

SEC(82) 1703

ANNUAL ECONOMIC REVIEW 1982 - 83

Commission staff paper

(Document submitted for information to
the Council, the Economic and Social
Committee and to the Parliament together
with the Annual Economic Report 1982 - 83)

Contents

1. Introduction and a reappraisal of policy issues
2. Economic outlook in the short and medium-term
3. Balance of payments
4. Prices and costs
5. Monetary policy and EMS
6. Budgetary policy
7. Labour market
8. Capital markets
9. Energy
10. External trade and competitiveness

1. Summary and a reappraisal of policy issues.

The Annual Economic Review 1982-83 presents a detailed study of the Community's economic situation as 1983 approaches; the document is organized around the major areas of macroeconomic analysis, discusses in turn and in depth the short-term and medium-term overall macroeconomic outlook, the balance of payments, prices and costs, monetary and exchange-rate policies, budgetary policies and employment. Special attention is paid to the problems of energy use and supply, and trends in the Community's external trade and structural competitiveness.

Faced with the still deepening problem of stagflation in the European economy the present chapter concludes with some brief reflections on the fundamental design of economic policy. The question is raised, in particular, whether a greater degree of consistency between monetary and budgetary policy as well as a clearer distribution of responsibility for macro-economic decision making could be obtained by attaching more importance to the growth of nominal GDP as a final objective for economic policy. According to this view, financial policies would be directed to controlling the evolution of nominal gross domestic product, whereas real wage adjustments and supply side policies would be principally responsible for the level of employment and productivity.

1.1 A short review of European economic performance and policies

The Community economy has continued to perform weakly in 1982, frustrating earlier hopes of a significant upturn in activity by mid-year and of a stabilization of unemployment by the end of the year. The persistence of high interest rates during most of 1982 has added to the uncertainty about the timing and strength of the upturn both in the Community and in other industrialized countries. The prospects for such an upturn are discussed in Chapter 2, where it is suggested, on the basis both of shortterm econometric forecasts and leading indicators, that a modest recovery may not get under way before the second half of 1983. A medium-term projection presented in Chapter 2 suggests that it will not be easy for the Community to break out of its slow growth pattern typical of the last decade.

1.2

A relatively encouraging aspect of Community performance in 1981 and 1982 has been the shifting of a substantial proportion of incremental output into net exports in reaction to the second oil-shock. This development, which, despite a further small terms-of-trade loss in 1982, is likely to have reduced the Community's current account deficit considerably this year is analysed in Chapter 3. That Chapter also shows that the deficits of recent years have transformed the Community's investment income account from surplus to deficit and that there have been net outflows of private long-term capital. The combined deficit on current and private long-term capital accounts has been financed mainly by a large net inflow of private short-term capital, much of it originating from oil-exporting countries.

The disinflation process in the Community has continued in 1982. The slowdown in the rate of increase of consumer prices gathered force, helped by sharp falls in the dollar prices of commodities. Domestic reaction to the oil-price and dollar shocks in the three years from 1979, when the overall import price rise was similar to that recorded in 1973/74, have so far been quite muted, although a greater convergence of performance between countries is taking longer to come about. The reasons behind these developments are analysed in Chapter 4, where the progress of income-adjustment, gradually proceeding but still needing to be carried further, is also discussed.

1982 has been a particularly eventful year in the area of exchange rates, interest rates and monetary policies. The growth of the money supply in the Community has probably decelerated through 1982, for the third successive year, but the deceleration is this time very modest. This degree of success in controlling the expansion of the monetary aggregates has helped the Community to avoid an explosion of inflation after the second oil-price shock. Real interest rates have remained very high during 1982, but European nominal rates have not displayed such strong volatility as those in the United States; in consequence there have been marked fluctuations in the dollar's exchange rate against European currencies. Within the European Monetary System (EMS) there have been three realignments in the period since October 1981, making it the most turbulent in the history of the System. A detailed discussion of monetary, interest rate and

exchange rate developments is contained in Chapter 5, where there is also an analysis of the conditions necessary for a lasting reduction in real interest rates and for the success of the EMS realignments and a return to greater stability within the system.

Budgetary policy in the Community as a whole has, taking account of the weakness of activity, again been restrictive in 1982 and the budget deficit, , on average for the Community, has widened marginally. The continued growth of government receipts and expenditure relative to GDP, the size of budget deficits, the growth of public debt and the burden of financing it are becoming more and more worrying in several Member States. Budgetary developments are discussed in Chapter 6, where special attention is devoted to the interaction between inflation, public debt and budget deficits.

Unemployment has continued to grow rapidly in 1982 and, as yet, shows no signs of stabilizing. Chapter 7 examines in some detail the underlying weak employment growth and strong labour force growth. The Community's experience is contrasted with the more favorable trends in the United States and Japan, and a partial explanation is sought in terms of the various measures of real wage positions which are presented in the Chapter.

An important, and growing, influence on the Community economy in recent years has been the increased degree of integration of financial markets. This increased integration has come about not so much as a result of the achievement of the original goal of the Community's member countries to build a free and integrated capital market by breaking down controls and restrictions but rather through the development of private Euro-currency markets. The growth of Euro-currency markets is described and its implications are analysed in Chapter 8, where it is argued that national monetary policy is inevitably constrained by capital mobility and efficiently functioning capital markets, irrespective of the exchange rate regime.

1.4

An important question concerns the Community's ability to economize in its use of energy and to diversify its sources of energy supply. Despite recent falls both in energy prices and in the Community's consumption of energy there is still insufficient coherence of energy-price and energy-investment policies in the Community to secure the degree of adjustment which is still required. Chapter 9 brings out the problems and concludes that the highest priority should be given to the implementation of a Community energy strategy.

Changes in the energy market have been part of a wider process of change in patterns of world trade and comparative advantage. A feature of the changing pattern, in which the growth of the newly-industrialized countries has been a major factor, has been a very rapid increase in import penetration of the Community's domestic markets, particularly for investment goods. Chapter 10 looks at these trends and argues that a lack of dynamism in investment in the Community and thus a sluggishness in the adaptation of the productive structure to changing demands are at their root.

1.2 A reappraisal of policy issues.

It is clear that far-reaching improvements are needed in the basic performance of the European economy, and it may be suspected equally fundamental progress also needs to be made in the conception of economic policy in the European economy taken as a whole.

Graph 1.1 and Table 1.1 illustrate how the European economy has been sliding progressively into a worsening economic performance since 1973. The growth of gross domestic product in nominal terms (in short: nominal GDP) has been faster than during the 1960-73 period but the split of this aggregate between inflation and real output has become progressively more unfavourable. The averages over these rather long periods, however, to some extent conceal the fact the the tendency for the trade off between inflation and real growth to worsen started already in the late 'sixties with the rise in the GDP deflator accelerating from a low of 2.3 % in 1967 to 7.7 % in 1973, the last year before the first oil crisis.

The acceleration of inflation was to some extent a consequence of the monetary expansion which occurred in the OECD area as a whole during most of the 'sixties. As shown in Table 1.1 the annual growth of money supply in the Community exceeded by 2 percentage points the growth of nominal GDP in the period 1960-73, entailing thus a gradual increase in the liquidity ratio of the Community. The economic expansion in the 'sixties was thus initially quite painless as interest rates were relatively low in proportion to the growth of nominal GDP (see Graph 1.3). But the resulting increase in the liquidity ratio must have contributed importantly to the more substantial boost to inflation and the financial disturbances met in the 'seventies, when the growth of nominal GDP gradually caught up with the growth of money supply while the real performance worsened considerably. In 1981 and 1982 money supply growth has fallen below the growth of nominal GDP and interest rates increased to record high levels both in the Community and in the United States.

The years from 1960 to 1973, however, saw not only a gradual building up of liquidity in the Community but also a considerable increase in the part of gross domestic product allocated through the public sector. Accumulated over the whole period, the share of public expenditure in GDP rose 7,7 % points and taxation 6,4 % points (Table 1.1 and Graph 1.2). The overall split between consumption and investment was nevertheless favorable with the former falling by 1,8 % points and the latter increasing by 2,2 % points its share in GDP.

A large aggravation of overall resource allocation took place during the subsequent seven years (1973-80) with public expenditure and taxes growing further in excess of GDP while the growth of investment fell considerably short of GDP and the profitability of enterprises saw a large deterioration with the labour income share (real wage gap) increasing by 3,3 % points.

Apart from a certain restoration of profit margins in the following two years when the labour income share fell 1 point, the allocation of resources became even more biased in favour of consumption. The investment ratio in 1982 fell to the lowest level in the Community's history.

The present relation between the current and prospective growth of nominal GDP, monetary expansion and the level of interest rates are at the core of the present policy dilemma facing the Community; the ways in which this dilemma is resolved may determine economic trends for a long time ahead.

A pronounced reduction in the level of interest rates relative to the growth of nominal GDP is, at present, a necessary condition for a revival of the Community economy. With prospects of a real rate of growth of only about 1 % and with the GDP deflator likely to increase by less than 9% in 1983, long term interest rates substantially above 10 % on average for the Community are not sustainable. But the level of interest rates is not exclusively determined by monetary policy in the Community. Interest rates in the international capital markets, present and prospective government borrowing requirements, and -more generally - the appreciation of international financial markets of the resolve of the Community to dampen inflation exert a strong impact upon the exchange rates and thus upon the strength of the external constraint in the conduct of monetary policy.

A discretionary relaxation of monetary policy in the Community might perhaps temporarily help to bring interest rates down to low levels and thereby ease the financial constraints on some firms and countries. But an expansion of money supply over and above the already fast rate of 10-11 % currently foreseen for 1983 would not eliminate the fundamental

causes of the present European weaknesses and could, in particular, be expected to be accompanied by an increase both in actual inflation and in the expected rate of inflation. The risk of building up a new wave of inflation - but from a much higher starting level than in the late 'sixties - would be considerable.

It is therefore essential that a reduction of nominal interest rates be brought about in the first instance through a substantial reduction in inflation expectations. This will require, first an adjustment of real wages leading to a decline in the labour income ratio, second a slowdown in domestic cost inflation and, third a lowering of government borrowing requirement in countries where this has become so large as to entail an unsustainable increase in public debt - (the latter clearly constitutes a risk of acceleration in inflation in the future).

With respect to the policy guidelines for 1983 the main issue would therefore now seem to be related to the reaction of monetary and budgetary policy to the downward revision of the forecast growth of nominal GDP for that year (thus from 12.1 % according to the May/June forecasts by the Commission services to 10 % according to the most recent revised forecasts; also bearing in mind the downward revision of the estimates for 1982).

The question is whether monetary and budgetary targets should be revised downward to accommodate the lower GDP figure. This would involve a risk: a downward adjustment of the norms for the monetary expansion and attempts to effect further cuts in the growth of public expenditure might increase the risk of a prolonged stagnation or even further declines in output, as the financial constraints will be strongly reflected in cuts in private investment. The maintenance of the growth of money supply considerably above 10 % for the Community as a whole and with budgetary aggregates equally geared to a GDP growth somewhat above the present forecasts would on the other hand create the risk of a revival of inflation expectations and of an aggravation of financial disequilibria if activity failed to recover in subsequent years.

1.8

It might perhaps be argued that at present the risk of a continued stagnation is larger than the risk of rekindling inflation. But the effectiveness of a policy of combatting this risk of stagnation with a certain reduction of interest rates would be considerably increased if it were combined with a social consensus to moderate the rise in wage costs. In practical terms this would for example require that the total wage bill in the economy would have to increase somewhat less than the growth of nominal GDP and that the two sides of industry accepted to negotiate wage increases within this ceiling with sufficient margin to allow an increase in employment, taking account of the expected increase in productivity.

While the fixing of general guidelines for monetary and budgetary aggregates and wage bill for the Community would seem to be an indispensable first step in the design of policies for 1983 and beyond, the translation of these Community averages into guidelines for the individual Member states clearly adds a further dimension to the policy issues. The differentiation of targets within the Community must take account of the need to reduce the divergence within the EMS through a more than proportionate adjustment effort by the countries with serious balance of payments problem and/or high rates of inflation.

Overall the policy-mix in the Community for the period ahead may best be managed in the framework of a clear assignment of policy instruments, and of responsibilities of the main actors (government, central banks, the social partners) for the final objectives of economic policy. Implicit in the foregoing summary is the view that financial policies (monetary, and the budget balance) should, and can realistically be addressed primarily to achieving a given trajectory for nominal GDP. This will already heavily constrain the inflation rate, but it still leaves open the ultimate split between inflation and real economic activity (output, productivity and employment) within the nominal GDP aggregate. To obtain favourable results for real economic activity, reliance has to be placed on income behaviour (be it guided by an 'incomes policy' or not), and on supply-side policies.

