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THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the European Council of 21-22 March 1983)

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I. Introduction

In early 1983, the Community economy is hesitating.

1. Recent indicators point to some incipient recovery in a number of Member States that is attributable in part to the more favourable trend of the US economy since the end of 1982, to the downward movement in interest rates internationally and, with some reservations, to the prospect of an easing of the oil constraint.

This does not mean that the end to the recession is already assured. The favourable developments observed still need to be confirmed as to their scale and duration. In addition, many of the world's economies have not as yet adjusted sufficiently to the consequences of the 1979 oil shock and the trend in the dollar since 1980. The international financial situation also needs to be closely monitored.

2. There is thus the chance of a positive turnaround, but there are also uncertainties. This chance to start bringing down unemployment through non-inflationary and hence sustained growth is offered to us for the first time in several years and must be seized.

For this reason, the ways and means of accentuating the favourable tendencies and initiating a period of sound growth must be the main point of the debate that is started at this European Council, will continue at the OECD and at the Williamsburg Summit, and will be completed at the European Council to be held in June.

3. This memorandum should help to launch the discussion and prepare the ground for follow-up action at Community level:

- it gives a brief description of the current economic situation and of the outlook for the immediate future,

- and sets out a number of thoughts on how to manage the recovery, that is to say on how to reinforce it and make it last.

II. The present situation and immediate outlook

A. Developments in 1982

1. On account of a very pronounced fall-off in the third quarter, growth in the Community in 1982 was weaker than forecast: it was 0.2% in volume terms, with Denmark showing the largest increase of 2.3% and Germany and the Netherlands recording declines of 1% and 1.5% respectively. This experience was common to all the industrialized countries, their real output falling in 1982 for the first time since 1975.

Much of the deterioration was due to the combined impact of:

- a worsening in the recession in the United States, where real GDP declined by 1.7%;
- a contraction in world trade attributable to cyclical conditions but also to the growing difficulties in international financing. World trade, which had expanded at an average annual rate of 6.9% in volume terms between 1976 and 1979, declined by 1.5% in 1982, after having been flat in 1981.

2. The number of people out of work continued to climb, to reach 9.6% of the labour force in 1982 on average, i.e. a level 75% higher than in 1979. As a result, unemployment in the Community, which, on average, has not shown any contraction since 1973, has risen steadily since 1978/79.

3. Two more positive aspects should be stressed:

- inflation, which dropped from 11.8% in 1981 to 10.5% in 1982, has eased in all Member States. However, the slowdown is less pronounced than in the United States or Japan and, what is more, quite marked divergences are still discernible within the Community. Inflation is below 6% in Germany and the Netherlands and has been brought down from 15.5% in 1980 to 8.5% in 1982 in the United Kingdom but it is still running at over 15% in Greece, Ireland and Italy;
- for the Community as a whole, progress in bringing the current account of the balance of payments back into equilibrium has been faster than anticipated; the deficit was equivalent to only 0.5% of GDP in 1982 compared with 1.3% in 1980.

Here too, the overall result masks sharp divergences between Member States. Belgium, Denmark, Greece, France, Ireland and Italy are in deficit while Germany, Luxembourg, the Netherlands and the United Kingdom are running a surplus, in some cases a large one.

B. Outlook for 1983

1. The forecasts at present available for 1983 are subject to three external factors of uncertainty:

- the first is the scale and duration of the US recovery, which are bound up *inter alia* with the prospects for interest rates, themselves dependent to a large degree on how developments in the Federal budget deficit will affect monetary policy;
- the second factor of uncertainty has to do with international financial developments;
- lastly, there is no way of knowing at the moment what the full extent or effects of the fall in oil prices will be.

Confirmation of the upturn in the US economy and, under certain conditions, a decline in oil prices should make it easier for the European economy to pick up again, although the combined effect of these two factors cannot be expected to alter fundamentally the profile for 1983.

