COMMISSION OF THE EUROPEAN COMMUNITIES

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ANNUAL ECONOMIC REPORT 1978-1979

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<u>ANNUAL ECONOMIC REPORT 1978-1979</u>

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FOREWORD

Under Article 4 of its Decision 74/120/EEC of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community as amended by its Decision 75/787/EEC of 18 December 1975, the Council, acting on a proposal from the Commission and after consulting Parliament and the Economic and Social Committee, is required, during the fourth quarter, to adopt an annual report on the economic situation in the Community and to set the economic policy guidelines to be followed by each Member State in the following year. Once the report has been adopted by the Council, the respective governments must bring it to the attention of their national parliaments so that it may be taken into account in budget debates.

This year the Commission is also submitting, as background material to the Annual Report, an Annual Economic Review which contains a factual analysis of economic developments. This latter document is intended for simultaneous distribution to the institutions concerned with the Annual Report, and subsequently for publication on the Commission's responsibility (not in the Official Journal). The Annual Report adopted by the Council on proposal of the Commission would thus clearly consist of the policy matters on which it is appropriate for the Council to deliberate, and would be separated from the background material which is needed, but is not necessarily, in the Commission's view, a matter for Council decision. This innovation in the procedures is considered desirable by the Commission because on the one hand it is necessary for the Community's decision-making mechanisms to operate as swiftly and economically as possible, while on the other hand there is an increasing need to provide the institutions and public opinion with systematic and objective analysis on the Community economy.

This report was completed on 18th October 1978.

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1. Community objectives

The theme of this report is that, while the economic performance of the Community is in several respects improving, the time has come for a stronger development of the Community's central economic mechanisms and procedures. This is aimed at enabling the Community to do still better in its economic performance in the period ahead. The objective is to provide a more effective common framework in both the economic and monetary domains for national efforts to secure the shared objectives of high employment and living standards, and monetary stability. Put another way round, the objective is to reverse through action at the Community level the undermining of the effectiveness of purely national economic policy that has resulted from the increased integration of the economies of Member States in the European and international economy.

While intent on building up its economic and monetary system from within, the Community is also seeking to strengthen the basis for its cooperation with third countries. This is illustrated by the positive collaboration that was in fact achieved in the summer of 1978 between the Community and the other participants in the Bonn western economic summit; as also by Community's intention that the European Monetary System be open for associated participation by non-member states having particularly close economic links with the Community. Moreover a major purpose of strengthening the Community's economic and monetary policy system is, throu achieving a sounder basis for internal growth, to restore conditions favourable to a rapid growth of an open world trading system and, thus also to a continuous evolution of economic structures. This adjustment process must aim at an efficient division of labour between industrialised countries and the fullest opportunity for the growth of developing countries. Thus a strengthened economic and monetary policy is aimed at supporting the positive adjustment objectives of the Community's trade and sectoral policies.

2. The Economic Outlook

The task of adjusting the Community economy to the difficult economic conditions prevailing since the oil crisis in 1973 is broadly portrayed in the following data - although, of course, there have been major differences in the experiences of individual Member States. The data for 1978 contain an element of estimation and forecasting by the Commission, and for 1979 they are Commission forecasts on the basis of policies described in this report:

The Community economy 1973-1979

	GDP volume growth %	rise in consumer prices %	current account balance of payments, billions E.U.A.	general government financial deficits, % GDP	money supply growth (m2), %	unemployed in labour force, %
1973	5.7	8.3	1.6	-0.9	16.5	2.5
1974	1.7	12.8	-9.2	-1.7	12.8	2.9
1975	-1.7	12.8	1.2	-5.2	12.7	4.4
1976	4.9	10.0	-6.3	-3.7	11.1	5.0
1977	2.3	9.1	1.7	-3.2	12.5	5.5
1978	(2.6)	(6.9)	(8.3)	(-4.1)	..	(5.7)
1979	(3.1/2)	(7)	(8.1/2)	(-4.1/2)	..	(5.6)

The years immediately after 1973 saw, to some extent, a volatile stop-go in the Community economy, which has to be avoided in the future. The period ahead is seen as being one of gradual rather than dramatic economic recovery. The growth rate is now strengthening, and valuable improvements have been made in price performance and in the external payments situations. The dispersion of inflation rates has been reduced as well as the average, and the current account payments situations have become much more balanced (the deficits of France, Italy and the United Kingdom have been reduced or reversed, and Belgium and The Netherlands have moved into balance of slight deficit - although the surplus of the Federal Republic of Germany has not declined). Unemployment appears to have peaked in the Community as a whole, and progress is beginning to be made in some Member States for its reduction.