The income behaviour of the social partners has to be recognised as the key to the employment objectives of society, given that government and the central bank cannot be expected to go further in demand support than in financing a particular nominal GDP evolution - which in many countries should be a decelerating one. Supply-side policies (contained in public expenditure, taxation and regulatory policies) will primarily influence investment and productivity trends, and so also employment.

1.10

Table 1.1

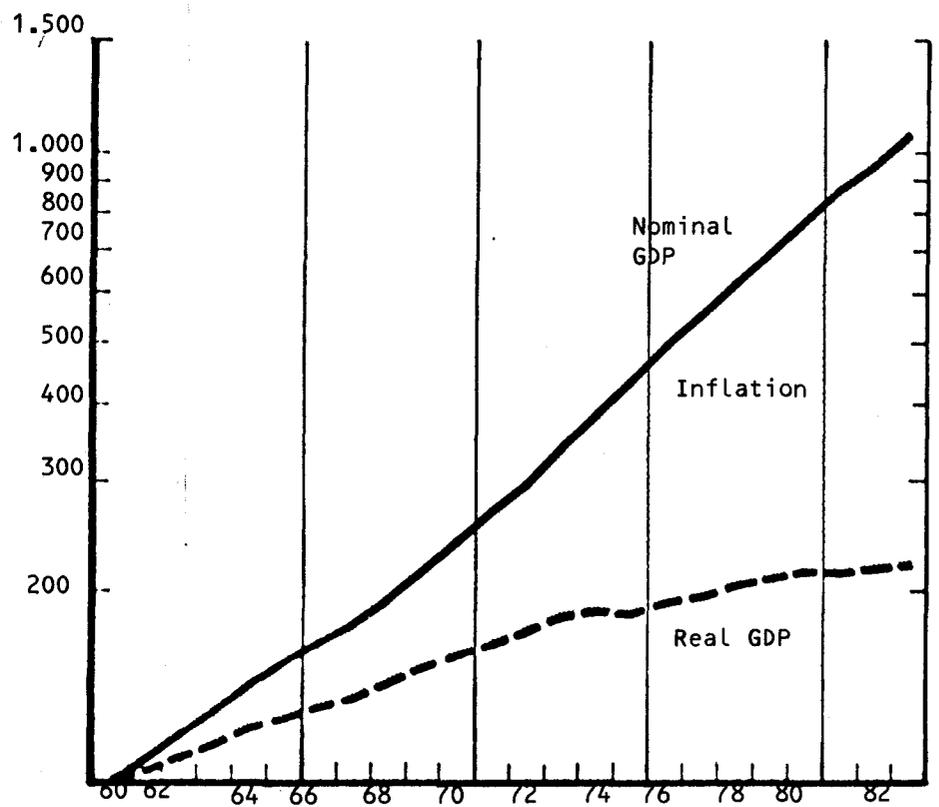
Nominal GDP in the European Community: its components and determinants, and influences on real economic performance

	1960-73	1973-80	1980-82	1983
	(annual average growth rate)			
<u>Components of nominal GDP:</u>				
1. inflation (GDP deflator)	5,0	10,8	10,6	8,8
2. real output (GDP volume)	4,6	2,2	- 0,1	1,1
3. nominal GDP (GDP value: 1 x 2)	9,9	13,3	10,5	10,0
<u>Primary determinants of nominal GDP:</u>				
4. money supply	11,8	12,6	10,6	10,2
<u>Influences on real economic performance within nominal GDP:</u>				
	(cumulated over whole period)			
5. public expenditure (1)	+ 7,7	+ 7,3	+ 3,7	+ 0,7
6. taxation (1)	+ 6,4	+ 4,5	+ 2,2	+ 0,8
7. real wage gap (excess over 'warranted' level (2))	- 0,2	+ 3,3	- 0,2	- 2,3
8. consumption (1)	- 1,8	+ 3,5	+ 2,6	- 0,2
9. investment (1)	+ 2,2	- 1,6	- 2,3	- 0,2

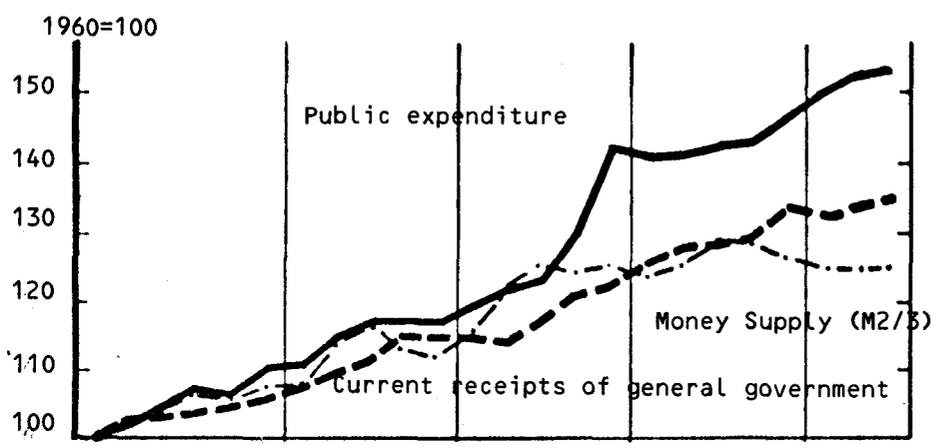
(1) % points change in the ratio to GDP

(2) the 'warranted' real wage is that which would leave the profit share of the enterprise sector unchanged (see Technical Annex for methodological details).

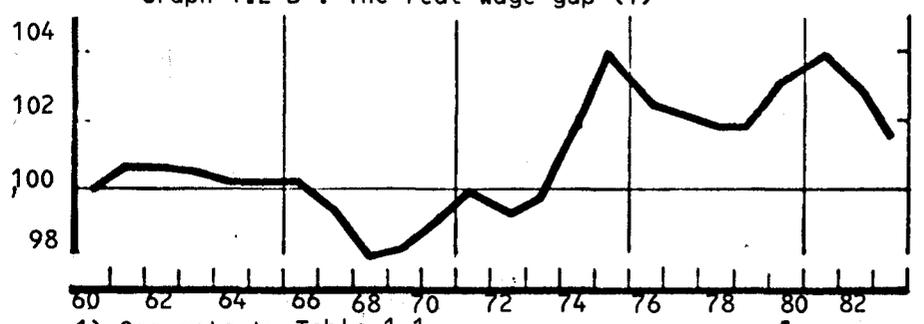
Graph 1.1 : Nominal GDP and its split between real output and inflation (EC total)



Graph 1.2 A: Public expenditure and receipts and money supply in proportion to GDP (1960 = 100)



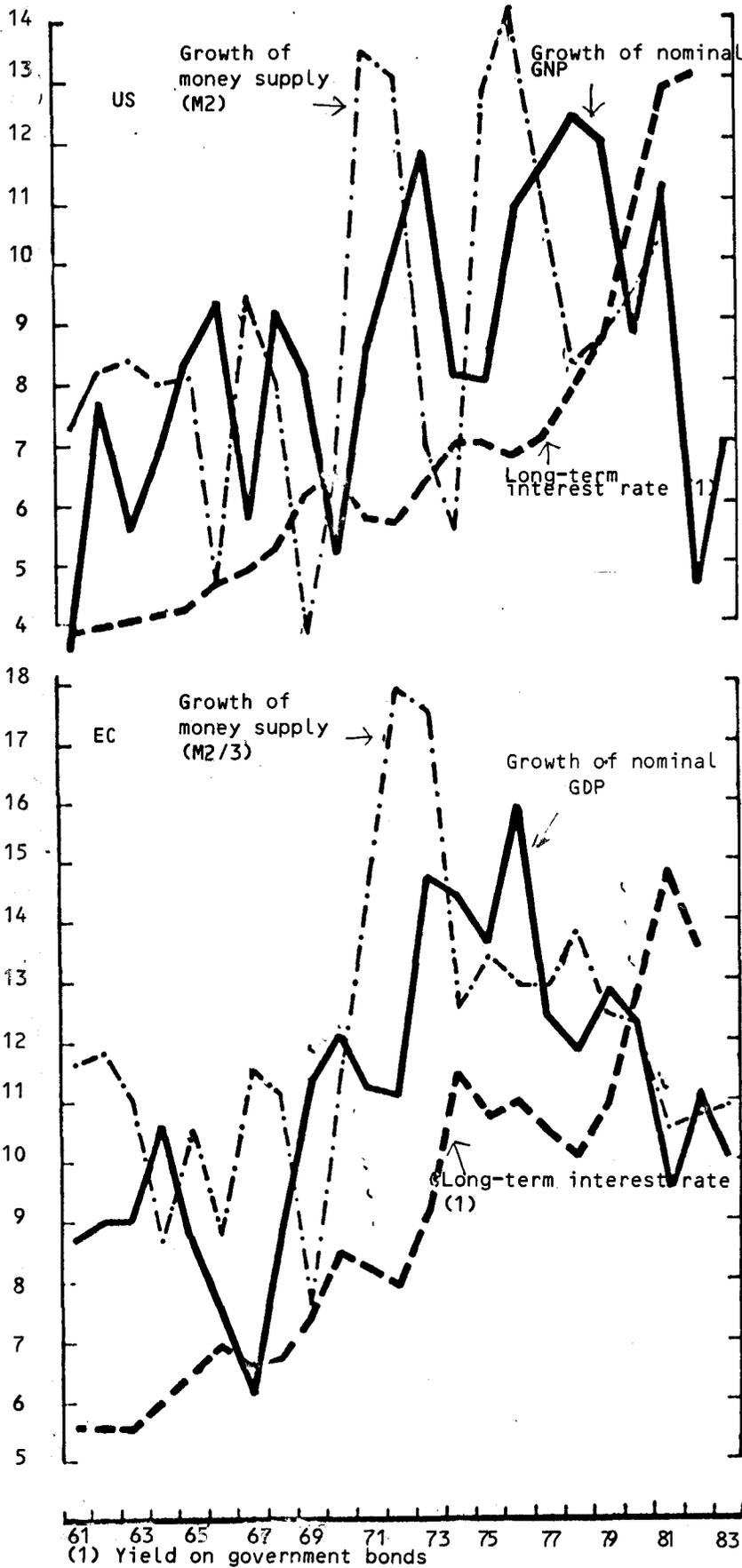
Graph 1.2 B : The real wage gap (1)



1) See note to Table 1.1

1.12

GRAPH 1.3 Interest rates, monetary expansion and growth of GDP



2. Economic outlook in the short and medium term

The world recession which started in 1980 has been very long, but a sluggish recovery in activity may at last get under way towards the end of 1982. The volume of world trade has stagnated during the recession and the rise of 2,1% expected for 1983 is modest by the standards of previous upturns. The weakness of oil imports and prices has led to a rapid adjustment of the balance of payments imbalances caused by the oil price rises of 1979-80, and this adjustment process is likely to continue into 1983. In the Community a period of essentially flat output gave way to renewed falls in the middle of 1982; any recovery now seems likely to be delayed until early in 1983, and in any case the pace of recovery is expected to be very gradual. Community GDP is forecast to rise by only 0,3% in 1982 and 1,1% in 1983. The persistence of very high interest rates (although they have fallen a little since August) has added to the uncertainty about the timing and strength of the upturn both in the Community and in other industrialised countries. Further progress is being made on containing inflation, but the number of unemployed continues to rise to very disturbing levels. The Community's current account deficit should move somewhat closer towards balance this year and next. Medium-term prospects for growth in the Community beyond the usual short-term forecasting horizon are analysed.

2.1 The international environment

The recession in world economic activity which began early in 1980 has been more prolonged than originally expected. The persistence of high real interest rates and weakness in all the main components of demand have everywhere delayed the upturn in activity which usually follows the onset of a fall in output within a period of about eighteen months. In the USA an initial revival of output in the second half of 1980 and early in 1981 gave way to renewed sharp falls in output during the remainder of 1981 and into 1982. In Japan domestic demand has remained very weak, and real growth in GNP, at a rate much lower than experienced in the past, was only achieved in 1981 due to a strong export performance. In the countries of Europe, both within and outside the Community, output has been stagnant almost everywhere since the Autumn of 1980, with industrial production flat on average and with at best only marginal additions to GDP.

Accompanying the depressed level of output in the industrialised countries there have been gains on the inflation front but no end to the worsening picture for unemployment. Thanks mainly to the weakness of dollar prices of basic materials, notably oil, and to some restraint in wage settlements, inflation rates in the OECD countries have slowed markedly. Consumer prices in OECD countries as a whole rose by 8,1% in the twelve months to July 1982 compared with year-on-year increases of 12,9% and 10,6% in 1980 and 1981 respectively. Particularly sharp reductions have occurred in the USA and Japan

2.2

and in Germany and the United Kingdom. On the other hand, unemployment has continued to rise everywhere. The number of unemployed in the OECD area as a whole reached over 30 million in the middle of 1982 compared with some 20 million at the end of 1979 just before the recession began.