2. The poor performance in the third quarter of 1982 has made it necessary to revise the GDP forecast for 1983 downwards for virtually all Member States (an increase of only 0.4% in volume terms compared with one of just over 1% forecast at the end of last year). Growth is expected to pick up during the second half of the year, helped by restocking, some support from public-sector demand and a recovery in exports, while private consumption and, at least in the first half of 1983, investment are unlikely to make any major contribution to a revival in activity.

These forecasts are based on a very cautious assumption regarding oil prices. All in all, in the present cyclical situation, the strength and duration of the hesitant expansion which is now getting under way are not assured even if the tendency towards recovery were to be more pronounced than expected.

3. According to present forecasts, there will probably be a further slowdown in the rate of inflation: in 1983, this rate is likely to be 8.6% for the Community as a whole, which is the lowest for seven years (with the exception of 1978 when it was 7.1%). While the need for consolidation remains as pressing as ever and differences in inflation rates will not disappear, 1983 is likely to see some narrowing of the differences in price rises within the Community: the rate of inflation will probably be slow in the Federal Republic of Germany and the Netherlands and relatively moderate in many countries (Belgium, Denmark, Luxembourg, France and the United Kingdom).

4. Unemployment, on the other hand, is likely to continue to rise in 1983 throughout the Community: the average rate of unemployment as a proportion of the labour force will easily exceed 10% in 1983, giving a total of more than 12 million jobless; the rates of increase will vary from one Member State to another.

5. The prospects in 1983 should see further improved equilibrium in the balance of payments on current account, with the deficit for the Community as a whole likely to fall to approximately 0.3% of GDP, notably as a result of reduced deficits in Belgium, Denmark, France, Ireland and Italy.

III. Guidelines

Despite the modest outlook for growth and the present uncertainties, there is a possibility of a change of trend, of a gradual upturn in the economy and therefore of a check to and then a reversal of the unemployment trend. If we miss this opportunity, the danger of continued stagnation is likely to increase. It is therefore more than ever necessary to define a common approach which can encompass the various elements of healthy and sustained growth.

The following three lessons can be drawn from the experience of recent years:

(a) The crisis, which is both cyclical and structural in nature, calls for national policies which are directed equally towards stability (the fight against inflation) and - if the employment problem is to be solved - towards the development of productive activities through creation of the conditions necessary for growth (improvements in supply, investment, mobility and competitiveness). No international cooperation will remove the need for such efforts.

(b) The Community, which is a large integrated market helping, through the EMS, to pull individual policies closer together and so to make them more effective, which acts as a catalyst for the strategies pursued in the fields of investment, industrial development and energy, and which is an influential spokesman in dealings with the outside world, is an asset which must be exploited at all costs. This theme is one which constantly underlies the Commission's actions and which the European Council has begun to examine. The fact that it is not set out in detail in this Communication in no way lessens the degree of priority it is given nor the obligation to observe the programmes laid down and to propose new courses of action.

(c) Economies are now so interdependent that no national policy can be sure of success without an orderly external framework. It is this order which is lacking, depriving economies and firms of a sufficiently stable environment, distorting expectations and altering management conditions through abrupt and unforeseen changes which do not reflect economic fundamentals. The economies which are most market-oriented cannot endure the present level of disorganization in the international economic system. Here lies also one of the dangers of rising protectionism, which we must join forces to roll back. The Community must cooperate with its main partners in order to assure the international conditions of a recovery - particularly in trade, financial, monetary and interest rate policies, but also in the economic domain proper.

This document, drawn up ahead of important international meetings, is largely centred on this final aspect. If recovery is to be brought about, it is not so much ad hoc measures, however firm they may be, but rather the awareness of interdependence and the manner of administering that interdependence more effectively which must form the substance of future concerted action.

It is with this in mind that the Commission, aware that the evidence which it has cited is now beginning to be generally accepted, proposes that discussions should cover five points relating to the strengthening of international economic organization or to the search for a cohesion in national policies which will improve the chances of a return to growth.