3. Concerted action

The stronger economic outlook for 1979, with a prospect of real growth of nearly 3 1/2 per cent, is partly due to the concerted action decided by the Council on 24 July 1978,[1] in implementation of the conclusions of the European Council of 6-7 July 1978 meeting in Bremen, and of the western economic summit of 16-17 July meeting in Bonn - at which the Community was represented by the President of the Council and the President of the Commission.

The meetings at Bremen and Bonn decided on a broad range of policies beyond budgetary and monetary policy, and notably at Bremen on specific measures to promote employment, to strengthen the Community's energy situation, to facilitate structural change in industry and the Mediterranean region, to strengthen the open world trading system and to aid the developing countries. The Bonnn meeting reached further agreement at the broader international level on largely the same policy issues.

The aim of concerted action in the field of macroeconomic policy at the Community level is to achieve a higher economic performance than would otherwise be possible, by making the use of macroeconomic policy instruments more effective.

More precisely, the economic rationale of concerted action is that:

- purely national action, in economies with large external trade sectors, will to a high degree be dissipated through the leakage of demand abroad; thus the multiplier effect of stimulatory action on the domestic economy will be lower than in a less open economy;
- this makes it less attractive to use possible room for manoeuvre in demand management policy, since, for example, the fiscal pay-back of budgetary measures is diminished in amplitude and the necessary confidence of consumers and investors weakened;
- this kind of preoccupation has been reinforced by doubts in industrial and financial circles as to whether expansionary action would have the desired effect on the real economy as opposed to an adverse effect on inflation and foreign exchange market expectations; and by concern in many Member States that the public finances have grown excessively in relations to the GNP;
- the antidote to these problems must, at least in part, be to pool national initiatives into a broader and coherent Community action, and so to restore the prospect of favourable multiplier effects, a more rapid fiscal pay-back to

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(1) O.J. No L 220/27, 11.8.1978.

demand management moves, and create a higher probability of inducing the positive real response from the private economy, rather than an aggravation on monetary instability.

Beyond these general principles, however, the present Community action is more ambitious and concrete in further respects.

There is the particular case of Member States whose economies are in the greatest need of monetary stabilisation and development. A deliberate concerted action by the remainder of the Community economy to strengthen demand improves the setting for domestic stabilisation policies. In all stabilisation programmes there is the problem of strengthening the monetary and public finances situation without creating recession. The preparation of such stablisation programmes alongside a concerted recovery programme for the majority of the Community increases the chances of success and diminishes the risks inherent in stabilisation policy. Ireland and Italy are both cases in point. This is why, as noted already in the terms of the concerted action Decision of 24th July, in the cases of Ireland and Italy the Community strategy includes a priority in the allocation of its financial resources in favour of investment and employment in these countries.

There is also the need to systematise and strengthen for the future the most positive features of 1978's concerted action experience and to identify the precise means of increasing its potential. The coordination process must be anchored in a more explicit setting of final objectives of economic and financial policy and monitoring of performance. The setting of final objectives has to be worked through at the technical level more thoroughly in terms of the collective analysis of forecasts and instrumental objectives. The synchronisation of national budgetary and monetary policy timetables has to be further improved in some countries. The link at the Community level in the decision-making process between the technical and political levels has improved in the course of the work that led to the 1978 concerted action decision, and this progress needs to be built on for the future. Moreover the European Monetary System will itself (as indicated further below) strengthen the need for progress in the area of harmonisation of budgetary and monetary policy.