The latest indicators suggest that the fall in output in the USA may have come to an end in the Summer of 1982. There, and in the other industrialised countries outside the Community, a slow recovery in output is foreseen for the second half of this year, although considerable uncertainties remain about the precise timing and strength of the upturn. This revival should become more solid and more widely based during 1983. The fall in interest rates which started in August, if maintained, should help to lessen one of the dampening influences which has held back recovery. The latest Commission forecasts of real GDP/GNP growth in the OECD area as a whole show no rise in 1982 compared with an increase of 1,1% in 1981. The gradually strengthening but slow recovery from towards the end of this year should result in a growth rate of some 1,8% in 1983 (see Table 2.1).

The volume of world trade has been depressed during the recession. A stronger development in the second half of 1981 was followed by renewed weakness in the first half of 1982, due to falls in imports both by OECD countries outside the Community, especially in North America, and by countries in the other world zones. Falling oil revenues and fast-shrinking current account surpluses for the OPEC countries mean a sharp cut-back in their imports during this year following two years of rapid expansion. The non-oil-producing developing countries face declining export revenues and increasingly severe financial constraints and are also being forced into substantial import reductions. The 'other' countries, which include the centrally planned economies, are also expected to have negative import growth this year. In the second half of 1982 the volume of world trade is expected to fall again even more sharply than in the first half, since in addition to weakness elsewhere Community imports (which showed some growth in the first half) are declining once more. In 1982 as a whole the total volume of world imports is likely to fall by 1%, and imports by the world outside the Community will be even weaker, falling by almost 3% (see Table 2.1).

In 1983 the prospects are for a very slow and gradual strengthening of world trade. Imports by OPEC and the non-oil developing countries remain very weak, at least during the first half of the year, but as the year progresses there should be a gradual acceleration in imports almost everywhere as the recovery in activity becomes more firmly established.

The figures for total world trade have continued to be affected by the weakness of demand for and trade in oil. In response to the recession in activity and in further adjustment to the large rise in real oil prices in 1979-80, consumption of oil in the OECD area is expected to fall again by over 4 % in 1982, after having already fallen by 13,9% between 1979 and 1981. Large reductions in stocks and some substitution of domestic production and non-OPEC production for OPEC supplies have meant an even sharper decline in the demand for OPEC oil. The volume of OPEC exports of oil is expected to fall by over 15% in 1982. Precise figures are not easily available, but the volume of world imports of oil could decline by some 6% this year. This implies that world trade in non-oil goods is stronger, as in 1980 and 1981, than suggested by the figures for total trade including oil which are given in Table 2.1. World trade in goods other than oil could rise marginally this year, compared with a fall of 1% for all goods. Similarly the calculations of Community export market growth in Table 2.1, which are based on the total imports of partner countries, could this year again understate the growth in demand for the kinds of goods the Community countries produce and export. In 1983 demand for and trade in oil is expected to be less weak, as economic recovery proceeds. Changes in the commodity structure of trade should therefore not distort the volume growth figures so much next year.

The weakness in the oil markets led early in 1982 to a sharp fall in spot prices and to reductions in the prices charged by some non-OPEC oil producers and in the premia on high quality oils from some OPEC suppliers, but at its meeting in Vienna on 19-20 March OPEC decided to defend its USD 34 per barrel reference price by introducing an agreed production limit of 18 million barrels per day (well below the average output of 22,5 million barrels per day in 1981). Although for a period OPEC oil output fell below this agreed limit, a degree of stability appeared for a while to return to the oil market, and the very large falls in oil prices which some commentators were expecting did not occur. However, with the apparent breakdown of the OPEC cartel at the meeting in July, the outlook remains very uncertain. Average export prices of oil in dollars are expected to be

2.4

almost 5% lower in 1982 than in 1981. The forecasts for 1983 are based on the assumption of no further changes in the nominal dollar price of oil, since it is expected that any strengthening in the demand for oil can easily be met without strain from increased OPEC production.

The dollar prices of other primary commodities continued to decline in the first three quarters of 1982, following sharp falls in 1981. Some steadying of prices near to their present low levels can be expected during the next few months. Then as industrial production starts to recover and stocks of raw materials are reconstituted, primary commodity prices should begin to edge up gradually in the latter part of 1983. The latest forecasts for the dollar prices of all non-oil primary commodities (UN index) are for a fall of some 9% in 1982 (following a drop of 10% in 1981) and then a rise of about 1% in 1983.

The prices of manufactured goods entering foreign trade were strongly influenced throughout 1981 and the first half of 1982 by movements in exchange rates, and in particular the strength of the dollar. In national currency terms there has generally been a slowing in the increases in the prices of manufactured goods (from 9,8% in 1981 to an expected 9,4% in 1982 and a forecast 7,0% in 1983 for the major industrialised countries including Community countries). When expressed in dollar terms, however, these exports of manufactured goods fell in price by 4,8% in 1981 and are expected to fall again by 1,1% in 1982 and then, on the assumption of no further appreciable change in the dollar exchange rate from now on, to rise by 3,4% in 1983.

Some sharp changes in the terms of trade (in goods) have occurred in 1982 as a result of price and exchange rate developments. Latest estimates suggest a deterioration in the terms of trade of OPEC countries of about 1 1/2% and a worsening for the non-oil developing countries of some 4%. The OECD countries as a whole should show an improvement of about 2%, but this will be enjoyed mainly by the USA with its strong currency (a terms-of-trade gain of some 3%) and Japan (a gain of some 4%). The Community countries are expected to show a smaller terms-of-trade gain of about 1 1/2%. In 1983 the forecasts show a further deterioration in the position of OPEC and the developing countries, and some further gains for OECD countries, which will probably be more equally shared than this year.

The severe current account imbalances which arose as the result principally of the oil price rises in 1979 and 1980 have adjusted far more rapidly than seemed likely at the time when they were at their extreme (see Table 2.2). The surplus of the OPEC countries, which reached some USD 113 000 million in 1980, fell to some USD 55 000 million in 1981. In 1982 a small deficit seems likely. This dramatic decline in the OPEC surplus is mainly due to the fall in the volume of oil exports, and in 1981 to the rapid rise in OPEC import volumes which has now come to an end; in 1982 and 1983 the terms-of-trade losses due to the weakness of oil prices are also expected to contribute to this process. The industrialised countries of the OECD area have managed to reduce their deficit, which amounted in total to some USD 70 000 million in 1980, but no further improvement is expected next year. In 1981 import volumes were cut by more than export volumes, and this year price developments, especially of oil and other raw materials, have been helpful. The most striking improvements have been seen in the position of Japan and of the Community; of the USD 54 000 million improvement in the total OECD current balance expected between 1980 and 1982, Japan alone is responsible for USD 18 000 million and the Community countries together for USD 23 000 million. On the other hand the non-oil developing countries have not shared in this adjustment as demand for and prices for their exports, mainly of primary commodities, have remained very depressed. Their current account position deteriorated further in 1981 and, although an improvement of about USD 9 000 million seems possible in 1982, their aggregate deficit is expected to remain very high both this year and next.

There is a growing asymmetry in the world current account position; the reduction in the OPEC surplus over the last two years does not appear to have its full counterpart in the improvement in the balances of the other world zones taken as a whole. In part this is due to the continuing problem of the growing discrepancy in the world balance on current account and its component transactions which has recently been investigated (1). In 1982 there also appear to be some special factors associated with trade in oil. Much of the substantial destocking carried out by the major oil companies during the early months of this year has been in oil travelling in ships at sea. Imports

(1) See also Chapter 3 below

of oil recorded by oil-importing countries have not therefore fallen by as much as have recorded OPEC oil exports and the importing countries current account balances have not improved to the extent of the deterioration in the OPEC surplus. If stocks at sea remain at their present depressed level then this discrepancy will not correct itself in due course. This interpretation remains highly speculative, however, and in general, although the trend for each zone in Table 2.2 appears reasonable, there must be considerable doubt about the precise magnitudes involved.

2.2 Short-term economic outlook for the Community

Following the sharp decline during 1980, output in the Community remained virtually flat throughout 1981. Some tentative indications of a slight upturn in activity in the early months of 1982 have not been fulfilled by subsequent developments. Industrial production in the Community as a whole stayed stagnant during 1981 at a level about 5% below that reached in the first quarter of 1980. Figures for the first quarter of 1982 showed only a very modest increase and there was then a renewed decline in production in the second quarter, with particularly sharp falls in several Community countries in June (see Table 2.3). Gross domestic product did not fall by as much as industrial production in 1980, and a modest increase was already recorded in the second part of 1981. Quarterly figures for the four major Community countries show a rise in real GDP in the final quarter of 1981 compared with the previous quarter at an annual rate of 4,3%, but the results for the first quarter of 1982 were barely positive, and provisional figures for the second quarter show a slight fall again. In the Community as a whole GDP appears to have risen marginally in the first half of 1982 at an annual rate of 0,8%. The main factor behind this slight rise was some reconstitution of stocks, which may have been partly involuntary; with fixed investment still falling, final domestic demand was flat, and weakness of exports meant a negative contribution to growth from the real foreign balance (see Table 2.4).

Graph 2.1 presents a comparison of the present cyclical position in the Community with that following the previous oil shock. Although the latest recession has been milder than that of 1974-75, in terms of the relation of the lowest values of gross domestic product or industrial production to the foregoing peaks, the duration of the period in which output has remained below these peak values is longer. Following the third quarter 1974 peak, gross domestic product recovered its peak value 5 quarters later, but in the present cycle domestic product has still (latest data

available - second quarter 1982) not regained the peak level of the first quarter 1980. It can also be seen from the graph that the latest available figures for industrial production are lower relative to the preceding peak than the corresponding data of the 1974-76 cycle, even though the trough of the latest recession (about 6 per cent below value at peak) was markedly less deep than that of the earlier cycle (about 12 per cent below value at peak). Despite the varying duration and degrees of severity of the two episodes, the delayed recovery of industrial production is a factor common to both. The trough in gross domestic product occurred two quarters after the third quarter 1974 peak, while the downturn in industrial production lasted five quarters. In the present cycle, the lowest point in gross domestic product occurred five quarters after the peak, but the trough in industrial production cannot yet be clearly identified, more than two years after the preceding peak.

A composite index of indicators of economic sentiment (see Graph 2.2), using data from the Community-wide business and consumer surveys together with an index of share prices, indicates a hesitant recovery of output during the next few months. The sentiment index, presented in the lower part of the graph with its component series, tends to lead the development of output by about six months, so that the slight improvement recorded between end-1981 and May 1982 suggested a higher level of output during the second half of 1982. The progressive worsening of sentiment between May and September, however, resulting in particular from a deterioration in the short-term industrial outlook, as indicated by the business survey, sheds doubt on the timing and strength of this recovery.

This evidence from the leading indicators, together with forecasts through to the end of 1983, suggests that after a lack of growth in the second half of 1982 a recovery should gradually get under way but that it will strengthen only very slowly. Private consumption in the Community is expected to rise very modestly this year, in line with real disposable income, but it should increase slightly faster in 1983. The growth of government consumption is expected to be relatively restrained and will not provide much support to total demand. Fixed investment is expected to continue to fall during the second half of 1982, but thereafter some slight recovery should ensue. After some renewed weakness in the second half of this year it is expected that stocks will be gradually reconstituted during 1983; the recent fall in interest rates may help this process. The components of final domestic demand

2.8

are likely to contribute increasingly to the slowly accelerating expansion of GDP next year. As stocks are rebuilt and demand picks up, imports by Community countries are expected to rise after falling back in the latter part of 1982. With its exports highly competitive because of the depreciation of Community currencies against the dollar, some further gains in export market shares are forecast, but with world demand outside the Community not very buoyant, total export volumes are unlikely to grow faster than imports and so the contribution from the real foreign balance to GDP growth is expected to be negligible.

Taken as a whole the forecasts show that, after a fall of 0,6% in 1981, Community GDP is expected to grow in real terms by 0,3% in 1982 and by 1,1% in 1983. Considerable uncertainty remains about whether even this limited rate of expansion will be achieved. The damage to growth prospects resulting from an extended period of high interest rates and the likely reaction to the recent reductions in rates are difficult to gauge. There is a clear possibility that the recovery in the rest of the world will be slower getting under way than has been assumed, with consequences for Community exports. Despite the fact that the Community business surveys already signalled a turning point at the end of 1980, the improvement in business sentiment has faltered in recent months, and there is as yet no clear-cut evidence of a resumption of steady growth. Although it is possible to picture scenarios which are more optimistic than those on which the forecasts are based, the main risks are clearly on the downside.