A. The security of the international financial system

1. The level, in absolute terms, of the indebtedness of the developing countries, the level of real interest rates and the effects of stagnation have created strains in the international financial system. Reactions have been rapid and effective: the amendment of the General Arrangements to Borrow, the increase in IMF quotas and the way in which a number of specific cases have been settled all bear witness to this fact.

2. These results do not obviate the need for continued and more thoroughgoing work to consolidate a still fragile situation. In addition to the decisions already taken, lessons must be learnt from developments which the western world has been unable to ward off.

Priority must be given to establishing an information and monitoring mechanism, to reinforcing the capacity of the international financial system as a whole to react, and to improving preventive machinery. In these various fields, the Community must define common positions and cooperate with its partners in order first to consolidate the results achieved and then to establish means of preventing a repetition of similar situations.

3. The solutions adopted will have to take account of a second factor: one of the reasons for the present stagnation lies in the low level of international demand. The Community and its Member States must therefore actively help to maintain an adequate flow of funds to the developing countries, both via the banking sector and through official development aid. The aim must be to carry out the necessary adjustment and at the same time to maintain international trade at an adequate level.

This last point is all the more important in that the health of the international financial system will depend greatly - through the development of trade, improved terms of trade and the reduction of indebtedness - on strong and lasting growth.

B. The stability of the international monetary system

1. One of the major lessons to be learnt from recent events is that the international economy can no longer withstand upheavals in its essential components. This applies not only to energy prices and interest rates, but also to exchange rates.

Volatile exchange rates, whose financial function is ominously tending to supplant the trade function:

- make business decisions more difficult at a time when a vigorous investment effort is a key condition for recovery;
- above all, disrupt trade relations to an intolerable extent, and jeopardize the maintenance of free trade.

2. The EMS, an essential element of stability, has shown, despite its setbacks, the value of systematic monetary cooperation. It is a major asset for internal Community purposes and a valuable means of influencing international monetary developments. Consequently:

- the Council of Ministers, and subsequently the European Council, should give careful thought to strengthening it and extending it to include sterling and the drachma;
- for the reasons which led to the setting up of the EMS and for basic economic reasons, the Community must get its partners to share its determination to stabilize international exchange rate relationships.

3. A step in this direction was taken at the Versailles summit. The Community must not be content with adopting a common position on the follow-up to the study of intervention problems. It must also persuade the United States and Japan of the importance of bringing exchange rates more into line with economic facts and of bringing down real interest rates. It must put across to them its view of how monetary cooperation should be organized. The Commission will put forward guidelines for this purpose and hopes that a Community position on these points can be voiced clearly at Williamsburg.

C. Oil prices, growth and energy policy

1. The recent drop in oil prices is likely under certain conditions to produce a moderate but real increase in growth, and this is to be welcomed.

However, the net results are difficult to forecast in any detail: they will depend on the impact of physical, financial and psychological threshold effects. Price falls that are visible but smooth are likely to be beneficial in terms of prices, external equilibrium and growth, without affecting unduly the pursuit of energy policy. But tumbling prices would jeopardize the policy on energy restructuring and impose strains on the international financial and trade equilibrium.

2. The Community must therefore help to keep matters on an even keel; this requires close cooperation with the Community's partners, notably the industrialized countries, so as to ensure a common view and consistent attitudes, including, if necessary, the provision of safety nets.

In this area of essential importance for economic growth and the pursuit of energy objectives, the Community must establish its general approach at the highest level. It will then be for the Commission and the Council of Ministers to implement it and follow up its effects.

D. Monetary policy

1. In last December's guidelines, priority was given, wherever economic policy conditions allowed, to the pursuit of monetary policies that would make for a fall in real interest rates and underpin the recovery in growth.

