

INFORMATION

ECONOMY and FINANCE

ECONOMIC PROSPECTS IN THE EUROPEAN COMMUNITY, 1973

42/73

One of the major objectives of the European Community is to set up an economic and monetary union by 1980. The formative charter for the union was laid down by the Council of Ministers, on a proposal by the Commission, in February-March 1971. Its practical application ran into a number of difficulties, including the currency crisis of May 1971, and the American measures of August 15 of the same year. The Union was, however, given fresh impulse by the measures taken in March 1972; and the Paris Summit in October, laid down a strict timetable to speed up its establishment, an important item in which was the formation of the European Monetary Cooperation Fund by April 1, 1973. (1)

For coordinating the national short-term economic policies, an important instrument in the Charter is the annual report on the economic position of the Community, finalised by Council on a proposal by the Commission, after consulting the European Parliament. The second of these reports is briefly summarised in the first two parts of this note. The third contains the anti-inflation resolution adopted at the same meeting of Council.

I. Present position and prospects

At the end of the summer of 1972, the Community is enjoying rising economic activity and an improved employment position. Costs and prices, however, are still rising very fast. Growth prospects for 1973, both international and internal, are nevertheless good.

-- The present position is improved internationally by the recovery in the United States, and by the new exchange parities agreed at Washington on December 19, 1971. The increase in world trade had the benefit, especially in the first quarter, of orders and deliveries postponed in 1971

(1) See Annexe -- the Summit monetary timetable

on account of the disturbed state of markets. The Washington monetary measures paved the way for a certain reflux of capital, which resulted in a reduction in the deficit on the United States balance of payments. Moreover, the agreement to narrow the margins of fluctuation between the currencies of Community countries, promoted a greater cohesion among the Europeans; and last July, meeting in London, they started work on the preparation of a joint position to be adopted in future negotiations on international monetary problems.

Inside the Community there was a substantial gain in economic activity. Domestic consumption, under the stimulus of the vigorous increase in incomes, was still the essential growth factor. Higher production made it possible to raise the level of employment; and at the same time, in those countries in which the unemployment problem was more acute, a tendency was noted for the problem to become less pronounced. The upward movement in consumer prices remained very vigorous, and the growth in production did not suffice to offset the rise in unit costs. The volume of money is increasing rapidly and is a matter for concern. The increase is due not only to the inward movement of capital, but also to the considerable growth in bank credit and in some countries, also, to monetary financing by the public treasury.

- The prospects for 1973 are good, both internationally and internally, but the struggle against inflationary tendencies must be the priority objective of Community short-term economic policy (1)

Development prospects in North America foreshadow intense economic activity. The same applies to Japan and most of the industrial countries in Europe which are not yet members of the Community. It is indeed expected that there will be increased demand for imports from developing countries.

Exports from the Community should show a material expansion; and this trend will be bolstered by the 10 % reduction, as from April 1 next, in the customs duties on industrial goods inside the enlarged Community, and

(1) Council resolution for the struggle against inflation (page 10 below)

between the Community and the EFTA countries which did not take part in the enlargement. The growth rate in the gross national product in 1973 should be quite substantial. For the Community as a whole, the gross product in real terms should grow by about 5 % in 1973, compared with 3.5 % in the two previous years. The prospects for prices and costs, however, will still be matters of anxiety. There is a danger that the increase in consumer prices in all the member countries will still be rapid; and unless we are prepared to consider rises in the price-level of 5 % to 6 %, or even more, as being a normal occurrence, it will be necessary to put up an energetic fight against the inflationary tendencies. Though the level of employment should again increase in 1973, it is nevertheless necessary to provide for a better balance of the market through measures of a structural character.

The present rise in prices is aggravated by inflationary behaviour. If the gathering pace continues in the up-swing in economic activity, it will become more and more difficult to deal with increased demand with the technical capacity available. At the same time strains in the labour market will certainly come into evidence. Precautions will therefore have to be taken to avoid bottle-necks and a further phase of demand/inflation. From now onwards, therefore, it is necessary to seek means for withdrawing the physical limits to the potential expansion in production, so as to keep the rate of increase in total demand within the limits set by a balanced medium-term growth. It would also be preferable to buttress production capacities by increasing the technical and manpower capacities of backward regions, than by having recourse to measures of a more general character. It will also be necessary to get the better of the inflationary tendencies in public finance, in which the increase is serving less and less the financing of collective requirements.

