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1. The Community economy under the impact of the oil shocks

Since 1973, economic policy has had to manage the super-imposition of major external shocks - in the oil price rises of 1973 and 1979/80 - on top of the traditional business cycle fluctuations. The second oil shock largely precipitated a turning point in the Community economy during the early months of 1980, after two-and-a-half years of steady upswing. While the increase in oil prices in the two episodes has in real terms (constant dollars) been of similar order of magnitude, several other conditions have been quite different. Capacity utilisation was higher in 1973 than in 1979. Price increases for non-oil commodities have been less than half as great in the second episode. Exchange-rate appreciation of European currencies against the dollar has also diminished the oil price impact on this second occasion, although this has also come with a weakening in demand for Community production in home and external markets. A more stable internal and external monetary policy has come with a more moderate wage reaction to the second oil shock. Overall, a lesser weakening in output trends is expected in 1980 and 1981 compared to 1974 and 1975, reflecting a steadier pattern of investment and consumption behaviour and smaller swings in sectoral financial balances. GDP growth in the Community as a whole is expected to remain positive in 1980 and 1981 (+1,3% and +0,6%). However, there is evidence to suggest that the underlying rate of growth of production potential has declined substantially from about 4 1/2% up to 1973 to perhaps about 2 1/2% since then.

The size of the oil shocks compared

The Community is now in the process of adjustment to a new increase in the price of oil of such a magnitude that it can be expected to have a major impact upon the pattern of demand from households and the choice of techniques of production in enterprises. Given the considerable influence of this event, both on short-term stabilisation policy and on longer-term economic prospects, it is important that policy decisions should take full account of the impact of the oil price increase on domestic prices, real incomes, balance of payments etc. so as to undertake adjustment policies on the relevant basis. In order to bring into relief the effects of the oil price increase, it is useful to introduce a distinction between these effects and the normal cyclical development of the economies. With this purpose in view, this section presents the essential results of estimates of the impact of the oil price, considered in isolation. The following section, in contrast to this somewhat theoretical presentation, provides a broader picture of the actual development of the Community economy after the first oil shock and during the period immediately following the most recent oil price increases.

From December 1978 to the middle of 1980, the average dollar price of oil rose from just over \$ 13 per barrel to almost \$ 33. In percentage terms this represented an increase of about 150%, much less than the 365% increase which occurred in the final months of 1973, but of course this earlier increase was from a very low base. Almost \$ 20 was added to the price of oil in 1979-80 compared with a rise of \$ 7,3 in 1973. Even when account is taken of the increase in prices generally which occurred in the Community between the two shocks, the addition to the oil price in 1979-80 is still somewhat larger than that in 1973 (\$ 8,7 and \$ 7,3, respectively, at constant prices).

The direct cost of the oil price rises to the Community's trade balance, ignoring exchange-rate changes and any reduction in the volume of oil imports, is almost \$ 70 billion for the 1979-80 rises⁽¹⁾ compared with some \$ 31 billion in 1974. Expressed as a percentage of Community imports of goods and services in the years preceding the oil shocks, the costs to the trade balance are of similar magnitude (13,4%, compared to 13% respectively)

As a percentage of GDP the dollar increase in the oil bill⁽²⁾ was 3,4% in the case of the recent price rise, as against 2,9% in the earlier case (figures based on 1978 and 1973 GDP respectively). However, exchange-rate performance, here summarised as the ECU's rate against the dollar, has been significantly different as between the two episodes. After the first oil shock the dollar oil price rise was amplified for the Community by the depreciation of the ECU (of 7,4% in 1974 as a whole over September 1973), whereas after the second oil shock the dollar price rise was eased for the Community by an appreciation of the ECU (of 5,4% in the first eight months of 1980 over December 1978). While it is difficult to select the appropriate exchange-rates to be used in these calculations, the above rates have the effect of changing the percentage of GDP represented by the oil price rise to 3,1% for the first oil shock, and 3,0% for the second (compared to the 2,9% and 3,4% figures quoted above). Thus, the oil shocks are now of even closer size, with the exchange-rate factor diminishing the direct impact in the case of the second oil shock.

(1) In fact, due to a decline in the volume of oil imports of around 10%, the increase in the Community's oil bill between 1978 and 1980 is expected to be about \$55 billion.

(2) With the volume of imports unchanged.

The theoretical impact on the price level of the increased oil import bill, based on the above figures adjusted for exchange-rate changes, is in both periods in the first instance of a similar order of magnitude. Thus the theoretical, direct impact of the second oil shock on the deflator for total final demand was about 2 1/2%, and on consumer prices about 3 1/2%. These figures become substantially larger (almost twice as large) if the prices of all energy products rise to keep on a par with the price of imported oil, but data on the speed and amplitude of this secondary energy price movement will only become fully available at a later date. (The measurement of energy price movements in practice is discussed in more detail in the next chapter on prices and incomes).

Assessment of the impact of the oil shock on demand and output starts also with the reduction in purchasing power represented by the increased oil bill of the European economy. The next major factors to be taken into account are offsetting in direction: on the one hand the increased demand for exports to the oil producing countries, and on the other hand the tendency for the net shortfall in demand to multiply itself through the workings of the cyclical process within the industrialised economies, to which should also be added some depression of demand from developing countries. In the second year after the oil price rises, a substantial fraction of the increased oil producers' earnings tends to be spent in the industrialised countries. It is possible that about half of the Community's \$ 70 billion initial loss of purchasing power be compensated by increased exports to oil producers after two years (total OPEC imports of goods and services from all sources are forecast to rise from \$ 100 billion in 1979 to ^{over} \$ 170 billion in 1981). On the other hand the process of multiplication of the demand depression within the industrialised countries could more than double the impact of the net external shock on the level of activity after two years. Thus as a simple rule of thumb, one might expect the impact on activity levels to reach a percentage of GDP somewhat greater than that of the initial oil bill.

increase (which was 3% of GDP). (1)

If the whole growth profile is, as a result of the oil shock, lowered for a period of years, then the loss of demand and output cumulates to a very high figure (the step loss in the level, times the number of years). However, such "demand-side" estimates become increasingly inadequate as the time horizon is extended beyond a short-run cyclical context and if they ignore the supply constraints that were implied by the oil shock in the first place. For example a strong supply side proposition could argue that the whole medium-term profile of productive potential had been instantly reduced by the oil price rise with the growth of real demand along the previous profile having become no longer attainable. The macroeconomic policy reaction to the oil shock, either compensating the demand loss or accepting it in the short run while not accommodating a rise in inflation, will in practice reveal the judgement of policy-makers on these questions - on which reliable mechanical quantification is extremely difficult.

(1) Estimates of the impact of the oil shock on the growth of GDP have been made using a multi-country multiplier model in which 16 country groups are identified (8 Community countries, Canada, Japan, USA, other OECD North, other OECD South, OPEC, centrally planned economies, and the rest of the world). The initial loss of real income for each of the oil-importing country groups leads to a reduction in imports which results, when allocated via a trade matrix, in a corresponding fall in exports by trading partners, and hence a further drop in real income. Second and subsequent round effects are similarly taken into account. The expansionary effect of increased OPEC imports and the increased exports, real income and hence imports this generates in the supplying countries are further calculated in the same way.

Economic developments in the wake of the two oil price increases

Thus a host of further factors are important in trying to understand the interaction between the oil shocks - as just summarised in isolation and in a highly schematic fashion - and what has actually been happening to the course of the economy, and what is likely to happen over the period ahead.

The first oil shock occurred at a time of higher capacity utilisation than in the second case. The rate of inflation of other commodity prices was far greater in the first episode. The psychological shock factor, in terms of creating new uncertainties about the future, was also of course much greater in the first case. These factors would lead one to expect a weaker impact on the production cycle in the case of the second oil shock - because the cycle was in the first case closer to a natural down-turn, and also because the uncertainty factor was greater then.

Non-oil commodity prices in fact rose about three times as fast in the two years to the end of 1973, compared to the two years to the end of 1979 (145% and 45% respectively according to the Economist's dollar index). This, together with the exchange-rate factor already mentioned, accounts for the fact that the contribution of imports to the rise in the overall price level has been probably only half as severe in 1980 than in 1974 (see Table 2.4 below).

More generally, the evolution of the terms of trade in the periods 1974/75 and 1979/80 is set out in Table 1.1 (where the data is constrained to annual average figures, giving a somewhat different picture to the less complete data available for more finely selected periods of time, as in the preceding section). Here the dollar oil price rises are seen to have been similar in magnitude, as also for other commodity prices (for which the main impact of the price boom in the first episode had already been felt in 1973). The differences in exchange rate experience concern particularly 1974 against 1979/80

(in 1975 Community currencies reversed most of their losses of 1974). The main further information conveyed by Table 1.1 is in showing how the prices of exports and of non-oil commodities affected the total loss in the terms of trade, which was nearly twice as severe in comparing 1974 alone (a loss of 9.6%) with 1979 and 1980 taken together (a loss of 4.4%); however, in 1975 one third of the loss experienced in 1974 was recuperated. The essential explanation here is that 1974 saw a faster acceleration of costs in the Community with high real wage increases obtained in spite of the terms of trade loss. This in part caused the substantial recession in 1975, which together allowed export prices to regain ground over import prices in that year - but only in highly unsatisfactory economic conditions. The more even profile in 1979/80, despite the comparable size of the oil shocks, reflects a more moderate "claw-back" of the terms of trade loss, but a less severe recession and less severe terms of trade loss.

Thus import prices, unit labour costs, and export prices have all been growing much more slowly in 1979/80 than in 1974. Consumer prices, however, have risen about as fast in 1980 as in 1974, reflecting price and tax policies (described in the next chapter) which, together with the more moderate wage bargaining, have kept the financial position of the enterprise sector more shielded from the oil price rise in this second episode.

These factors are also important for the prospects for the real economy through into 1981, compared to the experience of 1974-75. The Commission's forecasts for the main demand components and GDP are given in Table 1.3. The overall weakening of GDP is expected to be significantly less in 1980 and 1981 than in 1974 and 1975 (the total growth in the two pairs of years being respectively 1.9% and 0.3%).

There are even greater differences in the pattern of behaviour of the main demand components taken individually. This is not at first sight evident in the figures for private consumption, where the volume growth in 1974-75 and 1980-81 is around 1 1/2% per annum. The striking difference here lies in the fact that, while real wage increases rose very substantially after the first oil shock, this was accompanied by such an intensification in the climate of inflation and uncertainty that household savings increased very sharply; in 1980-81 it is expected that the savings ratio will remain much more stable alongside the absorption by wage-earners of the oil price rise.

The 1974-75 recession occurred principally through a sharp fall of private investment and run-down in stocks, which was the consequence of the climate of monetary instability, acutely reduced profitability in the

enterprise sector, and the sharp drop in demand that occurred in the course of 1974-75 (although this is smoothed over the annual average figures in Table 1.2). By contrast a much milder weakening in investment and stockbuilding is anticipated for 1980-81, in part because of the better financial position of enterprises (of course this describes the Community average, and there are exceptions - notably in the case of the United Kingdom in 1980).

Government consumption is a contrary influence, in the sense that it continued to grow in volume terms quite strongly after the first oil shock (2,2% in 1974, 3,9% in 1975), whereas it is expected to grow more modestly in 1980 (2,0%) and 1981 (1,3%). This is a consistent part of the overall picture, in which budgetary and monetary policy is, after the second oil shock, being kept on a stricter and steadier course than in the first episode (see also Chapters 4, 5 and 6).

It is through examining the course of monetary policy that the full chain of interactions between price, demand and output effects of the oil shocks can be linked up. The strict general stance of monetary policy has in part accounted for the stronger and certainly more stable exchange-rate experience after the second oil shock, a factor helpful to investment. On the other hand, while the appreciation of Community currencies has diminished the external price shock, it has also hardened the conditions of competition for the Community in international trade. As described in Chapter 3, the adjustments to trading performance since the second oil shock have been more favourable in the cases of the United States and especially Japan than for the Community. The Community's current account deficit in 1979 was about one third of the OECD total: in 1981 it will probably account for over half of the total. Demand for Community production in home and overseas markets has been weakening in a loss of market shares to other producers of industrial goods.

One cannot yet conclude, of course, on how the Community economy will emerge from the second oil shock. The objective, evidently, is to benefit from experience since the first oil shock, which in practice means to secure a steadier and firmer adjustment to the energy crisis, while at the same time beginning to reverse the long-run acceleration of inflation and the weakening of growth performance and world-wide competitiveness. Policy is aimed at these several formidable objectives, and there are some signs that the private economy too is adjusting in the right direction, for example as regards wage inflation and a steadier pattern of consumption and investment. The loss of output in the present down-turn should turn out to be less than in 1974-75, and the upturn expected in the course of 1981 should avoid the unsustainable precipitation of 1976.

Tracking the business cycle in the Community

The Community economy indeed reached a cyclical turning point in early 1980, probably in March. There was some decline in output in the second and third quarters of the year, following an upswing lasting nearly two-and-a-half years during which the annual average growth of GDP was 3,4% (see Table 1.3). The present down-turn is thus a continuation of the pattern of marked fluctuations which are plotted for the Community as a whole and the four largest Member States in Graph 1.1 (the shaded areas indicate the periods from peak to trough of the Community cycle; the reference cycle is shown alongside the indicator of business confidence reported by industrialists in surveys).

For the Community as a whole, three cycles may be recognised over the past decade (see Table 1.3), spaced between four peaks in July 1969, in August 1973 just before the first oil shock, in November 1976 after a short recovery period, and in March 1980 with the second oil shock.

The cycles have on average, from peak to peak, been about 3 1/2 years long, with the periods of upswing from trough to peak tending to be slightly shorter (21 months) than the periods of downswing from peak to trough (22 months).

Table 1.3 indicates the average annual rates of growth experienced over these phases of the cycle. The underlying rate of growth represented by the full cycle, from peak to peak, has sharply diminished, for example, from 4,7% (for GDP) in the last cycle before the 1973 oil crisis, to about 2 1/2% since then. However, there are difficulties involved in judging how far the potential growth rate has declined as a result of the oil shocks and other factors¹⁾.

The business cycle of the Community economy in the aggregate is a fairly well established economic reality, reflecting the strong interdependence of the economies of the Member States. This is reflected, moreover, in the average opinions of industrialists in the Community, as reported in the business surveys (published in *European Economy*, Supplement B) which give a consistent guide to the development of economic conditions in the Community as a whole. It is also shown by the cyclical fluctuations plotted in Graph 1.1 for the four largest Member States. But the cycles of the three large continental economies have been more closely synchronised to the Community aggregate than that of the United Kingdom. The degree of synchronisation has also varied over time: the peaks around August 1973 were somewhat dispersed, while the troughs around August 1975 and the peaks around November 1976 and again around March 1980 have been more tightly synchronised. The most synchronised turning points have, thus, not always been those associated with common external shocks.

1) See a discussion of these problems in the concluding section of this chapter.

The slow-down in the underlying rate of growth

The large changes in the real price of energy have reduced in some degree the optimal productive capacity of the economy as a whole, at least for the time being. Although physically it is still possible to produce just as much output as before, it is in part no longer economic to do so, as the most economically efficient mixes of factors of production have changed. It takes time, new investment and new human skills, and much reorganisation to return to a new optimum. In the meantime economic capacity has been lost, with capital equipment having become economically obsolete faster, and with a worse mismatch between the labour force and employment opportunities.

The difficult question is to quantify the loss of capacity, or the slow-down in the rate of growth which can be sustained without creating further inflationary tensions in product or labour markets. At the present time no sure answer can be given to this question. However, the issue is of such evident importance that it is worthwhile taking note of such information that exists.

One traditional short-cut approach to these questions has been to study the rate of growth experienced between cyclical peaks (the Wharton school technique), thus identifying a growth rate that cuts out cyclical fluctuations, and where the peaks represent circumstances in which capacity or inflation constraints are supposedly equivalent. The cyclical chronology set out above (in Table 1.3, and Graph 1.2) suggested that the Community's aggregate rate of GDP growth declined from 4.7% in the cycle before the oil crisis to 1.8% and 2.9% in the two cycles that have followed. These figures are open to the criticism that they reflect peaks of uneven height: indeed, capacity utilisation was surely higher in March 1980 than in November 1976. It may be more satisfactory to calculate the rate of growth between the two oil crises, or, more precisely, between the peaks of August 1973 and March 1980: this gives 2.4% for GDP, and 1.7% for industrial production.

This still does not entirely dispose of the problem that the peaks may represent different capacity utilisation levels, since the two indicators of industrial capacity utilisation obtained from the business surveys (see Graph 1.2 and Table 1.4) suggest that the recent peak in March 1980, while higher than in November 1976, was lower than in August 1973. However, the business survey data do provide an opportunity for a cross-check, by

making it possible to calculate the rates of growth experienced in slightly different periods for which capacity utilisation was reportedly equal at beginning and end-points. These data (see Table 1.5) provide confirmation of the figures already cited. For the selected period preceding the 1973 oil shock the underlying rate of GDP growth thus measured was 4,9%. For the selected periods ending in 1979 or 1980 the comparable rates of GDP growth were both 2,5%.

A supporting indicator may be seen in the growth rate of 3.4% experienced in the recent two-year upswing, from the trough in October 1977 to the peak in March 1980. While this rate of growth may seem moderate by earlier standards, it was accompanied by a substantial rise in capacity utilisation and a stabilisation of the total unemployment level. However, male unemployment declined over this period, and increased tensions became clearly apparent on labour markets in key regions and skill categories. Thus a 3.4% growth rate of GDP seems at the moment to be in excess of that of productive potential for the Community as a whole.

Overall, therefore, there is some convergence of indicators suggesting that for GDP the underlying rate of growth of productive potential in the Community as a whole may have declined from ^{between} 4 1/2% ^{and} 5% before 1973, to about 2 1/2% in more recent years. This of course does not prejudge what the rate of growth in the medium-term future may be. This will depend crucially on the rate of investment and more generally on the rate of structural change and productivity growth that the Community economy sustains in the period ahead.

TABLE 1.1

The Community's terms of trade under the impact of the two oil shocks

(percentage changes)

	1974	1975	1974/75	1979	1980	1979/80
Contribution to change in implicit import price deflator ⁽¹⁾ :						
1. Crude oil price in US dollars	12,7	0,9	12,5	3,5	6,9	11,5
2. Other commodity prices in US dollars ⁽²⁾	3,8	-1,0	2,8	2,3	0,5	3,0
3. Effect of \$/ECU exchange rate on above prices ⁽¹⁾⁽³⁾⁽⁴⁾	1,2	-1,0	-0,1	-1,7	-0,7	-3,1
4. Other import prices	18,6	5,6	27,2	5,7	9,6	16,3
5. Total change in implicit import price deflator (in ECU) ⁽¹⁾⁽³⁾	36,3	4,5	42,4	9,8	16,3	27,7
6. Change in implicit export price deflator (in ECU)	23,2	7,8	32,8	8,9	12,1	22,1
7. Change in terms of trade ⁽¹⁾⁽³⁾⁽⁵⁾	-9,6	+3,1	-6,8	-0,8	-3,6	-4,4
8. Effect of terms of trade on real domestic income ⁽⁶⁾	-2,6	+0,8	-1,7	-0,2	-1,1	-1,4

(1) Goods and services.

(2) Imports of food and raw materials (SITC 0-2,4) from outside the Community for which the dollar prices are assumed to move in line with UN price index for primary commodities excluding crude petroleum.

(3) Including intra-Community trade.

(4) Including small change in implicit deflator due to changes in trade structure.

(5) Percentage change in ratio of implicit export price deflator (line 6) to implicit import price deflator (line 5).
+(-) = gain (loss) in the terms of trade

(6) Difference between exports deflated by change in import prices and same exports deflated by change in export prices as percentage of GDP in first period.

Sources: Eurostat and Commission staff.

TABLE 1.2

Rates of growth of demand and GDP growth under two oil shocks,
1973-75 and 1979-81

	1973	1974	1975	1979	1980	1981
DK						
Private consumption	6.5	1.3	5.0	3.0	-3.7	-.4
Govt. consumption	2.9	3.9	3.5	5.4	4.4	2.1
Fixed cap. formation	7.4	10.6	10.7	3.0	-11.5	-3.7
Final domestic demand (1)	6.1	2.7	1.0	2.3	-3.4	-.3
Stockbuilding (1)	1.4	.7	2.3	.4	-1.5	-.3
Foreign balance (1)	-2.2	2.5	-.9	.8	3.0	1.2
GDP	5.2	-.9	-.4	3.5	-.9	.6
D						
Private consumption	2.3	1.3	3.7	3.2	1.9	2.0
Govt. consumption	4.2	2.6	1.7	2.9	2.5	1.5
Fixed cap. formation	.2	9.9	4.2	8.7	4.2	-.2
Final domestic demand (1)	1.9	1.5	1.4	4.3	2.4	1.3
Stockbuilding (1)	.5	-.2	-.7	1.6	-.6	-.8
Foreign balance (1)	2.4	2.2	2.6	1.3	-.3	-.4
GDP	4.9	.5	1.8	4.6	2.1	1.0
F						
(2) Private consumption	5.6	3.2	3.2	3.2	2.3	1.2
Govt. consumption	3.2	1.2	4.7	2.5	2.6	1.8
Fixed cap. formation	6.1	.9	3.2	2.5	2.6	.2
Final domestic demand (1)	5.3	2.3	1.8	2.9	2.4	1.1
Stockbuilding (1)	-.5	.1	2.7	1.0	-.6	-.2
Foreign balance (1)	-.4	.8	1.1	-.7	.0	.3
GDP	5.4	3.2	.2	3.2	1.8	1.2
IRL						
Private consumption	6.1	1.9	4.0	3.6	-1.5	.6
Govt. consumption	6.7	6.5	5.3	3.5	.5	.0
Fixed cap. formation	16.2	11.6	5.4	15.6	-6.4	-4.1
Final domestic demand (1)	9.6	.9	3.1	7.2	-2.9	-.8
Stockbuilding (1)	-.2	2.9	4.9	.5	-3.7	1.4
Foreign balance (1)	-5.6	1.6	10.2	-5.8	7.6	1.9
GDP	4.1	3.7	2.1	1.9	1.0	2.5
I						
Private consumption	5.8	2.5	1.4	5.1	4.0	.5
Govt. consumption	2.1	3.1	3.3	2.7	2.0	2.5
Fixed cap. formation	7.7	3.3	12.7	4.5	8.0	-2.0
Final domestic demand (1)	5.6	2.8	2.9	4.4	4.2	.3
Stockbuilding (1)	2.7	.0	3.2	1.1	.4	-.9
Foreign balance (1)	-1.2	1.3	2.4	.5	-.8	.8
GDP	7.0	4.1	3.6	5.0	3.8	.2
NL						
Private consumption	3.9	2.4	3.1	2.2	.0	-.3
Govt. consumption	.7	2.0	3.9	2.9	.8	1.0
Fixed cap. formation	4.5	3.8	4.9	.0	.0	3.3
Final domestic demand (1)	3.4	.8	1.3	1.9	.2	-.4
Stockbuilding (1)	1.5	.7	3.0	.6	-.3	.1
Foreign balance (1)	.8	2.1	.6	.9	1.2	.6
GDP	5.7	3.5	1.0	2.2	1.1	.3
B						
Private consumption	7.6	3.0	.5	4.7	1.8	1.2
Govt. consumption	5.2	3.4	4.8	2.7	-.2	.4
Fixed cap. formation	6.8	7.0	1.6	.5	2.0	1.2
Final domestic demand (1)	6.8	3.9	.6	3.3	1.5	1.1
Stockbuilding (1)	1.1	-.9	3.0	-.3	-.1	.0
Foreign balance (1)	-1.7	-.3	.4	1.1	-.2	-.2
GDP	6.1	4.5	1.9	2.4	1.2	.9
L						
Private consumption	4.9	5.9	4.1	2.2	1.7	1.5
Govt. consumption	2.4	4.1	3.2	2.0	1.8	1.2
Fixed cap. formation	9.8	2.0	9.4	4.9	3.1	1.5
Final domestic demand (1)	5.4	2.8	.0	2.6	1.9	1.4
Stockbuilding (1)	-.8	1.5	-.7	-.3	-.3	-.3
Foreign balance (1)	5.5	.4	8.7	-.2	-.9	-.4
GDP	10.2	4.7	9.4	2.7	.8	.5
UK						
Private consumption	4.8	1.9	1.0	4.0	.4	-.1
Govt. consumption	4.7	1.5	6.1	1.7	.7	.0
Fixed cap. formation	6.9	2.9	-.7	-1.9	-4.5	3.3
Final domestic demand (1)	5.5	1.5	.5	2.4	-.4	.6
Stockbuilding (1)	2.9	1.2	2.9	1.0	-2.3	.4
Foreign balance (1)	.5	1.1	1.4	2.5	.1	-.4
GDP	8.0	1.5	1.0	.9	-2.6	-.6
EC-9						
Private consumption	4.5	1.5	1.8	3.6	1.8	.9
Govt. consumption	3.6	2.2	3.9	2.7	2.0	1.3
Fixed cap. formation	4.5	3.3	4.8	3.8	2.1	1.0
Final domestic demand (1)	4.3	.4	.7	3.4	1.8	.6
Stockbuilding (1)	1.4	-.2	2.3	1.0	-.7	-.3
Foreign balance (1)	.2	1.4	.3	1.1	.2	.3
GDP	5.9	1.7	1.4	3.4	1.3	.6

(1) Change as percentage of GDP of preceding period
(2) Previous years' prices for years 1979-1981

Table 1.3
Business cycles in the EC economy as a whole 1969-80

	Duration in months	Economic performance during period		
		GDP growth % annual average	Industrial production % annual average	Capacity utilisation % change ⁽¹⁾
<u>Full cycles: peak to peak</u>				
July 69 to August 73	49	4,7	4,1	- 1,3
August 73 to November 76	39	1,8	1,0	- 7,2
November 76 to (March) 1980	40	2,9	2,6	+ 3,9
Average duration: 43				
<u>Upswings: troughs to peak</u>				
February 72 to August 73	18	5,4	8,5	+ 5,0
August 75 to November 76	15	5,9	11,4	+ 7,7
October 77 to (March) 1980	29	3,4	4,0	+ 5,3
Average duration: 21				
<u>Down-swings: peak to trough</u>				
July 69 to February 72	31	4,1	1,7	- 6,3
August 73 to August 75	24	- 0,6	- 4,8	-13,8
November 76 to October 77	11	1,7	- 1,1	- 1,4
Average duration: 22				

Note. Business cycles are here based on deviations from trend of a composite monthly index of output, consisting of monthly industrial production data and quarterly GDP, in which the quarterly GDP levels are attributed to each of the three constituent months. The trend is estimated on the basis of 75 months moving averages (extended by 37 months to cover end-points). Turning-points are located by successive application of the moving average procedures. Peaks are identified where output index reaches its highest point above the trend level after an upswing phase, and troughs where the output index reaches its lowest point (below-trend growth including both slow growth and declines in output below the trend level) after a down-swing phase. Peaks (or troughs) are recognised only if they are separated by 15 or more months and by an intervening trough (or peak). The Bry-Boschem method of the National Bureau of Economic Research (New York) has been applied to establish reference cycles of economic activity and turning-points in cycles.

(1) Source: business surveys, see Table I.4.

Table 1.4

Capacity utilisation in manufacturing industry.

Year and quarter	Rate of capacity utilisation, %							Proportion (%) of industries with production hold-ups reporting that production was hindered by lack of equipment								
	EC	D	F	IT	UK	NL	B	Months	EC	D	F	IT	UK	NL	B	L	IRL
1969 I	86.4	87.6	85.7	81.7	86.1		84.2	J/F	24	24	24	27		26		
II	87.5	88.9	85.9	83.1	88.3		86.1	J/J	28	27	26	33		27		
III	87.5	87.3	80.2	82.0	87.5		87.3									
IV	87.2	87.3	86.6	76.8	89.1		86.3	O/N	29	29	29	29		35	27	
1970 I	87.7	86.3	86.2	81.6	84.9		87.0	J/F	26	27	25	24		31	25	
II	87.3	85.4	85.7	80.4	84.8		86.2	J/J	25	25	26	23		27	24	
III	87.0	85.4	85.6	79.8	85.5		85.7									
IV	86.8	86.2	85.6	80.2	88.1		85.8	O/N	17	19	25	9		24		
1971 I	85.0	83.5	85.5	78.7	82.1		85.1	J/F	20	21	23	8		23	18	
II	84.0	80.8	85.8	75.8	80.2		83.5	J/J	15	13	22	6		19	24	
III	83.4	79.3	85.8	75.7	79.4		82.8									
IV	83.4	78.5	85.9	77.9	80.3	84.9	82.8	O/N	10	7	19	2		14	2	
1972 I	82.3	77.7	85.7	75.6	77.2	85.7	82.2	J/F	7	2	16	5		11	13	2
II	82.8	79.3	86.1	76.2	78.9	84.3	82.5	J/J	11	8	18	8		12	12	
III	83.4	80.6	86.5	76.5	80.7	84.1	82.7									
IV	84.2	82.3	87.0	77.5	82.4	83.2	83.2	O/N	14	8	22	18		14	15	25
1973 I	85.0	85.0	87.3	74.6	85.1	84.6	84.1	J/F	19	16	26	17		10	22	20
II	85.8	86.9	87.8	76.4	87.2	84.3	84.9	J/J	23	20	26	27		16	27	4
III	86.4	90.0	87.8	77.7	90.6	85.1	85.0									
IV	86.4	88.1	87.8	79.6	90.1	84.5	85.4	O/N	22	13	32	33		15	26	3
1974 I	83.8	77.7	87.7	79.7	79.6	83.9	84.5	J/F	18	8	32	28		14	22	
II	84.0	85.8	87.2	78.1	85.4	85.5	84.9	J/J	21	17	32	20		14	24	8
III	82.5	84.3	85.3	76.7	83.3	84.1	83.2									
IV	80.6	83.5	83.3	74.0	82.6	83.8	81.4	O/N	8	5	15	7		4	12	10
1975 I	78.0	81.6	79.9	71.7	83.3	79.9	75.3	J/F	4	2	7	4		5	5	5
II	75.1	77.7	76.5	70.1	77.6	76.7	70.7	J/J	3	2	1	1		3	2	7
III	74.5	76.2	77.4	67.4	75.4	75.9	70.0									
IV	75.4	77.0	78.4	67.6	75.9	75.2	69.5	O/N	3	2	6	1		3	4	4
1976 I	77.3	75.0	80.8	71.9	76.0	75.5	71.8	J/F	4	2	10	1		3	12	-
II	78.7	75.8	83.4	72.9	75.0	77.2	75.1	J/J	8	7	12	8		5	5	-
III	79.4	77.4	83.7	74.4	76.3	77.9	75.8									
IV	80.2	78.9	83.9	76.5	77.6	79.4	76.6	O/N	7	5	12	12		2	5	4
1977 I	81.1	80.4	83.6	76.0	81.8	79.7	74.9	J/F	6	2	13	9		4	6	16
II	80.0	79.7	84.2	73.2	80.3	81.1	73.3	J/J	7	9	14	7		2	2	1
III	79.4	79.7	83.8	71.8	79.9	79.5	72.0									
IV	79.1	78.5	81.3	72.0	78.1	77.7	70.1	O/N	4	2	9	1	8	2	2	3
1978 I	75.6	79.6	83.5	71.8	79.6	78.3	72.9	J/F	4	2	11	2	1	2	1	7
II	79.8	79.6	84.1	72.0	79.7	80.1	71.7	J/J	7	3	12	3	9	5	2	3
III	79.7	78.0	83.8	72.8	78.0	79.9	73.3									
IV	80.7	80.4	83.9	74.7	79.8	80.6	73.1	O/N	7	3	11	9	11	5	2	16
1979 I	81.8	81.6	84.9	75.5	80.9	80.3	76.2	J/F	8	6	11	9	10	15	5	3
II	82.8	83.9	84.1	75.1	83.8	81.7	78.0	J/J	9	4	12	13	15	3	5	1
III	83.4	85.4	84.7	76.8	85.7	82.9	77.7									
IV	83.5	81.6	85.1	77.1	82.2	83.0	78.4	O/N	11	9	16	11	10	14	8	2
1980 I	83.3	80.8	85.2	77.3	80.9	82.5	79.7	J/F	11	10	18	16	8	6	8	2
II								J/J	10	10	19	6	7	6	9	6

- (1) The figures are based on business survey results, and are adjusted for comparability with those of the other Member States in terms of average level and deviation.
- (2) The third quarter data for capacity utilisation are interpolated values of the second and fourth quarters, owing to lack of basic data.
- (3) Seasonally adjusted.

Source: European Community and national business surveys.

Note: J/F = January/February)
 J/J = June/July) These are the months in which the relevant survey
 O/N = October/November) are conducted.

Table 1.5

Rates of GDP volume growth in the Community
between points of equal ⁽¹⁾ industrial utilisation

Reference period, year and quarter	Measure of capacity utilisation observed during the reference period		% annual average rate of GDP growth
	% industrial capacity utilisation		
IV 1970 - III 1973	86.8	- 86.4	4.9
IV 1974 - IV 1976	80.6	- 80.2	3.2
I 1977 - I 1979	81.1	- 81.8	2.5
I 1974 - I 1980	83.8	- 83.3	2.5
	% of enterprises with production limited by lack of equipment		
I 1969 - II 1973	24	- 23	5.1
IV 1974 - II 1976	8	- 8	2.7
II 1976 - I 1979	8	- 8	2.6

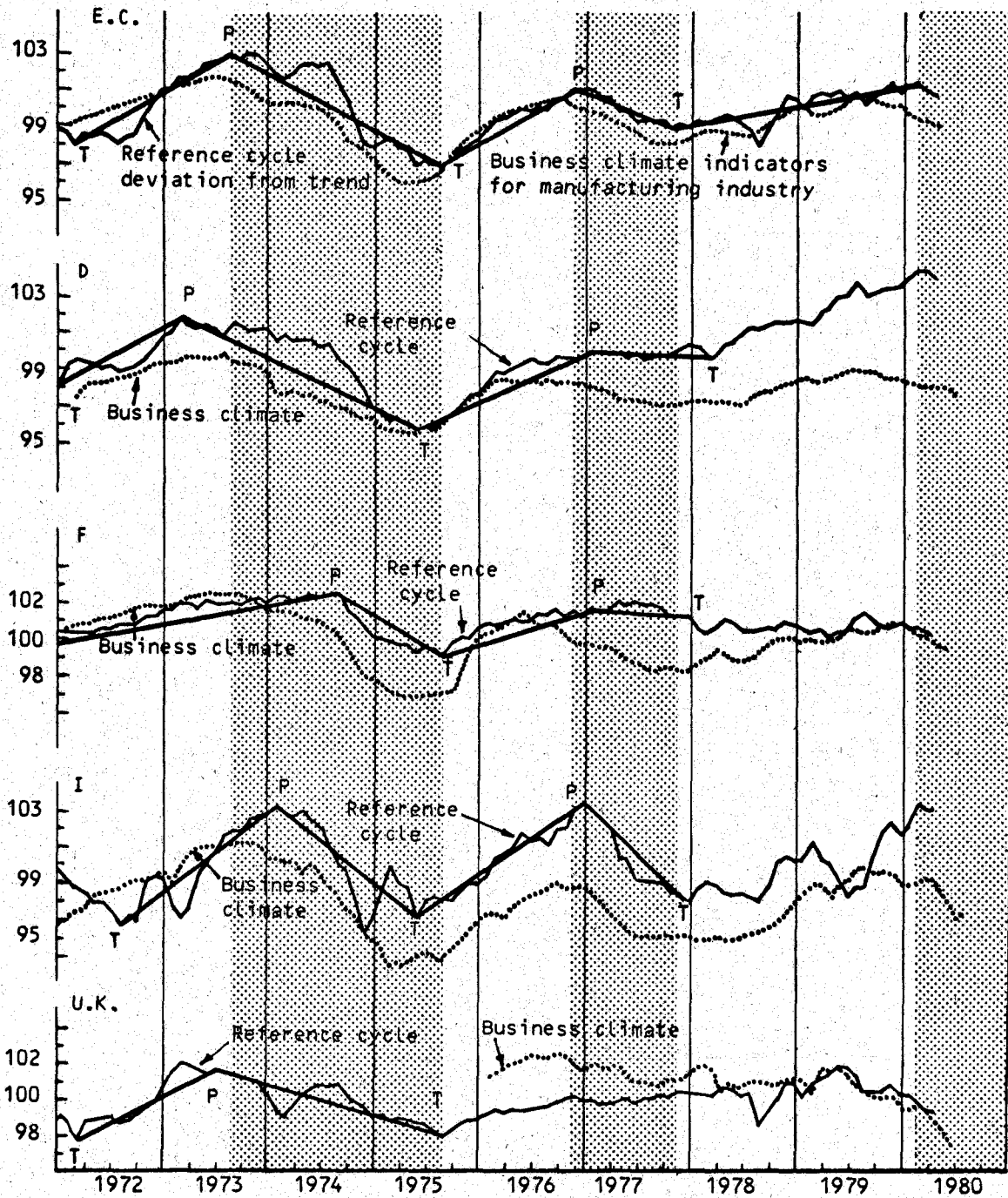
Source : Commission services, and European Community business surveys.

1) The capacity utilisation rates measured during the selected periods are, if not equal, as close as the observed data allow.

GRAPH 1.1

Business cycles and leading indicators, EC and four larger Member States

Indices based on 1967 = 100

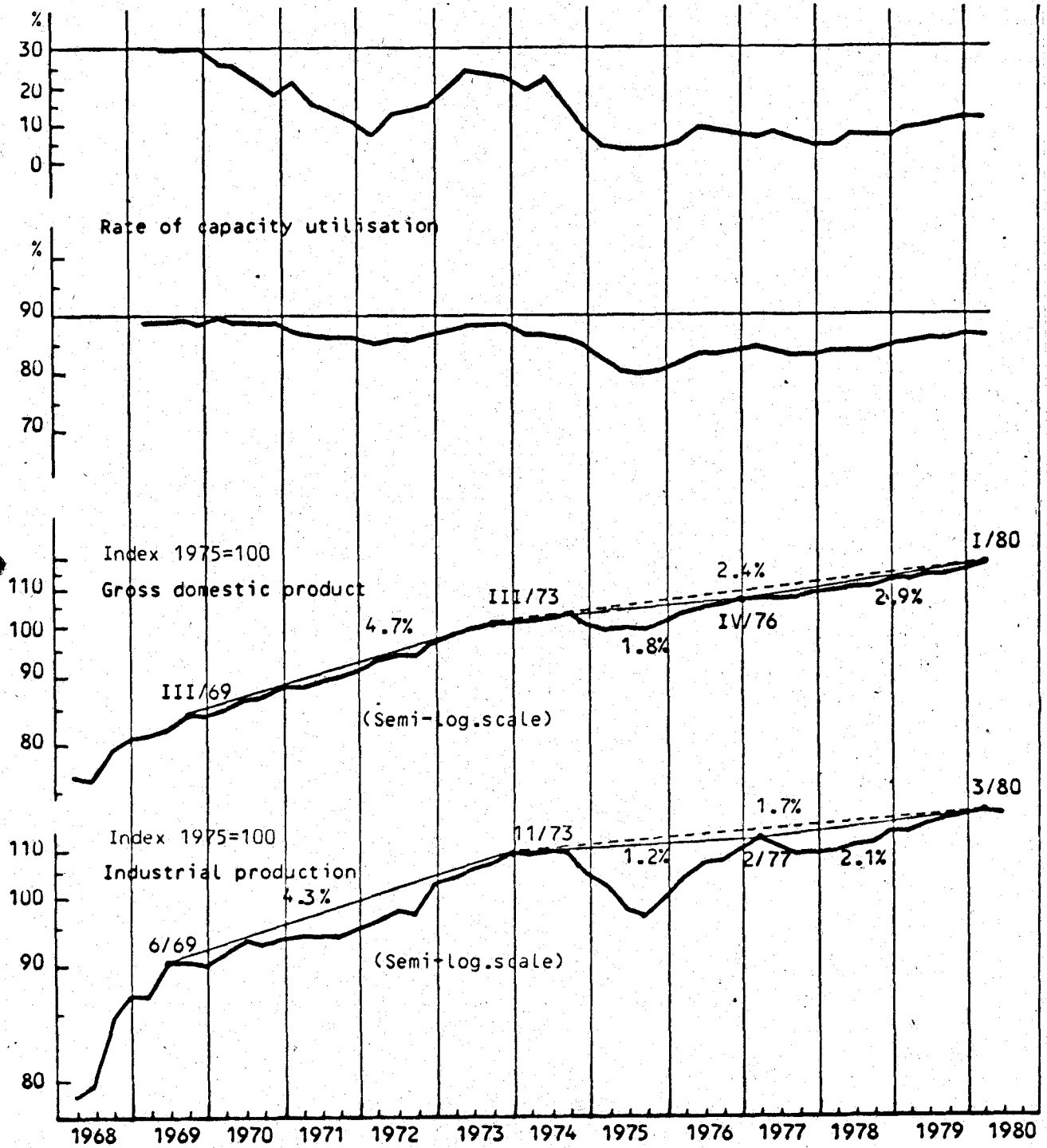


Sources : EC business surveys and national statistical publications. For methodology see Table 1.1.

GRAPH 1.2

EC GROWTH TRENDS AND CAPACITY UTILISATION, 1969-1980

Enterprises with production bottlenecks reporting equipment shortages



2. Stabilisation and convergence

The substantial acceleration of consumer prices in 1980, and the renewed divergence of performance between Member States, have at first sight been about as serious as after the first oil shock in 1973. However, there are some mitigating factors. The recent consumer price rises reflected in part deliberate acts of policy to liberalise price and rent control, pass oil price rises rapidly through to consumers, and change tax structures; in all cases aiming at improved resource allocation and faster structural adjustment. Moreover, wage incomes have, unlike in 1974-75, more readily been absorbing the oil price rises, rather than avoid them through more inflationary wage bargaining. Performance under the main measures of domestic inflation (GDP deflator, labour costs) has deteriorated in 1980 less than for consumer prices, and should in 1981 show renewed improvement. However, acute problems of inadequate profitability in the enterprise sector, in conjunction with high inflation, remain outstanding in some countries, notably in the United Kingdom and Italy.

Prices

The trend of consumer prices in the Community, measured by the index of consumer prices (Table 2.1), worsened considerably during 1979 and the early months of 1980, although there were signs of deceleration in the rate of inflation in the second and third quarters of 1980. Thus for the Community as a whole the increase of 8,6% recorded in 1979 gave way to a 13,7% in the twelve months to July 1980: for 1980 as a whole an average of 12% is expected, and for 1981 a significant deceleration down to 9,7% is forecast.

However, the trend in the GDP price deflator, which reflects domestic prices and costs to the exclusion of any direct impact from imports, accelerated less. This is most evident in comparisons with 1974 and 1975. The GDP deflator in 1980 is estimated to have risen 11,1%, compared to 13,6% in 1975, whereas the consumer price rise in 1980 came much closer to the 1975 experience.

These trends are likewise evident in the data on standard deviations given in Table 2.1: the divergence in consumer price rises between Member States was, according to this measure, about the same in 1980 as in 1975, whereas the GDP deflator showed a much lesser divergence than after the first oil price shock.

