8	1.6	4.6	2.9	6.4
EC ¹⁾	5.8	11.4	14.3	25.0	20.1	36.4

1) Gross : includes intra and extra.

2) Principally emigrants' remittances.

3) Principally aid to developing countries and contributions to/receipts from the Community budget.

Source : Commission Services.

4. Prices, costs, income distribution and relative cost performance

Due to the strength of Community currencies in 1979 and 1980, the impact of the oil price shock has been marginally less than in 1974-75 although exchange rate developments have extended the period of adjustment. The divergence in impacts on individual countries has been greater than previously but these effects have been moderated by a more restrained domestic response which has absorbed the shock rather than amplified it. Thus there has been a general reluctance to cushion economies from external price rises and wage reaction has been more moderate, although problems of inadequate corporate profitability remain in a number of countries. The sharp depreciation of Community currencies in 1981 has resulted in a considerable improvement in the relative cost position but has also added importantly to inflationary tendencies. The stability of exchange rates within the EMS in the period up to the realignment of 4 October has, however, not been accompanied by greater convergence of inflation performance.

4.1 Prices

Consumer price trends in the Community, measured by the implicit price index of consumers' expenditure (Table 4.1) continued to accelerate on a year-to-year basis in 1980 despite some slowdown noted in the latter part of the year. However this deceleration from 14,9% in the twelve months to May 1980 to 13,3% by December was halted and some further pick-up was recorded in the early months of 1981. Forecasts for 1981 as a whole suggest that this should be a temporary phenomenon and that a continuation in the downward trend can be expected in the second half of the year giving a Community average deflator of 11,3%, marginally down from the 1980 level of 11,8%. This trend is forecast to continue into 1982 when the average rate for the Community is projected to fall to 10,4%. Overall the deceleration in prices could be slower in the coming period than that recorded after the previous oil price shock.

The trend in the GDP price deflator, which reflects the overall change in domestic costs, showed a more even development over the most recent period and did not increase at such a rapid pace in 1980 as in 1975. Of greater note, however,

is the absence of an immediate second round reaction to the terms of trade loss in domestic costs whereas in the earlier period the initial impact was amplified substantially, as can be seen in Table 4.1 for 1975. This more favourable position is, nevertheless, counterbalanced by the lagged profile of the adjustment shown in the forecasts with the Community deflator dropping by less than two percentage points over the period 1980 - 1982, compared with the massive drop of 4 percentage points recorded in 1976.

On an overall basis the divergencies in inflation rate performance by countries in 1981 confirm existing classifications of inflation groups. Thus the Member States experiencing low inflation remain the Federal Republic of Germany, and the Benelux countries all within a range of between 5,8 and 8%. An intermediate group from 11 to 14% now also includes the United Kingdom, as well as Denmark and France, while to the higher group, between 19,5 and 24% and including Italy (where the price acceleration has been bigger than in 1974-75) and Ireland, must be added Greece which has moved up from the middle group.

Tables 4.2 and 4.3 endeavour to give a more detailed account of price trends by commodity and by origin, although there are some limitations in the data available already referred to in the previous Annual Review. The category fuel and light continues to outpace the price rises of other goods in the latest period available although at a Community level increases in this category are moderating. This, however, is not the case in all member countries. In the Netherlands, and to a lesser extent in the Federal Republic of Germany, energy prices have accelerated primarily due to the lag in the linking of natural gas prices to those of oil. It should be noted that other categories, particularly non-food goods and services also contain energy components. Non-food goods were again the largest contributor to the rise in prices, by virtue of their weight in the total, but this contribution

has declined in the most recent period studied. Aside from "fuel and light" only the category "services" has made a greater contribution to the rise in prices than its weight in the total would warrant. This was particularly true in the case of Italy, due mainly to more substantial adjustments than usual in the early part of the year of public utility charges and insurance. Only in France and Belgium have services not shown a greater contribution to inflation than their weight in the total. This general movement could indicate some secondary reaction to the initial shock or a more speedy adjustment of public enterprise charges. The category "food" is still having a moderating effect on inflation although some upward pressure is evident in the most recent period as Community agreed price increases feed through into the index.

The other method of examining the components of inflation is shown in Table 4.3 which shows the contribution of principal inputs to the rise in the price of total final expenditure. The contribution of imports to the rise in the total price level is 3,6% in 1981. Although the contributions in the individual years are far less than the massive 8,3% contribution recorded in 1974 this has been mainly due to the greater strength of Community currencies against the dollar than in 1974. Since the beginning of 1981 this effect has worked in the opposite direction so prolonging the stimulus to the rise in domestic prices. Although unit labour costs contributed less to inflation in 1980 than in 1974, a more significant factor is that of the decline in their contribution estimated in 1981 with a further tapering-off assumed in 1982 as against the severe amplification of the initial shock recorded in 1975. Indirect taxes are also shown to have contributed somewhat more to inflation in the recent period reflecting, undoubtedly, attempts by governments to change tax structures and/or redress their large deficits, this being particularly the case in the UK in 1979 and 1980.

In general, the price level has been affected to a considerable degree in most Community countries by the lack of government intervention in the price adjustment process. Policy has tended to place substantially less reliance on direct controls as a means of limiting inflation, preferring in most cases to let the full impact of external shocks bear on domestic prices. Also most countries have been quicker to adjust taxes on the consumption of energy as against the experience recorded earlier where the real value of such taxes was rapidly eroded. Community policy on farm products has continued to work in a price stabilising direction although this has been dictated to a greater extent by the desire to avoid excess supply on markets rather than to influence inflation rates directly. Initial Commission proposals for the 1981/82 agricultural year were for an average increase in common prices of 7,8% but this was subsequently raised by the Council to 9,4%. As can be seen from table 4.2 increases in food prices in the Community since 1978 have been less than the rise in the general price level.

4.2 Labour costs

The rise in nominal wages and salaries per person decelerated in 1981 to 13,1% in the Community without reaching the high rate of growth recorded in 1975 (16,3%); a further easing is projected for 1982.

Although the overall level of divergence between Member States, as measured by standard deviations, was slightly less in 1980 than in 1975, the improvement has been less pronounced in 1981. Additionally, divergence is considerably greater among the EMS group of countries in 1980 and 1981 (with standard deviations of 5,9 and 5,3 respectively) than was the case between snake currencies in 1975 and 1976 (3,1 and 2,5) indicating in general greater potential for disequilibrium on foreign exchange markets. Thus for example nominal per capita compensation of employees rose by over 20% in Italy and Ireland in 1980 compared to 5,7% in the Netherlands (the country with the lowest labour cost increase). For 1981 some improvement is registered, with the increases moving down to 19,3% for Italy, to 18,4% for Ireland but also to 4,3% for the Netherlands. It should be noted that the gap has not been bridged by greater productivity in the high wage countries since the gain in productivity (measured by the increase in volume of GDP per head) average around 1% p.a. in these three countries for the two years in question. Other EMS countries in 1980 were ranked between these extremes in the ascending order Federal Republic of Germany, Belgium, Luxembourg, Denmark and France, and this order was maintained in 1981. Developments in the United Kingdom showed a marked slowdown in nominal per capita compensation of employees estimated for 1981 after a steep upward trend from 1977 and reflects the very severe macroeconomic and monetary conditions. However, despite this turnaround with a near halving of nominal pay rises from 21% in 1980 to 12% in 1981, only limited progress has been made towards compensating for the massive rises in real compensation of employees over the years 1978 to 1980 since the rate of inflation is falling rapidly as well.

The performance of real compensation of employees may be considered together with institutional mechanisms for the indexation of pay, or otherwise. In Belgium, Luxembourg and Italy which have the most comprehensive and rapidly-working systems of linking hourly wages to a price index (in the latter country the indexation system was even speeded up in March 1980 by making adjustments at quarterly intervals in the public sector), real compensation of employees has appeared immune to cutbacks,

although this was also the case in certain countries where indexation does not apply. In the Netherlands and Denmark where indexation systems are semi-annual and partial (the index used not including in particular, the effects of increases in indirect taxes - already since 1963 in the Danish case) the results have been mixed. The indexation system in the Netherlands was modified in July 1980 when an indexation payment was replaced by a fixed sum and in January 1981 when measures were taken to achieve a reduction of 2 percentage points in the automatic link, as well as a reduction of 0,5 percentage points in holiday allowances. These changes would appear from the table to have achieved the aim desired of reducing real compensation in 1980 and 1981. In Denmark energy prices were excluded from the index with effect from January 1979 and the index was rebased again in 1980 (with the aim of reducing the number of tranches of indexation payments) and two tranches actually abolished in March 1980 (1). However although the reduction in purchasing power brought about has been significant in the past, forecasts for 1982 suggest some recovery in purchasing power, on the basis of present policies, in 1982. For Ireland, where indexation is not directly applied but tends to form the starting point for pay negotiations, real compensation of employees increased quite vigorously, although some slowdown is estimated for Ireland in 1981, after the massive increases of the previous three years. In France where only the minimum salary is indexed real compensation showed steady progress over the period.

The other non-indexed countries have also followed differing paths. Thus in the Federal Republic of Germany, real compensation has increased each year up to 1981 although at somewhat more modest rates in the period 1979-1980 whereas in the United Kingdom periods of large rises in real compensation have alternated with falls.

Overall it is clear that in certain countries indexation, even in cases where inflation has been kept down, produced rigidities which made adjustment more difficult and limited the powers of policy to confront problems, but it is also obvious that the absence of automatic indexation did not eliminate all problems of rapid adjustment. Indexation practices are in themselves highly variable in their actual application, and for this reason the Commission's recent Recommendation on Indexation lays particular stress on the principles that should govern their use.

(1) For further details see European Economy, N° 8 - March 1981.

Table 4.5, which gives figures for labour costs per unit of output, shows a fairly similar though somewhat more encouraging picture than the previous table. Thus real labour costs per unit of output rose substantially less in the Community in 1978 to 1981 than in 1975 as wage claims were pitched at a more moderate level. On a country basis the only exceptions were the Federal Republic of Germany, where productivity performance has weakened, in contrast to previous results, and Ireland where wages rose remarkably, but where some improvement should come through in 1981 and 1982 as employer resistance firms up. In Belgium real labour costs per unit of output continue to increase steadily over the period covered in the table. Another country which saw substantial problems emerge in 1980 was Luxembourg. Here the erratic year to year movements in the GDP deflator complicate the analysis but some slippage seems to have been recorded on the wage front in 1980 and into 1981, a factor which undoubtedly led to recent government measures on wages in the steel industry. Figures for the United Kingdom for 1981 and 1982 from this table look considerably more promising but since they do not take into account exchange rate changes, a full consideration of their implication for competitiveness must be postponed to Section 4.4.

Apart from the problems of divergence mentioned above, on an overall basis the trend in real unit labour costs for the Community in total suggest a relatively favourable position, with productivity growth from 1976 to 1979 exceeding the rate of growth of labour costs, compensating for the large increase in real wages in 1974-75. The bulge in 1980-81 is considerably less pronounced and is forecast to be reversed in 1982.

4.3 Income distribution

The impact of the oil price shock on the terms of trade implies a loss of real incomes for all countries except the United Kingdom. To the extent that this transfer of real purchasing power from oil importing to oil producing countries is not compensated for by the growth in productivity, real incomes must fall. In order to preserve lasting price/cost relationships, this adjustment has to be borne by the personal sector if the burden is not to affect investment and the future growth of income. Graph 4.2 shows the real wage gap defined as the cumulative margin between real per capita compensation of employees and productivity, adjusted for the terms of trade⁽¹⁾; the criteria for this comparison is an unchanged income distribution. For the Community as a whole, the graph shows that on average in the period 1960-75 there was a movement in favour of wage earners. However this overall development was broken down into two phases, relative stability in the sixties and a marked shift towards employees in the early years of the seventies. In 1974 and 1975 there was a considerably more pronounced gain in the income share of wage earners, due in 1974 to the significantly negative terms of trade and in 1975 to the decline in output, combined in both years with considerable wage resistance. In the following four years the gains in wage share were gradually eroded but not significantly enough to offset the gains made in 1974 and 1975. In 1980 the terms of trade effect again unbalanced the situation and a further shift towards the wage sector was recorded. However this movement was more short-lived than in the earlier period and according to the forecasts should return to the pre-1980 level in 1982. The conclusion to be drawn from the Community total would therefore be that although, on the basis of expected developments, the 1980 change in income distribution is likely to be adjusted for, there still remains a residual downward readjustment margin for the Community wage share if the distribution of income which pertained in the late sixties was to be re-established.

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(1) The adjustment method used is that proposed by J.L. Nicholson, "The effects of international trade on the measurement of real national income" Economic Journal, September 1960.

As far as individual Member States are concerned, Belgium and Luxembourg show perhaps the most striking developments. In these countries there has been a virtually continuous movement in favour of employees in the income distribution and only in the forecast for 1982 is any stability foreseen. The positive movement in favour of wage earners has also been important in France, despite some fluctuations. Movements in Italy and Ireland have also been significant but the increase in the labour/income ratio can be explained to some degree by movements out of subsistence agriculture into higher paid industrial occupations. The remaining countries are clustered in a group with small or even marginal shifts in favour of labour income. However natural gas and oil in the Netherlands and the United Kingdom respectively has meant for these countries deteriorations for the economy as a whole, although for manufacturing industry the movement of income distribution against profits has been substantial.

4.4 Relative cost performance

Over the period 1974 - 1980 unit labour costs in manufacturing in the Community, measured in common currency terms, rose on average by 2,4% per annum in relation to competitor countries outside the Community (for a detailed commentary on the method used and historical data for Member States see European Economy No 8, March 1981, pages 91 - 99). In the United States, however, there was an annual fall of about 1,5% over the same period after an even more marked downward trend in the opening years of the decade. A more substantial fall (1,8% per annum) was recorded in Japan in the years under study, admittedly after a progressive upward movement in the earlier years of the seventies.

Developments until 1980 were a product of several different factors. Wages and salaries in national currency terms rose more quickly in both Japan and the European Community (average of around 13% per annum) than in the United States (not quite 10%). However productivity growth in manufacturing in Japan at nearly 7% per annum was substantially in excess of that in the Community (3 1/2%) which in turn was substantially above the annual increase in the United States (1 1/2%). Labour costs per unit of output accordingly rose over the period at annual rates of just under 10% in the Community, 8 1/2% in the United States and 5 1/2% in Japan. Annual data for the movements of "relative" labour costs in national currency are presented in the second part of Table 4.6 and these were reinforced over the period up to 1980 by depreciations in the effective rate of the United States dollar and in 1979 of the yen while the opposite was the case with respect to the Community.

Since 1979 the gap in performance has become even more pronounced with the Japanese economy recording massive gains in competitiveness in 1979 and 1980 mainly due to low increases in relative unit labour costs in national currency reinforced by the decline in the effective exchange rate. The United States more or less increased its competitive edge built up in the first half of the decade until 1980, while the Community position continued to deteriorate both in national currency and to an even greater extent in common currency terms. More recently on the basis of Commission forecasts for 1981 a reversal of this position can be seen. In Japan, after some faltering in the second half of 1980, productivity is likely to pick up in 1981. In addition wages and salaries are

running below 6% due to the moderate wage round of 1980, with not much acceleration foreseen in forthcoming pay negotiations. Thus a continuation of the regular fall in Japanese relative labour costs in national currency recorded since 1976 is likely to be registered in 1981, ensuring that the marked appreciation of the effective rate of the yen (14.3% in 1981 on the basis of the assumptions of stability for the rest of the year) will only have a limited effect on the accumulated competitive position of Japanese industry built up over 1979 and 1980. On the other hand, the dramatic rise in the effective exchange rate of the dollar, since towards the end of 1980, has reinforced the weak position in national currency terms in 1981 of the United States, and means that the Community's cost competitiveness is restored to its 1970 level. The danger, however, exists that the deterioration in Europe's effective exchange rate may feed into labour costs to a greater extent than provided for in the forecasts.

Among the Member States, the largest deterioration in relative cost position since 1974 has occurred in the United Kingdom. The decline in British competitiveness over the period 1978-80 is unparalleled with relative labour costs in common currency increasing in total by nearly 60%. This has involved static or declining productivity, large wage increases and substantial rises in the effective exchange rate. Although some productivity gains may be made during 1981 and although the exchange rate of the pound has eased against the dollar, it is still relatively firm against the continental currencies. On present exchange rate assumptions, the effective rate of sterling, as shown in the first part of the table, will only show a slight depreciation, mainly as a result of positive carryover from 1980, as against strong depreciations in other Member States. Therefore, despite a considerable moderation in pay demands through the year and some gains in productivity, a further deterioration in competitiveness could be registered in 1981, although not nearly the magnitude recorded in 1980. Taking the EMS group of countries together the Federal Republic of Germany, Denmark and the Benelux have improved their relative labour cost positions in common currency appreciably in 1980, largely through the fall in relative labour costs in national currency, but also with an effective exchange rate depreciation in Denmark. On the other hand, in Ireland and to a lesser extent in France and Italy, relative labour costs in common currency increased despite effective exchange rate depreciations in the Irish and Italian cases. In 1981 all these countries should experience an improvement in their competitive positions due to the large appreciation of the dollar. The Federal Republic of Germany should record a large gain in relative

wage costs in national currency with most deals in the 4 to 5% range in the present round, as productivity picks up somewhat. Similar, although less favourable, patterns should apply in the other countries. However, in Italy the improvement could be fairly minimal as productivity declines and wage increases fail to slow down appreciably and in the United Kingdom a further decline in relative labour costs is expected.

Major developments in Prices and Incomes Policy

Belgium: Following a series of proposals by the Government and the entry into force at the beginning of January 1981 of a law containing interim and transitional income restraint measures ("mini-law on restraint") which froze incomes in excess of BF 35,000 per month, except for index-linked increases, general agreement was reached between two sides of industry for the period 1 January 1981 to 31 December 1982 on wage restraint arrangements. These permitted the application of existing wage scales and sectoral agreements, provided that they had been concluded before 1 January 1981 and allowed an extension of these for 12 months from their expiry date. New agreements can now be negotiated which, depending on working hours already in force, provide for a maximum of a 1% per year wage increase over and above the index-linked increase or a phased reduction in working hours totalling not more than one hour at the end of two years.

A freeze on prices was introduced in April 1981 on the basis of 19 March levels and was extended until the end of May on a selective basis. Exceptions were made for products subject to programme contracts (such as oil) and later for reasons of profitability or increased costs. Price controls were removed on 1 October 1981. In November 1980 the law on rent control was extended by one year, the authorised increase being raised to 6% as opposed to 5% in 1980.

Denmark: The national pay agreement which expired in early 1981 was renewed in a number of sectors and trades in February of this year. The agreements implemented were negotiated separately in almost all cases without legal intervention by the Government which had been the case from 1975 until 1981 due to failure to obtain agreement. They provided basic pay rises which varied by branch but in general were between 1 1/2 and 2 1/2%; wage drift was frozen until the end of the year. In addition to the measures taken in 1979 to exclude energy items from the wage regulating index, a monetary limit (0,90 Dkr per hour) was fixed for the maximum increase per index portion released. The absence of Government legal intervention in the negotiations has been explained by the need felt by the two sides of industry to reassert their autonomy as regards the Government, and to decentralise negotiations allowing developments in each sector to be taken into account, as well as by the Government's position on the permissible rise in wage incomes (see also box on "Incomes policy in Denmark" European Economy, No 8, March 1981).

The controls on prices, profits and dividends adopted in December 1979 expired at the end of February 1981 but it was decided to extend the rent freeze to the end of April. Accordingly, only very limited regulations governing price increases exist, principally aimed at controlling monopolies.

Federal Republic of Germany: No direct influence is exercised by the Federal authorities on income formation. However, the recent tax programme which granted certain reliefs to wage earners could be interpreted as giving support to moderation in wage claims. As regards prices, the desire of the authorities to let market mechanisms work was reflected in recent measures to increase excise duties on mineral oil and abolish certain subsidies on petrol.

Greece: Although automatic indexation has not applied in the past, increases in minimum wages and salaries are subject to Government norms which take account of past price rises. Wage and salary contracts, negotiated on a tripartite basis, include a clause which, subject to certain restrictive conditions, provides for a further flat rate increase in the event that price increases, in the twelve months to end of December 1981, exceed a threshold of 20%.

On 10 February 1981, prices of goods and services were freed from control except for certain categories of products. In May, a further series of products were decontrolled, leaving twenty-three basic consumer items still subject to price control. In addition, certain agricultural subsidies have been dismantled.

France: Wages are determined in annual collective agreements by industry, agreed between employers and representative trade unions. The Government does, however, act indirectly on incomes through its taxation and social policy and the determination of the SMIC (minimum inter-professional growth wage), as well as exerting its influences as an employer, with agreements in the semi-state sector often being used as a reference. In one of its first major policy decisions on 3 June, the new Government raised the SMIC by 10% which represented an increase of 6,7% in purchasing power terms.

The progressive elimination of controls on prices was pursued in the early part of the year with the decontrolling of the prices of a number of foodstuffs and café prices with effect from 26 March 1981 (see box "Lifting of price controls in France", European Economy, No 8, March 1981) More recently the new Government introduced price surveillance on certain services in tourist regions and took measures to improve consumer information. From 3 October 1981 the prices of services, key basic foodstuffs and importer's profit margins were frozen for three months.

Ireland: The second National Understanding finalised in September 1980 governs pay for a 15-month period starting for the majority of workers on 1 October 1980. In addition, it included commitments by the Government to increase certain tax allowances and social welfare payments. A review provision, which was included in the second phase of the agreement and applied if prices in the period May 1980 to February 1981 exceeded 10%, was invoked by the unions but the employers rejected these demands.

No alterations were made to existing controls on prices, under which sanction for increases in prices of specified goods and services must be obtained from the National Prices Commission before the increases can be implemented. In May, direct government measures were taken to increase subsidies on butter, milk, bread and flour and in August further subsidies on milk were introduced. In addition, sanctions for increases in prices of public transport and electricity were withheld until July.

Italy: Although various propositions have been made for the modification of the indexation of wages on prices, which has existed in industry since 1945-46 and was harmonized by the law of July 1975, no changes have as yet been made in the existing system. Neither have any changes occurred in prices policy which involves administered prices for a limited number of goods and services and surveillance of other prices by an Inter Ministerial Committee.

Luxembourg: In May 1981 the Tripartite Conference on the Steel Industry reached agreement on measures to limit the growth of wages in this sector which accounts for 36% of the Luxembourg work force. In the industry, the salaries of white collar staff will be frozen in real terms over the period January 1981 to December 1983, all advance indexation payments will be suspended and the sliding wage scale will be delayed by one month.

Under price control arrangements already in force, the Government, in February, authorized an increase in the prices of certain products and services in order to align prices to those charged abroad.

Netherlands: In the absence of agreement between the two sides of industry, the Government took measures in November 1980 to moderate the rise of wages and salaries in 1981, after the partial suspension of the indexation mechanism in 1980 and the payment of a flat rate monetary amount to all wage earners. These measures took the form of a cut of 2 percentage points in the adjustment of wages to price rises in January 1981, and in the holiday allowance of half a percentage point. The ceiling of the holiday allowance was set at 7 1/2% of an amount corresponding to two and a half times the "dominant" wage (that of the largest category of wage earners). In order to compensate for the effects of these measures on purchasing power, tax allowances and transfers were increased.

No additional measures to control prices directly were implemented during the year under review.

United Kingdom: The principle of free collective bargaining was maintained in the past year in the United Kingdom. The authorities only intervened in the public sector, where a 6% cash limit was proposed for pay in central government and the health services in the pay round to 1 August 1981. In addition, local authorities were asked to observe this limit for their employees also. The 6% cash limit was replaced by a 4% figure for the pay round 1981/82.

Following the abolition of the Price Commission in 1979, detailed price controls no longer apply in the United Kingdom.

Table 4.1

Consumer prices and the GDP price deflator

(national currencies) (percentage increase)

	1961-74 (average)	1975	1976	1977	1978	1979	1980	1981 estimate	1982 forecasts
Consumer prices									
B	4,3	12,4	8,0	7,0	4,2	3,5	6,4	7,5	7,0
DK	6,7	10,0	9,4	10,8	9,4	9,6	11,9	11,2	9,4
D	3,9	5,9	4,4	3,9	2,6	4,0	5,4	5,8	4,5
GR	4,8	12,9	13,3	12,0	12,3	18,2	23,7	24,1	22,5
F	5,3	11,4	9,9	9,0	8,7	10,3	13,2	13,5	13,0
IRL	6,6	22,3	18,7	12,7	7,2	12,2	18,2	20,0	16,0
I	5,8	17,6	18,1	18,2	12,9	15,0	20,3	19,5	16,9
L	3,5	10,2	9,5	5,8	3,5	5,8	6,3	8,0	7,0
NL	5,5	10,7	8,8	5,9	4,2	4,3	6,9	7,5	6,0
UK	5,7	23,5	15,5	15,1	8,9	12,5	15,5	11,8	10,5
EC-10	5,0	12,5	10,3	9,9	7,4	9,6	11,8	11,3	10,4
Standard deviation	1,8	5,4	4,4	4,3	3,5	4,8	6,2	6,0	5,5
GDP price deflator									
B	4,7	12,5	7,5	7,3	4,2	4,0	4,3	5,1	6,3
DK	7,2	12,6	9,2	9,0	9,2	7,3	8,4	9,2	6,0
D	4,3	6,4	3,4	3,8	3,9	4,0	4,8	4,4	3,9
GR	5,6	12,3	15,6	12,9	13,1	17,0	18,4	23,0	21,8
F	5,3	13,4	10,1	9,0	9,5	10,1	11,5	12,5	12,8
IRL	7,1	22,3	20,3	12,4	10,1	13,0	15,6	17,6	17,3
I	6,3	17,5	18,0	19,1	13,9	15,7	20,3	17,2	17,4
L	5,2	-1,0	13,0	1,5	4,4	7,0	5,1	5,7	6,7
NL	6,2	11,2	8,9	6,3	5,1	3,9	5,2	5,5	6,9
UK	5,8	26,8	14,3	13,9	10,7	14,6	18,9	10,9	9,1
EC-10	5,3	13,5	9,8	9,7	8,5	9,7	11,6	10,0	9,8
Standard deviation	2,3	7,3	4,9	4,9	3,6	4,9	6,2	6,1	5,6

Note: Consumer prices - implicit price index of consumers' expenditure. GDP price deflator = implicit price index of GDP.

Source: Eurostat and Commission services.

Table 4.2

Components of consumer price developments

(percentage increase)

	Food	Non food goods	Fuel and light	Rent (1) (2)	Services (3)	Total
EC-9 Total						
1974	12,3	14,6	25,4	8,1	10,1	12,4
1975	13,8	12,3	14,6	12,0	15,9	13,3
1976	12,9	8,9	12,9	11,2	12,3	10,8
1977	13,7	9,5	11,8	8,8	8,9	10,5
1978	7,4	7,3	7,1	6,4	9,3	7,5
1979	9,2	9,4	16,1	14,3	9,7	9,9
1980						
B	3,7	9,1	:	7,6	5,7	6,7
DK	10,1	11,8	42,5	7,4	9,2	12,3
D	4,1	6,5	10,3	5,1	4,4	5,5
F	9,9	14,5	25,9	13,0	13,0	13,6
IRL	10,7	19,7	41,8	19,8	:	18,2
I	15,7	26,7	51,1	20,5	15,2	21,2
L	3,6	:	17,3	:	:	6,3
NL	4,5	7,4	17,6	7,1	6,1	6,5
UK	13,5	16,0	25,1	28,9	23,5	18,0
EC 9	10,0	13,4	24,2	15,6	12,9	13,9
Percentage increase July 1981/ July 1980 (4)						
B	6,1	10,2	:	11,5	5,2	7,8
DK	9,9	10,7	29,6	7,5	13,2	11,6
D	4,4	6,0	14,3	4,3	5,9	5,8
F	14,6	11,2	22,3	13,7	11,4	13,4
IRL	16,2	22,3	25,3	13,2	:	20,1
I	18,9	21,2	36,4	14,9	23,0	21,0
L	9,8	:	10,6	:	:	8,5
NL	6,1	3,5	20,6	8,1	6,7	6,6
UK	7,7	9,7	20,6	16,5	13,4	10,9
EC 9	10,6	10,1	18,4	10,9	12,7	11,2

(1) Including repairs, maintenance and other expenses relative to property investment.

(2) For Ireland = housing.

(3) Excluding rent.

(4) August 1981/August 1980 for Ireland, June 1981/June 1980 for Italy.

Note: Consumer prices = consumer price indices.

Source: OECD and Commission services.

Table 4.3

Origin of price increases (final expenditure), EC 9

(Contribution to the increase in the deflator of total final expenditure)

	Imports	Unit labour costs	Indirect taxes (1)	Other factors (residual) (1)	Total (2)
1974	8,3	6,8	0,8	1,3	17,2
1975	1,0	7,4	1,3	2,2	11,9
1976	2,8	3,2	1,1	2,5	9,6
1977	2,0	3,6	1,0	2,1	8,7
1978	0,1	3,1	0,9	1,7	5,8
1979	2,1	3,6	1,3	1,9	8,9
1980	3,2	5,0	1,5	2,2	11,9
1981 (3)	3,6	4,5	1,2	1,9	11,2
1982 (4)	2,4	3,7	1,0	3,0	10,1

(1) Per unit of output.

(2) Total = deflator of final expenditure.

(3) Estimate.

(4) Forecast.

Source: Eurostat and Commission services

Table 4.4

Per capita compensation of employees

(percentage change)

	1961-74	1975	1976	1977	1978	1979	1980	1981	1982 (forecast)
Per capita compensation of employees									
B	9,6	16,4	15,3	9,3	7,4	5,3	7,8	8,8	7,3
DK	11,3	13,9	10,7	10,1	9,0	9,1	9,0	9,9	10,9
D	9,5	7,8	7,8	6,6	5,4	5,5	6,7	5,6	4,3
F	10,4	18,6	14,7	12,6	12,6	12,8	14,2	15,6	14,9
IRL	11,8	29,7	20,5	15,3	14,9	16,6	20,5	18,4	15,8
I	12,4	21,0	20,9	21,4	16,1	17,9	21,9	19,3	18,7
L	8,6	9,5	13,0	8,7	5,7	8,5	8,4	9,0	6,4
NL	11,7	13,3	10,9	8,1	7,1	5,9	5,7	4,3	7,6
UK	9,1	30,3	15,4	10,0	13,4	15,4	20,7	12,1	8,9
EC 9	10,2	16,5	12,4	10,1	9,7	10,6	13,4	11,5	10,8
Standard deviation	2,6	7,3	4,1	4,3	3,9	4,8	6,3	5,0	4,6
Real per capita compensation of employees (1)									
B	5,0	3,6	6,8	2,1	3,1	1,8	1,3	1,2	0,3
DK	4,3	3,5	1,2	-0,6	-0,4	-0,4	-2,6	-1,2	1,4
D	5,3	1,7	3,3	2,6	2,8	1,4	1,2	-0,2	-0,2
F	5,0	6,5	4,4	3,3	3,6	2,3	0,9	2,3	1,7
IRL	5,0	6,0	1,5	2,3	7,2	4,0	1,9	-1,3	-0,2
I	6,2	2,9	2,4	2,7	2,9	2,5	1,3	-0,2	1,5
L	4,9	-0,7	3,2	2,8	2,1	2,5	2,0	0,9	-0,6
NL	5,8	2,4	1,9	2,1	2,7	1,5	-1,1	-3,0	1,5
UK	3,2	5,5	-0,1	-4,4	4,1	2,6	4,5	0,3	-1,4
EC 9	4,9	3,6	1,9	0,2	2,1	0,9	1,4	0,2	0,3
Standard deviation	2,0	2,2	1,9	2,3	1,9	1,1	1,9	1,5	1,1

(1) Per capita compensation of employees deflated by the consumer price deflator.

Source: Eurostat and Commission services.

Table 4.5

Labour costs per unit of output : total economy

(percentage change)

	1961-74	1975	1976	1977	1978	1979	1980	1981	1982 forecast
Nominal labour cost per unit of output (1)									
B	5,2	17,1	8,8	8,2	4,3	4,1	5,1	7,4	6,6
DK	7,7	13,6	4,8	8,2	7,8	6,4	8,9	8,7	7,8
D	5,0	5,8	1,7	3,4	2,8	2,2	5,3	4,9	1,6
F	5,5	17,2	10,1	10,2	9,0	9,2	13,1	14,0	13,3
IRL	6,6	25,0	16,3	9,5	9,1	15,9	20,6	15,2	11,8
I	7,4	25,7	15,1	19,9	13,9	12,7	18,9	20,0	16,8
L	5,3	18,8	11,2	8,4	1,6	5,8	8,5	13,1	6,6
NL	7,3	13,7	5,1	5,9	5,0	4,5	4,9	3,9	6,1
UK	6,4	24,3	9,4	9,3	10,1	15,5	21,9	10,2	6,2
EC 9	5,7	16,3	7,7	9,1	7,8	8,6	13,1	12,2	9,3
Standard deviation	2,6	6,1	4,5	4,3	3,7	4,8	6,5	4,9	4,3
Real labour costs per unit of output (2)									
B	0,5	4,1	1,2	0,9	0,1	0,1	0,8	2,2	0,3
DK	0,5	0,9	-4,1	-0,8	-1,3	-0,8	0,5	-0,5	-2,0
D	0,6	-0,6	-1,6	-0,4	-1,1	-2,1	0,5	0,5	-2,2
F	0,1	3,3	0,0	1,1	-0,5	-0,8	1,4	1,3	0,4
IRL	0,3	2,2	-3,3	-2,5	-0,9	2,6	4,3	-2,0	-4,7
I	0,3	7,0	-2,5	0,7	0,0	-2,6	-1,2	2,4	-0,5
L	0,1	20,0	-1,6	6,8	-2,7	-1,1	3,2	7,0	-0,1
NL	1,0	2,3	-3,5	-0,4	-0,2	0,6	-0,3	-1,5	-0,7
UK	0,6	1,9	-4,3	-4,1	-0,5	0,8	2,5	-0,6	-2,7
EC 9	0,4	2,5	-1,8	-0,5	-0,5	-1,0	0,7	1,1	-1,1
Standard deviation	1,8	5,8	1,8	2,8	0,8	1,5	1,6	2,6	1,6

(1) Compensation per employee divided by gross domestic product per occupied person.

(2) Labour cost per unit of output deflated by the GDP price deflator.

Source: Eurostat and Commission services.

Table 4.6

Effective exchange rates, relative unit labour costs and relative cost performance of manufacturing industry, 1974-81

	B/L	DK	D	F	IRL	I	NL	UK	EC	US	JAP
Effective exchange rates (1) % change on previous year											
1974	1,8	0,7	6,3	-6,3	-2,7	-9,6	5,6	-3,5	-2,6	2,1	-6,5
1975	1,6	3,4	1,9	9,7	-5,3	-4,0	2,5	-7,6	2,4	-0,7	-3,0
1976	2,2	2,3	5,9	-3,7	-10,2	-17,4	2,8	-14,8	-8,4	5,2	5,0
1977	6,1	-0,3	8,5	-4,7	-3,1	-7,7	5,8	-4,8	0,9	-1,3	10,7
1978	3,7	0,4	6,8	-1,1	1,3	-5,8	3,1	1,1	3,0	-9,6	21,2
1979	1,5	-0,8	5,2	0,6	0,4	-3,2	1,7	6,4	5,8	-2,7	-6,7
1980	-0,3	-8,0	0,4	0,4	-2,6	-3,9	0,1	9,6	2,0	0,0	-4,0
1981 (4)	-6,5	-8,3	-7,1	-8,5	-10,6	-11,9	-5,9	-0,2	-15,8	13,1	14,3
1974 - 1981	1,2	-1,4	3,4	-1,8	-4,2	-8,1	1,9	-2,0	-1,8	0,6	3,4
Relative unit labour costs calculated in national currency (2) % change on previous year											
1974	4,0	1,2	-7,0	-2,7	1,3	4,3	-1,9	6,3	-3,5	-1,0	11,3
1975	-0,7	-8,8	-10,4	3,8	7,4	16,8	-0,7	16,2	3,3	-9,7	-0,9
1976	-1,2	-0,1	-4,2	4,0	3,3	5,7	-5,0	6,6	2,6	-0,8	-6,9
1977	-1,5	0,1	-2,9	0,8	2,2	10,7	-2,5	4,0	3,1	-1,3	-3,7
1978	-4,9	0,2	-2,4	1,9	-0,7	4,9	-3,4	6,0	2,3	2,7	-7,9
1979	-5,4	1,3	-4,0	3,5	0,4	3,0	-3,4	9,7	2,6	3,9	-8,1
1980	-4,3	-4,3	-2,5	1,6	8,5	5,6	-6,9	13,5	4,2	1,5	-6,9
1981 (4)	-2,8	-1,9	-5,5	4,0	2,2	11,8	-6,8	1,8	1,5	0,9	-3,4
1974 - 1981	-2,1	-1,6	-4,9	2,1	3,0	7,8	-3,8	7,9	2,0	-0,6	-3,5
Relative labour costs calculated in common currency (3) % change on previous year											
1974	5,8	1,9	-1,2	-8,9	-1,4	-5,8	3,6	2,5	-6,0	1,1	4,1
1975	0,9	-5,7	-8,6	13,9	1,7	12,1	1,8	7,3	5,8	-10,4	-3,8
1976	0,9	2,3	1,4	0,2	-7,2	-12,6	-2,3	-9,1	-6,0	4,3	-2,3
1977	4,4	-0,2	5,4	-4,0	-0,9	2,2	3,2	-0,9	4,0	-2,5	6,6
1978	-1,4	0,6	4,3	0,7	0,5	-1,2	-0,5	7,1	5,3	-7,2	11,6
1979	-3,9	0,5	0,9	4,2	0,8	-0,4	-1,8	16,7	8,6	1,1	-14,2
1980	-4,6	-12,0	-2,1	2,0	5,7	1,5	-6,8	24,4	6,2	1,5	-10,7
1981 (4)	-9,1	-10,0	-12,2	-4,8	-8,6	1,6	-12,3	1,5	-14,5	14,0	10,4
1974 - 1981	-1,0	-3,0	-1,7	0,2	-1,3	-0,9	-2,0	5,7	0,1	0,0	-0,9

(1) A positive figure denotes an appreciation in the effective exchange rate.