II. Orientations of economic policy

1) General tendencies

The primary objective is the struggle against inflationary tendencies. The conditions for a more balanced economic expansion in member countries, could flow from a policy covering the public finances, credit and cooperation between the social partners in relation to the growth of incomes.

Member countries should seek to bring the 1973 rise in consumer prices below 3.5 % compared with the 5 % or 6 % rate which will be shown for all the member countries in 1972.(1). If such a result is achieved, it will be necessary for public authorities, and the principal economic and social groups, to moderate their inflationary behaviour. From this standpoint it is indispensable that, for the rest of 1972, the provisions of the year's budget should be applied. In recent years the cash outlay has been growing considerably. This is shown by the total increase in the first six or eight months of the year, by comparison with the same period in the previous year. The following figures, though the periods covered do not exactly coincide, are indicative of this growth :

18.3 % in Italy
9.8 % in Federal Germany
6.6 % in France
20.5 % in Belgium
16.4 % in Luxembourg
15.7 % in the Netherlands

It follows that maximum pressure will have to be applied to contain the increase in expenditure in 1973, but allowing for the fact that the expenditure on collective equipment, and some classes of collective consumption, cannot be compressed.

Credit policy should also make for a moderation in the growth of total demand. It thus seems necessary that a brake should be applied to the granting of credit to the private sector, especially since provision must be made for the non-monetary financing of the deficit in public accounts. This policy will lead to an increase in short-term interest rates, which might have the effect of attracting external capital. It will therefore be necessary for the member countries to use their instruments for regulating the flow of foreign money, so as to limit the volume of their capital imports. In counterpart to this, it appears necessary for a more determined effort to be made to integrate the Community capital markets. On the supply side, adequate measures of competition policy

(1) The Council meeting on inflation at the end of October laid down 4 % as the target limit for the increase in consumer prices. See the Council resolution on page 10 below.

commercial policy and agricultural policy might also help to slow down the rise in the cost of living.

It will also be important to prevent firms, in fixing their prices, being dominated by the expectation of inflation; that wage claims should be adapted to the medium-term growth rate in productivity; and that credit policy and the public finances contribute to maintaining the basic economic equilibrium. There will therefore have to be a collective effort by everybody engaged in economic activity, to secure a higher degree of economic and social coherence; for the mastery of the inflationary trend cannot be achieved by technical methods alone.

2) Tendencies in the different countries

- In the Federal Republic of Germany, the expected speeding up of economic activity will begin from a point at which the utilisation of productive capacity is appreciably higher than the level to which it had fallen by the end of the earlier recession phases. There is thus a special risk that bottle-necks may appear at an early stage, reinforcing the upward tendency in costs and prices. The avoidance of this risk should be sought by a policy of regulating the demand.

For this purpose credit policy should put limits on the growth in credit to the private economy, and the volume of monetary instruments available. Continued use must be made of the various arrangements introduced at the beginning of the year, to limit the influx of capital from abroad, and neutralising its effect on internal liquidity. The net balance to be financed in 1973, from the whole of the budgets of the Federation and the Länder, should not exceed DM 9 billion, which means that the growth in expenditure outgoings for all the administrations should be of the order of 9.5 %.

- In France, the revival in industrial investment, and the expected growth in exports, especially to Community countries, will be factors increasing the expansion in demand, which is already growing at a comparatively rapid rate. There are thus serious reasons for fearing an accentuation of the inflationary tendencies, and a deterioration in

the external balance. For the last months of 1972 and through the year 1973, particular vigilance seems to be called for in economic policy.

The first point is, that the growth in internal liquidity, which has been extremely rapid in recent months, should be contained within much closer limits by the full application of the compulsory reserve ratio -- both on the liabilities side and in regard to credits -- and by stricter conditions for the granting of consumption credits and personal loans. A certain rise in interest rates might be found useful in so far as it does not result in an undesirable influx of capital balances.

Public expenditure in 1973 should not be allowed to increase by more than 10.5 % over the initial estimates for 1972 (or by 8.5 % over the probable effective total in 1972).

The mitigation of the rise in costs and prices, however, will not be realisable if the increase in wages and salaries continues with the same speed as in recent months. It will, therefore, depend to a large extent on the conduct of the social partners.

