COMMISSION OF THE EUROPEAN COMMUNITIES

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SUMMARY ACCOUNT OF THE ECONOMIC POLICIES PURSUED IN 1974

(forwarded by the Commission to the Council in accordance with Article 2 of the Decision of 18 February 1974)

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FOREWORD

In the new situation created by the energy crisis the economic policies pursued in the Community in 1974 failed to improve significantly the conditions of equilibrium or achieve a greater convergence of the various economies. Work on defining a common energy policy and a common approach to balance of payments problems ran into difficulties, and delays occurred. As regards the member countries' demand-management policies, rates of inflation differed widely from country to country partly because the Governments did not all act with the same degree of promptness or effectiveness. In several countries, monetary policy was the main stabilization instrument, although it probably curbed the propensity to invest to an undesirable extent. Throughout the year budgetary policy in most deficit countries was not sufficiently restrictive or was even reflationary, while in the other countries the operation of built in stabilisers played a large part in the greater stimuli released by budgetary policy in 1974. In addition, it often proved impossible to modify the structure of the public administrations' budgets so as to ensure a better income distribution or to safeguard the most essential investments. Finally, the various economic groups have not, generally speaking, adjusted their demands to the worsening economic situation, and this seems to have aggravated the deterioration in the labour market and delayed the adjustment of production to the new pattern of demand.

I. Budgetary policy

1.1. As a result of the slowdown in economic activity which occurred during the year, budget revenue in several countries in the Community increased less than forecast, particularly in Germany, Denmark and Ireland. In the other countries, revenues again exceeded the levels budgeted for, thanks to the greater - but purely nominal - increase in incomes and, in the case of France and Italy, to higher taxation introduced during the year.

1.2. Expenditure in all countries, however, continued to exceed expectations, though to differing degrees. The overall expansion in current expenditure, spurred on by rising costs, exceeded the growth in capital expenditure, which bore the brunt of attempts to restrict expenditure. Furthermore, the downswing in the conjunctural situation often necessitated additional expenditure, particularly in the form of unemployment benefits. The resulting built-in stabilization effect helped somewhat, particularly in Germany and Denmark, to sustain economic activity.

1.3. Most Member States used budgetary policy to help regulate the conjunctural situation. In Germany, the automatic reflationary effect of budget execution, effective throughout the year, was backed up by certain measures designed to sustain activity. In December 1973, tax measures which had hampered industrial investment and residential construction had already been dropped and a supplementary programme of expenditure was adopted in February 1974. It was decided, in the summer of 1974, to reform the structure, and the new system came into force in early 1975. The timing of this measure is relatively favourable as far as the conjunctural position is concerned. In addition to these measures, a programme of expenditure - still rather cautious - to assist regions suffering from high unemployment was adopted in September, and followed in December by the granting of a direct business investment premium,

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a new public investment programme and the introduction of a premium to bring unemployed workers back to work.

1.4. In the Netherlands and in Belgium, the budgetary policies pursued in 1974 also had a reflationary effect. In the Netherlands, the energetic programme for sustaining the conjunctural situation provided for in the draft budget and expanded in November 1974 strengthened this effect for 1975. In Belgium, however, direct taxation cuts in the autumn to assist tax-payers in the lower and middle income brackets has been more than offset by the increase in indirect taxation and by the earlier collection of tax on the income of the self-employed and of corporation tax. The expenditure provided for in the 1975 budget and the decision to implement the entire investment programme should, however, contribute towards sustaining economic activity from the beginning of 1975 onwards. Similarly, the higher taxes and the increased expenditure provided for in the Luxemburg budget should help maintain economic activity.

1.5. Of the countries with heavy balance of payments deficits, France and Italy adopted restrictive budgetary policies - although the latter's deficit remained very large. In Italy, the growth in expenditure was kept within strict limits; if there had not been an exceptional transfer of appropriations to the sickness funds designed to cover the debts of the hospitals, the growth in expenditure would have been no greater than 10 %. The increase in indirect taxation, although offset by a slight easing of direct taxation decided last summer, accentuated fiscal buoyancy. In France, the budget eventually yielded a small surplus, mainly accounted for by the special tax levy introduced in June 1974; if there had not been a considerable and exceptional increase in the Government's provisional advances to the local authorities against future tax accruals, the surplus would have been very large.