Forecasts of the growth of GDP and its components for each of the Community countries are given in Table 2.5. A weak outturn is expected for all the countries in 1982, with several of them likely to experience a further small decline in real GDP. In 1983 slow growth should be resumed in all countries (except the Netherlands), but this recovery will be very fragile.

Unemployment in the Community has been rising rapidly ever since the end of 1979. Although the rate of increase in the number unemployed has slowed slightly during 1982 it still remains appreciable. By August 1982 there were 11,0 million unemployed in the Community (seasonally adjusted figure for EC-9), representing 9,9% of the civilian labour force. The recovery in activity which is forecast should slow the increase in unemployment, but it is unlikely to be sufficient to halt the rise before the end of 1983.

Price trends within the Community have benefited from a slower rise in import prices during the early part of 1982 than in 1981. There has also been a slightly slower rise in nominal earnings per head, which both contributes to and is partly a result of declining inflation and which also reflects the difficult labour market situation. In the rest of 1982 and in 1983 a further decline in import prices is expected (the increase in the implicit price deflator of imports of goods and services by Community countries is forecast to fall from 14,9% in 1981 to 9,3% in 1982 and to 7,5% in 1983). Wage increases, however, are not thought likely to moderate much further (average earnings per head, after a rise of 11,9% in 1981, are forecast to increase by 10,8% and 9,8% in 1982 and 1983 respectively). Inflation in the Community (as measured by the implicit price deflator for private consumption) should slow further, from a year-on-year increase of 11,8% in 1981, to rises of 10,5% in 1982 and 8,8% in 1983.

The Community's current account deficit narrowed sharply from USD 38 000 million in 1980 to USD 21 000 million in 1981, due to a strong export performance and weak import volumes and despite a terms-of-trade loss. A further slight improvement in the deficit to USD 16 000 million is expected in 1982. The volume of exports has been weak throughout most of this year, while import volumes rose in the first half before a decline in the second half. The improvement in the deficit is therefore due to the weakness of import prices, especially of oil and raw materials, which should lead to an improvement in the terms of trade for the first time since 1978. In 1983, on the basis of present assumptions about world prices and exchange rates, the Community is expected to enjoy a further terms-of-trade gain. With import volumes growing at much the same rate as export volumes, this should allow some further improvement in the Community's current account, the deficit on which could shrink to about USD 11 000 million.

2.3 The medium-term outlook

The previous sections suggest that the bottom of the recession has been passed in the Community but that recovery from the exceptionally long recession will be slow and hesitant. For policy purposes it is important to look beyond the short term to an appreciation of the probable developments in the medium term. Will, for instance, the level of unemployment peak in 1983 or is it on a rising trend beyond the limits of the short-term forecast ?

The most recent quantified medium-term projection for the Community as a whole published by the Commission services is that which accompanied the Fifth Medium-Term Economic Policy Programme (1). The present projection has been prepared to allow a direct comparison with that of the Fifth Programme, although it has now been extended to a horizon of 1987. The past reference period has been adjusted however to give a better cyclical coincidence - both the 1980/74 and the 1987/80 periods begin with a year of recession.

The projection has been made with the aid of the Comet medium-term model and covers the period 1981 to 1987. The base year 1981 has been adjusted to correspond to the estimates used for the short-term forecast which was completed in October 1982. The model has been constrained to respect this short-term forecast for 1982 and 1983 as far as possible.

The 'central case' medium-term projection assumes that present economic policy objectives remain the basis of government policy in the Community. Policy is therefore likely to be more restrictive than it was after the first oil shock, with the control of inflation as the principal objective. Monetary policy will be tight relative to the policy followed in some member states after the first oil shock. This implies positive and high real rates of interest in contrast to the previous period. The battle to contain the budget deficit will dominate fiscal policy. This is likely to exclude any major expansionary fiscal policy initiatives at least in the first part of the medium-term period.

(1) European Economy, no. 9, July 1981

Though the projection shows some rise in the budget deficit, this results from the automatic effect of the built-in stabilisers and not from expansionary fiscal policy.

The exogenous assumptions, which for 1982 and 1983 are of course the same as those in the short-term forecasting exercise, are subject to considerable uncertainty. In comparison with the base projection made for the Fifth Programme, the assumption on real oil prices has been considerably modified (Table 2.6). It is now assumed in the central projection, that with very moderate economic growth and considerable energy savings, there is likely to be stability or even a slight fall in real oil prices from now to the end of the projection period. Obviously there is some risk that with a certain recovery in GDP growth, real oil prices could rise, even though the current situation on oil markets appears to be one of downward pressure on nominal prices.

The exchange rate assumption is that in spite of the relatively uncompetitive situation of the USA on world export markets in mid-1982, there will only be a very modest fall in the US dollar against the ECU over the period 1983-1987. Within the Community however it is expected that the D.Mark and the Guilder will rise considerably against the dollar over the medium term. These exchange rate assumptions are linked to assumptions about interest rates. The long-term interest rate in the USA is expected to stay high (around 12%) throughout the period. This is influenced by the prospect of a budget deficit over the medium term and the pick-up of economic activity in 1983 in the face of non-accommodating monetary policy. With inflation decelerating to end-1984 real interest rates stay high or even increase in the first part of the period. After 1984 with some increase in inflation, real interest rates decline somewhat but even in 1987 they are substantially positive and considerably above rates prevailing in the 1970's.

The outlook for world trade in this fairly sombre environment is not encouraging (Table 2.7). Excluding the Community, it is expected to grow by only just over 3% per year, somewhat lower than even the relatively disappointing second-half of the nineteen-seventies. The main difference with respect to the last decade, will be the only modest rise in OPEC and LDCs imports, resulting from the combination of low growth in industrial countries and financial pressures imposed by less easy access to credit and high interest rates. The projection assumes no significant increase in protectionism, even though considerable pressure for increased protection is likely to result from the poor outlook for growth and employment in the industrialised countries.

2.12

Any further rise in protection in the industrialised countries would have a severe effect on the LDCs and ultimately on the industrialised countries themselves.

The central projection suggests that output growth in the Community in the present cycle will be lower than in the previous one. Recovery from the partly oil-price-induced slump of 1974-75 was far faster than the hesitant upswing after the similar 1979-80 oil shock. This is largely due to different policy reactions to the transfer of purchasing power out of the Community. Many countries in the EC followed an expansionary fiscal policy and an accommodating monetary policy after 1975. As mentioned above, policy has been and is assumed to continue to be far tighter in the current cycle; the very high budget deficit in several countries is accompanied by relatively strict monetary policies.

Output is expected to rise at an annual average rate of 1,6% over the whole period 1981-87. This average implies a recovery of output in the second half of 1983 reaching a cyclical peak (at annual rates) in 1985 and then declining towards the end of the period (Graph 2.3). Average GDP growth over the last four years of the period (beyond the range of the short-term forecast), is not expected to exceed 2,5% per annum.

It is some recovery in private consumption and investment which leads to the recovery of GDP from 1983. Private consumption growth up to the end of 1983 is restrained by the relatively low increase in real wages and the loss of employment. From mid-1983 on however it is expected that there will be higher increases in real wages and a slowing of the rise in unemployment.

The low rate of investment in the Community (1975-1980 : +1,3% per year) is seen as a major problem for the medium-term growth of productive potential and, in the light of the need for structural adjustments in the stock of capital in the Community, an important constraint on future growth. The overall investment growth rate forecast for the period 1981-87 is just as weak as in the previous cycle. With somewhat stronger demand towards the end of the period, a recovery in company profitability, systems of investment incentives becoming more generalized and some pick-up in public investment, fixed capital formation should grow faster than output after 1983 (3,6% per year).

It should however not be forgotten that at the margin the amount of capital investment required for the creation of an additional job today has risen considerably over the last decade, and if much of the equipment now lying unused has in fact been rendered unusable by changes in relative prices and technology, a very high rate of investment over the medium and long term will be required to reach acceptable levels of output and employment (1).

In the early part of the period the growth of EC exports is reduced in the general downswing in world trade; imports follow in the wake of low output growth. Towards the end of the projection period, however, there is a recovery of imports as output expands again. Combined with a slight deterioration in the Community's terms of trade in the mid-1980s, these developments lead to an increase in the external deficit on goods and services of the Community towards the end of the period.

Inflation is decelerating fast in the Community and this is expected to continue well into the middle of the projection period, both as a result of weaker import prices and favourable internal cost developments. Real wages over the period grow far more slowly than in the previous period and there is a continuing fall in the corrected wage share. Nevertheless, towards the end of the period inflation turns up somewhat in response to higher import prices and a renewed acceleration in real wages.

The level of unemployment in the Community is expected to reach over 10 1/2% of the labour force by the end of 1983. This is equivalent to 12 1/4 million people, a level not reached since the 1930s. This total will have been produced by the coincidence of a very poor employment-creation performance in the 1970s and a rise in the labour force dependent on both demographic factors and on a rise in the participation rate (Table 2.9).

(1) An estimate in the Vth Medium-Term Economic Policy Programme suggested that the creation of an extra 1 million jobs would require 2 1/4% of GDP as additional investment. A more recent internal study suggests that, while this figure is consistent with average capital intensity figures in the past, capital requirements for new jobs, i.e. at the margin, are much higher.

Between 1983 and the end of the forecasting period the employment prospects should improve with a net job creation of about 0,3% per annum. This will however not be enough to reduce unemployment as the labour supply will be growing at an even faster rate. It is true that from the mid-1980s the demographic growth factor in the increase in the labour supply is expected to diminish but this does not affect the situation in the medium term. On unchanged policy the unemployment rate could then reach 11%, or 13 million people, by the end of the period.

Finally, it is the level of unemployment that is one of the main factors leading to the high level of the budget deficit in the end year of the forecast, in spite of government efforts to reduce that deficit.

The medium-term outlook suggests therefore that, on the hypothesis of unchanged policy, the Community is unlikely to break out of its slow growth pattern typical of the last decade. The main objectives of economic policy, reducing the levels of unemployment and inflation, are not achieved, and indeed the crucial unemployment problem becomes more difficult.

Table 2.1

World output, foreign trade and Community export markets

(% change over previous period, seasonally adjusted annual rate)

	1978	1979	1980	1981	1982 (3)		1983 (3)		1984 (3)		1985 (3)	
					I	II	I	II	I	II	I	II
GDP/GNP, OECD total	3,8	3,2	1,3	1,1	- 0,1	1,8	1,7	0,1	- 0,7	1,2	1,7	2,9
Imports of goods (volume)												
World (1)	6,9	7,0	2,2	2,1	- 1,0	2,1	2,1	6,0	- 1,9	- 3,8	3,5	4,7
EC-10	5,8	10,6	1,9	- 2,6	2,3	2,6	- 6,0	5,7	4,9	- 4,2	5,4	4,7
World excluding EC	7,6	5,0	2,4	4,8	- 2,9	1,7	6,7	6,1	- 5,8	- 3,6	2,4	4,7
of which :												
OECD excluding EC	7,2	6,5	- 1,5	2,2	- 2,6	3,1	4,2	7,1	- 5,7	- 2,9	4,5	5,0
OPEC	5,0	-12,0	12,0	22,4	0,0	- 1,9	29,0	21,1	- 5,1	- 7,8	- 2,0	4,0
Other developing countries	8,0	11,0	6,0	6,3	- 6,0	- 0,3	7,6	1,4	- 9,7	- 5,3	- 0,3	4,9
Other countries	10,0	2,0	3,8	- 0,1	- 1,0	2,5	- 0,5	0,8	- 0,9	- 0,7	2,5	3,7
EC export markets (2)												
Intra-EC markets	6,2	10,4	1,9	- 2,7	2,0	2,4	:	:	:	:	:	:
Extra-EC markets	4,5	4,0	4,7	5,7	- 1,7	1,6	:	:	:	:	:	:
Total	5,4	7,4	3,2	1,3	0,2	2,0	:	:	:	:	:	:
Exports of goods (volume), EC total (1)	5,0	7,4	2,7	4,0	2,0	2,7	6,3	8,0	1,7	- 2,8	3,8	5,6

(1) Including intra-EC trade

(2) Import volumes by the various markets weighted together according to their shares in EC exports of goods

(3) Forecasts

Source : OECD, IMF and Commission services

Table 2.2
Balance of payments on current account
('000 million US dollars, seasonally adjusted annual rate)