- In Italy, the extremely slow pace so far maintained in the economic revival which began in the autumn of 1971, has not sufficed to prevent an increase in unemployment; and a material raising of the level of economic activity thus remains the primary objective. The current trend in prices, however, is a factor of uncertainty in securing a balanced rate of economic growth; and other such factors are the exceptionally large number of collective agreements renewable during the autumn, and the introduction of the tax on added value on January 1, 1973. These factors must be taken into account in the application of economic policy.

The abundant internal liquidity is a positive factor for renewed expansion; but it should not be allowed to become an inflation factor as soon as there has been a decisive improvement in the utilisation rate of production capacities. In the execution of the budget, it will be necessary in 1973 to limit the increase in state expenditure

outgoings to 10 %,so that the net balance requiring finance shall not exceed Lit. 4,000 billion. Impulsion from the public finances must thus contribute to the growing rate of production and to the defence of the level of employment. The development of the Italian economy in 1973 will also depend in large measure on the forthcoming wage negotiations. What matters in this connection is,that there should not be an unduly sudden and unduly large increase in production costs. If,too, a lasting economic growth and increase in employment are to be secured, it will be necessary to catch up with the arrear in directly productive investment,and also in collective equipment. This explains the need for an effort to facilitate their financing.

- In the Netherlands, the resumed expansion which began early in 1972, foreshadows an improvement in the employment position, but raises difficulties in securing the desirable progress towards a more balanced economic development.

A material diminution of the inflationary strains is necessary for maintaining competitive capacity and absorbing the structural unemployment. It calls for energetic short-term action, based on the use of every available instrument of credit and budgetary policy, and on a closely concerted approach between the government and the social partners in securing an adequate moderation of the increase in incomes.

Budgetary management should be on stricter lines and should limit the growth in government expenditure in 1973 to under 10 %. In order to avoid an increase in the fiscal burden, which might lead to still further rises in costs and prices, an increase can be envisaged in 1973 in the net balance requiring finance which should not, however, exceed Fl.2.5 billion.

- In Belgium the expansionist tendency in economic policy through 1971 contributed in securing a definite rise in the growth rate; and in the months ahead this will not fail to have a favourable impact on the employment position. Anxiety regarding the trend in costs and prices, however, now makes it necessary for economic policy to be angled on containing the inflationary pressure.

The growth in government expenditure in 1973 should not be more than 10 %, and the net balance requiring finance should be materially curtailed from BF. 92 billion in 1972 to BF. 82 billion in 1973.

- In Luxembourg there are good prospects for the development of foreign demand in 1973. It is therefore important that the government should take a prudent course in regulating internal demand, so as to avoid the renewal of strong pressure on costs and prices.

Conclusions

Economic prospects for the months ahead and through 1973 hold out the promise of a very satisfactory expansion in economic activity, and a material improvement in Community standards of living. They foreshadow a position very close to full employment. They nevertheless raise the fear of a continuation of inflationary trends which have continued for nearly four years and which have not been successfully mastered.

There are various factors, both internal and external, both political and economic, which explain the comparative powerlessness of governments to regain a higher degree of stability. It is therefore to be feared that the countries of the Community may tend to accept inflation, and accustom themselves to the rise in wages and incomes. This may be convenient enough on the short-term, but on the medium-term it would be full of dangers. When the real economic position has been seriously vitiated by inflation, it is only possible to secure the necessary recovery by paying a high price in terms of growth and employment.

Community countries must therefore continue, despite all manner of difficulties, to seek means to conciliate continued growth with the maintenance of stability. This conciliation goes beyond the scope of present considerations, and remains the indispensable condition of the Community's smooth functioning and its economic and social development.