In the wider divergence of performance between Member States in 1980, three groups of countries are apparent: those in a relatively low inflation group with consumer prices rising in 1980 between 5 1/2 to 7% (Germany, Benelux countries), those in a middle group

around 13% (Denmark and France), and those in a higher inflation group in a range 18 1/2% - 20% (Ireland, Italy and the United Kingdom).

Tables 2.2, 2.3 and 2.4 seek to give a more disaggregated account of recent price trends by commodity, and by origin of the price increases (although there are considerable shortcomings in the data for these purposes). Not surprisingly the items fuel and light show the greatest price rises within the consumer price index over the past twelve months, with an average increase of some 24% in the Community as a whole (Table 2.2). The weighted contribution of these energy products, as in 1974, appears to have added about 1% directly to the total consumer price levels; however, this only covers electricity and heating oil but not fuel for private transport which has contributed importantly to the rise in prices of the item "other non-food goods". Moreover, the rising price of energy inputs in all other goods and services are of course reflected in all categories shown in Table 2.2 and 2.3. In particular there will have been a significant energy component in the price rises for non-food goods and services, but less so for food and rent .

The largest contribution to the consumer price rise came from non-food goods, rising in themselves 14% over the last twelve months recorded, and contributing about 5% to the rise in the total consumer price level. This reflects a mix of factors beyond the energy component mentioned including the lifting of price control in some countries (France, United Kingdom), the increase in indirect taxes also in a number of countries, and a more general strengthening of manufacturers' prices. This latter factor has no doubt contributed to maintaining a better financial position in the enterprise sector than in the squeeze that followed the first oil shock (see further in Chapter 4).

By comparison food prices have contributed relatively little to the general acceleration of consumer prices, reflecting the modest price rises agreed under the Common Agricultural Policy.

Rent increases, however, were more severe than in previous years, reflecting measures taken in a number of countries (Italy, United Kingdom); moreover, the 'rent' component of the index covers in some countries charges that have increased sharply (for example mortgage interest rates in the United Kingdom).

Another way of looking at the components of inflation is given in Table 2.4, based on the contributions of the principal inputs to the price rise of total final expenditure. The contribution of imports to the rise in total price level was 3,8% in 1980, compared to 8,3% in 1974, this much lower figure combining three factors: the dollar oil price rise which was of similar size (as indicated in Chapter 1), the much lower rise in other commodity prices in 1980 than in 1974, and the greater strength of the exchange rates of Community currencies against the dollar in 1980 compared to 1974. As explained more fully below, unit labour costs contributed significantly less to the total price rise (5,1% in 1980 against about 7% in 1974 and 1975). Indirect taxes are also shown to have contributed somewhat to the acceleration of inflation; general increases in the value-added tax were made in Germany and the United Kingdom in 1979 and in Italy in 1980, and indirect tax increases have also been important, especially for energy products, in Ireland, Denmark and France.

Overall the trend in the price level has been significantly influenced by government intervention. Indeed government policy directly affecting prices has been much different in 1979 and 1980 compared to the period after the first oil shock. Energy price rises have been passed quickly through to consumers, and there have been more upward adjustments of energy consumption taxes on this occasion, compared to the widespread erosion of the real value of such taxes after the first oil shock. This more adjustment-oriented energy pricing policy has more or less coincided with other price and rent liberalisation measures and some changes in tax structure easing direct taxes and accentuating indirect taxes. Community policy, for farm products, has worked more in a price stabilising direction, but here as well the intention of policy has been to seek a better supply/demand balance.

Labour costs

The acceleration of wages and salaries which also began in 1979 continued in 1980, but the rate of increase is expected to remain substantially below the high levels of the wage explosion in 1974/75, and may already be slowing down. However, experience among Member States is by no means uniform. In the third quarter of the year, the increase in compensation compared with twelve months previously, still varied from 4 1/2% in the Netherlands to over 23% in Italy. The average increase of 13,1% expected in 1980 is forecast to fall back to 10,3% in 1981 (see Table 2.5). As a reflection of this, the standard deviation of wage and salary increases widened sharply in 1980, but is expected to decline again in 1981.

In view of the importance of the need to avoid the second oil price shock generating a further, secondary acceleration of inflation through compensatory wage increases, considerable attention has been paid over the past year in the Community to the working of mechanisms for the indexation of wages on prices (see for example the conclusions to the 1979/80 Annual Economic Report). A description of such mechanisms as exist (or otherwise) and how they may have been changed in the recent past, is given in the attached inset "wage indexation in the Community".

The role of automatic wage indexation in income formation differs substantially from Member State to Member State. In Germany and the United Kingdom indexation is virtually non-existent and in France only the minimum wage is formally adjusted. Other Member States have some degree of wage indexation with the most comprehensive and rapidly working system found in Belgium, Luxembourg and Italy. Although the inflationary dangers inherent in full and rapid indexation systems are evident enough as theoretical arithmetic propositions, especially in the case of major external price shocks, it is necessary to proceed with caution before drawing too strong or simple conclusions on the effective impact of such mechanisms. Firstly it is to be noted that in the Community there is no simple correspondence between the propensities of Member States to have higher or lower rates of inflation, and the extent of their wage indexation practices. Thus, at the two extremes of each variable there are at present apparently contradictory experiences: full and rapid indexation going with high inflation in Italy and low inflation in Belgium, and the complete absence of indexation going with low inflation in Germany but high inflation in the United Kingdom. Secondly, the absence of such simple correlations does not

mean, however, that indexation practices may not be damaging to the economy in diffusing and increasing price shocks, and in preventing economically desirable adjustments in relative costs and income shares; rather, the absence of the correlation reflects the fact that the total wage and salary bill has several determinants (for example a "real" wage adjustment as well as a price adjustment), and inflation also has several origins (as illustrated in Table 2.4 above, which showed import price, tax, labour and other contributing factors).

A further reason for caution is that indexation practices can be fundamentally different in their impact depending upon what may seem to be technical variations in their definition: e.g. in the percentage extent of cost of living compensation, the delay before compensation is made, and the possible existence of special adjustments to the consumer price index (for example to exclude indirect tax changes, energy prices, etc.)

Among the main qualities to be sought in pay bargaining systems are their ability (a) to minimise uncertainty and industrial strife and (b) to permit rational reactions to unexpected price shocks and the needs to adjust for real competitiveness. Indexation systems, to the extent they are comprehensive in coverage, will tend to favour the former criterion and to ignore the second. Indexation systems which are less comprehensive may imply a greater degree of compromise. The ideal pay bargaining environment would seem to be that in which a sustained record on price stability assures the absence of uncertainty, and in which absence of indexation assures the possibility of adjustments in real incomes.

The approaches followed in the Member States on these questions in the past year have also been very heterogeneous. In several countries where the indexation is widespread, there have been efforts to limit the inflationary impact of the oil price rise. In Denmark, energy products have been withdrawn from the reference price index; in the Netherlands, there has been a temporary price freeze; in Belgium, the emphasis has been on low "real" wage demands; in Italy, adjustments of the indexation system have been debated, but not effected.

While the techniques of wage adjustment are extremely varied, there is no avoiding the fact that wage bargainers have, one way or the other, to accept the income loss implied by a major deterioration in the terms of trade - if the underlying rate of inflation is to be kept down. Whether this should be done by adapting indexation mechanisms or lowering real wage claims is essentially a matter to be worked out in the specific situation of each Member State.

An examination of developments in real per capita compensation and real unit labour costs presents a very different picture. From an annual average of 6% growth in the sixties and early seventies, real compensation declined until 1977, and after rising again in all countries in 1978 and 1979, fell back sharply in 1980 as the rise in consumer prices at first kept ahead of rises in compensation. In the year as a whole, there is expected to have been a 1% rise. Significant falls in real income occurred in the Netherlands and Denmark, with modest rises in Germany, France, Belgium and Luxembourg, and a large rise in Ireland due to substantial public sector pay rises. In 1981, the emphasis given to counter inflationary policy by governments is likely to restrain real compensation to a further small improvement, forecast to be 0,5% for the Community as a whole.

Taking into account developments in productivity, however, the downward trend in real wages probably represents no more than some catching-up of non-labour incomes for the losses experienced in 1974/75. The huge increases in both nominal and real wages in those two years far outstripped the increases in both consumer prices and productivity as aggressive wage bargaining in the wake of the oil price shock ensured that labour incomes did not suffer any loss. From 1976 onwards, however, this development changed: productivity growth in 1976 was substantial, and in every subsequent year has exceeded the rate of growth of real compensation per employee.

Moreover, the recent experience of individual Member States with respect to real compensation and real unit labour costs has been relatively similar, with moderate rises compared to 1974 and 1975, or/and a rather convergent pattern compared to the divergences in current nominal pay developments.

Functional Income Distribution

Despite the relatively slow increase in unit labour costs in recent years, income distribution in 1979 remained heavily biased in favour of labour income, as opposed to corporate profitability. The measure used here, called "normalised labour income", is labour income as a percentage of net domestic income at factor cost, including an imputed labour income for the self-employed to adjust for changes in the structure of employment. In 1979 the normalised labour income ratio of 86,5% remained still about four points over the typical level witnessed in the period 1960-1973. The ratio rose to a peak of 87,7% after the first oil crisis then subsiding somewhat to 86% in 1978, before rising again last year. While the figures for the Community as a whole show a remarkably stable development (see Graph 2.2) a country-by-country analysis reveals strong fluctuations often related to exchange rate developments, as seen in the cases of Italy and the United Kingdom especially.

Although the normalised labour income ratio may be somewhat more comparable from country to country than the unadjusted data, figures should be interpreted with great caution, particularly in the case of economies where wage and salary earners account for a relatively low share of total

employment like in Ireland and Italy. A cross-country comparison of these normalised levels may nevertheless give a clue to potential income adjustment problems and hence to the prospects for obtaining a higher degree of price convergence among the Community's Member States.

One major conclusion to be drawn from a cross-country comparison is that Germany on the whole has been rather successful in solving the income adjustment problems following the 1974 oil crisis. The labour income ratio in 1979 was back to the level of 1971/72 and is now some three points lower than the Community average. Also the French labour income ratio is relatively low, although the comparative advantage is less pronounced than in 1972/73. Among the small industrialised Member States, the labour income ratios in Denmark, the Netherlands and Belgium have shown a strongly rising trend over the past two decades, relative to the Community average. The exceptional rise in the ratio in Luxembourg in the mid-seventies reflects the weight of the steel industry's crisis in that country. In Italy, where in the late 1960s the normalised income ratio was only 3-4 points above the Community average, the level is now some 9 points higher. To some extent this may however be attributed to an increasing under-recording of non-wage incomes and not exclusively to a genuine shift of income distribution in favour of wage incomes. It is difficult to evaluate the relative importance of the various factors, but, on balance, it would seem that although a reduction of the Italian labour income ratio to the average level of the Community appears unlikely, a certain closing of the present gap should be sought as part of the Italian adjustment process.

This would also seem to be the case for the United Kingdom, where there has in 1979 and 1980 been a massive shift in income distribution in favour of labour income. As recently as 1978, the ratio may have been close to the Community average but this has now moved several points above, implying an adjustment problem perhaps as big as in Italy.

Thus in both Italy and the United Kingdom, real wages need to rise less than labour productivity for a period of years ahead.

Wage indexation in the Community

Denmark: Wage rates are traditionally fixed according to comprehensive national agreements covering two years. These agreements also fix the rules of indexation. The indexation system is automatic and semi-annual, with adjustments effected on 1st March and 1st September on the basis of the average of the three months ending in January and July respectively of a special wage regulation index derived from the consumer price index, excluding indirect taxes and subsidies. Compensation is normally granted in the form of a fixed sum released when the index value reaches certain thresholds (implying a higher percentage compensation for low incomes). On average, compensation has in the past corresponded to around 60-70% of the amount corresponding to full compensation. In the context of a major policy package aimed at dampening cost increases and reducing the balance of payments deficit the indexation system was modified as from 1st January 1980. Energy products were excluded from the regulation index and wage indexation restricted to the average increase of other products, wage adjustments due for 1st March 1980 were cancelled and the regulation index rebased to January 1980.

Germany: According to the currency law of 20th June 1948 authorisation is required for any index-linking of financial claims and this is not granted. There are no indexation clauses in wage contracts; parties may, however, agree to review the wage level if the cost of living exceeds a certain threshold.

France: In France, purchasing power guarantees have in the past been applied in certain nationalised industries, but at present only the minimum wage (SMIC), covering some 4% of the active population, is formally linked to a cost-of-living index.

Ireland: In Ireland wage and salary increases are normally fixed in annual national agreements. Such agreements have from time to time (five of the last eight) provided for cost-of-living adjustments in the course of the contract period. According to the National Understanding which expired in August 1980, wages were adjusted for the majority of wage and salary earners on 1st March 1980 on the basis of the cost-of-living increase during the 12 months up to mid-November 1979. The adjustment amounted to 1% for each percentage point increase in the cost-of-living index between 7 and 12% and about 60 pence or about 0.7% for each point between 12 and 16%. The new National Understanding proposed in September 1980 does not explicitly provide for wage indexation.

Italy: All collective wage contracts provide for indexation along a common system of adjustment, granting a compensatory increase of 2389 Lire in monthly earnings for each percentage point increase in a special cost-of-living index for wage earners. At present levels of earnings and consumer price index, a 1 percent increase in consumer prices will entail a 0.7% rise in average earnings, with adjustments taking place on 1st February, May, August and November on the basis of the increase in the index over the preceding three month periods. Since March 1980, adjustments of pay in the public sector are made according to the same system as in the private sector.

Netherlands: In most of the 1970s wages have been fixed through sectoral negotiations in the absence of national agreement. Most wage agreements have provided for indexation taking place in January and July on the basis of movements in a special wage regulation index excluding indirect taxes and with a reduced weight for medical services. Adjustment of the minimum wage is, however, provided for by law. The adjustment is generally granted as a percentage increase corresponding to the increase in the reference index. However, based on a special law covering income formation in 1980, the cost-of-living adjustment of July 1980 was given in the form of a flat rate amount of 26 Hfl to all employees with the exception of minimum wage receivers (36 Hfl).

Belgium: Index-linking of wages and salaries has been widely used in Belgium since 1948 and at present is applied to the wages of practically all employees in the private and public sectors. Wages are fixed on a sectoral basis and the system of index-linking may vary from branch to branch depending upon the provisions of the wage agreements. The adjustments are granted in most cases after one month in the form of a percentage increase in wages corresponding to the change in the reference index with certain thresholds. In the public sector, adjustments are made according to legal provisions.

Luxembourg: Index-linking of wages and salaries is applied generally in the public and private sectors. Legal provisions fix the rules of adjustment for public sector employees and the minimum wage. Adjustments are made in the form of a percentage increase in wage rates corresponding to the increase in the index, whenever the average of six preceding months' index value reaches threshold values (2.5%).

United Kingdom: Index-linking of wages and salaries has generally not applied in the post-war period, except under the incomes policy arrangements in 1972/73 (in Stage Three from November 1973 onwards). This included a provision for threshold agreements giving compensation for the rise in the retail price index above a certain level (6%) from its October 1973 level, and certain other collective bargaining agreements have also included threshold clauses providing for renegotiation of the contract if price increases exceeded certain values. The indexation arrangement starting in 1973 led fairly quickly and clearly to a major acceleration of inflation, and in subsequent incomes policy phases, and wage bargaining rounds, automatic cost of living adjustments have been practically non-existent.

Table 2.1

Consumer prices and the GDP price deflator.

(national currencies)

(percentage increase)

	1960-73 average	1974	1975	1976	1977	1978	1979	1980 estimate	1981 forecasts
Consumer prices									
DK	6,3	13,6	8,4	9,0	10,9	9,4	9,7	12,5	10,0
D	3,7	7,1	6,1	4,5	3,9	2,5	3,9	5,3	4,0
F	4,7	13,2	11,4	9,8	9,2	8,5	10,5	12,9	10,7
IRL	5,9	15,8	22,3	19,2	12,6	7,9	12,2	18,5	12,8
I	4,8	20,9	17,6	18,1	18,2	12,8	14,9	20,5	15,3
NL	5,2	10,0	10,7	8,8	5,9	4,2	4,6	6,9	6,8
B	3,8	12,6	12,4	8,3	6,8	4,4	3,5	6,1	5,5
L	3,0	9,0	11,2	9,4	6,7	3,5	4,5	6,4	5,6
UK	4,9	17,3	23,6	15,4	15,1	8,6	12,1	18,7	14,0
EC	4,5	12,7	12,5	10,3	9,8	7,3	8,6	12,0	9,7
Standard Deviation	1,0	4,1	5,7	4,7	4,4	3,2	4,1	5,7	3,9
GDP price deflator									
DK	6,8	12,5	11,7	7,9	9,2	9,6	7,1	9,3	9,6
D	4,2	6,9	6,7	3,3	3,8	3,9	3,8	4,7	4,2
F	4,9	11,1	13,4	10,1	9,0	9,3	10,3	11,0	11,1
IRL	7,2	6,1	22,2	21,0	13,0	11,3	13,2	15,8	11,9
I	5,4	18,5	17,5	18,0	19,1	14,1	15,1	19,1	15,1
NL	6,0	9,3	11,2	8,9	6,3	5,1	3,9	5,7	6,2
B	4,1	12,4	12,4	7,8	6,7	4,5	4,0	5,3	5,6
L	4,1	15,5	2,1	12,5	1,7	4,4	9,4	4,5	6,0
UK	5,1	15,1	27,1	14,5	13,7	10,3	14,4	21,2	15,1
EC	4,9	11,2	13,6	9,7	9,5	8,5	8,7	11,1	9,7
Standard Deviation	1,1	3,8	7,2	5,2	5,1	3,5	4,3	6,1	3,9

Note: Consumer prices = implicit price index of consumers' expenditure · GDP price deflator = implicit price index of GDP.

Source: Eurostat and Commission staff.

Table 2.2

Components of consumer price developments

(percentage increase)

	Food	Non-food goods	Fuel and Light	Rent ^{1, 2}	Services ³	Total
EC Total						
1974	12,3	14,6	25,4	8,1	10,1	12,4
1975	13,8	12,3	14,6	12,0	15,9	13,3
1976	12,9	8,9	12,9	11,2	12,3	10,8
1977	13,7	9,5	11,8	8,8	8,9	10,5
1978	7,4	7,3	7,1	6,4	9,3	7,5
1979						
DK	8,8	12,2	39,2	8,0	9,2	9,6
D	1,7	5,7	20,8	3,2	4,4	4,1
F	9,5	11,3	16,0	11,4	11,2	10,7
IRL	14,4	:	14,3	9,4	:	13,2
I	13,8	14,6	18,5	27,9	14,1	14,7
NL	2,1	4,3	7,0	6,8	4,7	4,5
B	0,5	5,9	:	6,0	5,6	4,4
L	2,6	:	13,8	:	:	4,6
UK	12,6	12,6	10,1	20,5	11,5	13,4
EC-total	9,2	10,1	16,1	14,3	9,7	9,9
Percentage increase July 1980 / July 1979 ⁽⁴⁾						
DK	11,9	15,8	36,9	7,4	9,4	12,8
D	4,5	6,3	4,4	5,4	5,2	5,5
F	10,4	16,5	25,1	13,1	13,3	13,7
IRL	10,2	:	51,1	:	:	20,3
I	15,1	29,1	56,3	20,3	14,0	21,7
NL	4,6	10,5	21,8	7,3	6,5	7,5
B	4,0	8,6	:	6,8	5,7	7,3
L	3,1	:	17,3	:	:	6,4
UK	13,7	14,5	28,3	29,4	22,9	16,9
EC-total	10,1	14,0	23,8	15,8	12,8	13,7

¹ Including repairs, maintenance and other expenses relative to property ownership.

² For Ireland = Housing.

³ Excluding rent.

⁴ May 1980/May 1979 for Ireland, June 1980/June 1979 for Italy.

Note: Consumer prices = consumer price indices.

Sources: OECD and Commission staff.

Table 2.3

Contributions to consumer price increases, EC total

	Food	Non-food Goods less Fuel & Light	Fuel and light	Rent	Services	Total (2)
1973	2,5	2,6	0,3	0,8	1,9	8,1
1974	2,9	5,5	1,0	0,8	2,2	12,4
1975	3,2	4,9	0,6	1,2	3,5	13,3
1976	3,0	3,4	0,5	1,1	2,7	10,8
1977	3,2	3,8	0,5	0,9	2,0	10,5
1978	1,7	2,9	0,3	0,6	2,0	7,5
1979	2,2	3,8	0,7	1,4	2,1	9,9
1980 (1)	2,4	5,2	1,0	1,6	2,8	13,7

(1) July 1980/ July 1979

(2) Totals may not add because of rounding adjustments.

Sources : OECD and Commission Staff

Table 2.4 Origin of price increases (final expenditure) EC Total
(contributions to the increase in the deflator of total final expenditure)

	Imports	Unit labour costs	Indirect taxes (1)	Other (1) factors (residual)	Total (2)
1974	8,3	6,8	0,8	1,3	17,2
1975	1,0	7,4	1,3	2,2	11,9
1976	2,8	3,2	1,1	2,5	9,6
1977	2,0	3,6	1,0	2,1	8,7
1978	0,1	3,1	0,9	1,7	5,8
1979	2,2	3,8	1,2	1,7	8,9
1980 (3)	3,8	5,1	1,5	1,9	12,3
1981 (4)	2,0	4,2	1,0	2,2	9,4

(1) Per unit of output.

(2) Total = deflator of total final expenditure.

(3) Estimate.

(4) Forecast

Sources: Eurostat and Commission staff.

Table 2.5

Per capita compensation of employees.

	percentage change								
	1960-73	1974	1975	1976	1977	1978	1979	1980	1981 forecast
DK	10,7	17,8	13,5	12,9	10,2	9,5	11,0	9,1	8,9
D	10,3	10,1	4,1	7,4	6,9	6,3	7,7	6,8	5,9
F	11,8	19,3	17,7	16,1	13,4	12,9	13,2	14,0	11,9
IRL	12,7	20,4	28,0	18,2	16,9	18,1	17,8	24,1	17,8
I	12,9	24,5	21,5	22,1	22,5	17,0	19,5	22,3	14,3
NL	13,0	16,2	12,8	11,1	9,0	7,9	7,1	5,5	7,3
B	10,6	20,2	15,2	14,4	9,2	7,4	7,8	7,4	6,6
L	10,0	26,2	12,0	11,6	9,0	6,5	7,1	7,7	6,7
UK	8,5	21,5	29,8	14,5	10,4	13,6	16,2	20,0	14,1
EC	10,7	17,4	15,2	12,5	10,7	10,2	11,9	13,1	10,3
Standard Deviation	1,4	4,4	7,7	4,0	4,6	4,3	4,6	6,9	4,0
Real per capita compensation of employees (1)									
DK	6,1	2,9	2,7	3,2	-0,5	0,1	1,2	-3,0	-1,0
D	6,3	2,8	-1,9	2,7	2,9	3,7	3,7	1,4	1,8
F	6,8	5,4	5,7	5,6	3,9	3,8	2,4	0,8	1,1
IRL	6,4	4,0	4,7	-0,8	3,9	9,5	5,0	4,7	4,4
I	7,7	3,0	3,3	3,4	3,6	3,7	4,0	1,5	-0,9
NL	7,4	5,6	2,0	2,2	2,9	3,6	2,4	-1,3	0,5
B	6,6	6,8	2,5	5,6	2,3	2,9	4,2	1,2	1,0
L	6,8	15,9	0,7	2,0	2,1	2,9	2,5	1,3	1,0
UK	3,4	3,6	5,1	-0,8	-4,1	4,6	3,7	1,1	0,1
EC	5,9	3,6	1,7	1,6	0,4	2,5	3,0	1,0	0,5
Standard Deviation	1,2	3,9	2,2	2,2	2,5	2,3	1,1	2,0	1,5

(1) Per capita compensation of employees deflated by the consumer price deflator.

Source: Eurostat and Commission staff.

Table 2.6

Labour Costs per unit of output.

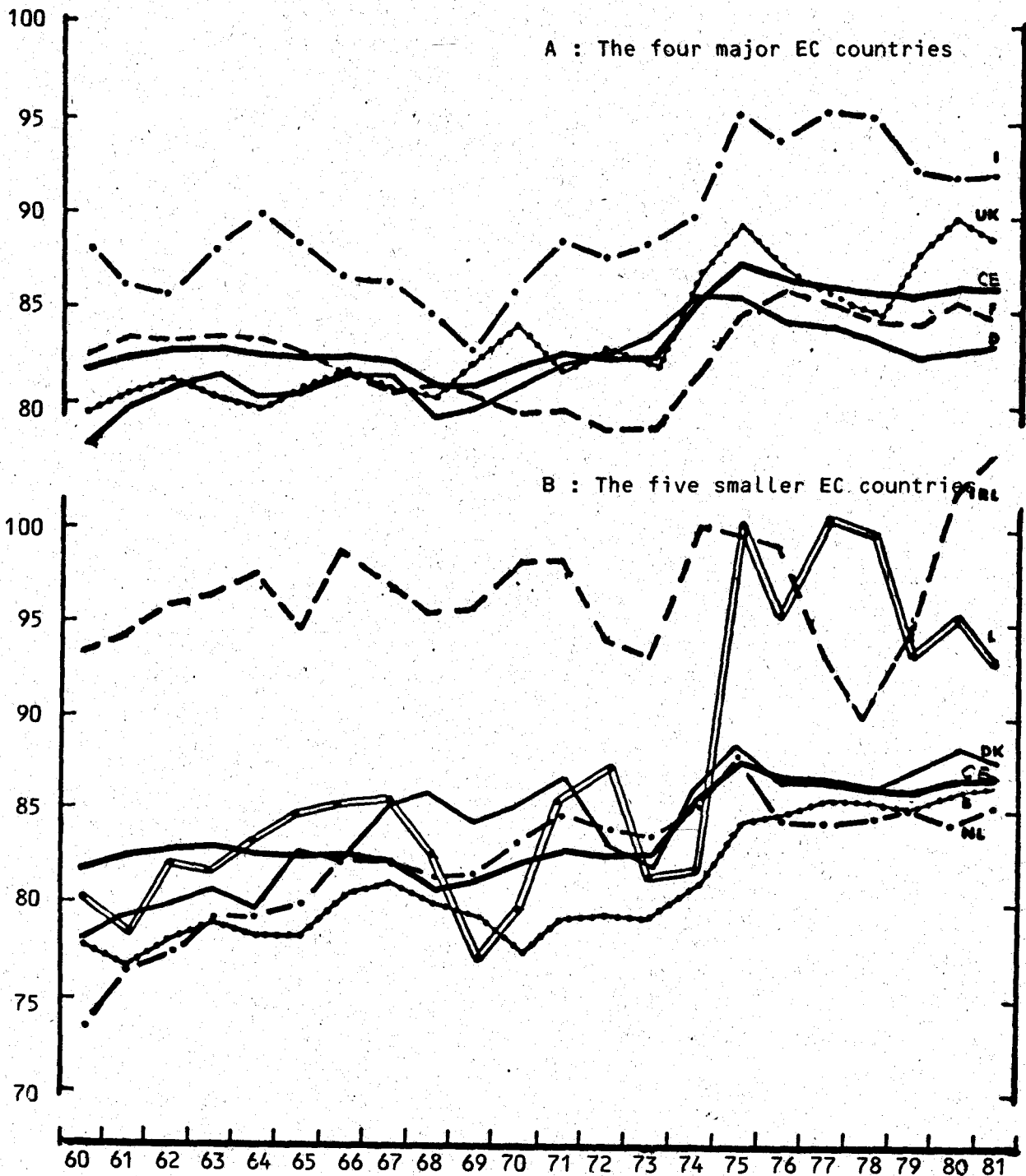
	percentage change								
	1960-73	1974	1975	1976	1977	1978	1979	1980	1981 forecast
	Nominal Labour cost per unit of output								
DK	7,5	19,2	13,7	5,2	8,2	7,9	8,0	10,1	8,3
D	5,5	9,5	6,0	2,1	4,1	3,0	3,0	5,3	4,9
F	5,9	15,5	17,5	10,6	10,2	9,3	10,5	12,0	10,6
IRL	8,1	16,2	25,4	16,4	10,7	11,4	16,4	23,0	13,1
I	7,2	19,5	26,1	15,3	20,1	14,1	15,6	17,8	14,1
NL	7,6	12,2	14,0	5,5	6,5	5,3	5,0	4,4	7,0
B	5,5	15,1	17,4	8,8	8,1	4,9	4,5	6,1	5,6
L	5,6	20,6	23,6	8,5	7,2	2,1	2,7	6,8	6,2
UK	5,1	23,4	31,1	10,5	8,9	10,1	14,6	23,2	14,8
EC	5,8	15,4	16,8	7,2	8,3	7,0	8,7	11,6	9,6
Standard Deviation	1,1	4,1	7,3	4,4	4,2	3,8	5,2	7,1	3,6
	Real labour costs per unit of output (1)								
DK	0,7	5,6	1,0	-3,6	-0,7	-1,2	0,8	0,7	-1,2
D	1,2	2,4	-0,7	-1,1	0,3	-0,8	-0,8	0,6	0,7
F	1,0	4,0	3,6	0,5	1,2	-0,5	0,2	0,9	-0,5
IRL	0,8	9,5	2,6	-3,8	-2,0	0,1	2,8	6,2	1,1
I	1,7	0,9	7,3	-2,3	0,9	0,0	0,4	-1,1	-0,9
NL	1,5	2,7	2,5	-3,1	0,1	0,1	1,1	-1,2	0,8
B	1,2	2,5	4,4	0,9	1,3	0,4	0,5	0,8	0,0
L	1,3	4,5	21,1	-3,5	5,3	-2,2	-6,1	2,2	0,2
UK	0,0	7,2	3,1	-3,5	-4,2	-0,1	0,2	1,7	-0,3
EC	0,8	3,2	2,2	-2,8	-1,7	-1,5	0,0	0,5	-0,1
Standard Deviation	0,5	2,5	2,2	1,7	2,4	0,8	1,0	2,1	0,7

(1) Labour costs per unit of output deflated by the GDP price deflator

Source: Eurostat and Commission staff.

Graph 2.1

Labour income ratio (normalized) (1), EC and Member States



(1) Labour income, including an imputed income from labour of self-employed as % of net domestic product at factor cost.

Source: Estimates by the Commission's staff.

3. External performance : balance of payments

In common with almost all other industrialized countries the Community has suffered a very sharp deterioration in its current balance of payments as a result of the two and a half-fold increase in the price of oil between 1978 and 1980. So far, however, it has been markedly less successful than its two main competitors, the United States and Japan, in diverting real resources into the external sector to offset the adverse movement in its terms of trade. The Community's cost and price competitiveness has been somewhat eroded during 1979-1980 and there are some signs of a loss of dynamism in its export performance; its share of world export markets has ceased to grow and it appears to be becoming increasingly vulnerable to competition from the newly industrialized countries. Although member countries have experienced no difficulty so far in financing their current deficits through capital imports and the value of their official reserves has been greatly increased as a result of the steep rise in the price of gold, progress towards real adjustment, particularly in the case of some of the smaller countries, clearly needs to be accelerated.

The pattern of current balances 1978-1981

The salient feature of the last two years has been another massive improvement in the terms of trade of the oil exporting countries, resulting in a huge increase in their current surplus at the expense of the rest of the world. So far the greater part of the corresponding current account deterioration of the oil importing countries has been borne by the advanced industrial nations. In aggregate these countries' current balances are estimated to have experienced an adverse swing of over \$ 90 billion between 1978 and 1980. The absolute deterioration in the combined current balances of the developing countries over the same period has been relatively modest (approximately \$ 25 billion). However, these countries, unlike the industrial nations as a whole, were already in deficit in 1978. This year they are expected to have a combined current deficit of around \$ 60 billion, which is approximately three-quarters that of the industrial countries and far greater in relation to export earnings and reserves.

For the industrial countries as a whole the deterioration in their current account between 1978 and 1979 (- \$ 44 billion) can be wholly accounted for by the increase in their oil import bill (+ \$ 46 billion). However, this was not the case for all countries in the group, particularly those of the European Community. For EC countries as a whole only about two-thirds (\$ 17 billion) of the total (\$ 29 billion) adverse shift in their current balance can be accounted for by the higher cost of oil imports. By contrast for other industrial countries, considered as a group, the higher cost of oil imports (+ \$ 29 billion) was substantially greater than the increase in their current deficit (+ \$ 15 billion) so that this group of countries, in particular Japan and the USA, had clearly begun to make some progress towards external adjustment already in 1979.

Within the Community all member countries, except the Netherlands and United Kingdom, have experienced a serious worsening of their current balances. The shifts have been particularly large in absolute terms in Germany, France and Italy. But it is the position of certain smaller member countries which gives the most grounds for concern. Denmark, Ireland and Belgium were already in deficit before the 1979/1980 oil price increase and their deficits are now disturbingly large in relation to their export earnings and output. For these countries therefore an arduous adjustment cannot be postponed much longer.

Progress towards external adjustment

It is estimated that between 1978 and 1980 the terms of trade of the industrial countries have worsened on average by about 10%. Table 3.2 shows, for each member of the European Community, as well as for the United States and Japan, the cost of this deterioration, measured as a percentage of GDP. It also shows the extent to which the terms of trade shift has been offset by an improvement, or aggravated by a worsening, of the real trade balance during the two years 1979-1980, and on the basis of Commission forecasts, in 1981. These forecasts are particularly dependent on OPEC's pricing and output decisions.

The process of external adjustment has already begun in the two largest industrial economies outside the Community - the United States and Japan. These two countries were particularly hard hit as regards their terms of trade; those of the United States are estimated to have deteriorated by 11% between 1978 and 1980 and those of Japan by as much as 30% over the same period (these figures amounting to 1.2% and 5.2% of GDP respectively - see table 3.2), the adverse impact of higher oil prices having been aggravated by a steep fall in the exchange rate of the yen. Both countries have, however, achieved a substantial shift of real resources into the external sector, aided in this by the big improvement in their competitiveness (see below) and, in the US case, by a sharp fall in the relative pressure of demand as the economy has sunk into recession. For both the United States and Japan the improvement in the real trade balance during 1978-1980 is estimated at 1.7% of GDP, but bearing in mind that in both countries, and especially the United States, the external sector accounts for a fairly small proportion of the economy as a whole, this amounts to a very large shift of output in the tradeable goods and services sectors.

The experience of the Community has been strikingly different from that of its main competitors. The average terms of trade deterioration in Community countries during 1979-1980 has been less severe than in the USA or Japan (approximately 5 % compared with 11% and 30% respectively), but the cost, in relation to GDP has been higher than in the USA (though still lower than in Japan - see Table 3.2) since foreign trade accounts for a higher proportion of output in the Community than in these countries. For certain individual Member States, however, notably Ireland, Denmark and Italy, it has been particularly high. Moreover, the effect of the worsening terms of trade has been aggravated, rather than offset, by a deterioration in the real trade balance, due in part to a weakening of the Community's competitiveness vis-à-vis the other major industrial countries, particularly Japan, and to the fact that the rate of capacity utilisation in the Community as a whole has not fallen so far or so fast as in some other countries, particularly the United States.

However, there have been exceptions within the Community to this overall pattern. Both the Netherlands and Denmark, where domestic demand has been particularly severely restricted, have achieved substantial real adjustment. The United Kingdom's performance has also differed sharply from the general pattern, reflecting the change in the structure of that country's foreign trade now that it has achieved virtual self-sufficiency in oil production. This transformation would in any case have caused the United Kingdom's terms of trade to improve, for precisely that reason for which other industrial countries' terms of trade have deteriorated. But superimposed upon this "oil effect" has been a much higher than average rate of inflation and a strongly rising exchange rate. The consequent deterioration in the real trade balance is estimated to amount to 2.4% of GDP in 1979 and 1980 combined, larger than for any other industrial country, and this despite the displacement of imported by domestically produced oil supplies and the almost complete stagnation of domestic demand.

The weaker evolution of economic activity expected in 1981 should lead to an improvement in the real trade balances of the industrial countries, which, in the case of the European Community may amount to about 0.3% of GDP. Since it is hoped that the terms of trade will stabilise, this real improvement should be very largely reflected in nominal current balances. So far as the Community is concerned, however, this will be no more than a small first step in the process of external adjustment. On the basis of present forecasts only about one-seventh of the estimated \$ 60 billion adverse swing in the current balance between 1978 and 1980 will be reversed in 1981. By contrast, it seems that the United States will by then have achieved a much more complete adjustment. Much the same applies in the case of Japan where export volume is now showing remarkable growth and import volume has fallen in absolute terms.

Financing and reserves

In 1979 the Community's total current deficit of ECU 14 billion was aggravated by a net outflow of non-monetary capital amounting to some ECU 3 billion, most of it from Germany in the form of export credit. The resulting deficit of nearly ECU 17 billion on total non-monetary transactions was financed by a net inflow of banking capital of over ECU 19 billion, mainly into Germany and the United Kingdom, where a combination of high interest rates (nominal in the United Kingdom, real in Germany) and confidence in the exchange rate (due to relatively low inflation in Germany and to North Sea Oil in the United Kingdom) offered an attractive risk return ratio to foreign investors. Total Community reserves therefore increased by ECU 3 1/2 billion, before valuation adjustments.

During the first six months of 1980 the current deficit widened sharply to about ECU 18 billion (not seasonally adjusted). Almost the whole of this appears to have been financed by capital inflows, mainly in the form of public sector borrowing and an increase in the liabilities of the banking sector, so that, so far as the Community as a whole is concerned, there has been only very modest recourse to the use of official reserves. Indeed, taking the whole period from the end of 1978 to mid-1980, total Community reserves actually increased by slightly more than ECU 2 billion if valuation adjustments are excluded. German reserves fell by approximately ECU 8 billion, although from an initial level that was abnormally high following the operations in support of the US dollar in late 1978, while France and, to a lesser extent, the United Kingdom and Italy all substantially increased their reserves.

As mentioned above, the foregoing references to changes in reserves are flow figures consistent with balance of payments data and do not take account of valuation adjustments. However the stock figures have been affected by valuation changes in two important respects. In the first place the ECU appreciated against the US dollar by about 6% between the end of 1978 and mid-1980, thus causing a fall in the ECU value of reserves held in dollars. Secondly, and quantitatively much more important, the free market price of gold rose very steeply during 1979 and early 1980. The physical quantity of gold held by Community central banks hardly changed over the period from the end of 1978 to mid-1980, but the value of these holdings, if gold is valued according to the market-related price formula used in the EMS, increased from ECU 68 billion to ECU 157 billion or nearly two and a half times. As a result, total Community reserves increased from ECU 139 billion to ECU 223 billion, or by 60%. This was considerably faster than the rate of growth of total Community imports over the same period so that the reserve: import ratio for the Community as a whole increased from 42% to 50%. This should be reassuring at a time when the Community is faced with a large external deficit that is likely to persist for some time, although there does appear to be some reluctance on the part of the monetary authorities actually to use gold as a means of settlement.

Price Competitiveness

Since the European Monetary System went into operation early in 1979 intra-Community exchange rates have for the most part been fairly stable. The principal changes have involved sterling, which appreciated on a trade-weighted basis against other Community currencies by 13% between the end of 1978 and mid-1980, the Danish krone, which depreciated by 12% over the same period and the Italian lira, which depreciated by 6.5%.

As is often the case over fairly short periods of time, the behaviour of exchange rates during the past eighteen months has not conformed particularly closely to the theory of purchasing power parity. As a result there have been several significant changes in competitiveness not only among Member States but between the Community as a whole and the rest of the industrial world.

From the end of 1978 to the second quarter of 1980, Community currencies appreciated in nominal terms against the dollar and the yen, the currencies of the Community's major competitors on world markets. Over this period the ECU rose against the dollar by 6% and against the yen by 22%. As a result the Community's competitive position vis-à-vis the outside world has weakened (see Table 3.5) while Japan's has improved spectacularly, especially against the Community, albeit from an initial position at which the yen was perhaps overvalued. Japan being a major trading partner of the United States, the weakness of the yen has caused the dollar to appreciate on a trade-weighted basis and the United States global competitive position to deteriorate somewhat over the last eighteen months, but this has eroded only a small part of the advantage built up during earlier years. Vis-à-vis the Community the United States competitive position, which was already strong at the end of 1978, has continued to improve.

Within the Community itself too the competitive positions of member states have changed against one another, as can be seen from Table 3.6 (which, for each member country, indicates changes against other Community members only and not against the world as a whole). As is frequently the case with comparisons of this kind, the picture to emerge from the table is not entirely unambiguous, since the various indices do not all point in the same direction. Nevertheless, there are a number of interesting conclusions which may be drawn from the data presented.

The Federal Republic of Germany appears to have improved its price competitiveness vis-à-vis the other Member States quite significantly over the period under review, the result of maintaining a stable effective exchange rate while the internal rate of inflation has been well below the Community average. This improvement has more than cancelled out the loss of competitiveness suffered during 1976-1978, with the result that the German competitive position vis-à-vis other Community countries is today stronger than at any time for the last five years.

The competitiveness of French industry vis-à-vis the rest of the Community seems to have undergone little change over the last eighteen months. Italy, on the other hand, does seem to have suffered an appreciable loss of competitiveness during 1979-1980, the exchange rate depreciation over this period having been substantially less than the adverse inflation differential. Nevertheless the deterioration has not been sufficient to erode completely the competitive gains against other Community countries achieved during 1976-1978.

The loss of competitiveness has, however, been far more serious in the United Kingdom. Broadly speaking, it appears that United Kingdom costs and prices have risen by about 20% in relation to those of other Community countries since the end of 1978, thus more than offsetting the gains chalked up during 1976-1977. So far the UK share of both intra-Community and world trade has held up surprisingly well in spite of these developments (see following section), but loss of competitiveness on this scale seems bound to affect the United Kingdom's trading performance in future.

Superficially the figures for the Benelux countries appear fairly satisfactory. On average the Netherlands' export prices have risen faster than those of competitors, but this can probably be accounted for largely by the relatively heavy weight of natural gas in Dutch exports. Since fuel prices have risen world-wide, higher natural gas prices do not entail any loss of competitiveness for the Netherlands. If allowance is made for this factor, Dutch export prices have probably moved broadly in line with world prices, which is what one might expect in the case of a small economy which is a "price-taker" rather than a "price-maker" in international trade. Belgian export prices have conformed to this pattern too.

The figures for wholesale prices of manufactures and unit labour costs in manufacturing indicate a very striking improvement in the competitiveness of both the Netherlands and Belgium, but these figures may be misleading for a variety of reasons. The indices of relative consumer prices, although in theory not a very satisfactory guide, seem to conform more closely to what is known from other sources about these two countries' trading performance in industrial goods, namely that there has been some improvement in their competitive positions over the last two years or so, but that this has been insufficient to undo completely the losses suffered in earlier years.

Denmark's competitive position was also seriously undermined during the early seventies, when the krone appreciated with other "Snake" currencies so that the starting point for the indices used (1970-1975 = 100) was already one of substantial overvaluation. That overvaluation increased during the period up to the end of 1978, but since then there has been a very striking improvement. Between the end of 1978 and mid-1980 the krone depreciated on a trade-weighted basis against other Community currencies by 12% in nominal terms. However, contrary to what might have been expected in a small, open economy with a fairly high degree of indexation, this nominal depreciation appears to have been fully absorbed, thereby improving competitiveness.