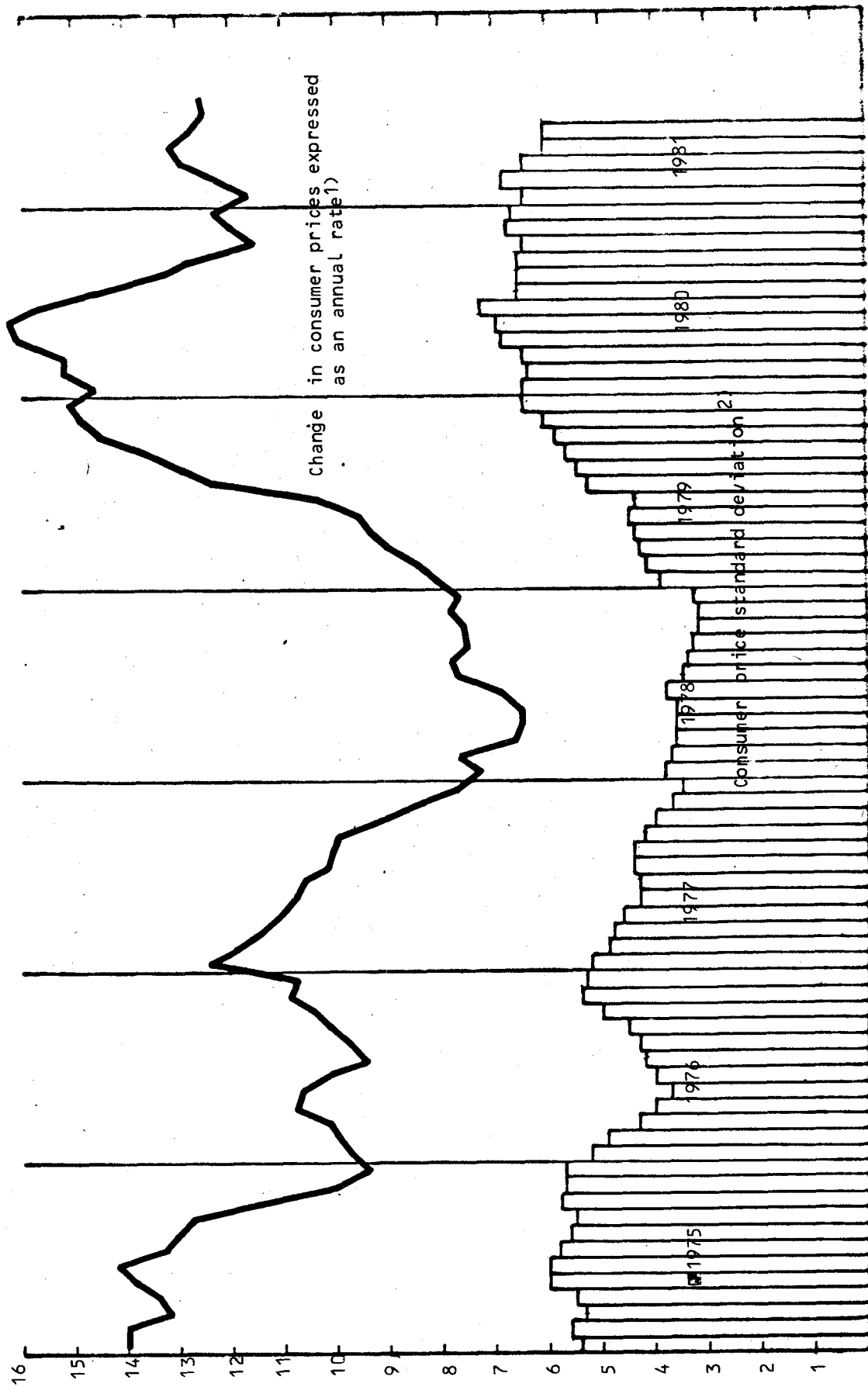
(2) Unit labour costs in manufacturing industry in national currency by reference to the weighted average for 17 main competing countries

(3) Unit labour costs in manufacturing industry in dollars by reference to the weighted average for the 17 main competing countries

(4) Provisional forecasts on the basis of September 1981 exchange rates.

Source: Eurostat, estimates and forecasts by Commission services

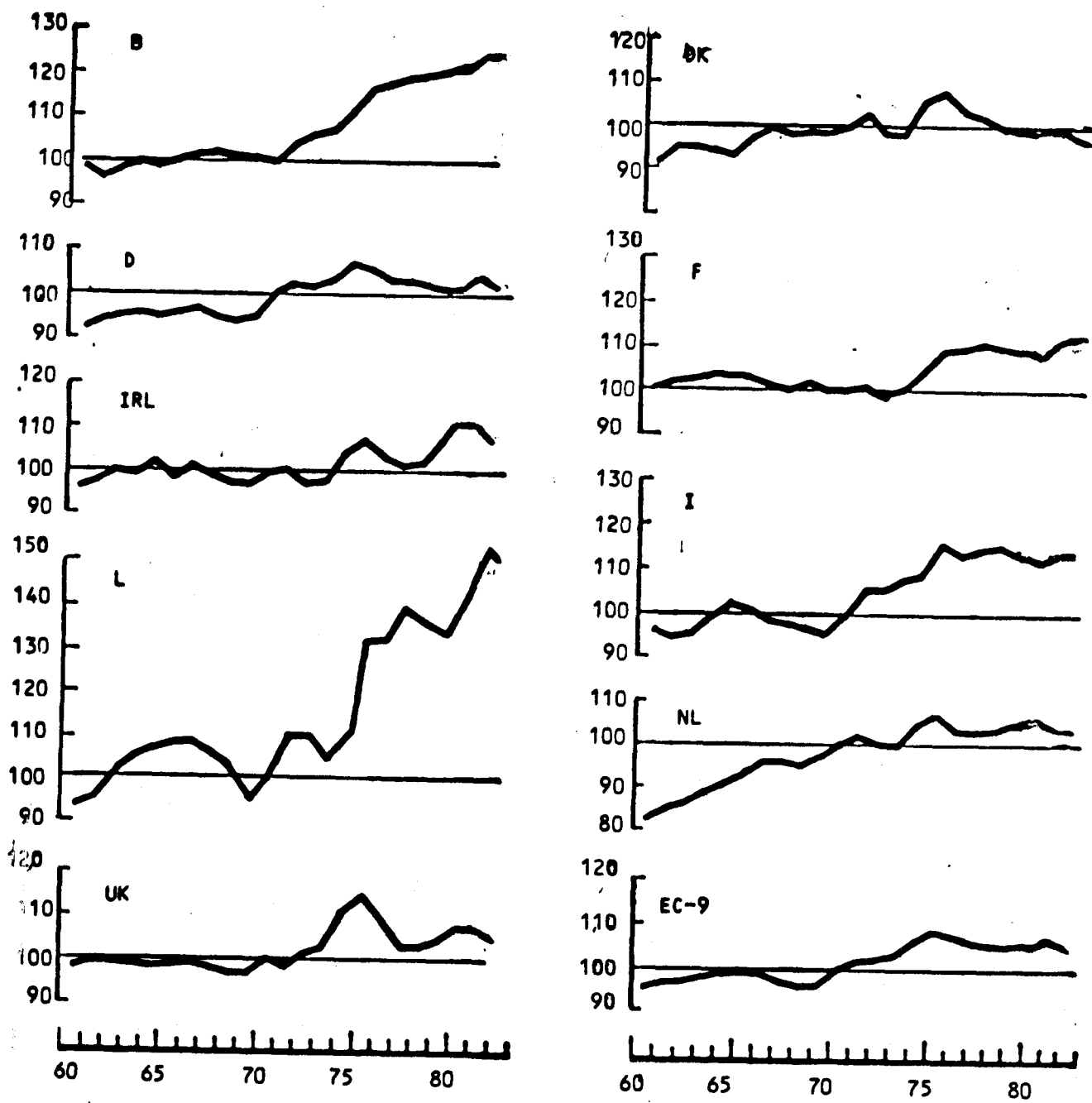
GRAPH 4.1 Consumer price development and divergence



1 Underlying annual rate of growth of the consumer price index for the Community, based on the change over six months (s.a.)

2 Standard deviation of year to year increases in Member States (EC-10)

GRAPH 4.2 Real wage-gap ¹⁾



¹⁾ Cumulative gap between real per capita compensation of employees and productivity. Real compensation per head is shown in Table 4.4. Productivity is defined as GDP per employed person adjusted for the terms of trade.

SOURCE: Eurostat, estimates and forecasts by Commission services

5. The European Monetary System and monetary policy in the Community

Since 1979 the instability of the main non-Community currencies on the exchanges has, together with the shifts of the U.K. pound and the drachma, been in contrast with the relative stability of exchange rates within the European Monetary System (EMS). Intervention by EMS central banks has been substantial, but has been far from exhausting the resources of the system. Participating countries have in general observed the rules and adapted domestic monetary conditions promptly to the requirements of the system. It has not so far been possible to reduce the divergence of cost and price rises within the EMS. Their effect has been moderated, but not fully offset by realignments of pivot rates. The resulting shifts of real exchange rates have been sustainable only because large margins of relative costs and prices existed in 1978. By thus establishing more normal relative positions, the EMS has exercised a moderating influence in countries where inflation or the level of relative costs was too high. An important factor in the success of the EMS since 1979 was the stance of monetary policy in favour of stability and greater convergence. However, monetary growth has departed in 1981 markedly from earlier forecasts in several countries. After the realignments of 4 October 1981, it is essential to make a success of the devaluations and ensure that monetary policies within the EMS are convergent. If more weight is to be put on employment and growth objectives without putting at risk the improvement of the external balance and a reduction in the rate of inflation, monetary policy must be prudent. Its restrictive effects can be reduced by measures affecting the size of public sector deficits and their means of financing as well as by action affecting the growth of incomes and their functional distribution. European interest rates have followed the rise in rates in the USA since 1979 without, however, undergoing the same wide fluctuations. A fall in European rates, which would be desirable in view of the depressed state of the Community economy, must, if it is to be durable, be conditional on a reduction of inflationary expectations in most member countries. Even if this condition is fulfilled, long term rates will show a fall in nominal rather than in real terms : real interest rates will in fact continue to reflect the size, which differs from one member country to another, of structural imbalances as revealed by real wage positions, public sector deficits and current account balances of payments.

5.1 Dollar, Yen, Ecu and EMS

In contrast with the relative stability of exchange rates within the European Monetary System (EMS), international currency fluctuations have persisted and actually widened in 1981, affecting relations between the three major currency areas in the West : Japan, the United States and Europe. Between February 1980 and August 1981, the yen rose against the ECU by some 50 %, but this upturn followed a drop of roughly the same amount between August 1978 and November 1979 (cf. Graph 5.1). The US dollar was worth the same as one ECU in August 1981 (as it had been in 1970), whereas in July 1980 one ECU had been worth \$ 1.45, a rise of 45 % in the value of the dollar in thirteen months. Clearly, such large variations in exchange rate relationships

over a fairly short period do not mirror similar divergences in inflation or in costs but are the reflection - accentuated by the foreign exchange markets - of other factors, notably differences in economic and monetary policies. Exchange rate movements of such magnitude add considerably to the uncertainty attaching to international trade.

For a more thorough analysis of the dollar's movements against the European currencies, a distinction has to be made between the currencies participating in the EMS exchange-rate mechanism, on the one hand, and sterling and the drachma, on the other, the latter two having diverged significantly from the EMS currencies since March 1979 (cf. Graph 5.2). One highly important economic factor in the dollar's performance against the EMS currencies (in the shape of the ECU, minus its sterling component) is that the respective current-account positions have been reversed. A further factor was the delayed effects of the depreciation of the dollar and of the appreciation of the German mark and of other European currencies prior to establishment of the EMS. On account of their widening external deficits, but also because of the monetary stabilization policy they pursued after the new oil shock, the EMS countries were obliged between 1978 and 1981 to follow, at times reluctantly, the underlying rise in US interest rates (cf. 5.5 below). But the extreme volatility of US rates, stemming from the monetary control arrangements adopted in the United States from October 1979 onwards, led to a saw-toothed movement in US and European interest rate differentials (cf. Graph 5.2). This development and the short-term capital movements it triggered were a major determinant of the dollar's fluctuations against the EMS currencies, especially in 1980. Although these fluctuations were substantial (a fall of around 10 % between May 1979 and January 1980, a rise of 13 % between January and April 1980 and a fresh fall of 10 % between April and July 1980) and although they gave rise to further uncertainty in international trade, they were not, until the last quarter of 1980, grouped around an upward trend. It has only been since the end of 1980 and early 1981, as the dollar has continued its climb despite a marked narrowing of interest rate differentials, that an unmistakable and more sustained upward tendency has emerged which culminated in August 1981.

In order to reduce the fluctuations of the dollar against the EMS currencies and to curb the upsurge in interest rates (notably in Germany during 1980 and up to February 1981), the EMS central banks intervened massively in

dollars on the exchanges, particularly between November 1979 and April 1980 and between December 1980 and June 1981 (cf. Graph 5.2). In all, gross sales of dollars on the exchanges by the EMS central banks totalled \$ 50 000 million for the period April 1979 - June 1981, and net dollar intervention amounted to \$ 32 400 million (equivalent to some 1.4 % of the EMS countries' GDP in 1980). A large proportion of these operations was by the Bundesbank, whose net interventions totalled \$ 18 700 million, equivalent to around 2.3 % of Germany's 1980 GDP. In the case of the EMS countries, the large-scale interventions in dollar did not bring about a matching fall in their official net reserves, except in Germany. This was due not only to accounting factors (valuation of gold and foreign currency) but also to substantial imports of capital partly in response to a deliberate policy of external borrowing on the part of the public authorities (cf. Chapter 3). The effect of dollar intervention by the EMS central banks was strengthened until March 1981 by intervention in European currencies by the Federal Reserve Bank of New York. In May 1981, however, the US authorities officially confirmed that, except in exceptional circumstances, they no longer intended to intervene on the exchanges. Thus European countries are compelled either to shoulder the burden of intervention alone, to permit their currencies to float freely against the dollar or to allow their interest rates to be as volatile as those of the USA. These are choices which, under certain circumstances, may prove extremely awkward. European views on these matters need to be spelt out (1), not only in the interests of closer cooperation between the major currency zones but also to ensure that international monetary tensions do not damage the internal functioning of the European Monetary System.

5.2 Community Currencies and developments within the EMS

Between 13 March 1979 and the end of July 1981, the two Community currencies not participating in the EMS exchange-rate mechanism, sterling and the drachma, rose by 23 % and fell by 17 % respectively against the EMS currencies (as represented by the ECU, minus its sterling component - cf. Graph 5.2). Since the sharp rises in the dollar at the beginning of 1981,

(1) cf. Commission foreword to the draft of the fifth medium-term economic policy programme, COM(81)344 final of 22 July 1981, page 8.

both currencies have moved quite closely in line with the EMS currencies. The depreciation of the drachma in 1979 and 1980 broadly reflected the inflation differential and was in line with the policy pursued by the Greek authorities before Greece joined the Community. The rise in sterling can be put down not only to the resolute monetary stabilization policy of the United Kingdom and an interest-rate differential of around 3.5 to 5.5 points compared with the average rate for the EMS currencies throughout 1979 and 1980 but also to the appreciable improvement in the UK's current account between 1978 and 1981 equal to 0.6 % of GDP, brought about by North Sea Oil and the recession.

The European Monetary System has, during this period of wide fluctuation in international exchange rates, satisfactorily performed its role of creating a zone of greater currency stability in Europe, even though no progress has as yet been made towards achieving its other, more ambitious, objective of convergence towards internal stability. The two realignments of pivot rates which occurred in the autumn of 1979 and the lira devaluation of March 1981 had only a modest effect on the system's parity grid. The realignment of 5 October 1981 did not change the bilateral pivot rates of the Danish krone, the Belgian/Luxemburg franc and the Irish pound; in relation to these currencies the German mark and the Dutch florin were revalued by 5.5 % while the french franc and the italian lira were devalued by 3 % (see Table 3 of the Annual Report). Since the creation of the system the only bilateral pivot rates which have not changed are those between the Belgian/Luxemburg franc and the Irish pound. Table 5.1 shows in detail the pivot rates at present in force and the cumulative change in bilateral pivot rates since 13 March 1979.

Such realignments are a sign of the flexibility of the system and, if used properly, can prevent the cumulative delays in adjusting exchange rates that were one of the drawbacks of the Bretton woods system. In retrospect, and disregarding the difficulties obtaining at the time, the 1979 realignments merely rectified the initial pattern of pivot rates whereas the lira devaluation of March 1981 can be seen as a partial - and hence not fully accommodating - adjustment to soaring relative costs and prices in Italy (cf. 5.3 below). To forestall a vicious circle between devaluation and inflation, the lira devaluation was accompanied by monetary measures and the announcement

of domestic stabilization measures. Similarly, the recommendation (1) addressed by the Commission to the Italian Government on 1 July 1981 calls for the introduction of stabilization and domestic adjustment measures, stressing in particular that no protectionist measure can correct the factors causing fundamental disequilibrium, and that adjustment of the growth of nominal incomes holds the key to improved competitiveness of the economy and hence to exchange rate stability and disappearance of the latent propensity of market operators to anticipate a devaluation of the lira. This recommendation has lost more of its relevance since the realignment of October 1981. This last realignment was of a more general nature ; triggered by the rise of the German mark and the problems of the French franc, it moderated but did not fully offset the consequences of the divergent rises of costs and prices which have occurred since the beginning of 1979. If this realignment is to be a success it must be accompanied by appropriate measures of economic and monetary policy which, particularly in the devaluing countries, must put the emphasis on stability.

To date, currency management within the EMS has not, generally speaking, given rise to major conflicts. The divergence indicator (2), which provides a systematic indication of the extent to which each EMS currency diverges from the other participating currencies as a group, has fulfilled the role expected of it. Between March 1979 and August 1981, its upper threshold (set at a level equal to 75 % of maximum upward divergence) has hardly ever been crossed (cf. Graphs 5.3a and 5.4a) although the French franc (in April and November 1980 and in January/February 1981) and the German mark (in August) have approached or reached it. The DM crossed the upper threshold in September and this event was followed by the realignment of 5 October 1981. The lower warning limit has been reached and overstepped on a number of occasions and for lengthy periods. In the case of the Danish krone (August/September 1979) and of the Italian lira (March 1981) there followed an adjustment of the pivot rate. In the case of the Belgian franc (May to July and September 1979, February/March 1980 and February/April 1981) and the French franc (May 1981), the necessary measures (intervention, an increase in interest rates and other monetary and economic policy measures) were taken to redress the situation. On numerous occasions, policies have been adjusted before a currency has moved unduly out of line. In this way the discipline imposed by the system has had a pre-emptive effect.

(1) Commission Recommendation of 1 July 1981 to the Government of the Italian Republic pursuant to Article 108(1) of the Treaty, O.J. L189 of 11 July 1981

(2) For the calculation of the divergence indicator, cf. European Economy N° 3 of July 1979.

The maximum permissible spread between two currencies at any one time (2.25 %, but 6 % for the Lira) has frequently been taken up, notably in 1979, in April 1980 and between October 1980 and August 1981 (cf. Graph 5.3b and 5.4 b). On one occasion, two currencies which stood at opposite extremes within the band swapped places within a short period. Between January/February and May 1981, the French franc moved from the top to the bottom of the band, changing places with the German mark. As a result, the maximum permissible divergence between two EMS currencies over time (4.5 points) was almost reached. Movements within the currency band and reversals of positions constitute a further element of flexibility in the EMS. They can reduce the need for intervention and weaken the close link that tends to develop between nominal short-term interest rates, in spite of differing inflation rates, if there are no expectations of exchange rate adjustment. Further, a particular currency's position within the EMS band at any given moment does not provide an automatic indication of its strength or weakness as measured by the fundamental factors that determine its performance in the longer run. With a given set of underlying factors (relative prices and costs, current account balance, etc), a currency's position is determined principally by the degree of restrictiveness of the monetary policy pursued by the country in question (and the way it is perceived by the markets) and by its external borrowing policy.

Two examples may illustrate the point (cf. Graph 5.5b). In spite of Germany's favourable and steadily improving relative price and cost position vis-à-vis its EMS partners, the German mark was weak in the EMS band in the second half of 1980 and up to February 1981. The main reasons for this were Germany's external deficit and the authorities' reluctance, due to the weak economic situation at home, to allow money-market interest rates to rise. Following the measures taken on 19 February 1981 when the Lombard facility was suspended and German interest rates rose from around 9-10 % to 12-13 %, the German mark reversed its position in the EMS band and, since 9 March, has been the strongest currency. The other example concerns France. In spite of relatively high domestic inflation and a slow but continuous deterioration in the relative price and cost position, the French franc was one of the strongest currencies during 1980 and until April 1981. It maintained this position even though, compared with the rate of inflation, money-market interest rates remained modest (11-13 %). This was due to three main factors: a policy of tight control over the expansion of money and credit, spontaneous and organized inflows of capital which more than offset the current account deficit, and a nominal interest-rate

differential vis-à-vis Germany. The latter two factors came into play because market operators did not expect any adjustment in exchange rates.

The position within the band of the major currencies - and especially the German mark, an alternative reserve currency - also influences the currency band's movements against third currencies, notably the dollar. The German mark's weakness within the band in the second half of 1980 and up to February 1981 thus dragged down the entire EMS against the dollar. In some respects, this helped the other EMS currencies (e.g. the Belgian franc) and contributed to the cohesion of the system. Following the turnaround in the situation in February/March 1981, it has been the German mark which has curbed the dollar's climb, with its own rise being curbed to some extent by the other currencies within the band. This example also underscores the importance of defining a common position for the European currencies against third currencies, notably the dollar.

Some countries such as Denmark and the Netherlands, but also Italy and Ireland, appear to be seeking a comfortable position for their currencies or one that is easier to defend within their respective bands. On numerous occasions, this has led them to adjust their monetary policy stance before their currencies have approached their permissible fluctuation limits, thereby voluntarily enhancing the disciplines of the system and probably reducing the amount of intervention needed. The Belgian franc, on the other hand, has found itself in the lower half of the currency band ever since the system came into operation. For long periods, it has been the weakest currency, touching its lower intervention threshold. This is due to fundamental features of the Belgian economy (highly unfavourable relative labour cost position vis-à-vis its EMS partners and large budget and current account deficits) which have so far shown little, if any response to monetary stabilization policy and which require very high - and, in real terms, rising - interest rates if the exchange rate is to be maintained (cf. point 5.5 below). In theory, the position of the Belgian franc within the currency band could be improved if monetary conditions in Belgium were tightened

further but, since monetary policy is already very restrictive, the cost in terms of employment and growth is deemed to be excessive. Devaluation, on the other hand, will hardly resolve the problem because of the "openness" of the Belgian economy (imports of goods and services are equivalent to about 70 % of GDP, with 60 % of such imports coming from Belgium's EMS partners) and because of a rigid and generalised system of indexation. Under these circumstances, the monetary authorities in Belgium are walking a tightrope, keeping monetary conditions sufficiently restrictive to maintain the exchange rate yet avoiding any further tightening, a move which could ease the position of the Belgian franc within the currency band. Belgium can be regarded as the EMS country that has come closest to exhausting the possibilities of monetary stabilization policy, which, in Belgium, has traditionally taken the form of exchange rate policy. It is now evident that the solution to Belgium's macroeconomic problems lies in a reform of public finance and in an adjustment of incomes and notably of labour costs. It was with this in mind that the Commission addressed a recommendation (1) to the Belgian Government on 22 July 1981 in which it stressed that monetary policy should not be relaxed until parallel concrete and satisfactory progress had been made in the other areas of economic and social policy.

In addition to intervention in dollars (cf. point 5.1 above), there has been a substantial volume of intervention in Community currencies, undertaken to influence their positions within the system and to keep them within their margins of fluctuation. Intervention in Community currencies totalled around \$ 30 000 million between March 1979 and June 1981. In the first two years of the system's operation, some 64 % of intervention in Community currencies was intra-marginal, i.e. carried out before intervention limits were reached. These operations reflected the authorities' desire to guide the movement of their currencies within the EMS band or to repurchase them from creditors for the purpose of settling debts arising from previous intervention operations. As yet, there are no special rules governing intra-marginal intervention, which is entirely dependent on the consent of the central bank issuing the intervention currency.

(1) cf. Commission Recommendation of 22 July 1981 to the Government of the Kingdom of Belgium pursuant to Article 11 of the Council Decision, O.J. L 228 of 13 August 1981.

This is why, in practice, some countries which wished to intervene before their fluctuation limits had been reached (1) have relied almost exclusively on intervention in dollars, being unable, in an emergency, to make immediate and automatic use of Community currencies. This practice may have undesirable effects in that it accentuates a given dollar trend. To remedy this drawback and to make intervention policies more effective, it has been suggested that certain rules be laid down to facilitate wider use of intra-marginal intervention whenever a divergence threshold is crossed and that this be combined with more closely coordinated action against the dollar.

Intra-marginal intervention is not normally notified to the EMCF except where it is financed by transfers of ECUs or use of the very short-term financing mechanism. Intervention at fluctuation limits, on the other hand, which results from the basic principles of the EMS, must be notified. Between March 1979 and July 1981, the EMCF was notified of intervention operations totalling some 15 000 million ECUs, over half of which were carried out in the first half of 1981. Graph 5.3c shows that intervention operations peaked in June 1979 (in support of the Belgian franc), in September 1979 (in support of the Belgian franc and the Danish krone, whose pivot rate was subsequently adjusted); in March/April and October/November 1980 and in February 1981 (French francs sold against Belgian francs and German marks), in March/April 1981 (in support of the Belgian franc) and in May 1981 (in support of the French franc). Although large, these operations were far from exhausting the system's resources. In particular, no calls have yet been made on the short-term monetary support facility or on the arrangements for medium-term financial assistance. An interesting point is that, generally speaking, these operations have so far not resulted in any build-up of large debtor or creditor positions with the EMCF. Germany, for example, which was in a creditor position in 1979 (maximum of + 1 900 million ECU at the end of September), moved into a debtor position in 1980 (a maximum of - 2 100 million ECU at the end of December), before returning to a creditor position in the second quarter of

(1) This is particularly true of Italy, whose currency has been given a wider margin of fluctuation; if Italy had to make full use of this margin, this might have more marked psychological repercussions than in the case of a margin of 2.25 %.

1981 (+ 4 100 million ECU at the end of June). Conversely, France built up a creditor position in 1980 and in early 1981 particularly (maximum of + 4 700 million ECU at the end of February 1981) before moving into a slight debtor position in the second quarter of 1981 (- 900 million ECU at the end of June). Belgium is the only country that has permanently been in a debtor position (just over - 3 000 million ECU in June 1981). The debtor or creditor positions of the other countries have been negligible. This record of debtor and creditor positions with the EMCF shows that the EMS countries have by and large complied with the system's rules, adjusting their domestic monetary conditions to the system's requirements at the right time while pursuing a policy of borrowing on the international capital market which has broadly enabled them to finance their current account deficits.

5.3 Effective exchange rates and adjustment of real exchange rates within the EMS

In spite of the adjustments of pivot rates made in 1979 and March 1981, there was very little change in the effective exchange rates of the countries participating in the EMS exchange rate mechanism (see Table 5.2). Trade between EMS countries has not therefore been affected by the wide fluctuations in exchange rates internationally. This differs from the divergent exchange-rate trends recorded within the Community in the period 1973-78 and is important for an area on the road to closer economic integration in which some 46 % of trade (in 1979, for the EMS countries) is transacted between member countries. As a result, intra-area imports (averaging 45 % but rising to 60 %, for example, for the Belgo-Luxembourg Economic Union) have not been directly affected by the dollar's rise; however, in view of the continuing inflation differentials between member countries, this also means to some extent that the countries having more stable prices have imported inflation and that the countries having less stable prices import stability through the mechanism of direct price interdependence. Conversely, intra-area exports (averaging 48 % but rising to 65 % in the case of the BLEU) do not benefit from increased competitiveness due to the dollar's appreciation, but the countries having more stable prices have gained from the slower rise in their costs while the countries having less stable prices have been obliged to take steps to boost their competitiveness and to rein back to domestic costs. Although the realignment of 5 October 1981 did not have a very large effect on effective exchange rates (see Table 3 in the

Annual Report) it will nevertheless serve to damp down this process of imported inflation or stability. Compared with the industrialized world as a whole (17 or 23 trading partners - cf. Table 5.2), the slide in the EMS currencies' effective exchange rates was less market than might have been suspected given the upward surge in the dollar and the yen. This is not only because, in spite of its volume, trade with the United States and Japan accounts for only a relatively small proportion of the EMS countries' total trade (7.8 % in 1979) but also because the currencies of a large number of other third countries, notably in Europe, have moved in line not with the dollar but with the EMS currencies (e.g. the Austrian schilling) or with a basket of currencies in which the EMS currencies play a predominant role (e.g. the Swedish krona). Similarly, the drachma since August 1980 and sterling since January 1981 have moved more or less in line with the EMS currencies (cf. Graph 5.2). The effects of greater exchange rate stability thus permeate beyond the group of countries participating in the EMS exchange-rate mechanism. Even so, the relatively insignificant variations in effective exchange rates, especially against the 23 trading partners (cf. Table 5.2), should not obscure the fact that, in many cases, imports of raw materials, notably oil, have to be paid for in dollars. As a result, these indices of effective exchange rates give an unduly favourable measure of the situation, at least in the short term view. In the medium term, if the dollar were to hold steady at its summer 1981 level, the adjustment would have to come through a slower increase or through a fall in the dollar price of these raw materials.

The relative stability of effective exchange rates within the EMS has so far not been matched by a greater convergence of prices and costs. On the contrary, when expressed in national currencies, average annual divergences from EMS partners were, in many cases, greater in the period 1979-81 than in the period 1971-78 (cf. Table 5.3, Column 2). For the years 1979-81, aggregate variations in the relative levels of unit labour costs (in national currency) have ranged from - 14.5 % (Germany : index 1981/78 : 85.5) to + 32.7 % (Italy : index for 1981/78 : 132.7). The EMS, then, has resulted in appreciable variations in real exchange rates, that is to say, in the relative levels of unit labour costs expressed in a common currency (Table 5.3). In the countries having more stable prices, the fall in the

relative level of labour costs ranged from -3.8 % in Belgium (index of 96.2, in Column 4) to 8 % in Germany (index of 92). In the EMS countries having less stable prices, the relative increase ranged from 12.1 % (France) to 25.7 % (Ireland). (1).

The accumulation of such deviations in a relatively short time can be ascribed to a combination of factors : primarily a monetary and interest-rate policy tailored to maintaining nominal exchange rates and the existence of deviations in the reverse direction accumulated during the preceding period. Table 5.3 shows that, during the period 1971-78, such deviations had accumulated under the combined impact of the relative movements in national currencies (Column 2) and of the movements in effective exchange rates (Column 3), which had been much larger in the countries with depreciating currencies (France, Ireland, Italy and, outside the EMS, the United Kingdom). Thus changes in effective exchange rates between 1978 and 1981 represent, in the majority of cases, the balancing off of positions which had developed prior to 1978 during a period of monetary disturbance; and should not be interpreted as a setback for the system.

However, it is evident that a single base year (1970 in Table 5.3) need not necessarily represent an "equilibrium situation" for all EMS countries or for all Community countries. For this reason, and to make it easier to gauge the margins available in 1978 (the year prior to introduction of the EMS) and the margins remaining available in 1981 (almost three years after introduction of the EMS), Table 5.4 expresses the relative level of costs and prices for these two years in a common currency by reference to different base periods : 1970, the period 1961-70 and the period 1968-72.

It will be noted that, irrespective of the base period, the countries which had belonged to the earlier "snake" (and which, in the second half of the 1970s, had become the countries with more stable prices) had accumulated much sharper increases in unit labour costs (expressed in a common currency - cf. Table 5.4a) by 1978 mainly as a result of their appreciating currencies. The only exception was Germany, which, thanks to a more rapid adjustment in its labour costs, reverted to a position slightly below that for the base

(1) These calculations do not yet take account of the most recent realignment which does not have a very great effect on the annual figures for 1981 since it only affects the last three months of the year. In 1982 it will have its full effect on effective exchange rates but this will be more or less offset by continuing divergences of costs and prices expressed in national currencies.

year 1970 (index of 99.1). In 1981 (1), taking the same base periods, the deviation became negative in Germany (in spite of the rise in the effective exchange rate) and in Denmark (notably as a result of the devaluation of the Danish krone), while the deviation remained positive for Belgium and the Netherlands but narrowed (by 4.2 or 4.4 points depending on the base period and by 7.6 or 8.4 points respectively) as a result of an adjustment in labour costs and without there being any significant movement in the effective exchange rate. The relatively high level recorded in the Netherlands, particularly when compared with the period 1961-70, was influenced by a structural factor since the country's rapid industrialization in the 1960s, the discovery of natural gas and, later, the increase in the price of gas permitted some upward shift in relative costs without thereby jeopardizing external equilibrium. By 1978, the other countries (France, Ireland, Italy and the United Kingdom) had accumulated large negative deviations compared with all the base periods. These deviations were the result of currency depreciation well in excess of the rise in relative costs expressed in national currency. Depending on the base period, these disparities have, to differing degrees, been made good in 1981 in France and Ireland (1), while Italy thanks to the devaluation of March 1981 still has some margin available. The United Kingdom, however, as a result of the combined effects of inflation and currency revaluations suffered a deterioration of its costs relative to those of its partners belonging to the EMS of more than 50 % between 1978 and 1981.

Section b) of Table 5.4 similarly shows relative movements calculated on the basis of GDP deflators, which may be broadly interpreted as "total costs per unit of output". In general, section b) confirms the results given in section a). It is important, however, to note the differences between the relative positions calculated on the basis of unit labour costs and those based on GDP deflators. In the case of the Netherlands, Germany, Denmark and the United Kingdom, the relative levels based on labour costs are distinctly lower, indicating that labour costs have adjusted more rapidly than GDP deflators. In Italy, Ireland and Belgium, labour costs have been stickier. This phenomenon is particularly significant in Belgium, where the relative level in terms of labour costs is between 12.7 and 16.1 points higher than that based on GDP deflators depending on the base period taken. This difference reflects a much tighter squeeze on company profits

(1) See footnote on previous page

than in the other member countries. The persistence of this gap has meant that an increasingly restrictive monetary and interest-rate policy has had to be pursued to maintain the exchange rate. This bears out the analysis made earlier (point 5.2), which showed that the failure to adjust labour costs is one of the major problems of the Belgian economy.

The fact that, in its first three years of operation, the EMS has, in spite of realignments, absorbed a large part of the relative cost and price margins that existed in 1978 does not mean that from now on any persistent divergences in costs and prices would automatically require an adjustment in central rates (1) of the same order. On the one hand, a number of countries still have a low relative cost or price level which allows some leeway for an upward movement. On the other, it is quite possible that a shift from a low to a high relative cost and price level will serve to exert pressure in favour of increased domestic stability if backed up by an appropriate monetary policy. This is often the only way in which the real problems of domestic adjustment are forced into the open (Belgium is one example). These problems would otherwise be obscured by a spiral of devaluation and inflation; and this would do nothing to resolve the basic problems (this was the experience in the UK and Italy between 1973 and 1978). It is important that this EMS stabilization mechanism should be allowed to operate freely in countries where inflation or the level of relative costs is still too high; this means not only that monetary policy must defend the exchange rate but also that domestic adjustment, notably in the areas of incomes and public finance, must be facilitated and speeded up through other appropriate measures. The need for domestic adjustment of this sort is particularly pressing because the leeway given by low relative costs is disappearing (the Irish case) or has been - partly - restored by devaluations, for example in France and Italy; or because, in some cases, positive relative costs have persisted for too long and threaten to stifle economic activity (notably in Belgium). Quite independently of the existence of EMS, such internal adjustment is necessary in order to open up possibilities of economic growth in conditions of stability and to increase employment. The EMS simply highlights the need for adjustment and helps in its realisation. This is an important role which the EMS must play in the years ahead.

(1) Any overall assessment of relative prices and costs in a particular country must also take account of its relations with countries outside the Community or countries not participating in the EMS exchange-rate mechanism. This aspect is dealt with in Chapter 4.

What has been said above does not, however, mean that EMS pivot rates should remain unchanged after the realignment of October 1981. Persistent divergences in costs and prices, and chronic balance-of payments disequilibria, will probably make further pivot-rate adjustments inevitable after a certain time. The decision to modify an EMS pivot rate is a political decision to be taken by mutual agreement and by reference to a set of economic and political criteria including that convergence of cost and price changes towards stability which is one of the objectives of the EMS. This objective will be easier to achieve if the lower-inflation countries block imported inflation in good time by revaluing their currencies and if the higher-inflation countries maintain for a sufficiently long period the stabilizing discipline imposed by a fixed exchange rate. Should domestic stabilization policy in a higher-inflation country come up against major obstacles, steps must be taken to prevent the development of unsustainable situations which might encourage protectionist tendencies. However, any devaluation deemed to be inevitable would have to be accompanied by additional domestic stabilization measures for it to have any chance of success. In the final analysis, revaluations and devaluations within the EMS should be carried out little by little so as to minimize uncertainty, which is damaging to trade, and avoid undue disruption of the process of economic integration.

5.4. Quantitative monetary policy

Since 1979, the stance of quantitative monetary policy has become more restrictive in practically all Community countries. This change has been prompted by the need to combat inflation and in particular by the desire to prevent the emergence of secondary inflationary effects following the rise in the price of oil. At the same time, the introduction of the EMS has provided those countries participating in the exchange rate mechanism with a strong incentive to a de facto coordination of their monetary policies : if an EMS country had adopted a monetary policy stance significantly different from that of its partners, it would not have been able to fulfil its exchange rate commitments.

This interdependence means that monetary policies within the EMS are strongly influenced by the larger countries. In these countries, the intermediate objectives of monetary policy, expressed in terms of the growth of specific monetary aggregates, are normative. The figure chosen is set largely with an eye to domestic economic policy objectives, and, among them, principally to the fight against inflation during recent years. The fact that there has been agreement on the objective of stability has been of great importance for the operation of the EMS : it has meant that major conflicts between quantitative monetary objectives and the maintenance of EMS pivot rates have been avoided.

In the smaller countries such as Belgium, Denmark, Ireland and the Netherlands, intermediate monetary objectives have less of the nature of a commitment; they frequently serve only as indicators for the authorities. Owing to the openness of their economies, the exchange rate in these countries is of particular importance for internal stability, and monetary policy is determined largely in the light of the objective of maintaining the exchange rate; this is a case of a derived stability objective.

The pragmatism which has governed the control of the monetary aggregates in countries whose quantitative objectives are normative has helped to resolve the accidental conflicts between such targets and exchange rate objectives : temporary deviations from the prescribed path of the aggregate chosen as an intermediate objective have been allowed; the effects on monetary aggregates of exchange market intervention have been only temporary and have largely been sterilised; wherever possible, interest-rate policy has taken account of both internal and external objectives and has never been completely subordinated to the short-term control of monetary aggregates. This pragmatism in monetary policy within the EMS contrasts with the monetary policy pursued since October 1979 in the United States, where very short-term and frequently fortuitous deviations from the prescribed path of the target aggregates have immediately led to corrective measures and therefore to great instability in interest rates.

The wide range of aggregates chosen as the key variable of monetary policy in Community countries is perhaps surprising and certainly does not make it easier to interpret a synoptic table (cf. Table 5.5). It is due to a number of factors : institutional factors, the varying stability of the demand for money, the size of the economy, etc. While an objective based on the broadly defined money supply, as used in Germany, France and the United Kingdom, may help to reduce the rate of inflation in the medium term, it does not make it possible to detect excessive domestic credit expansion allowing a persistent balance of payments deficit ; conversely, an objective or indicator expressed in terms of domestic credit expansion, such as is generally adopted in the smaller countries and in Italy, may help to contain an external deficit, but, if the balance of payments moves into surplus, it may allow a too rapid growth in the money supply and so lead to a subsequent acceleration in inflation. This is why assessments of quantitative monetary policies must focus both on the money supply and on its counterparts (cf. Tables 5.6 and 5.7). This is also one of the reasons why harmonization, at Community level, of the intermediate objectives and instruments of monetary policy is a much less urgent task than the coordination of the policies actually pursued. Given sufficient agreement between the large countries on fundamental objectives, the EMS constitutes a powerful instrument in this respect.