2. The Commission proposes that the European Council confirm this priority. It is a key element in consolidating the recovery both within the Community and internationally, especially as a fall in real interest rates is the best way of stimulating investment and reducing the burden of internal and external indebtedness.

It is therefore essential that those Member States which have been the first to achieve favourable results in terms of inflation and the balance of payments (the Federal Republic of Germany, the Netherlands and the United Kingdom) should pursue their monetary policy with the degree of flexibility and openness that is consistent with a steady and lasting fall in real interest rates. Closer monetary policy coordination and greater efforts to achieve economic convergence within the EMS would help to extend the benefits of this policy to the whole of the Community.

3. The same need to provide rapid support for the early signs of recovery is evident at international level, especially as the results achieved in the United States will be decisive even for the success of our own efforts. The Community must endeavour to get its main partners to recognize explicitly the central role of lower interest rates in improving the economic situation and the need to pursue the measures that will allow this objective to be attained, and to affirm their desire to establish the necessary close cooperation.

E. Public finance

1. With regard to public finance, the two-pronged approach adopted in December remains entirely valid. The first element was the steadfast pursuit of efforts to bring the deficits and the growth of the budget aggregates under control and to change the emphasis of budget structures, with a shift towards investment. But provided that this general line was observed, a second element was that in certain Member States, for example the Federal Republic of Germany and the United Kingdom, when the results of current policies permitted, public finance could be used to fuel the upturn, in fostering the development of productive activities by stimulating investment, adjusting taxation or reducing company costs.

2. At any event, the present situation holds out two definite, and one possible, courses of action for these few countries in the use of public expenditure:

- the basic principle to be respected absolutely must be to restore or to reinforce confidence in governments' ability to bring budgets under control; this means that every instance of the use of public finance must be compatible with the fight against inflation, must comply with the imperatives for restructuring public expenditure, and must not impede the rundown of the deficits; these are the essentials for credibility in a situation where lack of confidence is rife;
- even if the "automatic stabilizers"[1] must, in any event, operate on the assumption that developments are disappointing, they must not be allowed, with the first uncertain signs of recovery, to move prematurely in the direction of lowering deficits;
- lastly, despite the hopes that the economic situation will improve, should it not do so as rapidly and as substantially as wished, there is no reason why, in the present situation, certain Member States should rule out the use of cyclical budgetary action which satisfies the above conditions and will consolidate an upturn which is still hesitant.

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[1] By "automatic stabilizers" is meant those public expenditures or receipts whose impact tends to attenuate economic fluctuations.

The question whether to pursue such a course of action must be decided soon, i.e. as soon as the facts are clearer, so that if it is decided to go ahead action can be taken at the right time in the cycle. The decision ought to be taken as part of the process of determining internationally coordinated economic action in the few weeks between the next European Council meeting and the Williamsburg Summit.

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To permit Europe to approach the forthcoming international meetings in a position of initiative, the European Council should approve the proposed guidelines on the five main domains of action indicated above, and take the procedural decisions necessary for the Council of Ministers to assure their rapid and precise implementation.

TABLE 1: **Gross domestic product at constant and current prices, and deflator of GDP** (percentage change on preceding year, EC countries, EC, 1981-1983)

	at constant prices			GDP deflator			at current prices		
	1981	1982	1983	1981	1982	1983	1981	1982	1983
B	−1,7	−0,7	0,4	5,4	7,7	6,6	3,6	6,9	6,2
DK	0,1	2,3	0,9	10,9	10,3	7,7	10,9	12,8	8,6
D	0,1	1,0	0,2	4,2	4,8	3,9	4,2	3,7	3,6
GR	−0,7	0,4	0,8	19,7	18,1	20,9	18,9	18,5	21,9
F	0,3	1,4	0,8	11,7	11,3	10,3	12,0	13,4	11,2
IRL	1,1	1,4	1,5	17,8	18,5	12,5	19,0	20,2	14,2
I	−0,2	−0,2	−0,3	17,6	17,6	15,0	17,4	17,5	14,7
L	−1,8	−1,6	−1,1	8,1	8,6	8,5	6,1	6,9	7,3
NL	−1,2	−1,5	0,1	5,6	5,9	1,7	4,3	4,3	1,8
UK	−2,0	1,2[1]	1,5	12,1	8,2	5,8	9,9	9,5	7,4
EC	−0,4	0,2	0,4	10,6	10,5	8,6	10,1	10,7	9,1