Ireland's competitive position vis-à-vis the rest of the Community has improved steadily throughout the seventies. The continuation of this trend during the last eighteen months, however, probably owes much to the fact that the competitiveness of the United Kingdom, which is still by far and away Ireland's most important trading partner, has deteriorated very steeply. Vis-à-vis other Community countries, towards which Irish trade is increasingly directed, the cost competitiveness of Irish products probably worsened, as a result of the combination of a stable exchange rate with a higher than average rate of inflation. Such developments can only damage the prospects for the growth of export orientated employment, which remains vitally important for Ireland.

For the most part, the changes in intra-Community real exchange rates that have taken place over the past eighteen months appear at least to have been in the right direction. In the case of both Italy and the United Kingdom, some real appreciation was acceptable particularly from the point of view of internal policy objectives - i.e. reducing inflation - although it may be that sterling's real appreciation is greater than can be sustained in the medium term. Among the smaller countries both Denmark and Ireland clearly need to shift resources into the external sector and the real depreciation of their currencies that has occurred should contribute towards the achievement of this objective. The question of whether a real depreciation of the Deutsch mark vis-à-vis the rest of the Community, of the order of 10% is appropriate in present conditions is more debatable. Admittedly, the Federal Republic of Germany is at present running a current deficit which is a little higher in relation to exports and output than the corresponding figure for the Community as a whole. However, the German economy, with its reputation for financial stability and abundant reserves, is better placed than almost all other member countries to finance a sizeable current deficit over a period of several years. If the improvement in German competitiveness was to lead to a sharp relative improvement in the Federal Republic's current account performance, this could render the process of external adjustment more difficult for Member States where the need for such adjustment is considerably more urgent.

Market share performance

The modest increase in the Community's share of the industrial world's exports in the latter half of the 1970's came to a halt in 1979, whilst the United States has reversed its loss of share. Comprehensive data for 1980 are not yet available, but it is to be expected that the Community's loss of competitiveness will have some further adverse effect on its export performance. Japan's share of industrial countries' exports, which had increased substantially during the mid-nineteen-seventies, fell sharply in 1978-1979. Recently, Japanese export volume has been growing vigorously, but because of the weakness of the yen this has not yet been reflected in Japan's export share measured in current price terms.

The development of the commodity composition of Community exports to the rest of the world gives grounds for some concern. The share of machinery and transport equipment has diminished sharply, while the share of those commodities most vulnerable to third world competition has increased.

Within the Community itself there have also been changes.

Both the United Kingdom and Italy have increased their export shares at the expense of other members. That the United Kingdom should increase its share of intra-Community trade in the post-entry period was to be expected. What is, at first sight, somewhat more surprising, is to find that the United Kingdom share in Community exports to third countries has also increased.

The explanation appears to be that the United Kingdom already had fairly close commercial ties with the oil exporting countries of the Middle East where demand for imports has proved the most dynamic element in world trade during the period under consideration. The United Kingdom, Italy and Ireland also no doubt benefitted from the considerable improvement in their competitive strength during the mid-nineteen-seventies, although the recent deterioration in their competitiveness mentioned above is likely to affect their performance in future.

By contrast, and as might have been expected, those countries whose competitive strength had declined during the mid-seventies tended to lose market share, both in intra-Community trade and in Community exports to third countries. This was the case with the Federal Republic of Germany and the Benelux countries and also Denmark, where one would normally have expected an increase in the share of intra-Community trade during the post-entry period, but where in fact there was a decline.

TABLE 3.1

Current balances 1978-1981

£ billion

	1978	1979	1980 (forecast)	1981 (forecast)
Oil exporters (OPEC)	+ 5	+ 68	+ 119	+110
Industrial countries(OECD)	+ 8	- 36	- 84	- 65
of which :				
E.C.	+ 15	- 14	- 43	- 36
of which :				
DK	- 1 1/2	- 3	- 3	- 3
D	+ 9 1/2	- 5 1/2	- 15 1/2	- 12 1/2
F	+ 3	+ 1 1/2	- 9	- 9 1/2
IRL	- 1/2	- 1 1/2	- 1 1/2	- 1 1/2
I	+ 6	+ 5	- 6	- 3 1/2
NL	- 1	- 2	- 2 1/2	- 1 1/2
BL	- 1	- 3 1/2	- 4 1/2	- 6
UK	+ 1	- 5	- 1	+ 1 1/2
Other industrial countries	- 7	- 22	- 41	- 29
Developing countries	- 35	- 43	- 60	- 63
Other countries	- 10	- 18	- 17	- 18
Total (1)	- 32	- 29	- 42	- 36

Source : Commission services

(1) In principle world current balances should, of course, sum to zero. In practice they do not, due to errors and omissions of various kinds.

TABLE 3.2

Changes in the terms of trade and real adjustment in 1979 to 1981

	1978 to 1980 cumulative change		Forecast change in 1981	
	Terms of trade(1) loss (-) or gain (+)	Change in real trade balance	Terms of trade(1) loss (-) or gain (+)	Change in real trade balance
	as % of 1978 GDP (2)		as % of 1980 GDP (2)	
DK	- 4.5	+ 3.6	- 0.2	+ 1.1
D	- 2.6	- 0.7	- 0.1	+ 0.3
F	- 2.4	- 0.6	- 0.1	+ 0.4
IRL	- 6.0	- 0.7	- 1.3	+ 1.7
I	- 4.1	- 2.2	- 0.7	+ 0.6
NL	- 2.4	+ 2.2	n.c.	- 0.5
B	- 2.3	- 1.4	- 0.2	- 0.2
UK	+ 3.0	- 2.4	+ 1.2	- 0.4
Total EC	- 2.0	- 0.8	n.c.	+ 0.3
USA	- 1.2	+ 1.7		
Japan	- 5.2	+ 1.7		

(1) Equal to the additional exports required to leave the balance of trade in goods and services unaltered and then expressed as a percentage of GDP.

(2) For practical purposes these percentages can, for each country or region, be added together to derive the change in the trade balance in nominal terms as a percentage of GDP.

TABLE 3.3

Balance of payments financing 1979-1980

ECU billion

	DK	D	F	IRL	I	NL	BL	UK	EC
<u>1979</u>									
Current account	- 2.0	- 4.0	+ 1.1	- 1.1	+ 0.8	- 2.0	- 2.8	- 3.7	-13.7
Non monetary capital (including errors and omissions)	+ 2.1	- 5.4	.	+ 0.2 (est)	+ 0.8	.	- 0.4	- 0.3	- 3.0
Banks	- 0.2	+ 7.4	+ 0.3	+ 0.5 (est)	+ 1.0	+ 1.6	+ 2.2	+ 6.4	+19.2
SDR allocation	.	+ 0.2	+ 0.2	.	+ 0.1	+ 0.1	+ 0.1	+ 0.3	+ 0.1
Change in reserves (1)	- 0.1	- 1.8	+ 1.5	- 0.4	+ 2.7	- 0.3	- 0.9	+ 2.7	+ 3.5
<u>1980 (Jan/June) (2)</u>									
Current account	- 1.2	- 4.8	- 2.9	- 0.6	- 4.0	- 1.5	- 1.6	- 1.8	-18.4
Capital movements	+ 0.7	- 1.6	+ 8.6	+ 0.7	+ 2.7	+ 1.6	+ 1.9	+ 1.7	+16.2
SDR allocation	.	+ 0.2	+ 0.2	.	+ 0.1	+ 0.1	+ 0.1	+ 0.3	+ 1.0
Change in reserves (1)	- 0.5	- 6.2	+ 5.9	+ 0.1	- 1.2	+ 0.2	+ 0.4	+ 0.2	- 1.2

(1) Excluding valuation adjustments

(2) Provisional estimates, not seasonally adjusted.

Note : Figures are on a transactions basis, except those for Italy and the Netherlands, which are on a payments basis. This explains the discrepancy in the current balances of these two countries compared with those shown in Table 3.1.

TABLE 3.4

European Community official reserves 1978-1980

ECU billion

	DK	D	F	IRL	I	NL	BL	UK	EC
<u>End December 1978</u>									
Foreign currency, SDR and IMF position	2.3	35.3	6.7	1.9	8.1	3.7	2.9	10.8	71.7
Gold	0.3	18.8	16.2	0.1	13.2	8.7	6.8	3.6	67.6
Total	2.6	54.1	22.9	2.0	21.3	12.4	9.7	14.4	139.3
<u>End June 1980</u>									
Foreign currency, SDR and IMF position	1.7	26.6	8.9	1.5	8.0	3.2	3.2	13.3	66.5
Gold	0.7	43.6	37.5	0.2	30.5	20.1	15.6	8.6	156.9
Total	2.5	70.2	46.4	1.7	38.6	23.3	18.8	21.9	223.4

Note : In order to facilitate comparison between the two dates member countries ECU holdings, which did not exist in December 1978, are not shown separately in the table. The dollar counterpart to reserves held in ECU is included with foreign currency and the gold counterpart with gold. Gold is valued here, as in the EMS, either at the average price of the preceding six months or at the price on the penultimate working day of that period, whichever is the lower.

TABLE 3.5

Indices of effective exchange rates price competitiveness :

The Community, USA and Japan

Index : 1970-1975 = 100

	1978 Q IV	1979 Q IV	1980 Q II
EC			
Effective exchange rate	98.9	107.3	106.4
<u>INDICES OF PRICE COMPETITIVENESS :</u>			
Export unit values	107.2	110.7	110.9
Wholesale prices	104.0	111.8	111.0
Consumer Prices	100.9	110.3	110.4
Unit labour costs	109.0	122.7	123.1 ^{*)}
USA			
Effective exchange rate	84.0	86.1	85.9
<u>INDICES OF PRICE COMPETITIVENESS :</u>			
Export unit values	92.2	93.9	89.5
Wholesale prices	88.0	93.3	95.6
Consumer prices	75.3	80.0	80.9
Unit labour costs	71.2	75.2	76.4 ^{*)}
JAPAN			
Effective exchange rate	148.7	118.5	122.3
<u>INDICES OF PRICE COMPETITIVENESS :</u>			
Export unit values	104.9	89.0	93.5
Wholesale prices	119.7	94.8	96.6
Consumer prices	157.2	118.3	120.4
Unit labour costs	145.4	105.7	98.9 ^{*)}

*) Figures for 1980 QI

Note : The effective exchange rate index represents the weighted average exchange rate change of the currency of the country, or group of countries, concerned against the currencies of other industrial countries. The indices of price competitiveness represent effective exchange rate changes adjusted for inflation differentials, four separate measures of inflation (as indicated) being used for this purpose. In calculating the effective exchange rate/competitiveness index for country A, the weights accorded to countries B, C, D ... take account of the latter's importance to country A, both as trading partners and as competitors in third markets.

TABLE 3.6

Indices of effective exchange rates and price competitiveness in the European Community

Index : 1970-1975 = 100

	1978 Q IV	1979 Q IV	1980 Q II	1978 Q IV	1979 Q IV	1980 Q II
	DK			D		
Effective exchange rate	108.5	101.1	95.1	152.2	155.1	152.2
<u>INDICES OF PRICE COMPETITIVENESS :</u>						
Export unit values	99.0	94.6	90.7	103.6	95.7	89.6
Wholesale prices	104.6	95.8	91.2	105.5	101.6	96.3
Consumer prices	108.3	100.2	91.8	106.9	101.8	95.8
Unit labour costs	98.8	91.3	86.5*)	110.7	105.0	101.9*)
	F			IRL		
Effective exchange rate	95.8	94.8	94.3	79.0	78.5	75.9
<u>INDICES OF PRICE COMPETITIVENESS :</u>						
Export unit values	95.9	95.9	93.8	97.8	95.3	88.4
Wholesale prices	97.4	97.7	99.5	96.8	94.9	87.3
Consumer prices	100.2	100.5	100.6	92.7	95.0	91.1
Unit labour costs	103.1	104.0	105.5*)	93.0	92.4	90.8*)
	I			NL		
Effective exchange rate	57.3	55.0	53.6	122.6	120.9	120.5
<u>INDICES OF PRICE COMPETITIVENESS :</u>						
Export unit values	91.7	98.8	105.1	104.0	108.5	111.9
Wholesale prices	91.1	96.3	98.4	105.3	97.9	93.8
Consumer prices	83.0	87.2	89.2	115.4	108.4	105.9
Unit labour costs	88.0	93.0	94.3*)	95.7	86.5	85.5*)
	BL			UK		
Effective exchange rate	117.8	116.1	115.8	64.2	67.0	72.7
<u>INDICES OF PRICE COMPETITIVENESS :</u>						
Export unit values	99.3	102.7	102.4	104.5	109.5	119.3
Wholesale prices	97.6	91.1	87.4	98.8	110.2	123.7
Consumer prices	114.4	107.9	104.6	88.0	99.1	113.5
Unit labour costs	102.9	96.4	93.9*)	90.8	104.7	111.0*)

*) Figures for 1980 QI

Note : The indices in Table 3.6 are constructed in accordance with the same principles as those in Table 3.5, except that they represent the development of each individual Community country's effective exchange rate/competitiveness vis à vis other Community countries only, rather than vis à vis all industrial countries.

TABLE 3.7

Share in industrial countries total exports
(excluding intra-EC trade)

per cent

	Average 1974-1975	1977	1978	1979
EC	35.0	35.8	35.7	35.6
USA	25.3	23.0	23.1	24.3
JAPAN	13.7	15.4	15.7	13.7
OTHER	26.0	25.8	25.5	26.4

Source : OECD Statistics of Foreign Trade, June 1980

TABLE 3.8

Commodity shares in Community total exports
(excluding intra EC trade)

per cent

	1970	1973	1977	1978	1979
Food, beverages, tobacco	7,2	7,7	6,3	6,6	6,8
Fuel products	2,9	3,1	4,3	4,1	5,3
Raw materials	2,7	2,8	2,3	2,3	2,4
Machinery and transport equipment	41,6	41,1	43,1	41,5	39,6
Chemicals	11,2	11,4	11,7	11,7	12,1
Intermediate manufactured products	22,9	23,0	20,8	21,9	21,4
Manufactured products in final demand	9,8	9,3	9,2	9,7	9,9
Miscellaneous	1,7	1,6	2,3	2,3	2,4
Total	100	100	100	100	100

Source : Eurostat - Monthly external trade bulletin - Special number 1958-1979

TABLE 3.9

Shares in intra-Community and extra-Community exports

(%)

	Intra-Community exports		Extra-Community exports	
	Average 1974-1975	Average 1978-1979	Average 1974-1975	Average 1978-1979
DK	2.7	2.4	3.1	2.8
D	27.9	27.2	34.9	34.0
F	17.5	16.9	16.7	16.9
IRL	1.5	1.8	0.5	0.6
I	10.3	11.5	12.5	13.4
NL	16.5	15.0	7.0	6.6
BL	14.1	13.4	6.0	5.7
UK	9.5	11.8	19.3	20.0
EC	100.0	100.0	100.0	100.0

Source : Eurostat - Monthly trade bulletin - Special number 1958-1979 (?)

4. Budgetary policy and sectoral financial balances

After stimulative measures in 1978, budgetary policy, which in 1979 globally exerted a small contractionary impact, is in 1980 and 1981 expected to provide a certain support to activity, due essentially to the operation of automatic fiscal stabilizers under recessionary conditions. Despite the fact that budget deficits in the late seventies are generally larger than in the previous decade, the demand impact seems to be lower now than earlier, when certain adjustments are made for inflation. Thus government deficits have in part reflected interest payments to offset substantial losses in the real value of domestic private sector holdings of public debt. In some member countries these factors may go some way to explaining the sharp rise in nominal savings of households since the first oil crisis. The financial deficit (as % of GDP) of the enterprise sector after a decline in 1978 rose in 1979. A further rise may have taken place in 1980 but the level of the deficit is likely to remain below the record values of 1973 and 1974.

Budgetary policy and its measurement

The trend in the recent past has been for Community governments to base budgetary policy to a greater extent than hitherto on medium-term rather than on cyclical demand-management considerations. In a number of countries governments have been seeking to dampen the rise in tax pressure, especially that of direct taxes, in an attempt to strengthen incentives and encourage productive investment. At the same time efforts are being made to stabilize or reduce general government deficits as a proportion of gross domestic product. The principal factor underlying these efforts is a perceived need to ensure consistency between budgetary policy and a monetary policy which has been given a central role in medium-term stabilization programmes; in some cases foreign trade imbalances have been seen as an additional factor dictating budgetary retrenchment.

The weakening of economic activity in 1980 and 1981 has increased the difficulties of reconciling these various objectives and the room allowed by governments for budgetary policy as a short-term stabilizer in recessionary conditions has been very limited, as is borne out by the budgets adopted or planned for 1980 and 1981. On the basis of budgets currently adopted, Commission forecasts suggest that the aggregate deficits of general governments in the Community, as a proportion of GDP, are reduced to 3,5% in 1980 from 3,6% in 1979, and that there will be a slight rise, to 3,9% in 1981 (Table 4.1).

In 1980 current receipts of general government rise faster than nominal GDP (respectively 14,4% and 12,5%). Of the major categories of receipts, indirect taxes are rising most rapidly, reflecting increases in tax rates in some countries during 1979 and 1980. Total current expenditure rises at the same rate (14,4%) as current receipts in 1980, but "other current outlays" (mainly debt interest payments) rise considerably more rapidly. It is noteworthy, however, that the relatively strong increase in government consumption in 1980 stems largely from increases in compensation of government employees, while in volume terms government consumption in 1980 rises by only 2,0%. The increase in current transfers, especially in view of the increasing number of recipients of social benefits, implies some reduction of benefits in the aggregate in real terms. Government fixed capital formation rises by 13,2% in nominal terms in 1980, a faster rate of increase than that in nominal GDP. However, although a volume figure is not directly available, the fact that construction prices are forecast to rise more rapidly than total investment prices in most Community countries **suggests** that little change or perhaps even a fall in the volume of government investment in the Community is implied.

The budgetary forecasts for 1981 indicate that the main categories of current receipts will rise at a rate similar to that of nominal GDP. On the expenditure side, debt interest payments will again rise rapidly, while current transfers and government consumption will also outstrip nominal GDP growth. Once again, however, the volume growth in government consumption will be modest, at 1,3%. A fall in the volume of government investment seems likely.

The Community aggregates are the result of action taken in the Member States which reflect their differing economic circumstances. Thus a continuation of external or internal imbalances, excessive inflation rates and problems of consistency between monetary and budgetary policy have led to measures of budgetary restraint in Denmark, Ireland, the Netherlands, Belgium and the United Kingdom. In Italy the authorities are aiming at a restrictive stance of budgetary policy but without, as yet, the assurance of achieving it in the short term.

Thus in Denmark (Table 4.2), extensions to the multiannual programme were adopted in Spring. Total public expenditure plans for 1981 will be reduced by 8 000 million kr which implies that the actual level in real terms is maintained for the central government and that the increase for local authorities is reduced to 2%. Indirect taxation was raised at the end of June and in October to yield some 4 000 million kr annually, of which the rise in the VAT to 22% accounts for some 3 100 million kr and taxes on energy for another 900 million kr. Taxes on personal income will be raised in 1981 by some 1 000 million kr. Finally the framework of the industrial and employment programme valid for the period 1981-83 is implemented to the amount of 5 400 million kr in 1981. Despite these measures, a number of autonomous factors continue to exert a pressure on the general government borrowing requirement which in 1981 could rise to some 4% of GDP against an estimated requirement of 3.5% of GDP this year.

In Ireland the 1980 budget sought to set in train a reduction of the budget deficit: it implied a tight control of non-wage public expenditure and a shift from direct to indirect taxation. The original target for the budget deficit (10 1/2% of GDP) seems likely to be considerably overshoot, partly as a result of slippage in public sector pay. The 1981 budget has not yet been prepared, but Commission forecasts assume that tax policies will be rather restrictive in that year, while government capital spending is expected to rise somewhat in volume terms. Given only modest economic growth in 1981, and based on the Commission's assumptions and forecasts, the general government budget deficit is likely to be similar, expressed as a percentage of GDP, to that for 1980, at 12,8%. Government policy has been to seek a fall in the underlying deficit.

In the Netherlands the likelihood of a shortfall in tax receipts in 1980 led the government to propose substantial cuts in planned public sector wages, social transfers and government purchases to prevent an overshooting of the 1980 target for the public sector cash deficit (including loans and participations this was set at 5 3/4% of net national income, with the medium-term target set at 4,0%). Present budget forecasts assume that there will be a further shortfall in receipts in 1980, so that the budget deficit, on this basis, under the impact of recession, will reach 6%. The budget proposals for 1981 aim at reducing the public sector cash deficit to 5 1/4% of net national income by further cuts in expenditure of about 3 600 million guilder, a slight increase in indirect taxation and a sharp increase in natural gas revenue, compensated by a substantial reduction of charges for enterprises (2 000 million) and some other measures to stimulate activity.

Measures adopted in Belgium during the summer bear mainly on 1981, but a freeze on public sector staff levels took effect in March while indirect taxes were raised from mid-year and direct taxes reduced. The latest official estimate implies a budget deficit for 1980 greater than the original target for the State budget, as a result of the recession in activity and the impact of high interest rates on debt servicing. The proposals for 1981 involve a rate of increase in current expenditure no higher than that in nominal GNP. This implies zero volume growth in categories of current expenditure which are not regarded as priorities (debt service and unemployment benefits being regarded as the major priority areas). The receipts side will show the influence of an effort to stabilize the pressure of direct taxation, while changes in the taxation of energy products are aimed at reducing their consumption. Despite the effects of recession, the official estimate is that the central government cash deficit, expressed as a percentage of GDP, will fall by 1 point in 1980. Latest Commission forecasts, however, imply a smaller reduction in the absence of measures to redress the financial situation of the social security funds.

In the United Kingdom, budgetary measures for the 1980/81 financial year amounted to a tightening of the fiscal stance. They included a slight increase in the burden of taxation and a reduction in public expenditure below previously planned levels. Activity has weakened more rapidly than was thought likely by the authorities when the budget estimates were made but the public sector borrowing requirement in 1980 is still likely to decline as a percentage of GDP. Medium-term plans involve a steady decline both in the volume of public expenditure and in the budget deficit as a percentage of GDP. Latest Commission estimates thus envisage a further small fall in 1981 in this latter measure.

The budgetary outturn for 1980 in Italy seems likely to depart from the pattern in most other countries, since both economic activity and the rate of inflation were unexpectedly high in the first half of the year, thus easing the public sector deficit. This spontaneous tendency has been reinforced by the results obtained in the efforts to reduce tax evasion and by the fiscal measures adopted in July so that the latest official estimate for the enlarged public sector domestic borrowing requirement in 1980 is below the original estimate and indeed below the outturn for 1979 as a percentage of GDP. However, Commission forecasts established before the announcement of the 1981 budget proposals suggest that the public sector deficit will rise substantially in 1981 as a percentage of GDP.

In the remaining countries policy has had a more neutral stance.

In Germany the budget outturn in 1980 is likely to reveal a deficit similar, as a percentage of GDP, to that for 1979. A reduction in personal income taxes and increases in certain social benefits are due to take effect at the beginning of 1981, taking the increase in current receipts below that in nominal GDP. At the same time, according to present Commission forecasts, current spending will rise more rapidly than nominal GDP. These forecasts envisage a widening of the general government deficit to 3.3% of GDP in 1981.

In France it seems likely that the 1980 general government deficit will be very slightly higher than originally planned (just over 40 000 million FF as against 34 000 million). Given the twin aims of stabilizing tax pressure and reducing the budget deficit, a strict limitation of government spending has been provided for in the budget proposals for 1981: the general government borrowing requirement will rise, to 1.7% of GDP, owing to a significant worsening of the financial position of the social security funds.

In Luxembourg, the Budget Law for 1980 reduced the tax burden on households and firms, the general government budget surplus being eliminated as a result. For 1981, Commission forecasts assume slower growth of investment and employment in the public sector. However, the deceleration in the tax base in parallel with weak activity, as well as rapid growth in transfers to households and enterprises, will entail a general government deficit.

The general impression which emerges from these developments and forecasts is that attempts are being made to limit the impact which recessionary conditions would normally tend automatically to have in increasing budget deficits (for example through shortfalls in tax receipts and increases in unemployment benefits). The limitation is being effected through a restriction of real government spending and real per capita social benefits below the levels that might have been expected if underlying growth prospects were more favourable. However, in certain countries estimates of trend output growth, and hence of medium-term possibilities for affording government consumption, have been revised downwards.

An indication of changes in the budgetary policy stance may be obtained from rudimentary estimates of "constant activity" budget balances based simply on the additions to (or reductions in) tax revenue, at unchanged average tax/GDP ratios, which would occur if real GDP growth in each year were such as to keep activity unchanged from the previous year, with an adjustment made for the actual increase in expenditure on unemployment benefits. Estimates of these "constant activity" balances (Table 4.3) show a tightening for the Community by some 0,5% of GDP in 1980 with a further slight tightening in 1981, suggesting that in both years discretionary budgetary policy - on the assumptions made - exerts a contractionary influence on activity (compared to the forecast of an actual tightening of only 0,1% in the balance between 1979 and 1980 and a widening of 0,4% in the actual deficit between 1980 and 1981).

In order to give a somewhat sharper impression of the demand impacts, a simple income-expenditure model has been used to weight changes in components of the budget balance according to their demand effects. Estimates of the real first-round impact (before allowing for multiplier effects) are thus derived. Commission forecasts of government receipts and expenditures for 1980 and 1981 are used in calculating the impacts for these years. The estimates confirm (Table 4.4) that in 1978, in the context of the "concerted action programme", budgetary changes in the Community countries provided a significant stimulus to activity (although this stimulus would not be wholly felt in 1978 - the impact estimates do not take account of lags in the multiplier process). In 1979, however, budgetary changes generally had a contractionary impact, even at the absolute level of activity, not just at the theoretical "constant activity" level of activity. For 1980 and 1981 the picture varies from country to country. For the Community as a whole there is a stimulus (to the absolute level of activity) in both years, but its size is small compared with those in the 1974/75 recession.

The estimates take account neither of monetary repercussions (notably the possibility of the "crowding-out" of private investment as a result of the interest rate impact of public sector deficits) nor of wealth effects of budget balance changes. In particular, as regards wealth effects, they neglect changes in the real value of the stock of public debt while including, as "true" income of the private sector, all interest payments on the public debt. For some countries with consistently high budget deficits in recent years (for example Belgium and Italy) there is evidence to suggest that some dampening influence has been at work to prevent large budget deficits being translated into unusually high pressure of domestic demand. Indeed, neither capacity utilization indicators nor unemployment rates (both of which are admittedly fallible guides) would suggest that the pressure of domestic demand has been consistently higher in these two countries than in the Community as a whole.

As shown in the following section on sectoral financial balances the increase in budget deficits (and thus the positive demand impacts shown in Tables 4.3 and 4.4) has been accompanied by an increase in the savings ratio of households, this relatively weak demand from the private sector having offset in some degree the stimulus to demand emerging from the public sector. This development seems to be particularly pronounced in countries with above-average inflation rates (Ireland, Italy, United Kingdom). Thus in assessing the demand impact of changes in budget balances, some part of current public expenditure on interest rates could be regarded as an accelerated redemption of the national debt, and might, notionally, be counted as lowering the effective size of budget deficits. Such adjustments to budget accounting should, of course, be regarded as aids to understanding the workings of the economy, and not in a normative sense to dismiss the argument that very high public deficits are likely to be prejudicial to monetary stability and efficient resource allocation.

Financial balances in the private sector (households and enterprises) (1)

For five years there has been a high level of financial surplus in the private sector (see Table 4.5) because of the persistence of high net lending by households (due to a high savings ratio) and low net borrowing by enterprises, partly reflecting a low investment ratio. Consequently, the overall demand of the private sector has remained weak. This has to some extent been offset by the increase in the general government borrowing requirement which was very largely induced by the slow-down in economic growth (in particular because of the smaller rise in tax receipts and the increase in transfer expenditure). The behaviour of the domestic sectors as a whole was reflected in a Community balance positive and negative by turns: its movement clearly reflects the variations in real growth but also the fact that the balance of payments has been a prime concern of economic policy. The persistence of inflation and the growing importance which economic agents attach to real variables help to explain the new distribution of balances between private and public sectors. Inflation is in fact playing a redistributive role in respect of real wealth: the holders of monetary and financial assets the value of which is fixed in nominal terms suffer a loss in real terms while debtors benefit from a net gain. More specifically, because of their net lending, households are net holders of assets and consequently see the real value of their balances being eroded by inflation while enterprises and, in particular, general government, which are net debtors, benefit in real terms from this situation.

Households' net lending has since 1970 followed a rising trend (Graph 4.1). The very high surplus of saving over investment observed in 1975 was corrected in 1976 and 1977 but since then, and contrary to expectations at the time, households have maintained their net lending, as a percentage of GDP, at a high level. The main determinant of the movement of this balance is the trend increase in the savings ratio (Graph 4.3). There are a variety of causes for this trend: if the rise in real personal disposable incomes probably favoured the process up to 1974, it has since

(1) The enterprise sector is itself the aggregation of the institutional sectors non-financial corporate and quasi-corporate enterprises, credit institutions and insurance enterprises.

slowed and can therefore no longer have as much influence. The precautionary motive has certainly played an important part in the rate of saving with account being taken of the rise in unemployment and the slowdown in growth. But inflation seems to be the crucial factor explaining the rise in the savings ratio. By raising the savings ratio, households have sought to maintain the real value of their cash holdings and financial assets. Whereas a flight from money might have been just as probable, at least when inflation was accelerating, this has not taken place. On the contrary, the succession of high inflation rates has certainly taught households to adjust to the inflationary environment and money illusion has been reduced. Efforts were then concentrated on preserving a real level of saving (1).

The greatest rise in the household savings ratio occurred in Italy, the United Kingdom and Ireland (Graph 4.3), i.e. in three countries in which inflation was particularly pronounced. In these three Member States, the 1974/75 crisis was reflected in a fall in private consumption in 1975 (as early as 1974 in the United Kingdom) and in a resumption of its rise up to 1978 which was slower than in the other Member States. In France, the savings ratio has generally stayed higher in the last few years than at the beginning of the decade. Germany and Belgium, by contrast, returned to lower than pre-crisis saving levels; the relatively small scale of variations in the inflation rate perhaps made it possible in these countries to limit the changes in expectations, thus helping to sustain the rate of consumption relatively well.

The trend of households' net lending as a percentage of GDP follows the same direction as the trend of the savings ratios in the four large Member States (Graph 4.2). Italy stands out because of the scale of Italian households' net lending as a percentage of GDP which is counterbalanced by a very high general government borrowing requirement. Although there are specific causes to explain the exceptional level of Italian households' net lending, namely a sharp surge in wages and structurally weak housing expenditure, these arguments nevertheless seem insufficient. In fact it is possible that the succession of heavy budget deficits in a highly

(1) An econometric analysis of these phenomena entitled "The effect of inflation on household consumption" was presented in European Economy N° 5, March 1980, p. 39.

inflationary environment has pushed the curve of the households' balance upward. Adjusted for the effects of inflation on the real value of the public debt to households, households' net lending is in reality low while general government indebtedness is greatly reduced.

The macroeconomic importance of the loss in real value of households' financial assets is particularly great in the countries where the level of public debt has been relatively high and which have experienced a marked acceleration in the inflation rate (Table 4.6). Thus in Italy, holders of public securities have suffered heavy losses in real wealth. The annual amount of these losses can be put at a level of between 5 and 8% of GDP since 1973, and this could go higher in 1980 and 1981. As a result of such a loss in real wealth, households have probably moderated their overall demand fairly appreciably, and have in particular devoted a large part of their incomes from interest payments to reconstituting their assets in real terms. Large budget deficits and high inflation rates in Ireland have meant that since 1973 the extent of the erosion in the real value of the private sector's holdings of public securities has been at least as great as in Italy.

Of the other Member States, the purchasing power losses caused by the erosion of the real value of the public debt held by the private sector have been rather low in Germany, France, the Netherlands and Denmark (although in Denmark they may be greater in 1980 and 1981). This is due to the relatively small scale of the public debt and/or the more moderate rates of inflation in these countries.

The United Kingdom and Belgium are in an intermediate position. In the former country, the public debt as a percentage of GDP was high in the early seventies (some 60%, having been even higher in the sixties) and the rapid inflation in 1974 and 1975 caused heavy losses in the real value of the public debt. This could well be one of the factors explaining the financial behaviour of households since 1973. From 1975 on, the annual purchasing power losses have fallen to an average of some 5% of GDP because of the substantial reduction between 1973 and 1975 in the size of the public debt as a proportion of GDP.

In Belgium, the ratio of public debt to GDP is relatively high (although lower than in Italy and Ireland) but inflation has been relatively low so that the purchasing power loss in respect of the holding of public debt assets is distinctly smaller than in Ireland and Italy, slightly smaller than in the United Kingdom but slightly greater than in the other Member States.

As a result of the 1974/75 crisis, the financial management of enterprises became stricter than in the past. This trend is clearly reflected in the decline in enterprises' net borrowing as a percentage of GDP since 1974 (Graph 4.1). The marked change of direction in the curve in 1975 is connected with the large cut in investment in that year. The upturn which followed brought no return to earlier net borrowing levels and 1978 actually saw a further cut in net borrowing as a percentage of GDP. The general weakness of investment enabled enterprises to decrease their external borrowing (Graph 4.5). The gross profit margin of enterprises (ratio of enterprises' gross operating surplus to their value added - see Graph 4.6) tended to decline up to 1975 and then recovered slightly from 1976 to 1979. Comparing this development of gross profit margin with the slowdown in the rate of investment and, at least up to 1978, reduced recourse to outside financing an improvement in the cash position of enterprises in the last few years can be observed.

The increase in fixed capital investment in real terms since 1976 has been greatest in German enterprises. The positive trend of their profit margin has enabled them to invest while reducing their reliance on external financing, at least up to 1979. In France and Italy, by contrast, we see a steady reduction in enterprises' net borrowing (Graph 4.4), a decrease in their calls on outside sources of capital and a slowdown in the rate of investment as compared with the early seventies. Yet the profit margin of Italian enterprises has recovered to some extent since 1975 and, if the French profit margin has narrowed slightly, this is due to the relatively poor results of sole proprietors and partnerships (mainly of agriculture) and not of companies, whose margins have consolidated since 1975. This leads to the conclusion that French and Italian enterprises

have made it a priority to reduce their indebtedness and their net borrowing and have not sought to take advantage of the improvement in their results to engage in a vigorous investment drive. In the United Kingdom, the sudden increase in enterprises' external financing in 1979 does not particularly reflect an investment drive as it does in Germany, but a deterioration in profitability.

A number of favourable signs appeared in 1979, in particular in the enterprise sector. With good sales prospects and operating results, firms were increasing their investment expenditure even if this meant increased borrowing. It is true that the process was favoured by a steep rise in the prices of manufactured products. Although the saving level of households remained high overall, the rise in real personal incomes meant that a high rate of consumption could be maintained. Consequently, the general government balance benefited from the revival of activity, while a decline in the terms of trade contributed to the deterioration of the external balance. Although growth was improving, inflation was rising too, mainly because of a strong surge in import prices.

The forecasts for 1980 and 1981 have been established on the assumption of no change in economic policies, and must therefore be interpreted as tracing the most probable path in the absence of new exogenous elements or of policy changes. In 1980, the savings ratio and net lending of households should be lower because of a marked slowdown in the rise of real incomes. Faced with less buoyant domestic demand, enterprises should see their net borrowing increase, no longer because of heavy investment expenditure but because productivity growth will be reduced, leading to a squeeze on margins. Recessionary tendencies are therefore particularly clear for 1980 within the private sector in the Community. The high rate of inflation makes the situation more difficult. In 1981, the upward movement of prices should slow down. Compensation of employees should rise more moderately, but households should see their real incomes improve as prices rise more slowly. The savings ratio could move back upwards slightly. It should not, however, regain its 1979 level and should remain well below the rates reached during the 1974/75 recession. The investment ratio of enterprises should remain low overall and should in all cases be insufficient to ensure that global supply makes a substantial contribution to the economic upturn.

Technical note to Tables 4.3, 4.4 and 4.5

In Table 4.3 the changes in "adjusted" budget balances indicate the budget balance which would have resulted (given the average net tax rates in the year in question on household income, business income and private expenditure) if gross domestic product in that year had risen at a rate sufficient to maintain the level of unemployment unchanged from the previous year (also assuming the distribution of factor income between household, business and public sector unchanged). An adjustment is made for the change in unemployment benefits brought about by the actual change in unemployment in the year in question (and the average net tax rate, counting transfers as negative taxes on household incomes, is also adjusted accordingly).

For the years 1970-73 a constant level of activity is defined as the level of activity which would have resulted if GDP had risen at its 1960-73 trend rate. For the period 1973-81 the rate of growth of potential output has been assumed to be higher than the actual trend over this period, the gap resulting mainly from the lower degree of utilisation of labour resources.

Average tax rates are assumed to represent marginal rates. Since in most countries the elasticity of tax receipts with respect to income may be greater than unity and greater than the equivalent elasticity for transfer payments, the automatic effects of changes in activity on budget balances are thus likely to be underestimated. There is likely to be an opposite, but probably smaller, bias in the calculation of the adjustment for unemployment benefits since no account is taken of the growing proportions of young people and married women in the unemployed, and thus the average payment per unemployed person is probably overestimated.

The "first-round" budget impact estimates presented in Table 4.4 represent weighted changes in budget balances, changes in the various components of general government receipts and expenditures being given weights according to their first-round demand effects. The weights are calculated using a simple income-expenditure model, following the methodology described in the OECD Special Study 'Budget Indicators', July 1978.

The parameters of the model were assumed to be fixed over the period covered (1970-81), with marginal values equal to average values except in the case of import propensities, which were taken from the OECD Occasional Study 'Fiscal Policy Simulations with the OECD International Linkage Model', July 1980. For the years 1970-77 the data source was (except for import propensities and price deflators for government investment, obtained from national sources where available) the sectoral accounts published by Eurostat within the framework of the European System of Accounts (ESA). For 1977-81 data were taken from national sources, adjusted where necessary to conform with the ESA, and from estimates and forecasts of the Commission services.

Table 4.5 attempts to give estimates of the loss of purchasing power of public debt held by domestic private sectors. The estimates do not, therefore, correspond to the so-called "inflation tax", which is usually defined as the loss of purchasing power of public debt less interest payments on the debt. The estimates are obtained through deflation of the nominal value of outstanding domestic public sector

debt in domestic currency with the percentage increase over previous years in the private expenditure deflator (see below). A 10 percent rise in this deflator thus results in a purchasing power loss amounting to 10 percent of outstanding debt.

Estimates of this nature present severe problems, and no pretence is here made that Table 4.5 represents a satisfactory resolution of these problems. There are, in fact, considerable statistical and conceptual difficulties and the estimates are reproduced only to point out the potential importance of losses of "real value" of the public debt.

The concepts used are as follows:

Denmark: central government domestic currency debt excluding holdings by the central bank (source: Konjunkturoversigt, Danmarks Statistik; estimates of Commission services).

France: central government domestic currency debt (source: Bulletin du Conseil National du Credit; estimates of Commission services).

Ireland: domestic holdings of capital liabilities of central government (source: Central Bank Quarterly Bulletins; "Irish Public Debt", R. Bruton, ESRI, July 1978; estimates of Commission services).

Italy: general government domestic currency debt excluding central bank holdings (source: "Il Bilancio del Settore Pubblico e gli Effetti di Spiazzamento: un Esame dell'Esperienza italiana", F. Cotula, R. Maserà and G. Mercaldo; revised version of paper presented to conference of CEEP and Centio Torre Argentina, 14-15 December 1979; "Relazione sulla stima del fabbisogno del settore pubblico allargato per l'anno 1980", quarterly report to Parliament of the Minister for the Treasury; estimates of Commission services).

Netherlands: central government domestic currency debt (source: Netherlands Bank Annual Report).

Belgium: domestic holdings of central government debt (source: National Bank, Annual Report).

United Kingdom: domestic private sector holdings of general government debt (source: "Public Sector Debt", D.J. Reid, "Economic Trends", May 1977; Bank of England Quarterly Bulletin; estimates of Commission services).

Nominal (as opposed to market) values of debt are used in all cases. While this makes no difference to the total loss of purchasing power on a bond over its lifetime (when the loss is measured at prices ruling at the time of redemption), the profile of losses over time is rather different. (see "Real national savings and its sectoral composition" C.T. Taylor and A.R. Threadgold, Bank of England Discussion Paper, No 6, October 1979). This means that great caution should be exercised in relating the figures for a particular year in Table 4.5 with the first-round impact estimates given in Table 4.4. An additional difficulty arises where bonds are issued below par, but this problem is unlikely to be quantitatively important.

The estimates in Table 4.5 are different from those in Table 4.4 in that no attempt has been made to assign demand-impact "weights" to the estimates in the former table, there being no clear guide, either theoretical or empirical, to what values such weights might be expected to have.

Table 4.1
Income and outlay transactions of general government, EC total
('000 million ECU) (1)

	1978	% change	1979	% change	1980	% change	1981
Indirect taxes	203,8	15,6	235,7	15,1	271,3	10,7	300,3
Direct taxes	192,1	10,4	211,9	15,8	245,5	11,4	273,4
Social security contributions	219,0	14,6	250,6	13,4	284,2	10,2	313,3
Other current receipts ¹⁾	50,0	14,0	57,1	10,9	63,3	10,7	70,1
Total current resources	664,8	13,6	755,3	14,4	864,3	10,7	957,1
Current transfers	329,5	11,8	368,4	12,8	415,6	12,0	465,3
Other current outlays	45,6	19,9	54,8	23,7	67,8	17,4	79,6
Government consumption	283,5	12,3	318,8	14,7	365,5	11,3	406,7
Total current uses	685,5	12,6	742,0	14,4	848,9	12,1	951,5
Gross saving	6,4		13,3		15,4		5,6
Net capital transfers	16,4		19,2		19,6		21,0
Gross capital formation ²⁾	52,7	9,9	57,9	13,2	65,5	8,0	70,7
Net lending (+) or borrowing (-)	-62,6		-63,7		-69,6		-86,0
Net lending (+) or borrowing (-) as % of GDP - EC total	-4,0		-3,6		-3,5		-3,9

(1) Unless otherwise indicated

Table 4.2
Public finance aggregates, 1979-81

	General government (percentage changes)						General government (percentage of GDP)			Central government (percentage of GDP)		
	Expenditure			Receipts			Net borrowing (1)			Net borrowing requirement (2)		
	1979	1980	1981	1979	1980	1981	1979	1980	1981	1979	1980	1981
DK	13,4	12,1	12,7	13,2	11,8	12,1	-3,3	-3,5	-3,9	-5,0	-5,8	-6,1
D	8,0	7,1	5,5	7,7	7,1	4,8	-3,0	-3,0	-3,3	-2,9	-3,1	-3,3
F	14,0	15,5	13,9	18,0	15,3	12,0	-0,8	-0,9	-1,7	-1,6	-1,3	-1,1
IRL (3)	24,2	26,3	13,2	19,8	29,6	12,9	-12,8	-12,8	-12,8	-13,7	-13,2	-11,2
I	19,1	24,5	21,5	19,5	27,8	18,2	-9,4	-8,5	-10,0	-10,9	-11,4	-11,7
NL	11,7	7,6	7,3	9,8	9,1	8,3	-3,0	-2,3	-1,8	-4,4	-4,6	-3,9
B	9,5	9,6	8,6	8,1	7,8	10,2	-7,2	-8,2	-7,7	-6,9	-7,4	-6,9
L	8,3	9,7	8,7	4,6	7,8	7,1	1,0	0,1	-0,7	0,1	-0,9	-1,7
UK	15,7	21,9	13,9	19,8	23,5	15,0	-3,2	-2,7	-2,3	-3,9	-3,8	-3,6
EC	12,7	14,0	11,7	13,9	14,2	10,6	-3,6	-3,5	-3,9	-4,2	-4,3	-4,3

(1) National accounts, transactions basis, excluding loans and participations.