While there was a tendency towards overshooting of the monetary objectives in 1978 and 1979, the generally lower norms fixed for 1980 were observed fairly closely in the member countries, except in Denmark and the United Kingdom. The targets for 1981 generally continue to reflect a policy of gradually reducing the growth of money or credit in line with the general aim of combating inflation, but they are likely to prove more difficult to achieve. The information available in September 1981 on the success of member countries in achieving their various monetary objectives or indicator levels shows that five countries (Greece, France, Italy and the United Kingdom) have gone above the levels implied by their initial objectives or chosen indicators, sometimes by a wide margin (see Table 5.5).

Whereas most countries, and in particular France, Germany and Italy, had adopted between 1979 and 1981 a pragmatic policy of a phased reduction in their quantitative objectives, the United Kingdom announced in advance that as part of a medium-term financial strategy it would reduce its intermediate objective (expressed in terms of sterling M3) from the 7 % - 11 % adopted in June 1979 to approximately 6 % per annum by the spring of 1984. However, this objective has so far proved very difficult to achieve, not only because of major changes in monetary control arrangements (1) but also because of the sharp appreciation of sterling in 1979 and 1980, which has exerted a very strong stabilizing pressure on the economy that would have been even greater if the authorities had adhered to their monetary objective regardless of cost.

The monetary policy adopted since 1979 aimed at stabilization and produced a reduction in the rate of growth of the money supply (M2 or M3) in the Community from 13.9% in 1978 to 10.5% in 1980, the latter being close to the average rate of the 1960's. As recently as May 1981, forecasts suggested a further reduction in 1981 to 8.8% (see Table 5.6). The forecasts of September 1981, however, show figures for several countries which are higher, and in some countries considerably higher; the impression thus emerges that in terms of the Community average the deceleration of monetary growth ceased in 1981 and gave way in some countries to a renewed acceleration. In the wake of the recent realignment it is necessary to make a success of the devaluations and ensure that monetary policies within the EMS are convergent. It is particularly necessary to avoid further realignments of pivot rates caused by developments in the monetary domain rather than by those fundamental factors such as relative price and cost levels and balances of payments on current account which should determine pivot rates within the EMS. The need to bring the external account back into balance and the need to reduce the rate of inflation both indicate that monetary policy in the Community must continue to aim at stability. Such a policy does not necessarily exclude a higher priority for objectives of employment and growth : its restrictive effects can be reduced by measures affecting the size of public sector deficits and their means of financing as well as by action affecting the growth of incomes and their functional distribution. Adjustments in these two areas are essential if lasting opportunities are to be opened up for growth with stability.

As regards the structure of financial flows, Table 5.7 - which depicts the development of the counterparts of money supply and therefore their contribution to monetary expansion - gives some idea of the extent of the

(1) Abolition in June 1980 of the supplementary special deposits scheme or "corset".

problems. In all Community countries, domestic money creation, as measured by the expansion of bank lending to residents (private and public sector), has been appreciably greater than the growth of the money supply. The difference has been absorbed either by non-monetary liabilities or by the negative external impact resulting from the balance of payments deficit (current account and non-bank capital account). Thus in many countries domestic credit expansion has fed through into the acquisition of longer-term assets not included in the definition of the money supply, as is to be expected in a period of high interest rates; it should be noted, however, that, if interest rates fall, this development might well be reversed, adding to the liquidity of the economy. The expansion in lending has also enabled the non-bank private sector to finance its current deficit and/or the export of non-bank capital. (The figures, expressed as a percentage of the money supply at the beginning of each period, are particularly high for Ireland and Belgium - cf. Table 5.7). Such a phenomenon is to be expected initially in a period in which a current account deficit is made inevitable by an external shock; but if it were to continue for long on such a scale, this might make it more difficult or even impossible for the balance of payments to recover. A very high proportion of the expansion in domestic credit has gone into the monetary financing of the public sector: the figures, expressed as a percentage of the money supply at the beginning of each period, are particularly disturbing in the case of Ireland, Greece, Belgium, Denmark and Italy. This is a major source of money creation and potential inflation that is extremely difficult to stop: any attempt to increase the share of non-monetary financing of the public sector would have the effect of further boosting the rise in interest rates and would be likely to squeeze out the private sector and in particular that productive investment which creates employment. In those countries, therefore, in which the public deficit as a proportion of GDP (cf. Table 5.9) is particularly high (close to double figures or even higher) a policy directed towards stabilization and, in time, growth and higher employment can be pursued only at the cost of a thorough reform of public finance, however difficult this may appear in the present economic situation.

The importance of an adjustment in income trends and income distribution for the lasting success of monetary stabilisation policy should also be made clearer. The reduction in monetary growth in the Community between 1978 and 1980 was not followed by a fall in the rate of growth of nominal GDP until 1981 (1978 : 12.8%; 1981 : 9.5% - cf. Table 5.8). This development comprises an accelerating rise in the GDP price deflator (from 8.9% in 1978 to 11.6% in 1980 and 10% in 1981) and a marked reduction in the real growth rate, from 3.1% in 1978 to - 0.5% in 1981. Monetary stabilisation policy has thus prevented an explosion in the inflation rate of the kind which occurred after the first oil shock (GDP price deflator : 6.8 % in 1972, 14.2 % in 1975), but a reduction of real growth has been inevitable, notably as a result of an inadequate adjustment of incomes and costs (greater although it has been than in 1974/75). Monetary policy succeeded in 1979 and 1980 in stabilising, broadly speaking, the margin for price increases, in the sense of the growth in the money supply per unit of real GDP, (cf. Table 5.8, line 1); the faster rise in the GDP deflator actually recorded until 1980 was made possible only through a reduction in the liquidity ratio of the economy or, in other terms, through an increase in the velocity of circulation of money, which has accompanied the rise in interest rates. At the same time, however, the margin for real GDP growth resulting from the combined effects of monetary growth and the increase in unit labour costs (cf. Table 5.8, line 2) has considerably narrowed (from 4.7 % in 1978 to - 1.3 % in 1980). The rise in labour costs, which is responsible for this phenomenon, is due firstly to the acceleration, in most countries, of the rise of per capita nominal wages following the increase in import prices (particularly of oil products) and secondly to frequent cases of underestimation, when collective agreements were concluded, of the slowdown in growth and productivity gains. The actual slowdown of GDP growth in volume terms has been somewhat less marked than that of the margin for growth owing to the reversal of a structural element determined by changes in the relationship of the liquidity ratio to the divergence of real wage growth from productivity (see Table 5.9, line 5). In 1981 this factor had the opposite effect so that in spite of a

small reduction in the growth of wage costs and some acceleration of monetary growth, GDP volume shows an absolute decline.

For 1982 Commission staff forecasts indicate a growth of the money stock slightly less rapid than that of 1981, alongside a more noticeable slowdown in the growth of wage costs on the basis of a more rapid rise of productivity rather than a slowdown in per capita wages. Consequently, the scope for growth allowed by the relationship between monetary growth and rising labour costs should again be marginally positive (cf. Table 5.8, column 1982a, line 2), while the actual growth in real GDP (1982a : 2.0 %) is expected to be slightly higher owing to the structural factor mentioned above. According to this estimate, the margin for price increases would narrow considerably, but the actual rise in the GDP deflator would not be reduced owing to a sharp fall in the liquidity ratio, i.e. a further acceleration in the velocity of circulation of money.

These figures (column 1982a of Table 5.8) reflect estimates made in September 1981. They are not satisfactory, either for growth and employment prospects or for inflation. It is therefore important to ask how - with the same stability-oriented monetary policy - this performance might be improved through a better adjustment of incomes trends and incomes distribution. Supposing, for example, a 50 % reduction compared with 1981 in the increase in unit labour costs and assuming, at the same time, an increase in real per capita wages which is 2 % lower than that of productivity, it would theoretically be possible (subject to changes in the liquidity ratio) to obtain both an appreciably higher rate of growth and a reduction in the rate of inflation (cf. Table 5.8, column 1982 b). This example clearly has only illustrative value. However, it should be remembered that in 1976, compared with 1975, the increase in labour costs was reduced by more than half and that the slowdown in the increase in real wages in relation to productivity was of the same order as that envisaged in this example.

The slowdown in the rise in unit labour costs - as in all nominal incomes per unit of output - would be necessary to reduce the rate of inflation and to increase, given unchanged monetary growth, the margin for real GDP growth. The increase in unit labour costs would have to be less than that in prices or, put another way, the growth of real per capita wages would have to remain below that of productivity so that firms' profit margins could be restored (1) ; this is a prerequisite for increasing firms' propensity to invest and their capacity to create jobs. Such a development in 1982 and beyond would permit an expansion of non-inflationary demand resulting either from a spontaneous growth in exports and investment or from certain stimulatory measures whose adoption would be facilitated by the fact that they would no longer threaten to lead rapidly to further inflation. Such a development would in time bring about a reduction in unemployment and a higher growth in real wages than the stagflation now in prospect.

Clearly, monetary policy cannot alone trigger the process outlined above. However, the policy aiming at monetary stabilization which has been pursued for three years in the Community is a necessary condition. Against this background, "an incomes policy of some suitable design, based on consensus rather than on constraint, should not be ruled out. Admittedly, incomes policies have foundered in the past, but in many cases they have failed because they were seen as an alternative to monetary restraint rather than as a supporting instrument. It is because it was used in this second way that the deliberate moderation of income growth has had quite good results in a number of countries, and notably in those which have had most success in mastering inflation. Is this merely a coincidence ? " (2).

(1) A substantial improvement in firms' profit margins is all the more necessary for improved growth and employment prospects, since, in most member countries, the gap which has opened up since the 1960s between the growth of real per capita wages and that of productivity, adjusted for changes in the terms of trade, is still very wide (cf. Table 5.9b); these are after-effects of what went wrong in the first half of the 1970s and of the first oil shock, which have not yet been overcome at macroeconomic level.

(2) See the conclusions of the 1981 annual report of the Bank for International Settlements, p. 165.

It is also clear that a decision to let the rate of monetary growth in the Community rise from 10.5% in 1980 to 12, 13 or 14% in 1982 might lead to a possible recovery in 1982 or 1983 ; but a resumption of growth under such monetary conditions would not allow a reduction in the base-line given by the present rate of inflation (Community average of 10% for the GDP deflator) and would quickly lead to an acceleration of price rises ; such a development would rapidly unleash a new stabilization crisis and would contribute nothing to a lasting improvement in growth and employment prospects.

5.5 Interest rates

The present phase of high interest rates has already lasted longer than the 1973/74 phase, which accompanied the overheating of 1973 and the first oil shock ; furthermore, interest rate levels are higher. In the autumn of 1981, this phase is in its third year and the peak money market rates (three-month interbank rates, Community averages) have been of the order of 14 to 16 %, whereas the previous phase lasted only from the second quarter of 1973 to the first quarter of 1975 and the maximum levels then were between 12 and 13 %.

The new wave of rising interest rates started with the acceleration in inflation in the United States which began in 1978 ; to this was soon added the impact of the second oil shock. In the Community, the resurgence of inflationary pressures, the emergence of a substantial balance of payments deficit on current account and the more restrictive stance of monetary policy led, during 1979, to a rise in money market rates comparable to that in the United States. Graph 5.5 shows that the rise in Community rates has been a good deal more steady than that in the United States : average Community rates increased from around 7 - 8 % in 1978 to approximately 12.5 - 14 % in 1980 and to 15 - 16 % by mid-1981, whereas in the United States three-month Treasury bills fluctuated between a first high of 16 % in March 1980, a low of 7.9 % in June 1980, a second high of 16 % in December 1980, a further low of 12.5 % in March 1981 and a further high of 16 % in May/June 1981 (see Graph 5.5). This extreme volatility of U.S. rates is probably one of the main reasons why public opinion in Europe has frequently put the blame for the general escalation in interest rate levels following the second oil shock squarely on the shoulders of authorities in the United States.

The average level of interest rates in the Community was kept between 12,5 % and 14 % from the end of 1979 until the beginning of 1981 partly because the monetary authorities in the member countries did not wish to follow the instability of transatlantic rates but mainly because they were guided by considerations of domestic economic policy : an appreciable fall in rates after March 1980, on the United States pattern, would have been compatible neither with the Community's substantial deficit on current account nor with the need to combat inflation ; a further big upsurge in interest rates in the second half of 1980 would have conflicted with the worrying fall-off in activity and rise in unemployment. However, the continuing high external deficit and rate of inflation, which were likely to be further aggravated by the soaring rate of the dollar, made a further upward adjustment of interest rates in Europe inevitable. This movement was started by the Bundesbank measures of 19 February 1981 (suspension of the Lombard facility) and followed, between February and May 1981, by the Benelux countries, Italy and France.

Graph 5.5 shows that, since 1978, the general trend in money market interest rates has been very similar in Germany, France, Italy and the Benelux countries in particular - a result of the EMS. The differences in level are due mainly to divergent rates of inflation and to different situations as regards payments balances and public budgets. However, it should be emphasized that, when the markets do not anticipate a shift of pivot rates, short-term investment in the various member countries is guided simply by nominal rates, and that the influence of differing inflation rates on short-term interest rate differentials tends to diminish as a result of the existence of EMS. Short-term rates in the United Kingdom have followed a different pattern : a very sharp rise from 1978 to the end of 1979 was followed by a gradual fall until the middle of 1981 ; this trend reflects the great effort made to achieve monetary stability and the gradual reduction in the rate of inflation from a level exceeding 20 % at an annual rate in the first half of 1980 to approximately 11 % in July 1981 : short-term interest rates in real terms thus fluctuated around zero from the beginning of 1979 until the middle of 1981.

Long-term interest rates are less influenced by the day-to-day conduct of monetary policy. Since 1978, their trend in the Community has generally been similar to that of short-term rates, although they have fluctuated much less. As measured by the Community average, short-term rates exceeded long-term rates from mid-1979 until mid-1980 and did so again from the first half of 1981. Despite the methodological problems involved in calculating real interest rates, a structural study of real long-term interest rates over a long period provides interesting findings. Taking the Community as a whole, the level of real long-term rates was positive and relatively high during the 1960s (average for 1961-70 : 2.9 % - cf. Table 5.9 and Graph 5.6). This level was accompanied by low rates of inflation, high rates of GDP and investment growth, public budgets more or less in balance, current payments generally in surplus and a trend in real per capita wages - leaving aside cyclical fluctuations - parallel to that of productivity adjusted for changes in the terms of trade (see Graph 4.2). At the beginning of the 1970s, real long-term rates started a steady fall (cf. Graph 5.6), the low point being reached during the 1975 recession (- 1.8 %). At the same time, a considerable gap opened up between the growth of real wages and that of productivity adjusted for changes in the terms of trade ; the rise in prices accelerated considerably, the trend growth rate of GDP and of investment fell and public budgets and balances of payments showed substantial deficits. These trends were closely linked with the lax monetary policies pursued in the early 1970s (cf. Chapter 5 of the 1980 annual review) and with the inadequate adjustment of incomes to the consequences of the first oil shock. It would seem that, during this period, the role played by interest rates in the allocation of resources and the distribution of incomes was greatly disrupted. The major structural distortions which resulted were only very partially corrected by developments in the second half of the 1970s. While the stricter monetary policies adopted at the time of the second oil shock prevented inflation from again getting seriously out of control, they led in 1981 to a reappearance of high real long-term interest rates.

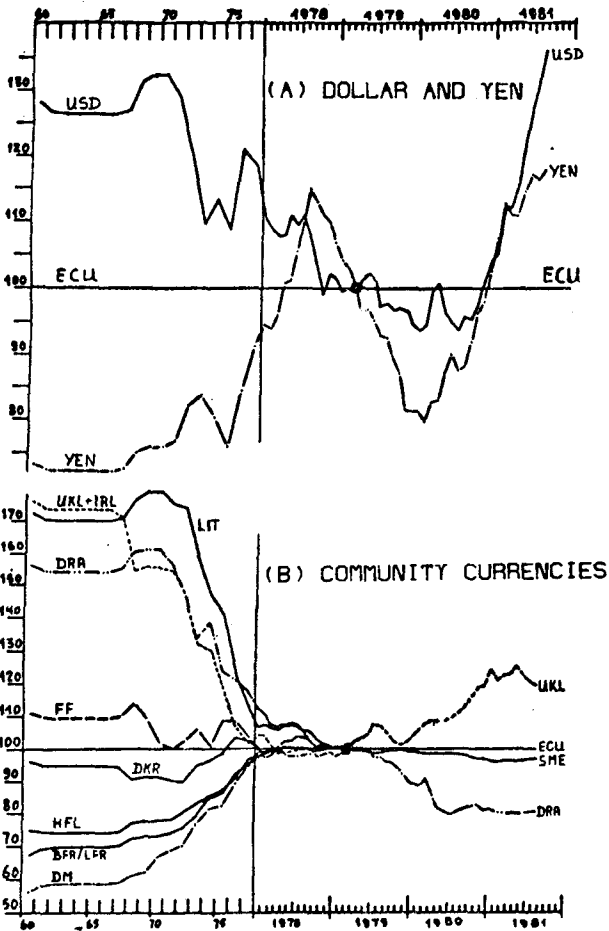
Owing to the present prospects of slower growth, these real rates are having a greater impact on the economy than the similar rates observed during the 1960s.

With economic activity sluggish in the Community, a general fall in short- and long-term interest rates would undoubtedly be desirable. For the time being, the high level of United States interest rates prevents such a fall from occurring, although the decline in demand for credit resulting from the current slowdown in economic activity could well justify a downturn in the near future. For a fall to last, however, inflationary expectations would have to be reduced appreciably in most member countries. Even if this were achieved, the general fall in long-term rates would be more a fall in nominal rates than in real rates and the differences in real rates would continue to reflect the varying size of structural imbalances in the member countries. Table 5.9 shows how the level of real long-term rates is associated, in member countries, with the divergence of real wages from the growth of productivity adjusted for changes in the terms of trade (real wage position) and with high or persistent public budget and current account deficits. The situation differs appreciably from one member country to the next. In Belgium the divergence of real wage position is widest (+23%) and the deficits both of the public sector and of the balance of payments are highest (Ireland left apart): these three factors combine to force real long-term rates up to a very high level; in Denmark the position of real wages has been corrected, although the sharp growth in the public sector deficit since 1978 and the continuing balance of payments deficit on current account since the 1960s, resulting in a very substantial external debt, have also led to a very high level of real rates; Germany, where real long-term rates have never been negative, and the Netherlands and France occupy, albeit with major differences of detail, a middle position, though this in no way implies the absence of structural imbalances; in Italy and Ireland, real rates remained negative or marginally positive until 1981 despite a high or very high position of real wages and substantial public sector and external deficits, because in both countries the process of reducing the rate of inflation (between 17% and 18% in 1981 in terms of GDP prices) has scarcely got under way and the monetary financing of the public sector is still very substantial: in the United Kingdom,

finally, after a lengthy period of negative rates (from 1974 to 1980 with the exception of 1978), real long-term interest rates again became positive in 1981. These country-by-country observations show that the high level of interest rates in the Community is not exclusively a problem of international relations or of overall monetary control, but is also one of structural imbalances which largely developed in the first half of the 1970s. A monetary policy which aims at stability and which refuses to permit an escape route which would involve a further wave of inflation shows up these imbalances and may prevent them from worsening. However, in order to speed up this corrective process, while at the same time limiting the cost in terms of growth and job losses, the reform of public finances and a more rapid adjustment of incomes are essential.

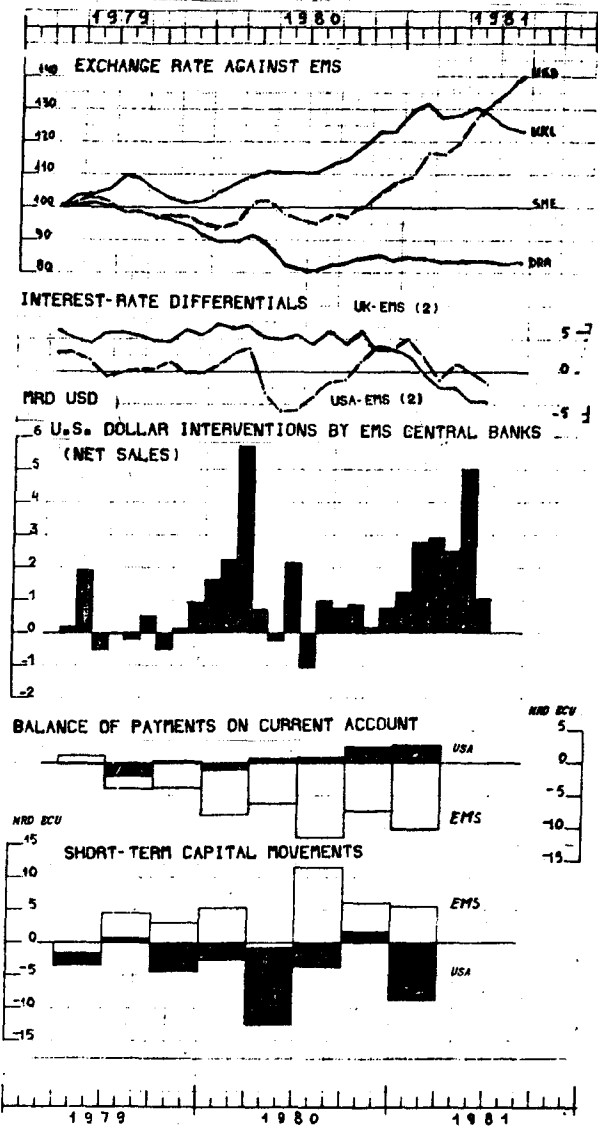
GRAPH 5.1

EXCHANGE RATES AGAINST THE ECU
(MARCH 1979 = 100)



GRAPH 5.2

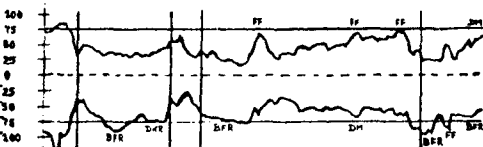
DOLLAR, STERLING AND DRACHME EXCHANGE RATES
AGAINST EMS (1) CURRENCIES, AND SOME EXPLANATORY FACTORS



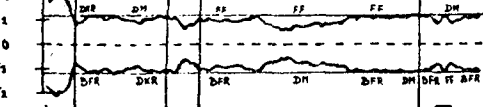
GRAPH 5.3

INDICATORS OF STRAIN WITHIN THE EMS

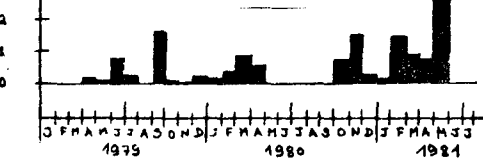
A. DIVERGENCE INDICATOR, MAXIMUM AND MINIMUM VALUES (1)



B. BILATERAL EXCHANGE RATE SPREADS, MAXIMUM AND MINIMUM VALUES (1)



C. INTERVENTIONS IN COMMUNITY CURRENCIES NOTIFIED TO THE ERCF (MRD ECU)



(1) WEEKLY AVERAGES.

(1) ECU WITHOUT UKL

(2) MEMBER COUNTRIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM

Table 5.1
Pivot rates of Community currencies (1)

		Bruxelles in BFR/LFR	København in DKR	Frankfurt in DM	Paris in FF	Dublin in IRL	Roma in LIT	Amsterdam in HFL	London in UKL
a) Pivot rates against ECU									
13 mars 1979	1 ECU =	39,4582	7,08592	2,51064	5,79831	0,662638	1148,15	2,72077	(0,663247)
24 sept. 1979	1 ECU =	39,8456	7,36594	2,48557	5,85522	0,669141	1159,42	2,74748	(0,619821)
30 nov. 1979	1 ECU =	39,7897	7,72336	2,48208	5,84700	0,668201	1157,79	2,74362	(0,648910)
23 mars 1981	1 ECU =	40,7985	7,91917	2,54502	5,99526	0,685145	1262,92	2,81318	(0,542122)
5 oct. 1981	1 ECU =	40,7572	7,91117	2,40989	6,17443	0,684452	1300,67	2,66382	(0,601048)
b) EMS bilateral pivot rates since 5 october 1981									
100 BFR/LFR	+ 2,25 %	100	19,4105	5,9128	15,1493	1,67934	3191,26	6,53583	-
100 DKR	- 2,25 %	515,186	100	30,4619	78,047	8,65169	16440,9	33,6716	-
100 DM	+ 2,25 %	1691,25	328,279	100	256,212	28,4018	53972,2	110,537	-
100 FF	+ 2,25 %	660,097	128,128	39,0302	100	11,0853	21065,3	43,1428	-
1 IRL	+ 2,25 %	59,5471	11,5584	3,5209	9,02098	1	1900,31	3,8919	-
100 LIT	+ 6,0 %	31,3355	6,0824	1,85281	4,74714	0,52623	1000	2,04804	-
100 HFL	- 2,25 %	1530,03	296,986	90,4673	231,789	25,6944	48827,2	100	-
c) Total appreciation (+) or depreciation (-) of bilateral pivot rates in % between 13 March 1979 and 5 october 1981 2)									
BFR/LFR		0,0	+ 8,09	- 7,07	+ 3,09	0,0	+ 9,67	- 5,21	-
DKR		- 7,48	0,0	- 14,03	- 4,62	- 7,48	+ 1,47	- 12,31	-
DM		+ 7,61	+ 16,31	0,0	+ 10,94	+ 7,61	+ 18,02	+ 2,09	-
FF		- 3,0	+ 4,85	- 9,86	0,0	- 3,00	+ 6,38	- 8,06	-
IRL		0,0	+ 8,09	- 7,07	+ 3,09	0,0	+ 9,67	- 5,21	-
LIT		- 8,82	- 1,45	- 15,27	- 6,00	- 8,82	0,0	- 13,57	-
HFL		+ 5,50	+ 14,03	- 1,96	+ 8,76	+ 5,50	+ 15,71	0,0	-

1) The Drachma has not yet been integrated into the ECU ; the pound sterling is represented in the ECU, but does not participate in the EMS exchange-rate mechanism.

2) Table to be read from left to right.

Table 5.2
Changes in effective exchange rates - March 1979 = 100 - monthly averages

	Against EMS countries (1)			Against 17 partners (1)			Against 23 partners (2)			Against the dollar only		
	March 1980	July 1980	July 1981	March 1980	July 1980	July 1981	March 1980	July 1980	July 1981	March 1980	July 1980	July 1981
B/L	98,9	100,1	99,2	98,9	100,5	91,7	98,7	100,2	95,0	98,4	105,3	73,7
DK	90,3	91,0	91,2	89,8	90,8	81,5	89,5	90,6	83,0	90,0	96,0	67,9
D	102,3	102,3	105,0	101,9	102,4	95,3	102,9	104,0	99,1	100,6	106,5	76,2
F	100,2	100,9	100,1	100,2	101,3	92,4	100,5	102,0	95,1	99,5	105,8	73,9
IRL	99,5	100,6	99,4	96,4	97,7	83,9	-	-	-	98,5	105,4	73,4
I	98,3	95,7	92,6	98,4	96,4	85,6	99,8	98,7	89,2	97,9	101,1	69,3
NL	99,6	100,0	99,7	99,3	100,1	91,9	99,4	100,2	94,7	99,0	105,1	74,0
UK	109,6	111,3	129,1	110,4	113,0	115,8	110,7	113,5	114,9	108,3	116,4	95,1
USA	100,8	95,4	135,4	103,8	98,1	114,7	103,8	98,8	115,9	100,0	100,0	100,0
Japan	83,6	88,9	120,0	83,2	91,2	93,9	83,8	92,0	96,6	83,0	93,3	88,8

1) Combined export and import weighting; source: Commission departments.

2) Source: Bundesbank, monthly report, August 1981, export and import weighting.

Table 5.3
Breakdown of the changes in relative unit labour costs^{a)} vis-à-vis EMS partners

	Changes in each country, in national currencies			Relative changes in national currencies				Changes in effective exchange rate				Relative changes in common currency			
	1			2				3				4 = 2 x 3 in indices			
	Annual rates as %			1973		1981		1978		1981		1978		1981	
	70	78	81	Ind.	%p.a.	Ind.	%p.a.	Ind.	%p.a.	Ind.	%p.a.	Ind.	%p.a.	Ind.	%p.a.
B	3,4	9,7	6,0	109,9	+1,2	96,3	-1,2	107,2	+0,9	99,9	-0,0	117,8	+2,1	96,2	-1,3
DK	6,7	9,6	8,5	109,3	+1,1	103,2	+1,0	93,9	-0,8	90,9	-3,1	102,7	+0,3	93,8	-2,1
D	3,9	5,6	3,9	70,0	-4,4	85,5	-5,1	141,6	+4,4	107,6	+2,5	99,1	-0,1	92,0	-2,7
F	4,3	9,9	12,0	104,6	+0,6	112,2	+3,9	88,6	-1,5	99,9	-0,0	92,6	-1,0	112,1	+3,9
IRL	5,5	13,6	16,5	140,7	+4,4	126,4	+8,1	55,3	-7,1	99,4	-0,2	77,9	-3,1	125,7	+7,9
I	4,4	15,4	17,5	172,1	+7,0	132,7	+9,9	48,0	-8,8	86,0	-4,9	82,7	-2,4	114,2	+4,5
NL	6,4	8,5	4,1	102,1	+0,3	92,2	-2,7	110,6	+1,3	101,0	+0,3	112,9	+1,5	93,2	-2,3
UK ^{b)}	4,3	13,0	14,9	127,1	+3,0	118,2	+5,7	60,1	-6,2	129,1	+8,9	76,3	-3,3	152,5	+15,1

a) Export weighting, variable from year to year until 1979.

b) Changes relative to EMS countries.

1) + 2) Index of changes in compensation of employees per employee divided by the index of productivity per person employed; source : SOEC; from 1980 : economic budgets of May 1981.

3) + 4) Exchange rate estimate made in August, 1981, and compatible with pivot rates established on 23 March 1981. This estimate does not take account of the realignment of 5 October 1981; the shift in effective exchange rates implied by that realignment appears in table 3 of the Annual Report but since it affects only the last three months of this year, and that only to the extent that market rates reflect the realignment of pivot rates, only about one quarter of the shift would be relevant to the above table which shows the annual average for 1981 and would thus be little affected if the realignment were taken into account.

Table 5.4
Adjustment of relative changes^{a)} in costs and prices in relation to EMS partners

	a) Relative change in unit labour costs ^{b)} whole economy; indices in common currency						b) Relative change in GDP price; indices in common currency					
	Relative level in 1978 (=available margins relative to different base periods = 100)			Relative level in 1981 (=remaining relative margins relative to different base periods = 100)			Relative level in 1978 (= available margins relative to different base periods = 100)			Relative level in 1981 (=remaining relative margins relative to different base periods = 100)		
	1	2	3	1	2	3	1	2	3	1	2	3
	1978	1978	1978	1981	1981	1981	1978	1978	1978	1981	1981	1981
	1970	ø61-70	ø68-72	1970	ø61-70	ø68-72	1970	ø61-70	ø68-72	1970	ø61-70	ø68-72
B	117,8	111,4	115,1	113,4	107,2	110,7	105,6	102,5	105,7	97,3	94,5	97,4
DK	102,7	104,8	102,7	96,3	98,2	96,3	110,2	112,5	110,3	101,1	103,3	101,2
D	99,1	106,4	103,0	91,2	97,9	94,8	104,0	111,4	107,1	97,5	104,3	100,4
F	92,6	81,1	89,3	103,8	90,9	100,1	92,9	83,3	89,9	102,8	92,2	99,5
IRL	77,9	74,8	82,2	97,9	94,0	103,3	82,6	80,1	83,4	99,0	96,0	100,0
I	82,7	81,4	80,2	94,4	92,9	91,6	77,6	76,5	78,0	89,3	88,0	89,7
NL	112,9	121,7	111,5	105,1	113,3	103,9	119,1	123,2	116,3	113,9	117,8	111,2
UK ^{c)}	76,3	69,8	77,7	116,4	106,5	118,5	80,1	73,4	80,6	123,0	112,7	123,8

a) Export weighting, variable from year to year until 1979 - Source : SOEC; from 1980, Economic Budgets of May 1981; exchange rate estimate made in August 1981 and compatible with pivot rates established on 23 March 1981. This estimate does not take account of the realignment of 5 October 1981; the shift in effective exchange rates implied by that realignment appears in table 3 of the Annual Report but since it affects only the last three months of this year, and that only to the extent that market rates reflect the realignment of pivot rates, only about one quarter of the shift would be relevant to the above table which shows the annual average for 1981 and would thus be little affected if the realignment were taken into account.

b) Index of compensation of employees per employee divided by the index of productivity per person employed.

c) Change relative to EMS countries.

Table 5.5
Monetary objectives and outturns
Variables chosen as objectives (annual change in %)

Country	Key variable *	1979		1980		1981	
		Objective	Outturn	Objective	Outturn	Objective	Outturn in the 12 months ending in:
B	TDCE	12.0 (p)	12.4	11.0 (p)	9.5	10.0 (p)	9.6 June
DK	DCE	9.0	12.9	9.5	17.3	6.0	5.8 June
D	MZ*	6-9 (1)	6.3 (1)	5-8 (1)	4.9 (1)	4-7 (1)	4.9 July
GR	PSCE *		28.9	16.0	19.5	19.3	21.9 May
F	M2 *	11.0	14.4	11.0	9.8	10.0	14.2 July
IRL	PSCE	18.0	19.3	13.0	13.0	15.0	21.3 July
I	TDCE *	18.5	18.6	17.5	18.0	16.0	18.9 April
NL	DM2 *	8.5	10.8	7.5-8.0	7.6	6.5	4.4 June
UK(2)	EM3 *	8-12 (3) 7-11 (4)	13.5 (3) 10.8 (4)	7-11(5) 7-11(6)	16.9 (5) 18.5 (6)	6-10	16.9 July

* The variables marked with an asterisk (*) are objectives published and having a normative significance.
 TDCE = Total domestic credit expansion. DCE = Domestic credit expansion. MZ = Central bank money.
 PSCE = Domestic credit extended to the private sector. DM2 = money creation from domestic sources.
 (1) Growth between the mean of the last quarter of the preceding year and of the present year.
 (2) Financial year ending in March of the following year, unless otherwise indicated.
 (3) October 1978/October 1979.
 (4) June 1979/April 1980 (at annual rate)
 (5) June 1979/October 1980 (at annual rate).
 (6) February 1980/April 1981 (at annual rate).
 (p) Forecast.

Table 5.6
Growth of money stock

Broadly defined money stock M2/3, end of year, annual percentage change															
Definition	70	72	73	74	75	76	77	78	79	80	81		82		
	59	70	72	73	74	75	76	77	78	79	11.81	v.81	IX.81	v.81	IX.81
B M2H (2)	8,2	14,2	13,5	9,0	14,8	13,6	8,4	7,8	6,0	2,7	5,0	3,9	6,1	5,8	5,8
DK M2	10,0	11,7	12,6	8,9	25,1	11,4	9,8	6,7	9,9	10,9	5,7	8,1	9,3	9,0	12,0
D M3	10,4	13,9	10,1	8,5	8,6	8,4	11,2	11,0	6,0	6,2	4,5	5,4	5,4	6,1	5,7
GR M3	17,9	23,0	14,5	20,9	26,5	26,8	22,7	39,4	18,4	24,7	19,8	22,4	31,7	18,3	19,9
F M2	13,1	18,1	15,0	15,9	18,2	12,9	13,9	12,2	14,4	9,7	10,0	12,5	15,2	14,3	13,0
IRL M3	9,9	13,1	26,2	19,2	18,9	13,7	16,4	28,9	19,0	16,9	12,0	12,2	14,3	15,9	15,9
I M2	13,9	17,7	23,0	15,3	23,5	20,8	21,8	23,0	20,3	12,0	13,1	11,0	16,7	10,0	16,0
NL M2	8,9	10,4	21,9	20,0	5,7	22,7	3,6	4,2	7,6	3,6	6,5	6,2	6,6	8,2	7,9
UK EM3	5,6	18,8	26,4	10,2	6,5	9,5	10,0	15,0	12,7	18,6	10,2	8,5	11,5	8,5	7,8
CE10(3) M2/3	10,5	16,3	17,5	12,5	13,4	12,9	12,9	13,9	11,9	10,5	8,8	8,8	11,2	9,4	9,9
Weighted dispersion EUR-10(5)	2,4	2,6	5,8	3,6	6,4	4,0	3,6	4,2	4,3	4,1	2,9	2,8	4,1	2,6	4,2

(1) Commission forecasts; the figures 11.81, v.81 and IX.81 indicate the months in which these forecasts were compiled.
 (2) For Belgium, the figures for the period 1959-78 refer to the money stock with the main monetary institutions.
 (3) The index of the Community money stock was calculated as a weighted geometrical average of the indices (1975=100) of the money stocks of nine Community countries (Luxembourg being excluded). The weighting used is that of 1975 GDP at 1975 prices and purchasing power parities (see Statistical Office of the EC "National Accounts ESA 1960-79, Brussels 1981, page 158); the weight of Luxembourg was added to the weight of Belgium. This type of weighting ensures better comparability of the Community aggregate with the ESA national accounts series.
 (4) In the United Kingdom, the growth in the money stock recorded in the statistics - 12.7 % in 1979 and 18.6 % in 1980 - was distorted by measures in force in 1979 (the "corset") and abolished in June 1980. The figures in brackets - 15.6 % and 15.6 % - are broadly adjusted for this distortion.
 (5) Weighted dispersion EUR-10 = weighted average of absolute deviations of the growth rates of the various countries from their weighted average.
 (6) Because there has been a shift from bank deposits to Treasury bills in response to a rise in the yield of the latter, the September forecasts for 1981 and 1982 relate to M3 (M2 plus Treasury bills). M3 grew in 1980 by 16.9%; M2 is expected to grow in 1981 by 3.2 %.

Table 5.7
Contribution of the counterparts of the money stock to monetary growth
1980: outturns, 1981-82: Commission estimates^{a)}

- as percentage of money stock at the beginning of each period -

Country	Definition	M2/3 end of year % per annum			Lending to the private sector			Lending to the public sector			External component			Non-monetary liabilities		
		1980	1981	1982	1980	1981	1982	1980	1981	1982	1980	1981	1982	1980	1981	1982
B	M2M	2.7	6.1	5.8	8.1	7.4	8.1	13.7	19.8	18.4	-10.2	-14.1	-13.0	-8.5	-5.4	-3.6
DK	M2	10.9	9.3	12.0	6.5	4.6	5.3	10.2	11.6	13.3	-6.5	-7.0	-6.6	-	-	-
D	M3	6.2	5.4	5.7	14.6	12.8	12.2	3.5	4.1	3.3	-1.5	+1.5	3.4	-9.2	-12.1	-12.4
GR	M3	24.7	31.7	19.9	16.5	18.8	14.3	18.5	24.4	15.6	-5.1	-7.4	-6.7	-5.1	-3.9	-3.4
F (1)	M2	9.7	15.0	13.0	11.8	14.7	13.3	-0.6	2.1	2.8	2.0	-1.5	-1.0	-	-	-
IRL	M3	16.9	14.3	15.9	14.0	13.0	13.1	17.5	21.9	21.6	-10.8	-19.2	-17.7	-4.2	-1.7	-1.5
I	M2/3(3)	12.3	16.7	16.0	13.6	10.7	8.7	10.3	11.2	9.8	-2.3	-0.6	0.0	-7.0	-4.6	-2.5
NL	M2	3.6	6.6	7.9	15.6	16.9	16.8	4.5	3.1	0.0	-3.9	0.9	5.5	-12.6	-14.3	-14.3
UK (2)	£M3	18.4	10.5	9.2	22.2	14.5	13.2	3.8	3.6	0.0	-5.3	-5.8	-2.2	-2.2	-1.9	-1.7

- (1) The external component includes only the official reserves.
 (2) Financial year.
 (3) For 1980, M2 and its counterparts; for 1981 and 1982 M3 and its counterparts.
 a) September 1981.

