

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(81) 131 final

(Revised text of the
doc. COM(81) 95 final)

Brussels, 18th March 1981

THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the European Council,
Maastricht, 23 and 24 March 1981)

COM(81) 131 final

1. Recent economic performance in the Community

The slow-down in economic activity in 1980, with GDP growing 1,3% in the EC as a whole, was approximately as foreseen by the Council in in December of last year. Output peaked in the first quarter of 1980, but declined thereafter. However, private consumption was probably beginning to grow again in real terms by the end of the year, while the EC business surveys showed first signs that the sharp deterioration in business sentiment may have been arrested.

There was hardly any increase in employment in 1980, while the labour force continued to expand rather rapidly. The result was a sharp rise in unemployment: the average rate for the year was 6,0%, and by the beginning of 1981 had passed 7,0%. Over the last twelve months the unemployment rate increased most in Denmark and the Netherlands (up by about one half) and the United Kingdom (up by two-thirds). The additional cost to the national exchequers of the rise in unemployment amounts for the Community as a whole to some 0,15% of GDP for 1980 compared to 1979.

The deterioration in inflation performance which had begun in 1979 was accentuated in 1980; the increase in consumer prices in the Community on average reached 12,1% in 1980, compared to the low point of 7,3% in 1978. Divergence between consumer price rises of Member States also widened to twice the average for the seventies as a whole (the standard deviation rose to 5,6%). However, a somewhat better performance was evident in the second half of the year, especially in the United Kingdom where the annual rate had fallen to below double figures.

The Community's current account deficit in 1980, expressed as a percentage of GDP, was the largest ever recorded. In contrast with 1979, there was some improvement in 1980 in export in relation to import volume. However, this was more than offset by a terms of trade deterioration (2,8%) considerably larger than that in 1979 (although this was still very much smaller than that suffered in 1974 after the first oil-price shock).

Exchange-rates developments in the EMS in 1980 were limited to movements permitted by unchanged central rates. However, the UK pound appreciated 15% against the ECU in the course of the year, and the Yen 24%. The US dollar was on a declining trend against the ECU until mid-year, but has since recovered substantially.

2. Outlook for 1981

The present cycle is now seen as being sharper and deeper than anticipated. The starting point, the high level of activity in early 1980 has been again revised upwards, with the steeper fall later in 1980 then carrying a heavier recessionary momentum over into 1981. Domestic private demand (consumption, stockbuilding and investment) wholly accounts for the more pronounced cyclical profile. Foreign demand has stayed on the expected path, while government consumption in volume terms is still expected to grow slightly in 1981. Thus the revised forecasts prepared by the Commission's services in February suggest that the upturn in activity may be delayed until the third quarter of 1981, two quarters later than earlier expected. GDP growth at an annual rate of about 2% is now expected in the second half of 1981 and into 1982. The year on year growth of GDP for 1981 for the Community as a whole is revised down from + 0,6% in the Annual Economic Report to - 0,6%.

Employment could fall by nearly 1%, and by the end of the year the unemployment rate could be above 7 1/2% ⁽¹⁾ and still rising.

A significant slowdown in consumer prices can be expected during the course of 1981, as the effect of more moderate wage settlements in the first half of the year is reinforced by some rebound of productivity in the second half. Although consumer prices for 1981 as a whole could be up by around 10 1/2% on 1980 (Table 1), the annual rate in the second half of the year could, at 8,2%, be 4 1/2 points lower than in the second half of 1980. Divergence of inflation rates should also lessen somewhat, with the standard deviation of consumer prices increases falling back to 4,6%.

The Community's balance of payments current account is likely to change little during the course of 1981 and for the year as a whole could be slightly worse than the high deficit recorded in 1980. A further worsening of the terms of trade in 1981 will slightly more than offset an improvement in volume movements.

3. Policy issues

The Council is required (according to the 1974 Convergence Decision) to deliberate in March as regards possible adjustments to the economic

(1) Seasonally adjusted figure.

policy guidelines adopted in the Annual Report in December.

At the time the Council concluded that the policy mix should give priority to the reduction in inflation, savings in oil imports, and the pursuit of the other necessary structural changes in the Community economy, and be only moderately supportive in terms of cyclical demand management. The weaker economic outlook cannot imply an easier way out of the constraints. While the evolving situation calls for technical adjustments to some financial policies, the fundamental line of policy - to reduce inflation and push ahead with structural adaptation - has to be pursued with even greater urgency.

Control of domestic monetary aggregates and exchange rates within the European Monetary System has on the whole been satisfactory. However, monetary policy in Europe has been and is still confronted with the need for a concerted reaction to the very high and volatile interest rates prevailing in the United States, and to the appreciation of the exchange rates of the dollar and yen.

The appreciation of the Yen appears to be justified in the light of Japan's trading performance. With respect to the United States' monetary policy, Europe is much affected by both interest and exchange rate movements.

