european community PRESS RELEASE

EUROPEAN COMMUNITY INFORMATION SERVICE

2100 M Street Northwest, Suite 707, Washington D.C. 20037 • Telephone: (202) 296-5131

BACKGROUND INFORMATION No. 19

December 1, 1971

ANNUAL COMMON MARKET REPORT WARNS MEMBER COUNTRIES OF ECONOMIC DIFFICULTIES IN 1972

A Summary of the 1971 Annual Report on the Economic Situation in the European Community

This year's Annual Economic Report warns the Six that economic prospects for 1972 are dim because of uncertainty in international monetary and economic affairs.

The Report is the first of its kind designed to help coordinate the short-term economic policies of the member states with the aim of achieving eventual economic and monetary union.

In March, 1971, the Council of Ministers issued a decision calling for the preparation of annual reports to which member country parliaments could refer when discussing national budgets. In addition to providing current information on the economic situation, the report proposes guidelines for Community members' 1972 budget policies, structural policies, and adjustments in national instruments of economic policy. The text, drawn up by the European Communities Commission, approved by the European Parliament, and adopted by the Council of Ministers on October 26, 1971, is summarized below.

The 1971 situation in the Community is characterized by monetary uncertainty on the international front, and continued inflation combined with a business slow-down in the domestic domain.

The International Monetary Crisis

Not only has the international monetary crisis disturbed the economic equilibrium of member states, it has also jeopardized one of the Community's most desired goals - economic and monetary union. Faced in May with an accelerated growth in the US balance of payments deficit due mainly to massive outflows of US capital to Europe, Germany and the Netherlands countered the inflationary pressure by allowing their currencies to float. Other Community countries (France, Belgium and Luxembourg) modified exchange regulations to cope with the situation.

Measures taken by the United States on August 15 plunged all the countries in the international monetary system into an even more critical situation. Given the volume of US foreign trade, the continuation of protectionist measures taken by that country runs the risk of affecting employment levels and economic growth rates of its trade partners.

With unity already strained by the May crisis, Community countries have failed, since August, to define a common monetary policy and have applied widely divergent exchange rate arrangements. Germany continued the system put into effect in May. The Benelux countries have decided to float their currencies jointly, while retaining different rules on capital movements. The Italian currency is floating within fairly narrow limits. France, following the Benelux model, has created a double exchange market, where commercial and related transactions are carried out on a fixed exchange rate basis, while financial and tourist transactions are subject to a floating rate.

These monetary disturbances and obstacles to world trade have occurred at a time when the Community's balance of current payments shows a slight deficit, in contrast to the substantial surpluses of recent years.

The Community's Internal Economic Situation

Monetary instability has coincided with a slowdown in the rate of economic activity within the Community.

The volume of exports to third countries increased very little during the second quarter of 1971, despite a temporary improvement in the economic situation in the United States and countries such as the United Kingdom and Canada.

Domestic investment dropped in most of the member states. Despite the sustained level of consumption, therefore, overall production did not increase during the spring, although it remained higher than at the end of 1970. For this reason, the means of production were no longer used to the same extent as previously.

Industrial Production

(percentage variations in comparison with the index for the preceding quarter, corrected for seasonal variations)

	1970				1971	
	I	II	III	IV	I	II
Community	5,2	- 0,5	- 0,5	0.4	4.0	- 2.5*
Germany	2,5	- 0,3	- 1.2	0	4.5	- 0.5
France	4.8	- 5.6	3.9	1.4	3.7	- 4
Italy	18.7	- 3.0	0	0.3	0.5	- 8
Netherlands	4.5	- 2.4	0,9	4.0	4.2	0
Belgium	- 2.4	6.4	0	1.0	6.4	2
Luxembourg	- 0.1	0.1	- 3.0	- 5.1	1.0	3

(*) Estimated

The rise in costs and prices has continued sharply. Wage increases have remained substantial, sometimes reaching almost 15 per cent annually despite a decrease in the rate of productivity. Although the Community has had to contend with strong inflationary tendencies as a result of international monetary pressures, the causes of sectoral disturbances in the balance of supply and demand and the sharp rise in costs have been mainly domestic.

Consumer Prices

(percentage increases per quarter)

	1970				1971	
	I	II	III	IV	I	II
Germany	1.9	0.8	- 0.1	1.3	2.5	1.2
France	1.7*	1.3	1.0	1.1	1.5	1.6
Italy	1.9	1.3	1.2	0.8	1.5	1.0
Netherlands	2.4	0.9	2.0	0.4	3.2	1.9
Belgium	1.3	0.4	0.7	0.6	1.8	1.0
Luxembourg	1.2	1.2	0.4	1.1	1.7	1.0

(*) Former French index

(more)

The Outlook

The economic outlook remains particularly uncertain in view of the monetary instability and the adoption of protectionist measures by the United States. Community exports to third countries will be severely checked by the appreciation of most member states' currencies and the newly-erected US trade barriers. Whereas the economic improvement which had begun to take place in the United States, Canada and the United Kingdom had promised accelerated Community sales to third countries, external demand is now expected to stagnate.