(2) Budgetary accounts, cash basis, including loans and participations.

(3) 1979 and 1980 figures reflect distortions in government financial transactions due to the 1979 postal strike.

Source: Eurostat; estimates of Commission services.

Table 4.3

Constant-activity budget balances

Changes (1) in actual general government budget balances, and as adjusted (2) to exclude the effect of cyclical fluctuation in the level of activity

% GDP

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
DK Actual	0.8	0.6	2.1	-1.3	-8.9	3.7	-0.5	0.5	-2.4	-0.2	-0.4
DK Adjusted	1.6	0.5	2.2	0.3	-7.3	2.7	-0.2	1.3	-3.3	0.9	0.7
D Actual	-0.5	-0.3	1.7	-2.6	-4.4	2.2	1.0	-0.2	0.2	0.0	-0.3
D Adjusted	-0.3	-0.2	-0.1	-1.8	-2.8	1.8	0.9	-0.2	-0.6	0.2	0.6
F Actual	-0.2	0.1	0.1	-0.3	-2.8	1.8	-0.9	-1.0	1.5	-0.1	-0.8
F Adjusted	0.0	0.1	0.1	0.0	-0.7	1.8	-0.6	-0.9	1.7	0.3	-0.3
IRL Actual	0.2	0.2	-0.5	-3.4	-4.1	1.1	1.2	-1.5	-2.3	0.0	0.0
IRL Adjusted	0.4	0.5	-0.7	-3.3	-3.2	1.7	1.0	-1.8	-2.4	0.7	0.7
I Actual	-1.9	-2.1	0.8	0.4	-8.6	5.5	1.0	-1.7	0.3	0.9	-1.5
I Adjusted	-1.5	-2.0	0.6	0.3	-7.7	5.4	1.4	-1.3	0.3	1.1	-0.8
NL Actual	0.3	0.5	1.1	-1.2	-1.6	0.7	0.3	-0.5	-0.8	0.7	0.5
NL Adjusted	0.3	0.6	0.8	0.1	-1.2	0.8	0.7	-0.2	-0.5	1.3	1.4
B Actual	-0.5	-1.3	0.7	1.0	-2.3	-1.0	-0.7	-0.4	-1.2	-1.0	0.5
B Adjusted	-0.5	-1.4	0.4	0.9	-0.8	-1.0	-0.1	-0.1	-1.3	-0.2	1.1
UK Actual	-1.4	-3.1	-1.5	-0.7	-0.9	0.1	1.6	-0.9	1.0	0.5	0.4
UK Adjusted	-1.1	-2.9	-2.3	0.5	0.3	0.1	1.8	-1.0	1.4	1.9	1.4
EC Actual	-0.9	-0.9	0.8	-1.0	-3.9	2.0	0.4	-0.8	0.3	0.1	-0.4
EC Adjusted	-0.5	-0.8	-0.3	-0.3	-2.5	1.9	0.7	-0.7	0.2	0.5	0.1

(1) A minus sign indicates an increase in the budget deficit/reduction in surplus.

(2) Estimate of the change in the budget balance corresponding to an unchanged level of activity (compared to previous year).
- See technical note for description of methodology and sources.

Source: Eurostat and estimates of Commission services. Figures for 1980 and 1981 are forecasts.

Table 4.4

"First-round" impact (1) of the public budgets on real demand.

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
	% of real GDP in previous year										
DK											
Tax	-1,6	-1,4	-1,3	0,6	0,5	-2,9	0,9	-0,5	0,2	0,2	0,1
Expenditure	0,6	1,7	0,9	1,7	1,3	0,7	0,9	1,3	1,0	0,0	0,0
Total	0,1	0,3	-0,4	2,3	1,8	-2,2	1,8	0,9	1,2	0,3	0,2
D											
Tax	-0,9	-0,4	-1,7	0,4	2,0	-1,0	-0,1	-0,4	-1,4	-0,3	0,0
Expenditure	1,5	0,8	0,6	1,0	0,3	0,1	0,2	0,9	0,5	0,6	0,4
Total	0,7	0,4	-1,2	1,4	2,3	-1,0	0,1	0,5	-0,9	0,2	0,4
F											
Tax	-0,7	-0,6	-0,6	-0,2	0,4	-1,2	-0,1	0,0	-1,0	-0,3	0,2
Expenditure	0,8	0,7	0,8	0,4	1,3	1,2	0,4	1,2	0,5	0,5	0,6
Total	0,2	0,1	0,2	0,2	1,6	-0,1	0,3	1,2	-0,4	0,2	0,8
IRL											
Tax	-1,0	-0,7	-0,5	0,9	1,1	-1,4	0,0	0,0	0,3	-1,1	-0,1
Expenditure	1,7	1,8	2,8	0,8	2,4	0,1	0,1	1,8	1,5	1,1	0,0
Total	0,8	1,2	2,3	1,8	3,5	-1,2	0,2	1,9	1,8	0,0	-0,2
I											
Tax	0,0	0,6	-0,3	-0,1	1,6	-1,3	-0,8	0,4	-0,3	-0,7	0,5
Expenditure	1,3	1,1	0,5	0,2	1,2	0,6	0,4	0,7	0,7	0,9	0,8
Total	1,3	1,8	0,2	0,1	2,8	-0,8	-0,3	1,1	0,4	0,3	1,4
NL											
Tax	-1,1	-0,6	-0,8	0,1	0,3	-1,3	-0,4	0,2	0,0	0,2	0,3
Expenditure	0,9	0,7	0,4	0,8	1,1	0,9	0,4	0,5	0,6	-0,3	-0,3
Total	-0,2	0,2	-0,4	0,9	1,4	-0,3	0,0	0,8	0,6	-0,1	0,0
B											
Tax	-0,3	0,0	-0,5	-0,4	0,0	0,3	-0,3	-0,1	0,2	0,2	-0,5
Expenditure	1,5	1,5	0,8	0,5	1,2	1,1	0,6	1,1	0,7	0,3	0,3
Total	1,1	1,5	0,4	0,1	1,2	1,3	0,3	1,0	0,9	0,5	-0,2
UK											
Tax	0,5	0,9	0,5	0,4	-0,5	0,2	0,0	0,4	-1,0	-0,6	-0,1
Expenditure	0,9	1,2	1,6	0,4	1,7	0,2	-1,0	0,2	0,1	0,2	-0,2
Total	1,4	2,1	1,1	0,8	1,2	0,4	-1,0	0,5	-1,0	-0,4	-0,3
EC⁽²⁾											
Tax	-0,4	0,0	-0,7	0,1	0,8	-0,9	-0,2	0,0	-0,9	-0,4	0,1
Expenditure	1,1	1,0	0,9	0,6	1,1	0,6	0,1	0,8	0,5	0,5	0,4
Total	0,8	1,0	0,3	0,7	1,9	-0,4	-0,1	0,8	-0,4	0,1	0,4

(1) For definitions and methodology see the technical note below. (2) Weighted average of country figures, with no account taken of the feedback via intra-Community trade.
Source: Estimates of the Commission's staff.

Table 4.5

Net lending or net borrowing by the Community as a percentage of gross domestic product

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Private sector (enterprises, households)	0,2	1,2	2,1	0,9	0,8	5,4	3,2	3,2	4,6	3,0	1,8	2,6
General government	0,3	-0,4	-1,3	-0,6	-1,8	-5,3	-3,7	-3,1	-3,9	-3,6	-3,5	-3,9
Community to or from abroad	0,5	0,8	0,8	0,2	-1	0,1	-0,5	0,1	0,7	-0,6	-1,7	-1,3

Sources: Eurostat. Commission staff forecasts.

Table 4.6

Loss in "real value" of domestic private sector holdings of public debt, 1973-81

	% of GDP in volume										
	1973	1974	1975	1976	1977	1978	1979	1980	1981		
DK	:	:	:	0,5	1,1	1,3	1,7	2,7	2,5		
D	1,3	1,4	1,4	1,1	1,0	0,9	1,4	1,7	1,3		
F	0,5	0,9	0,9	0,8	0,7	0,7	0,8	1,0	0,9		
IRL	6,2	8,9	12,4	11,9	8,0	5,5	9,3	11,6	8,3		
I	5,3	8,0	6,4	6,6	7,7	6,0	7,8	9,9	8,0		
NL	1,9	2,2	2,2	2,0	1,5	1,2	1,9	1,9	2,0		
B	2,6	5,3	5,0	3,2	3,0	2,3	3,9	3,8	3,5		
UK	5,6	9,2	10,8	7,5	6,3	3,4	4,7	6,8	4,6		

Notes:

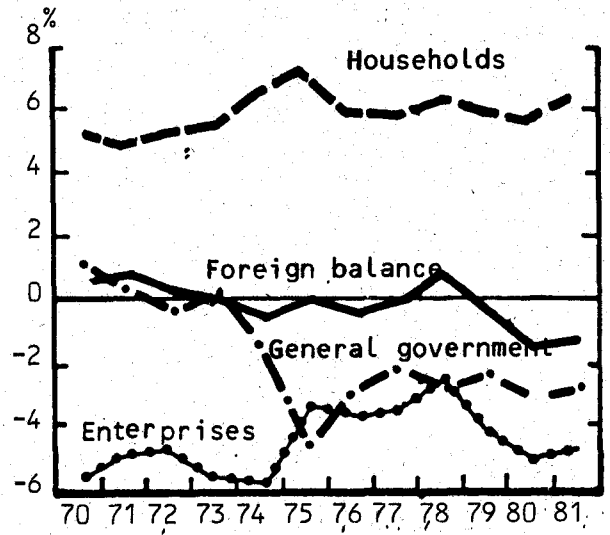
For F, I, IRL and NL figures refer to debt issued in domestic currency, rather than to domestic holding of debt.

D, IRL, NL, B: central government; DK, F: central government excluding central bank; I, UK: general government excluding central bank.

Source: Estimates by the Commission's staff.

Graph 4.1

EUR-4. Net borrowing or net lending by sector as % of GDP

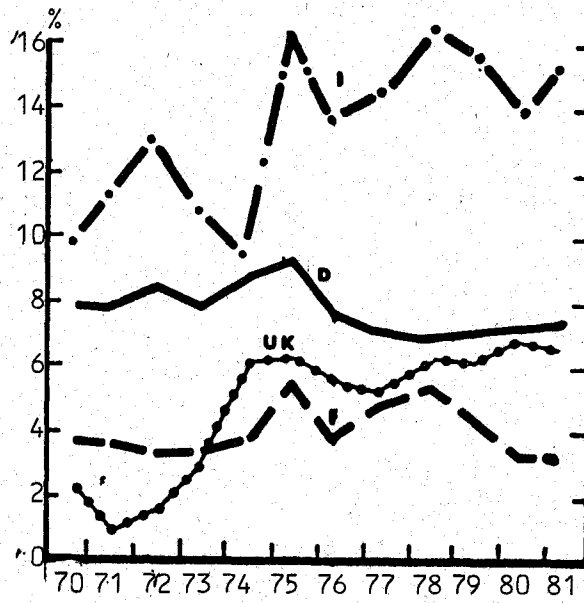


See explanatory notes to graphs

Source: Eurostat. Forecasts of Commission services.

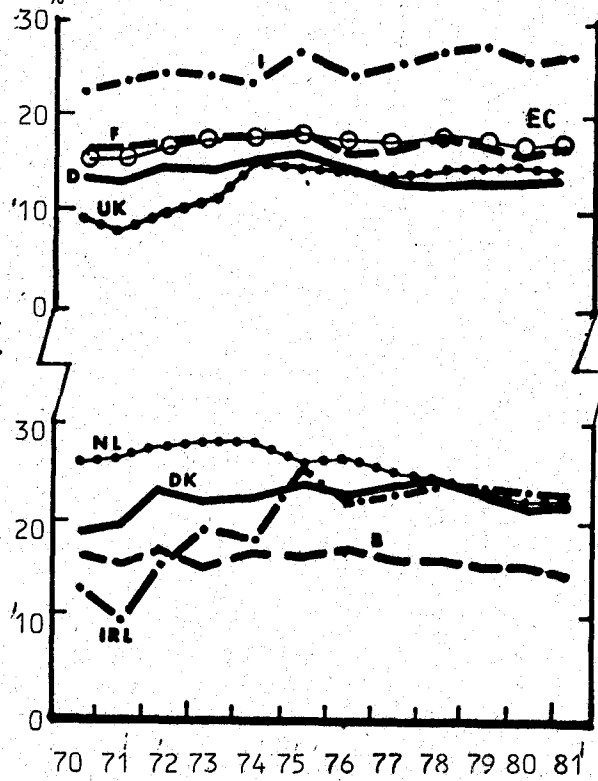
Graph 4.2

Net Lending of households as % of GDP



Graph 4.3

Gross savings ratio of households

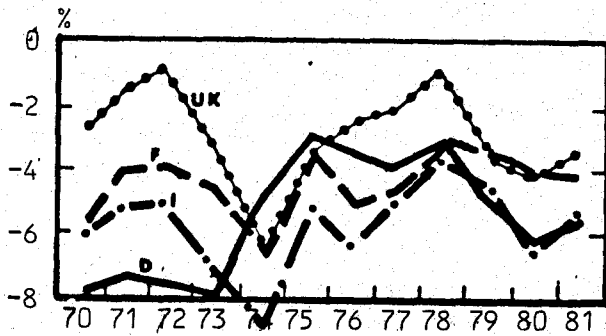


See explanatory notes to graphs

Source: Eurostat. Forecasts of Commission services.

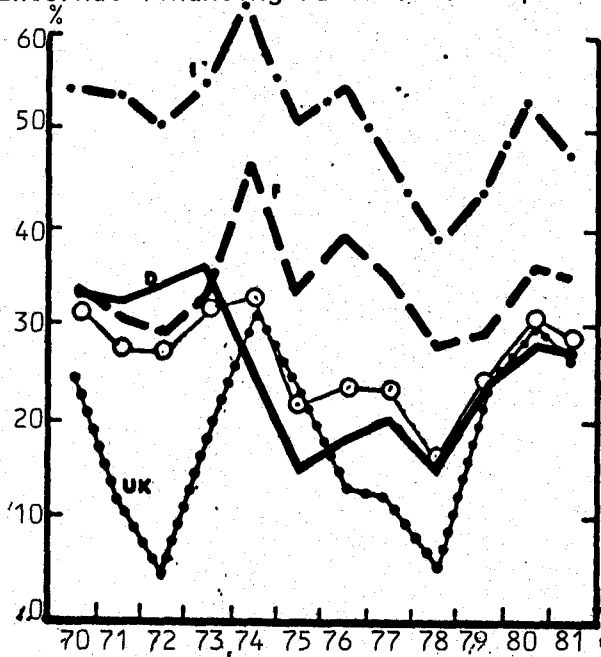
Graph 4.4

Net borrowing of enterprises as % of GDP



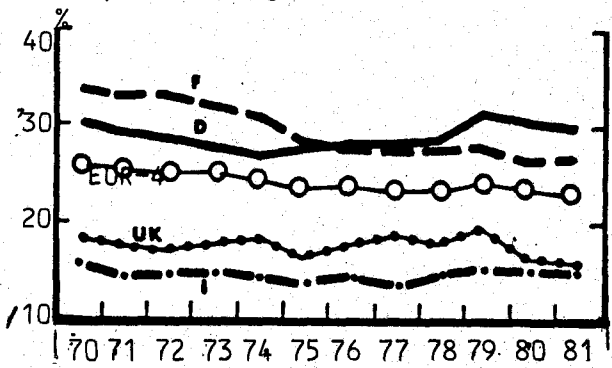
Graph 4.5

External financing ratio of enterprises



Graph 4.6

Gross profit margin of enterprises



See explanatory notes to graphs

Source: Eurostat. Forecasts of Commission services.

Explanatory notes to graphs in chapter 4

Graph 4.1

Sectoral accounts statistics distinguishing between households and enterprises are available only for the four large Member States: Germany, France, Italy, the United Kingdom. The plotted lines in the graph show the sectoral balances for the aggregate EUR-4 (the figures for these four member countries aggregated using current prices and exchange rates).

Graph 4.3

The gross savings ratio of households is the ratio, expressed as a percentage, of gross saving to gross disposable income of households.

For Denmark and the Netherlands, the figures refer to the gross savings ratio of the private sector.

The gross savings ratio for the Community is calculated by weighting the national savings ratios by 1978 GDP.

Graph 4.5

The external financing ratio of enterprises is the ratio, expressed as a percentage, of their net borrowing to their gross capital formation.

Graph 4.6

For Germany, France and Italy, the gross profit margin is the ratio of the gross operating surplus of enterprises (including sole proprietors and partnerships) to their value-added. The gross operating surplus of sole proprietors and partnerships has been split into two components: "wage" incomes imputed to proprietors and partners, equal to average compensation of employees in the main corresponding branches of activity; and a component representing the gross profit margin of sole proprietors and partnerships. Only the second component has been included in the numerator of the ratio. In Italy, the gross operating surplus of sole proprietors and partnerships has been arbitrarily calculated as 90% of the gross operating surplus of households.

For the United Kingdom, the gross profit margin is the ratio of gross trading surplus of companies and public cooperations to their added-value (sole proprietors and partnerships being excluded).

The gross profit margin EUR-4 is weighted by 1978 GDP.

5. Monetary policies

The monetary disorder of the 1970s aggravated inflation and the problems of growth and employment. The appropriate lessons were drawn with the introduction of monetary targets and, in particular, with the establishment of the European Monetary System (EMS) at the beginning of 1979. Despite the difficulties resulting from the second oil price shock, the discipline thus imposed is beginning to produce results. Changes in central rates have remained limited. In 1980, for the first time in ten years, monetary expansion in the Community is close to the trend of the 1960s. A greater convergence of monetary policies, reinforced by the trend of interest rates, is serving to resist inflationary pressures and divergences in cost and price trends. This is a necessary, but not a sufficient, condition for ultimately achieving convergence of cost and price trends. The time needed for monetary policy to produce results is often long, and structural distortions, or indeed a recession, may develop if stabilisation remains purely monetary. This is already evident in some countries. If the chance of stabilisation and convergence provided by present monetary policy is not to be missed and if improved prospects for growth and employment are to be restored, this effort must be supplemented by public finance measures, by the restructuring of supply and, in particular, by a rapid adaptation of the trend of incomes to new conditions.

Past experience (1)

The 1960s were characterized by moderate inflation rates and by fixed exchange rates which, in some cases, had to be adjusted upwards or downwards because of external disequilibria that were regarded as fundamental. Though there were no monetary targets, all the member countries showed great stability in their money supply trends. This was the result of efforts to achieve the "intermediate objective" of exchange rate stability. The average inflation rate under the Bretton Woods system was largely determined by the dominant economies. Any countries exceeding this inflation rate rapidly incurred the sanction of an external deficit: a restrictive monetary policy became necessary at domestic level so as to comply with the rules of the system; thus, the margin for inflationary trends in incomes and public finance was relatively narrow. The surges in inflation in 1963/64 in Italy, France and the Netherlands

(1) See Graph 5.1.

- with the subsequent stabilisation which avoided devaluations - are an example. The countries whose stability objective was more ambitious than the average inflation rate of the system experienced problems of a different nature. Germany is the prime example in this respect: the revaluations of 1961 and 1969, the recession of 1967, the overdevelopment of the export sector and the simultaneous importation of capital and labour must be interpreted in this light. Domestic monetary policy was confronted with the dilemma of being self-defeating unless a moderate revaluation was carried out in time. The Bretton-Woods system thus imposed rules on the conduct of domestic monetary policy; however, it was not able to function satisfactorily unless the country whose currency was the reserve currency observed these rules itself. This was no longer the case towards the end of the 1960s.

The period 1969-73: The period of relative price stability came to an end around 1969. The acceleration in the growth of wage costs in practically all the member countries in 1969 and 1970 was due notably to strains on the labour market, to the feeling that the share of wages and salaries had to catch up again following its decline since 1963, but also to socio-political unrest in several member countries and to the belief that the public authorities would be able to ensure full employment irrespective of the behaviour of employers and employees. In 1969, this trend occurred despite the marked slowdown in monetary expansion in practically all the member countries. However, the unprecedented surpluses in the Community's and most of the member countries' balances of payments (on an official settlements basis) in 1970 and 1971 undermined the scope for monetary policy in Europe. The inflow of liquidity from the American deficit and the Eurodollar markets, the maintenance of the dollar exchange rate until December 1971 and the fear that domestic monetary policy might provoke a stabilisation crisis set the stage for an upsurge of inflation: the rise in prices and wage costs accelerated or remained at a high level, and the growth in the money supply for the Community as a whole reached an unprecedented rate, particularly in 1972 and 1973. These developments and the death throes and final demise of the Bretton Woods system in March 1973 opened the way for major divergences within the Community and these became clearly evident starting in 1972/73.

The autonomy of domestic monetary policy created by the switch to floating exchange rates was used to pursue a very strict counter-inflationary policy in Germany and a vigorous expansionary policy in Italy and the United Kingdom. In 1973, the monetary authorities in Germany regained control of the growth of the money supply, while in Italy and the United Kingdom monetary expansion accelerated and approached annual rates of 23% and 26% respectively. At the same time, the influence of exchange rates on prices and costs led to "virtuous" and to "vicious" circles, while substantial divergences emerged in balances of payments. France occupied a middle position in this context: its monetary expansion roughly followed the Community average and its weighted exchange rate varied relatively little. While in 1972/73 the inflation rates of the major countries were still only slightly divergent, though high, it was the policies pursued during this period that were the root cause of the wide inflation differentials observed later in the Community.

The period 1974-75: The first oil price shock occurred in a situation where most of the countries, to differing degrees, enjoyed ample liquidity allowing price rises to be passed on to incomes. Thus, major second-round inflationary effects developed through a second explosion in wage costs with unprecedented divergences between countries; these second-round inflationary effects are the reflection of the money supply and exchange rate developments of the previous years. The combination of the oil deficit and the effects of the divergent policies pursued in the previous period led to a very uneven distribution of balance of payments surpluses and deficits and to untenable situations for the countries whose currencies had depreciated strongly. This and the continued acceleration in inflation obliged the authorities in all the member countries to curb monetary expansion significantly. Thus, the growth of the money supply in the Community fell from 17 1/2% at the end of 1973 to 12 1/2% at the end of 1974. The effects of a restrictive monetary policy combined with the continued sharp increase in wage costs helped to bring about recession and an increase in the share of wages and salaries, thus undermining profits, investment, growth and employment well beyond this period.

The period 1976-78: Following this stabilisation, in 1976, the increase in wage costs fell by about half, or by even more in some countries, and there was a vigorous but temporary revival in growth. In addition, most of the member countries introduced intermediate objectives in the monetary field between the end of 1974 and 1977. However, the growth of the money supply during the period 1976-78 came down much less than the trend of wage costs, thus re-establishing conditions for a more normal economic development. The relative stability in the growth of the money supply in the Community did not mean that trends by country were already convergent. However, Germany, the Benelux countries and Denmark (countries participating in the "snake") and France (which aimed to achieve a degree of stability in its effective exchange rate) successively regained rates of monetary expansion during this period which were comparable to those of the 1960s. The average inflation rate in the Community fell, but divergences between countries remained substantial. Some countries (Germany, Belgium, the Netherlands and Luxembourg) virtually succeeded during or at the end of this period in bringing down inflation rates to the level of the 1960s. But these successes also indicate the substantial time-lags between the introduction of monetary measures aimed at stabilization and their impact on the real economy and show the limitations of a stabilization based almost exclusively on monetary policy. Experience in Germany and in Belgium appears significant in this respect. In Germany, efforts to regain control of money supply growth, which were begun as early as the spring of 1973, were immediately accompanied by a major revaluation, but did not entail an adjustment in the trend of nominal incomes until early 1976. In Belgium, the spectacular reduction in the inflation rate between the end of 1974 (16% a year) and the end of 1978 (about 4% a year) was secured essentially through persistent efforts on the part of monetary policy to maintain the exchange rate within the "snake". However, neither the adjustment in the relative trend in wage costs compared to the other Community countries nor the stabilisation of public finances were obtained; this situation seriously affected competitiveness - not in terms of prices, but in terms of costs - ,

profitability, investment and employment and it largely explains the particular problems in Belgium in 1979 and 1980 regarding the balance of payments, the public sector deficit and the level of real interest rates. This example highlights the dilemma which arises if stabilisation is essentially based on monetary policy and is not backed up by a complementary effort in the areas of incomes and public finance.

Monetary policy in 1979 and 1980

During the last two years, monetary policy in the Community has been marked by the introduction of the European Monetary System (EMS), the effects of the new oil price shock and the reversal in the relative cyclical positions of the Community and the United States.

The introduction of the EMS may be regarded as an institutional attempt to draw the relevant lessons from the experiences of the past as outlined in the paragraphs above. The two key objectives of the EMS, defence of central rates and convergence towards price stability, impose certain rules on the conduct of domestic monetary policy in the participating countries. Monetary policy in one country whose cost and price trend is diverging "upwards" compared with the average of its partners, should be relatively more restrictive so as to maintain the central rate and exercise pressure towards stabilisation of costs and prices. Experience shows that this process can take several years and that it is important to supplement monetary policy measures by an adequate policy mix, notably in the areas of public finance and the adjustment of the growth of nominal incomes. Devaluation would disturb the stabilization process and should be avoided if at all possible. If it is regarded as unavoidable, it should be limited in size and should be accompanied by a domestic stabilisation policy so as not to trigger a vicious circle between exchange rates and inflation. By contrast, monetary policy in a country where the trend of costs and prices is diverging "downwards" compared to that of its partners should not aim to adjust to an "average level of inflation", but should continue to be directed towards the price stability objective. In order that

such a policy should not become self-defeating in the long run (cf. experience in the 1960s), there would from time to time have to be small-step revaluations corresponding broadly to the underlying gains in the competitiveness of the economy. Such a policy within the EMS, asymmetrical as regards exchange rates, but symmetrical in pursuing the price stability objective, would be in line with the lessons of the last twenty years and would make it possible to achieve more stable exchange rates and to make progress on convergence towards greater price stability. In 1979 and 1980, changes in central rates within the EMS remained relatively limited, despite substantial divergences in costs and prices. This was largely due to greater convergence in domestic monetary policies, but was helped by relative cost margins existing at the time when the EMS was established (resulting from excessive variations in exchange rates during the period of floating rates) and by the fact that the distribution of payments surpluses and deficits between countries was more even than it was following the first oil price shock.

The reaction of monetary policy to the inflationary effects of the new oil price shock shows that due account has been taken of the lessons of the 1970s: in almost all the member countries, the rate of monetary expansion has been reduced. Taking the Community average, the reduction since 1978 is of the order of 3 percentage points, with the result that, at the end of 1980, for the first time in ten years, monetary expansion is nearing the trend of the 1960s (10.4% a year). The main purpose of this policy is to avoid providing the liquidity which would facilitate the development of second-round inflationary effects in the wake of the oil price rise, such as those observed at the time of the first oil price shock following the very sharp increases in money supplies during the previous years (1971-73).

The reaction of policy in Europe to the reversal of cyclical positions as between the United States and the Community and to American monetary measures is based on similar considerations: acceptance, to some extent, of a general rise in interest rates in response to the rise in American rates, not only on counter-inflationary grounds, but also for reasons relating to the balance of payments, which was simultaneously affected by the increase in the oil bill and the substantial cyclical improvement in the current account of the

United States. In order to moderate a temporary but significant tendency for the dollar to appreciate against the DM and the ECU, which would have increased still further the Community's oil bill, the Bundesbank made massive interventions on the exchange markets at the end of 1979 and during the first half of 1980, and this also prevented a further escalation of interest rates in the Community.

Quantitative monetary policy (1)

The growth of the Community money supply is probably the best single indicator of the monetary situation in the Community. However, the stability of the demand for money varies from one country to another, and this is one of the reasons for the diversity of the intermediate objectives adopted by member countries, another reason being the extent to which their economies are open to external influences.

Germany, France and the United Kingdom express their intermediate objectives in terms of the broadly defined money supply (2). In Germany, the concept involved is "central bank money", which is a weighted average of the major components of the money supply broadly defined. Achievement of this target is pursued through all the instruments available (interest rate policy, changes in minimum reserves, in re-discount and Lombard ceilings etc., but excluding credit ceilings). During the first half of 1979, the target figure moved towards the top of the desired range (6% - 9%), but a fairly restrictive policy slowed down monetary growth appreciably during the second half of that year. The relatively low level thus attained served as the reference point in setting the target range for 1980, which aims at lower growth than the previous one (5% - 8%). In August 1980, actual monetary growth, at about 4 1/2% a year, was indeed slightly below this range, and this represents a considerable slowdown compared with the rate recorded at the end of 1978 (12.1% a year). In relation to probable growth of about 7% in nominal GDP in 1980, monetary policy is having a major restraining effect based on the need to fight inflation and on considerations of external equilibrium (see above). In France, the intermediate objective of

(1) See Table 5.1

(2) Notes and coin in circulation, sight deposits, and, to some extent, time deposits and savings accounts.

monetary policy is expressed in terms of M3. The main instrument used in achieving this objective is a system of ceilings imposed on bank lending. In 1979, the growth of M2 accelerated (14.4% a year at the end of 1979 as against 12.2% at the end of 1978), and the target (11% a year) was overshot. Nevertheless, the authorities took the level reached at the end of 1979 as the base for carrying over their 11% target into 1980. During the first half of this year, the rate of monetary expansion fell slightly, and the target rate could be approximately achieved in the second half of the year; it would thus be 1 1/2 to 2 percentage points below the probable growth of nominal GDP in 1980 (13%). The monetary target in the United Kingdom, sterling M3, excludes residents' foreign currency holdings, which are not considered to constitute potential demand for domestic production. This target is pursued mainly through interest rate policy and by limiting the public sector borrowing requirement; the system of direct control on banks' interest-bearing liabilities ("supplementary special deposits scheme" or "corset") was ended in June 1980, and this distorted the sterling M3 statistics from July onwards: the 8% growth of sterling M3 in July and August was probably due in large measure to reintermediation following this institutional change, but it may also reflect a limited and temporary relaxation in monetary policy in view of the liquidity problems encountered by firms. An analysis of the methods to be used in order to achieve monetary targets is at present being carried out in the United Kingdom (1). It seems probable that the reserve asset system will be replaced by a fairly low cash ratio to be applied to the whole of the banking sector. The target range for sterling M3 was successively reduced from the 9% - 13% announced in 1976 to 7% - 11% in June 1979; as part of a medium-term financial plan, the rate is to be lowered gradually to about 6% in the year beginning in the spring of 1984. The annual rate for the actual growth of sterling M3 fell from 13.3% at the end of 1978 to 11.7% at the end of 1979, and in the first half of 1980 it was between 10% and 12%, whereas the growth rate of nominal GDP rose from 13.7% in

(1) See "Green Paper on monetary control", Cmnd. 7858, H.M.S.O., March 1980.

1978 to about 18% in 1980 under the combined influence of inflation and the recession. However, leaving aside the difficulties of statistical assessment which emerged in July 1980, the policy pursued is one of vigorous stabilisation comparable in some respects (including the area of the effective and real exchange rate) to that pursued by Germany in 1973 and 1974. It clearly raises the question of the time lag in the effect on incomes, and the question of the appropriate policy mix.

Elsewhere in the Community, definitions of intermediate monetary policy objectives differ more widely. In Italy, the authorities express their target in terms of total domestic credit. The principal means used in pursuit of this target is a system of ceilings on lending by each bank to the private sector. The official target for total credit was achieved in 1979 and resulted in a reduction in the rate of expansion. In April 1980, the Ministry for the Treasury confirmed that, for 1980, it had adopted a target of Lit 59 300 000 million in new lending, i.e. a further reduction in the rate of expansion to 17.4%, which represents a considerable restriction since nominal GDP is likely to grow by some 23 %. This policy stance found practical expression when, with the economy showing signs of overheating, the authorities announced tighter limits on the growth of bank lending to the private sector in July 1980 and stricter penalties for overshooting these limits. In Belgium, after having in the past set targets for the growth of credit, the authorities have for the past several years made the defence of the exchange rate in effect the intermediate objective of stabilisation policy, and make use mainly of the interest rate instrument to achieve this objective. In Denmark, similarly, defence of the exchange rate plays, in principle, an important role in stabilisation policy, and the measures taken by the authorities to control the growth of domestic lending and interest rates have recently been mainly dictated by the need to cover a chronic current account deficit. In the Netherlands, the authorities now concentrate mainly on an intermediate objective expressed in terms of domestic money creation, i.e. the

growth of the money supply minus the change in the net external position of the banking system. The present monetary target, thus defined, is 8%, which, in view of the position of the external account, may be regarded as consistent with forecast growth of nominal GDP of about 7% in 1980, this growth being mainly due to the rise in the inflation rate. The Irish authorities concentrate on bank lending to the private sector. The extremely rapid expansion in lending during 1978 was considerably slowed down in 1979 and, given that the target for the present year (13%) is likely to be achieved, this could help to reduce the high inflation rate.

The scale of the reduction in the growth of monetary aggregates in the Community between the end of 1978 (13 1/2% a year) and the end of 1980 (probably 10 - 11% a year) becomes clear when these monetary growth rates are compared with those of the Community's nominal GDP, which increased by 10.9% in 1978 and will probably increase by 12 1/2% in 1980, mainly as a result of inflation. In the present situation, however, the growth of lending to the domestic economy is, in most member countries, greater than the growth of the money supply. This phenomenon is linked to the monetary impact of the current payments deficit. Payments by residents to non-residents absorb a part of the money supply created by lending by the banking system to residents; at the same time, the banking system relies heavily on external resources (see Table 5.2).

Table 5.2 also provides some indication of the role which the financing of public deficits has played in monetary growth. There are considerable differences between member countries in this respect. In France the impact of the public sector on monetary expansion has been negligible, whereas in Ireland, Denmark, Belgium, and, to some extent, Italy the recourse of the public authorities to banking systems cannot but be regarded as disquieting. Since, however, such recourse in the United Kingdom and Germany has been more moderate, it can be approximately estimated that in the Community as a whole the public sector has recently absorbed only one fifth of new bank credit, by far the greater part of that credit being taken up by companies and households.

Interest rates (1)

The acceleration of inflation in 1979 and the measures taken to curb the expansion of the monetary aggregates led, in 1979 and at the beginning of 1980, to a general rise in interest rates in the Community comparable with that in 1973/74. The increase was particularly pronounced in the case of short-term rates. The yields on medium- and long-term bonds followed more slowly, the financial markets believing that inflation rates as high as those at the end of 1979 and at the beginning of 1980 would not persist. Taking the Community as a whole, short-term interest rates thus overtook long-term rates from the third quarter of 1979, as was the case in 1973/74 (see Graph 5.1). Monetary policy in Europe had already switched to a restrictive stance when the Federal Reserve Board in the United States announced its measures of 6 October 1979. The most important point for the Community was that the United States authorities expressed their willingness - soon carried into action - to allow a much wider range of interest rates in order to achieve their own money supply objectives (2). The rise in United States interest rates was a reaction to the inflation rate, which was accelerating rapidly. Consequently, it did not necessarily and by itself restore confidence in the dollar, but it occurred at a time when markets were becoming aware of the cyclical reversal of the Community's and the United States' position on current account, leading to massive outflows of capital from the European Community. The most spectacular of the immediate reactions in the Community was undoubtedly that of the Bank of England, which increased its minimum lending rate on 16 November 1979 by 3 percentage points to 17%. This decision was also dictated to some extent by the

(1) See Table 5.3.

(2) Three-month money rates reached 13.7% in New York at the end of December and 18.4% at the end of March 1980. They were at 9.6% at the end of August, 1980.

lifting of all remaining exchange control restrictions in the United Kingdom on 23 October 1979, following which it became necessary to compensate for outflows of capital due to portfolio adjustments by attracting foreign capital to the United Kingdom. Other member countries felt it necessary to attract foreign capital or to prevent capital outflows, particularly Belgium, the Netherlands and Italy, which increased its discount rate on 1 December 1979 by 3 percentage points to 15%. In Germany, the large-scale interventions on exchange markets at the end of 1979 and at the beginning of 1980 (see above - the official reserves fell by DM 21 000 million between October 1979 and May 1980) put pressure on bank liquidity, which was relieved mainly by increases in rediscount quotas in October 1979 and in February and April 1980 and by a reduction of the minimum reserve ratio at the end of April and by similar measures in July and August 1980. At the same time, the restrictive stance of Germany monetary policy was reflected in successive increases in the discount rate, which rose from 3% at the beginning of 1979 to 7.5% on 2 May 1980, whereas interest rates in the United States had been declining since the end of March 1980. In Germany, however, the level of market interest rates in 1979/80 did not reach the peak recorded in 1973: for example, the three-month interbank rate, which reached a maximum of some 10% in April/May 1980, was a great deal below the record levels in excess of 14% recorded at the end of 1973. In the United States, on the other hand, the level of interest rates in March 1980 outstripped by far the maximum levels in 1973/74 (the yield on 13-week Treasury bills was in the region of 7% in 1974 and approximately 15% in March 1980). This was one of the factors which helped to trigger the American recession, with the resultant appreciable reduction in demand for credit leading subsequently to a fall in U.S. rates.

Concern has frequently been expressed that the rise in interest rates in Europe might further curb growth rates which are already slackening sharply. Although the rise in interest rates has generally been less spectacular than the maximum levels reached in the past, such a danger cannot be ruled out entirely. However, the links between nominal interest rates on the money market and the real economy are very complex. Generally speaking, there is a fairly close relationship

between money market rates and bank lending rates, and bond rates have tended to follow, albeit more slowly, the rise in short-term rates; this may curb investment activity. It has also been argued, however, that in many countries the rise in interest rates corresponds broadly to the rise in inflation rates and that there is nothing worrying about real interest rates. The very high real interest rates in Belgium and Denmark are due to the special situation in these countries (budget shortfall and external deficit) and the positive real rates in Germany are in line with the level reached in earlier periods of stabilization. For some firms, however, arguments concerning real rates are less significant than the impact of high nominal rates on cash flow. In the context of the EMS and the defence of central rates, high nominal interest rates have generally served to channel short-term capital flows and have helped in the longer term to finance the Community's deficit on current account. Furthermore, if the policy pursued had not in general protected exchange rates, the inflationary pressures caused by devaluation would have required much more drastic measures subsequently. Overall, therefore, it is fair to say that the interest-rate trend in the Community during the period in question has been appropriate, given the need to guide the economy through a particularly perilous period.

Outlook for 1981

As in previous years, the Commission's departments have attempted to estimate for the current year and to forecast for next year (1981) the growth of the broadly defined money supply in member countries (M2, except for Germany and Ireland (M3) and for the United Kingdom (sterling M3) - see Table 5.1). These forecasts have been drawn up at the same time as those for the real economy; the main hypothesis as to monetary policy underlying these forecasts is that efforts will continue to be geared to moderate and steady expansion of the monetary aggregates in the medium term, including a gradual reduction in the rates of money supply growth for those member countries in which inflation and monetary expansion are still very high. This hypothesis takes account of past experience and implies maintenance of the policy stance adopted in 1979 and 1980 by the monetary authorities in the member countries; it is in line with the

need, in the EMS (see above), to restrict the danger of devaluations as much as possible and to enhance convergence towards price stability. The forecasts show that, on a Community average and for most member countries, monetary expansion in 1981 is likely for the second consecutive year to be close to or even slightly below the trend in the 1960s. Thus, despite major difficulties, monetary policy should satisfy an important condition for the return to a more stable and more convergent trend within the Community. It is ten years since such a prospect last arose. It must be stressed, however, that these monetary expansion rates are only a necessary and not a sufficient condition for a more stable and more convergent trend in prices and costs. Past experience has shown not only the long time lags between monetary policy measures and the resultant adjustments in the real economy, but also the serious problems which may arise if efforts towards stabilisation are based exclusively on monetary policy. It is therefore important to try to shorten these response lags and to supplement monetary measures by action in the field of public finance, by moves to restructure supply and, particularly, by efforts to adapt the growth of incomes to the new conditions.

The need for this would seem to be particularly pressing in those member countries in which the limits of purely monetary stabilisation are clearly in evidence. If there are no further disruptions from outside the Community, the degree of restrictiveness of this monetary policy stance depends to a large extent on the behaviour of employers and unions. A further acceleration of internal price rises and/or a wage cost explosion, such as experienced in 1974/75 in the Community and most member countries, would make present monetary policy extremely restrictive and recession might well become inevitable. To try to avoid such a recession through a sharp upward adjustment of monetary expansion rates would be to abandon the struggle for stability and convergence in the Community and would probably only postpone the recession and aggravate it at the end

of the day. If, on the other hand, the movement of internal prices and wage costs adapts rapidly to the environment of relative stability established by monetary policy, the growth and employment losses resulting from the second oil crisis can be contained and the stage set again for an improvement in the outlook for growth and employment. In this case, with a given rate of monetary expansion, the level of interest rates can come down not only, in a first stage, in response to the drop in credit demand caused by the temporary and inevitable slowdown in growth, but also, subsequently and more permanently, as a result of the reduction in inflationary expectations and of weaker growth in the volume of lending as price and wage cost increases slow down. However, the interest rate trend depends also on the balance of payments and other international factors; if there is further stabilisation in the United States and if the reduction in interest rates there proves to be lasting, a further fall in interest rates in Europe might well become possible and, where appropriate, be supported by concerted action by the authorities.