4. European Monetary System

Monetary stability is a priority objective in itself. But it is also the route through which to restore effectiveness to the instruments of macroeconomic policy. Nothing is more damaging to the effectivenss of demand management policy and growth than to have to try to operate on a disturbed basis of domestic or external monetary instability.

Member States with revaluing and devaluing currencies, especially where there have been overshooting or exaggerated movements, have the common experience of recent years of being unable to obtain full satisfaction from demand management policy in the prevailing conditions of domestic and/or external monetary instability. Countries with revaluing currencies have found business investors unresponsive to expansionary policy moves where great uncertainty has surrounded their international competitive situation and the prospectes for demand abroad. Countries with devaluing currencies have experienced how strongly and quickly exchange-rate depreciation can aggravate domestic inflation and also create a climate of uncertainty and instability detrimental to the objective of inducing a strong flow of new, competitive investment.

These are the economic reasons which have led the Community towards establishing a European Monetary System.

Discussions will be proceeding (in the Council, the Committee of Governors of Central Banks and other Community bodies) on the design of the European Monetary System at the time that this report is before the Community institutions. The European Council intends at its meeting on 4-5 December 1978 to take decisions on a scheme following the terms of reference adopted by the European Council at Bremen on 6-7 July.

It would therefore be premature for this report to go into any detail on the European Monetary System, beyond noting the main characteristics of proposals under discussion, and its implications for general economic policy in the period ahead.

According to the Annex to the conclusions of the Bremen European Council, the European Monetary System would consist of an exchange-rate management mechanism at least as strict as the 'snake',changes in central rates would be subject to mutual consent; the European Currency Unit (ECU), having the same definition as the present European Unit of Account, would be at the centre of the system; a large volume of reserves and credit facilities would be put at the disposal of the system; within two years of the start of the system the existing arrangements and institutions would be consolidated in a European Monetary Fund; the successful functioning of the system will require all participating countries to pursue policies conducive to greater internal and external stability.

Alongside work on the monetary mechanisms the European Council requested that there be undertaken concurrent studies of the action needed to be taken to strenghten the economies of the less prosperous member countries in the context of the monetary system envisaged.

The economic policy implications of the European Monetary System envisaged can be indicated in broad terms, although not yet in the precise form that will become appropriate at a later stage.

The system will provide a more clear-cut frame of reference for domestic monetary stabilisation policy, although the choice of instruments of stabilisation policy will no doubt continue to differ as between Member States. However, the System will in any case need, in spite of the difficulties it involves, a more rigorous coordination of monetary policies in the Community framework, as well as of budgetary policies.

The availability of larger volumes of credit implies that there would be a larger recourse within the Community to the collective negotiation of economic policy conditions accompanying credits of relatively long maturity.

The successful functioning of the System will also require that the Community as a whole strikes the right balance in policies for stabilisation and growth, i.e. to aim at convergence on a low rate of inflation and stronger growth. To this end all Member States must accept obligations to manage their economic policies accordingly.

In these respects the functioning of the European Monetary System will be strongly linked to the further development of the 'concerted action' approach to economic policy in the Community.

Above all, for the system to be credible and durable further progress will have to be made in reducing the average and the dispersion of inflation rates; the progress achieved in external payments situations will have to be consolidated; a steady expansion of real demand and output will have to be maintained, with special responsibilities assumed by the most strongly placed Member States.

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5. Guidelines for 1979

The guidelines that follow carry forward and extend the concerted action Decision of 24th July. The present time is therefore a significant one for economic policy not only because of the preparation of the European Monetary System, but also because it is a period of implementation of the Decision of July.

In particular the budgetary measures decided by the Federal Republic of Germany of 28th July are now passing through the legislature. France has since implemented a larger budget deficit in 1978, and the United Kingdom's expansionary 1978/79 budget has now been enacted. Belgium and The Netherlands have been adopting important new budget policy programmes in which the future growth of public expenditure is being constrained more tightly, permitting nonetheless a positive short-run policy stimulus to the concerted action programme. Luxembourg is proceeding with its stimulative measures. Denmark, while retaining a moderately expansionary policy, has taken steps to strengthen its public finance situation and its stabilisation policies more broadly. Ireland and Italy are both in the course of preparing major changes in budgetary policy following the 'Green Papers' of earlier this year in Ireland and the 'Pandolfi Plan' in Italy; both are aimed at constraining or cutting current public expenditures, reallocating resources to development oriented investment expenditure, while cutting the public deficit as a share of GDP.