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1.6. In Denmark too, efforts were made throughout the year to use budgetary policy as a means of curbing demand and thereby reducing the current-account deficit. In May, indirect taxation was increased in order to slow down the rise in consumers' expenditure. Nevertheless, the increase in tax revenue was smaller than in the previous year and this meant that, in contrast with the substantial surplus budgeted for, there was in fact a net borrowing requirement.

1.7. In Ireland and the United Kingdom, however, budgetary policies were given a reflationary bias and will not, therefore, help to remedy the divergent price trends and balance of payments situations in the Community. In Ireland, expenditure grew at a more rapid rate and revenue at a slightly lower rate than forecast, with the net borrowing requirement amounting to almost 12% of the gross domestic product. A considerable proportion of the deficit was financed by credit from abroad. In the United Kingdom, the initial budgetary provisions for the 1974/75 financial year aimed at reducing the deficit, but were amended in July and November 1974 by provisions to lighten taxation, mainly on VAT and corporation tax, whilst rapidly rising costs boosted expenditure. The end-of-year deficit is, therefore, expected to be very much greater than the previous year's.

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TABLE 1

DEVELOPMENTS IN BUDGET SURPLUSES OR DEFICITS

Country	1973 Forecast[1]	1973 Outturn[2]	1974 Forecast[1]	1974 Outturn[2]
Denmark (Dkr '000m)[4]	+ 4.4[5]	+ 5.5	+ 3.8[5]	- 2.2
F.R. of Germany (DM '000 m)	- 2.0[5]	- 2.2	-13.0[5]	-19.0
France (FF '000 m)	0.0[3]	+ 4.8	+ 0.1	+ 2.0
Ireland (£Ir m)[7]	-	- 209	-313	-339
Italy (Lit '000 m)	- 4.560[8]	-7.731	-6.940[8]	-7.569
Netherlands (Fl '000 m)	- 2.3	- 0.7	- 2.0	- 2.2
Belgium (Bfrs '000 m)	-91.1	-79.9	-83.2	-89.0
Luxemburg (Lfrs '000 m)	- 0.7	+ 2.3	- 1.1	+2.2
United Kingdom (£stg m)[6]	- 3.996	-2.222	-1.525	-3.930

1 Draft budget

2 Probable outturn

3 Disregarding the easing of indirect taxation (about FF 7.500 m) which was decided a the Finance Bill had gone to Parliament.

4 and 6 1973/74 and 1974/75 financial years.

5 Forecasts made in June/July of the corresponding or current year.

7 The 1973 forecast was drawn up in terms of the 1973/74 financial year.

8 Initial cash forecasts.

Source: Commission services

II. Monetary Policy

2.1. For most of 1974 all the member countries committed their monetary policies to the fight against inflation. This resulted in occasional liquidity shortages whenever interest rates were high. There are several reasons why these policies have not yet slowed down to any appreciable extent the rate of price increases:

(a) Monetary policy measures are felt only after a certain time lag.

(b) The restrictive policies pursued by the various countries were not properly synchronized. At a time when the monetary authorities of the member states, after the obligation to support the dollar had been removed, gained more scope for manoeuvre, it was, however, only in the Federal Republic of Germany and in the Netherlands, that restrictive measures were introduced up to the spring of 1973. In Italy and France the restrictive nature of monetary policy was not strengthened until much later in the year. The timing in the other countries varied between the two extremes .

(c) As inflation rates have increased, the control of the phenomenon has become all the more difficult. The effects of the restrictions were felt only during the second half of the year, mainly in the form of a fall in employment in most member countries. To a large extent, this is because firms and individuals based their pricing and their income objectives on the expectation that inflation would continue or even accelerate. Since the expansion in liquidity has not taken place, money demand has not been sufficient to guarantee full utilization of the production factors in question. Consequently, the restrictive monetary policies initially had a heavier impact on employment than on inflation itself.