[1] Expenditure based measure. The compromise estimate which also takes into account the output and income measures of GDP is expected to rise by 0,75%.

Source: Commission services

TABLE 2: **Components of demand** (percentage change on preceding period at constant prices, EC, 1981-1983)

				half years[1]			
	1981	1982	1983	82.1	82.2	83.1	83.2
Private consumption	0,2	0,1	0,1	−0,1	0,3	0,1	0,2
Government consumption	1,5	0,8	0,6	1,7	0,4	0,7	0,9
Fixed capital formation	−4,7	−3,0	−0,4	−2,9	−3,7	0,0	2,7
GDP	−0,4	0,2	0,4	1,2	−2,0	0,8	2,1

[1] Half yearly figures at annual rates, seasonally adjusted (82.01 = first half 1982, etc.)

Source: Commission services

TABLE 3: **Main economic aggregates** (EC countries, EC, 1981-1983)

	Unemployment rate[1]			Private consumption prices[2]			Balance on current account in % of GDP			General government net borrowing in % of GDP			Money supply M2/M3[3]		
	1981	1982	1983	1981	1982	1983	1981	1982	1983	1981	1982	1983	1981	1982	1983
B	11,7	13,9	15,4	9,1	8,8	7,4	−5,4	3,8	3,1	13,3	13,2	12,3	6,6	5,8	6,0
DK	8,4	9,1	10,0	12,1	9,9	8,0	3,1	−4,5	−3,8	7,1	9,2	9,7	9,6	12,0	9,0
D	4,7	6,8	8,9	6,0	5,3	3,7	1,1	0,5	0,6	4,0	3,9	4,1	5,0	7,1	6,5
GR	4,0	5,0	5,2	24,4	21,3	22,0	2,1	5,7	−4,7	10,1	8,7	8,9	34,3	27,8	26,0
F	7,3	8,3	8,9	12,5	11,2	8,9	−1,8	−2,4	−1,7	1,5	2,8	3,1	11,4	12,5	10,5
IRL	10,5	12,1	14,7	19,6	17,5	12,0	−13,2	−8,0	−5,9	15,4	15,0	13,0	17,4	14,2	16,1
I	8,8	10,4	11,3	19,0	16,5	14,0	−2,3	−1,5	−0,7	11,9	12,0	10,8	16,0	19,0	17,0
L	1,0	1,2	1,8	7,7	10,0	9,0	31,0	30,2	29,8	0,7	1,7	1,6	:	:	
NL	7,3	10,5	13,3	6,5	5,5	3,0	2,4	3,3	1,4	4,6	6,0	6,2	5,2	7,6	5,2
UK	9,2	11,4	12,2	10,9	8,5	7,0	2,4	1,5	0,3	2,1	1,0	0,9	14,6	10,3	10,3
EC	7,9	9,6	10,6	11,8	10,5	8,6	0,5	−0,5	−0,3	4,8	5,0	5,0	10,8	11,5	10,4

[1] Number of unemployed as percentage of civilian labour force (SOEC definition) except GR (national definition). UK: new definition in 1982.
[2] Percentage change on preceding year.
[3] Percentage change at end of year on twelve months earlier. F, NL: M2; D, GR, IRL, I: M3; B, DK: M2H; UK: £M3.

Source: Commission services

Note: The above forecasts were completed in early February 1983 and do not take into account the effects of the Irish budget of 9 February.