	1978	1979	1980	1981	1982 (2)	1983 (2)		1982 (2)		1983 (2)			
						I		II		I		II	
						I	II	I	II	I	II		
EC-10	15,4	- 9,3	-38,3	-20,8	-15,6	-11,0	-24,1	-17,4	-19,7	-11,6	-10,0	-12,0	
USA	-14,1	1,4	1,5	4,4	8,4	- 4,5	10,0	- 1,2	7,0	9,8	- 3,0	- 6,0	
Canada	- 4,3	- 4,2	- 1,6	- 5,5	0,2	- 0,8	- 5,6	- 5,4	1,3	- 0,9	- 0,5	- 1,1	
Japan	16,5	- 8,8	-10,7	4,8	7,4	12,5	2,2	7,6	6,9	7,9	11,0	14,0	
Other OECD countries	- 3,4	- 5,7	-21,4	-19,2	-13,9	-12,4	-20,6	-17,8	-14,5	-13,3	-12,3	-12,5	
OECD, total	10,1	-26,6	-70,5	-36,3	-13,5	-16,2	-38,1	-34,2	-19,0	- 8,1	-14,8	-17,6	
OPEC	4,0	62,0	113,0	54,7	- 6,4	- 0,6	:	:	:	:	:	:	
Other developing countries	-23,0	-38,0	-60,0	-81,0	-72,2	-72,7	:	:	:	:	:	:	
Other countries	- 9,0	- 4,0	- 1,0	-12,6	- 9,4	- 8,9	:	:	:	:	:	:	
World (1)	-17,9	- 6,6	-18,5	-75,2	-101,5	-98,4	:	:	:	:	:	:	

(1) Including errors and omissions

(2) Forecasts

Source : OECD, IMF and Commission services

28

Table 2.3

Recent developments in GDP and industrial production in the Community

(% change on previous quarter, seasonally adjusted annual rate)

	1980				1981				1982	
	1	2	3	4	1	2	3	4	1	2
Real GDP (EC-4) ⁽¹⁾	3,9	-5,2	-2,6	1,4	1,0	-2,3	-0,4	4,3	1,2	-1,1
Industrial production (EC-10)	0,9	-5,1	-9,8	-4,4	-0,3	-0,4	0,3	0,3	1,5	-1,8

(1) Estimates based on quarterly national accounts data for the Federal Republic of Germany, France, Italy and the United Kingdom

Source : EUROSTAT and national statistics

Table 2.4

Demand, output and external balance, EC-10

	1978	1979	1980	1981	1982 (2)	1983 (2)	1981		1982 (2)		1983 (2)	
							I	II	I	II	I	II
	% change at constant prices (seasonally adjusted annual rate)											
Private consumption	4,2	3,5	1,6	-0,2	0,1	0,8	-0,4		0,2	0,5	0,8	1,0
Government consumption	3,5	2,4	2,4	1,4	1,0	0,9	0,3		1,5	0,7	1,0	1,1
Gross fixed capital formation	2,7	4,0	2,3	-5,6	-3,0	0,6	-2,9		-3,8	-2,0	0,8	2,6
Stockbuilding (as % of GDP)	0,8	1,7	1,4	-0,4	0,8	1,2	-0,5		1,0	0,7	1,1	1,4
Domestic demand	3,4	4,4	1,4	-2,1	0,4	1,1	-2,3		1,6	-0,6	1,4	2,1
Exports (goods and services)	5,0	6,1	2,2	3,7	2,0	2,7	8,5		0,3	-0,8	3,0	4,9
Imports (goods and services)	5,5	10,4	2,1	-1,4	2,3	2,8	3,8		4,4	-2,7	4,6	4,3
Gross domestic product at market prices	3,2	3,3	1,4	-0,6	0,3	1,1	-0,1		0,7	0,0	1,0	2,3
Industrial production	2,4	4,8	-0,9	-2,2	0,1	1,3	0,7		0,3	-0,4	1,7	2,2
Unemployment rate (1)	5,4	5,4	6,0	7,9	9,4	10,3	8,3		8,9	9,8	10,1	10,4
	as % of GDP											
Trade balance (fob/cif)	-0,1	-1,3	-2,2	-1,7	-1,4	-1,2	-1,6		-1,6	-1,2	-1,3	-1,1
Current balance	0,8	-0,4	-1,4	-0,8	-0,7	-0,4	-0,7		-0,9	-0,5	-0,4	-0,4

(1) Unemployment as % of civilian labour force

(2) Forecasts

Source : Eurostat and Commission services

Table 2.5

Rates of growth of demand and output, 1971-83

(% change)

	B	DK	D	GR	F	IRL	I	L	NL	UK	EC-10
Private consumption	1971-80 (1)	3,8	3,3	4,7	4,2	2,7	3,2	4,1	3,1	2,1	3,2
	1981 (2)	-1,4	-1,2	0,7	2,2	-0,5	0,2	0,7	-2,6	0,0	-0,2
	1982 (2)	-2,5	-1,5	0,9	3,1	-2,8	0,5	-2,5	-2,1	0,7	0,1
	1983 (2)	-2,0	0,4	1,3	1,4	-0,5	1,1	0,0	-3,1	2,6	0,8
Government consumption	1971-80 (1)	4,2	2,8	6,1	3,1	6,1	3,0	3,7	2,7	2,5	3,0
	1981 (2)	0,6	2,0	6,5	1,4	-0,1	1,8	1,5	1,7	0,0	1,4
	1982 (2)	-1,8	0,8	3,0	2,0	2,3	2,0	0,5	-0,2	0,5	1,0
	1983 (2)	-2,2	0,5	2,1	1,5	1,6	2,1	-0,6	1,1	0,9	0,9
Gross fixed capital formation	1971-80 (1)	2,2	2,0	2,5	2,4	5,2	1,2	2,4	0,3	0,6	1,6
	1981 (2)	-16,2	-3,8	-10,1	-2,8	5,2	-0,2	-3,6	-10,8	-7,9	-5,6
	1982 (2)	-5,2	-6,3	-4,8	-1,4	-2,1	-2,4	0,1	-4,0	1,1	-3,0
	1983 (2)	0,5	0,9	3,4	-1,5	1,2	-0,7	1,2	-0,5	2,5	0,6
Change in stocks (as % of GDP)	1971-80	0,8	0,8	5,3	1,3	1,0	2,3	-0,9	0,9	0,5	1,2
	1981 (2)	0,3	-0,1	3,0	0,0	-0,9	0,6	4,1	-1,0	-1,7	-0,4
	1982 (2)	0,5	0,4	4,0	0,0	-0,7	0,6	4,1	-0,4	0,1	0,8
	1983 (2)	0,6	0,4	3,9	0,0	-0,7	0,6	4,1	0,2	0,9	1,2
Domestic demand	1971-80 (1)	3,3	2,8	4,5	3,6	3,6	3,1	3,5	2,2	1,7	2,8
	1981 (2)	-4,0	-2,4	0,3	-0,8	1,1	-2,7	-0,5	-5,3	-1,3	-2,1
	1982 (2)	-2,6	-1,6	1,1	2,2	-1,5	0,2	-1,4	-1,4	2,6	0,4
	1983 (2)	-1,5	0,9	1,8	0,7	-0,2	0,9	0,3	-1,2	2,9	1,1
Exports (goods and services)	1971-80 (1)	5,4	6,2	10,5	8,0	8,0	7,0	3,0	5,4	4,1	6,0
	1981 (2)	2,5	8,1	5,4	5,1	1,5	6,0	-10,6	0,9	-1,7	3,7
	1982 (2)	3,2	3,8	1,4	-2,1	7,6	5,6	1,7	2,5	-0,6	2,0
	1983 (2)	3,8	2,9	4,2	2,7	6,4	3,2	2,8	2,6	1,0	2,7
Imports (goods and services)	1971-80 (1)	5,7	6,3	6,3	7,7	6,3	5,9	3,6	4,1	3,3	5,4
	1981 (2)	-1,4	-0,7	9,0	0,4	1,6	-5,4	-8,4	-7,4	0,4	-1,4
	1982 (2)	-0,1	0,5	3,1	2,3	1,1	3,7	0,3	1,0	5,8	2,3
	1983 (2)	0,9	2,7	2,8	1,7	2,6	2,9	1,9	1,2	5,1	2,8
Gross domestic product at market prices	1971-80 (1)	3,2	2,9	4,7	3,6	4,1	3,1	3,0	2,8	1,9	2,9
	1981 (2)	-1,7	0,1	-0,7	0,3	1,1	-0,2	-2,4	-1,1	-1,9	-0,6
	1982 (2)	-0,5	-0,5	0,7	1,1	2,0	0,8	-0,3	-0,5	0,6	0,3
	1983 (2)	0,5	1,0	1,9	1,0	2,4	1,0	1,0	-0,3	1,7	1,1

(1) Annual average

(2) Forecast

Source : EUROSTAT and Commission services

2.20

Table 2.6

Oil prices in the central projection

(annual average growth rates %)

	1980/1974	1987/1980
OPEC export prices in US dollars	14,3	4,4
OPEC import prices in US dollars	6,1	4,1
Real oil price in US dollars	8,2	0,3

Source : COMET model data and simulation banks

Table 2.7

Import volumes (goods and services) in the central projection

(annual average growth rates %)

	1965/60	1970/65	1975/70	1980/74	1987/80
U.S.A.	7,1	10,0	2,6	5,2	3,1
Japan	12,6	17,3	4,0	2,2	4,4
Other OECD	10,5	9,0	3,4	2,4	2,4
OPEC	} 3,3	} 7,3	10,7	15,7	4,0
Developing countries			7,1	3,8	2,8
State-trading countries	6,4	8,1	10,7	3,6	3,0
World excluding EC	6,9	9,2	6,1	5,0	3,1

Source : COMET model data and simulation banks

Table 2.8

Medium-term forecast - EC-10

(annual average growth rates %)

	1973/60	1980/74	Vth	New Central Case		
			Programme	1985/80	1987/80	1987/83
			1985/80			
GDP	4,6	2,3	1,9	1,2	1,6	2,5
GDP prices	4,9	10,5	8,1	8,2	8,0	7,8
Investment	5,4	1,3	1,1	0,6	1,2	3,6
Employment	0,2	0,1	- 0,2	- 0,4	- 0,2	0,3
Purchasing power of per-capita wage	5,0	2,0	0,8	0,8	1,1	1,8
Corrected wage share	0,2	- 0,1	- 1,1	- 0,7	- 0,7	- 0,6
Unemployment rate at end of period	2,5	6,1	10,2	11,0	11,1	11,1
General government net lending at end of period (GDP % points)	- 0,8	- 3,5	- 3,0	- 3,9	- 3,8	- 3,8
Balance of goods and services at end of period (GDP % points)	0,4	- 1,4	- 0,2	- 0,8	- 1,2	- 1,2

Source : COMET model

Table 2.9

The demographic component of labour force growth ⁽¹⁾

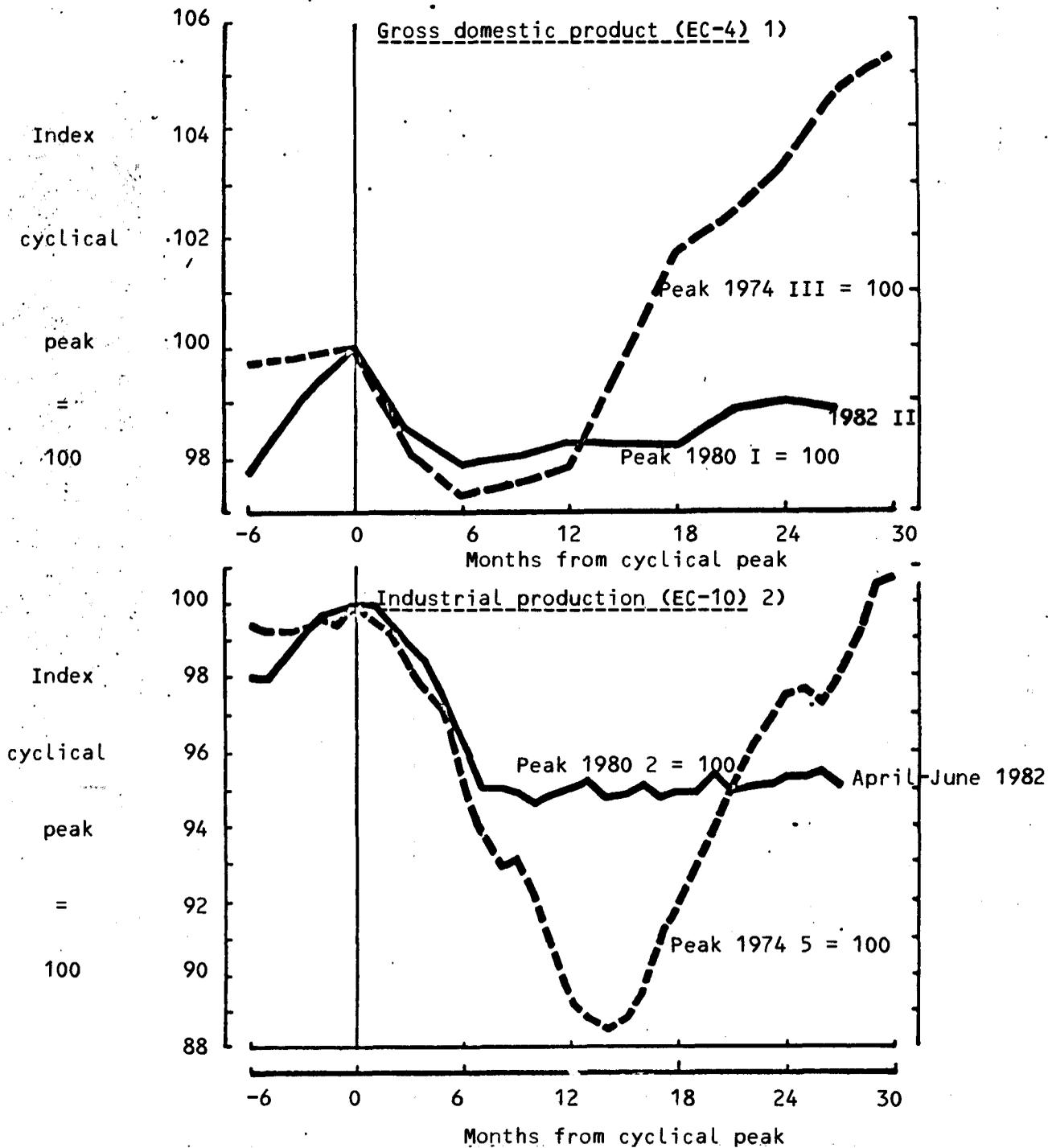
Average annual growth (thousands)	Total	New Entrants
Years		
1961-1973	393	2911
1974-1980	792	3262
1980-1987	703	3324
1987-2000	16	2760