Overall this set of policy adjustments amounts to a substantial net stimulus for the Community economy. The differences in the measures as between Member States are deliberately aimed at achieving a more convergent and stable structure of balance of payments positions. They also reflect the need to correct public finance trends in a number of countries where the growth of public expenditure has become excessive, or inbalanced as between current and investment expenditure.

As regards monetary policy the present strategy (and without prejudice to changes that may be required by the European Monetary System) is one in which all Member States pursue specific quantified objectives, be it money supply or credit norms in the case of the four larger economies, and/or the discipline of a fixed exchange-rate relationship in the case of the other five Member States. These objectives first of all aim at maintaining or improving monetary stability; however, at the same time the management of monetary policy must allow and help the Community economy to return progressively towards its potential performance.

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Strong efforts are still required in several Member States to bring trends in costs and prices into a range of performance compatible with a durable functioning of a European Monetary System. The modalities of policy can and do vary widely between Member States. However, in their different ways, Denmark, France, Ireland, Italy and the United Kingdom all face a crucial period ahead in their need to achieve a further reduction in the rate of inflation.

The normal occasion for considering adjustment of the following guidelines would arise in the framework of the first examination of the economic situation in the Community in 1979, notably during the first quarter of that year [1]. That occasion will be of more than usual importance because it is at the turn of the present year that, on the one hand, economic prospects in the light of the recent concerted action will be clearer, and, on the other hand, decisions will have been taken on the European Monetary System.

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(1) According to Article 2 of the Council Decision of 18 February 1974.

Growth prospects for Denmark in 1979 are still moderate because the external constraint on economic policy leaves only a narrow margin of manoeuvre. The Danish Government has confined itself, within the framework of concerted action, to granting some temporary reductions in personal income tax. On 31st August 1978 it decided to propose amendments to the system of index-linking for personal income tax scales, applicable from 1979, and raised VAT rates from 18 per cent to 20 1/4 per cent on 1st October 1978, as well as budget savings partly effected through postponement of certain public infrastructure projects. These provisions should mean that the spontaneous central government deficit will be reduced in 1979, and thus the 1979 general government deficit will increase by only 1/2 per cent of GDP in relation to 1978. Domestic costs will for the six months to the end of February be subject to severe control; only wage increases provided for under existing wage agreements may be passed on in price increases. In order that the effects of these measures are felt beyond this period, the authorities should ensure that incomes policy is strictly applied, so that the expected results of the budgetary measures are not endangered and that progress is made towards an improved internal and external equilibrium position.

After a weak performance in the first quarter, economic activity in the Federal Republic of Germany has gained momentum over the past few months. It should be further stimulated after 1 January 1979 by the measures the Federal Government has adopted as part of Community concerted action. In particular, tax reductions are planned on low and medium incomes and additional public expenditure to stimulate investment and strengthen disposable income through increased family allowances. To reduce the burden on the budget resulting from these measures, the VAT rate will be increased on 1 July 1979. In accordance with the Council Decision of 24 July 1978, these measures will involve a net amount of about 1 per cent of GDP; as a result the general government deficit will reach about 4 1/2 per cent of GDP.

The measures should contribute in particular to reinforcing private consumption, and in general improving the short-term situation. They should permit annual average growth of about 3 1/2 per cent in 1979, compared with 2 3/4 per cent in 1978. The stimulatory effects of the programme will continue to be felt after 1979, particularly on business investment. In view of the introduction of a new European monetary system in 1979, it is of paramount importance that the German economy should keep up sustained and balanced growth. In the area of monetary policy, it would be desirable for the Bundesbank to bear in mind the need to support policy for growth and stability when fixing its monetary objective for 1979.