(d) In a number of countries, the restrictive monetary policies pursued have lacked proper support from other stabilizing instruments, particularly in the budgetary field.

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2.2. Until the autumn, two major monetary stances were observed in the Community. Certain countries, namely the Federal Republic of Germany and the United Kingdom, did not tighten their restrictive policies relative to the previous year. The authorities were more concerned with limiting their effects and introduced cautious measures. to ease the situation. In other countries, however, not until 1974 did the monetary policy reach its most restrictive, the main feature often being the tightening of quantitative limits on the expansion of bank credit, particularly in Italy, France, Belgium and Denmark.

2.3. Only towards the end of the year did the monetary policies in all the Member States again converge, becoming more flexible. Very broadly speaking, the Community arrangements for supporting exchange rates facilitated coordination of the policies of the Member States participating in the scheme.

2.4. In most Member States, the money supply expanded less in 1974 than in 1973. However, on a year-to-year basis, the growth rates of the money supply in its narrow definition (M1) again tended to accelerate during the second half of the year in the countries which did not tighten further their restrictive monetary policies in 1974.

2.5. The changes in interest rates reflect the monetary policies pursued. Although the rates were generally high, the trends from country to country were well out of phase. For instance, interest rates in Italy, Belgium and France made up by the autumn the leeway resulting from the increases recorded in 1973 by the other countries. Increases, in some cases large increases, in the discount rate supported the dear money policy pursued in these three countries and in Denmark. By way of contrast, short-term interest rates in Germany, the Netherlands and the United Kingdom had already reached their maximum levels during the first six months of the year. Declining interest rates in the autumn in the United States allowed the countries of the Community sufficient freedom of action to relax their own interest rate policies. Towards the end of the year and in early 1975, the short-term interest rates were tending to ease down in all member countries. Between the middle of December 1973 and the end of January 1975 the discount rate was reduced in six member countries.

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2.6. Throughout almost the whole of 1974 capital-market rates were rising or stabilising at high levels in all the countries. Since savers expected the rates to increase further and since, in a number of countries, the return on short-term investments was higher than long-term interest rates, there was at times a good deal of unrest on a number of financial markets. After short-term rates fell in the second half of the year, the structure of capital market rates reverted to a more normal situation. But it was only towards the end of the year that long-term rates fell in most Community countries.

TABLE II

DEVELOPMENTS IN THE MONETARY SITUATION

	Money supply[1]						Short-term bank credit (annual growth rates, %)			Interest rates					
										Short-term[3]			Long-term		
	1972 2		1973 2		1974		1972[2]	1973[2]	1974	1972[2]	1973[2]	1974[2]	1972[2]	1973[2]	1974
	M1	M2	M1	M2	M1	M2									
Denmark	17.1	15.0	10.0	12.7	5.9[2]	8.9[3]	12.5	15.4	7.1	6.0	8.5	9.5[4]	10.4	12.2	14.6[6]
F.R. of Germany	14.4	16.9	1.8	13.8	10.9[2]	5.2[2]	18.8	6.2	8.7[4]	6.7	11.9	8.4	8.6	9.7	9.4[7]
France	14.9	18.6	9.7	14.3	16.3[4]	17.5	18.8	-0.8	17.8[5]	7.3	11.2	12.0	8.4	9.8	11.9[4]
Ireland	16.0	18.2	7.1	25.7	2.1[4]	17.5[4]	33.7	22.9	15.5	7.6	13.5	14.0	10.3	13.5	15.5[6]
Italy	17.3	18.2	24.5	23.3	15.6[5]	19.6[5]	19.5	17.2	24.0[8]	6.1	8.2	17.5	7.3	7.4	11.4
Netherlands	17.6	11.9	-0.2	22.0	8.4[4]	21.2[4]	15.2	34.5	26.6	3.2	8.8	7.0	7.5	9.0	9.0
Belgo-Luxemburg Economic Union	14.2	17.5	8.4	14.6	8.7[4]	10.2[6]	20.2	19.5	10.6[6]	3.7	7.2	9.0	7.2	7.8	9.0[7]
United Kingdom	14.2	25.4	4.5	28.5	8.3[4]	11.9[4]	57.1	11.5	15.0[6]	6.3	9.5	6.8	9.6	12.5	15.7[5]