Table 5.8
Margins for price increases and margins for growth in the Community¹⁾ resulting from the interaction of monetary policy and the growth of incomes - % per annum

	70/60	73/70	74/73	75/74	76/75	77/76	78/77	79/78	80/79	81/80	82/81 ^{a)}	82 ^{b)} /81
1. Margins for price increases = money supply per unit of real GDP (1=10:7)	5,5	10,8	13,1	14,1	8,4	9,5	10,0	9,5	9,4	11,8	8,1	6,0
2. Margins for growth = ratio of money supply to unit labour costs (2) (2 = 10 : 8)	5,8	7,1	-0,2	-4,0	5,0	2,3	4,7	3,5	-1,3	0,5	1,7	4,5
3. Liquidity ratio (3 = 10 : 9)	+1,2	3,2	1,2	0,0	-1,8	-0,6	+1,0	-0,6	-2,0	1,6	-1,5	-1,3
4. Divergence between real per capita wages and productivity (4 = 8 : 6)	0,1	+0,6	3,2	+2,6	-1,9	-0,7	-0,5	-0,8	0,4	0,6	-1,3	-2,0
5. Structural factor (5 = 3 : 4)	+1,1	+2,6	-1,9	-2,6	+0,1	+0,1	+1,0	0,2	-2,4	1,0	-0,2	0,7
6. GDP deflator (6 = 1:3 = 8:4)	4,2	7,4	11,7	14,2	10,4	10,2	8,9	10,2	11,6	10,0	9,8	7,4
7. Real GDP (7 = 2:5)	4,6	4,4	1,8	-1,5	5,0	2,2	3,1	3,3	1,1	-0,5	2,0	3,8
8. Unit labour costs (2)	4,3	8,0	15,3	17,2	8,3	9,5	8,4	9,3	12,1	10,7	8,4	5,3
9. Nominal GDP (9 = 6 x 7)	9,0	12,1	13,7	12,5	15,9	12,6	12,3	13,8	12,8	9,5	12,0	11,5
10. Average money stock (M2/3) (3)	10,3	15,7	15,0	12,5	13,7	12,0	13,4	13,1	10,6	11,2	10,3	10,0
11. Money stock at end of period (M2/3) (3)	10,3	16,7	12,4	13,2	12,8	12,7	13,5	12,1	10,5	10,6	10,2	9,4

- (1) 1980-82 = September 1981 economic budgets data, EUR-10
 1960-79 = ESA National Accounts, aggregates, 1981, EUR-9
 a) Commission estimates (September 1981)
 b) Purely illustrative hypothesis
 (2) Compensation of employees per employee divided by total productivity per person employed
 (3) The method of aggregation used in this table is consistent with that used for the aggregation of real sector variables:
 1980-1982 : weights based on GDP of the previous year at current prices and 1980 exchange rates.
 1960-1979 : weights based on 1975 GDP at purchasing power parities of that year.

Table 5.9

Real long-term interest rates and their interrelationship with certain macro-economic variables

	61-70 average	1975	1978	1980	1981	61-70 average	1975	1978	1980	1981
a) Real long-term interest rates - % p.a.						b) Real wage position; Indices: 1961-70 average = 100				
B	+ 3,2	- 3,4	+ 3,3	+ 5,6	+ 7,1	100,0	116,6	119,6	122,1	123,4
DK	+ 2,1	+ 1,7	+ 6,2	+ 6,2	+ 9,4	100,0	111,1	101,8	102,3	103,0
D	+ 4,0	+ 2,5	+ 2,5	+ 3,0	+ 5,2	100,0	110,5	106,9	107,0	106,7
F	+ 2,2	- 1,4	+ 0,9	+ 0,9	+ 2,7	100,0	107,1	108,2	107,8	107,7
IRL	-	+ 0,7	+ 1,3	+ 0,9	+ 1,6	100,0	108,2	102,9	115,3	112,9
I	+ 2,6	- 5,8	- 0,5	- 3,5	- 0,9	100,0	117,8	117,5	115,4	118,0
NL	+ 1,3	- 0,6	+ 3,1	+ 4,2	+ 5,2	100,0	115,3	111,2	112,4	109,9
UK	+ 2,8	- 5,2	+ 1,5	- 1,6	+ 3,8	100,0	116,4	104,8	109,3	108,0
CE	+ 2,9	- 1,8	+ 1,6	+ 0,7	+ 3,4	100,0	112,5	109,1	109,6	109,3
c) General government borrowing requirement as % of GDP						d) Balance of payments on current account as % of GDP				
B	- 1,3	- 4,4	- 6,0	- 9,1	- 12,4	+ 0,6	- 0,2	- 1,6	- 5,2	- 7,2
DK	+ 1,4	- 1,9	- 2,2	- 6,1	- 9,8	- 2,3	- 1,5	- 2,7	- 3,8	- 3,3
D	+ 0,6	- 5,8	- 2,7	- 3,5	- 4,0	+ 0,7	+ 0,9	+ 1,4	- 1,8	- 1,4
F	+ 0,4	- 2,2	- 0,8	+ 0,4	- 2,1	+ 0,2	0,0	+ 0,6	- 1,4	- 1,4
IRL	- 3,5	- 12,8	- 14,3	- 13,1	- 14,3	- 2,5	- 0,2	- 2,4	- 8,3	- 14,8
I	- 2,2	- 11,7	- 9,7	- 7,8	- 9,0	+ 1,8	- 0,2	+ 2,4	- 2,5	- 2,3
NL	- 0,9	- 2,2	- 2,3	- 3,7	- 4,1	0,0	+ 2,5	- 0,9	- 1,4	+ 0,6
UK	- 0,7	- 5,0	- 4,3	- 3,5	- 2,2	- 0,1	- 2,2	+ 0,2	+ 1,2	+ 1,2
CE	- 0,4	- 5,6	- 4,0	- 3,5	- 4,4	+ 0,4	- 0,1	+ 0,7	- 1,4	- 1,2

- (a) Yield of public sector bonds, real rates calculated using a 25-month moving average of consumer price indices; for 1981; average of interest rates in the first half of the year, real rates calculated using forecast private consumption deflators, average of annual rates for 1981 and 1982.
- (b) Index of compensation of employees per employee adjusted by private consumption deflators, divided by productivity adjusted for changes in the terms of trade; source: SOEC and economic budgets of May, 1981.
- (c) and (d) Source: SOEC and economic budgets of September 1981.

6. Budgetary policy

In most countries the thrust of budgetary policy in 1980 and 1981 has been aimed at reducing budget deficits over the medium-term and at giving support to anti-inflationary monetary policy. Thus measures to restrain expenditure or increase tax rates are limiting the increase in budget deficits in 1981 to an amount equal to 0,9% of Community GDP, whereas otherwise the deficits could have risen by more than twice as much under the combined impact of weak economic activity and rising interest payments. In 1982, government attempts to compress deficits are likely to be reinforced in a number of countries, but in others discretionary policy may swing into a more expansionary posture. For the Community as a whole discretionary policy will be slightly less restrictive than in 1981, but the overall budget deficit in the Community should be reduced by about 0,2% of GDP as the impact of the recession on government finances recedes somewhat. Slightly increased reliance has been placed on non-monetary financing of deficits in 1981; such reliance will probably be maintained in 1982. The interplay of policy changes and the movement of the economy in 1981 is reflected in a rise in the ratio of transfers and interest payments to GDP, while government final expenditure as a proportion of GDP is rather stable and tax pressure rises. These results continue a longer-term trend for government's role as redistributor, rather than final user, of income to expand. In 1982, tax pressure could increase further but the proportion of GDP taken up by final government expenditure could fall back.

6.1 Budgetary developments in the cycle: 1978-82

The likely resumption of a moderate growth of output in the first half of 1982 will complete a somewhat atypical cycle of three-and-a-half years length which began in the second half of 1978 with an upswing which was cut short by the oil-price shock. The stance of budgetary policy in the Community is, however, substantially different now as compared with the period at the outset of the 1978 upswing.

Then, budgetary policy had been supportive of activity in a number of member countries. Further, the Concerted Action Decision of 24 July 1978 was aimed at significantly increasing budgetary support to economic activity, especially in the Federal Republic of Germany, the United Kingdom and France.

The effects of measures resulting from the decision of 24 July 1978 bore mainly on 1979. But during the course of 1979 the drastic change in the economic climate brought about by the oil price shock was accompanied by a shift to a more restrictive stance of budgetary policies in a number of countries, offsetting the global effects in 1979 of policies introduced in 1978. Thus for the Community as a whole the main net outcome for 1979 was a restructuring of government budgets: the pressure of taxes and social security contributions as a percentage of GDP was little changed, but with a switch away from direct taxes, while the volume of government current consumption as a percentage of real GDP and the share of current transfers to households in nominal GDP both fell. The net borrowing

of general government (henceforth referred to as the "budget deficit") in the Community declined from 4,0% of GDP in 1978 to 3,6% of GDP in 1979 (Table 6.4). Relatively rapid economic growth in 1979 tended to increase tax receipts, and falling unemployment to reduce the growth in payments of unemployment benefits, in the Community as a whole. Among Member States (Table 6.1) the budget deficit indeed rose in the Federal Republic of Germany and declined in Ireland and Italy, as foreseen by the Council Decision, but rose in Denmark, Belgium and the Netherlands, countries in which the Decision had sought efforts to curb the growth in current spending.

In most member countries budgetary policy in 1980 was aimed at reducing or at least restraining the general government deficit as a percentage of GDP. In consequence, programmes of expenditure reduction or restraint, sometimes supplemented by tax increases, were announced in a number of countries. In some instances (notably Belgium and Italy) political or administrative difficulties prevented the full implementation of programmes of restraint of expenditure. Other countries experienced difficulties in the areas of public sector salaries (Ireland, the United Kingdom) and of expenditure only indirectly controlled by central governments (Denmark, United Kingdom). In addition, announced programmes of restraint were in some cases modified to provide support to particularly hard-hit sectors, notably the construction industry (Denmark, Ireland, the Netherlands), and to stimulate private investment through subsidies and incentives. Nonetheless, tax pressure rose in 1980 (to 40,3% of GDP) and the volume growth of current expenditure was reduced from its 1979 rate. Against this, the recession in economic activity worked to reduce tax revenues and swell current transfers, particularly unemployment benefits. Moreover, high nominal interest rates increased the cost of servicing public debt. For the Community as a whole (see Table 6.2) a very slightly reduced general government deficit as a percentage of GDP resulted, with a substantially lower deficit in the United Kingdom (though still not as large a reduction as originally planned by the Government) and in Italy and even a small surplus in France exactly offsetting deteriorations elsewhere, particularly in Belgium, Ireland and Denmark.

Policy changes in 1981 again are having the effect, other things equal, of tending to reduce deficits, reflecting a desire in a number of countries to steer as close as possible to medium-term targets for budget deficits and to concentrate on structural rather than on traditional "demand-management" policy measures. This is particularly true of the Federal Republic of Germany, the United Kingdom and the Netherlands. In Belgium and Ireland the avowed aim of governments to restrict deficits reflects more urgent worries about growing public sector indebtedness and balance of payments deficits, but again political factors have prevented effective restraint in 1981. In Denmark the balance of payments deficit is also a major preoccupation, but the effort of budgetary restraint which bore some fruit in a reduced current deficit in 1980 appears to have been somewhat weakened in 1981.

For the Community as a whole, government consumption is forecast to grow by 1,5% in volume, a rate of growth probably below what might be expected to be its trend rate even given worsened medium-term prospects and, in some countries, an intention to reduce the share of expenditure accounted for by the public sector. Similarly, whereas the share of social benefits in GDP increased by about 2 points in the deep recession year of 1975, the increase in 1981 is expected to be about 1/2 point, the difference being considerably bigger than is explained by the somewhat smaller increase in the unemployment rate in 1981 as compared with 1975. Further, the need to limit the expansion of deficits has, at least in part, frustrated the desire of governments to avoid increases in tax pressure as measured by the share of taxes and social security contributions in GDP (see section 6.3).

On the basis of announced policies, 1982 is also likely to be a year in which a desire to restrict or reduce budget deficits is, in many Community countries, the strongest influence on budgetary policy. In France and Denmark, however, concern about the implications of unemployment is leading to a change of targeted budgetary stance.

Deficits are likely to fall as a percentage of GDP in Germany, Belgium, the Netherlands, Ireland and the United Kingdom, to be little changed in Italy, and to increase in Denmark, Luxembourg and France. Gross saving will remain substantially negative in Belgium, Denmark, Ireland and Italy, but only in Denmark would this be the case if net interest were excluded (see box on budgetary developments in individual countries). For the Community as a whole, general government budget deficits in 1982 may be reduced somewhat as a percentage of GDP (to 4.2% of GDP), measures of budgetary restraint just more than offsetting the effects of rather modest growth in output and a continued rise in unemployment (Table 6.1). Net of interest, the budget deficit as a percentage of GDP could decline by a slightly larger amount, being reduced to 1.1% as against the 1.6% likely for 1981.

In sum, the traditional counter-cyclical role of budgetary policy has been, in the Community as a whole, severely circumscribed during the present cycle. The consequences of an emphasis on monetary control and on medium-term policy objectives (in which the adjustment of external imbalances is also an important factor for certain member countries) have in many Community countries ruled out discretionary budgetary action in response to the weakness of activity and employment in the Community economy. Further, to the extent that such weakness could be ascribed to poor competitiveness, structural maladjustment and a shortage of profitably utilizable capital, budgetary stimulation of demand would be inappropriate even without taking monetary repercussions into account. This drawback would apply as much to the "automatic stabilizers" as to discretionary stimulation of demand and would imply that an increase in budget deficits brought about by the "automatic stabilizers" might not be easily reversible. The operation of these mechanisms would in such circumstances pose a threat to the attainment of financial plans involving medium-term reductions in budget deficits.

These considerations mean that it is difficult to divide changes in budget deficits into conventional "automatic" and "discretionary" components. However, it is still clearly of interest to examine the effect that variations in output and unemployment, whatever their causes, have on the budget deficit. For this purpose, a trend rate of growth for the Community economy has had to be assumed and thus the calculations have something of an illustrative nature. The rate chosen from 1974 onwards is 2 1/2% a year; this corresponds to estimates prepared by the Commission services using capacity utilization data from the EC business surveys (see Annual Economic Review 1980-81, pp. 1.9 and 1.10). The effects of changes in net interest payments are shown separately, so that "discretionary" changes (identified with the residual change shown in Table 6.3) in budget deficits are taken to mean changes in effective rates of tax and transfers, excluding net interest payments, and changes in the ratios of government consumption and capital formation to trend GDP.

The calculations suggest that whereas following the first oil-price shock discretionary budgetary policy tended to increase budget deficits in the Community, the reverse has been true after the second oil-price shock. In particular, "discretionary" changes in 1981, a recession year, would have reduced the budget deficit by an amount equivalent to 1,2% of GDP in the absence of the deficit-increasing "automatic" effects of changes in economic activity and the effects of increased net interest payments. The comparison of 1981 with 1975 points up the seriousness of the constraints on budgetary policy which arose or were perceived between the two episodes.

For 1982, "discretionary" changes are smaller than in 1981, and more than offset "automatic" and interest payment effects so as to produce a reduction in the actual deficit.

6.2 Longer term budgetary trends

The previous section analysed recent changes in general government budget deficits explicitly in terms of "discretionary" and other changes. The present section examines changes in budget deficits in the Community, over a longer period, in terms of the development of the major budgetary aggregates.

It is first of all noteworthy that gross saving of general government in the Community has tended to deteriorate more rapidly than the overall budget deficit from a substantial 5,5% of GDP in 1970 to -0,4% in 1981. Capital outlays (capital formation plus capital transfers) have declined fairly steadily as a proportion of GDP (Table 6.4). Government capital formation has declined steadily (with 1974 and, to a lesser extent, 1980 being exceptions).

Within the current account of general government, total taxes and social security contributions rise from 35,7% of GDP in 1970 to a forecast 41,1% in 1982. A particularly sharp rise in tax pressure, thus defined, took place between 1972 and 1977. Since 1977 the rise has been more restrained but nonetheless evident, especially in 1980 and 1981. Governments in a number of Community countries have seen a reduction in tax pressure as a desirable aim, other things being equal, but a perceived need to counter "automatic" increases in budget deficits and, particularly in the case of Denmark, the policy priority of correcting an external disequilibrium have up to now frustrated this desire. For 1982, however, a small reduction in tax pressure in the Community is forecast. Among countries, the rise in total tax pressure over the period was strongest in the Netherlands and Belgium, while the United Kingdom, at the other extreme, showed little change.

Social contributions have been the fastest-growing elements of tax and parafiscal charges, especially in the Netherlands, where such charges reached 20% of GDP by the beginning of the 1980's. With an unchanged régime, the elasticity of contributions with respect to GDP might be expected to be close to or below unity: the rise in the ratio of contributions to GDP over the period probably represents attempts to balance the operations of social security funds in the face of strongly-rising social benefits, especially in Denmark, Belgium, France and the Netherlands.

Such benefit payments have increased from 14,3% of GDP in 1970 to 20,2% in 1981. The increase results from a combination of factors: rising unemployment, and at least until the later 1970s, a growing number of pensioners, improved eligibility conditions and increased real benefit rates. The slight fall in the ratio in 1979 probably reflects the fact that the fall in unemployment in that year, although small in total, was concentrated among males. The stability of the ratio in 1980 and the relatively small rise in 1981 compared

with 1975 (despite strongly rising unemployment) are evidence of measures in a number of countries to restrict eligibility and/or reduce real rates of benefit per recipient. In 1982 it is forecast that, with a slower rise in unemployment, these measures will help produce a fall in the ratio.

The period between 1972 and 1977 saw a rise in the ratio of direct taxes to GDP from 10,4% in the former year to 12,6% in the latter. This rise was primarily brought about through the workings of fiscal drag during a period of rapid inflation. Only in 1972 and 1975 did the share of direct taxes in GDP fall slightly, years in which cuts in direct tax rates (before the effects of fiscal drag are considered) were made in response to weak economic activity. However, schemes of at least partial fiscal indexation were introduced in a number of countries towards the end of this period. In combination with reduced inflation in 1978 and 1979 these schemes reduced the effects of fiscal drag in those years, while direct tax rates were reduced in a number of countries in attempts either to support activity or to re-structure the tax burden. A reacceleration of inflation in 1980 and policy changes in a number of countries led to a further rise in the ratio. Little change is in prospect for the Community as a whole in 1981 and 1982. Among the member countries, however, the direct tax ratio rises quite sharply in Denmark and the United Kingdom.

Indirect taxes tended to fall as a percentage of GDP during the first half of the 1970's, excise duties being generally non-indexed. The fall at the Community level in this period mainly resulted from developments in Italy and the United Kingdom. In 1976 and 1977, however, indirect tax rates were increased, along with the tax burden as a whole, as part of discretionary moves aimed at reducing budget deficits. Since then they have continued to increase, most noticeably in the United Kingdom and the Federal Republic of Germany, bearing the weight both of effects to restructure the tax burden or, as in 1980 and 1981, to restrict the growth of deficits while increasing the direct tax burden as little as possible.

On the expenditure side, government consumption, as a percentage of GDP, has tended to rise in years of low or negative growth (1972, 1974, 1975, 1980, 1981) and to fall in years of rapid growth (1973, 1976). The ratio fell,

however, in 1977, and rose slightly in 1978 and 1979, years when private domestic demand was already rising quite strongly. Over the period as a whole the trend in the ratio was upwards (but it is expected to fall back somewhat in 1982). Until 1975, an increase in purchases of goods and services and in consumption of fixed capital was the biggest factor in the rising share of government consumption. From 1977 to 1980, however, these elements of government consumption fell back as a share of GDP, while compensation of employees was on a rising trend. The forecasts for 1982 are based on the assumption that governments will seek to reduce the burden of expenditure restraint on private sector suppliers, on whom it has tended to fall so far, and shift more of it onto their own direct employment outlays.

The proportion of other current outlays (almost exclusively interest payments) in GDP more than doubled between its 1970 level and that forecast for 1982. The increase is even more marked in Denmark, Belgium and Italy. A rising cost of debt service, as a proportion of GDP, does not necessarily imply a consistent rise in the ratio of general government debt to GDP, since a major reason for the increased cost of debt service has been an inflation premium in interest payments on nominally-fixed debt.

On capital account, gross capital formation by general government has declined markedly as a proportion of GDP over the period since 1970; only in 1975, when the denominator of the ratio fell sharply, was there any clear break in this trend, which is forecast to continue in 1982. Governments faced with budgetary constraints find it easier to prune capital expenditure than government consumption both because discrete capital expenditure projects are easily shelvable and because such pruning is felt by the private sector rather than by public sector employees.

Net capital transfers will be at a similar level, as a proportion of GDP, in 1982 to their level in 1970. The ratio rose in 1975, as governments strove to mitigate through grants the collapse of investment, but fell in 1981 despite some probable element of subsidies to "crisis" sectors, although this is difficult to identify.

The forecast and assumed or declared monetary policy targets for 1982 would allow room for monetary financing slightly lower than the 3.0% of GDP estimated for 1982 (with wide differences among Member States, to some extent depending upon differences in definition of the monetary aggregates). The total net borrowing requirement is expected to decline from 6.1% of GDP in 1981 to 5.2% and non-monetary financing could thus be expected to draw slightly less upon financial markets in 1982 than in the previous year (Table 6.5).

Major budgetary policy developments affecting 1981 and 1982 in the Member States

The 1981 draft budget for Belgium was first outlined in August 1980. The 1981 central government borrowing requirement was then estimated at 6,4% of GNP as against 7,3% in 1980. In October, the new Government's programme included plans to counter tax avoidance, to implement higher VAT rates and excise duties and to increase effective tax rates on married couples, to stimulate construction activity and employment in small firms. In November an additional VAT surtax on luxury goods was introduced. In December eligibility of young persons for unemployment benefit was restricted. In March a number of planned measures designed to produce budget savings in 1981 equivalent to about 1% of GDP were announced, so that the budget deficit should not rise as a percentage of GDP. However, the implementation of the programme encountered serious difficulties. Further, slippage in the current account of the central government has been very considerable. Commission forecasts indicate a central government cash deficit in 1981 equivalent to 13,0% of GDP (9,3% in 1980). On 6 August the former government decided on a number of measures to be included in the draft budget for 1982, which was due to be tabled at the beginning of October. A central government current deficit of FB 201 200 million and general government net borrowing of around FB 455 000 million (12,1% of GDP) was envisaged. Increases in taxes would bring in an additional FB 43 900 million and expenditure plans would be reduced, although complete details of the expected savings (mainly in the fields of public administration, education, social security and subsidies to public utilities) were not available.

In Denmark, measures to aid construction activity were taken in October 1980. The central government budget for 1981, adopted in December 1980, involved an estimated deficit equivalent to 5,1% of GDP, against a then-estimated

deficit of 4,5% of GDP in 1980. In the Spring of 1981 the national pay agreement involved somewhat higher pay increases in the public sector than in the private sector. The conditions for pursuing the pluriannual programme in 1982 were also agreed in May by a majority in Parliament. With a view to reducing the external disequilibrium, cutting unemployment and slowing expenditure growth, the employment and business programme was to be continued at its 1981 level (yearly outlays equivalent to 1,4% of 1981 GDP), there was to be no real increase in non-cyclical central expenditure and a limit of 1,6% in real spending (excluding spending on energy supply, on the establishment of public transport and on certain job-creation measures) by local authorities. It was furthermore agreed that indirect taxes were to be increased. Current Commission forecasts put the central government cash deficit in 1981 at 7,5% of GDP, against 4,6% in 1980. The draft central government budget for 1982 envisages a further increase in the cash deficit, to about 8 1/2% of GDP, in 1982.

Measures to reduce the income tax burden and improve certain social benefits from 1981 onwards were approved in the Federal Republic of Germany in July 1980 (estimated budgetary cost equivalent to 0,8% of GDP in 1981 and 1% of GDP in 1982). In December the Federal budget proposal for 1981 was released. It involved a total increase of nominal expenditure of only 4,3% and a net Federal borrowing requirement equivalent to just under 1,8% of GDP, very slightly lower (as a percentage of GDP) than the outturn then estimated for 1980. In March 1981 excise duties on oil products and alcohol were raised.

In May, a supplementary Federal budget was introduced to meet the forecast rise, as a result of worse-than-expected unemployment, in the financing needs of the Federal Labour Office (to about 1/2% of GDP). Further, the recession in activity led to a reduced estimate of tax revenue in 1981. Current official estimates suggest that Federal government net borrowing in 1981 will amount to 2,2% of GDP as against 1,8% originally planned. The preliminary draft Federal budget for 1982 envisages cuts in subsidies, tax allowances and public sector wage increases so as to reduce the Federal borrowing requirement from DM 34 000 million in 1981 to DM 26 500 million in 1982.

The most striking development in budgetary aggregates in Greece in 1981 has been a very substantial increase in central government capital outlays, both on investment and, more particularly, capital transfers. Earthquake relief expenditure early in the year was partly responsible for this. Direct tax rates were also reduced, however, and while the very large firstquarter borrowing requirement of central government was undoubtedly swollen as a result of the earthquakes, the total for the year is likely to exceed the 3,2% of GDP earlier forecast. For 1982 it is the intention of the present government to reduce the central government borrowing requirement as a percentage of GDP, but because of elections in autumn it may be the beginning of 1982 before a draft budget for that year is presented.

In France the 1981 draft budget was introduced in September 1980. It featured a tight squeeze on public expenditure, but more aid to investment and the creation of a counter-cyclical investment reserve. In October, public enterprises' investment programmes were adopted for 1981: they implied no volume change from 1980. Over the following few months a number of expenditure increases were announced involving improved social benefit rates and conditions, agricultural income-support, subsidized investment loans, labour market measures and civil service salaries. Following the change of government in mid-year social benefits were increased, employers' social security contributions were reduced, the anti-cyclical investment fund was activated (50 000 additional housing starts being aimed at), and a first step in increasing public sector employment (by 54 000) was decided. The government expected these measures to be financed in part through stronger economic activity (and hence higher tax receipts), in part by a surtax, a levy on banks and oil companies and a tax on the outgoings of large companies. On the basis of the macroeconomic assumptions of the original Finance Law, the central government cash deficit for 1981, was not expected to exceed the figure of 57 000 million FF (1,89 % GDP) laid down in the original law, as amended by the "Loi rectificatif". However, activity has been weaker than assumed in the original law and the outturn for the deficit is likely, on Commission estimates, to be very slightly higher. The draft budget for 1982 foresees a central government cash deficit of 95 400 million FF; tax pressure would be increased slightly while expenditure increases would be concentrated on employment-support measures (including the creation of new public service jobs) and on stimulating investment. On 7 October a freeze was announced on public investment of 15 000 million FF in 1982 as part of an effort to avoid expenditure overruns.

The budget deficit foreseen in the original 1981 budget in Ireland is likely to be considerably exceeded as a result of the introduction of new housing and food subsidies, of civil service pay increases, of the deferring of increases in public transport fares and electricity (all in the spring) and of increasing housing grants and education grants to students immediately

after the election. On 21 July the new government introduced a package of corrective measures involving cuts in public expenditure (partly offset by some increases in social welfare payments), increases in taxation (in particular excise duties and VAT), and the implementation of the previously postponed rises in electricity and public transport charges. The measures are officially forecast to reduce the Exchequer Borrowing Requirement (EBR) in 1981 from 20% of GDP to 16 1/2%, still considerably higher than the original 1981 budget estimate of 13% of GDP. The government has also reaffirmed its intention to eliminate the current budget deficit (now officially forecast at 8% of GDP in 1981) over a period of four years. Further, the Government is committed to providing subsidies, to restricting the coverage of indirect taxation and to reducing the burden of direct taxation on the average worker.

Following the installation of a new Government in Italy in October 1980, the Prime Minister (Mr. Forlani) emphasized the need for a stabilisation of public finance, and a package of budgetary measures, including higher VAT rates, higher advance payments of income taxes and increased fuel excise duties, was adopted. Soon afterwards, fiscalization of employers' social security charges was extended to mid-1981 and a credit line was opened to assist earthquake victims. Following the devaluation of the Lira in March 1981, the government announced its intention to cut public expenditure by LIT 5 000 billion so as to bring net domestic borrowing by the broadly-defined public sector down to the LIT 37 500 billion (9,4% of GDP) announced in the *Relazione Previsionale* for 1981. At the same time the Government approved a three-year plan (1981-83) involving a reduction in current expenditure in each year equivalent to 1% of GDP, balanced by an equal increase in capital spending. In July there was approved a budget-amending bill aimed at giving effect to these targets. That the target for 1981 should be met was also stressed in the Commission's recommendation of 22 July to the Italian government.

In the Netherlands, the draft budget for 1981 was first presented on 16 September 1980. It foresaw a central government cash deficit equivalent to 4 1/4% of net national income (5% in 1980) and general government net borrowing equivalent to 5 1/4% of net national income, against a then estimated level of 6% in 1980. A slight increase in tax pressure was implied, mainly a result of an increase in some VAT rates. Savings of about 1% of GDP were to be sought in social transfers and public consumption, but an extra 0,2% of GDP was to be spent in assisting housebuilding and employment. In October investment subsidies were increased and in November a number of measures were introduced, in the context of the incomes policy, to give tax reliefs to low income families and to assist housebuilding, regional development, employment, exports and the financial position of firms. As the deterioration of the economic position worsened, it became clear that the planned deficit would be exceeded. In the first few months of the year measures were introduced aimed at making substantial savings in the areas of civil service salaries and recruitment, social security, and departmental expenditure and at increasing revenue from fuel excise duties. In the spring, however, some increases were made in allowances to low-income families, housing construction was subsidized and full indexation of civil service salaries (with effect from 1 July) was restored. Notwithstanding the expenditure cuts, the central government cash deficit for 1981

is likely to rise to nearly 6% of net national income. In September the draft budget for 1982, prepared by the outgoing government, was submitted. It foresaw a central government cash deficit equivalent to 5,5% of net national revenue. The net borrowing of general government in 1982 was put at 6 1/2 of net national revenue (7 3/4 to 8% in 1981). The tax burden in 1982 would remain unchanged and expenditure savings would be made in the areas of social security and public sector salaries. Some additional expenditure to support industrial activities was included.

Simultaneously with the presentation of the draft budget for 1981 in July of last year, the Government in Luxembourg reduced income tax rates, improved eligibility for unemployment benefit and increased appropriations for the restructuring of industry. The budget was amended in November to take account of the steel industry aid programme (investment subsidies, contributions to social expenditure and participations in certain other costs of the crisis), estimating the 1981 expenditure increase at 11,8%. In February 1981 changes in the income tax regime reduced effective rates, and in April certain social benefits were increased. In May further aid was granted to the special work schemes in the steel industry. General government net borrowing in 1981 is now estimated by Commission services at 3.0% of GDP.

Towards the end of 1980 it became clear that the Public Sector borrowing Requirement (PSBR) in the United Kingdom was likely to overshoot the 1980-81 target considerably, partly because of a deepening recession and partly because of difficulties in keeping within the planned level of public expenditure. In response to these problems, in November 1980, the authorities announced a set of measures for the financial year 1981-82, including increased social security contributions and a supplementary oil tax, and adjustment to expenditure plans, which aimed at reducing the 1981-82 PSBR below what it was otherwise forecast to be. Furthermore, in order to strengthen the authorities' control of expenditure, a 6% cash limit was announced for pay provisions for a number of groups of workers in the public sector. In addition to the November measures, the Budget for 1981-82, presented in March, involved a further increase in the burden of taxation, namely an increase in the effective rates of income tax (by permitting no adjustment for fiscal drag), substantial increases in excise duties, and a new tax on bank deposits. The volume of public expenditure was foreseen to remain unchanged between 1980-81 and 1981-82. Taken together the measures sought to bring the PSBR for 1981-82 closer into line with that allowed for in the Government's Medium Term Financial Strategy, published in March 1980, which set out the authorities' intentions with regard to public expenditure and borrowing up to 1983-84. The official budget estimate put the 1981-82 PSBR at UKL 10 600 million (4 1/4% of GDP). The latest Commission forecast suggests that the outturn will be UKL 11 200 million. In July a package of measures, including extensions of existing measures was announced with the aim of reducing unemployment. The additional cost of the measures (to be met from the contingency fund) is put at UKL 150 million in 1981/82 and UKL 320 million in 1982/83.

Table 6.1
(1)
Public finance aggregates, EC and Member States, 1980-82

	Current expenditure % increase			Current receipts % increase			General government gross saving, % GDP			General government net lending (+) or borrowing (-) % GDP			General government net lending (+) or borrowing (-), net of interest payments % of GDP		
	1980	1981(2)	1982(3)	1980	1981(2)	1982(3)	1980	1981(2)	1982(3)	1980	1981(2)	1982(3)	1980	1981(2)	1982(3)
B	10,9	10,5	9,6	6,6	6,1	10,6	-4,6	-7,3	-7,4	-9,1	-12,4	-12,0	-3,8	-5,8	-4,0
DK	14,9	16,5	14,6	12,2	8,5	12,5	-2,1	-6,1	-7,2	-6,1	-9,8	-10,8	-3,5	-6,8	-7,5
D	8,3	6,9	4,8	7,2	4,9	6,8	2,3	1,2	2,1	-3,5	-4,0	-3,0	-2,0	-2,3	-1,0
GR	24,8	23,1	22,9	25,1	19,7	23,6	0,4	-0,4	-0,3	:	:	:	:	:	:
F	15,9	17,7	17,3	16,6	11,5	16,2	3,5	1,2	0,5	+0,4	-2,1	-2,6	+1,5	-1,0	-1,4
IRL	27,3	25,8	19,8	26,7	23,1	22,8	-5,0	-6,4	-5,5	-13,1	-14,3	-13,7	-8,6	-8,8	-6,8
I	24,4	27,1	21,0	29,7	24,9	21,2	-3,3	-4,6	-4,0	-7,8	-9,0	-9,0	-2,4	-2,8	-2,9
L	10,5	10,5	8,4	8,6	6,6	7,3	8,3	7,2	6,6	-1,3	-3,0	-3,6	-2,6	-4,5	-5,2
NL	9,5	8,0	7,2	8,1	7,1	8,7	1,7	1,6	2,3	-3,7	-4,1	-3,2	-2,7	-2,9	-1,9
UK	21,3	12,9	9,9	24,4	15,3	11,2	-0,5	0,3	0,8	-3,5	-2,2	-1,6	-0,2	+1,6	+2,2
EC	14,7	14,1	12,0	15,0	11,4	12,6	0,8	-0,4	-0,3	-3,5	-4,4	-4,2	-1,0	-1,6	-1,1

(1) National accounts definitions.
(2) Estimate.
(3) Forecast.

Source: Eurostat and estimates of Commission services.

Table 6.2

(1)

Income and outlay transactions of general government, EC total

'000 million ECU

	1980	% change from 1979	1981 (2)	% change from 1980	1982 (2)	% change from 1981
Indirect taxes	275,3	16,5	305,3	11,7	340,4	11,0
Direct taxes	249,2	17,5	276,8	10,3	311,5	13,3
Social security contributions	287,4	14,6	320,6	11,5	358,7	12,0
Other current receipts (excluding interest)	46,5	15,1	50,5	8,6	57,3	13,5
Interest received	20,6	21,9	25,6	24,6	29,6	19,7
Total current resources	878,9	16,2	978,8	11,4	1095,0	12,6
Current transfers	416,4	13,0	477,7	14,7	536,6	12,3
Other current outlays	70,0	27,5	87,8	25,5	106,8	21,6
Government consumption	376,7	18,0	422,8	12,2	465,8	10,2
Total current uses	863,1	16,2	988,3	14,5	1109,2	12,2
Gross saving	15,8		-9,5		-6,7	
Net capital transfers	20,7	13,0	19,8	-4,3	21,4	8,1
Gross capital formation	65,7	13,1	69,1	5,5	75,3	9,0
Net lending (+) or borrowing (-)	-70,6		-98,4		-103,4	
Net lending or borrowing net as % of GDP	-3,5		-4,4		-4,2	
Net lending or borrowing less net interest payments as % of GDP	-1,0		-1,6		-1,1	

(1) National accounts definitions.

(2) Estimate.

(3) Forecast.

Source: Estimates of Commission services.

Table 6.3

Components of changes (1) in budget deficits, EC 1971-82 (2)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 (3)	1982 (4)
	% GDP											
Actual change	-0,9	-0,9	+0,8	-1,0	-3,9	+2,0	+0,4	-0,8	+0,3	+0,1	-0,9	+0,2
Effect of change in activity	-0,6	-0,4	+0,4	-0,5	-1,9	+0,9	-0,2	+0,1	+0,3	-0,6	-1,7	-0,3
Effect of change in net interest payments	+0,1	0,0	0,0	-0,2	-0,3	-0,2	-0,2	-0,2	-0,2	-0,2	-0,4	-0,3
Residual change	-0,4	-0,5	+0,4	-0,3	-0,7	+1,3	+0,8	-0,7	+0,2	+0,9	+1,2	+0,8

(1) A plus sign indicates a reduction in general government net borrowing, a minus sign indicates an increase.

(2) For methodology see text and "Technical note" to chapter 3 of "Annual Economic Review" 1980-81.

(3) Estimate.

(4) Forecast.

Source: Eurostat and estimates of Commission services.