Prospects for the expansion of demand within the Community are also dim, due to expected investment and consumption trends. Monetary instability, new obstacles to trade and capital movements, a business slowdown, continued production cost pressures on reinvestment margins, and a drop in the rate of production factor utilization point to a less favorable climate for commercial investments. Current trends in individual plant requisitions and the results of enquiries to the heads of commercial businesses already are headed in the same direction.

There will be a considerable increase in income per household in 1972, but the rate of increase is likely to drop during the year mainly due to a slower increase in wage levels combined with a reduction in real time worked.

Difficult Period for Stabilization

The Community faces the most difficult situation since its creation. Not only is it undergoing a difficult adjustment process after the excesses of the 1969 and 1970 boom years, but it also has to re-establish basic equilibrium in a climate of extreme uncertainty in international monetary and commercial affairs.

A return to balanced growth for the member states raises awkward problems for the coordination of short-term economic policies. The retention of different exchange arrangements in member states will undermine previous Community achievements in economic integration and will place the Community in an inferior position vis-à-vis its major trade partners. An abrupt halt to cost inflation, therefore, combined with the establishment of uniform exchange rate policies is imperative. Certain stabilization policies which the various member states have adopted also endanger the equilibrium of the Community. These will have to be eliminated as soon as possible.

The member states will experience inflation and an economic slow-down in varying degrees. The difficulty of carrying out a coordinated policy at Community level lies not only in such variations but also in the attitudes of the member states' economic authorities. When determining priority between full employment and stability, they must realize that the autonomy of national policies is more and more restricted by the increasing interdependence of the member states' economies. Any attempt to return to complete autonomy would harm the interests of all.

A return to stability remains the Community's prime objective, but the choice, the breadth, and the timing of the means to be employed will be guided by the need to ensure conditions for medium-term growth.

General Guidelines for Economic Policy

The rise in prices should be gradually reduced to an annual level of about 3 to 3.5 per cent in the last quarter of 1972, and wage increases should be contained at an annual rate of about 6 to 7 per cent. If such results are to be obtained between now and the end of 1972 without damage to the growth rate, the economic and social policy of all the member states must have the support of workers and employers.

The authorities of the member states should endeavor, during the coming months, to apply further brakes to the growth of monetary and quasi-monetary liquid assets, particularly in countries where this increase has been very great in 1970 and the first half of 1971. This aim can be attained by a strict regulation of bank liquidity, by a greater control of capital inflows and, where necessary, by the neutralization of their expansionist effect on internal liquidity.

Budgetary policy should aim at maintaining cost increase at a rate similar to the predicted increase in the value of the gross national product, subject to any budgetary adjustments that might have to be made in the event of a pronounced short-term falling-off in economic activity. Within these limits, an effort should be made to leave sufficient scope for infrastructural expenditure. In other words, the distortion which has recently developed between the rapid increase of individual consumption and sluggish public works expenditure should be remedied.

Finally, the stimulation of saving and the encouragement of long-term financial investment remain indispensable for the achievement of more balanced growth.

National Guidelines

GERMANY

Better control of price and cost trends should remain a prime concern of the public authorities.

The de facto revaluation of the Deutschemark has limited the expansion of foreign demand. An appropriate policy for regulating domestic demand should now be carried out. A cautious credit policy will also be necessary during the coming months. This will require tight control over bank liquidity, and regulation of financial flows to and from foreign countries.

In the budgetary field, the return to greater stability requires that federal and state cash expenditure, considered as a whole, should not increase by more than 7.5 to 8.5 per cent in 1972 and that the net balance to be financed from the total federal and state budget should be about $1.9 billion. Should a pronounced slowdown in the short-term economic situation become apparent during 1972, the Government would have the option of mobilizing reserves frozen in the short-term contingency fund.

FRANCE

The currency revaluations of certain major trading partners, both in and outside the Community, initially will have an inflationary effect on the economy. The relationship between import and export prices should be watched closely. The return to greater stability combined with further expansion requires increased investment both in the public and private sectors and economically satisfactory trends in consumer spending.

Credit policy should be aimed at slowing the expansion of liquid assets, which has been particularly rapid since autumn of 1970. This involves appropriate controls and neutralization of short-term capital inflows and appropriate use of the control device for bank liquidity.