(1) The demographic increase in the total labour force and the number of new entrants into the labour force assuming constant 1978 participation rates

Source : Commission Services

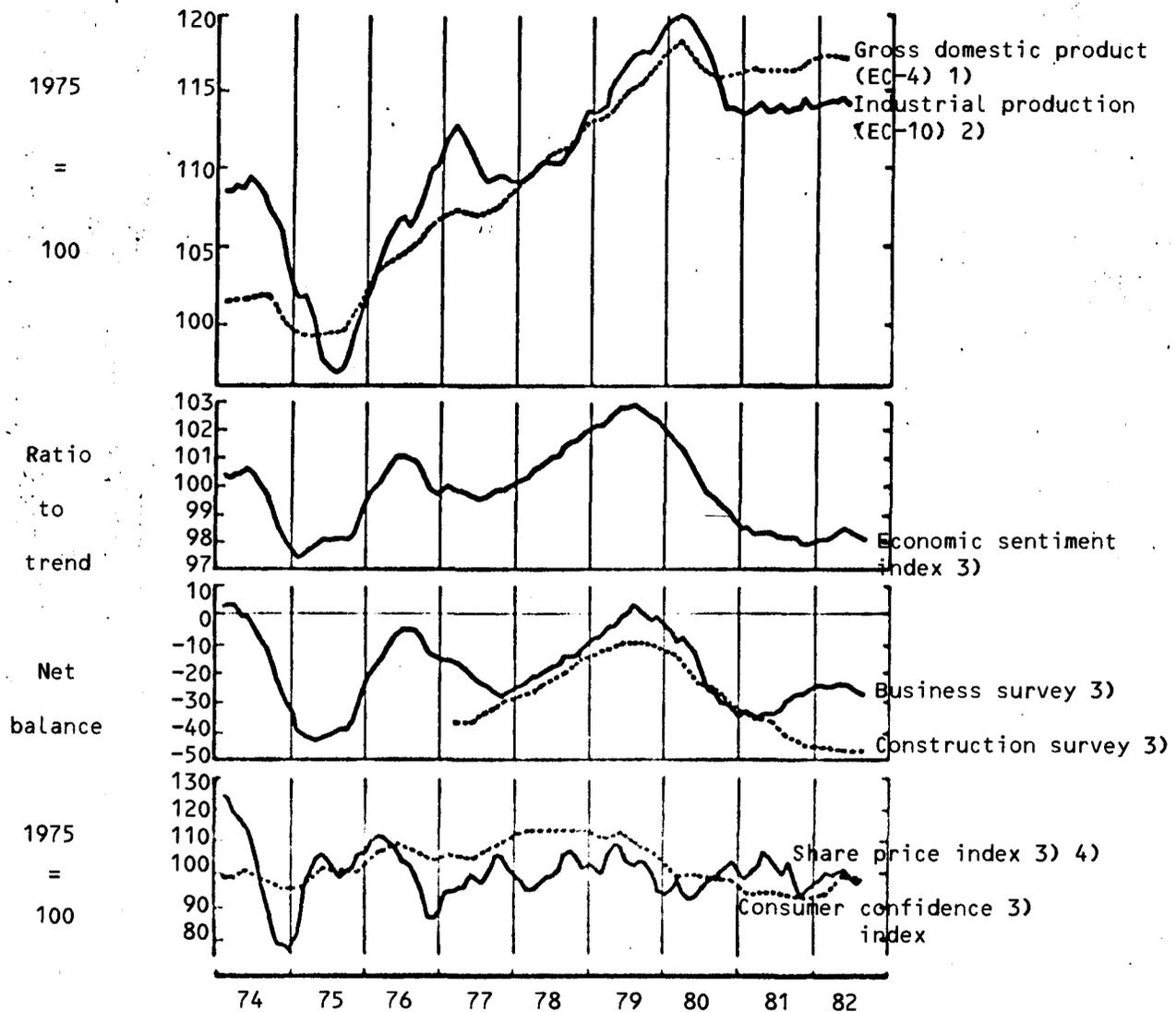
2.24

Graph 2.1 : Comparison of cycles in the Community 1974-77 and 1979-82



1) Quarterly figures for the Federal Republic of Germany, France, Italy and UK.
 2) 3-month moving average.

Graph 2.2 : Output and economic sentiment index - European Community

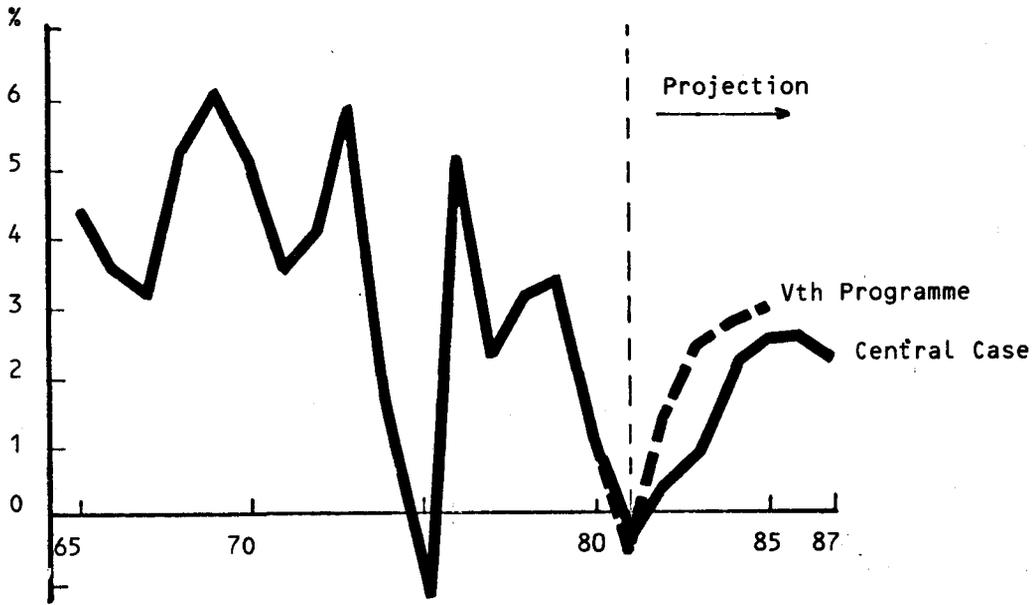


- 1) Quarterly figures for the Federal Republic of Germany, France, Italy and UK.
- 2) 3-month moving average.
- 3) Composite index computed from three business survey series (production expectations, order-books, stocks of finished products - inverted), two construction survey series (order-books, employment outlook) - see E.E. Supplement Series B-, the consumer confidence index - see E.E. Supplement Series C-, and the share price index.
- 4) Deviations from long-term trend.

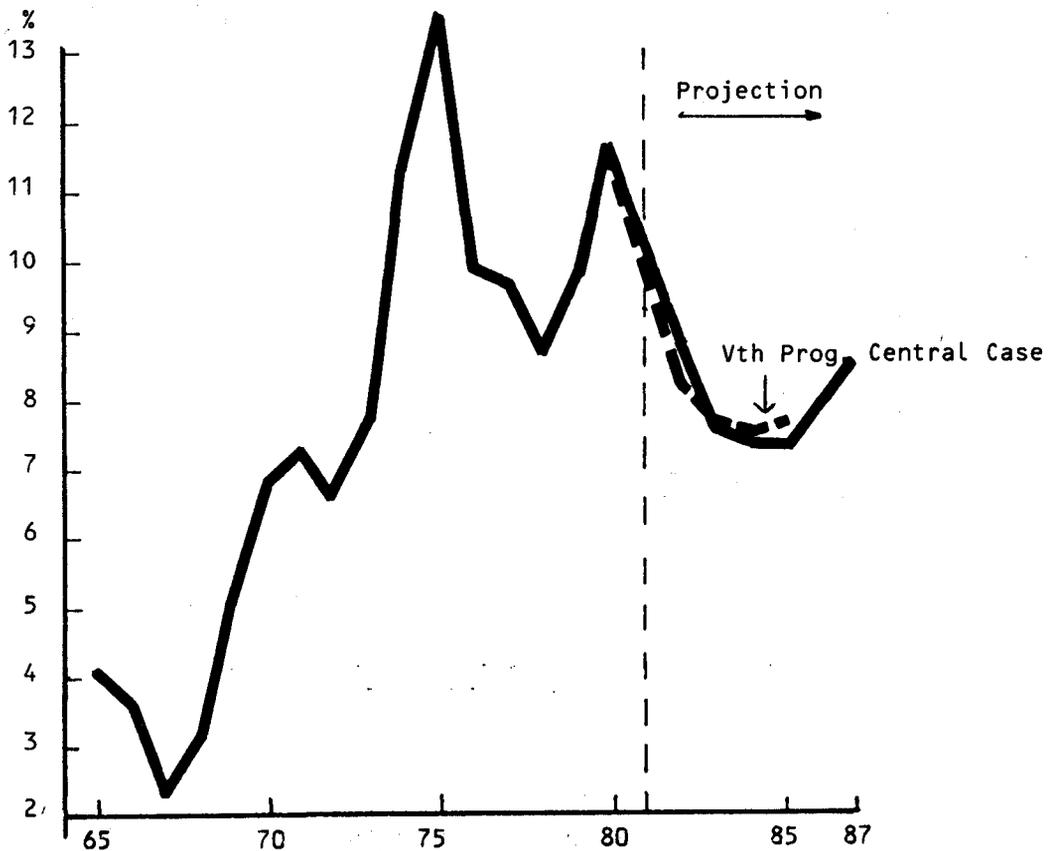
2.26

Graph 2.3 GDP and Inflation in the Community

2.3a GDP (annual average growth rate)



2.3b Inflation (annual average growth rate of GDP deflator)



3. Balance of payments

The two "oil crises" of the nineteen seventies have produced massive changes in the terms of trade of oil exporters, industrial countries (including the European Community) and non-oil developing countries. Industrial countries have responded by shifting a substantial proportion of their incremental output into net exports and the Community's achievement in this respect, especially during the last two years, has been impressive. Energy saving and the substitution of North Sea oil for imported energy have played a major role in this process. In spite of this the Community, in common with most other oil importing countries, has been in deficit on current account for most of the last ten years and has yet to emerge from this condition. The borrowing necessary to finance these deficits has transformed the Community's balance on investment income account from surplus to deficit. The current deficit of the Community as a whole has been aggravated by a net outflow of private long-term capital and this combined current and private long-term capital deficit has been financed mainly by a large net inflow of private short-term capital, much of it originating from oil exporting countries. Official financing, although it has been significant in certain individual cases, has not made a major contribution to the Community as a whole.

3.1 International payments adjustment 1972-1982

In considering the development of the balance of payments of the Community as a whole, and of its individual members during recent years, it is helpful to set it in a wider context covering the other major groups of countries in the world. The successive oil price increases of 1973-1974 and 1979-1981 produced huge changes in the terms of trade of these major groups. Since 1972, the last full year before the first "oil crisis", the terms of trade of the oil exporting countries have improved more than four and a half fold. Since the oil exporting countries account for a relatively small proportion of total world trade, the deterioration in the terms of trade of the other major groups - industrial countries and non-oil developing countries - that was the necessary counterpart to the improvement in the oil exporters terms of trade, has been proportionately much smaller, but very substantial nonetheless - 20% in the case of the industrial countries and 10% in the case of the non-oil developing countries (see Table 3.1). These unprecedentedly large and abrupt terms of trade shifts had an immediate destabilizing effect on world payments. In 1974 and 1980, following each of the two oil crises, the sum of world current surpluses and deficits (regardless of sign) rose very steeply in absolute terms and quite considerably in relation to output and trade.