Table 5.1

Monetary targets and outcome

a) Definition of targets; annual growth rates in %

Country	Target variable ¹	1977 Outcome	1978 Outcome	1979		Target	Outcome during the 12 months to:
				Target	Outcome		
DK	BCE	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
D	M2	10.0	8.4	6-9	6.3	5-8	4.9 July
F	M2	13.9	12.2	11	14.4	11	12.1 May
IRL	PSCE	26.4	33.0	18 ²	19.3 ²	13 ³	6.7 ³ July ³
I	TDCE	17.7	20.7	18.5	18.5	17.4	18.5 March
NL	DM2	4.7	10.1	8.5 ⁴	10.0	8	10.9 June
B	TDCE		11.8	12 ⁵	12.9 ⁵⁺⁷	11.0 ⁶	n.d. ⁷
UK	EM3	10.0	13.3	8-12 ⁵	(13.1) ⁵⁺⁷	7-11	(18.2) ⁷ August

b) Broadly defined money stock, end of year, yearly rate of change in %

Country	Defi- nition	1979					1980			1981			
		60-70	71-72	73	74	75-78	1979		Outcome during the 12 months to:	PX 80			
		PX 79	Out- come	PX 79	PX 80	PX 79	Out- come						
DK	M2	10.0	11.7	12.6	8.9	13.1	9.0	9.9	8 ½	6.0	5.6	July	8
D	M3	10.4	13.9	10.1	8.5	9.8	7.0	6.0	6 ½	5.5	4.3	July	6
F	M2	13.1	18.1	15.0	15.9	14.3	12.5	14.4	11	11.5	12.1	May	10
IRL	M3	9.9	13.1	26.2	19.2	19.3	21.0	19.0	16	12.0	8.6	July	12
I	M2	13.9	17.7	23.0	15.3	22.3	17.8	20.4	16 ½	16.5	15.6	May	15
NL	M2	8.9	10.4	21.9	20.0	8.9	8.1	7.3	8,8	5.5	7.4	June	5
B	M2R	8.2	14.2	13.5	9.0	11.1	9.1	6.0	10,8	6.8	2.9	May	6,8
UK	EM3	5.6	18.8	26.4	10.2	10.2	12.5	(14.6) ⁷	11 ½	(14.6) ⁷	(18.2) ⁷	August	9
CE-9	M2/3	10.4	16.2	17.5	12.4	13.0	11.4	(12.2) ⁷	10 ½	(10.6) ⁷	.		9.0

- 1) DCE = domestic credit expansion by banking sector PX 79 forecast published in the last annual review (79/80)
 M2 = Central bank money stock PX 80 forecast made in October 80 in view of the present
 DM2 = domestically created money supply annual review (80/81)
 TDCE= expansion of total internal credit
 PSCE= expansion of domestic credit to the private sector
 by the banking system

2) February 1979 to February 1980

3) February 1980 - February 1981. As the definition of the target has changed since February 1980 (loans denominated in foreign currency are now excluded), the figure given for Ireland is the increase observed between February and July, converted into an annual rate of change.

4) Forecast by Belgian Authorities

5) October 1978 to October 1979

6) June 1979 to October 1980, converted into an annual rate of change.

7) In the United Kingdom the growth of the money supply EM3, as recorded in the official statistics does not accurately reflect the underlying growth of monetary expansion: The control of the growth of interest bearing liabilities ("corset") favored the development of credits outside the banking system and its abolition has given rise to reintermediation by the banking system (see text). If the growth rates for 1979 and 1980 are adjusted assuming in both years an equal increase by 14.6 %, the growth in the Community's money supply would change to 12,2 % in 1979, and to 10,6 % in 1980. Without this adjustment, the money supply (EM3) would have increased by 11,7 % in the year ending December 1979 and its increase in the year ending December 1980 is estimated to be about 17 1/2 %.

Table 5.2

Bank lending to domestic economy

Sectoral distribution and counterparts

Percentage share

Lending over 12 months to:	DK Aug'80	D Aug'80	F May'80	IRL Aug'80	I May'80	NL June'80	B March'80	UK Aug'80
Share of								
public sector	52	20	-	56	39	24	45	14
other domestic sectors	48	80	100	44	61	76	55	86
	100	100	100	100	100	100	100	100
Based on								
non-monetary liabilities	-	61	22	-	-	58	31	10
external ¹ resources	65	15	-14	60	4	23	50	26
monetary liabilities	35 (M2)	24 (M3)	92 (M2)	40 (M3)	96 (M2)	19 (M2)	19 (M2H)	64 (EM3)
	100	100	100	100	100	100	100	100

1 = a positive figure corresponds to a deficit in the balance of payments of non-banks.

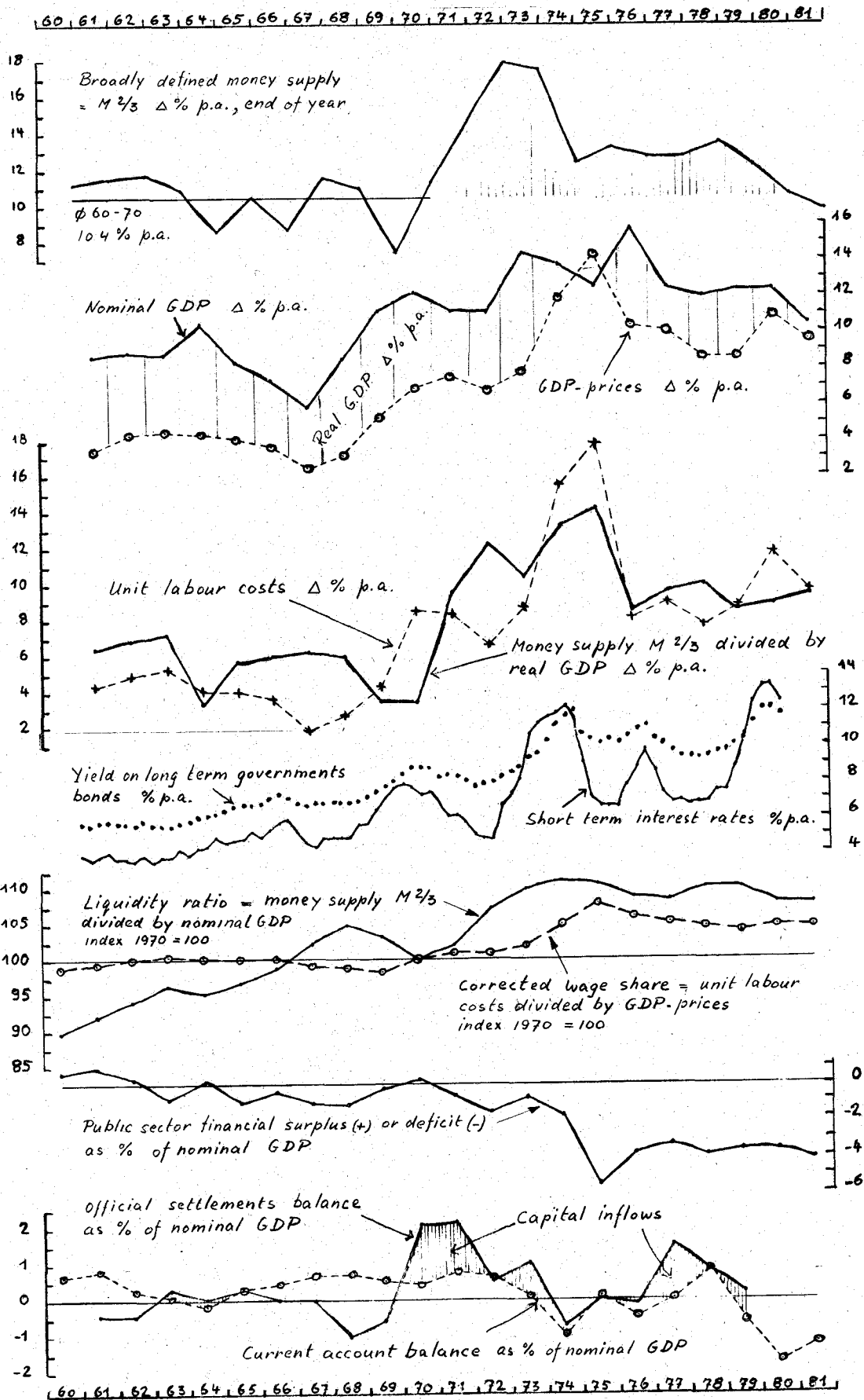
Table 5.3

Short term interest rates - 3-month money market rates - % p.a.

	DK	D	F	IRL	I	NL	B	UK	EC	USA
<u>1979</u>										
End March	11.25	5.30	6.75	14.25	11.41	7.19	7.30	12.13	8.4	9.99
June	12.0	6.55	8.38	17.56	11.24	9.50	9.40	14.00	9.7	9.94
Sep.	19.0	7.95	11.50	17.44	11.32	9.75	11.80	14.16	11.2	11.95
Oct.	18.12	9.50	12.13	17.06	12.23	10.63	13.35	14.81	12.1	14.72
Dec.	16.50	9.55	12.38	18.50	15.52	13.0	13.75	17.06	13.3	13.70
<u>1980</u>										
End March	18.88	9.85	13.25	19.0	17.29	11.2	16.50	18.56	14.3	18.44
June	18.88	9.95	12.25	17.56	16.96	10.55	13.90	17.13	13.6	10.0
Aug.	18.67	8.95	11.38	14.75	17.0	10.70	11.85	16.88	12.9	9.6
<u>Memorandum</u>										
Change in consumer prices over 12 months to July 80	12.8	5.5	13.7	20.5 ¹⁾	21.7	7.5	7.3	16.9	13.7	12.9
<u>Yields on long-term government bonds - % p.a.</u>										
<u>1979</u>										
End March	15.8	6.9	9.6	13.3	13.4	8.1	9.0	11.6	10.0	9.0
June	16.7	7.8	10.7	15.4	13.4	8.7	9.4	12.8	10.8	8.8
Sep.	17.4	7.5	11.6	15.7	13.4	8.4	10.0	12.6	10.9	9.3
Dec.	17.4	7.9	12.6	16.3	14.3	9.1	10.9	14.7	11.9	10.2
<u>1980</u>										
End March	18.6	9.4	14.4	16.8	14.8	10.8	11.7	14.6	12.9	12.5
June	19.3	8.2	13.3	14.6	15.2	9.2	12.5	13.8	12.2	9.9
Aug.	19.9	7.8	13.5		15.7	9.0		13.9		

1) For Ireland up to May 1980

Graph 5.1 Principal monetary and macroeconomic indicators for the Community



6. The European Monetary System

The European Monetary System is intended to establish greater monetary stability in the Community, and since its entry into force, on 13 March 1979, it has fulfilled this function. The exchange rates of the participating currencies have been more stable than before. Central rate adjustments have been minor, infrequent, and orderly. Success is however relative. The system has worked well over the last eighteen months partly as a result of favourable underlying circumstances and partly as a result of the workings of its own mechanisms. If the system is to continue to contribute to more monetary stability in an increasingly unfavourable environment the existing mechanisms must be strengthened and new ones developed, in addition to the improvements, in economic performance required.

Role and position of the E M S in the economic policy of the Community

The experience of the seventies demonstrated the disadvantages of using exchange rate flexibility as the preferred instrument of external adjustment; especially in that this policy response has often worsened domestic imbalances. Faced with a decline in their terms of trade caused by successive oil price rises, and with the emergence of new competitors on the world stage, Community Member States have recognized since the mid-seventies the need to pursue and implement rigorous stabilization policies.

The dangers of high and divergent inflation rates together with low growth rates were behind the initiative in 1978 of setting up a European Monetary System, initially termed a "scheme for the creation of closer monetary cooperation leading to a zone of monetary stability in Europe". The purpose behind the E M S is therefore to reduce macro-economic and monetary uncertainties which have inhibited the plans of economic agents, their propensity to invest, their entrepreneurship and their ability to stand their ground on Community markets. All these factors are in the long run crucial for growth and full employment in Europe.

Exchange rate developments of E M S currencies

In its first eighteen months the E M S has not experienced any excessive or lasting strains, both because the pressures affecting each of the currencies individually have for the most part been moderate, and to a certain extent because of active use of the system's mechanisms. The following paragraphs will discuss the movements of the currencies and the next section will examine the role of the mechanisms.

The average fluctuation measured against the ECU has been considerably smaller in the last eighteen months than in preceding years, both for the currencies which had been floating separately before 1979 (French franc, lira and Irish pound) and for the currencies which formed part of the earlier monetary arrangements (the "snake"), with the exception, however, of the Danish crown (see Table 6.1). The markets in the E M S currencies have therefore not experienced the pronounced upheavals suffered by the other major world currencies (1).

There have been two changes of central rates over the eighteen month period. In September 1979 the DM was revalued by 2 % against all the other currencies except the DKR against which it moved up 5 %. At the end of November there was a further downward movement of the DKR by 4,86% against all the other currencies within the system. Between these changes the currencies have all remained within their fluctuation margins of 2.25 percent (6.0 percent for the lira) as required by the system. There have been changes in the relative positions of the participating currencies (see graph 6.1), but these movements (discussed below) of each of the currencies should be seen against this background of general stability.

The DM remained strong mainly reflecting dollar weakness until early autumn 1979, and on several occasions even reached the upper limit of its margin of fluctuation against the Belgian franc and the Danish crown. This strength was however short-lived and after the September 1979 realignment of the central rates within the system, the German currency gradually became weaker relative to the other currencies within the system reflecting growing market awareness of the deterioration in the German current payments balance. As one of the world's major international currencies the DM tends to be increasingly affected by the position of the dollar; consequently a further factor in its weakness has been the effects of the restrictive measures adopted by the American monetary authorities, which led to substantial capital flows to the United States. In the first quarter of 1980, the dollar became definitely firmer and the DM has moved to the bottom of the system and even needed sporadic support.

(1) However, unlike the other main third currencies, the Swiss franc remained relatively stable against all the E M S currencies on the initiative of the Swiss authorities who have officially set themselves, since October 1978, a "concrete objective for the rate of the franc, defined by reference to the mark" (Banque Nationale Suisse, "Tâches, moyens d'action, organisation", Zurich, 1980).

The lira was also firm in the first months of the system's operation, but its position gradually declined from the end of 1979. This change became more pronounced from early summer 1980 onward resulting in an overall movement from March 1979 end September 1980 of 5 % against the ECU. The causes behind this were Italy's worsening competitiveness and its deteriorating current payments balance. However the authorities' resolute policy of supporting the currency (raising interest rates to a record level, intervening on the foreign exchange market, charging part of firms' social security costs to general taxation, etc...) have made it possible to contain the lack of confidence in the lira.

The Belgian franc and the Danish crown have been the most persistently weak currencies since the system came into operating, although within the last few months they have strengthened. Apart from this their experience has been different. The Danish crown has only recovered at the price of two successive devaluations amounting in total to about 9 % against the ECU whereas the Belgian franc has remained with the other currencies. This has been achieved by firm action, especially on interest rates, by the monetary authorities.

Since late 1979, the French franc has been near the top of the exchange rate system apart from a temporary setback last summer. The reasons behind its comparative strength are: a competitiveness margin (for labour in particular) as a result of the depreciation which occurred during the period of floating; the market's positive appraisal of monetary policy which treats defence of the currency as a priority, the medium-term impact of the French plan to diversify energy sources and relatively better balance of payments position as compared with other participants (in particular Germany).

The Irish pound and the guilder have not been under any significant pressure and have remained for most of the period towards the centre of the system. This general stability, and familiarity with the operation of the newly set up foreign exchange market in Dublin, allowed the Irish authorities to end on 13 June the transitional period introduced when parity with sterling was broken. During this period the issuing institution had monitored currency fluctuations closely. The guilder has progressively appreciated towards the end of the period and is currently at the top of the system.

The pound sterling, which does not participate in the exchange rate mechanism, has fluctuated much more than the other Community currencies. Over the period March 1979 to September 1980, it has appreciated 11,3 % against the ECU. Its effective exchange rate (as calculated by the Bank of England) has reached its highest level for five years and its market rate against the dollar is back to the 1967 level. This performance is mainly a result of the increase in the price of oil with its affect on the UK balance of payments and on the maintenance of particularly high interest rates as a part of domestic monetary policy.

The role of the E M S mechanisms

The underlying economic data have thus contributed to the stable development of exchange rates, but the relatively satisfactory performance of the system over the first eighteen months also owes a considerable amount to the workings of the mechanisms of the system. However these mechanisms are incomplete and in some cases unused.

The short discussion below suggests that:

- The exchange rate mechanism is, for the moment at least, the backbone of the system, but its role in overall currency developments especially as regards pressures from outside the system remains to be more precisely defined.
- A substantial quantity of ECU have been created. They have been used both in the context of the very short term financing and for some spot settlement, but their existence remains precarious and their quantity depends upon the exchange rate of the dollar and the price of gold.
- The short and medium term credit facilities available to the system were increased to 25 billion ECU at the start of the system, but they have remained unused.

In the absence of central rate changes the main role of the exchange rate mechanism is to retain currency fluctuations within the margins at the limit of which there must be intervention in Community currencies. Policy measures others than intervention can be triggered by the divergence indicator and the system recognises the need for both intra-marginal intervention in Community currencies and intervention in dollars. There are however no clear ground-rules for these interventions and this has led to some conflicts of interest.

Intervention and domestic monetary policy measures have succeeded in curtailing the excessive fluctuations of exchange rates, but the system foresees the need for central rate realignments from time to time. There have been two adjustments (see above) and these have been orderly, have not been preceded by excessive speculation and have been carried out by mutual agreement.

All the Community central banks have transferred 20 percent of their gold assets and the same percentage of their dollar reserves to the EMCF and against these a very substantial quantity of ECU have been created. The method used for the transfer, a system of three-month revolving swaps against gold and dollars has resulted in the mobilization of part of the central banks gold holdings. While this method has in the circumstances given some extra room for manoeuvre by making available additional means of settlement, it has resulted in a very large increase in the number of ECU which is quite independent of any policy wish of the system. Thus the appreciation of the price of gold alone entailed a 75 % increase in the EMCF's liabilities to the central banks (when the E.M.S. came into force, the latter held a total of 26.000 million ECUs (1), and at the end of August 1980 this amount was 45.500 million ECUs).

Intervention in Community currencies has taken on a greater importance than in the system which preceded the E.M.S., the "snake". The amount involved is still however small compared with the amount of intervention in dollars. When an intervention is made at the margin, the debtor may chose whether or not to activate the very short-term financing mechanism (VSTF). If he choses to do so he has a right to use ECU to settle upto 50 percent of the claim. In cases where the financing mechanism is not activated the two banks may agree that some or all of the settlement should be made in ECU. When intra-marginal interventions takes place, the debtor has no right to the VSTF but it may be granted with the agreement of the creditor in which case the above rules for settlement in ECU would again apply.

(1) Including the Bank of England's deposit which was made only in July 1979.

Some central banks have therefore already made fairly wide use of the ECUs with which they were credited on the books of the EMCF in return for their gold and dollar contributions; others, in contrast, because of the better performance of their currencies, have kept their ECU allocation, and even accumulated a net credit position on the EMCF. It should be recalled, in this connection, that these assets have appreciated in recent months, and that the ECU, the value of which is a weighted sum of all the Community currencies, has itself advanced both against the dollar and against the SDR (see Graph 6.3). The net ECU positions resulting from the above transactions are not however permanent to the extent that they are based on the swap-system for creating ECU which is limited to two years.

Of the credit mechanisms, only the very short-term financing facility has been used, and for moderate amounts, in order to support certain currencies - mainly the Belgian franc, and to a lesser extent, the Danish crown. The overall outstanding amount of these financing arrangements (2.200 million ECUs) represents only a small part of all global intervention by central banks, both in Community currencies and more importantly in dollars. The amounts were repaid in full in March 1980 and the facilities have not been used since.

Problems to be solved

The analysis of the first eighteen months of the EMS leads to the conclusion that it has been relatively successful in contributing towards achieving the aim of a zone of greater monetary stability. However this success is partly a result of favourable circumstances and is only partial. As seen in Chapter 2 there has been a considerable rise in the average rate of inflation and an increase in the dispersion of price performances in the Member States. The EMS must contribute towards resolving these problems and to do this the main questions are i) how a correct balance between financing of payments imbalances and adjustment to them both through external and internal measures can be achieved; and the effects on domestic liquidity; ii) how a policy vis à vis third countries can be determined, and iii) how domestic monetary policies can be better co-ordinated in the context of the system.

The provision of credit within the system should allow participants to finance temporary imbalances rather than resort to adjustments, which could be harmful both to themselves and other participants. It is however difficult to determine ex ante what is a temporary and what is a more

lasting imbalance. Cooperation between participants could be increased with a view to making such decisions in common. Credit may also have a role to play in cases where imbalances are not temporary and adjustment is necessary, as it can expand the policy choices open to the authorities. This is especially important in that the logic of the EMS is that adjustment should where possible rely on internal measures rather than exchange rate changes. The role of the system, its liquidity creation powers and the function of the ECU in these areas need to be developed. At present when a participant chooses to finance an imbalance it must opt for recourse to Community credits or for recourse to the markets. So that Member States are not encouraged by unconditional financing to postpone unduly the adoption of the necessary adjustment measures or rules should be established for access to Community assistance, and these should encourage its early use. However, the current payments deficit of all the participants makes any substantial recourse to EMS short and medium term credits difficult at the present time. The Community is in fact examining the possibility of setting up a renewed Community loan mechanism, similar to the one introduced in 1975 following the first oil shock, but one which would encourage the recipient Member States to adopt the proper adjustment measures, as soon as any imbalance became apparent.

The EMS cannot however survive in a vacuum. It has been seen above that outside events can have a large effect on its working. For these reasons policies towards third currencies and the dollar in particular should also be coordinated. In this area progress has been made: consultations between central banks, in which the Member States are now taking a more active part, have been increased; detailed exchanges of views on the market situation and future trends take place at regular intervals. The coordination of national positions is nevertheless insufficient, and coordination of the actions of the Community central banks can still be improved, so as to arrive at coherent attitudes towards the dollar not only by limiting its erratic day-to-day variations, but also by reducing the scale of cyclical or short-lived movements which are incompatible with the underlying economic trends. Such action has been undertaken in the last few months. In particular in the first quarter of this year when the sudden jump in interest rates in the United States caused the dollar to appreciate by more than was justified by relative competitiveness

on either side of the Atlantic. In this event, the movement of the dollar, which was excessive and was the vehicle bringing inflationary dangers to the European countries had, by general agreement, to be contained. However, on other occasions, dollar interventions have increased strains between currencies participating in the E M S exchange rate mechanism. This was the case when the dollar shot upward in the third quarter of 1979. Intervention by the German Bundesbank then helped the mark to appreciate within the E M S, and this caused difficulties for the weakest currencies in the system (the Belgian franc and the Danish crown). Similarly, dollar interventions to reinforce the cohesion between the currencies of the system have had destabilizing effects on the American currency's exchange rate. This occurred in the third quarter of 1980 when in a period of pronounced weakness for the American currency, the central banks of the Member States participating in the E M S were overall net sellers of dollars, because of the intervention of a single central bank designed to limit the fall of its currency (the lira) against its partners. Indeed, the persistence of simultaneous reverse dollar operations (with some Community central banks buying while others sell dollars) conforms neither to the letter nor the spirit of the system.

In addition to the difficulties in establishing a common attitude to the dollar, there are those stemming from temporary conflicts between intervention made necessary by observance of the margins of fluctuation and the effect of these on domestic liquidity and the pursuit of national monetary policies based on quantitative targets. So far these conflicts have not been great since the absence of sharp strains within the system and the small scale of intervention has not affected the conduct of monetary policy in the countries which have set themselves money supply targets (in particular France and Germany). It should be noted in this connection that to the extent that policies are defined in terms of medium term targets, or expressed in the form of a range, day-to-day movements in exchange markets may not create persistent strains.

Transition to the institutional stage of the EMS

The basic texts instituting the EMS (see European Economy, No 3, July 1979) suggest that all the mechanisms of the system should be consolidated after a transitional phase. They also contain important pointers as to what should happen in the next stage: the ECU should assume its role as a fully utilised reserve asset and settlement instrument; and the exchange rate and credit mechanisms should be consolidated in a newly created European Monetary Fund (EMF).

The work done already and the experience derived from the workings of the system makes it possible to assess the scale of the problems and to identify the possible choices between the different solutions which can be envisaged. The Commission has earlier reviewed the progress made and some of the difficulties to be overcome in its report on the European Monetary Fund which it presented to the European Council in March 1980 (see box).

It has also become evident that the upheavals in the international environment which have occurred since the start of the EMS pose new questions that must be dealt with in the period ahead. The reemergence of an acute recycling problem following the rise in oil prices, the resurgence of inflation, the soaring price of gold, the swelling of international liquidity are all changes giving new dimensions to the problems to be solved.

The form of the Fund and the role of the ECU are central problems, on which ideas are being concentrated at present. If the ECU is to be freely useable as a reserve asset and means of settlement, it is necessary to envisage eliminating the present restrictions on its acceptability and to study the questions related to its convertibility and negotiability, which also raise problems about the way in which international reserve assets are transferred to the future EMF. Added to these, are questions about the role that the ECU will play in the consolidated credit mechanisms and whether it could have any place in the recycling process.

Work is continuing in all these areas in various Community bodies.

EUROPEAN MONETARY FUND

Report from the Commission (of 20 March 1980) to the European Council

I. At the Dublin meeting on 29 and 30 November 1979, the European Council invited the Commission to submit, for the meeting in March 1980, a report setting out the progress made in studying the establishment of the European Monetary Fund and pointing out any difficulties.

The studies on the European Monetary Fund were started by the Commission as early as May 1979. Since then, the Monetary Committee and the Committee of Governors have looked into this question, and their respective chairmen have reported to the Council on the progress of work. This work has not yet been completed; rather than producing specific guidelines, it has so far made it possible to identify problems and possible choices between solutions. However, as can be seen from the analysis below, the preliminary technical work has shown that, if it is to make a real extra contribution, the transition to the institutional stage of the European Monetary System can be carried out only if certain basic questions have been resolved which have not yet been fully clarified.

II. Current work is based on three main elements :

A. The first is the desire expressed by the European Council in Bremen and Brussels, to transform the European Monetary System into a "durable scheme" guaranteeing the creation of a zone of monetary stability in Europe. For the purpose of attaining this objective, the European Council defined the operating rules of the system in the first stage and indicated certain characteristics of the "final stage".

B. The second is the lessons to be learnt from the first year of operation of the European Monetary System and from monetary and exchange rate developments in the Community since 13 March 1979.

The assessment of the operation of the European Monetary System in its first year is largely positive. The procedures for consultation between the authorities of the Member States in the various Community bodies have been improved. Despite sharp economic and monetary disturbances which entailed interest rate increases ranging from 3 to 5 points according to the country, the group of participating currencies maintained a greater degree of cohesion than that recorded since 1972. Two adjustments of central rates in September and November 1979 were carried out in good time and fairly smoothly. Lastly, the monetary compensatory amounts were reduced appreciably, reflecting progress towards the objective of uniform prices on the European agricultural market.

In stressing the positive factors, the Commission is expressing its conviction that it would have been much more difficult to achieve these results if there had been no European Monetary System. However, between the end of 1978 and the end of 1979, the average rate of inflation in the Community rose from 6.9 % to 9.0 %, and the spread between the lowest and the highest rate of inflation in the Member States widened from 10 to 17 points. Although progress has thus been made towards exchange rate stability, the same has not been the case in the field of prices. Consequently, the European Monetary System must be consolidated and strengthened so as to make its own active contribution to better economic equilibrium in Europe. Economic policies for their part will have to be brought to converge more closely to ensure the stability of the monetary system.

C. The third element is the developments in the international economic, financial and monetary situation. In 1978, the serious disruption of exchange rates, payments balances, prices and financial markets caused by the 1971-74 monetary and energy crises, seemed to be about to ease. Today, the threat of renewed disequilibria in international payments relations is growing.

The future development of the European Monetary System must therefore be such as to contribute actively to the overall stability of the international financial and monetary system and to meet the Community's general interests in the trade and financial fields - both its own interests and those of the countries with which it has particularly close relations.

III. The Commission and the committees concerned have primarily concentrated on the role of the ECU and on the organization of the credit mechanisms in the European Monetary Fund. They have examined the institutional aspects, which will be largely governed by the solutions adopted to the questions of substance discussed above.

1. The credit mechanisms

Two features of the credits granted under present agreements should be noted : to a large extent they are bilateral credits, the accounting procedures for which are handled by a Community body, the EMCF; and since the body which issued the ECUs - the EMCF - is only an accounting intermediary in the credit operations, these do not give rise to the direct creation of ECUs.

Two problems have been studied in particular : first, the consolidation of existing credits (short-term and medium-term) and of very short-term credit facilities. It became clear that, whatever solution is adopted, this is not a fundamental problem in the transition to the institutional stage of the European Monetary Fund.

Second, the EMF's ability to create ECUs against credits, which is a crucial issue. This ability raises the problem of the limits and conditions under which these ECUs could be created or the credits could be granted, and therefore that of the means which would be available to the European Monetary Fund to impose tighter monetary discipline in the Community. The solutions to this problem will depend to a large extent on the role of the ECU in the institutional stage of the European Monetary System.

2. The ECU

(a) In the present system, the ECU serves as the numeraire for the exchange rate mechanism, as the basis for the divergence indicator, as the denominator for intervention operations and as a means of settlement between the Community's monetary authorities.

However, the ECU lacks the principal features of a currency : it is not an instrument of payment; there can be no autonomous creation of ECUs through the credit operations; and though it appears in the central bank's balance-sheets, this does not mean that it is a genuine reserve instrument, since it is merely the expression in the accounts of the assets (dollars and gold) against which it has been issued and whose movements it reflects automatically.

(b) The decisions taken at Bremen and Brussels, certain fundamental considerations and recent monetary trends together mean that the development of the ECU will be the locomotive for transition to the institutional stage of the European Monetary System : it is by expanding the role of the ECU that the Community will be able to organise internally the coordinated action necessary to achieve a greater degree of monetary stability and establish its monetary identity at international level.

(c) The full and complete use of the ECU as a means of payment and the regulation of the creation of ECUs to serve the objective of monetary stability raise the question whether, to what extent and under what conditions the future Monetary Fund could possess an independent power of money creation.

If it were given such power, the future European Monetary Fund could create ECUs in two ways : against a contribution of reserves (as is done under the present agreements), or through credit operations; these two methods could even be combined.

The full use of the ECU as a means of payment or reserve instrument within the Community would require that several conditions be met :

- first, certain legislative measures would have to be taken to abolish the limits to the acceptability of ECUs to the central banks, to provide that a certain percentage of reserves must be held in the form of ECUs, and possibly to impose the exclusive use of the ECU as an instrument of settlement between the Community's central banks;

- if the limits to the acceptability of the ECU were abolished, the ECUs inherent characteristics (convertibility and yield) would have to be strengthened to make it as attractive as the other possible reserve instruments;

(d) Apart from the role to be performed by the ECU in the areas described above, a second major decision of principle will have to be taken; this concerns the wider use of the ECU outside the system of Community central banks, both on the private financial markets and by the authorities of non-Community countries, so as to ensure the full negotiability of the ECU and to enhance its status as a reserve asset. In this context, the question arises as to whether the strengthening of the role of the ECU might allow it to play a part in recycling the surpluses of the oil-producing countries.

IV. Once the European Monetary System enters into its institutional stage, consistency between domestic monetary policies, credit mechanisms and exchange rate agreements will have to be ensured within a single system of procedures, so as to provide a full and proper basis for the smooth operation of the system and the achievement of monetary stability.

This raises the question firstly, of the institutional powers with which the Fund will be endowed in order to administer the system itself and, secondly, of the back-up measures which will have to be taken so as to ensure the smooth working of the system, including measures such as the coordination of exchange rate policies vis-à-vis non-Community currencies and the achievement of a sufficient degree of convergence in the economic and monetary policies pursued in the Member States.

Examination of the institutional aspects has already begun. It has started from the principle that a Fund endowed with increased powers should be integrated into the institutional system of the Community and of the existing international monetary organizations on the basis of clear and precise legal arrangements. Fuller examination of the institutional aspects must necessarily be carried out in parallel with the basic questions raised above; it is on the solutions arrived at with regard to these basic questions that the powers of the European Monetary Fund and the nature of the bodies running it will to a large extent depend. It will at all events be necessary to work out a balanced system of tasks, responsibilities and safeguards for the European

Monetary Fund; this is essential to the exercise of any function of a monetary nature. A balanced system of this kind is, moreover, to be found in all the Member States, though the features of each system differ in accordance with national legal and institutional circumstances.

Some of the functions or tasks allotted to the European Monetary Fund once it is established will probably have to be taken up only gradually depending on how the relevant political authorities assess the way in which the situation is developing and on whether they find the mechanisms suitable.

In conclusion, the Commission proposes that the European Council request the relevant Community bodies to pursue their work along the lines set out in this report. The Commission is ready to provide the European Council with further information on the progress achieved and difficulties encountered in setting up the European Monetary Fund proposed in the texts that were released after the meetings of the European Council in July and December 1978.

Table 6.1

Variation of major currencies vis-à-vis the ECU

	1972	1973	1974	1975	1976	1977	1978	E.M.S.	
								Mar 79 Sep 80	Sep 79 Sep 80
B/LFR	9,4	11,4	20,9	9,6	38,5	6,2	11,4	4,9	4,5
DM	8,1	46,3	16,9	7,7	42,7	11,6	11,7	7,6	7,7
HFL	8,7	27,8	17,1	6,4	39,0	5,7	11,3	5,1	3,3
DKR	16,1	11,3	15,6	5,7	33,8	32,4	7,7	39,4	28,2
FF	12,6	13,6	22,0	26,9	30,1	9,6	18,0	5,1	4,8
LIT	11,2	50,8	33,9	14,3	55,5	21,1	24,8	21,0	18,3
IRL	34,1	45,0	19,2	28,3	63,5	11,3	23,8	7,6	4,7
Average EMS	14,3	29,5	20,8	14,1	43,3	13,9	15,5	12,9	10,2
FS	n.a.	n.a.	n.a.	n.a.	43,5	45,5	53,9	17,9	19,2
UKL	34,1	45,0	19,2	28,5	63,2	11,3	23,8	34,2	35,7
£	11,0	54,2	25,7	47,5	20,1	24,9	49,1	29,0	24,8
YEN	n.a.	n.a.	n.a.	n.a.	34,1	39,2	70,8	66,3	49,0

(1) The standard deviation of the end of month rates for each currency divided by the average. Results are multiplied by 1.000.

Source : Services of the Commission.

Table 6.2

Interventions in Community currencies (April 1979 to August 1980)
(millions ECU)

Interventions in Community currencies notified to the E.M.C.F.		4.162,-
- of which settled by spot transfer of ECU	1.932,-	
- of which financed through the very short term support mechanism	2.230,-	
Other intervention in Community currencies (1)		2.738,-
TOTAL		6.900,-

(1) Of which about 1/3 are interventions by the Central Bank of Ireland in Sterling.

Source : Services of the Commission.

Table 6.3

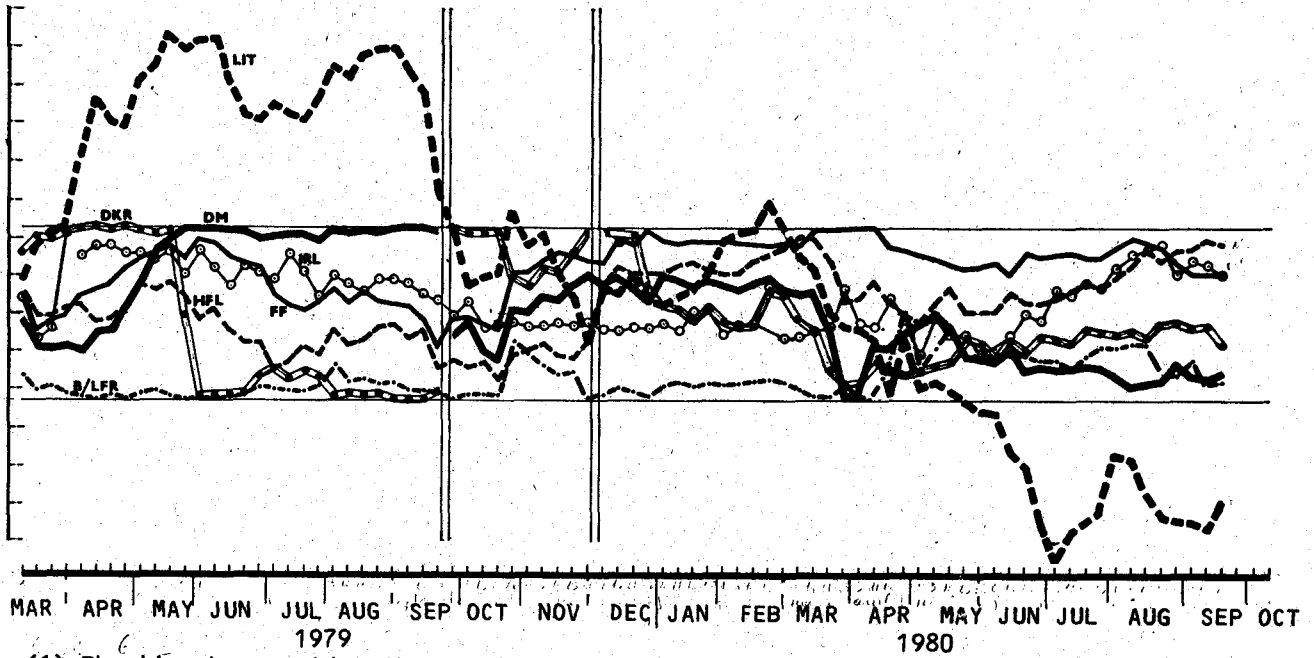
Central rates of Community currencies in ECU

	1979 13 March	1979 24 September	1979 30 November	% variation (1) 13 March 1979 30 Nov. 1979
B/LFR	39.4582	39.8456	39.7897	- 0.83
HFL	2.72077	2.74748	2.74362	- 0.83
DKR	7.08592	7.36594	7.72336	- 8.25
DM	2.51064	2.48557	2.48208	+ 1.15
LIT	1148.15	1159.42	1157.79	- 0.83
FF	5.79831	5.85522	5.84700	- 0.83
IRL	0.662638	0.669141	0.668201	- 0.83

(1) A + sign indicates an appreciation of the currency vis-à-vis the ECU.

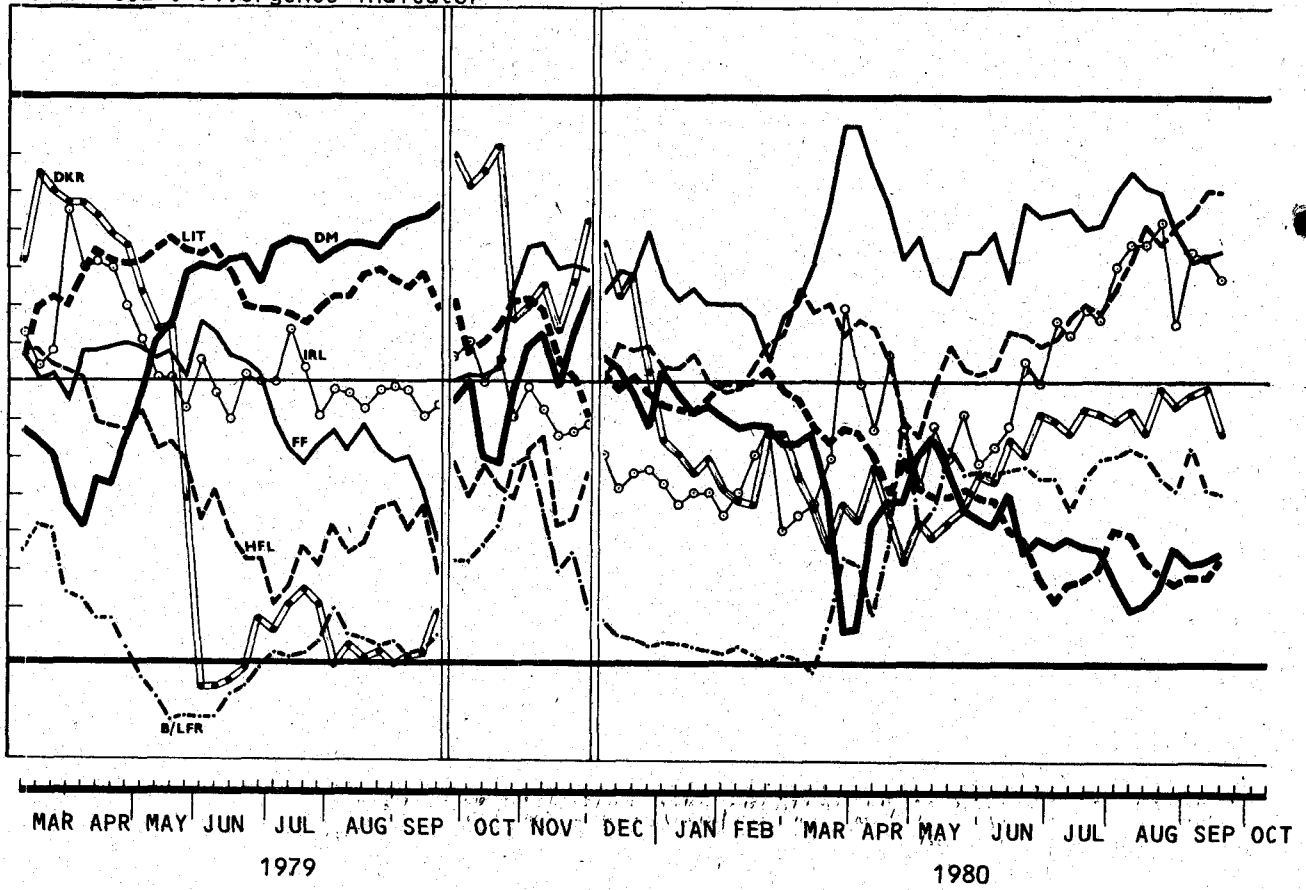
Source : Services of the Commission.

GRAPH 6.1 : Bilateral movements of currencies participating in the EMS (1)

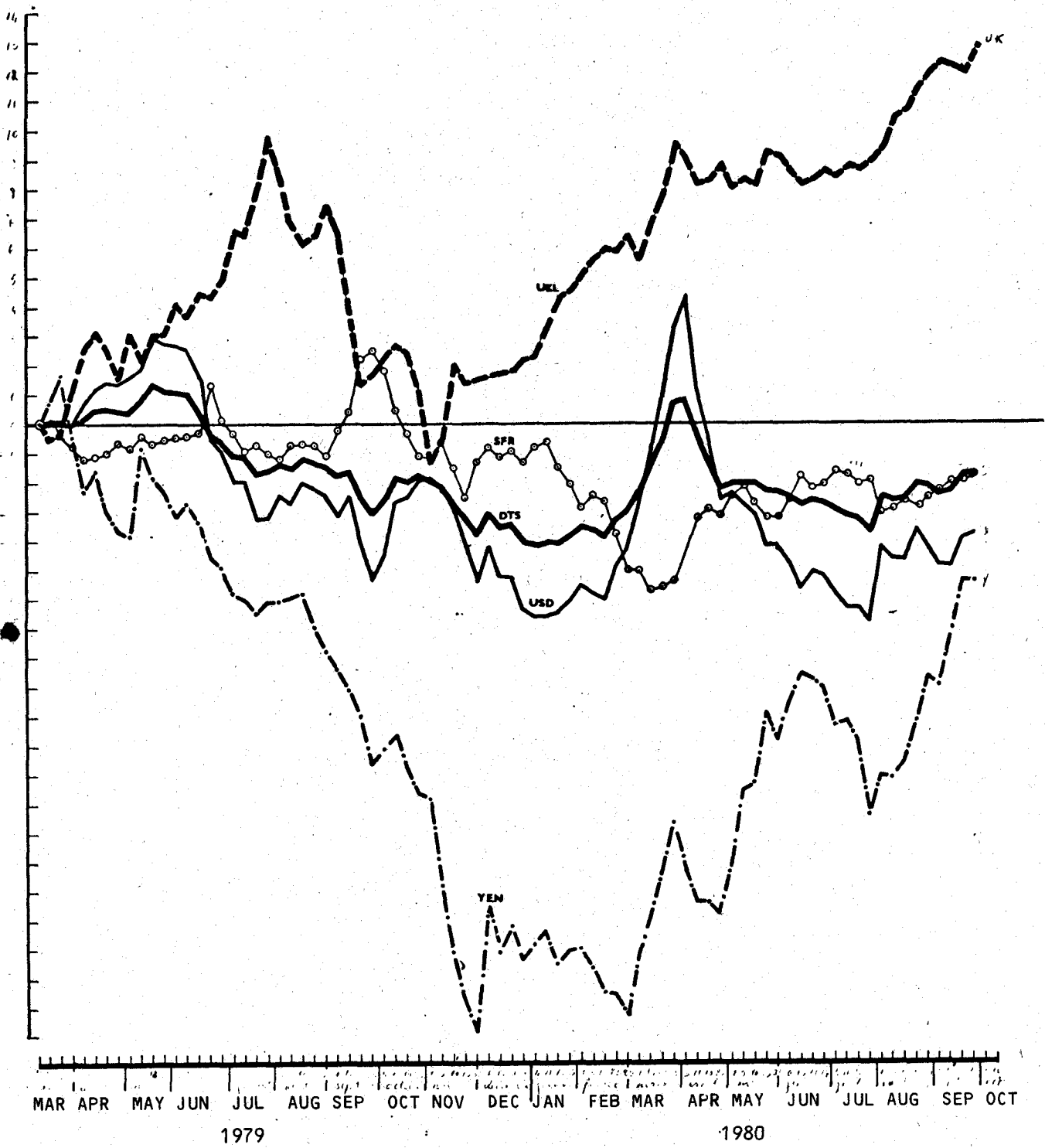


(1) The Lira has a wider fluctuation margin of $\pm 6\%$

GRAPH 6.2 : Divergence indicator



GRAPH. 6.3 - MOVEMENT OF THE SDR, THE UKL AND THE MAJOR THIRD CURRENCIES AGAINST THE ECU (% CHANGES ON 13 MARCH 1979)



7. Investment and energy policies

The new situation as regards energy and the international division of labour calls for a rapid adaptation of the productive apparatus. The brunt of this adjustment falls on industry. Even though the scale of unemployment still presents a major challenge, the failure to bring inflation under control and the external constraint impose strict limitations on overall demand management policy. In this context, a return to more sustained growth and a reduction in under-employment are conditional on measures aimed at achieving better adjustment of the factors of production. Restoring a satisfactory level and rate of productive investment is a key objective of this supply policy. The growth in productive capital formation in recent years has not been sufficient to permit at the same time the restructuring that is necessary following the decline of certain activities, the introduction of new production techniques and the commitment of all the investment needed to cope with the energy constraints. In addition to an appropriate macroeconomic management policy, specific incentive policies are essential if there is to be a return to the high rates of investment on which any improvement in the employment situation depends. This is particularly true in the energy field, where the objectives which the Community has set itself calls for an appropriate policy on prices and on measures to stimulate investment.