In the budgetary field, strict management is still required. The increase in state expenditure should not exceed 9 per cent. While it would be desirable in 1972 to achieve a slight cash surplus, the national budget should, in any case, be balanced.

The need to end inflation calls -- in addition to appropriate short-term measures -- for public action to assist development in the fields of vocational training and housing, and to improve competition in the so-called sheltered sectors.

ITALY

Priority should be given to raising the level of production. Success depends primarily on improvement of the social climate. It also requires a stimulating economic policy which would avoid intensifying inflationary trends. This last aspect is especially important since the introduction of the Value-Added Tax, expected in July, 1972, involves large-scale changes in price structure.

Authorities should exercise control over all liquid assets, which have been expanding rapidly in the last eighteen months. Credit expansion should be limited so that the growth of nominal demand remains proportional to the increase in production capacity.

The budget should supply the necessary incentive for an acceleration of economic activity. An increase of 11 to 12 per cent in real expenditure from the 1971 level is recommended. Such an increase, taking into account the forecast development of resources, would bring the deficit to be financed by the state to about $4 billion in 1972. Expenditures likely to stimulate investment, particularly in the building sector, are encouraged. Expenditures stimulating household consumption should be made cautiously.

Contact maintained with the representatives of various social groups, especially when the Value-Added Tax is introduced, will be useful to avoid a price-wage spiral.

Indirect tax relief could contribute to economic stabilization and a fairer distribution of the national income.

NETHERLANDS

Vigorous restrictions on domestic demand are required to safeguard longer-term growth potential.

In view of the continuing rise in prices (5.2 per cent between December and June 1971), monetary policy should continue to be restrictive during the coming months. It should be supplemented by control of excessive capital inflows.

Budgetary policy should remain strict and frugal. The growth of state expenditure should be held to below 10 per cent.

A sharp reduction in the net balance to be financed, up to a level of about $441 million, is advised. If necessary, there should be temporary recourse to fiscal pressure through imposing the short-term surtax, levied mainly upon income.

Budget austerity should be applied in ways which will not affect regional investment and vocational training.

BELGIUM

The main economic policy problem will remain that of moderating price trends, especially since a number of adjustments have been delayed by the extension of price controls coinciding with the introduction of the Value-Added Tax.

A policy strictly limiting the expansion of domestic demand should be applied without risking employment or growth rate. The authorities should continue to apply a conservative monetary policy to control liquidity.

Regarding social policy measures that came into force in mid-1971 and those planned for 1972, certain types of consumer expenditure and public investment commitments should be curtailed. Despite such caution, there is still a risk that state expenditure may increase sharply (between 10 and 11 per cent), perhaps necessitating increased direct taxation and consolidation of the public debt. Limiting the balance to be financed out of the state budget to $33 million is advisable.

In the event of a short-term economic slowdown, the authorities should adopt a well-timed, flexible policy to support domestic demand, in accordance with the general provisions outlined above.

LUXEMBOURG

The success of efforts to stabilize the economy depends to a great extent on a healthy economic situation in other countries. Nevertheless, the authorities should strive to achieve gradually adequate stability of costs and prices. They should stagger public expenditure in order to limit the balance to be financed out of the national budget to about $32 million.

Structural Policy at Community Level

Community authorities must ensure that the free movement of goods within the Common Market and the subsequent competitive pressure on prices are not obstructed by cartels or irregular practices by firms enjoying a dominant position. It will also be necessary to see that competition is not seriously threatened by exaggerated concentration in certain sectors.

To resolve the conflict between security of employment and professional mobility, the Community should protect workers more effectively against risks of reduced or lost income during periods of vocational retraining. A coordinated policy in this area should be studied by the member states.

The Community must intensify its efforts to assist underdeveloped regions, especially those situated in the outlying parts of the Community.

Finally, the Community will have to pay special attention to all matters relating to environmental protection and improvement.

Adaptation of Economic Policy Instruments

National economic policy instruments must be adapted to the new requirements of coordinated economic policies leading to full economic and monetary union.

Instruments of short-term policy, especially budgetary policy, should be given greater flexibility. Member states which do not already have the means to adjust rapidly taxation and expenditure levels should adopt them. This is essential if the national authorities are to apply a policy of price and cost moderation, without running the risk of slowing down economic growth for an unacceptable length of time.

In the field of international monetary relations, the Community must extricate itself from its present situation while strengthening its monetary solidarity. A means should be developed to stabilize international capital flows, and, where appropriate, to neutralize their effects upon internal liquidity. Such arrangements would allow limited exchange rate flexibility in relation to the currencies of third countries, while exchange rates between the member states would remain fixed.

# # #