In France the authorities have introduced a number of measures which, due notably to a faster growth of investment, ought to result in a moderate acceleration of growth in 1979. This should avoid a further significant increase in unemployment, without hindering restoration of balance on current external transactions - which should be consolidated. However, the deceleration of inflation will remain the priority objective, so as notably to contribute to the implementation and the smooth working of the proposed European monetary system. The draft central government budget, in accordance with the guidelines laid down by the Council in its Decision of 24th July 1978, maintains the action introduced in 1977 and reinforced in 1978 to support national economic expansion, notably through measures in the field of social transfer payments; and there are also employment measures aiming at favouring stable employment in sectors with promising future prospects. The finances of the large nationalized firms should be further strengthened. The net borrowing of general governments should thus be situated at a level of about 2 per cent of gross domestic product, as in 1978. In the framework of the fight against inflation the central government budget deficit should be financed mainly by non-monetary means. Monetary policy should for its part, aim at a small reduction in the level of liquidity in the economy. Finally, the efforts to avoid an excessive growth of earnings should be maintained and reinforced.

The prospects for Ireland in 1979 are still favourable, and the rate of growth of the economy could remain higher than the Community average. If economic policy is to lay the foundation for lasting and balanced growth in the longer term, it should endeavour to reduce the central government borrowing requirement. To this end, the projects described in the 'Green Paper' intended to reduce the net borrowing requirement of central government in 1979 to 10.5 per cent of GDP, by moderating current expenditure and reducing subsidies, should be accompanied by increased taxation. At the same time, economic development and employment could be supported by a transfer of resources from the Community to finance infrastructure investment. Incomes policy should try to moderate wage increases so as to reduce inflationary pressures and thus establish favourable conditions for participation in the new European monetary system. This implies that incomes policy should not aim at compensation for the effects of heavier taxation, but should also try to avoid too steep an increase in wage drift which was the case in 1978. Monetary policy management will be facilitated by the expected reduction in the central government net borrowing requirement. However, to limit domestic credit expansion and as reflected in recent measures, it is desirable to control more strictly the expansion of credit to private individuals.

In 1978, Italy made considerable progress towards controlling inflation, improving the external surplus and preparing for more rapid growth. It is therefore important that economic policy in 1979 should endeavour to consolidate the successes already achieved, to step up the fight against inflation and the effort to stabilize public finances, while ensuring the transfers of resources required to support economic growth. This is the intention of the 'Pandolfi Plan', the translation of which, into appropriate legislative terms, is now advisable. These efforts will be facilitated by Community action which could help the Italian authorities improve economic structures. As far as budgetary policy is concerned the enlarged public sector budget deficit (E.C. definition) in 1978 should be about 15 1/2 per cent of gross domestic product. This latter ratio represents a ceiling, it being desirable to achieve a lower level already in 1979. In the course of 1979, the structure of public expenditure should in any case be improved, through restricting the growth of consumption expenditure, compensated in part by an increase in investment. The ratio should also be reduced in the two following years. The reduction should be achieved mainly by limiting the increase in current expenditure, in particular through measures to reduce the growth of social transfer payments and expenditure on health. Better management of public-owned companies and companies in which there is State participation could also enable a reduction in State aid. Tighter budgetary management would facilitate the task of the monetary authorities and would help stabilise or even reduce the ratio of domestic credit expansion to gross domestic product. The creation of monetary base should be strictly controlled, through the workings of the interest rate mechanism, so as to avoid destabilising capital flows. The success of this policy will depend to a large extent on how rigorously the incomes policy is applied, alongside the measures to promote investment. In this context, it is essential to control increases in costs by preventing any rise in real hourly wages.

Economic growth in The Netherlands in 1979 should gain momentum, thanks to the favourable effects of concerted action, and in particular to vigorous support of domestic demand. If the medium-term prospects for employment are to brighten, competitivity will have to be strengthened through further reducing the rate of inflation, and improvements in the functioning of the labour market. This should stem the loss of jobs at present arising from high real labour costs, and encourage investment. The Dutch authorities have therefore stepped up their efforts to moderate the increase in wage costs, mainly by limiting the rise in compulsory levies while reducing at the same time the rate of growth of public expenditure so as to keep the structural government borrowing requirement over the next few years between 4 per cent and 5 per cent of national income. Demand support, as part of concerted revival action, will nevertheless have to continue next year; a temporary increase in the general government borrowing requirement from 5 per cent in 1978 to nearly 6 per cent in 1979 (provided for in the draft central government budget for 1979) is therefore consistent with the economic policy objectives set for the Community as a whole. A certain amount of monetary financing will inevitably be required to cover so large a budget deficit, but this is consistent with maintaining the liquidity ratio in the economy at its 1978 level.