Table 6.4
Major categories of general government receipts and expenditures as % of GDP (current prices), EC total 1970-82

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 (1)	1982 (2)
Indirect taxes	13,8	13,4	13,2	12,8	12,5	12,2	12,5	12,6	12,9	13,1	13,4	13,8	13,8
Direct taxes	10,5	10,6	10,4	11,0	11,9	11,8	12,2	12,6	12,5	12,2	12,7	12,5	12,7
Social contributions	11,4	11,6	12,0	12,6	13,1	14,0	14,4	14,6	14,6	14,8	14,9	14,5	14,6
Total tax and social contributions	35,7	35,6	35,6	36,4	37,5	38,0	39,1	39,8	40,0	40,1	40,3	40,9	41,1
Total current receipts (3)	38,9	38,8	38,7	39,7	40,9	41,4	42,8	43,5	42,7	43,1	43,8	44,4	44,6
Current transfers of which:	15,7	15,9	16,8	17,1	17,9	20,4	20,5	20,9	21,0	20,8	20,8	21,7	21,7
Social benefits	14,3	14,7	15,4	15,8	16,7	19,0	19,2	19,6	19,7	19,5	19,5	20,2	20,2
Government consumption	14,3	14,9	15,0	14,9	15,6	16,6	16,2	16,1	16,2	16,3	16,7	17,2	16,8
of which:													
Compensation of employees	10,1	10,7	9,5	10,0	10,2	10,7	10,8	10,8	12,0	11,9	12,1	12,4	12,1
Intermediate consumption (4)	4,2	4,2	5,5	4,9	4,3	5,9	5,4	5,3	4,2	4,4	4,6	4,7	4,7
other current outlays (5)	2,1	2,1	2,0	2,0	2,3	2,6	2,7	3,2	3,1	3,3	3,5	4,0	4,3
Total current expenditure	32,7	33,6	34,6	35,0	37,7	40,9	40,8	41,5	42,1	42,1	43,0	44,8	44,9
Gross saving	5,5	4,6	3,5	4,0	3,1	-0,2	1,2	1,3	0,5	0,8	0,8	-0,4	-0,3
Gross saving less net interest payments	6,6	5,6	4,5	5,0	4,3	1,3	2,9	3,2	2,6	3,1	3,3	2,4	2,9
Capital formation	4,1	3,9	3,7	3,6	3,9	3,8	3,6	3,2	3,2	3,2	3,3	3,1	3,0
Net capital transfers	1,0	1,1	1,2	1,1	1,1	1,6	1,4	1,4	1,3	1,2	1,0	0,9	0,9
Net lending (+) or borrowing (-)	-0,4	-0,4	-1,4	-0,7	-1,7	-5,6	-3,8	-3,3	-4,0	-3,6	-3,5	-4,4	-4,2
Net lending (+) or borrowing (-) less net interest payments	+1,5	+0,6	+0,4	+0,3	-0,5	-4,1	-2,1	-1,4	-1,9	-1,3	-1,0	-1,6	-1,1

(1) Estimate.
 (2) Forecast.
 (3) Including consumption of fixed capital, general government factor income and miscellaneous current transfers received.
 (4) Including consumption of fixed capital.
 (5) Interest payments and miscellaneous current transfers.
 Source: Eurostat and estimates of Commission services.

Table 6.5

Financing of public sector borrowing requirements ⁽¹⁾, % of GDP, EC and Member States, ⁽²⁾ 1979-82

	1979			1980			1981 (3)			1982 (3)		
	Total	Non-Monetary	Monetary	Total	Non-monetary	Monetary	Total	Non-monetary	Monetary	Total	Non-Monetary	Monetary
B	8,5	2,6	5,9	10,9	1,5	9,4	14,9	1,5	13,4	13,6	1,2	12,5
DK	6,0	1,4	4,6	6,9	2,6	4,3	9,3	4,4	4,9	10,4	5,2	5,2
D	3,4	1,4	2,0	3,9	2,1	1,8	4,5	2,6	1,9	3,4	1,8	1,6
F	1,2	0,8	0,4	1,1	1,4	-0,3	2,1	1,1	1,0	2,6	1,2	1,4
IRL	13,9	3,9	10,0	14,2	3,9	10,3	16,3	3,7	12,6	15,0	3,3	11,7
I	11,2	6,8	4,4	11,0	-0,6	11,6	11,9	:	:	10,2	:	:
NL	5,1	3,3	1,8	6,4	5,0	1,4	6,8	5,8	0,9	5,7	5,7	0,0
UK	5,2	4,8	0,4	5,9	4,9	1,0	4,6	3,6	1,0	3,5	3,5	0,0
EC	4,7	2,0	2,7	5,4	2,7	2,7	6,1	3,0	3,0	5,2	2,8	2,4

(1) Budgetary definitions, including loans and participations. Sector coverage by country as follows: B: general government; D: general government; DK: central government; F: central government, cash basis; IRL: Exchequer; I: Treasury; NL: total public sector; UK: total public sector.

(2) Figures for Greece not available on comparable basis.

(3) Amount of monetary or non-monetary financing compatible with targets or forecasts for the monetary aggregates (See Chapter 5).

Source: Estimates of Commission services.

7. Employment and Unemployment

Labour market developments in 1980 and 1981 have been dominated by the coincidence of high labour force growth due to adverse movements in demographic trends and low employment growth because of the recession in demand and output. In the last two years unemployment has accelerated sharply to reach record levels as increasing numbers of young people and women came on to the labour market, swelling the number of people looking for work, while employment growth slumped in the wake of the new oil price rise in 1979 and the number of available jobs actually declined. For the next year, unemployment will continue to rise, albeit at a slower rate; employment growth will continue to be negligible and the main impact of the upturn in activity will be a much faster rate of productivity growth. Labour market policies aimed at specific groups and regions have played an increasingly important role in response to the problems raised by changes in the structure of unemployment, with unemployment being disproportionately concentrated on young people, women and older workers. The cost of unemployment affects both workers and governments directly. For an average production worker who became unemployed, unemployment pay in 1979 averaged 60 per cent of his previous net earnings if he was single, 66 per cent if he was married with two children. This 'replacement ratio' varies between countries and can be as high as 85 per cent or as low as 32 per cent; it is likely to be higher for low-paid workers than for the average worker. Because of tax losses, the direct cost to the government of an unemployed worker is of the same order of magnitude as his gross earnings.

7.1 Labour market trends and prospects

The Community's labour markets at the beginning of the 1980's are characterised by high rates of expansion of the labour force, extremely low rates of growth of employment, and consequently, high and rising rates of unemployment. In the 1970's, labour supply growth tended to exceed the growth of new jobs, and each cyclical peak in economic activity left the total rate of unemployment temporarily stabilized but higher than the previous peak. In the last two years, moreover, the rise in unemployment has accelerated: from an average of 5,5% in 1979 it reached 8,3% by August 1981 for the Community as a whole.

In the first oil price shock recession, unemployment increased sharply in the face of the slump in output and demand, only stabilising in the 1978-1979 upturn, when GDP growth reached some 3 1/2% on average for the two years. Since the end of 1979, with a new fall in the rate of growth of output, the rate of unemployment has again increased rapidly. The majority of this

increase has taken place in the last half of 1980 and the first half of 1981: in those twelve months alone, unemployment in the Community has increased by some 35%.

While all Member States have more or less followed the overall trend, the degree to which they have been affected has varied widely: by far the biggest jump has occurred in the United Kingdom where registered unemployment has nearly doubled (up by 98%) since the end of 1979. Of the 9 million unemployed in the Community, one-third are in the United Kingdom, and nearly 40% of the unemployed adult males are in the United Kingdom. Other badly affected countries are Denmark (up 79%), and the Netherlands (up 83%). In some Member States with very high current unemployment rates such as Belgium (12%), Ireland (10,5%) and Italy (8,8%) the acceleration was more progressive. At the other extreme are some Member States with much lower unemployment rates such as Luxembourg (1,0%) and the Federal Republic of Germany (5,2%) which have only recently begun to show signs of acceleration.

A comparison of results from the Labour Force Sample Survey, the results of which for 1979 have just become available, with the numbers of registered unemployed shows a relatively similar pattern between Member States (Graph 2). In most of them, unemployment according to the sample is slightly lower than registered unemployment, but still follows the same trend. In Denmark and Luxembourg unemployment according to the two measures follow a similar general trend, but the sample survey gives a higher result. This difference between the two measures is probably a function of the definition of unemployment for administrative purposes in the various Member States, and the unemployment benefit régime which determines the relative strength of the incentives to register, as well as the ability to do so. On the other hand, the fact that the sample survey generally gives a lower result than the official registration statistics is probably indicative of the extent to which people may drop out of the labour force, albeit temporarily (particularly married women), or find alternative occupations as family workers, or in the underground economy⁽¹⁾,

.. / ..

(1) Estimates of the size of the unofficial or "underground" economy vary considerably, since by its very nature the irregular economy is difficult to measure precisely. If it is true that the size of the informal economy is indeed expanding, then this could affect the official picture of developments in three ways: income statistics will be underestimating true growth levels, unemployment statistics will be exaggerating the severity of the problem, and inflation measures will be too high.

while still being registered as unemployed as long as there is an incentive to do so. This could explain the quite sizeable gaps between the two measures for Italy and Belgium (see section 7.4). In Ireland and the United Kingdom, the two measures do not follow the same trend over the whole period, but this is probably due to changes in the sampling method between the different dates.

The present rapid expansion of the Community's labour force is due to a coincidence of developments in demographic trends and activity rates. While the Community's total population has grown steadily, at some 0,3% per year, the population of working-age is expanding faster than for many years. The very low birth-rate during the First World War means that the number of males reaching retirement age in 1982 and 1983 is exceptionally low (those born during the baby boom of the early 1920's will only reach retiring age after 1985, when the numbers retiring will more than double). At the same time, the high birth rate of the early 1960's means that the number of school leavers arriving on the labour market will reach very high levels over the next four years. Consequently, the rate of growth of the working-age population is forecast to double, from an average of 0,5% a year during the 1970's to 1,0% a year by 1982 and remain at that level until 1985 when these special demographic factors will begin to operate in the opposite direction.

These demographic factors have been reinforced by trends in activity rates in recent years. Information on activity rates, defined as the proportion of each age group which is economically active, is contained in the two-yearly Community Labour Force Sample Surveys and some results for the Community are presented in Table 7.2.

Activity rates for workers in the central age-groups 25 - 54 have increased steadily over the period 1973 - 1979, but within this overall trend there is a difference in the behaviour of male and female activity rates, the former declining steadily, the latter expanding quite rapidly. In addition, in the younger and older age-groups, while both male and female activity rates have declined, the female rate has declined much less. This tendency towards increasing female activity rates over the 1970's may be attributed to the movement toward equal pay and growing opportunities in services as well as changing social attitudes to women working which have encouraged more women to seek employment, although there are still considerable differences between Member States. The reasons for the decline in male activity rates are not so clear. It is possible that the cumulative effects of the recession on job opportunities may be having

a "discouraged worker effect", and to that extent the decline in male activity rates may only be temporary, and pick up again when adequate employment growth is re-established. This would also reinforce the notion that the increase in male unemployment has been due to fewer jobs being available, while the increase in female unemployment is the result of more women trying to find jobs.

In the older age-groups, the combined effect of high unemployment rates and the growth of early retirement schemes in recent years is quite evident. Both these groups have seen a steady decline in their activity rates over the period, and given the well-known difficulty of workers in this age-group to find re-employment after being made redundant, is consistent with the steady rise in the overall unemployment rate. The impact of early retirement schemes in the last 5 years can be seen particularly in the declining activity rate of males in the 55 - 59 age-group.

In the early years of the 1980's, most of the underlying trends in the Community's labour markets will continue, and for the next year at least, no major improvement in the situation may be expected, with unemployment forecast to rise further to average 7,7% of the Community's labour force for 1981 as a whole. The upturn in activity which is forecast to take place in 1982 should slow down the rate of increase of unemployment however: GDP growth at 2,0% is expected to limit the increase in the unemployment rate to 0,8 percentage points.

In the 1970's, employment growth fluctuated sharply in the line with the cyclical swings in activity. It slumped during the post oil shock recession after 1973 and did not recover its momentum until the upswing of 1978 and 1979. This resumption of growth was short-lived, however, and the fall in employment growth in response to the fallback in GDP growth has been much sharper than in the earlier recession: after not expanding at all in 1980, employment is expected to fall by 1,3% in 1981, exactly the same as in both 1974 and 1975, but in response to a fall in GDP of only 0,5% in 1981 compared to a fall more than twice as large (-1,2%) in both 1974 and 1975. In 1982, employment growth is forecast to be just negative (-0,1%), in response to GDP growth of 2,0%, but it is likely that the main impact of the upswing in activity on the labour input will come through in the form of a sharp increase in productivity growth, which is forecast to double to 2,0% as the slack in production is initially taken up through better capacity utilization.

On a sectoral level, long-term trends in employment are continuing. Evidence from the Labour Force Sample Surveys confirms that until 1979, employment in

agriculture continued to decline, at least for those people for whom it was the main occupation. This decline in agricultural employment may since have slowed down, partly as a result of less scope for productivity gains, and probably as a result of fewer job opportunities, particularly in industry where employment has also been falling steadily over the period. If anything, the decline in manufacturing employment has probably accelerated in 1980 and particularly in 1981, the manufacturing sector having borne the brunt of the decline in output, and because firms seem to be exercising a much stricter policy towards retaining labour during the recession than has been previously the case. The only sector where employment has expanded has been in services, both marketed and non-marketed, but even there the expansion is expected to be negligible in 1981 and little more in 1982.

The decline in employment has been accompanied by a decline in the rate of growth of productivity, although by much less. The annual average rate of growth of salaried employment in the 1970's has been only one-third that of the 1960's; the rate of growth of productivity per employee has fallen by nearly a half.

In manufacturing industry, for which more detailed information on working hours is available (Table 7.4), there has been a parallel decline in the rate of growth of productivity per head and per hour. It is clear that most of the slowdown in the growth of industrial output in the period 1973-80 (1,5% annual average growth rate) compared with 1960-1973 (5,6% annual average growth rate), which was not absorbed by the fall in productivity, was borne by the fall in employment: while total hours worked fell quite sharply, the rate of decline in average weekly hours worked remained virtually unchanged between the two periods at nearly 1% per year, despite widespread demands for a reduction in working time, either through a shorter working week or longer paid holidays to combat the rising level of unemployment. In the event, employment fell almost twice as fast as average hours, and recent evidence for 1979 and 1980 indicates that the decline in average weekly hours may have slowed even further in 1980 while employment continued to fall.

The same appears to be true for the economy as a whole. In the 1980 and 1981 downturn, productivity growth (per person employed) was higher than might have been expected on the basis of the 1975 experience when the average rate of productivity growth fell by 4,3 percentage points between the two phases of the cycle, from 4,2% in the period 1972-73 to -0,1% in 1973-1975, while employment growth fell by only 1,7 points, from 1,2% to -0,5% (annual averages)

between the two periods. Over the 24 months from August 1973 to August 1975, unemployment rose from 2,4% to 4,6% (Table 7.5). In the recent experience, employment growth has borne a larger share of the adjustment. While productivity continued to grow at an average rate of 1,3% (a fall of 1,4 points from that of the previous upswing), employment declined sharply falling by an average rate of 0,9% (a 1,6 point drop). As a result, in a period of only 14 months from March 1980 to May 1981, unemployment jumped from 5,7% to 7,8% of the Community's labour force. The upturn in activity now under way is not expected to bring about any dramatic improvement in this situation. On present forecasts, with negligible employment growth and considerably faster productivity growth in 1982, at least some part of the shake-out in employment, particularly salaried employment, which has occurred during the recession is expected to remain, and unemployment may continue to rise, although at a somewhat slower rate.

7.2 The structure and nature of unemployment

In addition to the rise in the unemployment rate in the Community since the first oil shock in 1973, the structure of unemployment has altered. Over the last eight years, the cumulative effects of the steadily rising rate of overall unemployment have produced a dramatic increase in unemployment among young people, particularly females; among older workers, who have been driven out of the labour force by lack of job opportunities; and in the long-term unemployed, for whom the chances of finding a job diminish progressively the longer they remain unemployed. The results of the last Community Labour Force Sample Survey for 1979 provide detailed information on these developments.

In the 1975 Sample Survey, the number of unemployed persons who had been made redundant or who had previously been occasionally occupied but were now wholly unemployed made up nearly half the total number of unemployed (Table 7.8). In the later period from 1977 on, however, this pattern changes. Cyclical factors decline in importance and the relative disability of young people and females in particular becomes more apparent. Although the proportion of unemployed young people in relation to total unemployment was much the same in 1979 as in 1973, it had declined sharply in 1975 under the impact of the big cyclical increase in adult unemployment, before rising again throughout the rest of the period covered by the sample survey. Since then, it appears from the data on registered unemployment that the share of young people in total unemployment reached a peak in mid-1980 of nearly 42% but may have declined slightly since then to around 39% in mid-1981. If this is the case, then it is probably due to the large cyclical rise in adult unemployment throughout 1980 and 1981, rather than a decline in youth unemployment as such.

A similar pattern may be observed among female workers: over the period covered by the Labour Force Sample Surveys the relative position of women deteriorated progressively. For the Community as a whole, unemployment rates for adult women in 1979 were some 55% higher than those for adult men. The equivalent figure for young women was 40%. In 1973, only women aged 25-29 had a considerably higher unemployment rate than men of the same age.

It is in the very youngest age-group, comprising school-leavers and workers in their first jobs that the female unemployment rate has risen both in absolute terms and relative to male unemployment in the same group; from equality in 1973, unemployment among young females in 1979 was some 40% higher than male unemployment: while the number of males seeking a first job actually declined in 1979, the number of females increased substantially.

While the persistently high rates of total unemployment have contributed to this situation, it is also likely that specific factors have been acting to weaken the relative competitive position of females in the labour market. It is notable that after 1975, redundancy as a cause of unemployment among males actually declined, while among females it increased, and the increase in the number who had previously worked occasionally is also largely made up of females. The difficulties faced by women returning to work after a spell away are also still substantial in 1979, while the number of men in this category has declined sharply. The subsequent period of sharply rising overall unemployment has seen a different development: between mid-1979 and mid-1981, registered male unemployment in the Community rose by 56%, and female unemployment by only 33%. On the same basis, the share of female unemployment in total unemployment fell from its high point of some 47% in October 1979 to nearly 43% in July 1981.

It seems, therefore, that while developments in male adult unemployment are largely conditioned by cyclical developments, trends in female unemployment, and particularly the weakening in the unemployment position of women relative to men in the pre-1979 period is essentially determined by structural factors.

The expanding number of administrative controls and legislation governing the employment of women, and the impact of equal opportunities and equal wages legislation may have combined to make employers less willing to employ women in periods of high unemployment when males are freely available. In this context, it should also be noted that there are large differences in the pattern of female unemployment rates among Member States. The majority of female unemployment in the Community - among

both adults and young people - is concentrated in four Member States, (Belgium, Denmark, France and Ireland) with widely differing total unemployment rates. To that extent, it is reasonable to suppose that high rates of female unemployment may be due not only to the absence of economically significant wage differentials but also to administrative arrangements which provide an incentive to women to register as unemployed, or which place restrictions on the conditions under which women may be employed. It is notable that Belgium, the Member State in which unemployment benefit is most generous towards females, also has the highest registered unemployment rate for women.

While the problem of female unemployment is undoubtedly concentrated among younger women, that for males is equally concentrated among young men and older workers, although for the latter it is less immediately apparent. Since 1977, unemployment among older workers has declined quite sharply (only the male unemployment rate is really significant for this age-group, due to the low female activity rate), and the proportion of total unemployed in this age-group shrank from 6% in 1973 to barely 2% in 1979. It is highly unlikely that in a time of increasing unemployment, despite expanding activity, the only group to have increased its employment prospects should be the oldest age-groups, when all the evidence suggests that age is highly correlated with lengthening duration of unemployment. The nature of unemployment for these workers is probably somewhat different: their family and hence their financial commitments are likely to be lower than for a man 10 years younger, the level of social benefits available as well as the increasing opportunity to take early retirement may not only reduce the need to find a job, but may encourage him to drop out of the active labour force. Although the data on retirements in Table 7.8 are insufficient for this purpose, there is a large increase in the "others" category of non-active persons seeking employment. At the same time, the sharp decline in the activity rate, not only for the over 60's but also for the 55-59 age-group, at whom early retirement schemes are particularly aimed, suggests that this has indeed been the case.

While data relating age to the duration of unemployment are not available from the Labour Force Sample Surveys, older workers will obviously be among the most seriously affected by one distinct structural change in the Community's labour markets, the increase in the volume of long-term unemployment. It is a corollary of persistent high levels of unemployment that workers will tend to become less employable the longer they remain unemployed, not only because they are less attractive to employers but because they tend to lose the

motivation to work as the duration of unemployment increases. In times of sharp, cumulative cyclical downturn, workers made redundant may be unemployed for up to 6 months but they are confident of regaining their jobs when the economy picks up again. If the subsequent recovery is either too short or insufficient to provide adequate employment growth, one result is that the average length of unemployment spells increases. In 1973, although 30% of all unemployed persons had been unemployed for more than one year, given the low rate of overall unemployment, this only represented some 0,6% of the labour force: the minimum "hard core" unemployment. By the time of the 1979 Labour Force Sample Survey, however, long-term unemployment had reached a rate of 1,6% of the labour force.

In the period since 1979, there is some evidence to indicate that the average duration of unemployment has continued to lengthen: the ratio of inflows onto the unemployment register to total unemployed (annual averages) has fallen from about 3 to 1 in 1976 to some 2 to 1 in 1980 and to about 1,7 to 1 in the first six months of 1981, implying that the average duration of unemployment has lengthened from about 4 months to 7 months. A calculation of outflows from unemployment gives a virtually identical result. Moreover, the volume of flows into and out of the register have fluctuated in line with the cycle of activity; between 1979 and 1980, the volume of new registrations per year increased by some 1.2 million, and the volume of outflows fell by some 250 thousand. In the first six months of 1981 this trend has even accelerated, the volume of new registrations per month running even higher, and the volume of outflows even lower than in 1980. It is clear, therefore, that the present increase in unemployment is made up of both an increase in the number of new unemployed and a lengthening of the duration of unemployment spells.

7.3 Unemployment benefit systems

The unemployment benefit schemes in operation in Member States can be classified into three types of which the main features are given in Table 7.11.

- a taxable benefit (i.e. subject to personal income tax, which is a fixed percentage of gross earnings (Denmark, Netherlands and Luxembourg);
- a non-taxable benefit which is a fixed percentage of gross earnings (Belgium) or net earnings (Germany);
- a non-taxable flat-rate benefit (France, Italy, Ireland and the United Kingdom) possibly with an earnings-related supplement (France, Ireland).

Whereas taxable benefits related to gross earnings are of the order of 80 to 90 per cent, the non-taxable benefits are lower - in the range 60 to 70 per cent of the reference level - and the supplement is lower still.

The taxation of social benefits implies a considerable administrative burden for a minor increase in tax-yield, but it avoids many of the anomalous situations and income 'traps' which arise when social benefits are exempt from personal taxation.

For a newly unemployed worker, the net cost of being unemployed is the difference between his income from various social security benefits and his previous earnings when employed.

Flat rate schemes have a "replacement ratio" (i.e. the relationship of the disposable income of the unemployed person to his disposable income when employed) which is much higher at the lower end of the earnings scale than at the higher end, and when combined with supplements for dependent adults and children imply a concern with the purely welfare aspects of unemployment benefit. Earnings-related schemes, on the other hand, have a connotation of insurance against a risk of unemployment, covered by (and possibly related to) premiums paid during periods of employment. A recognition of the enhanced risk of unemployment due to redundancy, i.e. unemployment arising from staff reductions, plant closures and failure of businesses, is shown in the special schemes for this type of unemployed worker which are relatively important in Italy, where the normal unemployment benefit is very low, and in France. All schemes have maxima; thus it is implicitly assumed that higher paid staff will have financial resources which will cushion the impact of unemployment.

The maxima themselves tend to be above the average level, except in Denmark and Belgium, where the maximum benefit corresponds with a level of earnings which is well below the industrial average, so that a flat-rate benefit operates over a very wide range of incomes.

Income tax and social security contributions reduced the take-home pay of an average single industrial worker in the Community by 27 per cent in 1979. The family man fared somewhat better, because of the operation of tax allowances for dependent and social benefits for children, and kept some 89 per cent of his gross earnings. Should a single worker become unemployed, his mean unemployment pay is less than half his previous earnings, but can vary between 23 per cent of his previous gross earnings in the United Kingdom and 80 per cent in the Netherlands and Luxembourg. In Denmark, Luxembourg and the Netherlands where social benefits are taxable the replacement ratio converges towards that in other countries which pay lower levels of benefit but do not tax them. For the average married production worker, the replacement ratio varies from 50%-60% in the United Kingdom and France to over 80% in Denmark, Ireland, Luxembourg and the Netherlands.

Thus, although much depends on the relative movement with respect to gross earnings of income-tax and employers' social contributions on the one hand, and rates of unemployment benefit on the other, it can be deduced without recourse to complete income distribution data that replacement ratios are highest, and may exceed 100%, at the bottom of the earnings scale, and there is a range, usually extending beyond the average earnings level, at which they are constant. Beyond the upper bound of this range, the replacement ratio declines rapidly.

Unemployment has both direct and indirect costs for governments too. When a worker becomes unemployed, the government not only assumes the responsibility for providing him with an income, but also loses the tax and social security contributions paid by the worker and his employer. Indirect costs arise principally from the fall in indirect taxes due to the reduction in the worker's consumption.

Direct government unemployment costs are particularly high in Belgium, Luxembourg and Italy where employers' social contributions are a relatively large element in wage costs: indirect costs are likely to be above average in Denmark, Ireland and the United Kingdom where direct costs are relatively low and where consumption taxes are more important as a source of revenue than elsewhere. Indeed, the cost to the government is close to the previous earnings of the unemployed worker, whose loss of income is much smaller than than the corresponding cost to the government.

7.4 Labour market policy problems

The preceding analysis of the development and the nature of unemployment as well as of the unemployment benefit systems illustrates both the complexity of the labour market and the difficulties facing governments attempting to design policies to cope with the unemployment problem. The large differences between Member States with respect both to institutional arrangements, the actual budgetary cost of unemployment allowances and to the income loss for the private person due to unemployment may also be part of the explanation of the different orientations of government policies in the labour market.

It is difficult to provide precise figures for the impact of direct labour market measures. A rather rough estimate would suggest that in 1981 unemployment has been lowered by slightly more than 2 million people in this way, with direct job creation (mainly in the public sector) counting for about 1/2 million, early retirement measures for another 1/2 million, vocational training for 1 million and various schemes for short-time working for some 100 000 persons. The total number of persons concerned by such measures of course was much higher (probably up to 5 million), as the duration of work-sharing programmes or training programmes is typically less than a year.

Although the contribution of direct labour market policy measures thus is substantial, it has clearly in 1980 and 1981 been insufficient to prevent a pronounced rise in unemployment. Member States have therefore to some extent been induced to rethink the approach to this problem. In France, in particular, the new government, while stepping up both public sector job creation and certain other direct measures, is relying heavily upon a lowering of working time and global budgetary measures to bring the rise in unemployment to a halt. In other Member States the tendency has been to seek an intensification of labour market measures rather than a relaxation of budgetary policy. In the United Kingdom, in particular, where unemployment has shown a very large increase in 1980/81, the authorities in July announced an extension of vocational training and other measures in favour of young people but at the same time declaring that the additional expenditure would be financed by budgetary cuts elsewhere.

In all countries, labour market policies are indeed now running up against budgetary constraints, implying that further expenditure increases under this item would have to be compensated by additional cuts in other categories of expenditure. A key question facing Member States now is therefore to define the most employment efficient allocation of budgetary resources as between direct labour market measures, various aid programmes to ailing industries, stimulus to investment and global stimulus to demand. More fundamentally, the Community's employment performance depends upon the willingness and ability of enterprises to expand the number of job opportunities and, hence, upon the general business climate and the relative competitive position.

Recent Developments in Labour Market Policy

Belgium. Labour market policy remains centred around the "Spitaels Plan" of December 1977, which set up the "special temporary scheme in the public service", young peoples training schemes, and the provision of early retirement or early pension on request. In December 1980, the Government adopted a plan to prolong these specific employment measures for another year, at the same time improving their coverage and effectiveness.

Denmark. In June 1980, the Government adopted the "Employment and Industry Programme 1981-83", which extends and amplifies the 1977 Employment Promotion Plan which was due to expire at the end of 1980. Under this new programme, 1,5 billion kroner (out of a total of 5,5 billion) were set aside in 1981 for improving the functioning of the labour market. In February 1981, a further plan was presented, which, together with the existing programme should reduce unemployment by 80,000, by means of job offers to the long-term unemployed, and employment stimulation measures in areas such as energy-saving and urban renewal. In May 1981 it was announced that the Employment and Industry Programme would be maintained at its existing level in 1982 and 1983 despite budgetary stringency.

Federal Republic of Germany. Labour market policy is principally aimed at easing the problems of certain population groups and regions. The 5th Amendment to the Employment Promotion Law, which entered into force on 1 August 1979, concentrates on vocational training, vocational information and guidance and selective development of efforts to promote employment in specific areas (65% of young people who leave school at the end of secondary level, embark on an apprenticeship in the private sector). At the same time, the Government adopted a special DM 900 million programme to improve the economic situation in problem areas. By the end of 1980, more than 44.000 workers had been helped under this scheme, which emphasises vocational training, the re-integration of unemployed persons and job-creation schemes designed to improve social services. The ninth outline plan to improve regional economic structure (August 1979) will create 305.000 new jobs and protect 164.000 existing jobs between 1980 and 1983, involving measures to stimulate private investment totalling DM 47.300 million. In February, the Federal Labour Office announced that DM 850 million would be available for special employment measures in 1981.

Greece. The Greek labour market is characterised by a very low level of registered unemployment, covering only urban areas, but a high level of under-employment, particularly in rural areas. Specific labour market policies exist only in the field of educational reform. The most recent initiative was training in 1975-1977, when a series of technical and professional schools was set up to provide a more practical form of vocational training than the traditional university system.

France. At the beginning of 1981, various additional measures were announced, including loans to firms for job-creating investment in small and medium-sized enterprises, improvement of vocational training, better use of short-time working to avoid redundancies and a temporary lowering of the age limit under the early retirement scheme. In March, the two sides of industry agreed to renew the 2-year agreement on voluntary early retirement (70% of gross wage at 60 years until the age of 65 years 3 months). This could affect about 350.000 workers. In June the new Government announced that while awaiting a complete revision of the vocational training and guidance system in Autumn 1982, it would prolong the Third National Employment Pact until July 1982 in an expanded form under the title "measures for entry into working life". This will cost FF 6,900 million and involve 625.000 young people, compared with the previous phase (1980/81) which cost 4,000 million and created 534.000 jobs. At the same time it also announced the creation of 54.290 new jobs in the public sector.

Ireland. Various new measures to stimulate job creation have been announced in the follow-up to the National Understanding agreed between the Government and the two sides of industry in November 1980. IRL 57,3 million will be devoted to improving the situation on the labour market, through attracting new industries, and expansion of training and job experience programmes. In addition, the Employment Incentive Scheme is maintained, and employers in vulnerable labour intensive industries receive a subsidy of IRL 6 per week for each worker. In June, the Government announced the creation of the National Enterprise Agency, which will be responsible for ensuring that all development opportunities offering stable employment opportunities are explored. In the July Budget a 1% levy on incomes to fund a Youth Employment Agency, which will integrate and extend youth employment schemes, was announced.

Italy. The Government issued a Decree-Law in December 1979 introducing new rules on worker mobility and labour market management, but this was not adopted by Parliament as the constitutional time limits (60 days) were exceeded. A draft law presented to the Chamber of Deputies in August 1980, which provides for wide-ranging decentralization of many functions presently carried out by the Government, and more co-ordination between placement and training authorities is still under discussion.

Luxembourg. Labour market policy in Luxembourg is aimed particularly at the special problems of the iron and steel industry, within the framework of medium and long-term policy to achieve a stable situation on the labour market. Following the provision of early retirement opportunities for workers with 40 years service in February 1980, in October of that year, the provision allowing the Government to take action to prevent redundancies due to cyclical causes was extended for a further year. In June 1981, a further series of measures was introduced to encourage mobility and re-training for steel workers, renewing and extending the policies originally adopted in January 1979 relating to the vocational re-training, further training and the temporary "re-employment" allowance for steel workers.

Netherlands. The aim of Dutch labour market policy is to stimulate job creation in the private sector. In November 1980, the Government announced measures to stimulate employment by subsidies totalling some HFL 900 million for housebuilding, exports, and to assist the financial position of firms. At the same time, the employment service was re-organised, with emphasis on the development of a rapid information service as well as placement

services, and the courses for young people aiding the transition between school and work were made permanent. In May 1981 the proceeds from all excise duties on petrol and diesel fuel were allocated to employment support programmes.

United Kingdom. Since February 1980 resources devoted to labour market policies have been concentrated on specific requirements and groups, such as unemployment in inner-city areas, among young people, the long-term unemployed and older workers. In November 1980, some changes and extensions to these policies were introduced. The budget for the Youth Opportunities Scheme was increased for 1981/82, allowing 140,000 more young people to obtain training or work experience. The Special Temporary Employment Programme for the long-term unemployed was replaced by a wider Community Enterprise Programme providing some 14,000 more places by the end of 1981/82. Assistance under the Temporary Short-time Working Compensation Scheme (designed to encourage employers to adopt short-time working rather than redundancies) will now be available for up to nine months (previously six months) at a rate of 50% of daily earnings (previously 75%). In response to increasing levels of unemployment, particularly amongst young people, the UK Government announced, in July, a set of measures designed to reduce the number of people on the unemployment register by over 450,000, by early 1983. The measures included extensions to existing schemes namely - increased funds for the Youth Opportunities Programme for 1982-83 with the guarantee of a place on the scheme for all school-leavers by Christmas 1981; a reduction in the age limit for the Job Release Scheme to 62 by next February; additional funds to encourage more young people to remain at school. New proposals include a UK£ 15 weekly subsidy to employers for each new person employed under 18, provided they earn less than UK£ 40 per week; the establishment of 20 information centres in inner cities to train the young unemployed in computing and electronic assembly skills.

Table 7.1

Population, employment and unemployment in the Community

	1970-79	1980	1981 (1)	1982 (2)	1970-79	1980	1981 (1)	1982 (2)	
	Working age population (3) % change				Civilian labour force % change				
B	0,5	0,6	0,7	0,9	0,9	1,0	0,2	0,2	
DK	0,4	0,5	0,7	0,8	1,2	0,9	1,0	0,6	
D	0,4	0,6	0,9	1,2	-0,2	1,0	0,5	0,4	
GR	:	:	:	:	1,3 (1)	1,6	1,0	1,1	
F	0,7	0,7	1,2	1,3	0,8	0,7	1,0	1,0	
IRL	1,3	1,6	1,6	1,5	0,9	1,1	1,5	1,3	
I	0,4	0,7	0,7	1,0	0,9	0,8	0,9	1,1	
L	1,0	-0,4	0,4	0,4	1,8	0,5	0,2	0,2	
NL	1,2	1,1	1,1	1,0	1,1	0,9	1,1	1,0	
UK	0,2	1,6	0,6	0,7	0,5	-0,1	-0,1	0,1	
EC	0,5	0,7	0,8	1,0	0,5	0,7	0,6	0,7	
	Aggregate employment % change				1970 1979 Unemployment rate % (5)				
B	0,3	-0,2	-2,3	-0,5	2,2	8,7	9,3	11,6	12,3
DK	0,9	0,0	-1,1	0,1	1,0	5,3	6,2	8,2	8,7
D	-0,3	1,0	-1,0	-0,5	0,6	3,4	3,4	4,8	5,6
GR	1,5 (4)	1,7	0,4	0,9	:	(2,2)	(2,8)	(2,3)	(3,6)
F	0,4	0,5	-0,4	0,8	1,3	6,0	6,5	7,8	8,1
IRL	0,9	1,1	-1,1	0,0	5,3	7,4	8,3	10,4	10,9
I	0,6	0,3	0,3	0,6	4,4	7,5	8,0	8,6	9,0
L	1,6	1,1	0,3	-0,1	0,0	0,7	0,7	1,0	1,2
NL	0,6	0,4	-1,5	-0,9	1,0	4,1	4,9	7,3	9,2
UK	0,2	-2,2	-3,6	-1,1	2,5	5,3	6,9	10,2	11,3
EC	0,2	0,2	-1,3	-0,1	2,0	5,5	6,1	7,7	8,5

(1) Estimate.

(2) Forecast.

(3) Population aged 15 - 64 years.

(4) 1975 - 1979.

(5) Number of unemployed as percentage of civilian labour force.

Source : Eurostat, and estimates of the Commission services.

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Table 7.2
Activity rates by age and sex (1), EC total

	Total											
	Men				Women							
	1973	1975	1977	1979	1973	1975	1977	1979	1973	1975	1977	1979
14 - 24	46,0	44,9	44,0	43,4	51,4	49,2	47,7	47,1	40,7	40,7	40,3	39,8
25 - 29	69,8	71,8	73,4	74,1	93,4	93,0	92,3	91,7	45,5	50,9	54,8	57,0
30 - 39	69,7	71,7	72,6	73,8	97,6	97,3	96,9	96,6	40,9	45,4	47,8	50,6
40 - 49	69,6	71,2	71,8	72,3	96,3	96,2	95,7	95,6	43,6	46,3	47,7	48,8
50 - 54	65,8	66,9	66,9	67,1	92,3	92,5	91,8	91,4	43,2	43,9	43,9	43,9
55 - 59	53,7	59,0	59,6	57,4	84,5	85,4	84,2	81,4	34,1	36,2	38,0	36,7
60 - 64	40,3	38,7	35,5	33,6	64,6	62,1	56,8	53,6	20,6	19,2	17,8	16,8
65 +	7,6	7,5	6,6	5,2	12,9	12,9	11,2	8,2	4,2	3,9	3,6	2,8

(1) Persons with a main occupation and unemployed persons (Labour force) as a percentage of the total population of the same age and sex.

Source: Eurostat - Labour Force Sample Surveys for the European Community 1973, 1975, 1977, 1979, Population and Employment 1950 - 1976, and estimates of Commission services.

Table 7.3

Salaried employment and productivity per employee - whole economy

(%)

	1960- 1973	1973- 1979	1973	1974	1975	1976	1977	1978	1979	1980	1981 (1)	1982 (2)
	Salaried employment											
B	1,5	0,2	1,9	2,0	-1,5	-0,5	-0,1	0,1	1,3	0,3	-2,5	-0,4
DK	1,5	0,6	1,9	0,5	-0,8	1,9	0,1	0,5	1,7	0,2	-1,3	0,4
D	0,9	-0,4	0,6	-1,8	-3,5	-0,5	0,3	1,2	1,7	1,5	-0,8	-0,3
F	1,8	0,6	2,2	1,5	-0,8	1,2	1,2	0,6	0,1	0,3	-1,2	1,5
IRL	1,1	0,8	1,6	2,1	-1,8	-1,5	1,2	2,0	2,7	2,3	-1,1	0,0
I	1,0	1,0	1,6	2,0	0,4	1,0	0,9	0,3	1,4	0,9	0,5	0,7
L	2,1	1,4	2,8	3,8	2,3	-0,2	0,7	0,4	1,4	1,5	0,5	0,1
NL	1,4	0,5	0,4	0,4	-0,4	0,2	0,8	0,8	1,2	0,4	-1,5	-1,0
UK	0,2	0,1	2,3	0,5	-0,4	-0,8	0,3	0,2	0,7	-2,3	-4,0	-1,2
EC	0,9	0,3	1,6	0,4	-1,2	0,1	0,6	0,6	1,0	1,9	-1,5	0,2
	Productivity per employee											
B	3,3	2,1	4,2	2,4	-0,4	5,8	0,9	2,9	1,0	2,4	1,5	0,6
DK	3,2	1,3	2,7	-1,7	0,2	5,2	1,7	1,0	-1,6	-0,4	1,3	2,6
D	3,7	2,9	4,3	2,6	2,0	5,5	2,7	2,1	2,7	0,4	0,5	2,5
F	3,7	2,3	3,1	1,7	1,0	3,7	1,9	3,0	3,4	1,0	1,7	1,5
IRL	3,1	2,8	2,5	1,5	4,1	3,5	4,5	4,2	-0,8	-1,4	2,8	3,6
I	4,3	1,6	5,3	2,1	-4,0	4,8	1,0	2,1	3,4	3,1	-0,8	1,1
L	2,0	-0,2	7,6	0,8	-8,4	1,3	-0,2	3,8	2,2	-1,1	-3,8	-0,4
NL	3,5	2,0	5,3	3,2	-0,6	5,1	1,6	1,7	1,0	0,1	0,4	1,9
UK	2,9	1,2	5,0	-1,6	-0,4	5,0	0,7	3,5	0,3	-0,7	2,1	2,6
EC-9	3,7	2,2	4,2	1,4	0,0	5,0	1,8	2,7	2,4	-0,8	1,0	2,0

(1) Estimate

(2) Forecast

(3) Annual average growth rates

Source : Eurostat and estimates of Commission services.