Inadequate investment growth

After slowing down significantly in 1974 and 1975, the rate of growth in gross fixed capital formation in the Community has failed to climb back to the buoyant levels recorded in the 1960s; the average annual growth rate of 2.8 % achieved in the period 1976-80 is half that observed in the period 1960-70, and, indeed, a negative growth is expected in 1981.

It is in this depressed environment that firms in Europe will need more than ever to adapt their manufacturing processes to the conditions of a production situation that has been profoundly affected by successive oil shocks and the increased pressure of international competition. The relatively slack rate of their investment expenditure constitutes a major obstacle to the adjustments needed resulting in a fall in potential productivity gains and a continuing contraction in industrial employment.

Further, the persistent disparities in the annual rates of investment growth between Member States remain one of the major features of economic development in the Community. The spread of the individual countries' rates of growth in gross fixed capital formation, which was relatively narrow before 1973, has widened sharply since 1975, adding over the years to the lead built up in the field of structural adjustment by the countries recording the best economic performances (see Table 7.1).

Investment growth has thus been all the more remarkable in Germany, returning since 1976 to the rate observed in the pre-crisis years without showing the slightest sign of losing momentum (an annual rate of over 6 % in real terms). By contrast, the rate in France has not exceeded 2.5 % per annum, while investment in Italy has picked up somewhat only since 1979. The contrast even more marked in the case of the United Kingdom, which has recorded a succession of negative growth rates, but also in the case of Denmark and, since 1979, the Netherlands (although a sharp recovery in investment was registered in the latter country after 1975).

The sectoral analysis brings into somewhat sharper relief the picture afforded by the analysis carried out at Community level. It highlights the key role played by investment in the market services sector (23.3 % in 1970 and 28.3 % in 1980, at 1970 prices and exchange rates), the relative stability since 1975 of investment in the energy sector (some 8 % of total investment), the decline since 1970 in the share accounted for by industrial investment, and the contraction since 1977 in the share accounted for by public-sector investment (see Table 7.2 and Graph 7A).

The sectoral data available for each country (see Table 7.3) confirm the divergences observed at macroeconomic level. Besides recording the sharpest expansion in investment in the market services sector between 1975 and 1978 (an annual increase of 7 %, compared with 6.6 % in the Netherlands and 5.5 % in Belgium), Germany is the only country where industrial investment has grown at a rate equivalent to that recorded in the years of rapid expansion prior to 1973. By contrast, the rate of growth of investment in manufacturing was negative between 1975 and 1978 in France, Italy and Belgium. It was low elsewhere. However a reversal in the situation is under way in the Netherlands and Ireland.

While public investment played something of a counter-cyclical role during the recession in 1975-75 in Germany but above all in France and the Netherlands, it has since increased only very slightly or indeed fallen in most countries.

Trend of investment : more rationalization

This inadequate rate of investment growth in virtually all Member States is severely impeding the expansion of their economies; however, while investment is a key determinant of demand and, operating through the multiplier effect, directly influences the level of production, it also shapes the development of future productive capacity. This prompts an analysis of the impact on each country's productive apparatus of what has already been a long period of reduced capital investment, with account being taken of the changes discernible in the type of investment undertaken.

In thus allocating fewer resources than previously to new investment, firms in the manufacturing sector - those in the market services sector having continued to expand - seem to have devoted a greater proportion of their expenditure to purchases of plant and machinery, thereby cutting back on the setting up of new production units more likely to absorb a rapidly expanding population of working age.

The analysis of investment by major product categories shows (see Table 7.4) that, with the exception of the Netherlands, plant and machinery account for a growing proportion of investment and that, taking into account national policies on aids to the residential construction industry, the share of what can be regarded as an extension of productive capacity is falling. Admittedly, since movable capital goods are, by their very nature, replaced more frequently than immovables, the breakdown of firms' annual investment tends to show a steady shift in favour of the former. This trend seems, however, to be gathering momentum. Between 1976 and 1980, investment in plant and machinery expressed as a proportion of total gross fixed capital formation rose by 1.9 percentage points in Italy, by 2.6 percentage points in Belgium, by 3.1 percentage points in Germany and by 7.1 percentage points in the United Kingdom. In all cases, the rate of growth is more rapid than in the past. In the case of France, data are not available for 1979 and 1980, but between 1976 and 1978 this proportion also increased by 1.4 percentage points. In the Netherlands, following a buoyant recovery in residential investment, the figure for 1980 is lower than that for 1979, although the latter was the highest ever recorded (up 3.1 percentage points on 1976).

This behaviour on the part of investors is attributable both to recent economic developments and to the growing pressures on the productive apparatus over the last few years. The effect of these pressures has been to focus special attention on measures to rationalize production and modernize manufacturing processes, often at the expense of industrial employment. A wide variety of factors have also contributed to this trend including the following :

- Prior to the 1973-74 increase in oil prices, the more rapid growth in the cost of labour compared with that of capital had been one of the factors in the steady increase in the capital/labour ratio (see Table 7.5); and the new cost of energy - by making part of the stock of plant and machinery obsolete - has also encouraged substitution between factors of production;
- The existence of unused production capacity has not fostered the setting up of new production units but, if anything, has encouraged firms to replace their existing means of production gradually in order to be in the best position possible to face the new conditions of international competition;
- The monetary policies pursued, involving a pronounced rise in nominal short-term and long-term interest rates have tended to make private individuals more cautious in their purchases of durable goods and housing and to cause managements to postpone certain long-term investments in fixed assets;
- The investment incentive policies which have been deployed have served above all to promote purchases of plant and machinery; tax incentives in particular have had a more direct impact on plant and machinery replacement than on new building, for which the depreciation period is much longer.

Investment in highly labour-intensive industries seems to be directed towards areas where labour costs are more favourable. However, despite greater relocation of certain types of production, the amounts of investment involved are still limited. In Germany, for example, new direct investment abroad in 1979 totalled DM 5 900 million, or around 1.8 % of total gross fixed capital formation at national level. In the United Kingdom, it would seem to account for less than 3 % of domestic investment. These investments appear to have been made mainly in

order to exploit the changes in comparative advantage or to penetrate protected markets. It is difficult to assess a priori their possible repercussions on the balance of payments and on employment. Most of the studies carried out suggest, however, that the repercussions on employment will probably be slight.

Nevertheless, in line with the restructuring which is under way in many branches of industry and which is already having a direct adverse effect on employment, the proliferation of labour-saving investments is contributing to the contraction of the labour market but has not as yet managed to counteract the slower rate of growth in labour productivity taking the Community as a whole, (3.6 % a year between 1975 and 1977, 2.7 % in 1978 and 1979 and 11 % in 1980).

The period 1980-81 : a varied but generally unsatisfactory picture

Gross fixed capital formation will probably increase at a somewhat slower rate in 1980 than in 1979, with the rate then falling in real terms in 1981. Although the relatively high growth rate recorded in 1979 continued during the first half of 1980, the weaker economic activity observed during the second half of the year is expected to continue in 1981.

This picture of the Community in general masks very pronounced disparities between Member States. In Germany, the long-term policy of improving supply conditions, which was geared in particular to the need to boost investment has meant that capital formation has grown at a very satisfactory rate in recent years. This is true notably of plant and machinery, where real growth rates of 4.5 % and 2 % are expected in 1980 and 1981 respectively. No other country has experienced as stable and as steady a rate of investment growth in the medium term.

It is only in Italy that the prospects in this field for the period 1980-81 are equally favourable. Investment in new plant and machinery is expected to grow by 13 % in real terms in 1980, although a fall of 5 % is then projected for 1981. This growth comes after a long period prior to 1978 in which investment marked time or fell back and following which many firms were faced with shortages of plant and machinery. It is still too early to say whether the growth recorded during the period 1979-80 marks the beginning of a more buoyant expansion of medium-term investment.

In France, the slow rate of investment growth in recent years is expected to continue owing to the anticipated fall in demand in the second half of 1980 and in 1981. This demand trend will offset the effects which production bottlenecks and the general improvement in firms' financial positions might be expected to have in the normal course of events.

In Belgium, developments similar to those in France are envisaged for 1980 and 1981 (with investment expanding by 2 % and 1.2 % respectively), although a substantial volume of investment will be devoted to industries experiencing serious structural problems (steel, textiles and shipbuilding).

In Luxembourg and in the Netherlands, the authorities have taken measures to boost investment. The fact that Luxembourg continues to attract foreign companies and the efforts made to diversify the Luxembourg economy will probably lead to some slight growth in investment in 1980 and 1981. In the Netherlands, however, the forecasts for 1980 and 1981 suggest a fall in investment in real terms, despite the investment aid programme.

Three Member States - the United Kingdom, Denmark and Ireland - are expected to record negative rates of investment growth in 1980 and 1981. In the United Kingdom, the falling demand, high interest rates, low profit levels and the financial constraints on the public sector will lead to an appreciable contraction in investment, the impact of which will probably be felt more in the building and construction industry than at the level of plant and machinery. A similar situation prevails in Ireland, where, after climbing very rapidly for a number of years, investment is expected to fall by more than 10 % in 1980 and 1981. In Denmark, the tight monetary and budgetary policy pursued, together with the decline in domestic and export demand, goes a long way towards explaining the marked slowdown in the rate of investment growth that is also expected in this country.

With the exception of some countries (Italy and Ireland), budgetary policies will probably continue to impose restrictions on the growth of public-sector investment. This approach is already a feature of the situation in the United Kingdom and in Denmark but is also expected to be adopted in 1981 in Germany, in the Netherlands and in Belgium, exerting a further squeeze on the volume of public- but which has, however, grown appreciably in 1980.

Policy measures to support investment

One of the priority objectives of the macroeconomic policy pursued by Member States' governments in recent years has been to restore firms' financing of the first oil shock, and rising energy costs aggravated the constraints on the factors of production, which were already affected by the increase in the share of wages and by the financial costs of a high level of indebtedness.

The profit margins needed to permit investment have been restored in virtually all the Member States since 1975. In 1980, the adjusted share of wages, expressed as a percentage of GDP, is generally speaking, 2 percentage points down on the peak level reached in 1975, except, that is, in France and Italy, where it has remained stable, and in Belgium, where it has continued to rise.

The Commission's forecasts for 1980-81 indicate no change in the situation. In other words, as distinct from what happened at the time of the first round of oil price rises, wage and salary earners rather than the corporate sector will probably bear the brunt of the second oil shock, averting a further squeeze on profits that would work to the detriment of an already sluggish investment climate.

The relative cost of labour/energy generally fell after the 1973-74 oil crisis, but it has since increased gradually and, in some cases, has exceeded its 1973 level. The result has been that investors have sometimes been led to take inappropriate decisions (see Table 7.6). These "perverse" developments have probably considerably biased the choice of efficient factor combinations as well as affecting productivity growth, thereby checking adjustment to the new energy situation.

The authorities in the Member States have also intervened directly both to encourage firms to develop or embrace new technologies and to induce them to step up the volume of their fixed investment.

Action by the authorities to promote research and development (see Table 7.7) has consisted either in providing support for research carried out directly by firms or in promoting the dissemination of new technologies. An analysis of the national programmes for promoting innovation shows that, despite recent efforts to make such policies more effective and although it has been stressed just how important it is to market the idea of innovation, that the measures taken are still geared extensively to research proper. The obstacles to innovation encountered specifically by small and medium-sized firms include, in addition to financing and vocational training problems, the unwieldy administrative procedures that have to be followed in order to receive aid and the difficulties of penetrating new markets, both of which still represent major handicaps.

The variety of instruments used to promote investment reflects the diversity of factors influencing firms' decisions in this field. Thus, alongside the trend of demand and management expectations, particularly as regards inflation, factors such as the cost and availability of financing, the level and structure of indebtedness and the self-financing capacity created by profits earned have been taken into account in framing the measures adopted. While these measures have, generally speaking, formed part of economic recovery programmes, they have in some cases, been adopted with a much more specifically structural objective in mind. The measures taken in the Member States include the following : in France, the package of investment incentives announced in September 1980; in Germany, the changes made in the tax treatment of investment and in the rules on depreciation

at the end of 1977; in Belgium, the measures contained in the Law on economic expansion and employment of February 1977, which covers the period 1977-80; and, from a more specifically structural angle, the Dutch Investment Account Law of May 1978. In the case of the United Kingdom, the changes in direct taxation will probably also have the indirect effect of providing firms with the means to finance additional investment.

These different measures taken by the public authorities to promote investment have been implemented against the background of radical changes in the energy situation: as a result of the role it now plays in the structure of firms' production costs, energy has, since the first oil shock, become one of the key determinants of supply profitability but, at the same time, as a result of the large amount of direct or indirect investment in the energy sector, it has also become an important factor shaping demand.

The energy constraint

After the sudden rise in real energy prices in 1973-74 and an irregular easing between 1975 and 1978, the real cost of energy once again increased in 1979 and 1980. In 1979 the "energy and fuels" component of the wholesale price index - expressed in the form of a weighted average for the five countries for which it is available (Germany, France, Italy, Belgium, Denmark) - increased in real terms by 21.7 %.

In the various sectors of consumption (industry, transport, household/tertiary), this trend has had the dual effect of encouraging energy substitution (a shift from petroleum products to gas and electricity), and prompting a real conservation effort, which has to some extent weakened the link between the growth of industrial production and the growth of energy demand.

Early results for 1979, however, confirm that very considerable efforts will still be needed if the growth of energy consumption is to be prevented from matching economic growth. A slight acceleration in the growth of the GDP and a particularly hard winter were enough to boost consumption and to increase the elasticity of energy consumption with respect to the GDP to 1.63 for 1978/79 as against 0.84 from 1975 to 1978.

Energy in industry, transport, household/tertiary sector¹

The industrial sector cut its consumption by 6 % from 1973 to 1978 (from 313.3 to 294.4 million toe), bringing its share in total energy consumption down from 38 % in 1973 to 35 % in 1978. Industry's performance can be appreciated in the light of the expansion of industrial production over this period : + 5.5 % between 1973 and 1978.

A detailed analysis should however be made for each country, of the part that structural changes in industry have played in reducing energy consumption for specific purposes, in order to identify the areas where improvements in energy efficiency have really been made.

One notable aspect of industrial energy consumption is the sharp reduction in oil consumption between 1973 and 1978, from 105.6 million toe to 86.9 million toe, i.e. a reduction of 17.7 %. With coal consumption continuing to fall during this period, the main substitutes were gas and electricity (the latter partly coal-generated, however) and these have both gained ground.

Energy consumption in the transport sector continued to increase, but at a slower rate than in the past : + 2.75 % per year from 1973 to 1978, compared with + 5.4 % per year from 1963 to 1973. The share of transport in total energy consumption therefore increased from 15 % in 1973 to 16.9 % in 1978. The increase was due to greater oil consumption (+ 3 % per year), replacing other energy sources.

Transport accounted for 29.3 % of final oil consumption in 1973 but 35.4% in 1978, thus becoming the sector with the highest oil consumption. Oil accounted for 95.7 % of the energy used in transport (94.7 % in 1973).

¹ Data from SOEC energy balance-sheets available up to 1978 (cf. Table 7.8)

Energy consumption in the household/tertiary sector increased again between 1973 and 1978, but at a far slower rate : 1.2 % per year compared with 4.5 % per year from 1963 to 1973. Taking account, however, of the fall in consumption in the industrial sector, there was a notable increase in the household/tertiary sector's share in overall consumption - from 39 % to 40.6 % - reflected in all countries except Denmark. The sector has gradually become, from 1963 to 1978, the greatest energy consumer. This is mainly accounted for by heating, domestic hot water supply, cooking and specific uses of electricity (lighting, domestic appliances).

Over the period 1973-78 there was a marked fall in the part of petroleum products in total energy used by this sector (45.4 % in 1973, 38.5 % in 1978) and an even sharper fall in coal consumption (10.7 % in 1973, 6.5 % in 1978). There was extensive substitution - mainly a shift to electricity (increasing from 29.8 % to 34.3 % of the overall total) and natural gas (from 13.4 % to 19.9 % of the total) - which generally eases dependence on oil, provided that the electricity is not produced from oil.

Dependence on external sources of energy and oil

With regard to supply trends for individual products, it is worth noting that in 1979 energy consumption rose substantially in the Community as a whole, while for the first time in many years, coal consumption increased in relation to overall consumption, from 18.7 % to 19.4 %. The considerable rise - 9.4 % - in coal consumption was covered by drawing on stocks and increasing imports, while production remained at virtually the same level. The increase is explained by the upturn in the iron and steel industry and promotion of the use of coal in power stations.

Natural gas also showed an increase (7.6 %) higher than that of gross inland consumption, and its share of the total rose from 17.1 % to 17.5 %.

The proportional increase of coal and natural gas has had the effect of reducing the percentage of crude oil, from 54.4 % to 53.3 %, despite an increase of around 14 million toe (+ 2.7 %) in oil demand in 1979.

A number of factors made it possible during this period to reduce to a notable extent the Community's dependence on imported energy and, more specifically, on imported oil :

- lower consumption in industry and substitution, sharply reducing the proportion of oil used;
- the replacement of oil by natural gas and electricity particularly in the household/tertiary sector;
- increased Community production of energy, particularly oil;
- the outback (to varying extents) in the use of oil in power stations and its replacement by coal, natural gas and nuclear energy.

The Community's dependence on imported oil fell from 60.7 % in 1973 to 46.9 % in 1979 (as measured by net imports of oil and petroleum products as a percentage of gross inland consumption and banking).

The Community's dependence on imported oil is likely to fall further in 1980, since over the first nine months of the year imports have decreased by 44 million tonnes (about 12.5 %) compared with the corresponding period in 1979.

Energy investments

The Community's growing self-sufficiency in energy and oil has not been accompanied by the massive investment effort that might have been expected after the 1973-74 crisis.

On the contrary, fixed investment in the energy sector, which accounted for an average of 1.4 % of the GDP (6.2 % of GFCF) from 1968 to 1972, still accounted for only 1.4 % of the GDP (about 7 % of the GFCF) in 1979, whereas in 1976 it had been estimated that energy investments amounting to 1.8 % of the GDP would be required over the five years from 1976 to 1980, (cf. Table 7.9).

Among these investments, there was a notable increase in those directed to electricity generation by nuclear power - from 10.8 % of the total in 1974 to 17.8 % in 1979; but those devoted to prospecting for other conventional sources - gas, oil and coal - have increased at the same rate (11.7 % of the 1974 total and 21.3 % in 1979).

The Commission departments' first calculations, based on the Member States' energy programmes up to 1990, show some increase. Including investments in energy conservation and in the new energy sources, there would be an average volume of about 40 000 million ECU at 1979 prices and rates of exchange, over the period 1980-90, i.e. slightly under 2 % of the GDP and about 9 % of total investment. However, it would hardly be more than the relative level of energy investments made in the 1950s.

Furthermore, from a list of the Member States' energy programmes drawn up at the beginning of 1980, it appears that the ambitious guidelines recently set out by the Council in its Resolution of 9 June 1980 (cf. section below on Community energy objectives) could not be put into practice by 1990 without additional investment aimed mainly at oil savings of the order of 60 to 70 million toe. Although it would be speculative to suggest total figure for the investment effort needed to achieve such savings, a tentative estimate, based on an average cost of between 600 and 1 200 ECU per toe saved, would put the level of additional investment needed in the Community during the first half of the period 1980-90 at around 60 000 to 80 000 million ECU, at 1980 prices, i.e. about 15 000 million ECU per year.

Total energy investment (production, distribution and conservation) could therefore reach approximately 55 000 million ECU per year : amounting to 12 % of the gross fixed capital fonction, this contribution to the Community's process of capital accumulation would be very close to total general government investment. The public authorities would play a major part in attaining these objectives.

Energy policy

The bases of a common European energy policy were established by three Council resolutions adopted at the end of 1974 and early in 1975 which provided general guidelines and defined the objectives for each sector for 1985.

The objectives set by the Community for 1985 were further defined in the light of the conclusions of the European Council meetings of July 1978, March and June 1979.

Since the target date of 1985 is approaching, and since a period of about ten years is needed for carrying through changes in policy direction and implementing the investments, it is now necessary to define the objectives for 1990. The Commission's proposals in this respect led to the Council's adopting two new resolutions on 9 June 1980, one of which lays down the following guidelines for the Community as a whole :

- to reduce to 0.7 or less the average ratio for the whole Community of the rate of growth in gross energy consumption to the rate of growth of the gross domestic product;
- to cover 70 to 75 % of primary energy requirements for the production of electricity by means of solid fuels and nuclear energy;
- to reduce oil consumption in the Community to a level of about 40 % of gross primary energy consumption;
- to pursue an energy pricing policy aimed at achieving Community energy objectives. This policy should be based on the principles set out in the Annex to the Council's other resolution of 9 June 1980 concerning new lines of action by the Community in the field of energy saving.

These new Community objectives should form the consistent pattern within which the national energy policies are deployed.

Very broadly speaking, national reactions to the 1973-74 crisis led to the adoption of measures whose main objectives was much the same for all countries : to reduce dependence on imported oil. However, their practical implications varied considerably, as a result not only of each Member State's initial conditions of situation, particularly as regards national energy resources, but also of the possibilities of introducing fairly determined energy conservation or production policies at short notice. Consequently, the efforts made to bring in the necessary energy policies have varied widely in scale. While Denmark, France and Germany have developed detailed strategies, Belgium has no energy consumption in the Community. In the other countries, coherent energy programmes have gradually been set up, mainly for energy saving, for which the Commission has established a basic programme recommended to all the Member States.

Denmark, the Netherlands, Germany, France and the United Kingdom have all adopted measures to encourage efficient use of energy, covering all sectors. The Netherlands and Germany, however, emphasise the household sector more, whereas there is a wider distribution of effort in Denmark, France and the United Kingdom.

Over the last few years, increasing emphasis has been placed on investment incentives in the form of grants, leasing systems or tax credits. In the household sector, such investment aids are now on a considerable scale in Denmark, the Netherlands, Germany and France, but are still minimal or even non-existent in Belgium, Ireland and Luxemburg. In the industrial sector, they are relatively extensive in the former group of countries together with the United Kingdom, but are still scarce or non-existent in Belgium, Ireland, Italy and Luxemburg. In all cases, however, they are less than in the household sector.

There are wide variations in price formation mechanisms, ranging from complete freedom to controlled prices. Nevertheless, substantial progress has been achieved with the adoption of a general principle of applying "true prices", designed to pass on to the final user the full effect of increases in the costs of energy production, especially crude oil price rises. There are still however, marked differences in the way in which the taxation of energy is used to absorb or reinforce pre-tax trends, especially in connection with petroleum products.

In 1979 efforts were made in most countries (to a lesser extent - Italy), except Denmark and Ireland to replace petroleum products as far as possible with gas, which largely accounts for the only moderate increase in demand for petroleum products in these countries.

A certain shift from petroleum products to electricity was also observed in 1979, particularly in Denmark, Ireland, the United Kingdom. However, whereas additional electricity requirements are met by coal burning power stations in Denmark and the United Kingdom, in Ireland they are supplied by oil-fired power stations.

In 1979 power-stations oil-burn in the Community as a whole continued to increase rapidly at much the same rate as in 1978 (about 14 %), despite the efforts that have been made over the past two years to step up the use of existing coal-fired power stations in preference to oil-fired plants. The various Member States are now judged to have virtually no potential for changeovers of this type in 1980, and the emphasis should be placed on new coal-burning power plants and on the conversion of existing power plants to coal-firing.

What finally emerges from this rapid review of national energy policies is that the key to any further progress is investment in the replacement or renewal of installations. Consequently, it is vital that a sound energy pricing policy be accompanied by adequate information and technical assistance for the user. Public schemes, at either national or local level, should also be financed in order to expedite investment in energy conservation. Member States differ widely with regard to the public financing of energy-saving programmes. In this respect, the constraints stemming from the public finances situation in some countries are liable to have an adverse effect on the process of adjustment to the energy constraint.

TABLE 7.1

Gross fixed capital formation (1975 prices)

%

	Gross fixed capital formation as a percentage of GDP (current prices) 1968		Annual growth rate					Gross fixed capital formation as a percentage of GDP (current prices) 1980	
	1968-73	1973-75	1975-78	1979	1980	1973-80	1980	1973-80	1980
DK	23.0	6.9	4.6	-3.0	-11.5	-3.5	-11.5	-3.5	19.8
D	22.4	6.2	5.0	8.7	4.2	1.8	4.2	1.8	23.9
F	23.3	8.7	1.5	2.5	2.6	1.1	2.6	1.1	21.6
IRL	20.9	10.7*	8.6	15.6	-6.4	2.2	-6.4	2.2	30.3
I	20.3	3.2	0.6	4.5	8.0	0.5	8.0	0.5	19.9
NL	26.8	2.4	3.7	0.0	0.0	0.3	0.0	0.3	21.8
B	21.5	4.4	1.8	-0.5	2.0	1.7	2.0	1.7	21.0
L	21.6	10.4	1.0	4.9	3.1	-0.2	3.1	-0.2	28.0
UK	18.9	2.4	0.0	-1.9	-4.5	-1.4	-4.5	-1.4	16.8
EC-9	21.8	5.0	2.5	3.8	2.1	0.8	2.1	0.8	21.2
USA **	18.0	3.3	7.6	2.6	-9.2	-0.6	-9.2	-0.6	15.6
JAPAN **	33.8	12.4	6.0	8.8	1.0	2.2	1.0	2.2	31.7

Sources : ESA National Accounts 1960-78, EUROSTAT 1980; 1979-80 Economic Budgets, sept. 1980.

* 1973/70

** 1968-73 : EUROSTAT;

1979-80 : Commission estimates

TABLE 7.2

Breakdown of gross fixed capital formation in the Community by activity

	1970	1973	1975	1976	1977	1978	1979 ³	1980 ³
Agriculture	3.9	4.0	4.2	4.3	4.4	4.5	4.4	4.2
Energy	6.7	6.3	8.2	8.2	7.7	7.9	8.2	8.5
Manufacturing	19.3	16.3	15.4	15.3	15.7	15.6	15.7	16.0
Building & Construction	4.3	3.9	3.7	3.7	3.6	3.6	3.6	3.5
Market services	23.3	26.4	24.8	24.9	27.1	27.5	28.0	28.3
Housing	28.1	30.0	29.2	29.1	28.6	28.0	27.1	26.7
Non-Market services	14.4	13.1	14.5	14.5	12.9	12.9	13.0	12.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

¹ Gross fixed capital formation at 1970 prices and exchange rates

² Excluding Belgium and the Netherlands

³ Estimates

Source : Ifo-Schnelldienst, 5/80 Munich

TABLE 7.3.

Annual growth rate in and breakdown of gross fixed capital formation in 1978,
by owner branch

	1973/68	1978/73	1975/73	1978/75	1978 breakdown %
Germany (1970 prices)					
Agriculture	1.7	3.7	-2.6	8.1	3.6
Energy	10.4	0.0	4.8	-3.0	6.8
Manufacturing	6.7	-0.4	-9.3	6.1	19.0
Housing	5.1	-3.6	-13.9	4.0	23.7
Market services	8.9	3.2	-6.7	9.4	29.5
Non-market services	3.4	0.7	0.9	0.5	16.0
Total	6.3	0.0	-6.9	4.9	100
France (1975 prices)					
Agriculture	4.4	-1.6	-5.0	0.8	4.5
Energy	0.4	1.7	5.3	-0.7	6.1
Manufacturing	8.3	-2.8	-6.9	-0.0	15.3
Housing	7.9	-0.6	1.1	-1.7	28.8
Market services	10.3	2.5	-3.4	6.5	29.9
Non-market services	2.8	1.3	4.8	-1.0	13.0
Total	6.8	0.2	-1.2	1.1	100
Italy (1970 prices)					
Agriculture	-2.1	2.9	2.9	2.8	8.0
Energy	1.9	-2.7	-2.9	-2.6	6.8
Manufacturing	9.1	-5.8	-10.8	-2.3	17.7
Housing	-0.5	-2.1	-4.4	-0.5	25.5
Market services	5.9	1.9	-4.7	4.9	31.5
Non-market services	0.9	-2.5	-2.1	-2.8	9.4
Total	3.2	-1.7	-5.0	0.6	100
Netherlands (1975 prices)					
Agriculture	10.1	3.8	-12.8	16.7	6.3
Energy	1.6	-1.1	5.1	-4.9	7.7
Manufacturing	3.3	0.4	-4.8	4.1	15.9
Housing	4.5	-0.3	-10.0	6.7	26.6
Market services	3.4	1.8	-4.6	6.4	26.3
Non-market services	-3.8	-2.0	3.4	-5.5	14.8
Total	2.4	0.4	-4.3	3.7	100
Belgium (1975 prices)					
Agriculture	9.0	2.8	-15.0	16.7	3.0
Energy	-4.8	6.0	22.1	-3.5	7.1
Manufacturing	6.7	-5.4	1.5	-9.8	13.7
Housing	2.9	6.5	6.8	6.3	29.4
Market services	8.4	2.4	-1.0	4.7	28.4
Non-market services	2.3	1.0	0.8	1.1	16.2
Total	4.4	2.1	2.6	1.8	100
United Kingdom (1975 prices)					
Agriculture	7.6	-5.8	-19.7	4.8	3.0
Energy	-8.8	12.4	29.5	2.3	15.2
Manufacturing	-0.2	2.1	0.8	3.0	18.2
Housing	-	-0.9	-0.1	-1.5	19.3
Market services	4.7*	-1.7	-7.0	2.0	31.5
Non-market services	5.0	-9.2	-10.4	-8.3	11.3
Total	2.4	-0.7	-1.8	0.0	100
EUR-6 (1975 prices & exchange rates)					
Agriculture	3.0	0.9	-5.4	5.4	4.5
Energy	0.3	2.8	9.4	-1.3	7.9
Manufacturing	7.5	-1.7	-6.9	1.9	17.4
Housing	-	-1.6	-5.5	1.2	25.2
Market services	5.5*	1.8	-4.7	6.5	29.8
Non-market services	2.9	-1.2	-0.3	-1.8	13.4
Total	4.9	-0.1	-3.8	2.3	

* including housing.

Source : 1968-78 : ESA National Accounts.

TABLE 7.4
Changes in gross fixed capital formation by product.

%

	Relative shares					Annual growth rate				
	76	77	78	79	80	77/75	78/77	79/78	80/79	
D (1970 prices)	Plant & Machinery	40,4	41,8	42,4	43,0	43,5	6,9	7,8	8.5	4.2
	Bldg. & Construction	59,0	57,6	56,8	56,3	55,8	2,5	4,9	8.1	4.2
	of which :									
	Housing	23,8	23,4	22,8	22,7	22,8	4,3	3,3	8.1	7.0
	Total G.F.C.F.	100	100	100	100	100	4,4	6,3	8.7	4.2
F (1975 prices)	Plant & machinery	37,6	37,9	39,0	-	-	4,7	3,8	-	-
	Bldg. & construction	58,3	57,6	56,3	-	-	-1,2	-1,3	-	-
	of which :									
	Housing	29,8	29,5	28,8	-	-	-1,8	-1,6	-	-
	Total G.F.C.F.	100	100	100	-	-	1,2	1,0	2,5	2.6
I (1970 prices)	Plant & Machinery	39,4	39,5	39,1	40,3	41,3	4,7	-1,4	7,6	13.0
	Bldg. & construction	55,6	55,7	56,4	55,1	53,8	-1,0	0,7	2,1	3.8
	of which :									
	Housing	24,9	25,2	25,5	24,8	-	-1,1	0,7	1,7	-
	Total G.F.C.F.	100	100	100	100	-	1,2	-0,4	4,5	8.0
NL (1975 prices)	Plant & machinery	40,3	42,2	41,4	43,4	41,7	4,4	1,1	5.2	-3.4
	Bldg & construction	59,9	57,5	58,3	56,2	58,1	4,0	4,4	-3.8	2.8
	of which :									
	Housing	25,8	26,7	26,6	25,0	26,2	9,1	2,5	-3,7	1,5
	Total G.F.C.F.	100	100	100	100	100	4,3	3,1	0.0	-0.0
B (1975 prices)	Plant & machinery	33,1	31,0	32,4	34,1	35,7	-4,1	6,8	4.5	4.0
	Bldg. & construction	63,1	63,8	62,4	61,2	60,2	3,2	-0,2	-2.7	-1.1
	of which :									
	Housing	28,8	28,9	29,4	-	-	8,0	3,5	-	-
	Total G.F.C.F.	100	100	100	100	100	1,7	2,1	-0.5	2.0
UK (1975 prices)	Plant & machinery	43,3	46,3	46,8	49,7	50,4	2,3	2,7	4.5	-2.8
	Bldg & construction	50,2	47,6	46,7	44,2	43,7	-3,2	-0,3	-7.6	-6.3
	of which :									
	Housing	20,7	19,6	19,3	17,7	15,6	-2,2	0,1	-11,2	-15,0
	Total G.F.C.F.	100	100	100	100	100	-0,7	1,5	-1.9	-4.5
EUR-6 (1975 prices & exchange rates)	Plant & machinery	38,0	39,0	39,4	-	-	3,3	4,0	-	-
	Bldg & construction	56,5	56,3	55,7	-	-	0,3	1,6	-	-
	of which									
	Housing	26,0	25,7	25,3	-	-	1,2	1,1	-	-
	Total G.F.C.F.	100	100	100	-	-	2,1	2,9	3,8	2.3

Sources : 1975-78 : ESA National Accounts - 1978
1978-80 : Economic Budgets, sept. 1980

TABLE 7.5
Capital/labour substitution (capital stock/employment) 1968 = 100

	D	F	I	UK
1968	100	100	100	100
1973	126	138	128	120
1975	145	158	137	128
1978	168		148	139

Sources : D - Volkswirtschaftliche Gesamtrechnung, Wiesbaden, 1980;
 F - INSEE, Comptes des entreprises par secteur (base year : 1962) (ENF);
 I - ISTAT and Confindustria (all industry);
 UK - National Income and Expenditure, London 1979.

TABLE 7.6
Relative cost of labour/energy ¹
1973 = 100

	DK	D	F	I	B
1974	58.3	100.7	83.8	67.4	72.5
1975	65.6	94.3	90.1	77.2	79.2
1976	67.9	98.2	92.9	68.2	89.2
1977	71.0	105.9	98.3	76.3	98.3
1978	79.3	106.0	101.7	89.8	102.5
1979	67.7	85.0	94.8	75.8	87.8

¹ Compensation of employees taken from the national accounts and divided by the energy component of the wholesale price index (available for five countries only)

TABLE 7.7
Public-sector financing of research and development

Appropriations in million ECU, at current prices and exchange rates

	1970	1979	1979/70 % growth/year	1979 (non-military)
DK	84	257	13.2	255
D	1 738	6 318	15.4	5 588
F	1 818	4 500	10.6	2 907
I	421	855	8.2	823
NL	289	1 059	15.5	1 027
B	190	965	19.8	965
IRL	13	44 ¹	16.5	44 ¹
UK	1 474	3 220	9.1	1 440
EUR-9	6 026	16 967 ²	12.2	12 800

¹ 1978

² Estimates

Source : Eurostat 1980

TABLE 7.8
Trends in the structure of energy requirements

	Industry		Transport		Household/tertiary					
	1973		1978		1973		1978			
	M toe	%	M toe	%	M toe	%	M toe	%		
Coal and coal derivatives	45.8	14.6	37.1	12.6	1.0	0.2	34.3	10.7	22.1	6.5
Oil and oil derivatives	105.6	33.7	86.9	29.5	117.7	94.8	146.2	45.4	131.5	38.5
Gas	58.0	18.5	60.6	20.6	0.1	0.3	43.2	13.4	68.1	19.9
Electricity	103.1	32.9	108.8	37.0	5.4	5.6	96.0	29.8	117.2	34.3
Heat	0.8	0.3	1.0	0.3	-	-	2.3	0.7	2.7	0.8
Total	313.3	100.0	294.4	100.0	124.2	142.2	322.0	100.0	341.6	100.0

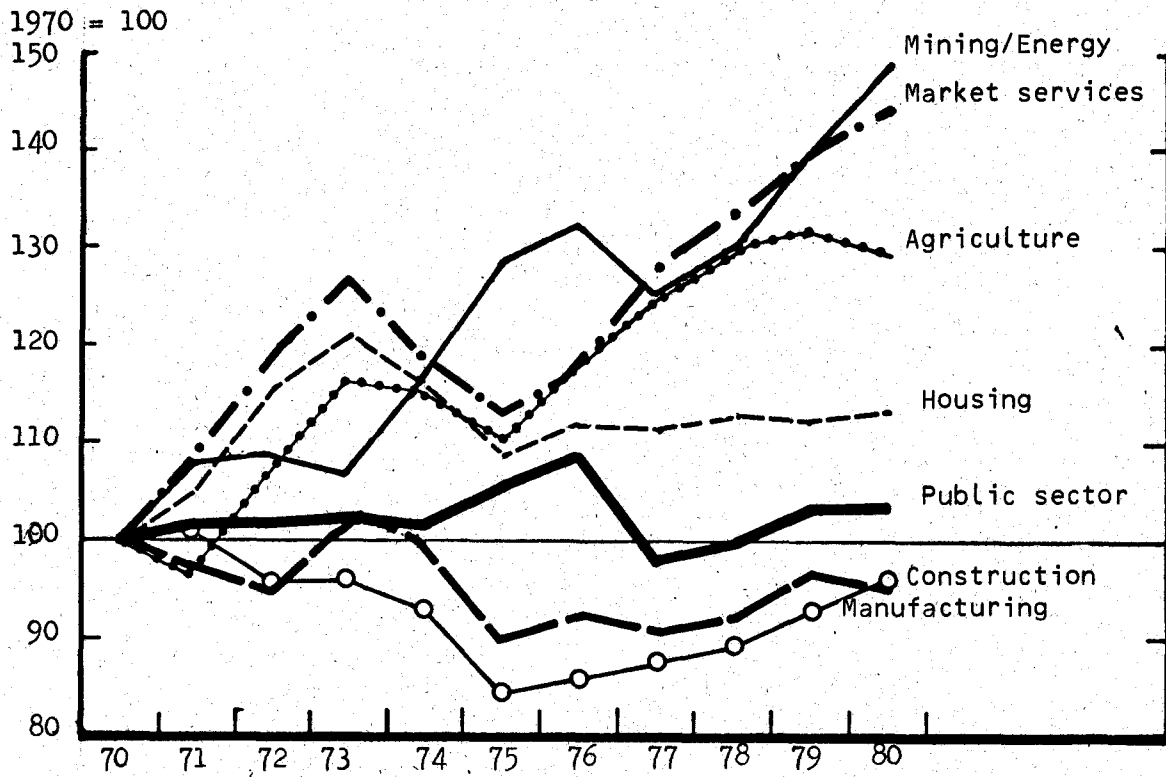
Source : Bilans globaux de l'énergie, EUROSTAT
(comprehensive energy balance-sheets)

TABLE 7.9
 Fixed investment in the energy sector
 Community - '000 million EUA at 1979 prices

	1974	1975	1976	1977	1978	1979
Solid fuels	0.4	0.6	0.9	0.9	1.1	1.1
Oil and Gas	9.2	11.1	9.6	10.4	11.1	11.6
- production	2.3	3.0	3.2	3.9	4.0	4.4
- refining, transport and distribution	6.9	8.1	6.4	6.5	7.1	7.2
Production of electricity	6.6	6.8	6.9	6.5	7.2	7.8
- nuclear energy	2.5	3.1	3.3	3.2	3.8	4.6
- other primary energy sources	0.8	0.7	0.8	0.8	0.8	0.8
- secondary energy sources	3.3	3.0	2.8	2.5	2.6	2.4
Transport and distribution of electricity	6.9	6.8	6.1	4.9	5.1	5.3
Total (1)	23.1	25.3	23.5	22.7	24.5	25.8
(1) as % of gross fixed capital formation	6.7	7.6	7.0	6.7	7.0	7.0
(1) as % of gross domestic product	1.3	1.5	1.4	1.3	1.4	1.4

Source : Commission staff calculations

Gross fixed capital formation in the Community by industry



Source and notes : cf. Table 7.2

8. Employment trends and policies

The employment trend in the Community has been marked - since the first oil crisis - by a fall in agricultural employment, a reduction of employment in industry and a continued steady rise in employment in the tertiary sector; this has been rapid enough for total employment in 1977, 1978 and 1979 to have increased at almost the same rate as the labour force. Employment will not grow in 1980 and should fall in 1981. The increase in the labour force is accelerating for demographic reasons, and there should be a rise in unemployment in 1980 and 1981. This will be particularly rapid among young people who may well account for almost 50% of the total.

Number of jobs created smaller than the increase in the labour force

After the negative employment trend recorded in the Community during the 1974/75 crisis, most of the Member States had, until recently, returned to a rate of job creation close to if not greater than that of the early seventies.

Thus, despite an environment in which economic growth had slowed in comparison with the pre-recession expansionary years, and despite the contraction in the growth of investment, the record of the labour supply trend is not unfavourable at macroeconomic level. Partly as a result of the measures taken by the public authorities to support employment, firms continued recruiting at a high rate until 1979 at least.

