COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION COMMUNICATION TO THE COUNCIL

application of Article 108 (3) of the EEC treaty to United Kingdom

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Application of Article 108(3) of the EEC Treaty to UNITED KINGDOM

On 15 July 1975, the Commission made a recommendation to the United Kingdom under Article 108(1) of the Treaty and subsequently authorized it, under Article 108(3) of the Treaty (Commission Decision of 23 July 1975 - ref 75/487/ ), to defer the liberalization of capital movements referred to in Article 124 (1)(a) and (b) of the Act of Accession.

Article 2 of the aforementioned Decision provides for the Commission to make an examination of the situation in the United Kingdom before 30 June 1976. The Commission has kept under review the development of the economic situation in the United Kingdom and representatives of the United Kingdom and of the Commission met to discuss the matter on 22 June 1976 in Brussels. The results of the meeting are set out in detail in the attached Memorandum.

The main conclusions are that the United Kingdom current account deficit will still be heavy in 1976 and that the present inflationary strain will begin to abate only early next year onwards.

Of the recommendations made by the Commission to the United Kingdom a year ago, it has been possible to implement only those concerning the balance of payments and the growth in the money supply.

The Commission considers that the prospects for the United Kingdom's balance of payments justify extension, for a period of one year and barring a substantial improvement in the meantime, of the authorization given to the United Kingdom to defer liberalization of the capital movements referred to in the Decision of 23 July 1975.

The Commission had made a fresh recommendation to the United Kingdom.

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ANNEX

NOTE

Conclusions of a meeting between representatives of the United Kingdom and the Commission on the economic situation in the United Kingdom

1. In order to provide background material for the Commission, for it to fulfil its obligations, as laid down in Article 2 of the Commission Decision of 23 July, 1975 authorizing the United Kingdom to take certain protective measures in accordance with Article 108 § 3 of the EEC Treaty, a meeting was held in Brussels on 22 June 1976 between representatives of the United Kingdom and the Commission.

2. The principal topics discussed at the meeting were the current account of the UK balance of payments and its financing, capital flows, exchange rate policy, recent trends in and prospects for public receipts and expenditure, monetary policy and incomes policy. The main points arising from the discussion were as follows:

a) The deficit on the current account of the balance of payments, which is estimated to have been only £ 0.6 billion during the first six months of 1976, is expected to widen sharply to around £ 1 billion during the second half of the year despite rapid export growth. This deterioration will partly be a result of the increased imports needed to sustain the recovery in activity, and partly the result of deterioration in the UK's terms of trade following the recent sharp fall in the sterling exchange rate and the increase in commodity prices. Given no further marked change in the sterling exchange rate, some improvement in the current balance is foreseen for 1977 as exports continue to benefit from the expansion of world trade and the strong competitive position of UK exporters. The extent of this improvement, however, is difficult to estimate, given the uncertainty about the behaviour of imports, both of raw materials and finished and semi-finished manufactures as the recovery gathers strength.

The financing of the 1976 deficit, provided that no further major sterling crisis occurs, is considered to pose no great difficulties, given the likely reversal in the "leads and lags" (in which there was a very strong adverse movement in the second quarter of 1976) and the recovery in foreign currency public sector borrowing; in addition, the recent drawings on the IMF (oil facility and first credit tranche) and the $ 5.3 billion standby facility, arranged on 6 June by the Central Banks of the Group of Ten (excluding Italy), together with Switzerland, the US Treasury and the BIS, are likely to strengthen foreign confidence and so have a steadying influence on the exchange rate.

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b) The underlying rate of inflation (about 16%, measured as the increase in the retail price index over the six months to May, expressed at an annual rate) could decline somewhat further during the remainder of the year although the recent fall in sterling may reduce the rate of progress. Between 1976 and 1977, retail prices may rise by perhaps 10%.

c) The Public Sector Borrowing Requirement (PSBR) for the fiscal year 1976/77, estimated in the April 1976 Budget to be slightly below £ 12 billion or 10.7% of GDP (at factor cost), could well turn out to be somewhat lower in spite of recent evidence that local authority expenditure has again been overrunning in the first few months of the financial year and that a large share of the contingency reserve for 1976/77 has already been committed. The extensive and effective use of cash limits over a large part of government spending, starting in 1976/77, is expected to reinforce the control over public expenditure during this fiscal year. On unchanged policies, however, and despite the fact that 1977 is forecast to be a year of above-average economic growth, the PSBR for 1977/78 may not show a sufficient decline, in which case the Commission's representatives were of the opinion that the implications of this requirement for the money supply gave cause for concern.

d) The new pay policy for the period August 1976 - July 1977, recently agreed between the Government and the Trade Union Congress, provides for an average increase in wages and salaries of about 4½%: this, together with the increasing importance of cyclical increases in earnings as the economic recovery strengthens, points to an increase in average earnings in the year from August 1976 of about 7½%, a sharp fall from the rate recorded in the previous 12 month period (estimated to be 13 to 14%). This relatively low rate of increase in earnings, coupled with a continual expansion in output, implies a further deceleration of unit labour costs and a marked fall in domestically generated inflationary pressures in the first half of 1977. It is not yet possible to say anything about wage developments after August 1977. The predominantly flat rate increases permitted since July 1975 will have compressed differentials between different groups of workers and will have altered relative wages as between one industry and another. This is an intensification of a trend which has been operating for some years: the compression is, of course, sharpest at the upper income levels. There is thus bound to be pressure for some rebuilding of former differentials: but at the same time there is an increasing general realisation that the rebuilding of differentials must not be allowed to produce the sort wage explosion which followed the collapse of

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the previous government's policy in 1974.

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3. The above summary assessment of the United Kingdom's economic situation and, in particular, the position of the United Kingdom's balance of payments provide substantial evidence to justify a maintenance until mid-1977 of the protective measures indicated in Article 1 of the Commission Decision of 23.7.1975. Such a maintenance implies that the Commission will need to keep the economic situation in the United Kingdom under constant review and that a further examination will be necessary before 30 June 1977.

4. This conclusion is consistent with the results of an examination of the United Kingdom's economic situation, carried out within the Monetary Committee at its meeting on 21 June 1976. At the same meeting, the Monetary Committee discussed the question of the non-participation of the United Kingdom in the Community's medium term financial assistance and concluded that such a derogation was still justified.