1 M1 : note and coin in circulation plus demand deposits. M2 : M1 plus near-money

2 December

3 Interest rate on overnight loans; Denmark : 91 day certificates of deposit of the Nationalbank.

4 November

5 October

6 September

7 January 1975

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Source: Commission Services

III. Exchange-rate policy

3.1. In 1974, the international monetary system suffered major disturbances. Exchange rates of all Community currencies fluctuated markedly with respect to the dollar, but most showed a marked tendancy to strengthen in terms of that currency. Thus the currencies of those five countries which continued to take part in the Community system appreciated by about 10 % against the dollar; the French franc which left the "snake" in January 1974appreciated against the dollar by 5 %, and the pound sterling by 1 %. On the other hand the Italian lire depreciated nominally by about 8 %.

3.2. Weighted exchange rates have behaved differently from nominal rates (see graph over). The five currencies in the Community "snake" have appreciated less markedly , given the importance of trade between those currencies. The lira, the pound sterling and the Irish pound depreciated while, in the second half of the year, the French franc regained some of the ground it lost in the first half-year.

3.3. Among most Community currencies, the divergent exchange-rate movements reflected the trends in balance-of-payments positions. On the one hand, the Federal Republic of Germany, the Netherlands, and the BL.E.U. showed considerable current account surpluses ($10,000 million in all), despite the negative effect of the increase in the price of oil on their trade balances. On the other hand, the United Kingdom, Italy, France, Denmark and Ireland suffered severe deterioration in their current accounts, and their overall deficit reached nearly $ 24,000 million.

3.4. Developments in the current balances show very clearly that, at least untill now, changes in exchange rates within the Community have not brought about the hoped-for results. This can be explained by the fact that conjunctural policy , in the surplus countries as well as in the deficit countries, has given a greater priority to internal problems than to external disequilibria. Certain governments, after some delay, have tried to reorientate their internal policies in this respect.