Economic growth could also gain some momentum in Belgium thanks to the prospect for exports which should develop notably in the framework of the concerted action. The effects of this improvement on the labour market will be reinforced by specific measures such as early retirement, training courses for young people and the creation of temporary posts in the public sector. Pursuant to the Community guidelines, the general government borrowing requirement could rise from about 5 per cent of GDP in 1978 to slightly over 5.5 per cent in 1979. Although it does not seem advisable to reduce this percentage in the short term, since such a reduction would have unfavourable consequences on activity, in the longer term it will probably have to be reduced to establish a more favourable balance between national resources and collective uses. With this in mind, efforts to moderate the growth of current expenditure should be continued and intensified. Monetary policy should continue to help contain inflation to a modest rate; the European monetary system, for which preparations are in progress, will probably be a great help in achieving these aims.

The Council's budget guidelines for Luxembourg recommend a budgetary stimulus of over 1 per cent of GDP; in its draft budget for 1979, the Luxembourg Government accordingly announced or implemented a number of measures intended to stimulate business investment and exports. The draft budget also provided for a rapid increase in public investment, and of reinforcement of the programme of specific individual measures in favour of employment and encourage private consumption (selective reductions in direct taxation, improvement of certain social benefits). The borrowing requirement of general government will thus probably increase somewhat, which, however, could be covered by loans and for the remainder by recourse to the budgetary reserve constituted in the years of strong economic activity.

In the United Kingdom, the significant reduction in the rate of inflation and strengthened balance of payments enabled the Government to propose, in the context of the concerted action programme, a stimulative budget for the fiscal year 1978/79. The planned level of the Public Sector Borrowing Requirement (PSBR) was raised to 8 1/2 billion pounds (5 1/4 per cent of GDP), just below the level communicated to the International Monetary Fund, as confirmed in the stand-by credit renewal of May 1978. The most urgent objective of policy must now be to keep the rate of inflation well below 10 per cent. To this end there must be a marked deceleration in the rate of growth of earnings which, in the year to July 1978, rose a good deal faster than the Government's guidelines of 10 per cent. For the fiscal year 1978/79 the growth of sterling M3 needs to be contained within the range of 8-12 per cent. For 1979/80 a lower target range for monetary growth should be considered. A more expansionary stance of fiscal policy should only be considered in the event that the growth of earnings is moderated, domestic demand is subdued and the balance of payments is strong.

PROPOSAL FOR A COUNCIL DECISION

of 1978

adopting the annual report on the economic situation in the Community and laying down the economic policy guidelines for 1979

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Decision 74/120/EEC of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community (1), as amended by Council Decision 75/787/EEC (2), and in particular Article 4 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament (3),

Having regard to the opinion of the Economic and Social Committee (4),

Whereas, in adopting Decision 78/658/EEC (5), the Council approved the analysis of the economic situation set out in the Commission communication of 24 July 1978 concerning in particular the preparation of the public budgets for 1979; whereas, in accordance with that Decision, the Member States shall pursue economic policies in conformity with the guidelines on the preparation of the public budgets for 1979, which are specified in the Annex to the said Decision,

HAS ADOPTED THIS DECISION:

Article 1

The Council hereby adopts the annual report on the economic situation in the Community as contained in Sections 1 to 4 of the Annex and lays down the guidelines to be followed by each Member State in its economic policy for 1979, as contained in Section 5 of the Annex.

Article 2

This Decision is addressed to the Member States

Done at Brussels, 1978

(1) OJ No L63, 5.3.1974, p. 16.
(2) OJ No L330, 24.12.1975, p. 52.
(3)
(4)
(5) OJ No L220, 11.8.1978, p. 27.