3.2

At the risk of some oversimplification it may be said that the two main groups of oil importing countries - industrial countries and non-oil developing countries - have so far reacted quite differently to the shocks inflicted on their economies by the two oil crises. In the industrial countries the threat - and in some cases the reality - of runaway inflation and the emergence of payments deficits of a size such that they could obviously not be financed for very long induced the authorities to take restrictive measures, in some cases rather belatedly, in order to stabilize their economies both internally and externally. In the non-oil developing countries, by contrast, higher priority has, in general, been attached to the maintenance of real economic growth, while price stability and external balance have been considered of secondary importance. As a result real growth of output has slowed down very sharply in the industrial countries, while in the non-oil developing countries the deceleration has been less pronounced.

The slower growth of output has, in its turn, produced a marked deceleration in the rate of growth of world trade, which has fallen by about two thirds (see Table 3.2). As might have been expected, it is the imports of industrial countries - which account for nearly three quarters of total world trade - that have been the most seriously affected, since these are the countries which have most effectively restricted the growth of demand and output for stabilization purposes. In these countries the elasticity of imports with respect to output has contracted sharply. During the nineteen sixties and early nineteen seventies the volume of imports of industrial countries grew approximately twice as fast as output, with trade between industrial countries themselves proving by far the most dynamic element. During the last nine years the volume of imports has grown at almost exactly the same pace as output - i.e. the elasticity of import growth with respect to output growth has fallen from 2 to 1. This weakening of the propensity to import is partly the natural consequence of slower output growth, since with so much spare capacity the incentive to seek out suppliers from abroad is greatly reduced. Energy saving has also been an important factor, for most industrial countries depend on imports for a large proportion of their energy supplies. Finally the increase in protectionism, which has itself been encouraged by the large payments deficits and high unemployment which have resulted from the oil crises and the attempts by oil importing countries to deal with them, may also have had a negative impact on the growth of trade, although it is difficult to produce firm evidence in support of this proposition.

The imports of the non-oil developing countries have registered a much less marked deceleration and, in contrast to what has happened in the industrial countries, there has been only a slight decline in the elasticity of imports with respect to output growth - i.e. there has been little tendency to shift expenditure in real terms towards home-produced goods at the expense of imports. However, the most dynamic element in world trade since 1973 has been the demand for imports from the oil exporting countries, which has grown very strongly as a result of the improvement in their terms of trade, although the effect of improved terms of trade on their real purchasing power has been to some extent offset by a sharp fall in the volume of their exports during the last three years.

Table 3.3 illustrates how the external balances of the three major groups of countries have reacted to the oil crises of the nineteen seventies. The increase in the value of the oil exporting countries' exports during 1973-1974 (due almost entirely to the increase in oil prices) produced a huge current surplus for these countries in 1974. Over the next few years world oil market conditions weakened as a result of changes in the balance between the demand for and the supply of oil throughout the world. Demand for oil grew much more slowly, partly in response to the relative increase in its price and partly in response to the slower rate of growth of the world economy. At the same time the higher real price of oil stimulated production from new sources which began to displace traditional suppliers. The oil exporting countries' exports therefore grew much more slowly in real terms during the mid nineteen seventies. Their imports, however, continued to grow very rapidly in response to the huge increase in their purchasing power. Their net imports of services also increased substantially, so that by 1978 the current surplus of this group of countries

3.4

as a whole, at least as recorded in the official statistics (1), had disappeared. The second round of oil price increases produced a new and even more massive surplus in 1980, but this has been melting away even more rapidly than the first one. On this occasion, however, adjustment has mainly taken the form of a decline in the volume of oil exporters' exports, with oil importing countries reacting more vigorously and effectively to the second round of price increases than they had done to the first.

The current account of the industrial countries constitutes the mirror image of that of the oil exporters, swinging from a small surplus in the early seventies to a substantial deficit in 1974, then back again to surplus by 1978 as a result of a massive increase in the value of exports to the oil exporting countries. The second round of oil price increases produced another sharp deterioration in the current account, culminating in a deficit of \$67 000 million or nearly 1% of industrial countries' GDP, in 1980. This in turn is expected, on the basis of preliminary estimates, to have been largely

(1) Conceptually the trade balances and current balances of all countries in the world must necessarily sum to zero, and since the three groups of countries whose trade and current balances are summarized in Table 3.3 account between them for about 95% of total world trade, the sum of their trade and current balances should in theory be fairly close to zero. In fact merchandise trade balances (on a fob/fob basis) show a consistent tendency to sum to a surplus. There are several factors which can be cited in explanation of this phenomenon. One is the so-called "timing discrepancy" between exports and imports. A proportion of the goods recorded as exports in a given year are not recorded as imports by the recipient countries until the following year and so long as world trade is growing in value terms the size of this discrepancy tends to increase from year to year. Another factor is the export of ships to "flag of convenience" countries. These are almost always recorded in the exports of the producing country, but very seldom in the imports of the purchaser country. Current balances, by contrast, show a consistent tendency to sum to a deficit. This appears to be mainly due to substantial under-recording of investment income receipts and to some extent of receipts in payment of services. The countries whose current balance seems to have been most seriously misrepresented by these recording errors are the oil exporters. The current surplus of these countries during 1980-1982 is believed to have been substantially larger than the recorded figures indicate. The current balance of the industrial countries, taken as a whole, has also probably been rather better than officially reported. It is not believed, however, that recording errors have seriously distorted the trade and current balance figures for the non-oil developing countries. In the case of these countries the recorded figures are thought to correspond reasonably closely to reality.

reversed by 1982, mainly as a result, on this occasion, of a very sharp drop in the volume of oil imports. The net oil imports of industrial countries this year are estimated to have sunk approximately one third below the peak level attained in 1977.

The non-oil developing countries also suffered a very severe deterioration in their current account, first in 1974-1975 and then again in 1979-1980. Although smaller in absolute terms, the adverse swing in the combined current balance of these countries was considerably larger in relation to their export earnings and GDP than that experienced by the industrial countries. In contrast to the industrial countries, however, the non-oil developing countries, taken as a whole, have so far made little progress towards external adjustment. Despite the recovery in their terms of trade during the later nineteen seventies, the current deficit of these countries continued to run at around \$30 000 million a year. The second round of oil price increases in 1979-1980 inflicted a further serious terms of trade loss upon them, bringing their terms of trade by 1982 back to the same level as in 1975, and precipitating another large increase in their current deficit. The oil crises have dealt a double blow to the external trade of these countries, both inflating their import bill through higher energy costs and damaging their export performance, since a side-effect of the restrictive measures adopted by most industrial countries has been to reduce their demand for imports from the developing countries.

The right-hand section of Table 3.3 shows "required" and achieved changes both in current balances at current prices and in net exports of goods and services at 1975 prices. In this context the term "required change" in the current balance at current prices means the change between 1970-1972 and 1982 that would have been necessary for the current balance of each group of countries, expressed as a percentage of exports of goods and services, to be the same in 1982 as it was in the three years 1970-1972; i.e. in the period immediately before the severe payments imbalances produced by the first oil crisis appeared. The changes in real net exports shown in the same column are those which would be consistent with such a distribution of current surpluses and deficits, at 1982 levels of trade and with the actual 1982 balance on investment income and unilateral transfers taken as given.

3.6

It is arguable, of course, that the distribution of surpluses and deficits that would be consistent with world payments equilibrium today is rather different from that which was consistent with it ten years ago. For example, following the redistribution of wealth and income in favour of the oil exporting countries that has occurred over this period, it might be considered "normal" for these countries to run a current surplus somewhat larger in relation to their output and exports, while at the same time providing a larger share of world capital exports, than they used to do. Nevertheless, comparison of the relationships prevailing today with those which prevailed in 1970-1972 does provide a very rough and ready indication of the ground which remains to be covered before international payments equilibrium may be said to have been restored.

Comparison of the column showing "required" changes with that showing the changes actually achieved reveals that both the oil exporting and the industrial countries have made very substantial progress in terms of both nominal and real adjustment over the last ten years while the progress made by the non-oil developing countries has been rather slow and uncertain. The oil exporters had a current surplus equivalent to about 5% of their exports of goods and services in 1970-1972. The current surplus of \$ 15 000 million forecast for 1982 bears roughly the same proportion to exports of goods and services today. The adjustment by the oil exporters to their improved terms of trade has been achieved by an increase in net imports of approximately \$ 135 000 million at 1975 prices, an enormous shift for such a small group of countries.

The counterpart is to be seen in the performance of the industrial and non-oil developing countries. Since 1972 the industrial countries have shifted approximately \$130 000 million of resources at 1975 prices into net exports, an amount equivalent to some 3 1/2% of their GDP at the beginning of the period and 12% of incremental output over the period. They have achieved this by drastically reducing the rate of growth of imports in volume terms, while their exports to the rest of the world have continued to grow at about the same rate as during the years before the first oil crisis erupted. The non-oil developing countries, by contrast, have been unable to achieve any shift of real resources into net exports at all over the same period. Measured at constant prices their deficit this year will in fact be slightly larger in

absolute terms (although smaller in relation to exports) than it was ten years ago. Their refusal to accept a drastic cut-back in the real rates of growth of demand and output of their own economies has prevented them from achieving a significant reduction in import growth while slower growth in the industrial countries has proved an insuperable obstacle to accelerating the rate of growth of their exports.

However, in comparing progress towards external adjustment made by the industrial and primary producing - both oil and non-oil - countries respectively it is necessary to bear in mind that, whereas in 1970-1972 the world economy was running at a fairly high rate of capacity utilization, today it is plunged deep in recession. Recession tends to benefit the current account position of industrial countries at the expense of primary producers and this has assisted the process of external adjustment by the industrial countries and the oil exporters (for this latter group adjustment in the present context entails a reduction of the current surplus) while impeding adjustment by the non-oil developing countries. Thus the recession has depressed the volume of oil imports by the industrial countries and this has been a major factor contributing to the improvement in the real trade balance of this group and the deterioration in that of the oil exporters. But it has also depressed industrial countries' imports of other products and this, while helping to improve the real trade balance of industrial countries, has made such improvement by the non-oil developing countries more difficult. The effects of these changes in real demand on the current balances of the various groups of countries are now being reinforced by movements in the terms of trade which, as is normal in a world recession, have begun to move back in favour of the industrial countries at the expense of the primary producers. However, once the world economy recovers these factors are likely to be reversed. The current account of the industrial countries may then be expected to deteriorate, partly through a fall in real net exports and partly through a deterioration in their terms of trade; while the real net exports, terms of trade and current balances of the oil exporters and other primary producers are likely to improve. In short, the cyclically adjusted current balance of the industrial countries today is somewhat worse than their actual current balance, while the reverse is true of the other two groups of countries.

3.2 External adjustment by the European Community

The experience of the European Community since 1972 has been broadly similar to that of industrial countries generally. The Community's terms of trade deteriorated sharply in 1974, recovered over the next few years and then declined again during 1979-1980, since when they have stabilized at a level very slightly above that to which they had sunk in 1974. However, whereas the oil price increase of 1974 damaged the Community's terms of trade more than those of industrial countries generally, due to the Community's greater than average dependence on imported energy at that time, the emergence of the United Kingdom as a major oil producer during the later nineteen seventies has reduced that dependence, with the result that the Community's terms of trade have suffered rather less from the second round of oil price increases than have those of industrial countries as a whole.

The adverse shift in the Community's terms of trade produced a sharp deterioration in the balance of goods and services in 1974 and again in 1980. On each occasion the recovery has been rapid and, according to the latest forecasts, the Community will once again have a surplus on transactions in goods and services this year. However, this is not yet large enough to finance the steadily increasing net outflow on unilateral transfers, so that the current deficit is expected to be of approximately the same size as it was last year.

In the three years 1970-1972, before the first oil crisis broke, the Community as a whole registered a current account surplus equivalent to 0.6% of GDP. The figures in the column headed "required changes" in the third column from the right of Table 3.5 represent the changes in current balances since 1970-1972 that would have been necessary for a current surplus equivalent to 0.6% of GDP to be achieved by each of the more developed Member States in 1982; and also the changes in real net exports of goods and services that would have been consistent with these nominal current account swings, taking 1982 prices, import volume, net investment income and net transfers as given. For the two least developed Member States, Ireland and Greece, for which a current deficit may be considered a normal and appropriate condition, the figures for "required" current balances represent the 1970-1972 ratios of current deficits to GDP applied to 1982 output levels.