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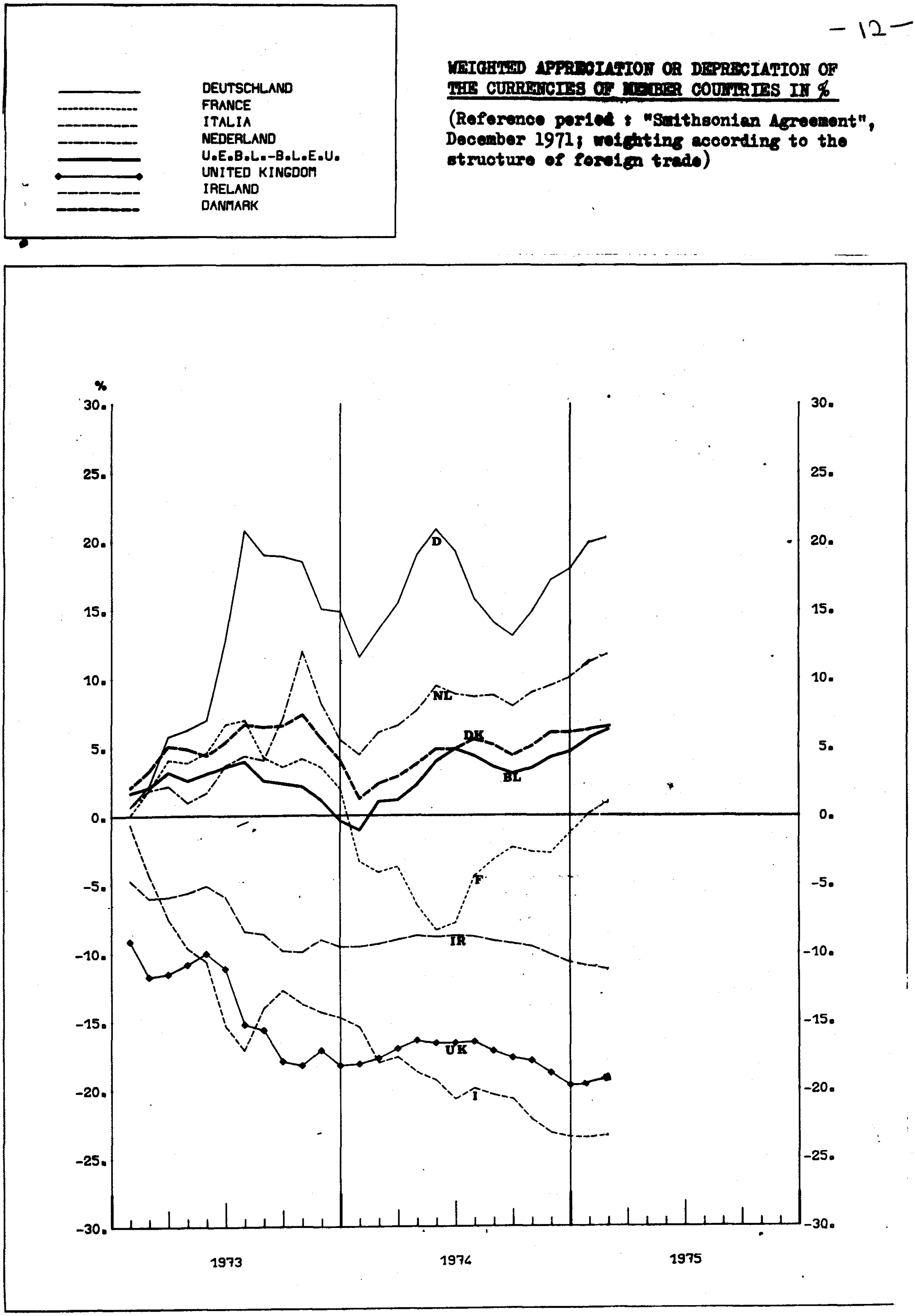
3.5. Despite what has happened to current balances, the official reserves of the member countries have not varied much, the only exception being those of Denmark, whose reserves fell 30 % during the year. The other member countries managed to compensate largely for their current deficits or surpluses by capital inflows or outflows. In certain countries, official exchange-market intervention has also helped to moderate exchange-rate movements.

WEIGHTED APPRECIATION OR DEPRECIATION OF THE CURRENCIES OF MEMBER COUNTRIES IN %

(Reference period : "Smithsonian Agreement", December 1971; weighting according to the structure of foreign trade)



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IV. Incomes policy

4.1. All the Governments in the Community attempted to regulate income growth and distribution, but most of them did so without reference to a clearly defined incomes policy and, generally, employing traditional demand-management instruments. A number of them preferred to rely more on prices policy measures, either temporarily freezing prices, as in Denmark and Italy, or controlling the increase in prices by various means: required prior announcements of price increases in Ireland, Belgium, the Netherlands, Italy and the United Kingdom; selective ad hoc measures in France; subsidies for companies in Denmark to offset the effects of wage increases; food subsidies and subsidies to nationalized undertakings in the United Kingdom. On the whole, the results were rather disappointing, as this type of intervention failed to neutralize the factors pushing prices up. In addition, the public authorities were seldom able to exert any great influence on the agreements negotiated between the unions and managements. Only in the United Kingdom and the Netherlands were real attempts made to lay down a pattern for income growth which was compatible with the overall objectives fixed; in the United Kingdom this took place within Stage Three and later within the "Social Contract" and in the Netherlands in accordance with the Special Powers Act, which allows the Government to lay down the rules under which increases can be decided by collective agreement.

4.2. In a number of countries income redistribution considerations also played a role. For instance, in Denmark and in Germany the tax reforms which were adopted in July and September respectively but which only came into force in 1975 included provision for higher tax-exempt allowances and the introduction of a new tax scale. In other countries, particularly Ireland, the Netherlands and the United Kingdom tax measures were also introduced to lighten the tax burden on the lowest incomes. Indeed, in November, the Netherlands Government announced an actual reduction in wage and income taxes as of April 1975. In Italy an exception was made to the measures adopted in July to restrict domestic demand, namely by raising the basic tax-free allowance.