Table 7.4

Total hours and average hours, productivity per head and per hour : manufacturing industry

	Hours worked				Productivity			% change
	Total		Weekly average (2)		per head (3)			
	1960-1973 (1)	1973-1980 (1)	1960-1973 (1)	1973-1980 (1)	1960-1973 (1)	1973-1980 (1)	1973-1980 (1)	
B	- 0,3	- 4,4 (4)	- 1,1	- 1,1 (4)	5,9	5,2 (4)	7,0	6,6 (4)
DK	- 0,8	- 2,3	- 1,6	- 0,5	5,3	3,8	7,2	4,4
D	- 0,3	- 2,7	- 0,9	- 1,0	4,5	3,6	5,5	4,8
F	0,9	- 2,1	- 0,5	- 1,0	5,2	3,6	6,0	4,9
I	- 0,2	0,1	- 1,8	- 0,2	5,3	3,3	6,9	3,5
NL	- 1,3	- 3,6 (4)	- 1,3	- 1,2 (4)	5,9	4,2 (4)	7,6	5,5 (4)
UK	- 1,0	- 2,9	- 0,4	- 0,8	3,5	0,2	4,1	1,4
EC 9	- 0,3	- 2,2	- 0,9	- 0,8	5,2	3,0	5,9	3,9
USA	1,6	- 0,1	0,2	- 0,3	3,6	0,9	3,0	1,7
Japan	2,3	- 0,6	- 1,0	- 0,3	9,2	6,6	10,5	7,2

(1) Annual average growth rate.

(2) Average weekly hours worked by employees (wage and salary earners), except for USA: all employed persons.

(3) Output per employee.

(4) 1973-1979.

Source: Eurostat, US Bureau of Labour Statistics, estimates of Commission services.

Table 7.5
Employment, unemployment and productivity, EC total

	GDP growth % annual average	Total employment (1) growth % an- nual average	Productivity growth per occupied person	Unemployment rate(2)	Capacity utilization % change (manufacturing industry)
<u>Full cycles: peak to peak</u>					
July 1969 to August 1973	4,7	0,3	4,4	2,0-2,4	-1,3
August 1973 to November 1976	1,8	-0,4	2,2	2,4-4,9	-7,2
November 1976 to March 1980	2,9	0,6	2,3	4,9-5,7	3,9
<u>Upswings: trough to peak</u>					
February 1972 to August 1973	5,4	1,2	4,2	2,8-2,4	5,0
August 1975 to November 1976	5,9	-0,1	6,0	4,6-4,9	7,7
October 1977 to March 1980	3,4	0,7	2,7	5,5-5,7	5,3
<u>Downswings: peak to trough</u>					
July 1969 to February 1972	4,1	0,1	4,0	2,0-2,8	-6,3
August 1973 to August 1975	-0,6	-0,5	-0,1	2,4-4,6	-13,8
November 1976 to October 1977	1,7	0,4	1,3	4,9-5,5	-1,4
March 1980 to May 1981	0,4	-0,9	1,3	5,7-7,8	-4,9

Note: Cycles defined by deviations from trend of a composite monthly index of output, consisting of monthly industrial production data and quarterly GDP. See Annual Economic Review 1980-81, Note to Table 1.3. European Economy No 7, November 1980.

- (1) Annual averages.
- (2) Seasonally adjusted.

Source: Eurostat, EC Business surveys and estimates of Commission services.

Table 7.6
Unemployment rates by age and sex (1), EC total

	Total				Men				Women			
	1973	1975	1977	1979	1973	1975	1977	1979	1973	1975	1977	1979
14 - 24	4,7	8,1	10,0	10,1	4,7	8,0	9,0	8,5	4,7	8,2	11,3	12,0
25 - 29	2,3	4,2	5,0	5,2	2,0	3,7	4,3	4,4	2,9	5,1	6,1	6,6
30 - 39	1,2	2,8	2,8	2,9	1,0	2,3	2,3	2,3	1,4	3,7	3,7	4,1
40 - 49	1,2	2,3	2,4	2,3	1,1	2,0	2,1	2,0	1,2	2,8	2,8	2,9
50 - 59	1,7	2,3	2,6	2,5	1,1	2,0	2,4	2,3	1,4	2,7	3,0	3,0
60 - 64	1,9	3,1	3,5	2,8	2,0	3,5	3,9	3,0	1,3	2,0	2,6	2,2
65 +	0,9	2,2	1,4	0,6	1,1	2,7	1,5	0,8	-	1,1	1,1	-
Total	2,0	3,7	4,2	4,2	1,8	3,3	3,5	3,4	2,3	4,4	5,3	5,6

(1) Unemployed persons as percentage of labour force of same age and sex.

Source: Eurostat - Labour Force Sample Surveys for the European Community 1973, 1975, 1977, 1979 and estimates of Commission services.

Table 7.7
Unemployment rates for adults and young people under 25

%

	Total				Men				Women			
	1973	1975	1977	1979	1973	1975	1977	1979	1973	1975	1977	1979
B	1,3	2,2	4,5	5,8	1,0	1,5	2,4	3,2	2,1	3,9	9,1	11,3
DK	:	5,5	5,7	5,0	:	5,9	5,0	3,6	:	5,2	6,8	7,0
D	0,4	2,4	2,4	2,2	0,3	2,3	2,0	1,6	0,7	2,6	3,1	3,3
F	1,3	2,3	2,9	3,8	1,1	1,9	2,4	3,2	1,7	3,0	3,9	4,9
IRL	:	7,5	7,3	5,8	:	8,2	8,1	5,5	:	5,6	5,4	7,1
I	1,9	1,6	1,9	2,5	1,6	1,4	1,5	1,9	2,8	2,2	3,0	4,1
L	:	:	:	0,8	:	:	:	0,8	:	:	:	:
NL	1,6	2,6	2,7	2,6	1,6	2,7	2,8	2,6	1,1	2,3	2,4	2,5
UK	1,9	3,9	3,8	2,8	2,1	3,5	4,1	3,2	1,5	4,6	3,3	2,2
EC	1,3	2,7	3,0	3,0	1,3	2,5	2,6	2,5	1,5	3,3	3,6	3,9
Unemployment rates - young people												
B	3,1	7,8	11,3	12,8	2,3	6,0	6,9	7,8	4,0	9,8	16,4	18,5
DK	:	13,9	13,4	11,2	:	14,4	9,3	7,5	:	12,7	18,1	15,6
D	0,9	5,3	5,3	3,8	0,8	5,6	4,8	3,1	1,0	4,9	5,9	4,6
F	4,1	7,8	11,5	14,2	3,4	6,8	8,6	10,4	4,9	9,0	14,6	18,2
IRL	:	15,1	14,4	11,4	:	16,3	16,5	11,7	:	12,8	11,7	11,0
L	:	:	:	4,2	:	:	:	3,9	:	:	:	4,6
NL	2,9	5,7	5,6	6,4	3,4	7,4	6,3	5,8	2,4	3,8	4,8	7,0
UK	3,2	7,7	8,6	6,8	3,6	7,6	8,8	7,0	2,6	7,8	8,4	6,6
EC	4,7	8,1	10,0	10,1	4,7	8,0	9,0	8,5	4,7	8,2	11,3	12,0

Source: Eurostat - Labour Force Sample Surveys for the European Community 1973, 1975, 1977, 1979 and estimates of Commission services.

Table 7.8

Main categories of persons seeking paid employment, 1973, 1975, 1977, 1979, EC total (000)

	1973(1)				1975				1977				1979			
	Total		Men	Women	Total		Men	Women	Total		Men	Women	Total		Men	Women
UNEMPLOYED PERSONS, TOTAL	1 880	1 140	740	3 752	2 171	1 581	4 353	2 371	1 983	4 445	2 285	2 160	1 679	1 001	678	
of which :																
dismissal	630	456	174	1 677	1 133	544	1 709	1 055	654	1 679	1 001	678	1 679	1 001	678	
resignation	266	142	124	507	267	240	566	277	289	637	315	322	637	315	322	
retirement	9	9	-	34	28	6	13	12	1	15	11	4	15	11	4	
self-employed	78	54	24	60	48	12	63	45	18	60	43	17	60	43	17	
occasionally occupied	94	66	28	236	141	95	227	114	113	384	184	200	384	184	200	
voluntary spell	173	81	92	466	158	308	538	244	294	460	171	289	460	171	289	
seeking first job	603	318	285	765	395	370	1 137	562	575	1 210	560	650	1 210	560	650	
NON-ACTIVE PERSONS SEEKING PAID EMPLOYMENT, TOTAL	1 685 ²	476 ²	1 209 ²	1 536	519	1 017	2 474	831	1 644	1 944	645	1 300	1 944	645	1 300	
of which																
voluntary spell	361 ²	28 ²	333 ²	271	25	246	586	57	529	432	57	375	432	57	375	
seeking first job	612 ²	149 ²	463 ²	248	104	144	1 012	380	632	562	210	353	562	210	353	
others	712 ²	299 ²	413 ²	1 017	390	627	876	394	483	950	378	572	950	378	572	

(1) Excluding Denmark and Ireland

(2) Excluding Federal Republic of Germany

Source : Labour Force Sample Surveys for the European Community 1973, 1975, 1977, 1979.

Table 7.9
Unemployed persons by duration of search, EC total

Months	%																	
	Total						Men						Women					
	1973	1975	1977	1979	1973	1975	1977	1979	1973	1975	1977	1979	1973	1975	1977	1979		
1 (1)	13,6	16,1	11,6	10,5	13,0	14,4	11,5	10,5	14,4	18,3	11,9	10,4	14,4	18,3	11,9	10,4		
1 - 2	16,1	20,4	15,5	13,5	14,8	20,9	15,8	14,2	18,2	19,8	15,1	12,8	18,2	19,8	15,1	12,8		
3 - 5	18,6	21,6	17,9	16,0	18,6	22,7	18,3	16,8	18,6	20,1	17,4	15,2	18,6	20,1	17,4	15,2		
6 - 11	22,0	23,5	22,4	22,6	21,2	22,6	20,6	21,5	23,3	24,6	24,5	23,8	23,3	24,6	24,5	23,8		
12 +	29,7	16,4	32,6	37,4	32,4	19,3	33,8	36,9	25,5	17,2	31,1	37,9	25,5	17,2	31,1	37,9		
	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100		

(1) Including not yet started.

Source: Eurostat - Labour Force Sample Surveys for the European Community 1973, 1975, 1977, 1979 and estimates of Commission services.

Table 7.10
Regional unemployment rates

		National Unemployment Rate (1)	Highest Regional Rate	Lowest Regional Rate
B	1973	1,6	2,2 Region Wallonne	1,4 Vlaams Gewest/Bruxelles
	1975	3,2	4,1 Region Wallonne	2,7 Vlaams Gewest
	1977	5,7	6,5 Region Wallonne	5,3 Vlaams Gewest/Bruxelles
	1979	7,0	8,3 Region Wallonne	6,1 Vlaams Gewest
D	1973	0,5	0,8 West Berlin/Saarland	0,3 Hessen
	1975	2,9	4,3 Schleswig-Holstein	1,6 Bremen
	1977	2,9	4,1 West Berlin	1,8 Hessen
	1979	2,4	4,9 Saarland	1,5 Baden-Württemberg
F	1973	1,9	3,7 Méditerranée	0,9 Est
	1975	3,3	5,5 Méditerranée	2,3 Est
	1977	4,4	6,0 Méditerranée	2,7 Est
	1979	5,4	7,8 Méditerranée	4,0 Est
I	1973	4,0	7,6 Campania	2,0 Lombardia
	1975	3,3	6,0 Sardegna	1,3 Lombardia
	1977	4,4	8,6 Sardegna	2,0 Lombardia
	1979	5,3	11,0 Campania	3,0 Lombardia
NL	1973	1,9	2,5 Zuid-West	1,7 West
	1975	3,2	4,7 Zuid	2,3 West
	1977	3,3	4,6 Zuid	2,5 West
	1979	3,3	4,4 Zuid	2,8 West
UK	1973	2,1	4,6 Northern Ireland	1,1 East Anglia
	1975	4,6	7,1 Northern Ireland	3,7 South East
	1977	4,7	8,5 Northern Ireland	3,8 South East
	1979	3,5	7,0 Northern Ireland	2,2 South East

(1) Figures refer to specific sampling dates in mid-year, not annual averages.
Source : Labour Force Sample Surveys for the European Community 1973, 1975, 1977 and 1979.

Table 7.11 Summary of Monthly Unemployment Benefits in 1980 for a mature male worker

National currencies per month

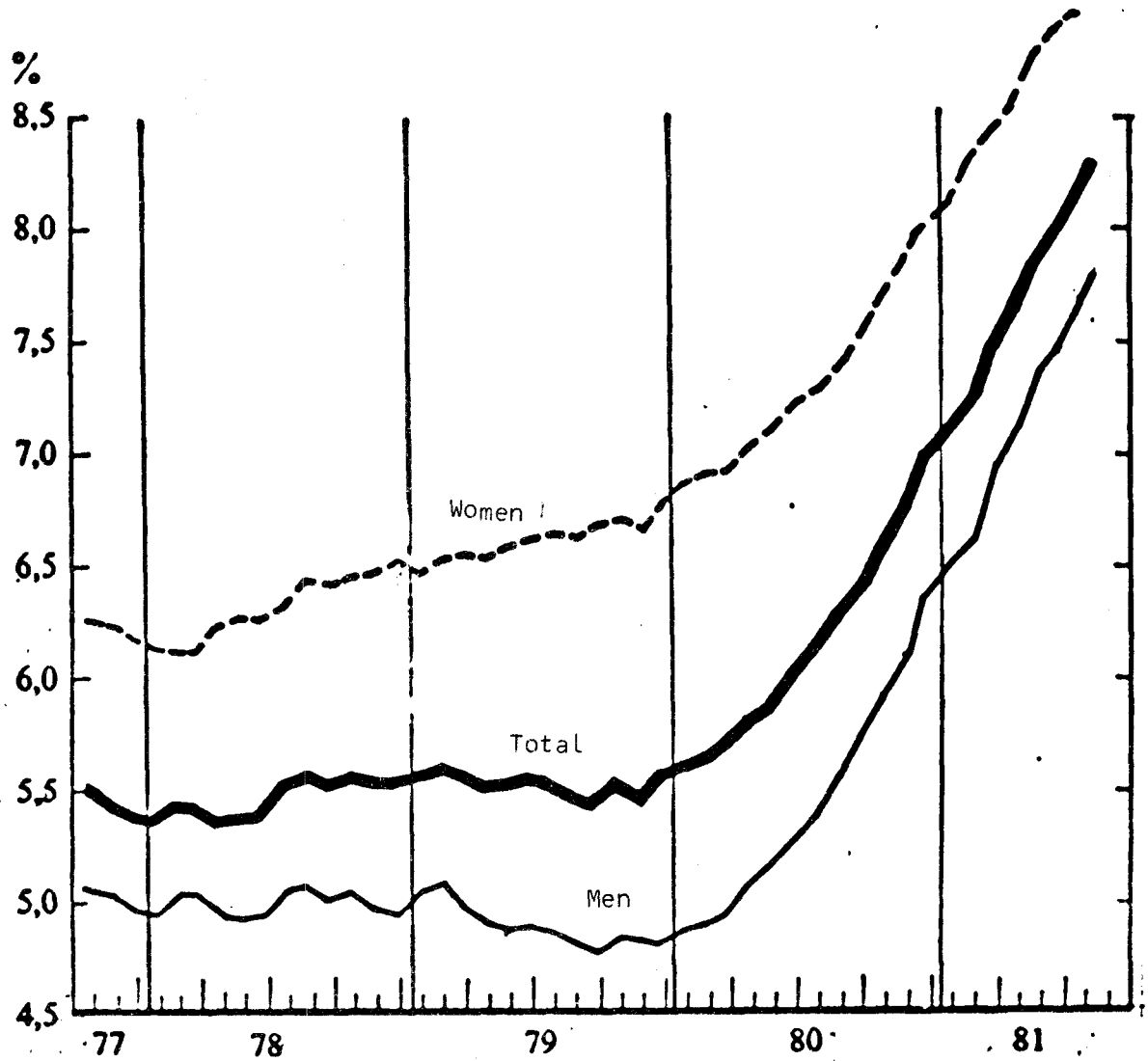
Country Currency	Unemployment Benefits				Taxable	Remarks	Compensation of employee per head
	Minimum or flat rate	Intermediate Scale	Maximum	Family Benefits			
Belgium BFR	16 290	60% of gross earnings	34 075	-	No: Unlimited	40% for those not heads of families	54 325
Denmark DKR	-	90% of gross earnings	6 786	-	Yes: 2 1/2 years		9 440
Germany DM	-	68% of net earnings	4 200	-	No: Up to 1 year depending on last period of employment	Then 58% indefinitely	3 100
France FF	715	42% of reference earnings + flat rate	20 040	-	No: 3 years	Special rate 65% reducing every 3 months for previously employed workers	6 970
Ireland IRL	88.6	40% of gross earnings between 61 and 607 + flat rate	685	Adults 57.5 Children 23.6	No: 65 weeks	40% reduced to 20% over 65 weeks	450
Italy LIT	292 000	-	-	-	No: 6 months	Special rate of two-third of previous earnings for redundant workers in industry, agriculture and construction	1 041 000
Luxembourg LFR	-	80% of reference earnings	2.5 times minimum earnings	-	Yes: 1 year		51 250
Netherlands HFL	1 811	80% of gross earnings	5 136	-	Yes: 6 months		3 925
United Kingdom UKL	234.3	One-third of earnings bet- ween 76 and 130 plus 15% of earnings between 130 and 520 + flat rate	600	Adults 137 Children 20	No: Flat rate 1 year: earnings-re- lated supple- ment (6 months)	Earnings-related supplement to be discontinued	495

Sources : Comparative tables of the social security systems of Member States of the European Communities (1 July 1980)
Commission short-term forecasts (final column).

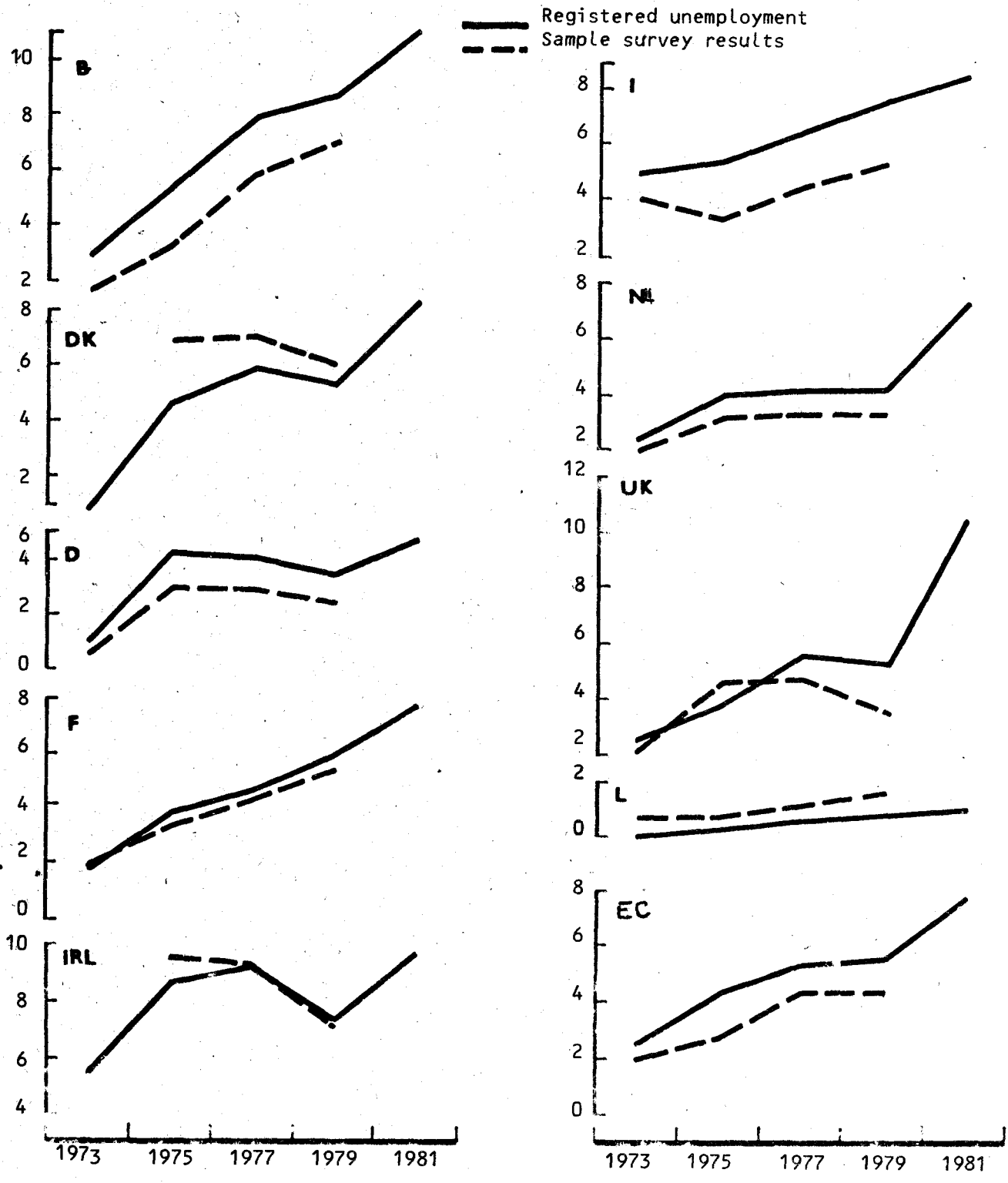
(a) Includes employers' social contributions.

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Graph 7.1 Unemployment rate, EC total (s.a.)



Graph 7.2 Unemployment rates: comparison of registered unemployment and sample survey results.



8. Sectoral problems and policies

Shaken by successive oil crises and under pressure from mounting international competition, the Community and the individual Member States are pursuing their efforts to achieve structural adjustment against a background of sluggish growth, a low level of investment, rising unemployment and persistent inflation. Alongside sectors, such as steel, textiles and shipbuilding, which are in the throes of adjustment and for which the Community is developing restructuring or conversion plans, the basic capital goods industries, on which both the modernization of production techniques and trade equilibrium depend, are suffering from a low level of growth, a fall in investment ratios, lower productivity growth and increasing import penetration. The machine tool industry has shown obvious signs of weakness for a number of years, but these are now spreading to other capital goods industries (metal manufacture, electro-mechanical equipment, transport equipment, etc). These industries must successfully carry out the major technological revolution now taking place, since it is here that they can recreate the conditions which will enable them to become competitive again. Under the pressure of events, Community policies initially focused on measures, often defensive in character, in those sectors which were in greatest jeopardy; now, however, first priority should be given to developing the advantages conferred by the Community dimension so as to ensure that a leading position is achieved in industries with promising future potential.

8.1 Adjustments in the Community's sectoral structures between the two oil shocks

After the first oil price rises and the economic recession which ensued in 1974-75, and before economic activity began to slow down again appreciably in 1980-81 following the second series of oil price rises, the Community economy had almost regained its early-1970s growth rate (3.5% on average from 1975 to 1979 as against 4.4% from 1970 to 1973). Only at a relatively detailed level of sectoral breakdown of the economy can it be seen that the growth pattern in some sectors shifted significantly from past trends, possibly reflecting an acceleration in the continuous adjustment process in European economic structures. Generally speaking, in most major categories of sectoral activity (intermediate products, equipment products, current consumption goods, services), average growth performance during the last ten years has invariably been some 20% lower than during the years of high growth, this drop being on the same scale as that for the Community economy as a whole.

Between 1975 and 1979, the last year for which sectoral statistics for most Community countries are available, the basic sectors contributing most to overall growth were energy (with a particularly high level of growth), intermediate products, particularly chemical products, and also steel in 1978 and 1979 and market services.

The sectors with the lowest performance in terms of value-added growth were building and construction, non-market services and agriculture (mainly because of two bad years in 1975 and 1976).

Changes of greater significance are evident in the capital goods sector. With 11.7% of the total of the Community value added, this sector accounts for around 40% of all industry and plays a decisive role in stimulating economic activity. Although a number of industries, such as data-processing equipment (office machines) came through the 1974-75 economic crisis with scarcely any slowdown in their growth and have since climbed back to a very high growth rate (almost 8% a year in volume terms), the more traditional industries such as those manufacturing metal products, and even more so those producing industrial machines, have had growth rates of only around 1% or indeed negative growth rates. They are quite clearly the principal victims of the low level of growth in Community and international demand for capital goods, but the duration of this contraction in demand is itself undermining the capacity of these industries to adjust to technological developments, resulting in a very low level of growth in their investment and productivity. A complicating factor is that the other capital goods industries (electrical and electronic goods), which had proved more resilient in holding out against the general reduction in investment expenditure, even in 1974-75, have since 1978 achieved only one third of their growth rate of the previous ten years. If account is taken of the situation in the transport equipment industry (motor vehicles), where there has been a sharp slowdown in growth since that date, a question mark may be seen to hang over the future of a whole sector of activity. Its growth is now based only on the manufacture of equipment for the setting up of electronic data transmission systems, but this branch accounts for only 0.9% of Community value added and provides only 0.7% of total employment. It is against this background that we must measure the scale of the difficulties confronting Community industry, the economic growth of which has hitherto relied mainly upon the production of capital goods.

The industries producing current consumption goods have seen a gradual decline in their contribution to economic activity, falling from 7.8% of total value added in 1973 to 7.1% in 1979, mainly as a result of the decline of the textile industry, which had negative growth rates during four of those six years. Only the rubber and plastics industry has on average achieved sustained growth, though with fairly marked cyclical fluctuations.

In overall terms, the basic pattern of the changes taking place in sectoral structures in the Community has not altered since 1973. Only two major sectors, energy and services, have increased their share in total value added between 1973 and 1979. No major industrial branch has maintained the relative level, in terms of value added, which it had in 1973; indeed, the building industry lost one percentage point between 1973 and 1979. The market services sector is by far the principal beneficiary to emerge from this process of change in Community economic structures. The acceleration in the shift of the economy towards services, despite or because of the adjustment constraints with which the Community countries are faced, is clearly evident from the figures : in six years, from 1973 to 1979, the share of the value added of market services rose by nearly two percentage points to reach 41.6% of the total for the Community economy, whereas in the thirteen years from 1960 to 1973 it increased only from 38.7% to 39.7%. As the draft fifth medium-term economic policy programme points out, the share of industry in the creation of wealth and employment is declining at a faster rate than long-term trends had suggested, and this reduction should be stabilized by developing competitive industrial activities.

As far as employment is concerned, the trends may be summarized even more simply : with two exceptions, no goods-producing sector, whether agriculture, building, energy or the various industrial branches, has shown any net job creation since 1975. The two exceptions are transport equipment and the rubber and plastics industry, which together accounted for net creation of 108 000 jobs out of the net 1.4 million jobs created between 1975 and 1979. Here again, virtually all of the increase is based on the services sector which, in the space of four years, provided 2.3 million jobs in the market services sector and 1 million jobs in the public service sector.

This does not mean, however, that the services sector has become highly labour-intensive. While public services, with 121 jobs per 1 000 units of value added in non-market services, have a very high labour content (the calculation of value added in volume terms being very conventional, this coefficient is relative arbitrary), market services by contrast, with a coefficient of 74, are still well below the average coefficient for industry (79). The labour content per unit of value added (which is merely the inverse of apparent labour productivity) has been declining steadily in all branches, with a very rapid decline in agriculture

and energy, a moderate decline in the various industrial branches except the most buoyant sectors such as chemicals and data-processing and electro-mechanical equipment, where the reduction is very sharp, and a slower decline in services and also in building.

Amongst the industrial branches, where the coefficient was 132 in 1979, the textile industry is by far the most labour-intensive and this, together with the fact that its annual rate of reduction is scarcely any faster than the average for the economy, indicates how far it still has to go before achieving profitable production conditions (by way of example, the textile industry's labour content per 1 000 units of value added in 1979 was 100 in the Federal Republic of Germany, 110 in France, but 150 in Italy and 187 in the United Kingdom). Although it shed 823 000 jobs in net terms between 1973 and 1979, the weakness of the growth of this branch itself contributed to the slowdown in the reduction of this coefficient. Between 1960 and 1973, its labour content fell by 5.1% a year, but after 1973 by 3.2% a year. During this period (1973-79), the labour content fell by 3.7% a year in the chemical industry, by 4.3% a year in electro-mechanical equipment and by 7% a year in data-processing equipment.

As regards sectoral investment, the deterioration in the conditions governing the real return on capital have to a large extent contributed to the contraction in the volume of investment. Though the growth in real profit ratios, which suffered considerably during the 1974-75 crisis, reverted to a significant upward trend in a number of industrial branches, the share of gross operating ratios in value added did not generally regain the levels achieved at the beginning of the decade. There is therefore still a considerable lag between the revival in the growth of macroeconomic investment and that of the gross operating surplus, since it was not until 1979 that the volume of GFCF exceeded the level reached in 1973, though the figures forecast for 1981 indicate that it will once again fall below that level.

The very length of this period, marked by a low level of growth in investment despite the apparent restoration of profitability conditions, probably explains in part why average productivity growth was only 2 to 3% a year.

Analysis of individual sectors shows relatively different patterns of performances. Between 1975 and 1979, the intermediate products sector had fairly sustained growth and high productivity gains, although the growth of investment was very substantially negative not only in the steel industry, but also in the chemical industry, at least until 1978, the last year for which detailed figures

are available. Conversely, the capital goods sector, despite less buoyant growth, carried out large-scale investment, though this is not reflected in any major productivity gains. However, it is evident that, although manufacturing industries as a whole saw some revival in their average rate of real gross operating surplus, following the disastrous results for 1974-75, this improvement was not sufficient to stop the steady decline in investment ratios. With the exception of agriculture, average investment ratios in each branch between 1976 and 1978 were uniformly below the average level for 1970-73. This situation is to some extent reminiscent of the comments made on the fall in the labour content per unit of value added, but the rate of decrease in this approximate measure of capital intensiveness, notably in some branches of industry (steel, chemicals, but also data-processing equipment and rubber and plastics) is even more rapid than that of the labour coefficients. Here too, the greatest degree of stability in the trend of investment ratios is to be found in the services sector, which does in point of fact account for 55% of total investment (or 30% if residential construction is excluded).

Although aggregation of the data at Community level masks the wide diversity in national situations, this combined decline in the intensiveness of two factors of production, capital and labour, in many branches of industry, shows at the very least the difficulty with which the process of adjusting the European productive apparatus is taking place. The external trade figures merely reinforce the view that Community industrial structures are in danger of falling some way behind major international competitors in the adjustment process.

Trade with countries outside the Community, accounting for a little under 50% of Member States' total external trade, is in overall terms almost in equilibrium as far as goods are concerned and in surplus if services are included. Similarly, while generally remaining fairly stable, export/import ratios for almost all categories of products improved during the period 1974-75, only to decline thereafter, especially in 1979, a year of fairly high internal growth. However, this relative stability cannot conceal the emergence of a deterioration in a number of the Community's major trading industries. The clearest case is that of the motor vehicle industry, whose export/import ratio fell in ten years from 18 in 1970 to 3.6 in 1979, but the other industries producing capital goods have, albeit to a lesser extent, shown the same difficulty in maintaining their competitive position; thus, export/import ratios have, for a number of years,

been falling in the case of electrical goods and machines, data-processing equipment and industrial machines. Whereas, as has been seen, activity in the capital goods sector has not managed to regain its past buoyancy, imports of capital goods increased from an average of 16.4% a year (in value terms) between 1970 and 1973 to 18.9% between 1975 and 1979, while the growth rate of exports fell during the same periods from 12.9% to 10.2%. This is a dangerous trend for the Community in the medium term, though it applies in differing degrees to the various Member States, being evident in the case of the Federal Republic of Germany at any rate. It is based in part on differences in price competitiveness, but also on some leeway in technological adjustment, notably in electronics as compared with the United States and Japan.

A return to stronger competitive positions must be sought not so much in an extension of sectoral protectionism as in a successful changeover to efficient manufacturing processes. This is obviously the course pursued, for example, by the chemical industry, which has steadily improved its export/import ratio, and it is not yet that pursued by the textile and clothing industry, where exports are still declining compared with imports.

8.2 Sectors with future potential

The above sectoral analysis is based on the traditional economic breakdown of industrialized countries into major sectors of activity whose importance is judged in terms of their share in value added or in the number of persons employed. For each group of industries or service activities, the whole body of statistics available, as may be seen in the annexed tables, derives from the choice of these criteria and governs the economic observation and interpretation of changes in sectoral structures. The current technological changes, which will profoundly alter production and working conditions in the years ahead and which the structural adjustment process in the European economies is basically aimed at achieving, lie almost entirely outside the range of these instruments of analysis. Here again, there must be change, even if there is no hope of eliminating all the uncertainties, but efforts must be made to correct the over-pessimistic picture of a productive apparatus in decline which emerges from the conventional approach outlined above.

In at least four areas, though the list is not exhaustive, the activities that are likely to develop may either offer substitutes for the declining role of certain industries or, through the transformation of production methods, revitalize sectors considered to be in decline by freeing them from the constraints which hold them back and by restoring to them the conditions of competitiveness which will enable them to regain their position : these areas are energy, micro-electronics, aerospace and biotechnology. There is no question here of describing in detail the possibilities which each of them offers or of examining the stage of development they have reached; what must be made clear, however, is that the achievement of a leading position in them by the Community countries is a fundamental condition governing growth prospects and a return to a more balanced employment situation.

Measures in the energy field have already been initiated on a large scale and considerable success in reducing oil dependence has already been achieved (see box : oil and energy). The measures are aimed both at easing balance of payments constraints and at creating new forms of production and consumption underpinning growth and creating jobs. The amount of investment required to finance national projects is substantial and will bring capital expenditure linked to either energy production or consumption up to 10% of total GFCF. However, while the scope offered by the development of new sources of energy and by energy conservation is considerable and varied, particularly as regards potential jobs in the case of energy conservation, it requires effort and the coordination of measures, both as regards research and development and financing and as regards the provision of information for users.

The microelectronics industry and, more generally, technologies connected with data processing are also expanding rapidly. By penetrating all sectors of the economy, from agriculture to services, microprocessors have far-reaching economic repercussions. They allow an acceleration in the growth of labour productivity and, by reducing the cost of capital, in the growth of the overall productivity of the factors of production, and they also result in a wider range of products, creating new demand and generating new production activities. However, their impact on employment is initially negative because the process of adjusting the vocational skills required is so slow. The fact remains that the Community is clearly lagging behind the United States and Japan. European producers do not enjoy the advantages offered by a genuinely unified market, the benefits of public procurement, which is insufficiently coordinated at European level and often goes to international competitors outside the Community, or massive public aid for research and development.

However, the Community does enjoy major comparative advantages in the development of software, which is fundamental to all forms of data processing, and in the manufacture of high capacity microprocessors, but here too major efforts must be made to increase the awareness of industry and the services sector so as to ensure the successful penetration of these new technologies.

In the aerospace industry, there are two prime areas in which close cooperation between Member States is necessary. These are the manufacture of the new generation of medium-range aircraft, with a potential market estimated at \$ 55 000 million, and the further construction of satellite launchers. These programmes have an impact not only on job creation, the improvement of telecommunications, meteorology and air transport, but also have a technological impact on the electronics industry and thus on the economy as a whole. As far as the bio-industry is concerned, the potential fields of application would seem to be extremely large, particularly in agriculture and chemicals. However, it is still in the field of alternative sources of energy that, in the short term, the first tangible effects of a technology whose precise economic impact is difficult to measure should make themselves felt.

In the case of all these industries with future potential, the amount of expenditure required for investment or research and development purposes is enormous. However, competition between countries or industrialized areas in these spheres is intensive, and the countries which are the first to establish a lead on this market will be the only ones that can draw any benefit in terms of employment and growth from the industries concerned. The Community is far from being in a strong position compared with the United States and Japan, since in terms of percentage of GDP, it channels fewer resources to research than those countries; it also has fewer engineers and scientists in terms of percentage of total employment. It is against this rather unfavourable background, aggravated by protectionist tendencies which hold up still further the efforts which must be made, that more energetic Community policies are required.

8.3 Community sectoral and structural policies

In addition to its proposals for economic policies intended to create a stable economic and monetary environment that favours growth in the Member States and is based on efforts to control the factors which generate inflation, the Community has at its disposal considerable well-defined measures capable of having a wide impact. Leaving aside the particular problem of the common agricultural policy, which is dealt with separately (see box No 1), Community measures are aimed at organizing and developing the proper operation of the internal market by removing obstacles to the free movement of persons and goods, drawing on a wide range of instruments :

- the establishment of a common external tariff so as to ensure uniformity of conditions governing access to the Community market;
- the elimination of technical barriers to trade;
- open tendering for national public contracts;
- the pursuit of an active competition policy under which State aids are subject to Commission control;
- aid to promote cooperation between European firms in the technical, commercial and legal spheres.

However, under the pressure of events and because of the adjustment difficulties encountered by the Member States, the Community has had to step up its sectoral intervention measures and has not yet managed to strike a balance between the measures it takes to support traditional industries that are undergoing a serious adjustment crisis, have a high degree of labour intensiveness and are very largely concentrated in certain regions, and those it takes to promote industries with future potential.

On the basis of the principle that, for economic as much as for strategic or social reasons, no sector could be abandoned even if there was no longer any chance of it being profitable, Community measures in sectors in difficulty have primarily been designed to strengthen their structures through more effective organization of their production and to re-establish improved conditions of productivity and profitability through temporary public aid in support of investment. Such measures designed to ensure restructuring and indeed, in some cases, conversion have applied to the steel industry, the textile industry and shipbuilding.

The most specific intervention measures have been in the areas of external commercial policy, competition and information, often involving a major social aspect.

The "Multifibre Arrangement" (MFA) in the textile industry and the proposed amended renewal to the end of 1986, limiting the growth of textile imports from 32 non-Community countries, is a typical means of "provisional" protection intended to shield a sector from having to carry out a process of overrapid adjustments which would have serious effects on employment and regional equilibria. Similarly, in the steel industry, a system of production quotas was established in October 1980, and minimum frontier prices were fixed, while 14 bilateral agreements covering 75% of the Community's steel imports were extended until 31 December 1981 (see box No 3 : the steel industry).