III. The plan for fighting inflation

The Community Council, at its Luxembourg meeting on October 30 and 31 1972, adopted an important resolution on the action to be taken to fight inflation. The action concerned will lie in the field both of national policies, and through joint policies coordinated by the Commission. The individual situations of the member countries will be taken fully into account in this general framework. The member countries themselves will carry out the measures agreed, in such a way as to take into account their own situation and the instruments of economic policy at their disposal. Subject to these general considerations, the measures laid down in the plan adopted by the Council can be summarised under ten headings :

- a) The rate of increase in consumer prices must be brought down to 4 % in the year 1973.
- b) concerted action by the social partners must enable the rise in prices to be slowed down by limiting the growth of incomes from labour and capital.
- c) The action against the rise in prices will be accompanied by structural action, aimed at reducing the regional imbalances in terms of available manpower and technical capacities. To this end the European Social Fund will finance action taken for vocational training and readaptation.
- d) The rate of expansion in the volume of money must, between now and the end of 1974, be adapted to the growth in the volume of the gross national product as increased by a rate of increase in prices conformable to the general objectives of economic policy. Countries, however, in which there is under-employment will be able to have the benefit of derogations; and countries in a state of full employment must come half way to this target during the course of 1973.

Monetary authorities must take action :

- on interest rates, by setting rediscount ceilings, or setting limits on the increase in the rates of intervention by the monetary authorities;
- on liquidity by imposing, or modifying reserve ratios affecting the liabilities of financial intermediaries and by recourse to the open market ;
- in case of need, on the volume of credit, especially by limiting the grant of credit by credit institutions and by restriction, or regulation, of consumer credits (instalment sales finance and personal loans).

The action taken by governments against speculative movements of capital will be energetically pursued, as provided in the directive of March 1972; and central banks must refrain from increasing their placings in the euro-dollar market.

The committee of governors of central banks will also have to engage in a quarterly examination of changes in the volume of money.

- e) The member governments will have to accept a strict discipline in the management of public finances.

In the execution of the public budgets in 1973, the effective increase in expenditure will be kept within the limits set by the rate of growth in the increase in value of the gross national product which is the basic budgetary-hypothesis in member countries. This does not apply to expenditure linked with the creation of jobs in countries which have to deal with endemic under-employment.

Member countries in a state of full employment must also provide, within the first half of 1973, either a system of staggering the expenditure envisaged, or the division of the expenditure into conditional tranches.

At the end of the first half-year, the Council will examine whether this arrangement should be maintained or adjusted. In the event of some of the expenditures exceeding the level provided, compensatory reductions will be applied to other budget items.

Surplus budgetary receipts arising through an increase in prices, exceeding that assumed for purposes of the 1973 budgets, shall be applied to a reduction of the net balance requiring finance; to a decrease in indirect taxation in countries in which the level of such taxes is comparatively high, or be sterilised in a deposit with the central bank.

Except for countries in which the situation is particularly characterised by under-employment, those member countries in which the budget shows a balance requiring to be financed, must abstain from recourse to any monetary financing of this balance.

If the inflationary pressures should not be sufficiently relaxed in the course of 1973, a more restrictive budget policy will be considered. In this case the member countries will proceed either, to higher taxation or to diminished expenditure.

The Budget Policy Committee will make a quarterly survey of the conformity to these prescriptions of the execution of the 1973 budgets.

- f) Measures of commercial policy will be subject to a decision to be reached by the Council before the end of January 1973. A reduction in customs duties has already been applied to certain classes of agricultural produce (beef). Quantitative restrictions on the import of potatoes have been suspended for the period between November 15 1972 and February 15 1973.
- g) The Commission shall strengthen its action in relation to the restriction of competition through horizontal agreements, concerted practices or discrimination in prices, the sharing of markets and other restrictive practices which may contribute to the maintenance of an unduly rapid rise in prices.
- h) The Council shall make decisions not later than June 30, 1973, on draft directives aimed at harmonising the provisions of laws and regulations which may impede the trade in food products inside the Community. It will also give decisions on other problems, including the award of public procurement contracts and public works contracts and concessions.
- i) The execution of this anti-inflation programme shall be regularly examined by the Council at the three meetings set aside for discussing the economic position in the Community.

ANNEXE

Timetable laid down at the Paris Summit Conference
on October 19-20 1972 for economic and monetary
policy

- April 1 1973 : Formation of a European Monetary Cooperation Fund.
- September 30, 1973 : Proposals to be submitted to Council by Community institutions on adjustments to short-term support arrangements (increase of available credits).
- December 31, 1973 : Proposals on conditions for progressive pooling of reserves.
- January 1, 1974 : Beginning of the second stage of economic and monetary union.
- Before the end of 1975. : Presentation by Community institutions of a report on the state of the European Union, preparatory to a further Summit meeting.
- December 31, 1980 : Completion of economic and monetary union.