This relatively positive picture in fact conceals two important structural factors upsetting the equilibrium of the labour market in the medium term:

- a rapid increase in the labour force both because of the age structure of the working-age population and because of the trend of participation rates (notably female participation rates) over the period 1975 - 80; the average growth rate of the labour force in the Community will have been 0.85% a year as against 0.36% for total employment;

- the continuing trends in the distribution of employment by sectors of activity, namely a decrease in agricultural employment at a rate similar to that of the sixties (despite the difficulties of absorption into other sectors), an equally negative growth rate for job creation in industry and the key role played by the tertiary sector. The main area for the creation of new jobs is the services sector - particularly market services, since the national public sectors are feeling the effect of more restrictive budgetary policies.

These structural factors recur to a greater or lesser extent in each Member State, the latest available figures (see Table 8.1) beginning to show up some trend reversals, particularly in industry, only for Germany, Denmark and Ireland: it is true that industrial employment in the former two countries was hard hit by very large numbers of job losses during the 1974 - 75 recession.

The situation in the industrial sector is the result of the need to be competitive combined with the weakness of investment which receives little stimulation from an uncertain - if not depressed - market. In France, the United Kingdom, Belgium and the Netherlands, the greatest employment adjustments have been made by industry.

Tertiary employment has so far benefited from a steady increase in demand, and - through the growth of temporary work - from a transfer of activities which were formerly considered industrial: it has thus been able to defer rationalization in a sector which enjoys greater protection from external competition. But the introduction of new technologies, with the productivity gains they should bring, makes continuation of this expansion more uncertain.

The steady rise in unemployment rates

The imbalance between employment supply and demand and the scale of labour-shedding in industry are the main causes of the rise in the unemployment level in all the Community economies since 1975. The exceptions are the Netherlands, which was enjoying a stable rate of close on 4%, and Germany where it has declined slightly. The thrust of unemployment will have been particularly strong in France, Belgium and the United Kingdom (see Table 8.2).

Women are affected by unemployment far more than men since their relative share in the total number of unemployed is appreciably greater than their relative share in the total labour force. Moreover, with the exception of Ireland, the unfavourable situation for women has distinctly worsened from 1975 to 1979, with the Community average relative share of women in the number of unemployed increasing from 36% to almost 45%.

There is no clear link between the increase in female unemployment and the movement of global unemployment rates since this increase is apparent in Germany and the Netherlands as well as in Italy and Belgium. Nor is there any obvious link between the relative share of female employment and the scale of or increase in female unemployment. By contrast, it is quite possible that the specific rules governing the payment of unemployment benefit in force in the different member countries exert substantial influence on the relative scale of female unemployment, without, however, affecting the general upward tendency; at least this is suggested by the very different rates, for Belgium on the one hand (62.5% of total unemployment in 1978), and for the United Kingdom (30.7%) and Ireland (22.9%) on the other.

Young people are the other group hardest hit by unemployment. The share of unemployed people under 25 years of age ranges from 26% to 47%¹ whereas the share of young people in the labour force ranges from 17 to 22% only.

¹ September - October 1979 figures: figures are traditionally highest at this time of the year.

The percentages of young unemployed are particularly high (between 40 and 50%) in France, Italy, Benelux and the United Kingdom - where the share has greatly increased from 1974 to 1978. They are between 25 and 30% in Germany, Ireland and Denmark - where the proportions have remained stable between 1974 and 1979. Among young people, women nearly everywhere and nearly always account for a higher percentage (49% in 1979 in the Community as against 34% for young men).

But if women and young people are two groups whose unfavourable situation is relatively easier to pinpoint, they do not by themselves make up the "hard core" of unemployment: this includes people with no vocational training, older people, migrants, the handicapped, and - more generally - the long-term unemployed; long-term unemployment - probably one of the most difficult aspects of unemployment - has been on the increase since 1975.

Labour market policies

With the overall imbalance between employment supply and demand, the steady rise in the number of unsatisfied job-seekers is the result of differences in the rates at which productive systems undergoing transformation and labour markets locked into economic, sociological and cultural rigidities adapt to each other. The public authorities have stepped up their intervention measures to reduce these rigidities. National measures have been associated with Community labour market policy, based on increased intervention by the Social Fund. But if all these actions have succeeded in limiting the most serious consequences of the existence of six million unemployed in the Community, the objective of full employment is still, in almost all the Member States, pushed back to an unspecified future.

With varying emphasis, national or Community labour market adjustment policies have followed the same guidelines:

- action mainly on employment supply, by granting firms favourable terms for the recruitment of young workers;
- action on employment demand by encouraging vocational training and retraining, labour mobility, and also early retirement schemes;
- changes in the social protection of job-seekers from the viewpoint of increasing and guaranteeing certain benefits over a period, and re-employment opportunities, and of adjusting the rules to eliminate a number of abuses.

Instances of public intervention relating to the labour market are many and varied. They are recorded in the "Report on the Development of the Social Situation in the Community" published by the Commission each year. Of the main ones, the following can be quoted by way of illustration:

- the national employment compacts in France under which employers' social security contributions can be cut for recruiting young people and women, and which cover apprenticeship subsidies, training courses, and contracts combining employment and training. In 1979 300 000 positions were filled under this compact;
- in Germany, the special employment assistance programme for high unemployment areas, for which DM 1 000 million has been earmarked;
- the late-1979 decision to grant recruitment premiums in Belgium; as a result 20 000 jobs have been created; or the premiums granted in Ireland for any additional job created under two major programmes (Employment Incentive Scheme and Work Experience Programme);
- the training and vocational integration measures which have increased in Germany with the employment promotion law (AFG), and in the Netherlands, Ireland and Denmark.

Improvements made to the situation of those seeking work have related to the reform of the Agence Nationale pour l'Emploi (ANPE) in France, tightening up the conditions for obtaining unemployment benefit in Italy and Belgium, and increasing the staff of the employment agency (ANCO) in Ireland.

The situation in the United Kingdom offers more of a contrast in that since 1979 a whole series of special employment measures - such as the temporary employment subsidy - have been ended, and the staff of the Manpower Services Commission has been cut by some 10%.

Lastly, in addition to the contributions by the Community's Social Fund, which amounted to 775 million EUA in 1979, the Community has worked for the implementation of the rules on the free movement of workers by eliminating barriers to mobility, and has continued with its labour market and labour force surveys. This is with a view to improving coordination of those measures to prevent and remedy unemployment which fall within the Community framework.

Recent trends and prospects

The labour market situation in the Community has deteriorated even further throughout 1980, and forecasts for 1981 indicate that there will be no immediate improvement. This shows up first and foremost in the unemployment rate, which has increased rapidly over the first half of the year, passing the 5,6% mark, the previous record rate, and reaching 6,2% by August, despite the fact that economic activity growth did not itself turn down till the end of the first quarter.

Trends in the labour market are, apart from the fluctuations in employment, determined by an exceptionally fast rate of growth in the working-age population (varying from 0,7% to 1% over the years 1980-85), due to the arrival of very large cohorts of 15 year olds into the working-age population in each of the next 5 years. These young people, numbering some 4 1/2 million in each of the next two years alone, even before the growth rate builds up to its peak rate in 1982-84, are the first generation echo of the very high birth rates prevailing in the years immediately after the Second World War.

Taking into account the "normal" participation rates of both the 15 - 19 and the 20 - 24 age groups, i.e. including all those just finishing further education or training, it is estimated that the total number of young people prepared to enter into the labour market will be of the order of 3 million in each of the years 1980 and 1981. Of course, it is possible that a discouraged worker effect will come into play and some young people may be diverted out of the labour market into alternative activities such as further education or the armed services, but on the basis of past evidence this is unlikely to be significant. Consequently, labour force growth at around 0,6% per year in 1980 and 1981 will far exceed the envisaged expansion in employment.

In view of the slow growth of activity in 1980 and 1981, productivity (output per occupied person) is expected to rise by only about 1% in each of the two years, or substantially less than during the preceding four years. Most Member States share the overall slowdown of productivity growth with, however, a particularly sharp decline taking place in the

United Kingdom in 1980. The weak trend in productivity is a reflection of the fact that only a moderate degree of labour shedding is expected in the present cyclical downturn - as indicated by the forecast fairly small decline in employment.

In fact, after having expanded roughly in the line with the growth of the labour force in 1978 and 1979 the total number of employed in the Community is estimated to have increased by 0,2% in 1980 and may, according to the forecasts by the Commission's staff, decline by 0,3% in 1981. Given the continued rise in the labour force, the rate of unemployment may rise to 7,5 million or 6,8% of the civilian labour force on average for 1981 and could by the end of the year be even higher.

While the unprecedented scale of the rise in unemployment will leave no sections of the labour market untouched, the tendency - described above - for some groups of workers to be more seriously affected by increasing unemployment than others is nevertheless likely to be accentuated over the next two years, and will have serious implications for the future.

Among these disadvantaged groups, the most important is that of young people under 25 years of age. As expected, already by autumn 1980, young people comprise some 42% of the unemployed in the Community, a figure which is considerably up on the figure for the similar period last year.

This tendency for the number of unemployed young people to increase relative to the total number of unemployed during recession will result from both increasing redundancy and increasing failure to get a first job. Indeed, it is to be expected that young people will be among the first to be made redundant, both for economic reasons - lower productivity and less work experience - and for considerations of social equity. In addition, young people will find it increasingly difficult to obtain a first job. Under conditions of rising unit labour costs and increasing adult unemployment, employers will be reluctant to offer employment with training, particularly in those Member States where minimum wage requirements make it relatively uneconomic, and young people will have to compete for unskilled jobs with other disadvantaged groups who may be prepared to accept lower wages.

As a result, it is likely that by the end of 1981, out of 8 million unemployed in the Community, some 3 1/2 - 4 million of these could well be young people under 25 years of age. Given the very fast growth of the working population until at least 1985, unemployment is likely to remain at fairly high levels even after activity has picked up again. In particular, the failure of large numbers of young people to obtain occupational training will leave a gap in the age/skill structure of the future. For unskilled young people, the failure to obtain or keep a job now will entail somewhat different consequences for the future: the lack of work experience, if it continues for any length of time, will create its own barrier to obtaining work.

Female unemployment, at 46% of total unemployment in the Community by mid-1980, is the other principal category of problem unemployment, but is made up of two distinct parts. To a large extent, the female unemployment problem is part of that of young people generally, since nearly half the unemployed people under 25 years are female, and in any case these have a higher participation rate than older women. If allowance is made for this, then the proportion of female adult unemployment is of course, much less, and at the Community level would appear to be rather a structural than a cyclical phenomenon linked particularly to the problems of certain female-intensive industries such as textiles, and will therefore not increase disproportionately over the next two years.

Table 8.1

Employment trends by sector
Average annual rate of change

%

	IX	D	F	IRL	I	NL	B	L	UK	CE
Total employment										
1968-73	1.0	0.6	1.1	-0.2	-0.2	0.6	0.7	2.4	0.1	0.4
1973-75	-1.1	-2.7	-0.2	-0.3	1.6	0.7	0.0	2.7	-0.0	-0.4
1975-78	2.0	-0.1	0.6	-0.2	0.8	1.0	-0.3	0.0	-0.1	0.3
1978-79	1.1	1.3	0.0	1.3	1.2	1.4	-	0.6	0.6	0.8
1979-80	0.0	0.3	0.4	0.8	0.8	-0.0	0.0	-0.2	-1.1	0.1
of which:										
Agriculture										
1968-73	-4.8	-5.0	-5.3	-3.5	-4.6	-2.6	-6.5	-5.1	-4.5	-4.7
1973-75	0.2	-3.4	-5.4	-1.6	-3.1	-	-2.8	-	-3.5	-3.8
1975-78	-1.9	-4.1	-3.0	-3.1	-2.0	-	-4.6	-	-0.7	-2.6
1978-79	-3.3	-4.0	-2.9	-4.0	-2.5	-4.1	-	0.0	-2.8	-3.0
Industry										
1968-73	-5.6	0.4	1.6	1.2	0.5	-0.8	-0.9	2.5	-1.0	0.7
1973-75	-4.6	-4.3	-1.5	-1.0	1.3	-	-2.0	2.2	-2.3	-2.0
1975-78	0.7	-0.8	-1.0	0.6	-0.2	-	-3.1	-0.9	-1.1	-0.9
1978-79	0.7	1.1	-1.7	3.4	0.2	+0.0	-	0.0	-0.5	-0.2
Services										
1968-73	3.7	1.9	2.5	1.0	1.4	2.0	2.7	3.8	1.4	1.9
1973-75	0.7	-1.0	1.9	0.8	3.8	-	1.7	2.9	1.9	1.5
1975-78	3.3	1.2	2.5	0.9	2.5	-	1.8	1.4	0.7	1.8
1978-79	2.0	2.2	1.6	2.3	3.3	2.5	-	1.3	1.6	2.1

Sources : 1968-1979; Table 1 - 1980 : Economic budgets.

Table 8.2

Unemployment, structural indicators

%

	DK	D	F	IRL	I	NL	B	L	UK	CE-9
Annual averages										
1975	4.6	4.2	3.9	8.5	5.3	4.0	5.3	0.2	3.8	4.3
1976	4.7	4.1	4.3	9.6	5.6	4.3	6.8	0.3	5.3	4.9
1977	5.8	4.0	4.9	9.4	6.4	4.1	7.8	0.5	5.7	5.3
1978	6.6	3.9	5.3	8.8	7.1	4.1	8.4	0.8	5.7	5.5
1979	5.3	3.4	6.1	7.9	7.5	4.2	8.8	0.7	5.3	5.6
Female unemployment as % of total unemployment										
1975	29.3	42.0	49.1	19.6	36.7	21.7	52.3	34.9	20.5	36.3
1976	37.2	46.6	52.5	19.1	37.3	24.2	57.0	38.7	24.7	38.7
1977	42.2	49.8	53.4	20.0	39.2	29.5	59.5	39.8	27.9	41.3
1978	45.2	50.8	52.8	20.6	41.5	33.7	60.3	43.5	29.5	42.8
1979	49.3	52.4	53.1	22.9	43.9	37.0	62.5	49.3	30.7	44.8
Female employment as % of total employment										
1975	41.6	37.8	37.1	-	28.8	-	34.4	-	38.8	35.5 (2)
1976	41.8	37.8	37.4	-	29.4	-	34.4	-	39.0	35.7 (2)
1977	42.3	37.9	37.8	-	30.6	-	34.7	-	39.3	36.2 (2)
1978	41.9	37.9	38.0	-	30.7	-	35.1	-	39.6	36.3 (2)
1979	-	-	-	-	-	-	-	-	-	-
Young persons, under 25 years as % of total unemployment										
1975	-	28.6	47.7	-	-	43.3	44.0	-	36.6	-
1976	-	28.6	48.0	-	-	42.9	42.3	-	44.0	-
1977	-	29.4	46.3	-	-	44.8	41.9	58.4	45.7	-
1978	35.0	28.5	46.1	-	58.2	47.3	42.3	57.3	44.8	46.3 (4)
1979	30.9	26.1	46.3	22.5	47.3	47.1	41.1	58.6	38.2	41.5 (4)
Young persons, 15 to 24 years as % of civil employment										
1975	16.5	19.0	19.7	27.8	16.4	22.0	18.2	21.3	17.7	18.5

- (1) annual average
(2) 6 countries only
(3) end-October
(4) Eurostat estimates

Source : EUROSTAT

Table 8.3

Population, Employment and Unemployment in the Community

	(percentage change)										
	1960-73	1974	1975	1976	1977	1978	1979	1980	1981		
1. Unemployed (number)	0,1	18,3	50,4	13,6	9,5	4,1	1,3	8,0	13,7		
2. Employers and Self-employed	-2,4	-1,5	-2,0	-1,4	-1,3	-0,2	:	:	:		
3. Employees	1,0	0,5	-1,0	0,2	0,8	0,6	:	:	:		
4. Civilian Employment	0,3	0,2	-1,2	-0,1	0,4	0,5	0,8	0,2	-0,3		
5. Civilian Labour Force	0,3	0,4	0,3	0,6	0,8	0,6	0,9	0,6	0,5		
6. Working Age Population	0,5	0,5	0,4	0,5	0,6	0,5	0,6	0,7	0,8		
7. Total Population	0,8	0,4	0,2	0,2	0,2	0,2	0,2	0,2	0,2		

Source : Eurostat, Estimates of Commission Staff.

Table 8.4

Productivity per occupied person, whole economy

(percentage change)

	1960-73	1973-79	1974	1975	1976	1977	1978	1979	1980	1981
DK	3,6	1,4 ⁽¹⁾	-1,1	0,4	5,4	1,9	0,6	2,4 ⁽²⁾	-1,1	0,4
D	4,3	3,1 ⁽¹⁾	2,4	1,6	6,1	2,9	2,5	3,3 ⁽²⁾	1,6	1,6
F	4,9	2,7	2,5	1,4	4,4	2,3	3,1	2,7	1,4	1,1
IRL	4,3	4,0 ⁽¹⁾	2,7	3,9	3,0	5,3	4,9	0,3 ⁽²⁾	0,3	4,8
I	5,7	1,4 ⁽¹⁾	2,6	-3,8	5,0	1,3	2,0	4,0 ⁽²⁾	2,6	-0,3
NL	4,1	2,3	3,5	-0,4	5,5	2,2	2,0	1,3	1,1	0,7
B	4,2	2,3 ⁽¹⁾	3,0	-0,5	5,9	1,2	2,3	1,5 ⁽²⁾	1,4	1,1
L	3,4	0,7 ⁽¹⁾	1,6	-8,7	4,1	2,1	5,1	2,4 ⁽²⁾	0,7	0,6
UK	2,9	0,9	-1,9	-0,5	4,4	0,9	2,9	-0,4	-1,5	0,6
EC	4,4	2,2 ⁽¹⁾	1,6	-0,1	5,2	2,0	2,6	2,6 ⁽²⁾	1,1	0,9

(1) 1973-78

(2) Estimate

Source : Eurostat and estimates of Commission Staff.

Table 8.5

Aggregate employment

	(percentage change)										
	1960- 73	1974	1975	1976	1977	1978	1979	1980	1981		
DK	1,4	-1,3	-1,0	2,6	0,9	2,4	1,1	0,2	0,2		
D	0,1	-2,0	-3,5	-1,0	-0,2	0,8	1,3	0,5	-0,6		
F	0,8	0,6	-1,1	0,7	0,9	0,3	0,7	0,4	0,1		
IRL	0	1,1	-1,6	-1,7	0,4	0,9	1,6	0,7	-2,2		
I	-0,5	2,2	0,6	0,8	1,0	0,5	1,0	1,2	0,5		
NL	1,0	0	-0,6	-0,1	0,3	0,2	1,1	-0,1	-0,4		
B	0,6	1,5	-1,4	-0,8	-0,2	0	0,9	-0,2	-0,2		
L	0,9	1,7	2,6	-0,6	0,3	0	0,3	0,1	-0,1		
UK	0,3	0,4	-0,5	-0,7	0,3	0,2	0,1	-1,1	-1,2		
EC	0,3	0,2	-1,2	-0,1	0,4	0,5	0,8	0,2	-0,3		

(1) Mid-April

Source : Eurostat and Estimates of Commission Staff.

Table 8.6
Unemployment Rate
(as percent of civilian labour force)

	1960-	1974	1975	1976	1977	1978	1979	1980	1981
	73								
DK	1,1	2,0	4,6	4,7	5,8	6,5	5,3	5,8	6,5
D	0,8	2,2	4,2	4,1	4,0	3,9	3,4	3,5	4,1
F	1,0	2,3	3,9	4,3	4,8	5,2	6,0	6,5	7,0
IRL	4,7	6,0	8,5	9,5	9,4	8,7	7,9	8,7	10,1
I	5,3	4,8	5,3	5,6	6,4	7,1	7,5	7,5	7,7
NL	1,1	2,8	4,0	4,3	4,1	4,1	4,1	4,8	5,6
B	2,3	3,2	5,3	6,8	7,8	8,4	8,8	9,2	9,8
L	0,1	0,0	0,2	0,3	0,5	0,7	0,7	0,6	0,8
UK	2,1	2,4	3,8	5,3	5,7	5,7	5,3	6,5	8,2
EC	2,2	2,9	4,3	4,9	5,3	5,5	5,6	6,0	6,8

Source : Eurostat and Estimates of Commission Staff.

9. The Greek economy and entry into the Community

Greece has been associated with the European Economic Community since 1962 and will become a member on 1 January 1981. Between these two dates, considerable economic progress has been achieved which has enabled great strides to be made in catching up with the average productivity and income levels of the Nine. Nevertheless accession to the Community will mean that, despite the transitional periods laid down, Greece will have to make great efforts to adjust her structures to the far stronger international competition she will face. The success of these efforts is itself largely dependent on the speed with which current corrective policies manage to set the economy free from the constraints of its present imbalances.

The development of the Greek economy from 1960 to 1979

Over the last two decades, Greece's economic development has been very rapid; her gross domestic product grew by well over three times in volume between 1960 and 1979 (Table 9.1a). The rate of growth did, however, slow down distinctly between the first decade, when it averaged 7.5 % a year, and the second, when it fell back to 4.5 %. The turning-point between the two periods occurred in 1973 and 1974, after which dearer energy and raw materials on the one hand, and keener international competition on the other, cramped the economy's growth opportunities more severely.

This development was accompanied, up to 1973 and 1974, by a very moderate rise in prices. Since then, double-digit inflation has become the norm, partly as a result of external causes, but above all of domestic factors - the sharp acceleration in wage rises and the swelling of the public deficit - which, in combination, have magnified the overall effect.

Growth was accompanied by important changes in the contribution made by the various branches of activity to the formation of gross domestic product (table 9.3). Thus, between 1960 and 1979, the share of agriculture fell from 23 % to 13 % while the share of manufacturing industry grew from 14 % to almost 22 %, and the share of industrial services (water, gas, electricity) from slightly over 1 % to over 3 %. The services share, already over 50 % in 1960, increased only slightly overall, but certain branches - transport and communications, the distributive trades and banking - gained in relative importance, while public administration, health and education, and housing declined in varying degrees.

The substantial industrial development during the period was itself accompanied by important changes within the spread of sectors. Textiles, construction materials, the basic metal industries, and the chemical industry, in particular, appreciably increased in importance, while certain traditional industries, such as the food and clothing industries, declined in relative terms.

It is remarkable that the rapid growth of the last twenty years was accompanied by a contraction in the labour force and in employment (table 9.4). The labour force has shrunk by over 10 % since 1960, as a result of emigration - heavy especially in the first part of the period - and of the flight from farming, the corollary of which was a fall in female auxiliary labour. Employment contracted in parallel, but to a smaller degree. Consequently unemployment has fallen steadily since the beginning of the period and now stands at a very low level (1). The structure of employment has also been profoundly modified; the most spectacular change has been the decline from 58 % to 32 % of the share of agricultural employment in total employment. By contrast, in non-agricultural employment, the proportion of wage and salary earners grew

(1) The statistics do not, however, include first job seekers - mostly young people, nor the rural unemployed. Also, short-time working is not recorded.

only slightly, and the proportion of non-wage and salary earners is still almost 30 % : this shows that the degree of economic concentration in industry and in the services is still low. Labour productivity has nevertheless made very large advances, having grown by 350 % in twenty years.

Growth and the concomitant radical structural changes have required a very high level of investment. Investment was in fact remarkably buoyant up to 1974, and resumed its growth, though at a more moderate rate, after the fall recorded in 1975 (table 9.1a). Between 1960 and 1979, the capital stock increased by a factor of almost 4, the coefficients being of the order of 3.3 for buildings and 4.7 for equipment respectively (table 9.5). Capital accumulation has therefore been considerable over the last twenty years, and this itself indicates the profound change in the economy during the period. Nevertheless, the accompanying trend was clearly for the profitability of invested capital to weaken.

Sharp growth and the capital accumulation which made it possible, were in their turn largely the result of increased foreign trade, another outstanding feature of development over the last two decades. Between 1960 and 1979, the share of exports in domestic product grew from 7 % to almost 15 %, and the share of imports in the counterpart of domestic demand grew from under 15 % to almost 30 % (table 9.1a).

In the same period, the composition of foreign trade changed profoundly (table 9.6). Food products and raw materials, which originally accounted for almost all exports of goods, represented no more than 40 % at the end of the period, with manufactured products making up the other 60 %. On the imports side, the share of mineral fuels increased sharply, in conjunction with the rapid expansion of energy consumption, while the share of manufactured products was falling

as competing national production expanded. Moreover, exports of services - transport and tourism - made considerable strides in line with the rapid expansion in trade. All in all, the volume of goods and services exported increased by a factor of 6.5 between 1960 and 1979, and the volume of imports by 5.8 (table 9.1a).

Great changes also occurred in the pattern of trade flows, particularly in the latter part of the period when the growing weight of imports from the oil and raw materials producing countries brought, in return, a significant expansion of exports to those countries. The Community countries nevertheless remain by far the main outlet for exports, continuing to absorb almost 50 %. Their share in imports has, by contrast, appreciably declined from over 50 % in the first half of the period to under 40 % in the last few years (table 9.6a).

Despite the very rapid expansion of exports of services and emigrants' remittances, the current balance has, throughout the period, continually recorded a heavy deficit (table 9.7). A significant proportion of this deficit was covered by long-term movements of capital, connected either with the establishment of foreign firms, or with property investments made by nationals using funds held abroad. Another item was the short-term borrowing of banks abroad, which has become more significant, particularly, in the latter years of the period.

The considerable improvement in productivity following on the economy's development and modernization was reflected in a sharp rise in living standards (table 9.2). Related to the number of inhabitants, consumption grew by 270 % between 1960 and 1979. It is still well below the average consumption level of the Nine, but has moved appreciably closer to it, having climbed from one-third to one-half of the

level in twenty years. The pattern of consumption has also changed, with the weight of expenditure on basic necessities (food, clothing, housing) falling slowly, in favour of expenditure on health and personal care, comfort and entertainment (Table 9.8).

The last twenty years have been marked, finally, by a considerable expansion in the use of resources by the public sector (Table 9.9). Measured as a percentage of gross domestic product, the sum of general government current expenditure and capital expenditure by the public sector, enterprises included, rose from 23 % to 35 % between 1960 and 1979. This sharp relative increase was produced by current expenditure, and in particular transfers to households, reflecting the redistributive activities of central government and the social security funds, since the increase in public sector investment was, in contrast, less than proportionate. A parallel feature was the increase, but to a smaller extent, in the overall tax burden, especially at the end of the period when heavy deficits appeared.

The economic implications of accession to the European Communities

Greece has been associated with the European Economic Community since 1 January 1962 and will become a full member of the European Communities on 1 January 1981. This year will therefore see the acceleration of an adjustment process, together with the start of a more active participation in an economic grouping largely open to the outside world, and subject to the hazards and dangers, as well as the benefits, of competition and the international division of labour. The adjustment will be facilitated by a five-year transitional period for the general system, extended to seven years for certain agricultural products and the full introduction of the free movement of workers.

The changes to be expected from accession are all the greater since, despite the significant progress made in modernization over the last twenty years, the structures of the economy display the

features of the agricultural sector's still over-dominant position, the industrial and commercial sectors' low degree of concentration and specialization, heavy external protection and a financial system governed by tight regulations which impede, in particular, the free determination of the exchange rate and of interest rates.

The liberalization of trade and the adjustment of production structures

Trade will have to be completely liberalized after five years, i.e. by 1 January 1986. This means, for industrial products, alignment on the common external tariff and the elimination of customs duties on products imported from the other member countries (1), and, for agricultural products, a gradual narrowing of the gap with Community prices by means of a special system of compensatory amounts.

Liberalization will probably require a substantial adjustment in production structures since these are very different from, and not necessarily complementary to, those in the rest of the Community.

The position in the national economy of manufacturing industry, in particular, is still modest (2) and although its share in the export trade has greatly increased to reach some two-thirds of the total today (3), the type of product is not very sophisticated and has up to now enjoyed a degree of protection high enough to ensure large domestic markets (4). During the phase of association with the Community, customs protection vis-à-vis the partner countries was phased out for roughly three-quarters of industrial imports, but retained for "sensitive" products. The ending of this protection,

(1) At a rate of 10 % per annum for each of the first two years and 20 % for each of the following years

(2) See above, Table 9.3

(3) See above, Table 9.6

(4) 15.8 % on average on raw materials, 24 % on semi-finished products and 32.9 % on manufactured products, with the exception of "sensitive" products on which the duties can be as high as 60 % (and even 80 % in the case of beverages).

planned for 1984, will mean that a good many firms without either a degree of specialization, or a technology, or sufficient financial resources will have to make a substantial effort to adjust to the competition of both the highly industrialized Community countries and the many developing countries with competitive technologies and low labour costs. The problems deserve all the more attention as accession to the Community could well push up wage costs, which have remained relatively low so far, without immediately improving skills and productivity. It is to be hoped, in any event, that the industrial fabric will be rapidly reinforced by investment from the western economies : this is likely to be stimulated by the liberalization of current payments (1).

Agricultural policy and alignment with Community prices

The productivity of agriculture, which still contributes 14 % of the domestic product and employs 32 % of the labour force, is much lower than in the rest of the Community. For most types of produce, the two agricultural systems are nevertheless complementary, in that Greece produces a surplus in fruit and vegetables, tobacco, cotton and oleaginous plants and has a deficit in certain cereals, milk products and meat. The Nine at present absorb some 55 % of Greece's agricultural exports and provides some 25% of its imports. All in all, the guaranteed prices mechanism which applies to beef and pigmeat, milk products, cereals and sugar, will concern only some 40 % of production, compared with 70 % for the rest of the Community. Because of the regulation of prices, an increase must be expected inter alia in the prices of durum wheat, olive oil and tobacco, which should stimulate production, but a fall in meat (in particular pigmeat) and milk production, owing to the higher cost of animal feedingstuffs.

(1) See below

Exports of fruit and vegetables, tobacco, olive oil and wine to the Nine could well increase rapidly, while meat and milk products from the Nine could find growing markets in Greece. The refund mechanism will also encourage the expansion of exports outside the Community.

A seven-year transitional period has been set for customs duties and prices. The gap between Greek prices and Community prices will be closed by a system of special compensatory amounts. There will be a phasing-in of production aid (for olive oil, durum wheat and certain processed fruit and vegetables) and deficiency payments (cotton, figs and dried grapes). Lastly, certain national aids will gradually be dismantled.

The liberalization of factors of production, the relaxation of exchange constraints and contributions to the balance of payments

At the same time as obstacles to the movement of industrial and agricultural products are eliminated, integration into the Community will bring gradual liberalization of the factors of production.

The free movement of workers will be achieved only gradually, over a seven-year transitional period. The free movement of capital, by contrast, should be accomplished as early as 1 January 1981 and - with only a few exceptions (1) - should cover initial flows as well as repatriations and current transfers.

The free movement of workers should not bring any substantial upturn in emigration, since the expected expansion of the Greek economy during the transitional period should continue to work towards the narrowing of pay differences.

(1) Direct investment in the EEC and transfers of the yield from investments made before 1975 are excepted for another few years.

It is more difficult, however, to grasp the consequences of measures to liberalize movements of capital. In the medium term, they are likely to encourage the growth of foreign investment. But, initially, they are liable to have certain disruptive effects on short-term movements, since they will be accompanied by the abolition of the particularly restrictive controls in force hitherto on exchange rates and interest rates. It is therefore impossible to foresee how operators will react to such major changes. However, their effect will probably be very limited on emigrants' remittances, which have remained at roughly the same level for several years mainly because of the large-scale unemployment prevailing in the host countries. Furthermore, the mobilization of foreign exchange reserves and the management of interest rates should enable the monetary authorities - in the framework of the close monetary cooperation which has been established between Member States - to limit the scale of the possible disruptions on the foreign exchange market and to stabilize the exchange rate at the level they deem appropriate.

By contrast, greater certainty is possible in evaluating the favourable consequences for the balance of payments of the action of the current transfers resulting from accession itself. Assuming no change in Community policies, Greece would receive from the Community, from the first year, some 265 million EUA, 165 million of which would be in respect of the EAGGF Guarantee Section, and this amount should increase sharply to reach 775 million EUA in 1985. Taking account of the payments which Greece would have to make in return - own resources and participation in the operating expenses of the institutions - the credit balance, negligible in the first year, should grow rapidly to reach 475 million EUA in 1985.

The economic situation - the short and medium-term outlook

Since mid-1979, the Greek economy has entered a phase in which economic activity has slowed down and even contracted. After increasing by 6.2 % in 1978, gross domestic product grew by only

3.9 % in 1979, the drop in agricultural production only partly explaining this fall-off. Despite the better results expected from this sector, zero - or even slightly negative - growth could be recorded in 1980.

Indeed, the index of industrial production, seasonally adjusted, has declined continuously since the third quarter of 1979 (See below).

This development is primarily due to the definite change of trend in private consumption which, after increasing sharply in 1978, stayed at virtually the same level in 1979, as a result of a slower rise in disposable income, a sharp acceleration in the upward movement of prices and the introduction of a special vehicle tax. Exports, for their part, rose far less vigorously than in 1978. The trend of fixed investment was, by contrast, favourable, not only in housing, but in industry, which recorded a distinct upturn in equipment expenditure by the manufacturing sector, which has been on a marked downward trend since 1974. For 1980, the persistence of factors serving to depress private consumption, the weaker buoyancy of exports and the expected drop in investment point, all in all, to a fall-off in overall demand.

The appreciable slowdown of economic activity has had no immediate negative effects on employment. Thanks to the services sector, non-agricultural employment in 1979 actually recorded particularly sharp growth. At the beginning of 1980, the number of registered unemployed was only 41 000, or slightly over 3 % of the urban and semi-urban population. The employment situation has, however, been deteriorating since the end of 1979.

Quarterly development of industrial production and consumer prices(1978-80)

Percentage change, at an annual rate									
1978				1979				1980	
I	II	III	IV	I	II	III	IV	I	II
<u>Industrial production</u>									
4.4	8.2	4.5	17.9	4.1	12.2	-5.9	-1.2	-6.6	
<u>Consumer prices</u>									
11.2	19.3	-2.4	19.3	28.7	23.1	11.4	30.2	31.1	31.1

Since the beginning of 1979, the economy has seen a sudden worsening in its structural imbalances. Price rises accelerated sharply at the same time as the current balance of payments deficit was widening rapidly.

The spurt in inflation was partly due to external causes : higher prices for oil and raw materials and, in the early months of 1980, a fall in the exchange rate. But domestic causes were even more to blame : agricultural and food prices were deliberately raised with the aim of beginning to align them with Community prices and reducing the weight of budget subsidies; more importantly, production capacities were subject to increasingly acute strains as a result of the contrast between a nominal demand fuelled by several years of sharp rises in incomes and the definite slowdown, from 1974, in productive capital formation. All these factors combined to produce a very sharp acceleration in consumer prices, which will have risen by 18 % in 1979 and 26 % in 1980.

The current account deficit, after falling in 1978 to 3 % of gross domestic product, increased again sharply in 1979, reaching almost 5 %. As well as the deterioration in the real trade balance, the terms of trade worsened considerably. Although it had increased substantially, the surplus on invisibles in 1979 covered only 63 % of the trade deficit, compared with 71 % in 1978. Thus the proportion of the current deficit which had to be financed by short-term borrowing was again larger. The situation worsened further in the first half of 1980, mainly because of the fall in the exchange rate, but also because exports slowed appreciably. The surplus on invisibles and on long-term capital movements also shrank, mainly due to speculation against the drachma : the effective exchange rate, after declining 6 % in 1979, fell further in the early months of 1980.

The heavier inflationary pressures and the faster deterioration of the balance of payments necessitated appreciably tougher budgetary and monetary policies in 1980. The 1980 budget plans to cut the public sector deficit by one percentage point of gross domestic product, by drastically reducing the rate of increase of expenditure on all items which can be squeezed, but especially of investment. The decision has also been taken to bring the rate of increase of bank lending to the private sector down from 19 % to 13 %, but this limit will most certainly be exceeded, since it was consistent with an anticipated rate of inflation well below the one actually recorded.

The economic outlook for the whole of 1980 can now be discerned fairly clearly. It is given in the table below which shows that final domestic demand will probably decline by 1 1/2 %, but that the increase in stocks, and in particular the improvement in the external balance in real terms, should offset this decline and should keep gross domestic product at its 1979 level. The current deficit in cash terms should nevertheless reach USD 2 500 million compared with USD 1 750 million in 1979.

Short-term trend and economic outlook (1979-1981)

	Percentage changes in volume		
	1979 Outturn	1980 Forecast (1)	1981 Outlook (1)
Private consumption	+3	- 2	+ 1 1/2
Public consumption	+5	- 3 3/4	+ 3
Gross fixed capital formation	+3 1/2	- 4 3/4	+ 3
Final domestic demand	+3 1/2	- 1 1/2	+ 2
Stockbuilding	+2	+ 1/4	- 1/2
Total domestic demand	+5 1/2	- 1/1/4	+ 1 1/2
Exports	+6	+ 3 3/4	+ 4 1/2
Imports	+11	- 1 1/4	+ 2 1/2
External balance	-1 1/2	+ 1 1/4	+ 3/4
Gross domestic product	+ 4	0	+ 2 1/4
<u>For reference</u>			
Private consumption deflator	+18	+26	+20

(1) Commission staff estimate

The outlook for 1981 is still very uncertain. The expected upturn in world demand and the depreciation of the drachma will probably secure a further improvement in the external balance in real terms. Furthermore, if budgetary and monetary policy stay on their present

course and if the exchange rate can be maintained, the inflation rate should slow down, providing there are no new and substantial oil price increases.

This could bring a moderate upturn in private consumption, if, as is probable, personal disposable incomes increase in line with prices and if the personal saving ratio continues to fall slightly. Lastly, the future trend of investment is unclear. It will be stimulated neither by budgetary or monetary policy, nor by the immediate prospects for demand. But it could benefit from the improvement in companies' financial situation and from a resumption of capital movements from abroad, which might occur as a result of the stabilization of the exchange rate and the prospects opened up by entry into the European Community. Under this set of relatively optimistic assumptions, domestic demand would recover by some 2 % in 1981 and gross domestic product increase by slightly more. Consumer price inflation would be brought down to 20 %, on an annual average, and the current deficit in cash terms should stabilize at its 1980 level. The upturn in production would not, however, prevent a deterioration in the employment situation.

In the longer term, the economy's growth prospects are governed by the need for a sharp cut in the current deficit and a rapid lowering of the inflation rate. The prospective development of world demand would not seem to permit exports to grow by more than 8 % per annum. Consequently, in order to keep import growth well below this figure, gross domestic product will not, for several years, be able to increase by more than 3 % and domestic demand by more than 2 to 2 1/2 %. The possibilities for increases in private consumption will be even more limited, since a proportionately much larger share of this margin will have to be reserved for investment, mainly so that the economy can

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adapt to the new international context. The inflation rate must be aligned with the average rate prevailing in trading partner countries as quickly as possible if sufficient stability in the exchange rate is to enable this outlook to become a reality. This is conditional upon a rigorous monetary policy, but the main factor in gradually reducing domestic borrowing so as to slow down the rate of money creation must be the squeezing of the public deficit.

Table 9.1

GREECE - Demand and output (1960-1979)

	Percentage changes at 1970 prices						
	1960-65 average	1965-70 average	1970-75 average	1976	1977	1978	1979 (2)
Private consumption	6,6	7,0	5,6	5,8	5,1	5,6	3,2
Public consumption	6,7	5,9	8,3	5,1	6,4	3,0	5,2
Gross fixed capital for- mation	11,0	7,6	0,3	6,9	8,6	5,2	3,6
Stockbuilding (1)	2,1	2,2	3,6	4,8	2,1	1,3	..
Domestic demand	9,0	6,9	4,8	5,5	4,8	4,9	5,3
Exports	7,6	12,7	12,8	12,7	- 0,7	14,4	6,0
Imports	14,9	7,6	7,8	6,3	8,2	3,9	11,1
Volume GDP at market prices	8,0	7,2	5,0	6,2	3,5	6,2	4,0
GDP price deflator	2,7	4,2	6,2	12,5	10,2	13,0	18,5
Consumer price deflator ...	2,2	3,4	5,9	10,5	9,1	12,2	18,0

(1) As % of GDP

(2) Provisional figures

Source : Statistical Office of the European Communities

Table 9.1a

GREECE : Demand and output (1960-1979)

1. in DR '000 million, at 1975 prices

	1960	1965	1970	1975	1976	1977	1978	1979(1)
Private consumption	188,5	259,7	364,9	478,0	505,8	531,7	561,6	579,8
Public consumption	37,3	51,5	68,7	102,0	107,2	114,2	117,6	123,7
Gross fixed capital formation ...	54,6	91,9	132,5	139,9	149,5	162,3	170,8	176,9
Stockbuilding (2)	-24,5	31,6	38,5	38,5	34,1	15,7	10,5	..
Domestic demand	278,4	428,2	598,6	758,4	800,4	839,2	880,0	927,4
Exports	18,7	26,8	48,8	89,3	100,6	99,9	114,3	121,4
Imports	41,7	83,5	120,8	175,6	186,7	202,1	209,9	233,2
Volume GDP at market prices.....	252,1	371,0	525,5	672,2	713,8	738,6	784,4	815,4

2. indice 1960 = 100

Private consumption.....	100	138	194	254	268	282	298	308
Public consumption	100	138	184	273	287	306	315	332
Gross capital formation	100	168	243	256	274	297	313	324
Domestic demand.....	100	154	215	272	288	301	316	333
Exports	100	143	261	478	538	534	611	648
Imports	100	200	290	421	448	485	503	559
Volume GDP at market prices	100	147	208	267	283	293	311	323

(1) Provisional figures

(2) Including statistical adjustments

Source : Statistical Office of the European Communities

Table 9.2

GREECE - Aggregates related to population and employment

EUA, at 1975 prices and exchange rates

	1960	1965	1970	1975	1976	1977	1978
1. GDP per inhabitant	757	1 085	1 494	1 858	1 947	1 975	2 075
(EUR - 9 average)	(2 636)	(3 175)	(3 851)	(4 286)	(4 494)	(4 591)	(4 724)
2. GDP per person employed	1 861	2 804	4 143	5 268	5 525	5 832	6 016
(EUR - 9 average)	(6 030)	(7 473)	(9 323)	(10 710)	(11 263)	(11 489)	(11 802)
3. Final consumption per inhabitant	678	910	1 233	1 603	1 672	1 728	1 814
(EUR - 9 average)	(2 034)	(2 443)	(2 909)	(3 350)	(3 466)	(3 527)	(3 648)
4. Private consumption per inhabitant	566	759	1 038	1 321	1 380	1 422	1 500
(EUR - 9 average)	(1 568)	(1 896)	(2 294)	(2 638)	(2 735)	(2 789)	(2 887)
5. Compensation of employees per employee .....	..	..	1 709	2 225	2 329	2 594	2 768
(EUR - 9 average)	(3 864)	(4 829)	(6 022)	(7 436)	(7 689)	(7 792)	(7 950)

Source : Statistical Office of the European Communities

Table 9.3

GREECE : Gross value added by branch as % of gross domestic product (1), at 1970 prices

	1960	1965	1970	1975	1976	1977	1978	1979
Agriculture	23,2	23,3	18,2	16,7	15,6	14,0	14,1	13,0
Mining	1,2	1,2	1,4	1,4	1,5	1,6	1,4	1,5
Manufacturing industry	14,2	15,1	19,1	20,9	21,7	21,3	21,5	21,8
Electricity, gas, water	1,1	1,4	2,0	2,5	2,7	2,9	3,1	3,2
Construction	9,6	9,6	8,9	6,8	6,8	7,4	7,4	7,5
Services	50,7	49,4	50,4	51,7	51,7	52,8	52,5	53,0
Gross domestic product (1)	100	100	100	100	100	100	100	100

(1) At factor cost

Source : Ministry of Coordination - National Accounts Department

Table 9.4

GREECE : Population, employment and unemployment trends (1960-1979)

	1960	1965	1970	1975	1976	1977	1978
1. Total population	8 327	8 550	8 793	9 047	9 167	9 268	9 360
(1960 = 100)	(100)	(102,7)	(105,6)	(108,6)	(110,1)	(111,3)	(112,4)
2. Labour force	3 601	3 413	3 270	3 204	3 197	3 202	..
(1960 = 100)	(100)	(94,8)	(90,8)	(89,0)	(88,8)	(88,9)	..
3. Employment	3 386	3 255	3 134	3 122	3 146	3 167	..
(1960 = 100)	(100)	(96,1)	(92,6)	(92,2)	(92,9)	(93,5)	..
Participation rate (1:2)	43,2	39,9	37,2	35,4	34,9	34,5	..
Unemployment rate (2-3:2)	6,0	4,6	4,2	2,6	1,6	1,1	..