As regards aids, limits have in some cases been imposed on the granting of public subsidies or loans. For example, the Fifth Directive on aid to shipbuilding, adopted by the Council on 28 April 1981, governs the cases in which the Commission may authorize aid to shipyards within the Community. The same applies to the way in which the Commission examines some of the aid granted in the textile industry, notably in Belgium and the Netherlands. However, it should be noted that such aid authorizations are regarded as exceptional, and in the steel industry for example the Council has decided that they must be abolished by 1985.

The purpose of measures taken in the social area is to facilitate the re-training of workers and to reduce its impact on their incomes; thus, in the shipbuilding industry, the European Social Fund (ESF) has provided assistance for some 7 000 persons in three Member States (D, I, UK) in order to increase the vocational and geographical mobility of the labour force; the Commission also presented the Council with a proposal aimed at helping to maintain the income of elderly workers affected by restructuring measures in this industry, but the Council did not endorse it and the question is being re-examined by the Commission. In the steel industry, on the other hand, the Council authorized the Commission, on 24 June 1981, to contribute under the ECSC Treaty to the financing of payments made by Member States in connection with early retirement measures (effective up to the end of 1984) and part-time working measures (for a period up to 30 June 1982).

Other industrial sectors, such as the motor vehicle industry, or service sectors, such as distribution, have until recently had a particularly high level of growth based on the steady rise in living standards and expanding export markets. The increase in international competition and the squeeze on private households' incomes during the past number of years have seriously affected these sectors making it more difficult for them to carry out the necessary adjustments to changes in technology, in the cost of energy and, more generally, in new conditions of production. For example, the Community motor vehicle industry saw its production and exports fall, in volume terms, by 9% and 8.4% respectively between 1979 and 1980, while imports grew by 9.0%.

Community policies in these sectors initially consisted in informing European producers of market conditions and trends, in improving the operation of the single market and, where appropriate, in bringing the Community's financial instruments to bear.

Thus, in June 1981, the Commission adopted a communication on the structures and outlook for the European motor vehicle industry. This was a study of the industry containing, firstly, a very detailed analysis of the situation and of the problems involved in increasing its international competitiveness and, secondly, guidelines for coordinated measures to back up the efforts made by the Community motor vehicle industry to improve its competitiveness, facilitate adjustments and develop an appropriate economic environment. More specifically, the Commission has continued with the harmonization of rules at Community level, putting forward the idea of "Community type-approval" with regard to technical specifications, which would make the approval of a vehicle in one Member State valid throughout the rest of the Community. It has also pressed the Japanese authorities to remove non-tariff barriers to imports into Japan and, at the request of the Council, it has started statistical monitoring of imports of Japanese cars into the Community.

Lastly, although Community financial assistance to the motor vehicle industry has so far in most cases been in response to regional or social needs, its impact in quantitative terms has been significant, amounting to 5% of investment. The share of ERDF assistance in the financing of investment to which it contributed amounted to nearly 7% between 1975 and 1980, and ECSC loans financed up to 50% of the cost of the operations concerned.

The Community has also embarked on measures involving sectors with future potential. There was no question of the Community acting in place of industry or the market in picking out activities with future potential as opposed to those considered to be more traditional, but rather of using the economies of scale provided by measures in the general interest carried out at European level. Two types of measures have thus been given priority : the stimulation of research and development and the extension of transnational cooperation in data-processing, electronic data transmission, aircraft and aerospace, biotechnology and new sources of energy.

Community assistance towards research and development ranges from the organization of meetings for groups of scientists to the financing of programmes such as pilot projects relating to new sources of energy, in connection with the objectives set by the Council on the long-term security of primary energy supplies, helping European industry to become more competitive and the protection of the

environment. However, over and above research proper, the Council has, for example, drawn up a multiannual programme (1979-83) on data-processing covering both general measures (standards, public contracts, assessment of the effects of the new microelectronic technology on employment) and industrial promotion measures relating to the production of the future generation of complex integrated circuits, software and the application of data-processing systems and equipment that are in the Community interest. The Community communication system known as DIANE (Euronet) is one of the first specific results of the implementation of this approach. Parallel to these measures carried out at European level, the Community promotes the development of projects involving two or more Member States, with considerable success in the aircraft or aerospace industry in particular within the framework of the European Space Agency.

Agriculture

General economic trend and structural adjustments : Community agricultural production increased, between 1973 and 1979, by about 1.5% a year with a fairly sharp acceleration in growth during the last few years. The increase in production was obtained through more intensive use of the means of production, resulting in an increase in intermediate consumption, especially after 1977, and reducing the average growth of value added in the sector to nearly 0.5% a year for the period 1973-79.

Although the rise in production seems to have been determined more by decisions taken under the common agricultural policy, the fixing of prices and weather conditions than by the general economic situation, the state of the economy has markedly influenced the annual rate of reduction in the number of persons employed in agriculture. The rate of reduction was 4.8% during the period 1968-73, but fell to some 3% between 1973 and 1979, mainly because of fewer employment possibilities elsewhere for agricultural workers wishing to leave the sector. Productivity growth accordingly slowed from 7.8% a year in the years before the crisis (1968-73) to 4.5% after 1973.

The slowdown in the growth of per capita output was not the only factor curbing the rise in agricultural income. The very appreciable increase in the prices of intermediate products, exceeding that in production prices, resulted first in a fall in "real income" per person employed in 1974, followed by slow growth up to 1978 and a further drop thereafter.

Though the financial situation was hardly favourable, structural changes have continued. The proportion of agricultural value added accounted for by investment rose steadily, despite the rising cost of borrowing. At the same time, the size and production potential of the average farm in the Community are continuing to increase. However, because of features specific to a sector heavily influenced by non-economic factors and managed under an agricultural policy whose social aspects influence price determination, prices and incomes do not have the same impact on adjustment as in the case of most other branches. Some 70% of agricultural products are covered by a system which guarantees both markets and prices, and this increases the risk of structural surpluses and imposes a burden on the Community budget because of the payments that have to be made from the EAGGF Guarantee Section.

At the same time, progress has been achieved in the common policy to improve agricultural structures. Since 1 January 1980, the EAGGF Guidance Section has had a total budgetary appropriation of 3 600 million ECU available for a five-year period to help in the financing of agricultural restructuring, this amount being supplementary to national expenditure. The Commission has urged member countries to give fresh impetus to structural policy, by updating existing measures and by initiating new measures along regional lines.

The Commission's report under the Mandate of 30 May contains proposals which should also influence structural adjustment. In particular, the Commission recommends that :

- policy on prices should be shaped in such a way that Community prices reflect market realities and thus come more into line with prices in the main competitor countries;
- producers should, more than in the past, be brought face to face with the reality of the market with regard to the potential for marketing their output, which means that there must be financial participation on their part or that the intervention guarantee in the event of structural surpluses should be limited.

Main economic indicators for agriculture EUR-9

(Rate of change from preceding year and absolute values)

	1973	1975	1976	1977	1978	1979	1980
1. Volume increase in production (in %)	:	- 2.3	- 0.5	3.7	5.3	3.5	:
2. Increase in Community agricultural prices (in %) - A	6.5	13.8	11.4	8.2	8.6	7.5	10.5
2. Increase in Community agricultural prices (in %) - B (1)	6.4	10.1	7.6	3.9	2.1	1.2	4.8
3. Agricultural production as a proportion of GDP (in %)	7.3	6.6	6.5	6.3	6.2	5.9	:
4. Persons employed (in millions)	9.4	8.7	8.6	8.3	8.1	7.9	:
5. Trend of employment (in %)	- 4.1	- 4.4	- 1.2	- 3.4	- 2.4	- 2.5	:
6. Trend of productivity (in %) (2)	:	2.1	0.7	6.2	7.9	6.1	:
7. Final production ('000 million ECU)	63.2	73.3	82.9	89.8	96.3	104.8	:
8. Exports to non-Community countries ('000 million ECU)	7.4	8.8	10.6	12.3	13.3	15.2	:
9. Imports from non-Community countries ('000 million ECU)	23.8	24.5	33.1	37.5	36.1	40.1	:
10. Trade balance ('000 million ECU)	-16.4	-15.7	-22.5	-25.2	-22.9	-24.9	:
11. Trade balance as % of production	25.9	21.4	27.1	28.1	23.8	23.8	:
12. Gross value added at factor cost ('000 million ECU)	40.2	45.3	49.3	52.1	56.3	59.3	:
13. Expenditure, EAGGF Guarantee Section ('000 million ECU)	3.8	4.7	5.6	6.8	8.7	10.4	11.5
14. EAGGF expenditure as % of gross value added at factor cost	9.4	10.4	11.4	13.1	15.4	17.5	:

(1) (A : in national currency) the prices relate to marketing years, which cover part of the year given in the column heading
(B : in ECU) and part of the following year

(2) Calculated on the basis of final production

Sources : Yearbook of Agricultural Statistics 1977 and 1975-1978; The Agricultural Situation in the Community 1975 to 1980; CRONOS; Green Europe, Nos 13 (December 1980) and 15 (April 1981).

Oil and energy

In two successive shocks, 1973-74 and 1979-80, the price (fob) per barrel of crude oil imported by the Community rose from less than \$ 3 to \$ 36, thus increasing by a factor of 13.8. These savage increases have given rise to adjustments on a very uneven scale, and, although the adjustments have in particular allowed a considerable reduction in the volume of net oil imports, they have not been sufficient to offset the price effects : the Community's oil bill has risen from \$ 12 600 million in 1973 (1.2% of GDP) to \$ 106 000 million in 1981 (some 4% of GDP).

In order to cope with the energy constraint, member countries have taken steps to boost their investment programmes with the aim of developing national energy production, substituting other sources for oil and restructuring demand so as to increase energy efficiency. However, the growth of energy investment has remained very moderate for the Community as a whole, rising from 1.4% of GDP in the period 1968-74 to 1.6% of GDP in the period 1975-80 (equivalent to 7.7% of total GFCF), though these average figures mask sharp differences between countries, with energy investment ranging from 0.9% of GDP in the case of Italy to 2.8% of GDP in the case of the United Kingdom during the second period. Member countries have also begun to introduce price policies which encourage energy production, the use of desirable substitutes and energy conservation. However, the impact of the price rises on the final consumer has in most cases been spread over time because of the time lags in the adjustment of specific taxes on petroleum products. In addition, many technical or administrative measures designed to regulate the use of energy (heating, transport, etc.) have been adopted in all Member States.

Throughout the whole of the period 1973-80, energy consumption in the Community remained below or very slightly above - with the exception of 1979 - the 1973 level, while GDP grew by an average of 1.9% a year. Oil consumption fell by some 100 million tonnes, or more than 17%, during the period 1973-81, and this, given the growth of North Sea oil production in the United Kingdom (up 87 million tonnes), explains the reduction in the volume of net imports from 585.8 million tonnes in 1973 to 389 million tonnes in 1981.

The Community's dependence on oil imports thus dropped dramatically from 61.7% in 1973 to a forecast 41.3% in 1981. The share of oil in energy consumption was cut from 60.5% to 50% during the same period. It might be pointed out here that the main energy objectives which the Community has set itself for 1990 are to :

- bring down to 0.7 at least the ratio between the growth rate of energy consumption and the growth rate of GDP;
- reduce the share of oil in energy consumption to about 40%;
- rely on solid fuels and nuclear energy to cover 70 to 75% of primary energy requirements for electricity generation.

The first examination of Member States' progress in pursuing these objectives highlighted the need for greater national effort. The key factor in this connection will be the volume of energy investment up to 1990 : Member States' current programmes provide for some 500 000 million ECU between 1981 and 1990, equivalent to 2.2% of GDP (10.1% of GFCF). However, in contrast to what has been the pattern in the past, most of the additional investment is to be concentrated on the use of alternative sources of energy in power stations and on energy conservation and is therefore subject to uncertainty and very dependent on the general economic situation. It is therefore necessary as of now to combine judicious price and taxation policies with possible financial support at national or European level. This question is at present being examined within the Community institutions.

Development of the oil market EUR 9

1973 1975 1976 1977 1978 1979 1980 1981(1)

Million tonnes of oil equivalent

1. Net oil imports (crude and refined)	585.8	482.6	517.8	481.1	472.1	474.2	420.3	389.0
2. Crude oil production	12.0	12.1	22.2	48.6	63.7	89.0	90.7	95.0
3. Gross inland consumption of crude oil and oil equivalents (2)	555.7	478.0	508.4	496.2	512.7	525.2	479.6	459.0
4. Gross inland consumption of primary energy (2)	919.1	847.4	902.0	897.9	924.5	969.3	925.9	917.0
5. Oil as a proportion of total inland energy consumption (%)	60.5	56.4	56.4	55.3	55.5	54.2	51.8	50.0
6. Dependence on oil imports (3) (%)	61.7	55.0	55.5	51.9	49.5	47.6	44.3	41.3

US dollars

7. Average import price per barrel of crude oil (fob)	2.6	10.3	11.4	12.6	12.8	19.5	31.3	36.0
8. Net crude oil import bill (cif) in '000 million	12.6	39.9	45.2	48.9	47.9	69.7	101.0	106.0

Percentage change

9. Net oil imports (crude and refined)	-17.6	7.3	-7.1	-1.9	0.4	-11.4	-7.4
10. Crude oil production	0.8	83.5	119.0	31.1	31.1	1.9	4.7
11. Gross inland consumption of crude oil and oil equivalents	-14.0	6.4	-2.4	3.3	2.4	-8.7	-4.3
12. Total inland consumption of primary energy	-7.8	6.4	-0.5	3.0	4.8	-4.5	-1.0
13. Crude oil import price (fob)	-6.8	11.1	10.5	1.3	52.3	60.5	15.0
14. Net crude oil import bill	-10.9	13.3	8.2	-2.0	45.5	44.9	5.0

(1) Estimates and forecasts

(2) Equal to production + net imports - increase in stocks - ships' bunkers (energy balances)

(3) Net oil imports as % of gross inland consumption of primary energy + bunkers

Source : Eurostat and Commission departments

The steel industry

Since the first oil shock (1974-75), the Community industry has been involved in a rapid process of adjustment, against a background of a substantial deterioration in the industry's relative position, with :

- a 17.9% fall in crude steel production from 1974 to 1980;
- a 180 000 reduction in the workforce between 1973 and early 1981;
- a decline in its share in world production from 21.9% in 1974 to 17.8% in 1980;
- a 13% increase in crude steel production capacity between 1974 and 1980;
- a drop in capacity utilization rates from 80% in 1974 to 55% in 1980;
- a 40% contraction in investments at current prices between 1975 and 1980.

The Community's trade balance in steel remains comfortably in surplus, but the ratio between imports and exports (in tonnes) of ECSC products rose from 30% in 1975 to 41% in 1980. At the same time, imports rose from the equivalent of 5% of total crude steel production (tonnes) in the Community in 1975 to 7% in 1980. However, the trend of the Community's balance of trade in steel products shows growing specialization on the part of the Community steel industry, with greater concentration on more sophisticated products, resulting in a relative increase in the value added of exports compared with that of imports. Since 1977, Community restructuring policy has consisted of measures designed to facilitate the reorganization of the productive apparatus and the retraining of workers, while leaving it to firms to decide on their own modernization and rationalization. These measures were accompanied by a self-discipline agreement between the main steel companies, notably with regard to production and prices. This voluntary agreement reached under the auspices of Eurofer broke down in May 1980 under the pressure of growing excess capacities.

So as to prevent a total collapse of a large part of the Community steel industry, a mandatory system of production quotas applying throughout the Community was introduced in October 1980 on the basis of Article 58 of the ECSC Treaty. A series of bilateral agreements with the major suppliers outside the Community, covering some 75% of Community steel imports, was gradually completed. This system of quotas, which were fixed quarterly for each undertaking was restricted in its duration; on 1 July 1981, it was replaced by a system of voluntary commitments entered into by steel companies, except in the case of certain products. The strategy which emerged from discussions between the Commission, the Council and the Parliament during the first half of 1981 is as follows :

The main obstacles to improving the profitability of undertakings are at present excess capacities that outstrip demand and the massive use of government assistance enabling recipient undertakings to pursue a policy of unfair competition. In March 1981, the Commission was given the task of establishing a new code of discipline on government aid, which is to be progressively abolished by 1985 at the latest. Until then, aid will have to be accompanied by effective restructuring in order to obtain authorization from the Commission.

Further, the Commission was given the task of asking undertakings to submit their medium-term restructuring plans so that it could examine the trend of investment, including contributions from public funds, the trend of capacities, etc. The Commission is now preparing further decisions on this question.

Lastly, with regard to social security, the Community will contribute to some of the expenditure (part-time working, early retirement) incurred in connection with restructuring.

Development of the steel industry EUR-9 (annual values)		1970	1975	1976	1977	1978	1979	1980
1. Crude steel production (in million tonnes)		137.6	125.2	134.2	126.1	132.5	140.7	127.7
(a) Volume growth rate in %		-	-9,0 X	+7,2	-6,0	+5,1	+6,2	-9,2
(b) Share in world production in %		23,1	19,4	19,8	18,7	18,5	18,8	17,8
2. Steel price index (weighted average EUR 9)		100	168	192	203	230	232	n.d.
3. Persons employed (end of year) ('000)		790,2(1)	766,4	759,0	719,7	685,2	670,1	599,2
4. Tonnes of crude steel produced per person employed (1:3)			167	181	179	198	210	213
5. Value of steel exports to non-Community countries ('000 million ECU)		:	4,8	3,9	5,5	6,6	7,3	7,0
6. Value of steel imports from non-Community countries ('000 million ECU)		:	1,3	2,0	2,3	2,3	2,7	2,9
7. Net steel exports, in tonnes, to non-Community countries (in '000 million ECU)		:	19,1	9,2	15,1	22,2	20,6	16,7
8. ECSC investment in steel industry ('000 million ECU)		:	3,3	3,3	2,4	2,0	2,0	2,0(1)
9. ECSC loans granted to the steel industry (million ECU)		:	567	726	474	371	317	424
10. ECSC financing as a proportion of total investment expenditure (9:8) in %		:	17,1	22,0	20,1	18,1	15,9	21,2

Note : (1) estimates

Source : Eurostat and Commission departments

Table 8.1
Sectoral structure of value added, employment and investment

(2)

	VALUE ADDED (2)		EMPLOYMENT (3)		GFCF (4)			EUR-6(1)
	1973	1979	1973	1979	1973	1978	1979	(4)
AGRICULTURE	4.2	3.9	8.6	7.2	4.2	4.6	4.4	
FUELS, POWER PRODUCTS	5.2	5.6	1.7	1.7	6.7	8.2	:	
MANUFACTURED PRODUCTS	30.5	29.4	30.2	27.9	18.7	16.5	:	
INTERMEDIATE PRODUCTS	6.5	6.4	4.9	4.5	6.2	5.0	:	
Metal minerals	1.9	1.7	1.5	1.3	2.4	1.4	:	
Non-metallic minerals	1.8	1.7	1.7	1.5	1.6	1.2	:	
Chemical products	2.7	3.0	1.7	1.7	2.3	2.4	:	
EQUIPMENT PRODUCTS	12.0	11.7	12.6	11.9	6.2	6.3	:	
Metal products	3.0	2.7	3.1	2.8	1.4	1.1	:	
Industrial machines	3.0	2.7	3.0	2.8	1.3	1.3	:	
Office machines	0.7	0.9	0.8	0.7	0.6	0.6	:	
Electrical goods	2.6	2.8	2.9	2.7	1.2	1.3	:	
Transport equipment	2.7	2.7	2.8	2.8	1.7	2.0	:	
FOOD, BEVERAGES, TOBACCO	4.3	4.2	2.9	2.8	2.4	2.1	:	
CURRENT CONSUMPTION GOODS	7.8	7.1	10.0	8.7	4.0	3.1	:	
Textiles, clothing, leathers	2.9	2.5	4.8	3.9	1.2	0.8	:	
Paper	2.1	1.9	1.9	1.8	1.0	1.0	:	
Rubber, plastic products	1.2	1.1	1.1	1.1	0.6	0.5	:	
Other manufacturing products	1.7	1.5	2.1	1.9	1.1	0.8	:	
BUILDING, CONSTRUCTION	7.6	6.6	8.5	7.8	2.0	1.8	:	
MARKET SERVICES	39.7	41.6	34.1	36.8	54.1	55.7	55.3	
NON-MARKET SERVICES	12.8	12.9	16.9	18.7	14.2	13.2	13.1	
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	

(1) EUR 6 : B, D, F, I, NL, UK

(2) Gross value added at market prices at 1975 prices and exchange rates

(3) Total employment

(4) GFCF : gross fixed capital formation by ownership branch at 1975 prices and 1975 exchange rates

Source : Commission departments

Table 8.2

Community capital goods sector : main economic characteristics

EUR '6 (1)

	Value added at market prices (2)			Total employment (average annual rates of change in %)		Labour content per unit produced (3) (average content per 1 000 units)			
	1973 1970	1975 1973	1979 1975	1973 1970	1975 1973	1979 1975	1970-1973	1974-1975	1976-1979
Metal products	2.5	-1.3	1.4	-0.1	-2.1	-1.4	107	100	92
Industrial machines	2.8	-0.4	1.2	-1.2	-1.1	-0.9	105	95	90
Office machines, data- processing	7.9	5.6	7.8	0.4	-1.3	-0.0	114	91	73
Electrical goods and equipment	6.1	2.1	4.2	1.1	-0.7	-1.2	116	101	86
Transport equipment	4.9	-2.9	4.8	1.0	-2.4	0.8	106	101	89
Total equipment products	4.2	-0.25	3.2	0.2	-1.6	-0.7	109	99	88

(1) EUR 6 : B, D, F, I, NL, UK

(2) Gross value added at market prices at 1975 prices and exchange rates

(3) Labour content per unit produced = (total employment/gross value added at market prices at 1975 prices and exchange rates) x 1 000

Source : Commission departments

Table 8.2 (continued)

Community capital goods sector : main economic characteristics

EUR 6 (1)

	Real gross operating ratio (2) (annual averages)		Gross fixed capital formation (3) (annual average rates of change)		Investment ratio (4) (annual averages in %)				
	1970-1973	1974-1975	1976-1979	1973 1970	1975 1973	1978 1975	1970-1973	1974-1975	1976-1978
Metal products	27.7	24.3	24.1	0.1	-14.3	1.5	12.0	9.3	8.7
Industrial machines	22.6	19.2	20.6	-1.8	-5.8	3.2	11.0	9.5	9.6
Office machines, data processing	33.6	24.2	28.2	3.9	-2.5	3.9	20.3	17.5	15.3
Electrical goods and equipment	23.5	19.2	22.6	2.5	-2.8	2.3	11.5	10.7	9.5
Transport equipment	16.9	13.6	20.0	-5.2	-0.8	6.7	16.9	16.2	14.1
Total equipment products	23.6	19.6	22.2	-1.1	-5.4	3.8	13.2	11.7	10.8

(1) EUR 6 : B, D, F, I, NL, UK

(2) Real gross operating ratio : Gross operating surplus deflated by the implicit price index of value added/gross value added at market prices at 1975 prices and exchange rates

(3) Gross fixed capital formation by ownership branch at 1975 prices and exchange rates

(4) Investment ratio : Gross fixed capital formation/gross value added at market prices at 1975 prices and exchange rates

Source : Commission departments

Table 8.3		EUR-6 (1)				
Export/Import ratios in trade with non-community countries (2)						
(Yearly Averages)						
	70-73	74-75	76-79	1977	1978	1979
AGRICULTURE *	.14	.17	.16	.14	.17	.19
FUEL, POWER PRODUCTS *	.14	.11	.14	.14	.15	.16
MANUFACTURED PRODUCTS *	1.45	1.67	1.56	1.63	1.59	1.44
INTERMEDIATE PRODUCTS *	1.25	1.63	1.52	1.51	1.66	1.47
METAL MINERALS	.74	1.10	.98	.95	1.16	.96
NON-METALLIC MINERALS	1.12	1.18	1.16	1.12	1.22	1.06
CHEMICAL PRODUCTS	2.32	2.69	2.47	2.58	2.51	2.35
EQUIPMENT PRODUCTS *	2.92	3.03	2.65	2.88	2.48	2.30
METAL PRODUCTS	2.33	2.37	2.39	2.59	2.51	2.01
INDUSTRIAL MACHINES	3.87	4.40	4.02	4.31	3.97	3.58
OFFICE MACHINES	1.30	1.24	1.08	1.17	1.04	.97
ELECTRICAL GOODS	2.17	2.02	1.93	2.04	1.94	1.70
TRANSPORT EQUIPMENT	3.93	4.14	3.18	3.51	2.48	2.66
FOOD, BEVERAGES, TOBACCO *	.48	.60	.65	.64	.70	.70
CURRENT CONSUMPTION GOODS*	.82	.79	.78	.82	.82	.74
TEXTILES, CLOTHING						
LEATHERS	1.15	.96	.80	.85	.83	.74
PAPER	.41	.39	.45	.47	.49	.44
RUBBER, PLASTIC PROD.	3.47	4.45	3.13	3.30	3.06	2.68
OTHER MANUFACTURING PRODUCTS	.50	.56	.66	.70	.71	.67
MOTOR VEHICLES	13.81	10.05	5.11	5.39	4.33	3.61
OTHER MEANS OF TRANSPORT	1.42	1.67	1.65	1.87	1.09	1.55
TEXTILES, CLOTHING	1.03	.89	.75	.80	.77	.68
LEATHERS, FOOTWEAR	1.98	1.44	1.11	1.16	1.14	.97
WOOD, FURNITURE	.19	.26	.32	.34	.35	.30
OTHER	1.15	1.02	1.11	1.19	1.11	1.13
TOTAL TRADE IN GOODS	.97	.92	.94	.96	.99	.90

(1) EUR 6 : B, D, F, I, NL, UK

(2) Export/Import ratio : exports/imports in trade with non-Community countries at current prices and exchange rates

Source : Commission departments

9. Some structural properties of subsidies, investment incentives and energy taxation

There is general agreement that economic policy has now to give heavier weight to remedying the structural weaknesses of the European economy. Unfortunately there is no escaping the fact that this means in practice, studying a vast number of complex mechanisms whereby public finance and regulations already promote or dampen the structural evolution of the economy. The present chapter makes a necessarily selective and highly summarised contribution to this subject, concentrating on three major aspects: firstly, the structure and size of subsidies, secondly, the nature of investment incentives, and thirdly, the evolution and relative levels of taxation of energy consumption. The relative importance of subsidies compared to GDP tended to increase in the 1970s reflecting extending government intervention while the overall economic situation worsened. Especially subsidies for housing and transport proved to be increasingly expensive. The increase and weight of current subsidies suggest that income and activity maintenance subsidies outweighed measures stimulating structural adjustment. The share of investment grants stayed near to 1% of GDP in the Community. A number of countries modified their tax depreciation allowance provisions balancing, at least partly, the negative impact of inflation and profit squeeze on business financing structures. Other investment incentives and subsidies like tax reliefs, debudgetized loans, credit guarantees and protectionist measures are highly opaque. Excise duties on gasoline, diesel and heating oil have been augmented in most member countries over the last months remaining in real terms nevertheless below 1973 levels in most cases. Higher real oil prices and in some cases higher value added tax rates led to higher charges per litre. For final users the combined total real tax charge of excise duties and VAT together reached or exceeded levels observed in 1973.

9.1 The structure and size of subsidies

The notion of subsidies is often used in ways embracing rather different interpretations. From an economic angle, the following wide definition appears appropriate: Subsidies are direct or indirect payments other than those normally made for goods, services, and production factors supplied to a firm or a factor owner, conditional on some action by the recipient and designed to induce a change in relative prices. The broad coverage of this economic definition is illustrated by the fact that it would include the subsidy equivalents of measures regulating prices and market entry, of tariff and non-tariff barriers to free trade, of preferential credits and credit guarantees, of tax reliefs or deferments, and direct government transfer payments to the business sector. The most narrowly defined concept at the other end of the scale is the one used in national accounts statistics including mainly production, export, import and interest rate subsidies as well as coverage of current trading losses of public enterprises, recorded as current transfers by government to production units (private and public enterprises).

A somewhat broader concept, also often used, adds (unrequited, non-recurrent) government capital transfers to the business and housing sector, including mainly investment grants, debt amortization and cancellation, and coverage of losses accumulated over several years. The development of subsidies according to this concept will be described below.

Table 9.1 gives the development during the 1970s of subsidies defined as current and capital transfers to production units. A clear upward trend prevailed in nearly all Community countries. In 1978 subsidies amounted to 65.000 million ECU or 3 3/4 % of GDP in the Community, 3/4 % points higher than at the beginning of the 1970s. The increase was particularly strong in Belgium (2 % points), Ireland (5 % points) (1), Italy (1 1/2 % points), and Luxembourg (3 % points). In all countries this trend resulted mainly from rapid growth of current transfer payments to the production sector (subsidies narrowly defined as in national accounts statistics; see table 9.2). While it would have been interesting to know what role interest-rate subsidies for investment and other purposes played in these developments no reliable figures on this subject are available. It seems, however, that they are used to rather different degrees in individual member countries.

The increase of current transfers appears to be much smaller if one looks at subsidy figures derived from national budgets, because since 1971/73 a substantial part of agricultural subsidies has been shifted from the national to the Community level. Current transfer payments of national governments alone increased only slightly from 1,6 to 1,9% of GDP for the Community as a whole with a constant share in Germany, a decline in Denmark but more or less substantial increases in all other member countries (see table 9.2 lower part). Series excluding subsidies paid by Community institutions are however misleading, given the transfer of competence for a traditionally subsidized sector from the national to the Community budget. A declining share of national subsidies under these conditions may nevertheless involve an increasing share of those subsidies remaining in the sole national responsibility. Thus Community subsidies have been included throughout this chapter.

(1) For Ireland this increase was largely a side-effect of agricultural policy. However, even after subtracting current EC transfers to Ireland (1,4 % in 1973 and 5,6 % in 1979) a significant increase of 3/4 to 1 % of GDP between 1973 and 1979 remains.

Information on the composition of subsidies by recipient sectors or branches generally proves to be surrounded by a number of substantial difficulties. Subsidies not targeted at special sectors are often difficult to attribute statistically; moreover, recipient sectors are not necessarily those who are intended to benefit from financial aid. Available data on the sectoral composition of subsidies which is much affected by institutional factors by country, are therefore not always compatible. Bearing these limitations in mind table 9.3 gives estimates for seven member countries of the orders of magnitude of the relative shares of financial aid going to housing, agriculture, transport, and industry and trade. These figures convey the following general impressions:

- the overall structure of subsidies varies widely between member countries, reflecting to a large degree different structural problems and long term policy choices.
- the transport and communication sector is one of the top aid recipients in all member countries. Subsidies paid to this sector have increased rather rapidly; their size compared to GDP varies widely from somewhat like a half percent in the UK to 2 1/2% in Belgium and Italy. In the latter two countries the transport sector is by far the biggest aid receiver.
- agriculture subsidies, determined by the combination of Community policies, additional national aids, and the relative weight and structure of this sector in national economies, in some countries outstrip visible aid to industry while remaining far below industrial aid in others.
- subsidies for housing, also absorb rather different amounts of financial resources, varying between negligible amounts in Italy, a third to a half percent of GDP in Belgium, Denmark, and Germany and 1 1/2% in the UK. These figures reflect only general government subsidy expenditures excluding tax expenditures which are structured rather differently in member countries. High housing subsidies for the UK result mainly from measures aiming at reducing rent payments of low income groups occupying dwellings owned by local authorities. Other countries may in fact pursue similar aims through rent regulation, subsidizing the supply of dwellings through tax reliefs, or transfer payments to low income households.
- industry and trade, finally, are generally found to have received between 3/4 to 1 % of GDP as direct subsidies in 1977/78. These subsidies are highly concentrated on a few branches with different weights in individual member countries. An example is the coal mining industry (see table 9.4), which

obtained a subsidy volume of 0,4 % of Community GDP in 1980 ranging from 0,1 % for the UK to 1,1 % for Belgium. Other important recipients have been ship-building, shipping, steel, aircraft and computer industries.

The description of subsidies so far has focussed on statistically recorded government expenditures. There exists however a number of other financial aid instruments which may be used as substitutes for subsidies. In some countries especially Belgium, Italy and the UK, government loans, equities and advances are an important tool for injecting money into selected branches or firms. The subsidy value of these sometimes rather important capital flows depends on the extent to which they are accompanied by preferential interest rates or rebates and later write-offs. Moreover, credit guarantees are used as a substitute for government loans to business. Where used as indirect financial aid to ailing firms, both general government loans and guarantees for bank credits may only delay recorded budgetary subsidies and accelerate their growth in the future when these loans have to be written-off, or guarantees have to be honoured.

Tax reliefs, taking the form of preferential tax rates or allowances deductible from the tax base for corporation tax and other business taxes, personal income or social security contributions are other indirect forms of subsidies. For Germany the 1979 subsidy report evaluates business tax savings at 13.000 million DM or nearly 1 % of GDP. An estimate of tax expenditure in favour of the Belgian business sector shows a rather rapid increase for the 1970s, reaching in 1979 a size comparable to direct subsidies (1,1 % of GDP). The UK "Government's Expenditure Plan" document of March 1980 estimates the combined impact of capital allowances and stock relief on corporation tax at £ 5 500 million, to which have to be added another £ 7 to 800 million for unincorporated business (excluding public corporations). These tax reliefs amounted to 3 1/4 % of 1979 GDP. As "no attempt is made to distinguish reliefs and allowances which can be regarded as part of the structure of the tax system", one may assume that normal capital allowances have no part in the estimate. But under the assumption of a 52 % standard corporation tax rate and "normal" declining balance capital allowances of 25 %, the above mentioned indirect subsidy would have amounted to only 1 3/4 % instead of the 3 1/4 % of GDP due to free depreciation for equipment and plant. While the coverage and the estimation methods are very different, the results illustrate, however, that the

size of indirect subsidies through tax reliefs are substantial and may well be of the same order of magnitude as, or even higher than, recorded subsidy expenditures for industry.

9.2 Investment incentives

There exists a wide range of instruments in Member States aiming at stimulating or supporting structural adjustment. Some of them are relatively permanent features of tax systems or financial markets, others are designed to be effective only over a shorter period of time. Such instruments with direct budgetary implications can be usefully grouped under one of the three following headings :

- interest rate subsidies (often combined with credit guarantees or loans),
- grants or refundable tax credits, and
- tax policy measures including depreciation allowances and tax rates.

Each of these tools affects, although to different degrees, investment determinants like liquidity, profitability, and capital costs, while each of these determinants can further be influenced by a variety of other policy measures. Limited available data and the large variety of specific features of existing schemes make general assessments about the effectiveness of incentives rather difficult. Impact evaluations are accordingly not numerous. The actual shape and use of these instruments therefore depends to a high degree on existing, historically determined structures and policy preferences.

Interest rate subsidies and investment grants are generally accorded on a selective basis and often subject to discretionary decisions. In some countries they are an important instrument of regional policy. Incentives for regions in Central and Northern Italy rely primarily on interest rate subsidies while the Belgian Economic Expansion act of 1970 explicitly envisages low interest rate loans. Generally interest rate subsidies are, however, primarily used as an incentive or aid for special branches, individual firms, or specific activities (e.g. housing, shipbuilding, export credits, R & D, capital support to firms in difficulty) whereby a special link to real investment is often absent or rather indirect, as in the case of export credits and special aid schemes including interest rate subsidies.

Investment grants accounted for an average 1% of Community GDP in the 1970s, much less than current transfers. On average total gross fixed capital formation (G D C F) was subsidised in this way by roughly 4% in the first half of the 1970s and by 5% since then.

Levels and trends varied substantially between member countries (see Table 9.5), reflecting to a large degree the varying emphasis placed on different instruments (like interest rate subsidies, investment grants, and tax depreciation allowances). For example, in Belgium considerable importance is attached to interest rate subsidies, and in Denmark limited intervention takes place under the cover of regional policy. Interestingly, countries with rather advantageous tax depreciation allowance provisions and high inflation accorded also high investment grants (Ireland, Italy, UK). Notwithstanding the wide differences in level, Belgium, Denmark, Germany and the Netherlands all doubled their respective volume of investment grants relative to gross fixed capital formation, while the UK reduced it. A major explanation of these opposing trends are shifts of policy emphasis over time between investment grants (or refundable tax credits) and tax depreciation allowances. Thus, the decline in investment grants in the UK and in Ireland in the first half of the 1970s, was a corollary of the introduction of extremely liberal tax depreciation allowances for equipment and plant, while the increase in the Netherlands since 1979 reflects a shift of policy preferences in the opposite direction towards investment grants. In all these cases it was intended, or it can be deduced by comparing changes of investment grants and tax expenditures, that either the observed increase in grants was not completely offset by cuts in preferential depreciation allowances or that the relative decline of grants was more than compensated for by better depreciation allowances. The underlying trend of investment subsidies may therefore be understated to some degree by available expenditure figures.

Financial regional policy aid, whose structure has not changed very much on average in the Community but sometimes substantially in individual member countries over the 1970s, reached approximately a quarter percent of GDP in 1978. Roughly half of this consisted of investment grants, another quarter of employment premiums, while the remaining quarter was mainly composed of interest rate subsidies and tax reliefs (expressed in terms of discounted subsidy values). As total investment grants in the Community amounted to 1%

of GDP only 10 to 20% of investment grants reported by national accounts are imputable to regional policy, while more than 0,8% of GDP must have been given in the framework of other investment subsidy programmes like housing, public transport, industrial and agricultural policy. While investment grants occupied the first place in regional policy in most countries with the exception of Italy the use of other instruments varied substantially between member States. Employment premiums were used extensively in Italy, but other countries avoided the use of this instrument in a regionally selective way. Interest rate subsidies and soft loans ranked high in Belgium, Denmark and Italy. Tax reliefs played a substantial role in France and Ireland and to some degree in Belgium. The practical conditions under which investment grants are accorded vary not only between, but also within individual countries. Grants may be subject to profit tax or not, and they may or not have to be deducted from the book values of investment, thus affecting depreciation allowances, tax payments and the actual subsidy value of a grant. The most systematic approach towards investment grants differentiated by regions and types of investment, combined with a special tax on investment to fight regional concentration was introduced in the Netherlands in 1978. Community efforts to avoid over-bidding between countries and regions have led to the limitation of the subsidy equivalents of grants to 25%, 30%, 40% or in exceptional cases 75% of initial investment costs, according to the gravity of regional disadvantage (1).

Tax depreciation allowances have been used in all member countries as an economic policy instrument for short and longer term purposes in the past. In principle depreciation allowances are based on two general rules: Capital consumption for tax purposes (a) is normally calculated on the historical costs of eligible capital goods and (b) it should be spread in an appropriate way over the life-time of capital goods. In practice these principles have not ensured approximately comparable provisions. The historical cost principle is widely applied (in spite of widespread debate about the case for replacement cost valuation in some countries), apart from occasional allowances which exceed 100% under special conditions. The spread of allowances over time, on the other hand varies widely between countries depending on life-time assumptions, advance allowances and depreciation formulae (see Table 9.6).