If European interest rates now moved further up on average towards United States levels, it is quite likely that as a result there would be no cyclical recovery in Europe this year. On the other hand, a further substantial depreciation of European currencies against the dollar could risk causing a new acceleration of inflation in the Community, through the increase in import prices in European currencies. Moreover, erratic swings in either exchange rates or interest rates are costly to the economy through the uncertainty that they introduce.

In view of its large current account deficit on the balance of payments, the Community should be prepared to accept higher dollar exchange rates than prevailed in 1980 on average. The inevitability of this deficit in the short-run means that its financing should be carefully prepared. This in itself should pose no insuperable problems; the Community has for its part in February renewed and expanded its own recycling facility. Experience confirms how quickly conditions may change as between EMS currencies and the main floating exchange rates, and Europe should not make fundamental changes in its domestic monetary policies in response to volatile exchange rate movements. The United States authorities for their part could contribute to the international interest by managing their budgetary-monetary policy mix and the techniques of monetary policy with a

view to reducing the level of interest rates consistent with a stable evolution of money supply.

Within the Community, Member States must match the difficulties of transatlantic monetary conditions with intensified cooperation as regards interest rate adjustments, intervention policy and official capital movements. In addition to full use of the mechanisms of the European Monetary System, there would seem now to be opportunities for adjustments of United Kingdom monetary policy as regards interest rates and criteria of exchange rate management.

Apart from the increase in unemployment a consequence of the weaker level of activity in 1981 is some increase in budget deficits over what had been forecast in the Annual Report. However, the structural weaknesses in parts of the European economy are such that a full play of the 'automatic stabilisers' cannot be risked in all countries. In particular, countries with the highest deficits (Belgium, Ireland, Italy) should act to prevent increases. Further increases in these countries' deficits cannot provide any sustainable increase in economic activity; on the contrary, increased deficits - whether spontaneous or discretionary - are likely to cause swift and significant interest rate increases. Among these countries, Italy has made progress in 1980 in reducing the borrowing of general government to well under 10% of GDP, and this should be conserved in 1981. In the case of Ireland the projection of a reduced deficit in relation to GDP is also significant, particularly in view of the increased spending on public investment. In other countries, some increase in budget deficits should be permitted to support activity; indeed the 'automatic stabilisers' should be allowed to operate fully in countries with the least high deficits. However, even in these cases, priority must be given to restructuring expenditure to improve productive potential.

Extensive structural problems have to be overcome to achieve higher trend rates of growth and employment. Policy must intensify efforts to improve productive potential by redirecting budgetary resources from subsidies that are supporting uneconomic or non-priority activities, into aiding public or private investment. The investment ratio has declined from 23% of GDP in 1970 to 21% in 1979 in the Community as a whole. Meanwhile, over the same period it seems that (subject to difficulties of statistical measurement) investment grants remained static at 1% of GDP, whereas subsidies

(notably operating subsidies, excluding tax expenditures) rose from 1,8% of GDP to 2,6%, with particularly large increases recorded in some countries. Justifications for higher or more rapid fiscal depreciation allowances exist in the accelerated obsolescence of existing capital stock due to the higher energy prices, and in the need to achieve fundamental improvement in industrial competitiveness vis-à-vis third countries. The Commission for its part is following these principles in areas of Community responsibility, having recently proposed a reduction of state aids to steel,⁽¹⁾ an increase in producers' financial co-responsibility for surplus agricultural production,⁽²⁾ and a strengthening in Community loan instruments for financing investment.⁽³⁾

Progress is being made in reducing the Community's dependence on imported oil. The share of imported oil in gross inland consumption of primary energy fell from 48% in 1979 to 44% in 1980, and is expected to fall further to 42% in 1981. The volume of net oil imports dropped by nearly 11% in 1980 and should further fall 5% or more in 1981.

However, much more progress must be achieved before the Community could consider its macroeconomic policy to be no longer constrained by energy market factors. Energy production and savings must be boosted by every possible means. Obstacles such as delays in investing in nuclear power and coal use, or failure to make timely adjustments to energy consumption taxes so as to sustain the 'price message', will ultimately exact an extremely high price in living standards. Several countries are relatively well endowed in hydrocarbon resources (Netherlands, United Kingdom) or have reasonable chances of becoming much more self-sufficient (Ireland, Denmark); France is making particularly rapid progress with other energy forms. Belgium, Germany and Italy - while making efforts in certain areas of energy production or saving - need urgently to strengthen major features of their national energy programmes, or their implementation. Examples of below-average taxation of energy consumption include heating oil in general as between forms of hydrocarbon consumption, and, as between Member States in relation to the Community average, heating oil in Germany, Belgium and the United Kingdom, petrol in Germany and Luxembourg and diesel oil in Italy and Luxembourg.

(1) COM (81) 71 final

(2) COM (81) 50 final

(3) COM (80) 670 final