Source : National Statistical Service of Greece

Table 9.5

GREECE : Trend of capital stock and capital productivity (1960-1979)

	1960	1965	1970	1975	1976	1977	1978	1979
Capital stock (1)	310	454	678	979	1 030	1 086	1 145	..
(1960 = 100)	(100)	(146)	(219)	(316)	(332)	(350)	369	..
of which : buildings	185	256	363	505	530	559	..	..
(1960 = 100)	(100)	(138)	(196)	(273)	(286)	(302)	..	..
equipment	125	198	315	474	500	527	..	..
(1960 = 100)	(100)	(158)	(252)	(379)	(400)	(422)	..	..
Capital productivity (2)	0,417	0,411	0,381	0,347	0,348	0,341	0,342	..

(1) In DR '000 million at 1970 prices

(2) Gross domestic product related to capital stock

Source : National Statistical Service of Greece, data quoted in "Economic development prospectives and Planning in Greece" by K.P. Prodromidis. A study prepared for the Commission of the European Communities, Athens, December 1979

Table 9.6

GREECE : Exports and imports (1960-1979) by product category

	(as % of total)									
	Exports					Imports				
	1960-64 average	1965-69 average	1970-74 average	1975-79 average	1960-64 average	1965-69 average	1970-74 average	1975-79 average	1960-64 average	1975-79 average
0. Foodstuffs and live animals	25,1	26,8	21,8	23,0	12,4	12,9	10,7	8,6		
1. Beverages and tobacco	38,1	27,1	12,0	7,4	-	0,1	0,2	0,2		
2. Non-edible crude materials, excluding fuels	25,1	18,3	13,6	9,0	9,6	10,0	9,0	6,7		
3. Mineral fuels, lubricants and related materials	-	0,9	7,2	8,9	7,5	7,7	13,4	19,4		
4. Animal and vegetable oils and fats	1,0	3,1	1,3	1,3	0,4	0,4	0,4	0,2		
5. Chemical products	2,6	4,0	5,9	4,3	9,4	9,3	9,0	8,1		
6. Manufactured articles clas- sified by material	5,2	16,4	29,5	31,1	19,2	17,7	17,0	13,2		
7. Machinery and transport equipment	1,6	1,3	2,2	4,0	38,4	38,6	37,4	40,4		
8. Miscellaneous manufactured articles	1,3	2,4	6,5	11,0	3,0	3,3	2,9	3,1		
9. Articles and transactions not classified by category	-	-	-	-	-	-	-	0,1		
TOTAL	100	100	100	100	100	100	100	100	100	100

Source : National Statistical Service of Greece

Tableau 9.6a

GREECE : Exports and imports by geographical areas

	(as % of total)															
	Exports					Imports										
	1960-1964	1965-1969	1970-1974	1975-1979	1960-1964	1965-1969	1970-1974	1975-1979	1960-1964	1965-1969	1970-1974	1975-1979				
	average	average	average	average	average	average	average	average	average	average	average	average				
EEC - 9	42,8	47,2	52,4	49,5	50,4	52,8	48,8	38,2	(19,4)	(19,3)	(21,1)	(20,7)	(18,3)	(18,3)	(18,6)	(13,6)
of which : Germany	(4,8)	(7,0)	(6,8)	(6,7)	(6,6)	(7,5)	(7,3)	(5,8)	(5,8)	(9,0)	(9,3)	(9,2)	(7,2)	(9,7)	(9,2)	(8,9)
France	(5,8)	(9,0)	(9,3)	(9,2)	(10,8)	(9,3)	(6,2)	(3,9)	(8,3)	(5,3)	(5,5)	(4,6)	(10,8)	(9,3)	(6,2)	(3,9)
Italy	(8,3)	(5,3)	(5,5)	(4,6)	(7,5)	(8,0)	(7,6)	(6,2)	(4,5)	(6,6)	(9,7)	(8,3)	(7,5)	(8,0)	(7,6)	(6,2)
United Kingdom	(4,5)	(6,6)	(9,7)	(8,3)	(7,5)	(8,0)	(7,6)	(6,2)	(4,5)	(6,6)	(9,7)	(8,3)	(7,5)	(8,0)	(7,6)	(6,2)
Other	(4,5)	(6,6)	(9,7)	(8,3)	(7,5)	(8,0)	(7,6)	(6,2)	(4,5)	(6,6)	(9,7)	(8,3)	(7,5)	(8,0)	(7,6)	(6,2)
Other OECD countries in Europe	4,9	11,6	11,8	7,1	11,2	11,9	9,9	9,3	14,5	11,2	11,8	7,1	12,4	10,0	8,9	6,1
North America	14,5	11,2	8,2	5,9	12,4	10,0	8,9	6,1	21,8	18,6	12,8	12,0	7,7	7,7	5,1	6,3
Eastern Europe	21,8	18,6	12,8	12,0	7,7	7,7	5,1	6,3	6,0	11,4	14,8	25,5	18,3	17,6	27,2	40,1
Other	6,0	11,4	14,8	25,5	18,3	17,6	27,2	40,1	TOTAL	100	100	100	100	100	100	100

Source : National Statistical Service of Greece

Table 9.7

GREECE : Balance of payments (1960-1979)

	1960	1965	1970	1975	1976	1977	1978	1979
	(in USD million)(1)							
1. Trade balance (FOB-CIF)	-310	-702	-1 093	-3 042	-3 333	-3 904	-4 342	-6 178
2. Invisibles	225	426	679	1 977	2 246	2 621	3 089	3 900
of which : transport	70	146	228	673	769	973	999	1 305
tourism	33	66	139	489	673	817	1 102	1 360
emigrants' remit.	99	213	343	782	803	925	984	1 168
other	23	1	- 31	33	1	- 94	4	67
3. Current balance (1 + 2)	- 85	- 276	- 414	-1 065	-1 087	-1 283	-1 253	-2 278
4. Long-term capital	80	196	275	476	515	612	823	1 176
5. Basic balance (3 + 4)	- 5	- 80	- 139	- 589	- 572	- 671	- 430	-1 102
6. Short-term capital	8	38	52	- 74	- 135	- 51	- 296	507
7. Monetary movements	3	42	87	663	707	722	726	495

(1) Current exchange rates

Source : Organisation for Economic Co-operation and Development

Table 9.8

GREECE : Personal incomes and private consumption

	1960	1965	1970	1975	1976	1977	1978	1979
	(as % of total)							
<u>INCOME</u>								
Agricultural incomes	21,7	22,7	16,8	17,1	17,2	15,0	15,3	14,1
Non-agricultural wages and salaries	33,0	32,3	35,6	36,3	37,7	39,8	41,0	41,3
Property and entrepreneurial income	37,0	33,9	35,3	34,9	33,2	32,7	30,8	32,0
.....								
General government transfers	5,4	7,4	8,5	7,7	8,1	8,8	9,6	9,5
Transfers received from abroad	2,9	3,7	3,8	4,0	3,8	3,7	3,3	3,2
TOTAL	100	100	100	100	100	100	100	100
<u>CONSUMPTION</u>								
Food, beverages, tobacco	48,0	46,9	41,6	41,0	40,5	39,2	39,0	38,5
Clothing	10,2	11,4	12,6	11,8	11,8	11,4	11,3	11,9
Rents	12,5	11,6	11,7	9,8	9,4	9,4	9,8	9,7
Domestic equipment	3,7	4,1	5,2	6,9	7,9	9,4	9,3	8,2
Other	25,6	26,0	28,9	30,5	30,4	30,6	30,6	31,7
TOTAL	100	100	100	100	100	100	100	100

Source : Ministry of Coordination

Table 9.9

GREECE : Economic accounts of the public sector (1960-1979)

	in DR '000 million									
	1960	1965	1970	1975	1976	1977	1978	1979		
General government current expenditure	17,9	36,7	66,0	177,6	223,4	277,1	345,2	421,6		
Goods and services	12,3	21,1	37,7	102,0	124,3	153,8	185,2	230,2		
Transfers	5,3	14,4	25,5	66,3	86,3	109,2	140,3	159,6		
Debt interest	0,3	1,2	2,8	9,3	12,9	14,1	19,7	31,8		
General government current receipts	21,8	42,2	79,2	182,1	240,9	285,0	347,4	433,2		
Direct taxes	7,7	15,0	30,1	70,3	104,0	118,8	150,7	188,5		
Indirect taxes	12,1	23,8	43,4	96,0	119,3	147,6	178,2	218,2		
Other	2,0	3,3	5,7	15,8	17,6	18,6	18,5	26,4		
General government saving	3,9	5,5	13,2	4,5	17,5	7,9	2,2	11,6		
Public sector gross capital formation	6,3	12,0	20,5	43,1	47,3	52,4	63,8	79,2		
As % of GDP										
Total expenditure	(23,0)	(27,1)	(28,9)	(32,8)	(32,8)	(34,2)	(35,3)	(35,2)		
Total receipts	(20,7)	(23,5)	(26,5)	(27,0)	(29,2)	(29,6)	(30,0)	(30,4)		
Net balance	(-2,3)	(-3,6)	(-2,4)	(-5,8)	(-3,6)	(-4,6)	(-5,3)	(-4,8)		

Source : Ministry of Coordination and Ministry of Finance

10. Outlook and policy options

While the 1979/80 oil price shock (measured in dollars) is of the same order of magnitude as that of 1973/74, the total external price shock of 1979/80 is - due to the lower price increases for other commodities and offsetting exchange rate developments - much smaller than the one which hit the Community in 1974. As a result mainly of a lower degree of absorption by OPEC countries and slow growth of imports to many developing countries in balance of payments difficulties external demand is, on the other hand, only rising slowly in 1980/81 and the deterioration of the Community's competitive position may be felt in a loss of market shares. The decline in output, which started in the second quarter of 1980, should come to an end in early 1981 and be followed by a gradual upturn in activity in response to a renewed increase of private consumption and inventory formation. The Community should respond to the oil price shock by intensifying energy policy, investment incentives and other measures aimed at increasing the growth potential without relaxing the overall restrictive stance of budgetary policy. A certain increase in the budget deficit in 1981 is unavoidable due to the operation of automatic fiscal stabilizers and should not be offset by restrictive measures.

The external price shock and its consequences

As shown in Chapter 1, the oil import price rise has been of similar order of magnitude in 1979/80 as in 1973/74; in fact somewhat larger in constant price dollars. Moreover, because the rate of OPEC absorption is probably going to be lower now than after the first oil shock, and because of a different evolution of the world terms of trade, the initial macro-economic impact of the new oil shock is indeed probably the stronger of the two. But there are other significant differences between the two episodes.

The 1973/74 oil price rise took place in a situation with excess demand and booming conditions, notably in raw material markets and many semi-finished products, which contributed strongly to the deterioration of terms of trade for the Community in 1973 and 1974. In addition, the first oil shock was followed by a rise in the value of the dollar which for the Community entailed a supplementary increase in import prices measured in national currencies. This time prices of non-oil imports to the Community have risen much less in dollar terms and exchange rate developments in 1980 have on the whole worked so as to dampen the import price increase even

further when measured in national currencies. The total external price shock to the Community, as measured by the real income loss resulting from a terms of trade deterioration is therefore in 1979/80 less than half as large as in 1973/74.

This less bad terms of trade deterioration for the Community is not inconsistent, however, with the proposition that the overall weakening in effective external demand may be greater. In addition to the likelihood of a weaker spending of their increased income by oil-exporters, the weaker increases of non-oil commodity prices puts many developing countries in a more difficult situation. The oil price increases have also coincided with the onset of cyclical down-turns in some major economies prompted by other factors (the United States, and, within the Community, the United Kingdom). Finally, since 1973 the Community's competitive position has been seriously eroded by a combination of high domestic cost increases and exchange rate appreciation. The deflationary impact of the oil price increase and restrictive policies may therefore, for the Community, be aggravated by a loss of market shares both in domestic and in export markets. In 1980 there were clear signs of loss of market shares for the Community's automobile industry but also other branches - where statistics on sales are less readily available - seemed to be experiencing similar conditions.

On the other hand (as discussed in greater detail in Chapters 2 and 4) the private sector's reactions to the changes in macro-economic conditions in 1980/81 may not be the same as in 1974/75; domestic demand in the Community may, in particular, not fall as markedly as in 1974/75. The cash flows of enterprises have not deteriorated as drastically as in 1974. Moreover, in line with policies, the rise in energy prices has this time been shifted more readily into retail prices and the financial position of the enterprise sector has also in this way been protected better than in 1974. Despite an increase since 1978, partly cyclically determined, the borrowing requirement of the enterprise sector is estimated _____

to be smaller in 1980 than in 1974/1975. Indeed, investment intentions in manufacturing remained relatively buoyant at least up to the spring of 1980. Rapidly rising import penetration and difficulties in export markets, may, however, in the course of 1980 have put a stronger-than-expected pressure on profit margins which if continued would not fail to weaken the financial position of key branches. This problem appears to be particularly pressing in the United Kingdom but is to some extent also felt in Italy.

Against this background the saving/expenditure behaviour of the household sector in 1980 and 1981 appears to be of critical importance for the overall trend in demand. In retrospect it is seen that one of the factors which in 1974 and 1975 contributed to the slowdown in activity was an increase in the savings ratio of households. There is probably no simple explanation for this increase in the savings ratio in 1974/1975 but econometric evidence (1) as well as the analysis in Chapter 4 above would seem to suggest that the acceleration of inflation may be one of the main explanatory factors. Rising unemployment and uncertainty about economic prospects may also have led to higher precautionary savings.

(1) See e.g. "The impact of inflation on household consumption"
European Economy N° 5, March 1980.

World trade: trends and prospects

The growth of world trade, estimated at 6.6% in real terms for 1979 over 1978 is likely to have dropped to 2.7% in 1980 and is forecast at some 1.9% in 1981. Foreign trade of the major country groupings, however, follows highly divergent patterns. Imports to the OPEC countries, which declined sharply in 1979 as a consequence mainly of the events in Iran, have expanded strongly (probably some 20% in real terms) in 1980 and should rise considerably (15%) also in 1981. Non-oil developing countries, on the other hand, which expanded their imports substantially (7.5% in real terms) in 1979, are now facing increasing balance of payments difficulties due to the sharp rise in their oil bill and slow growth of their exports to the industrialised countries and may be forced to cut down on imports. The growth of their volume imports is estimated at some 4% in 1980 but may drop to only 1.5% in 1981. Imports to the industrialised countries, on the other hand, as a result notably of a marked decline in imports to the United States, Canada and Japan, will hardly show any volume increase in 1980 and may stagnate also in 1981. Although non-oil imports are likely to rise somewhat faster than oil imports, the industrialised countries as a group will thus in 1980 and 1981 provide only weak impulses to activity in the rest of the world, and both the non-oil LDC's and the centrally planned economies will suffer from a slow growth of export markets.

Within the OECD area trends in the main economies have in 1980 followed roughly the same pattern, albeit with different amplitude. Gross domestic product in real terms fell in the second quarter of 1980 in the United States (as in the Community (see below) and growth may only resume towards the end of the year or in 1981 in both cases.

The surplus on the current account of the balance of payments of the OPEC countries is expected to reach 119 000 million dollars in 1980 (after 68 000 million in 1979) and to fall only slightly (to 110 000 million dollars) in 1981. The combined deficit of the OECD countries may rise from 34 700 million

dollars in 1979 to 84 300 million in 1980 but is forecast to decline to some 65 300 million in 1981. The current account of the United States is expected to show a small surplus in 1980 and 1981 whereas the Community may account for close to half the total OECD deficit and the smaller (non-EC) OECD countries for some 30% in 1980 and as much as 40% in 1981. Despite slow growth of total imports in volume terms the current account deficit of the non-oil exporting developing countries is forecast to rise from 43 000 million dollars in 1979 to 60 000 million in 1980 and may rise to 63 000 million in 1981. The deficit of the centrally planned economies is expected to remain little changed at 16 500 million dollars in 1980 and 18 000 million in 1981.

Outlook for the Community

Following a relatively buoyant development in late 1979 and in the first quarter of 1980 real gross domestic product of the Community fell in the second quarter of the year and is estimated to have declined also in the third quarter. For 1980 on average GDP is nevertheless estimated to show a rise of 1.3%. The cyclical slowdown is attributable in the first instance to a decline in private consumption reflecting trends in disposable income of households which started to fall in late 1979; in the first period of adjustment households seem to have reacted by a reduction in the savings ratio, but in the course of 1980 the level of expenditure was adapted to the lower income largely resulting in a sharp decline of consumer demand in real terms.

Developments in 1981 will be determined by a range of factors many of which are subject to important policy decisions still under preparation. Moreover, certain critical assumptions concerning the pattern of reaction of households and enterprises to some extent depend on conjectures and interpretation of qualitative information on attitudes and opinions. The currently available data would suggest that the expansionary forces may regain a certain strength in the course of 1981. Private consumption, in particular, after a probable fall in the second half of 1980, can be expected to recover as the growth of real disposable income of households is likely to resume in the first half of next year. Moreover, in sharp contrast to 1975 developments, households are not expected to step up their acquisition of financial assets in the coming phase of cyclical developments: the savings ratio of households is forecast to rise only moderately

in 1981, remaining approximately on the level of 1977-79. Fixed investment, after a decline in the second half of 1980 and the first half of 1981 is also expected to provide a modest support to activity as from the second half of 1981. Investment intentions in industry remained buoyant up to May 1980 and the financial situation of the enterprise sector as a whole had kept relatively healthy. There is as of yet no reason to expect anything like the collapse of business investment which was a major factor behind the 1974-75 recession. As normal in a period of cyclical slowdown the cash flow deterioration will be reflected in a decline in inventory formation: this process should come to an end in the course of 1981 and stockbuilding may by the second half of the year provide a small stimulus to activity.

This outlook for private sector demand would seem likely to be realised without any major change in economic policy and/or shift in public sector spending programmes. Public consumption is forecast to rise only moderately (1,3% in real terms) and public investment may actually fall in volume terms. Given, however, the temporary slowdown in the growth of income and expenditure in the private sector, the rise in tax receipts (net of transfer payments) will in 1981 fall somewhat behind the rise in public expenditure resulting in a certain rise in the budget deficit in proportion to GDP from 3,5% in 1980 to 3,9% in 1981. Even with unchanged general orientation of budgetary policy, the automatic budget reactions will thus contribute to sustaining the growth of activity in 1981.

As indicated above, world trade, after stagnation in most of 1980, is expected to resume growth in the first half of 1981, with notably a rise in imports to North America and Japan, following the marked decline in 1980. Exports to the non-oil LDC's may rise only slowly while exports to the OPEC countries should be a factor of buoyancy for the Community. A key issue is, however, whether the Community's industry is in a position to maintain its shares in domestic and foreign markets or whether the marked loss in price competitiveness since early 1979 will exert a negative influence on the sales performance notably in comparison with Japan which, despite the recent strength of the yen, has gained a sharp competitive edge over the Community. Against this background exports from the Community to the rest of the world may not rise as fast as the increase in markets (excluding imports of oil) although some acceleration is likely to take place in the course of next year. On average for the year 1981

exports of goods (including intra-trade) are expected to rise by 1,9% in volume terms after a rise of 3.5% in 1980. Imports, on the other hand, after a decline in volume terms in the second half of 1980 reflecting mainly the fall in inventory formation, should resume growth in the course of 1981. Although the rise in import prices is expected to decelerate the current account of the balance of payments, which is expected to improve between the first and the second half of 1980, may therefore see only limited further improvement in 1981. For the year as a whole the deficit may amount to some 25 500 million ECU (36 200 million dollars), corresponding to approximately 1.2% of the Community's GDP.

The rise in consumer prices is likely to slow down more rapidly than in 1974/75 as domestic cost increases have been kept in check more successfully since the second oil price shock. Part of the recent price deceleration may, however, be attributable to a narrowing of profit margins due to stiffer competition from abroad. The degree of divergence of price performance is likely to fall somewhat from the record-high figure of 1980; the difference between the highest and the lowest rate of increase in the deflator of private consumption is expected to fall from about 15 percentage points in 1980 to about 11 points in 1981. Nevertheless, even in 1981 the rate of inflation in the Community will, at 9.7% be more than twice as high as in the period 1960/73 with, in particular, a much higher difference in performance between Member States. The GDP deflator and unit labour costs, which are more reliable indicators of the underlying rate of inflation, and which showed a smaller acceleration in 1980, may only slow down moderately in 1981.

With only slow growth in activity in 1980 and 1981 employment may show only little increase in the former year and a fall in the latter. The labour force of the Community is, on the other hand, likely to expand relatively fast - mainly for demographic reasons. In 1981 it will therefore be particularly difficult to provide jobs for those who join the labour market for the first time or after a certain pause. On average for the year the rate of unemployment is forecast to reach 6.8% of the labour force and could by the end of the year be even higher.

Policy issues for the Community

In view of the unsatisfactory prospects for output and unemployment and the forecast of a deceleration in the inflation rate is there any room for a loosening of either monetary or budgetary policies? There is little doubt that the rather tight monetary conditions of the recent past have, in conjunction with domestic cost developments, had an initially depressing effect on activity in the Community, both through higher interest rates and through exchange-rate movements (for the Community as a whole and, more acutely, for certain Member States). However, given the imperative of reducing the rate of inflation in order to restore a platform for stability and medium-term growth, the argument for maintaining the present stance of monetary policies is a strong one. To abandon this would threaten not only to prevent a reduction of the average inflation rate in the Community but also to further widen divergences and to endanger the stability of the EMS. Further, the greater willingness of the private sector, as compared with 1974/75, to reduce (or at least not to increase) their rate of accumulation of financial assets may be linked to a reduced degree of uncertainty and an increased degree of confidence about medium-term stability; this development itself is very likely to have been influenced by the evident determination of the authorities in Member States to avoid feeding an inflationary spiral.

In addition, there are several constraints upon the use of budgetary relaxation aimed at eliminating or limiting the recession under the present circumstances. First, to the extent that the recession in the Community is due to the impact on activity and world trade of the restrictive monetary and fiscal policies in non-EC countries, discretionary budgetary measures aimed at offsetting such an impact cannot be taken in the Community without leading to an additional increase in the current balance of payment deficit. Second, a part of the recession is attributable not to a shortfall

in demand but to a loss of markets to non-EC exporters. In this case stimulatory measures would tend to leak heavily into imports. Moreover, due to the high marginal import propensity the impact on activity would be small and the loss of fiscal revenue too large to be acceptable. In both cases, even if the authorities were prepared to accept the higher budget deficits and the deterioration of the balance of payments, the chances are that the additional borrowing requirements would be covered only at increased rates of interest.

Thus, the conditions for discretionary budget action (which in some countries, of course, would mean a slowing of the rate of reduction of persistent and unacceptably large public sector deficits) in response to the initial oil-shock are not favourable. There might, however, still be a role for budgetary policy in offsetting the worsening of the recession which might result from private sector attempts to build up their holdings of financial assets such as occurred in 1975. As has been explained above, the present forecasts of the Commission do not envisage such a reaction on the part of the private sector within the Community as a whole, for reasons set out in Chapter 1 and 4. The possibility of a certain stepping up of private sector financial asset accumulation, however, cannot be ruled out and it may be appropriate to consider the policy options of the Community under this assumption.

There is only little information available on short-term developments in household incomes and expenditure in the Community and it is therefore impossible at present to provide more than qualified guesses with respect to the current situation in this field. According to the survey of consumer opinion made in May 1980 (1) the fall in consumer confidence between May 1979 and January 1980 had been brought to a halt: consumers in May 1980 on the whole did not expect their financial situation to deteriorate as much as in January and were somewhat less pessimistic with respect to the general economic situation. All in the consumer opinions in May 1980, however, appeared no more optimistic than on average for 1974 except as far as savings were concerned: both with respect to present savings and to savings over the next twelve months opinions in May 1980 were more favourable than on average for 1974.

(1) "European Economy" Supplement Series C, "Economic Prospects - Consumer Survey Results", No 2, July 1980.

Any conclusion drawn on the basis of this survey with respect to prospects for actual saving of households over the remainder of 1980 and 1981 must necessarily be tentative and provisional. On balance there might, however, appear to be some reason to expect the 1974/75 pattern to be repeated but with a considerably smaller amplitude. This would imply that the fall in the savings ratio which is likely to have occurred in the first months of 1980 could, under certain conditions, be expected to be followed by a return to levels close to those experienced in 1975/76.

The central economic forecast by the Commission's staff as outlined above assumes that the savings ratio of households declines somewhat (0.6 points) between 1979 and 1980 and rises by 0.3 points in 1981. If, instead, the savings ratio of households after the temporary decline in late 1979 and early 1980, as suggested above, rose far above the level of 1979, private consumption could hardly be expected to recover as early as suggested in the central forecasts and the recession could become both deeper and longer than expected in September. For instance, if as a result of higher-than-assumed savings, consumer spending were 1% lower than in the central forecast from the second half of 1980 onwards, GDP in the Community could by the middle of 1981 be about 1% lower than in the central forecast and output would be lower in the second half of 1981 than in the first half of 1980. The higher household savings ratio would have as a counterpart partly a lower current external deficit and partly a higher general government budget deficit, resulting from a short-fall of tax receipts and additional expenditure in the form of unemployment allowances. Despite the higher budget deficit, short and long term interest rates would, however, be lower than in central scenario. Thus the higher government borrowing requirement resulting from the operation of the automatic stabilizers would not make it harder or more expensive for private borrowers to find finance and would therefore not reduce private expenditure. However, the governments in some Member States have undertaken general commitments to keep the budget deficit below certain limits as a proportion of GDP, and even without a specific commitment governments are aiming at a gradual reduction of the rate of increase of nominal public debt. The possibility that budgetary policy would be tightened in response to the rise in household

savings could therefore not be altogether excluded. The combined deflationary impact of an increase in household savings and budgetary measures to keep the government borrowing requirement from rising would lead to a very considerable short-fall of GDP and to much higher unemployment than in the central forecast. On the whole it can be argued that in order to avoid a major loss of output, governments would be more or less obliged to accept, at least in the short term, the increase in the budget deficit resulting from the change in savings/expenditure behaviour of households.

It would be more difficult to advise, however, that budgetary policy should not only accept the induced increase in the budget deficit but go further and try to fully offset the deflationary impact of the rise in household savings through discretionary measures such as a tax reduction or an additional increase in public expenditure. The timing of such measures would be a key issue. While a certain activation of budgetary policy, if taken at a very early date in the cyclical process, might be beneficial for activity and employment and lead to only a marginal increase in the budget deficit the negative aspects of such measures would be larger if taken when the economy is already approaching a cyclical up-turn.

In practice it is difficult to bring about an activation of budgetary policy at a sufficiently early stage in a cyclical downswing to bring the decline to a halt one or two quarters earlier than would otherwise be the case. First, despite continuous improvement of the quality and availability of statistical data, a clear picture of the conjunctural situation can be obtained only with a delay of several months or in some cases several quarters. Second, even when data on cyclical developments are available the preparation and implementation of policy measures take time and, furthermore, such measures as might be introduced will often take effect only gradually over several months or with an even longer delay. Given that perfect foresight is impossible, discretionary budgetary measures might therefore have their main impact on activity at a time when the economy is already pulling out of the recession and thus on the whole accentuate rather than dampen the cycle.

This might well be the case if general stimulatory measures, for instance a tax reduction, were taken in Member States in early 1981 in response to the slowdown which has been under way since the second quarter of 1980. By the time such measures would have effect, the bottom of the cycle might have been reached and there would be a risk that the measures would stimulate price increases and imports rather than domestic activity.

Whether or not private sector income/expenditure behaviour does develop as in the central forecast, it is clear that the reaction of interest rates and investment expenditure is a key factor which may determine the speed and profile of the move out of recession. The analysis of sectoral financial balances and the loss in wealth due to inflation (Chapter 4 above) suggests that a close relationship exists between inflation and household savings and that, in particular, interest payments on public debt in some Member States are to some extent considered by the private sector as a compensation for the loss in wealth due to inflation rather than a unilateral transfer from the public sector. Although it would be premature to argue that a reduction of the rate of inflation in the Community would exert an expansionary impact upon demand, there are strong reasons to argue that a lowering of the rate of inflation is a necessary condition for a reduction of the household savings ratio which in the longer run would favour a return to a lower government budget deficit.

These findings therefore shed new light on the apparently contradictory economic performance of the various Member States and also have important implications for the choice of policy guidelines for the Community as a whole as well as for policies aimed at increasing the degree of convergence within this entity.

First, Member States which manage to permanently and convincingly reduce the rate of inflation can expect a certain cyclical "payback" from the stimulus to activity resulting from a higher propensity to consume out of current income.

Second, the "trade-off" between inflation and unemployment is considerably weakened by a positive correlation between inflation and savings. This correlation indeed explains why in a high-inflation Member State like Italy unemployment remains high and demand pressure (apart from temporary bouts of strength) so low, even with very high and increasing budget deficits.

Third, adjustment policies involving exchange rate depreciation in order to offset domestic cost increases may substantially depress domestic demand to the extent that they lead to a further acceleration of inflation. Policies aimed at breaking the inflationary spiral through appropriate monetary and budgetary policy measures may therefore be less deflationary than normally thought. The positive demand effects of maintaining competitiveness through moderation of domestic costs rather than through a weaker currency may indeed be part of the explanation of the strong growth performance of the German economy in past decades.

In sum, the benefits which a single country may reap from an "autonomous" orientation of macro-economic policy may be very limited indeed and are likely to be very short-lived. Member States, notably Italy and the United Kingdom, where large exchange rate depreciations have occurred from time to time have in the period immediately after the depreciation experienced a sharp drop in the labour income ratio, followed however by compensatory wage increases and a subsequent new decline in the profit share. Policies aimed at convergence through achieving realistic wage and price determination combined with appropriate domestic monetary and budgetary measures are on the other hand likely to present considerable advantages in the long run. Cases in point are the Benelux countries and notably Belgium where a gradual improvement of the cost and price performance is under way supported by a tight monetary policy and exchange rate stability. At the same time the speed of the more or less unrestrained appreciation of the United Kingdom exchange rate has called for a particularly rapid improvement in domestic cost conditions. The European Monetary System provides the institutional framework within which coordinated stabilisation policies may be implemented and therefore constitutes a key element not only in exchange rate policies in the narrow sense but indeed in the whole macro-economic policy structure of the Community.

The preceding analysis of the macro-economic policy options on the whole suggests that it is preferable to set a medium-term course for budgetary and monetary policies. Although it cannot be excluded that budgetary policy has a role to play in medium-term economic policy there is a strong case against abrupt changes in policy orientation, particularly when the

automatic fiscal stabilizers are relatively strong as in most European countries. The operation of the automatic stabilizers will - if not offset by restrictive policy measures - provide a certain support to activity but cannot prevent a slowdown in a situation when strong external and internal forces exert a deflationary impact upon activity as in 1980.

The restricted freedom of manoeuvre available to Member States in the demand-management field to limit the appearance of recessionary conditions in no way implies an inevitable policy negativism. Indeed, it may help to concentrate the minds of policy-makers on measures to improve the working of the various markets in the economy which tend to be ignored at times when demand-management measures seem to be a more obvious option for policy activism. It is important, however, that any micro-economic (or "supply side") measures taken should be such as would be positive and worthwhile at any stage of the demand-cycle; while aimed at having an impact in combatting the unfavourable employment and the structural effects of recession, they should not be considered as specifically short-term anti-recession measures forced on policy-makers by the frustration of more conventional demand-management policy.

For example, actions in the field of energy demand and supply must have as their starting-point the need to loosen the energy constraint on the Community's medium-term growth prospects. Thus, recalling the energy policy objectives adopted by the Council in May 1980, at a time when an underlying growth assumption of 3 1/2% per annum was used, it is even more important now, when it seems likely that such a growth assumption may be rather high, to ensure that the targets for reducing energy-consumption are met. Similarly, investment in new sources of energy supply and in reducing energy consumption in industry, construction and households is a priority independent of cyclical considerations. The importance of energy investment may in fact necessitate a change in the pattern of overall spending and taxation (so as to favour such investment) in the Member States' budgets at the expense of such traditional anti-recession spending areas as subsidies to "crisis" industries and social transfers. Further, the existence of recessionary conditions should not deflect governments from seeing that increases in energy costs are passed on to users or from moving towards convergence rates taxation of energy at the level of the highest-rate Member States. In this respect it is particularly important that any softening in oil prices as a result of recession should not be allowed by governments to weaken the efforts of domestic sectors to economize on energy.

A second major target of micro-economic policy should be to facilitate the reversal of that decline in the proportion of income invested by the private sector which has taken place in most Member States since the 1970's. The long-term Commission strategy for corporation tax harmonization is helpful in this direction. It is also important to consider the effects of tax systems on the operation of financial markets in a wider context. The favoured tax treatment given to certain savings instruments (usually public debt instruments) and to certain forms of borrowing (to finance household sector purchase of dwellings, for instance) is clearly not consistent with the most efficient pattern of resource-allocation through the financial markets.

In the field of public investment, governments should consider establishing contingency plans for investment schemes which could be put into operation at short notice should the economic and budgetary circumstances become such as to call for increased public investment. At times in the past the capacity of certain Member States to absorb available investment funds has been limited by the absence of adequate forward planning.

Where product markets are concerned, it is in recessionary conditions (when pressures mount to extend barriers to competition, both internal and external) especially important to foster the improvement of competition and to facilitate the development of the Community market for new products. This could be done, for instance, through a more active use of Community competence to counter the emergence of technical or regulatory obstacles to free circulation of goods and through more active preventive use of the harmonization approach in the field of technical standards.

The 1980/81 downturn coincides with a relatively large - demographically determined - growth in the potential labour force. The formulation of a policy response to this widening of the disequilibrium between supply and demand for manpower is therefore a key policy issue for 1981. As in other areas of micro-economic policy, measures taken should nonetheless be desirable in themselves and retain their worth whatever the state of the cycle. Thus in the area of labour supply, for instance, as stressed in the

Council resolution of 18 December 1979 on the adaptation of working time, the formulation of a Community approach making for overall coherence and fostering consensus at Community level should be aimed at through consultations and contacts with representatives of employers and workers. Detailed guidelines for voluntary part-time work, for Community action in the field of temporary work and for flexible retirement have on this basis recently been put forward in communications from the Commission. The communication on flexible retirement, in particular, recalls that measures in this field could have a dampening impact upon the growth of labour supply in a period with persistent unemployment. Such measures would not, however, necessarily tend to create bottlenecks during an upturn.

Adaptation of those aspects of employment and social security legislation which prevent employers from taking as much advantage of the demand by potential workers for part-time jobs as they might otherwise do might be considered. An extension of part-time and shift work would improve the utilization of the existing capital stock and thereby increase the structural possibilities for employment. A stepping up of part-time work and early retirement would, however, hardly be sufficient to prevent an increase in unemployment in a situation when almost 3 million young people join the labour force annually in the Community. Possibilities of extended schooling, special training schemes and other measures to improve the professional qualifications of the young elements of the labour force could bring a favourable social return over a medium-term in which the Community will be looking to establish or maintain an international competitive advantage in skill and technology-intensive industries.

Table 10.1
World output, foreign trade and EC export markets

	1976		1977		1978		1979		1980		1981	
	I	II	I	II	I	II	I	II	I	II	I	II
	% change over previous period, seasonally adjusted annual rate											
GDP/GNP, OECD total	5,2	3,7	3,9	3,4	1,0	1,1	2,9	3,2	1,2	-1,6	1,5	3,1
Imports of goods (volume)												
World	11,5	5,0	5,5	6,6	2,7	1,9	4,7	8,1	1,8	-0,8	2,4	3,9
World excluding EEC	10,7	6,7	5,1	4,5	2,6	2,5	2,0	7,5	1,2	0,4	2,8	4,4
of which:												
OECD excluding EEC	12,9	6,8	5,1	6,8	-1,8	0,5	7,6	3,8	-3,9	-3,3	1,3	3,2
OPEC	19,5	14,6	5,3	-12,0	20,0	15,0	-30,0	26,0	20,0	14,8	15,0	15,5
Other developing countries	5,0	6,6	7,5	7,5	4,0	1,5	4,0	9,2	3,0	1,0	1,0	3,0
Other countries	1,0	1,1	2,2	4,0	2,4	2,0	3,5	4,0	2,0	1,5	2,0	2,5
EC Export markets ¹												
Intra markets	13,4	4,1	6,2	10,4	2,6	1,0						
Extra markets	9,6	5,4	4,5	4,0	4,7	3,3						
Total	11,6	4,7	5,4	7,4	3,6	2,0						
Exports of goods, EC total ²	10,8	5,2	5,2	6,6	3,5	2,1						

¹ Imports to the various markets weighted together according to their share in EC exports (goods).

² Including intra-EC trade.

Source: Estimates and forecasts by the Commission staff.

Table 10.2

Balance of payments on current account (000 million dollars)

		1976		1977		1978		1979		1980		1981	
		I	II	I	II	I	II	I	II	I	II	I	II
EC		-5,5	2,5	17,1	-13,1	-43,1	-36,2	5,4	-20,8	-45,2	-40,9	-38,3	-33,9
USA		4,6	-14,1	-13,5	-0,3	-2,0	5,5	-1,0	0,4	-9,0	5,0	6,0	5,0
Canada		-3,9	-4,0	-4,6	-4,3	-4,8	-4,6	-4,9	-3,6	-3,7	-5,9	-5,3	-3,9
Japan		3,7	10,9	16,5	-8,8	-14,4	-8,0	-0,8	-16,7	-16,6	-12,2	-7,0	-9,0
Other OECD		-17,7	-20,0	-5,2	-8,2	-20,0	-22,0	-5,6	-10,8	-28,5	-19,5	-21,0	-23,0
OECD, total		-18,8	-24,7	10,3	-34,7	-84,3	-65,3	-6,9	-51,5	-103,0	-73,5	-65,6	-64,8
OPEC		36,5	29,0	4,5	68,0	119,0	110,0						
Other developing countries		-25,4	-20,6	-28,7	-43,0	-60,0	-63,0						
Other countries		-10,0	-7,0	-12,0	-18,0	-16,5	-18,0						
World (1)		-17,7	-23,3	-25,9	-27,7	-41,8	-36,3						

seasonally adjusted annual rate

(1) Errors and omissions.

Source: Estimates and forecasts by Commission staff.

Table 10.3

Trends in disposable household incomes and savings, EC total, 1975-80.

	1975	1976	1977	1978	1979	1980 forecast	1981 forecast
	(% change on previous year) ¹						
Compensation of employees	13,8	12,7	10,9	10,1	12,4	13,2	10,3
Compensation per employee	14,1	12,9	10,8	9,8	11,4	13,1	10,3
Other household incomes	11,5	13,3	15,0	11,4	13,6	14,3	11,7
Current transfers received	28,6	14,4	6,0	13,8	10,7	13,0	12,1
Direct taxes	14,2	18,0	9,1	10,6	10,6	16,5	10,8
Current transfers paid	17,5	16,6	11,0	7,6	12,6	12,3	10,1
Disposable household income ²	15,2	12,1	9,9	11,3	12,5	13,2	11,3
Real disposable household income ³	2,0	1,8	0,2	3,9	3,2	1,1	1,0
Real private consumption	2,6	3,8	2,1	3,7	3,6	1,8	0,9
Savings ratio ⁴	19,4	18,0	16,8	16,8	17,1	16,5	16,8

¹ Except for saving ratio.

² Incomes \pm transfers - direct taxes.

³ Disposable household income deflated by implicit price of consumers' expenditure.

⁴ Disposable household income - private consumption as % of disposable household income.

Note: average weighted with 1979 exchange rates.

Source: Eurostat and Commission staff.

Table 10.4
Demand, output and external balance, EC total.

	1976	1977	1978	1979	1980	1981	1979		1980		1981		
				esti- mate	1980 forecast		II	I	II	I	II	I	II
% change at 1975 prices (annual rates)													
Private consumption	3,8	2,1	3,7	3,6	1,8	0,9	1,3	3,0	-0,1	1,0	1,9	1,0	1,9
Public consumption	2,7	1,1	3,5	2,7	2,0	1,3	1,6	2,9	0,3	1,7	1,9	1,7	1,9
Gross fixed investment	3,3	0,9	2,8	3,8	2,1	-1,0	11,7	0,6	-2,9	-0,9	1,0	-0,9	1,0
Stockbuilding ¹	1,3	1,1	0,8	1,7	1,0	0,7	2,0	1,3	0,6	0,6	0,7	0,6	0,7
Final domestic demand	5,4	1,6	3,3	4,6	1,1	0,3	4,5	1,2	-2,4	1,0	2,1	1,0	2,1
Exports ²	10,8	5,2	4,9	5,9	3,5	1,9	6,5	5,1	-2,3	3,2	4,9	3,2	4,9
Imports ²	12,6	2,2	5,6	10,3	2,9	0,7	9,3	3,3	-3,0	1,6	2,8	1,6	2,8
Gross domestic product at market prices	5,0	2,3	3,0	3,4	1,3	0,6	3,5	2,0	-1,9	1,2	2,3	1,2	2,3
Industrial production	7,4	2,4	2,3	4,7	0,9	0,2	4,8	1,0	-3,2	1,1	2,3	1,1	2,3
Unemployment rate ³	4,9	5,3	5,5	5,6	6,0	6,8	5,6	5,7	6,3	6,6	6,8	6,6	6,8
as % of GDP													
Trade balance (fob/cif)	-1,3	-0,6	-0,1	-1,6	-2,5	-2,1	-2,1	-2,7	-2,3	-2,1	-2,0	-2,1	-2,0
Current balance	-0,5	0,2	0,8	-0,5	-1,5	-1,2	-0,8	-1,7	-1,5	-1,3	-1,1	-1,3	-1,1

1 As % of GDP.
 2 Goods and services.
 3 Unemployment as % of civilian active population.
 4 Average change over the period indicated.

Source: Eurostat and Commission staff.