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4.3. Social transfers were also increased in most countries in an attempt to provide better protection for certain sectors of society against the effects of inflation; this was the case in Belgium Ireland, France, the Netherlands and the United Kingdom. In particular, nearly everywhere retirement and widows' pensions and minimum guaranteed earnings were raised.

4.4. The deterioration in the employment situation induced the public authorities in most countries to raise unemployment benefits and in some cases to extend the maximum periods of compensation.

4.5. The authorities were in addition anxious to encourage saving. Compulsory savings arrangements became operational in Denmark in the autumn for certain income brackets and the amounts of saved income qualifying for tax-exemption were increased in Belgium in July.

<u>TABLE III</u>

SOME INDICATORS OF THE GROWTH OF INCOMES, PRICES AND COSTS

(Increases as % of preceding year values)

	GNP in value		Change in terms of trade as %		Price of National Expenditure		Wage and Salary Bill		Wage and Salary Bill as % of National Income		Wage and Salary Bill per unit of output		Real wage per head (1)	
	1973	1974	1973	1974	1973	1974	1973	1974	1973	1974	1973	1974	1973	1974
Denmark	15.0	15.0	+ 1.9	- 14	9.9	17.6	14.7	21.1	71.7	74.9	10.5	19.3	4.4	5.8
Germany	11.5	6.5	- 2.8	- 9	6.8	7.8	13.5	9.6	70.0	71.5	7.8	8.9	5.3	3.8
France	13.6	13.7	+ 1.9	- 18	7.1	13.5	15.1	19.8	67.0	69.9	8.6	15.4	4.9	3.6
Ireland	20.0	9.5	+ 7.5	- 15	12.3	16.9	18.4	19.7	64.2	68.5	10.4	17.9	4.4	1.7
Italy	17.0	19.0	-10.0	- 18	12.6	19.8	20.0	23.5	64.7	67.1	13.3	18.6	6.5	1.2
Netherlands	12.5	11.1	- 1.0	- 6	8.4	11.8	14.2	15.2	69.8	71.8	9.8	11.3	4.8	4.6
Belgo-	13.4	15.0	+ 2.0	- 4	7.7	12.6	14.9	18.5	65.6	67.6	9.0	13.6	6.5	4.5
Luxemburg Economic Union	19.7	12.0			8.0	12.7	13.6	19.8	70.0	74.5	5.7	14.2	4.7	7.1
United Kingdom	13.1	11.9	-14.7	- 15	9.5	16.1	14.1	18.3	76.8	81.2	8.4	16.1	3.0	1.8
E.E.C.	13.3	12.0	- 5.7	- 14	8.5	13.2	15.0	16.5	69.5	71.7	9.0	14.2	4.9	3.3

(1) Change in wage and salary bill per employed person, corrected by the change in the price of private consumption.

<u>Source:</u> SOEC and estimates by Commission services.

TABLE IV

WAGE COSTS IN INDUSTRY PER UNIT OF GROSS VALUE ADDED AT CONSTANT PRICES

(including construction)

	% increase on preceding year						1970-1974 % increases in national currency	1970-1974 % increases in EUR (1)
	Figures in national currency			Figures in EUR 1)				
	1972	1973	1974	1972	1973	1974		
Denmark	4,0	8,8	18,5	3,0	8,8	18,5	46	44 ½
Germany	4,6	6,9	8,8	9,2	12,4	12,5	32	50
France	6,4	7,6	14,5	6,4	7,6	5,8	39	28 ½
Ireland	8,5	8,9	18,5	3,5	- 6,8	13,5	54 ½	20 ½
Italy	5,5	12,4	17	4,4	- 2,6	4,7	55 ½	19 ½
Netherlands	3,0	9,7	11	5,7	11,2	14,7	32 ½	43
Belgium	7,1	7,9	13	10,0	7,9	13	40	43 ½
United Kingdom	9,7	7,5	26	4,7	- 8,2	21,1	60	25
United States	1,2	3,1	8,7	-6,6	-10,5	8,1	14 ½	- 8 ½

1) Calculated on the basis of figures in national currencies, adjusted for exchange rate variations in relation to the Eur.

Sources : Estimates by Commission's departments