(1) See also: Eighth Report on Competition Policy, Brussels, April 1979, pp. 109 to 114; figures refer to total subsidies including those given per job created through new investment.

The United Kingdom and Ireland opted at the beginning of the 1970s for a system of practically free depreciation for plant and equipment, excluding further improvement except the introduction of allowances above 100 % or a change from the historical to the replacement cost principle. Denmark applies the aggregate book value system allowing an annual write-down of up to 30 % for equipment and plant. The life-time of investment goods becomes irrelevant for the spread of allowances over time under this system, which favours long-lasting plant and equipemnt. Italy allows only straight-line depreciation (same percentage of original costs per year) admitting however substantial general advance allowances of 15 % for each of the first three years. Combined with favorable life-time assumptions, it allows equipment and plant to be written off by 50 % and more within two years. Other Community countries offer a choice between straight line and one or more declining balance methods (fixed percentage on residual book-value of individual investment goods), generally less favourable than the systems applied by the above-mentionned countries.

Assumptions about the life of investment goods, where relevant, are often negotiable, and seem to vary substantially from one country to another at the level of individual goods. Average life-time calculated over 40 types of equipment goods (unweighted) points towards figures varying between member countries from 7 1/4 to 9 1/4 years with Italy and France at the lower and Benelux countries at the upper end. Life-time assumptions for industrial buildings vary from 20 to 50 years between countries. To a significant degree, however, these discrepancies seem to be compensated for by advance depreciation allowances in countries assuming a long life-time.

Generally tax depreciation allowances are less used in a selective way than interest rate subsidies and investment grants. Nonetheless there exists in some member countries a preferential treatment of investment in energy saving and production, R & D, environmental protection, and regional policy. However, the primarily global use of depreciation allowances does not mean that actual systems have not substantial structural effects. It appears that capital cost recovery rules are often biased in favour of machinery and equipment and against non-residential buildings (1). Buildings benefit generally only from straight-line depreciation allowances, while machinery and equipment is mostly eligible for declining balance depreciation. In other countries, like the United Kingdom, initial allowances for buildings are lower than those for equipment while office buildings are not eligible at all (so also in Ireland and Denmark).

(1) see IMF-Survey, April 20, 1981 p. 118 and October 27, 1980 p. 333/4.

On the other hand one country in the Community, Italy, applies the same provisions to equipment and business buildings (see table 9.6).

Appraising depreciation allowances on the basis of their nominal rates alone may, however, be misleading. How favourable they actually are in economic terms depends on marginal income tax rates (for unincorporated business), corporate tax rates, and other taxes on capital costs or capital income. In fact, tax depreciation allowances are the more important, the higher tax rates and vice versa (e.g. with tax exempt income, depreciation allowances for related investment are irrelevant) because it is the level of profit tax rates and depreciation allowance provisions which determine together the extent of temporary tax savings. How far corporate tax systems vary between member countries with respect to standard tax rates, treatment of distributed profits, and double taxation is illustrated by table 9.7.

Standard corporate income tax rates in member countries vary between 36 % in Italy and 56 % in Germany, with a special rate of only 10 % on manufacturing industries' profits in Ireland, and reduced rates for profits below certain ceilings in the UK, the Benelux countries, and Ireland. In all countries, with the exception of Germany, standard corporate tax rates tend to be below the higher income tax brackets. As it is a major property of tax systems including corporate and personal income taxes to charge distributed profits twice, all countries with the exception of the Netherlands and Luxembourg accord income tax credits to shareholders for corporate taxes paid on distributed profits. Due to such provisions, sometimes extremely complex, actual corporate income tax on dividends (and double taxation) is excluded in Germany, Greece, and Italy and reduced to between 50 and 75 % of standard corporate rates in other member countries. The combination of standard corporate tax rates lower than the highest marginal income tax brackets, together with a substantial double taxation of distributed profits, involves for all countries, Germany excluded, a bias in favour of self-financing out of retained profits, weakening the role of capital markets. However, this does not apply to unincorporated, generally small and medium sized firms only subject to personal income taxation.

Moreover, the effect of depreciation allowance provisions changes with inflation, nominal interest rates and financing structures. Higher nominal interest rates together with higher inflation rates tend to reduce discounted real after tax capital cost recovery and make investment appear less profitable. The link between investment financing and inflation, while rather complex in a framework of changing growth and changing composition of investment, is illustrated by the following facts: Replacing an investment good in the Community after a ten years life-time required in 1970 on average roughly

32 % additional financial resources beyond the recovered nominal capital costs. In 1980, due to higher inflation, this ratio had increased to 62 %, varying between 40 % in Germany and 75 to 78 % in Ireland and the UK. Thus, replacing capital goods acquired in the past now requires substantially higher amounts of nominal capital expenditure and liquidity. As depreciation allowances are generally the most important source of gross investment expenditure (e.g. 60 to 80 % according to balance sheet figures for non-financial business in Germany over the 1970s) accelerating or high inflation tends to put strains on financing structures. Firms may thus be pushed to reduce the weight of investment with long recovery periods. Apart from other factors like longer term demand prospects, the combination of high inflation and prevailing depreciation allowance provisions may well have contributed to the observed weak investment performance especially for construction and capacity extension. This impact of inflation has been mitigated to some degree by higher investment grants, interest rate subsidies and better depreciation allowances (see tables 9.5 and 9.6). However, grants and interest rate subsidies are generally selective affecting only certain parts of total investment not chosen according to the impact of inflation. As it appears that selective measures favour primarily firms and branches in distress or notoriously in difficulty, the combined effect of higher inflation and selective support measures tended to slow down positive adjustment, i.e. the expansion of profitable activities. Measures like changes of depreciation allowance provisions and tax rates have been taken in several countries. Among OECD countries, the most radical measures are under discussion in the United States, including substantial simplifications and incentives through a generalization of the existing investment tax credit system and accelerated depreciation allowances. The latter will be achieved by distinguishing a few groups of goods with assumed life-times of 3, 5 or 10 years for equipment and plant, and 15 years for business buildings. These changes are to be introduced progressively over the next few years to spread the budgetary cost.

Investment incentives, interest rate subsidies, investment grants and depreciation allowances have a number of properties distinguishing them from each other with respect to (a) business liquidity, capital costs and profits, (b) the impact on government expenditure and receipts and (c) general economic and social side effects, all relevant for policy choices.

Interest rate subsidies paid out over a number of years primarily reduce capital costs and tend to increase profits, but they have only marginal effects on liquidity. As they are linked to credit financing they are often combined with credit guarantees or special loan arrangements. The budgetary impact of interest rate subsidies is spread over a number of years, deferring subsidy payments for today's investment into the future. Selective interest rate subsidies are not an efficient means of compensating for the global effects of high interest rates, a profit squeeze or the devaluation of depreciation allowances due to inflation. Their effectiveness depends on the interest rate sensitivity of fixed investment and therefore mainly affects projects of high capital intensity or of a long life time. From a more general point of view, the real economic importance may be attached to guarantees and loan arrangements channelling capital towards firms which otherwise would not be able to obtain the funds needed (e.g. small and medium sized firms or companies in distress), while interest rate subsidies themselves are only a supplement of limited economic relevance in the context of total cost and financing considerations - Actual gross interest cost according to business balance sheet statistics varied between 3,5 (1978) and 5,3 % (1974) of total costs from 1970 to 1978 in Germany. - While interest rate subsidies may well have an impact on capital cost calculations, their weight in investment decisions compared to other factors like liquidity, profits and demand prospects in an environment of high uncertainty and inflation is unavoidably limited.

Investment grants act simultaneously on liquidity and capital costs in subsidizing the purchase price of investment goods. They also tend to increase present or future profits; the extent to which this occurs, depends to some degree on technical details like asset accounting provisions and whether grants are subject to profit taxes or not. Compared with interest rate subsidies there is no deferment of subsidy expenditure into the future for the government budget. There may even be a partially compensating increase of future tax receipts, if grants have to be subtracted from the book values of subsidized investment goods (apart from real income effects).

Tax depreciation allowances are in general a rather complex instrument. Their benefit is subject to the existence of profits, limiting their potential benefits for new firms, and the size of relevant tax rates. A more favourable treatment brings forward allowances from more distant future accounting periods into the present, or nearer to it, leading to

temporary tax savings, and this can be considered as an interest free credit including some risk sharing between firms and the government with positive effects on business liquidity, capital costs and profits. Depreciation allowances do not increase government expenditure, but lower receipts. Because the budgetary effect is spread over a long period, the budgetary impact over time is difficult to estimate. Business surveys suggest that firms, and especially small and medium sized ones, prefer this tool because it is less subject to discretionary administrative decisions, red-tape and related uncertainties and delays. The dependence of the economic effects of depreciation allowances on tax rates means that firms producing no profits do not benefit immediately from this incentive, while those producing high profits may be stimulated most to invest in capacity extension or rationalization according to longer term prospects. Better tax depreciation allowances as an incentive to stimulate investment or to compensate for inflation induced disincentives include therefore a stimulus for positive structural adjustments through higher profitability and internal liquidity.

9.3 Energy saving incentives and taxation

Developments of crude oil prices since 1973 and the ensuing adaptation of other energy prices imposed abruptly and repeatedly a far reaching need for global and structural adjustments (see last Annual Review, chapter 1 and 7). Not only were business and private households called upon to change their behaviour and their plans: governments also were confronted with the need for political action to accelerate private adjustments especially through incentives for energy saving and fuel switching, like energy taxation and investment aids (major incentives for energy saving and fuel switching investment, applied by member countries) are summarized in Table 9.8.

All Community countries have for decades been levying substantial excise duties (volume taxes) on major refined oil products, affecting primarily gasoline and diesel oil, and to a minor degree light heating oil and residual heavy fuel oil (mainly used in industrial heating and power stations). As excise duties do not respond automatically to price changes their real weight in user prices tends to decline with crude oil price increases and general inflation. Many governments up to 1977/79 were reluctant

to increase energy excise duties sufficiently to prevent a decline of real tax receipts from this source. Generally high inflation countries adjusted excise duties more often than low inflation countries suggesting that required legislative measures are generally taken only when the real tax receipt loss becomes substantial. This interpretation is supported by the fact that tax adjustments were less numerous for low taxed products (heavy fuel, heating oil and even diesel oil).

Due to large differences in excise duty levels on gasoline and diesel oil on the one hand and heating and residual fuel oil on the other hand, user prices of low taxed oil products increased more rapidly than high taxed ones. This may have been another reason why low excise duties have been adjusted more hesitantly. As a result of this complex policy adjustment process excise duty charges per liter of gasoline remained substantially below their real 1973 levels in some countries like Belgium, Germany, and the Netherlands, while they kept pace with general inflation or increased even more rapidly in others, especially Denmark, France and Italy. The real excise duty charge on diesel oil declined in all member countries to some degree, except in Denmark, where a new energy tax was introduced in October 1977 which is levied at a moderate rate also on diesel road fuel, but reimbursed to professional users. Italy, where nominal rates have been cut by two-third, has now together with Denmark far the lowest rates of all member countries.

Excise duties on light heating oil remain rather low, in spite of increasing levels in nominal and real terms, generally significantly higher than in 1973. Belgium and the Netherlands substituted higher VAT rates for increases in excise duties on fuel oils. Belgium abandoned in October 1980 the excise duty on fuel oils and applies since the standard VAT rate on these products instead of the reduced VAT rate. The tax burden is thereby shifted to private consumption alone. Ireland introduced taxation of heating fuel oils in 1976 by reducing the excise rebate on heavy oils other than road fuels. Heavy fuel oil traditionally has been charged only with marginal or no excise duties at all especially in Denmark, France, Ireland and Italy. Other countries raised low rates of 2 1/2 to 5 ECU per ton in 1973. Only two countries, the UK and Ireland, adjusted their taxes on heavy fuel oil substantially since then. Denmark introduced a new relatively high excise

duty on heavy fuel oil in 1978, allowing, however, firms to deduct it like VAT. The general impression in the field of energy excise duties is one of partial adjustment to inflation according to budgetary needs, considerations of industrial competitiveness and energy policy requirements. The situation in summer 1981 as it emerged from these policies is given in Table 9.9.

While for the business sector energy excise duties are of primary interest because of their cost effects, private households' behaviour towards energy saving is influenced by final user prices including VAT. In fact, private households had to pay not only higher excise duties but also higher VAT due to higher oil prices, duties and VAT rates.

Total taxation of petroleum product consumption (excise duties and VAT) in nominal terms have increased substantially since 1973 (see Table 9.10). In general the tax take per litre on low taxed heating oil increased relatively more than that on gasoline or diesel oil, mainly because of the link between VAT, and before-tax (real) product prices. In real terms (see Table 9.11) the total tax take per litre generally (with the exception for diesel oil in Italy and gasoline in the Netherlands) has reached or exceeded its 1973 level, given the excise duty and VAT rate adjustments which occurred over the last 18 months in a number of countries. However, not only oil product related but general VAT rates, too, have increased in all countries, except France, since 1973. A constant or only somewhat higher total real tax take means that petroleum products have not supported a significant additional total tax charge to stimulate energy saving and fuel switching in households. The major incentive has originated in most cases from higher crude oil prices alone.

9.4 Community policies towards subsidies

Community policies on subsidies and investment incentives are governed by principles for aids by states set out in the Treaty of Rome (articles 92 to 94). The general approach to the problem set out in Art. 92 (1) is that any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods in so far as it affects trade between Member States, is incompatible with the common market.

Although these criteria are quite wide, in practise large blocks of aids and incentives remain the sole responsibility of member countries. Subsidies which do not affect intra-community trade like those for housing, local transport of passengers etc.. are not the subject of Community competition policy. Moreover, as only aids favouring certain undertakings, products or industries fall under Art. 92(1), measures applied to all enterprises within the country like general tax depreciation allowance provisions, however different they may be between countries, are also not a part of Community competition policy. Nevertheless such aids may well warrant economic analysis of underlying financial incentives or disincentives and policy recommendations at the Community level in so far as general economic policy issues like employment and budgetary policies are involved.

Aids given for special purposes in the framework of regional and sectoral policy as well as projects of special Community interest may be considered by the Commission to be compatible with the aims of the common market and benefit from one of the derogations set out in Art. 92 (3) a), b) and c). Measures referring to such special purposes have to be communicated to the Commission in advance and are examined by it before application at the national level and described in the annual reports on Competition Policy. Aids to continued operation are generally not admitted by the Commission, while aids for new investment to facilitate or promote growth, productivity, employment and structural adjustments may be considered to be compatible with the common market.

Over recent years Commission services have annually examined and taken a position on more than a hundred cases of all types of State aid envisaged or introduced by member countries. In three quarters of these cases no objections have been raised. The remaining quarter of cases has been subject to special procedures leading to additional enquiries, negotiations, and modifications or withdrawal. Only in a few cases have formal negative decisions been taken and published (1).

(1) see : Tenth Report on Competition Policy, Brussels 1981, p. 112

Table 9.1

	Total general government transfer payments to the business sector (1) (as a percentage of GDP)										
	B	DK	D	F	IRL	I	L	NL	UK	EC(9)	
1970	3,3	3,7	2,6	2,5	7,4	2,9	3,4	2,8	3,8	3,0	
1971	3,6	3,8	2,5	2,4	7,5	2,7	3,6	2,4	3,2	2,7	
1972	4,0	3,7	2,7	2,4	6,6	3,1	3,7	2,5	3,7	3,0	
1973	4,3	3,8	2,9	2,7	6,4	2,8	3,6	3,2	4,1	3,1	
1974	4,0	4,4	2,9	2,7	7,5	2,7	3,9	2,9	4,9	3,3	
1975	4,3	3,8	2,8	4,1	8,9	4,1	5,7	3,5	4,9	3,9	
1976	4,9	4,0	3,2	3,7	8,9	3,6	5,9	3,9	4,1	3,7	
1977	5,2	4,0	3,2	3,3	11,2	4,0	6,6	3,5	3,6	3,6	
1978	5,3	4,4	3,4	3,1	12,3	4,5	6,4	3,6	3,5	3,7	
1979	:	:	3,5	3,1	11,8	:	:	4,3	3,3	:	

(1) Current and capital transfers, including investment grants to private households and subsidies paid by EC institutions.

Source: Eurostat: General government accounts 1970-1978 and National Accounts 1960-1979

Table 9.2
Current transfers to the business sector (1)
(as percentage of GDP)

	EC										total	of which	
	B	DK	D	GR	F	IRL	I	L	NL	UK		Community	national
1970	2,9	2,6	1,4	0,8	2,0	4,9	1,5	2,4	1,8	1,7	1,8	0	1,8
1971	3,1	2,8	1,3	1,2	2,0	4,7	1,9	2,5	1,4	1,6	1,8	0,3	1,5
1972	3,5	2,9	1,5	1,3	2,0	4,3	2,3	2,7	1,5	1,8	1,9	0,3	1,6
1973	3,8	3,0	1,6	1,8	2,2	4,5	2,1	2,7	1,9	2,0	2,1	0,5	1,6
1974	3,4	3,5	1,5	2,6	2,1	5,6	1,9	3,0	1,9	3,6	2,2	0,3	1,9
1975	3,7	2,7	1,5	2,5	3,6	7,0	2,7	4,4	1,9	3,6	2,7	0,4	2,3
1976	4,2	2,9	1,5	2,8	2,7	6,8	2,6	4,7	2,5	2,8	2,4	0,5	1,9
1977	4,5	3,0	1,6	3,0	2,7	9,1	2,7	5,5	2,6	2,3	2,4	0,5	1,9
1978	4,5	3,5	1,8	2,9	2,7	10,0	2,9	5,5	2,7	2,2	2,5	0,6	1,9
1979	4,8	3,1	1,8	2,3	2,7	9,3	3,4	.	2,9	2,3	2,6	0,6	1,9

Excluding Community Institutions

1973	3,2	1,8	1,3	(1,8)	1,6	3,1	1,6	2,3	0,75	1,9	.	.	1,6
1979	3,8	1,4 (2)	1,3	(2,3)	2,1	3,7	2,8	4,6 (2)	1,4	2,1	.	.	1,9

(1) Subsidies (as defined in National Accounts - ESA) which governments and the EC pay to the (private and public) business sector with the objective of influencing prices or maintaining incomes including coverage of trading losses by public producers and grants for interest relief, even when intended to encourage capital formation. Not included are, however, transfers to cover losses, accumulated over several years, cancellation of debts or investment grants nor the costs of loans at preferential interest rates.

(2) 1978 Source : Eurostat and Commission services

Table 9.3

Composition of subsidies (1) by purpose

(as percentage of GDP)

	Belgium		Denmark		Germany		France		Ireland		Italy		Netherlands		U K	
	1973	1977	1973	1977	1973	1978	1976	1978	1973	1980	1973	1978	1973	1978	1973	1978
1. Housing	0,43	0,49	0,33	0,55	0,22	0,33	0,55	1,13	1,15	0,03	0,09	0,09	0,40	0,65	0,74	1,45
2. Economic Services of which	3,70	4,32	3,28	3,33	2,23	2,61	2,82	4,82	9,46	2,57	4,34	4,34	1,67	2,25	2,28	1,91
2.1 General administration, regulation, and research	0,00	0,03	0,02	0,14	0,00	0,00	.	.	.	0,00	0,00	0,00	0,04	0,09	0,00	0,16
2.2 Agriculture	2,41	1,00	1,38	1,86	0,63	0,68	.	3,15	6,31	0,67	0,82	0,82	1,21	1,29	0,51	0,38
2.2.1 National	1,82	0,25	0,11	0,17	0,29	0,16	.	1,77	1,81	0,23	0,43	0,43	0,07	0,02	0,43	0,17
2.2.2 E C	0,59	0,75	1,27	1,69	0,34	0,53	0,55	1,39	4,50	0,44	0,39	0,39	1,14	1,27	0,08	0,21
2.3 Industry, trade	0,89	0,76	1,03	0,42	0,56	0,87	.	1,18	2,20	0,72	0,98	0,98	0,08	0,11	1,28	0,72
2.4 Transport, communication	2,04	2,53	0,85	0,91	1,05	1,06	.	0,48	0,95	1,18	2,54	2,54	0,34	0,76	0,48	0,61
3. Others	0,58	0,73	0,44	0,49	1,26	1,22	0,54	0,42	0,65	0,24	0,09	0,09	1,33	0,93	1,04	0,13
4. Total (1+2+3)	4,71	5,54	4,04	4,38	3,71	4,16	3,89	6,37	11,26	2,84	4,53	4,53	3,40	3,81	4,06	3,49
5. Total excl. line 3	4,13	4,81	3,60	3,89	2,45	2,94	3,35	5,95	10,61	2,60	4,44	4,44	2,07	2,88	3,02	3,36

(1) Subsidies as defined in national accounts (R 30) plus capital transfers (R 70)

Note : The coverage of statistics used in this table differs from those used in tables 9.1, 9.2 et 9.5. It includes capital transfers to the household sector and to the rest of the world; available information did not allow to eliminate the inconsistency. Generally these transfers should mostly affect the category "other subsidies". The relative weight of the different sectors can therefore only be considered as a rough approximation, because the implicit share of capital transfers to private households and other countries may vary substantially between member countries. Moreover, the break-down is not always fully compatible between countries.

Source: Eurostat, General Government Accounts, 1970-78, Tables 5 and 2, and National Accounts - ESA, 1960-79, Tables 1 and 5 and national services.

Table 9.4

Financial aid and subsidies to coal mining industry

	1980				(mill. ECU)
	B	D	F	UK	
A. Subsidies for current and future production of which:	298,2	1.932,0	461,4	287,4	2.979,0
1. investment	11,3	327,8	-	-	339,1
2. labour	-	75,4	-	6,9	82,3
3. stocks	-	53,4	-	20,3	73,7
4. power stations	-	833,2(1)	-	19,2	852,5
5. coks subsidies	151,9	634,9	1,4	56,7	844,9
6. other (indirect subsidies)	10,4	7,2	6,8	-	24,4
7. coverage of losses	124,6	-	453,2	184,3	762,1
B. Subsidies for past activities of which:	636,7	2.837,4	1.438,4	95,8	5.008,3
1. excess cost of social security	636,40(2)	2.650,8	1.340,9	67,4(3)	4.695,5
2. other follow up costs of past activities	0,3	186,6	97,5	28,4	312,8
C. Total (A + B)	934,9	4.769,4	1.899,8	383,2	7.987,3
C. as a percentage of GDP	1,08	0,80	0,40	(0,11)	0,40
A. as a percentage of GDP	0,34	0,32	0,10	0,08	0,15

- (1) 2,1 mrd DM Kohlepfennig levied on electricity price subsidizing input of national coal
(2) 80 % of miners' pension fund deficit
(3) Only additional pension fund costs; given the integrated British social security system other excess costs cannot be assessed.

Source: Commission services.

Table 9.5

General government investment grants to other resident sectors

	B	DK	D	F	IRL	I	L	NL	UK	EC (9)
	- as a percentage of GDP -									
1970	0,4	0,1	0,7	0,5	2,5	1,4	1,0	0,6	1,6	0,9
71	0,4	0,1	0,9	0,5	2,9	0,8	1,1	0,6	1,6	0,9
72	0,5	0,1	1,0	0,4	2,3	0,8	1,0	0,6	1,3	0,9
73	0,5	0,1	1,0	0,5	1,9	0,7	0,8	0,7	1,3	0,9
74	0,6	0,1	1,1	0,5	2,0	0,8	0,9	0,6	1,2	0,9
1975	0,6	0,3	1,1	0,6	2,0	0,9	1,3	0,7	1,2	0,9
76	0,6	0,4	1,4	0,9	2,1	1,0	1,2	0,7	1,2	1,1
77	0,7	0,3	1,4	0,5	2,1	1,2	1,1	0,7	1,1	1,0
78	0,7	0,3	1,3	0,4	2,3	1,5	0,9	0,7	1,2	1,0
79	:	:	1,4	0,4	2,5	:	:	1,2	1,0	:

as a percentage of gross fixed capital formation

1970	1,6	0,6	2,9	2,3	11,4	6,5	4,2	2,4	8,4	4,2
71	1,9	0,5	3,3	1,9	12,4	3,9	3,7	2,5	8,7	4,0
72	2,2	0,6	3,7	1,9	10,4	4,0	3,4	2,6	7,1	3,8
73	2,3	0,6	4,0	1,9	7,6	3,5	3,1	2,9	6,5	3,8
74	2,8	0,6	5,2	1,9	7,8	3,7	3,7	2,6	6,0	4,0
1975	2,7	1,5	5,2	2,4	8,3	4,6	4,6	3,4	5,9	4,3
76	2,8	1,6	7,0	4,0	8,7	4,8	4,7	3,7	6,1	5,2
77	3,1	1,5	6,5	2,1	8,2	6,3	4,1	3,2	6,0	4,8
78	3,3	1,2	6,2	1,9	8,0	8,2	3,3	3,4	6,8	5,2
79	:	:	6,3	1,9	7,7	:	:	5,5	5,6	:

Source : Eurostat, General government accounts and statistics 1970-1978, table 4, and national sources.

Table 9.6 Corporate profit taxes, tax depreciation allowances, and investment grants in member states

Properties of corporate tax	Tax depreciation allowance systems		Investment grants	Main financial regional policy instruments
	Equipment and plant	Industrial buildings		
<p>B</p> <ul style="list-style-type: none"> - standard rate: 48 %; - progressive rates of 33 to 48 % for profits up to 15 mio BF - double taxation of dividends reduced to half the standard rate through tax credit 	<ul style="list-style-type: none"> - straight-line or declining balance (multiplier: 2) - 1981: additional 15 % allowance on incremental investment (= subsidy of 7,2 %) 	<ul style="list-style-type: none"> - only straight-line: 5 % p.a. 	<p>1978 : 0,7 % of GDP</p>	<ul style="list-style-type: none"> - investment grants - interest rate subsidies - tax reliefs - credit guarantees
<p>DK</p> <ul style="list-style-type: none"> - standard rate 40 % - no reduced rates for small and medium sized companies (SME) - double taxation of dividends reduced to 3/4 of standard rate through tax credit - tax free investment reserves of up to 25 % of annual taxable profits equivalent to an advance allowance for investment even before eventually purchased 	<ul style="list-style-type: none"> - aggregated book value allowance of up to 30 % - 1981 to 1983 additional initial allowance of 5 % equivalent to a 2 % investment subsidy 	<ul style="list-style-type: none"> - straight-line rate: 2 % p.a. plus repeatedly changed advance allowances 1981: 2 x 8 % + 6 x 4 % - no allowances for office space and housing 	<p>1978 : 0,3 % of GDP lowest figure of all member countries</p>	<ul style="list-style-type: none"> - investment grants - soft loans, - aid for purchase of industrial land and building - labour training aids
<p>D</p> <ul style="list-style-type: none"> - standard rate : 56 % - distributed profits: 36 % - no reduced rates for SME - no double taxation of dividends, fully refundable tax credit (new system introduced in 1977) 	<ul style="list-style-type: none"> - straight-line or declining balance, multiplier 2,5 with maximum rates of 25 % 	<ul style="list-style-type: none"> - modified straight-line system 2 to 4 % p.a. or 12 x 3,5 % 20 x 2 % 18 x 1 % 	<p>1979 : 1,4 % of GDP</p>	<ul style="list-style-type: none"> - investment grants - special advance allowances for eastern border regions
<p>F</p> <ul style="list-style-type: none"> - standard rate 50 % - no reduced rates for SME - double taxation of dividends reduced to half the standard rate through tax credit 	<ul style="list-style-type: none"> - straight line or declining balance, multiplier 1,5 to 2,5 maximum rates: 20 to 50 % - preferential multipliers of 2 to 3 for energy saving investment - 1981 to '85: 10% additional first year allowance equivalent to a 5 % subsidy 	<ul style="list-style-type: none"> - straight-line rate: 5 % p.a. 	<p>1979 : 0,4 % of GDP</p>	<ul style="list-style-type: none"> - investment grants - tax reliefs - soft loans - aid for purchase of industrial land and buildings
<p>IRL</p> <ul style="list-style-type: none"> - standard rate : 45 % - reduced rate of 10 % for manufacturing, replacing former system of tax exemptions for export profits - reduced rates of 35 to 45 % for profits up to 35.000 punts - double taxation of dividends reduced to less than half the standard rate through tax credit 	<ul style="list-style-type: none"> - free depreciation allowance up to 100 % in the first year since 1972; 	<ul style="list-style-type: none"> - normal straight-line rate 4 % p.a. - first year advance allowance of 50,20 or 10 % - no allowances for office space and dealings 	<p>1978 : 2,2 % of GDP</p>	<ul style="list-style-type: none"> - investment grants - tax reliefs - labour training aids - employment premiums
<p>I</p> <ul style="list-style-type: none"> - standard rates : state : 25 % + local : 15 % = effective-rate: 36,25 % - no reduced rates for SME - no double taxation of dividends 	<ul style="list-style-type: none"> - only straight-line; however advance allowance of 3 x 15 % in addition to normal rates 	<ul style="list-style-type: none"> - normal straight-line rates: 3 to 8 % p.a. - special advance allowances for equipment : 3 x 15 % 	<p>1978: 1,5 % of GDP</p>	<ul style="list-style-type: none"> - employment premiums - interest rate subsidies - investment grants - tax reliefs (exemption from local corporate tax for new activities during first 10 years)
<p>L</p> <ul style="list-style-type: none"> - standard rate: 40 % - progressive rates from 20 to 40 % for profits up to 1,3 mio LFR - full double taxation of dividends 	<ul style="list-style-type: none"> - straight-line or declining balance multiplier: 2 	<ul style="list-style-type: none"> - straight-line 3 % p.a. 	<p>1978 : 0,9 % of GDP</p>	<ul style="list-style-type: none"> - investment grants
<p>NL</p> <ul style="list-style-type: none"> - standard rate : 48 % - reduced rate : 45 % for profits up to 40.000 Hfl. - full double taxation of distributed profits 	<ul style="list-style-type: none"> - straight-line or declining balance, multipliers (2 to 2,5) maximum rates: (20 %) - number of preferences abolished in 1978 and replaced by complex grant scheme 	<ul style="list-style-type: none"> - straight-line 3 to 4 % p.a. 	<p>1979 : 1,2 % of GDP (rapidly rising due to substitution of grants for tax measures since 1978)</p>	<ul style="list-style-type: none"> - investment grants and investment tax on investment in central areas - tax reliefs - aid for purchase of industrial land and buildings
<p>UK</p> <ul style="list-style-type: none"> - standard rate: 52 % - reduced rates of 40 to 52 % for profits up to 200.000 # - double taxation reduced to 60 % of standard rate due to tax credit 	<ul style="list-style-type: none"> - first year 100 % initial allowance; since 1978 	<ul style="list-style-type: none"> - normal straight-line rate : 4 % - first year advance allowance : 50 % since 1981 increased to 75 % - no allowances for office space and housing 	<p>1979 : 1 % of GDP</p>	<ul style="list-style-type: none"> - investment grants - interest rate subsidies - employment premiums

Table 9.7

Corporate and maximum marginal income tax rates, 1981

	Corporate profit tax rates on (1)					highest marginal income tax rates	
	retained profits	distributed profits		total average rate (2)	rates	annual income higher than ... ECU (3)	
		gross rate	tax credit to shareholders				actual taxation
B	48	48	24	24	76	98 522	
DK	40	40	15	25	64	19 335	
D	56	36	36	0	56	51 383	
GR	38,24	0	0	0	60	50 641	
F	50	50	25	25	60	22 998	
IRL	45/(10)	45	23,6	21,4	60	14 053	
I	36,25	36,25	21,25	0 (4)	72	462 573	
L	40	40	0	40	57	26 305	
NL	48	48	0	48	72	68 271	
UK	52	52	20,6	31,4	60	46 405	
EC (5)	49	43	24	19	.	.	

(1) Belgium, Ireland, Luxembourg, Netherlands and UK offer reduced rates for profits up to certain ceilings.

(2) under the assumption that retained after tax profits are equivalent to 20% of before tax profits; share holders tax credit deducted.

(3) at 1980 exchange rates; for unmarried persons.

(4) dividends exempt from local profit tax on natural persons.

(5) GDP weighted average.

Source: Bundesministerium für Finanzen, Informationsdienst zur Finanzpolitik des Auslands, Bonn, Nr.2/1981 and own calculations.

Table 9.8

Main financial incentives for investment in energy saving and fuel switching
- Situation May 1981

H O U S I N G		B U S I N E S S	
B	Limited aids available from some regional administrations, for thermal insulation (Wallonie) or for double glazing in new buildings (Flanders)	- Free depreciation; Additional interest subsidy of 1 % point over 5 years within framework of a more general incentive scheme	
DK	30 % grant for renovation in rented dwellings max. 890 ECU, 20 % for owner occupied	- Selective grants up to 40 % (average 28 %) for energy saving in industry (processes + space heating); projects with a payback of less than 2 years excluded	
D	25 % grant (max. 4785 ECU) or tax reliefs for renovation in private dwellings	- Soft loans (8,75 %) for energy related investment in industry, especially small and medium-sized enterprises	
F	Grants up to 72 ECU per toe saved; Loans at reduced interest rates; 30 % grants in public housing	- 2 % bonification for loans related to coal conversion; 25 % capital grant for additional cost of coal-using equipment up to a maximum of 42 ECU per toe; special depreciation allowance	
IRL	33 % grant (maximum 72 ECU for renovation in private dwellings)	- Up to 35 % grants for approved capital expenditure to reduce energy consumption in industry; loans from the EIB with national exchange rate guarantees	
I	-	- Loans from the EIB with national exchange rate guarantees	
L	25 % grant (max. 3750 ECU) for renovation in private dwellings	-	
NL	Average 30 % grant (max. 1444 ECU) for renovation in private dwellings	- 10 to 15 % grants in addition to standard investment premium (up to 25 % for renewables)	
UK	66 % grant (max. 100 ECU) for basic insulation; 90 % grant (max. 150 ECU) for pensioners	- 25 % capital grant for the cost of Coal using boilers, up to a (normal) maximum of 930 ECU	

Note: The table given above summarizes the major investment incentive schemes for energy saving and fuel switching in housing and business, applied by member countries. The listing does not include measures to promote district heating in densely populated urban areas at a larger scale (Denmark, Germany, France and the Netherlands) which would require substantial private and public investment. Moreover, energy saving and fuel switching cannot be separated in many cases.

The table illustrates that investment grants limited by ceilings are the most widely used instrument. In addition or alternatively direct and indirect interest rate subsidies (Belgium, Germany, France, Ireland, Italy) and advance tax depreciation allowances (Belgium, France) are awarded. Estimates of budgetary charges from grants and direct interest rate subsidies underline the wide differences which exist between member countries with respect to implied budgetary expenditures varying between near to nothing and 0,4 % of general government expenditure. Actual budgetary charges may be somewhat higher due to advance depreciation allowances and energy related R & D expenditures often difficult to identify and allocate to energy saving investment.

Source: Commission services

Table 9.9

Taxation on consumption of petroleum products, July 15, 1981
- per 1000 l -

	B	DK	D	F	IRL	I	NL	UK	EC (unweighted)
Excise duties (ECU) (1)									
- super petrol	202,3	240,9	199,8	235,1	238,1	318,6	189,6	250,7	234,4
- automotive diesel	83,1	45,2	175,1	124,1	156,7	13,1	65,6	216,0	109,9
- heating oil	0	45,2 (2)	6,6	23,0	25,8	13,1	11,6	14,0	17,4
- heavy (residual) fuel oil (5)	0	51,4 (2)	5,9	0	26,9	0,8	5,0	14,5	13,1
V A T rates (3)									
- super petrol	25 (S+)	22	13	17,6 (4)	10 (S-)	18 (S+)	18	15	.
- automotive diesel	25 (S+)	22	13	17,6 (4)	10 (S-)	15	18	15	.
- heating oil	17	22	13	17,6 (4)	0 (S-)	15	18	0 (S-)	.
- heavy (residual) fuel oil	17	22	13	17,6	0 (S-)	15	18	0 (S-)	.
Total tax take in ECU (1)									
- super petrol	339,9	368,4	266,7	331,4	296,6	428,6	281,3	331,9	330,6
- automotive diesel	175,9	122,6	234,2	195,7	205,6	54,9	125,8	294,6	176,2
- heating oil	44,3	116,5	39,1	74,7	25,8	53,3	58,1	14,0	53,2
- heavy (residual) fuel oil (5)	29,8	110,8	30,6	32,1	26,9	29,5	41,2	14,5	39,4

(1) At January to June 1981 average exchange rates.

(2) Deductible like VAT; therefore business sector exempted from these excise duties

(3) S = special rate; + = higher; - = lower than standard rate

(4) Deductible only for producers and distributors, not for final consumers (professional or non-professional)

(5) Per ton

Note : Further adjustments envisaged or already decided in France, Ireland and Italy.

Sources : Commission services

Table 9.10

Evolution of taxation on consumption of petroleum products in nominal terms - excise duties and VAT in ECU per 1000 l (1)

	B	DK	D	F	IRL	I	NL	UK	EC (8) (unweighted)
Super petrol									
1973	169	137	140	155	101	168	155	99	140
1976	199	174	190	198	182	277	217	136	197
1979	249	259	218	323	176	313	244	166	244
1980	285	333	229	336	246	354	276	232	286
1981	340	368	267	331	297	429	281	332	331
Automotive diesel									
1973	73	.	130	88	86	72	54	99	76
1976	90	24	179	116	81	73	70	124	95
1979	110	51	208	179	84	45	109	170	120
1980	117	96	218	192	155	55	122	233	149
1981	176	123	234	196	206	56	126	295	176
Heating oil									
1973	16	7	7	11	2	8	2	4	7
1976	17	20	13	23	7	15	16	4	14
1979	21	46	30	51	7	34	39	10	30
1980	25	91	36	66	23	54	53	13	45
1981	44	117	39	75	26	53	58	14	53

(1) 1973 : January; 1981: July; all other years mid-June average annual exchange rates; 1981 January to June.

Source: Commission services

Table 9.11.

Evolution of taxation on consumption of petroleum products in real terms
 - excise duties and VAT at 1973 prices (1) and exchange rates in ECU per 1000 liter -

	B	DK	D	F	IRL	I	NL	UK	EC (8) (unweighted)
Super petrol									
1973	169	137	140	155	101	168	155	99	140
1976	132	114	139	139	144	219	142	101	141
1979	133	142	127	188	107	194	127	89	138
1980	146	182	128	176	131	190	137	96	148
1981	172	195	148	169	151	225	138	118	167
Automotive diesel									
1973	73	9	130	88	86	72	54	99	76
1976	61	16	131	82	65	57	46	92	69
1979	58	28	121	104	52	28	57	91	67
1980	61	52	122	101	82	29	61	97	76
1981	89	65	129	100	105	29	62	105	85
Heating oil									
1973	16	7	7	11	2	8	2	4	7
1976	11	13	10	17	6	12	10	3	10
1979	11	25	18	31	4	21	20	5	17
1980	13	50	21	36	12	29	26	5	24
1981	22	63	22	39	14	28	33	5	28

(1) deflated by GDP deflator 1973 = 100; figures of this table describe developments of the real tax take per 1000 liter in individual member countries over time. Only for presentational convenience they have been transformed into ECU. For comparisons of levels between countries see tables 9.9 and 9.10.

Source: Commission services.