The period 1970-1972 was one when the Community as a whole, if not each one of its constituent members, may be considered to have been reasonably close to external equilibrium. Although there is no reason why the ratio of current balance to output should be identical in all the developed Community countries, it is not without interest to compare such a hypothetical situation with that which actually exists. The gap between the two may be taken as an approximate measure of the ground still to be covered before the process of external adjustment may be said to have been successfully completed.

The progress made along this road has varied considerably from one member country to another. The most successful, although in very different ways, have been the Netherlands and the United Kingdom. Indeed, were it not for the prospects of diminishing natural gas exports, the Netherlands, with a current surplus expected to amount to 4% of GDP this year, might appear to have over-adjusted. The Netherlands' adjustment has been achieved by means of a massive shift of real resources into the external sector, with net exports accounting for nearly two fifths of the real increase in output over the last ten years. By contrast the United Kingdom's adjustment has been achieved entirely through a favourable movement of the terms of trade. The United Kingdom terms of trade, after deteriorating sharply in the early seventies, have recovered strongly in recent years, largely as a result of the development of North Sea oil, and are now back where they were before the first oil crisis erupted, while most other Community countries have suffered a deterioration of around 20% in their terms of trade over the same period. As a result the United Kingdom has been able to achieve a modest surplus on current account this year without any increase in real net exports at all compared with 1970-1972.

The Federal Republic of Germany has also achieved a fairly successful external adjustment by means of a substantial shift of real resources as a result of which it is expected that the current account will once again show a small surplus this year. Italy, the BLEU and Ireland have managed to shift some 15% of their incremental output over the decade into net exports but this has been insufficient to offset the terms of trade losses inflicted upon them by higher oil prices and exchange rate depreciation so that the current balances of all three countries have suffered a severe deterioration and are still today - especially those of the BLEU and Ireland - a long way from satisfactory balance.

Somewhat surprisingly, the country which has made proportionately by far the most impressive real adjustment is Denmark, where more than half of the addition to output over the last ten years has been channelled into exports. However, the increasing burden of debt service (see also section 3.4) has more than offset the effect of this real improvement, so that Denmark's current deficit has grown inexorably over the years. The gap between present performance and anything that can plausibly be described as equilibrium is still a wide one. The same applies to France, but in this case the cause is quite different, namely a failure to make any significant and lasting real adjustment. Of the total increment to French output since 1972 net exports have absorbed only 3%.

Taken as a whole the Community, by severely restricting the growth of demand and output, has shifted some ECU 33 000 million (at 1975 prices) into net exports during the last ten years, equivalent to 3% of 1972 GDP or about 14% of the increase in production over the whole period. In spite of this, however, the combined current balance of the ten Member States is still some ECU 25 000 million short of what might reasonably be considered an equilibrium level - and this despite the fact that cyclical factors have been favourable to the balance of payments of the Community and industrial countries generally.

3.3 Energy and the Community current account

The increase in the price of oil has been the most important single factor contributing to the worsening of the Community's terms of trade and current balance since 1972, and the Community's efforts to reduce its dependence on imported energy have been a major factor in the process of real adjustment described in the preceding paragraphs.

Between 1972 and 1982 the unit price of oil imported by the Community increased twelvefold and the unit price of energy of all types by only a fraction less. If the volume of the Community's net energy imports had remained unchanged the import bill in 1982 would have been ECU 117 000 million higher than it was in 1972. In fact the Community has, over this period, slightly reduced the absolute level of its energy consumption (despite the fact that GDP has meanwhile risen by 22%) and has substantially increased its own production of energy, with the result that dependence on imported sources of energy has declined significantly and the volume of such imports has fallen by 27%. Consequently the net energy import bill has risen by "only" ECU 83 000 million. Of the total improvement in the Community's real trade balance of ECU 38 000 million (at 1975 prices) since 1972, more than a quarter can be attributed to the reduction in net energy imports achieved by energy saving and the substitution of domestically produced for imported sources of energy (see Table 3.6).

3.4 Exchange rate changes and trade in price-elastic goods and services

Community countries have experienced substantial changes in exchange rates during the past twelve years. On a trade-weighted basis the deutschmark has appreciated by 62 per cent since 1970 and the lira has depreciated by 54 per cent. Sterling has experienced very large movements in both directions, the net result of these being a fall of 29 per cent over the period as a whole (see Table 3.7). Both the drachma and the Irish pound have also depreciated heavily.

Sometimes these movements have gone further than was necessary to offset inflation differentials; at other times they have not gone far enough to produce this result. Consequently there have been quite sizeable shifts in real (i.e. inflation adjusted) exchange rates. Among the currencies of the four largest Member States, the deutschmark appreciated in real terms (i.e. lost competitiveness) in the years up to 1978, since when it has depreciated in real terms and the loss of competitiveness in the preceding years has been wiped out. The mirror image of the deutschmark's behaviour is to be found in that of sterling and the lira. The French franc experienced comparatively little real variation until a downward movement commenced in 1981.

Doubts are still expressed from time to time as to whether changes in real exchange rates have much positive effect on the trading performance of the countries concerned. It is indeed true that, if attention is directed at the total trade or current account, there seldom appears to be much correlation between real exchange rate movements and swings in the trade or current balance. This is partly because exchange rate changes have not always been backed up by appropriate internal economic policies. But it is also because many types of trade and payments flows are insensitive to changes in relative prices. This is true, for example, as regards trade in many foodstuffs, raw materials and fuels, the price-elasticity of demand for which is generally very low. It is also true as regards many "invisible" transactions, for example government overseas expenditure and investment income flows. If these items are excluded and attention is concentrated on those goods and services (i.e. manufactures and tourism) which are in general thought to be relatively price-elastic, the position, not altogether surprisingly, looks rather different.

Graph 3.1 shows the movement of the real exchange rate index and the trade balance in price-elastic goods and services in current prices, expressed as a percentage of GDP, for the four major Community countries over the last twelve years, and it is clear from the graph that the trade of each of the four countries in such goods and services has, on the whole, responded fairly effectively and promptly to changes in competitiveness. Unfortunately the effect on trade in price-elastic goods and services has frequently been totally obscured by the behaviour of the non price-elastic elements in the goods and services balance.

The importance of price-elastic goods and services in total exports and imports varies from country to country, and also within a given country over time (see Table 3.8). Germany and Italy are the two countries for which price-elastic goods and services account for the highest proportion of total exports, although the ratio has been rising slowly in Italy over the last ten years while it has been declining in Germany. In theory, other things being equal, these are the two countries whose exports should prove the most responsive to relative price changes. In France the share of price sensitive goods and services in total exports has fallen quite significantly over the decade. This appears to be the result not so much of changes in the structure of French merchandise trade as of an increase in the share of non price-elastic invisible earnings, in particular investment income receipts. Nevertheless, the implication would seem to be that total exports of all goods and services may now be less responsive to relative price changes than they used to be. There has been little change in the share of price-elastic goods and services in total United Kingdom exports, at least until 1980 (figures on the commodity composition of United Kingdom trade in 1981 are not yet available). This is rather surprising in view of the growing importance of petroleum exports in the total and the deterioration in United Kingdom competitiveness. It appears that the rising real exchange rate of sterling has affected not so much the exporters of price-elastic goods, which presumably comprise the most specialized and efficient sectors of British industry, but rather producers serving the home market, who have been severely buffeted by foreign competition. The share of price-elastic goods and services in total United Kingdom imports has risen very sharply over the last ten years. As a result total United Kingdom imports should in future prove to be more responsive to relative price changes than they were ten years ago. In the other three countries, all heavily dependent on imported energy, the rise in

oil prices has greatly swollen the bill for imports of non price-elastic goods and services, so that the price-elastic component of imports has suffered a proportionate decline.

3.5 The changing balance on investment income account

During the years before the first oil crisis, when the Community as a whole was regularly in current account surplus, it built up a stock of foreign assets with the result that by the early nineteen seventies its net receipts of foreign investment income amounted to some ECU 2 000 million a year. Since 1974 the Community has been more often in deficit than in surplus and most of its members have, at one time or another, had to borrow substantial sums from abroad in order to finance their deficits, thus reducing their net foreign assets or increasing their liabilities. This deterioration in the Community's net external investment position has come at an unfortunate time, since it has coincided with a steep world-wide rise in interest rates. This year, according to Commission estimates, the Community may have a deficit on investment income account of about ECU 7500 million (see Table 3.9).

For the Community as a whole this is still a fairly modest amount, equivalent to less than 1% of exports of all goods and services. But for certain individual countries the proportion is much higher than this; in Denmark the deficit on investment income account is estimated now to be equal to about 10% of total exports of goods and services and in Ireland the figure may be close to 5%.

In Denmark the accumulation of external debt resulting from almost twenty years of uninterrupted current account deficits, financed, it would appear, largely by debt-creating capital inflows (rather than by direct investment) has greatly hampered the country's efforts to achieve successful external adjustment. Although very substantial and impressive efforts have been made towards reducing the deficit on other current account items - not only in real, but also in nominal terms - they have been rendered null and void by the ever-increasing cost of debt service. Between 1972 and 1982 the balance on all current items other than investment income improved by ECU 200 million, but the balance on investment income deteriorated by ECU 2 400 million, so that the total current account deficit increased from ECU 100 million to ECU 2 300 million. So long as the deficit persists

3.14

it has to be financed, with the result that new debt is incurred and the amount of interest that has to be paid increases. The rise in interest rates has undoubtedly exacerbated the problem and, if interest rates now fall, this will bring some relief. However, so long as Denmark relies heavily on debt-creating capital flows to finance its current deficit, progress towards reducing that deficit is likely to be both painful and slow. So far Denmark is the only Community country where debt service is proving a serious obstacle to balance of payments recovery, but there are others which could find themselves in a somewhat similar situation in the future, if present trends continue. In Ireland, for example, the accumulated current deficits of the last four years amount to 30% of 1982 GDP and in Belgium the equivalent figure is 18%. Both countries have, as a result, experienced a significant deterioration in their balance on investment income account, as also has Italy.

3.6 Financing current account imbalances

The Community as a whole accumulated a current deficit of nearly ECU 63 000 million over the eight years 1974-1981. To this has been added a net outflow of private long-term capital of ECU 38 000 million, most of it during 1979-1981. This deficit on current and private long-term capital combined has been financed almost entirely by a net inflow of private short-term capital, much of it originating from the oil exporting countries. For the Community as a whole therefore official financing, whether in the form of official borrowing (narrowly defined here to exclude borrowing by nationalized industries, etc.) or of reserve use has not been a major source of support (see Table 3.10), although certain individual Member States have, at one time or another, made extensive use of such facilities.

Although the Community as a whole registered substantial current deficits in 1974-1976 and again in 1979-1981 there have on each of these occasions been some member countries in comfortable surplus - the Federal Republic of Germany, the Netherlands and Belgium-Luxemburg in 1974-1976 and the United Kingdom during 1979-1981. Thus within the Community itself, as well as between the Community and the outside world, there has been a need to generate capital flows to finance these current account imbalances, with surplus countries exporting capital and deficit countries importing it.

Exchange rate movements have played an important role in producing this result. As a general rule changes in Community exchange rates appear to have occurred in response to, or at least concomitantly with, changes in the current account. Thus for most of the countries during most of the periods covered, an improvement in the current balance, or the maintenance of an already strong current account performance, has been accompanied by an effective appreciation (or a reduced rate of depreciation in the case of certain traditionally weak currencies); and a deterioration of the current balance has been accompanied by an effective depreciation (or, in the case of certain traditionally strong currencies, by a much reduced rate of appreciation). The Community's experience also suggests that exchange rate changes have, on the whole, encouraged stabilizing capital movements. Thus it can be seen from Graph 3.2 that for most Community countries, with the notable exception of Germany, during most of the periods considered, private capital flows have, to a substantial extent, offset current account imbalances. Other factors, notably interest rate differentials, have, of course, also contributed to this result. But the record seems to show that exchange rate movements, provided that they are sustained over reasonably long periods, such as two or three years, have been accompanied by net private capital flows at least in the required direction, if not always on the required scale, and thus to have played a stabilizing role.

There have been interesting differences between deficit countries with regard to the methods used to finance imbalances. Ireland and Greece have, on the whole, been able to finance most of their current deficits by attracting private long-term capital, although in the last few years Ireland has had to have increasing recourse to official borrowing. Italy has also financed its deficits by a combination of private capital inflow and official borrowing. Belgium-Luxemburg, on the other hand, since its current account moved into deficit in the middle seventies has made increasing use of short-term finance to bridge the gap - nearly 60% of the net private capital inflow during the five years 1977-1981 was short-term. France, which has continued to export long-term capital despite the worsening of its current account, has relied entirely on short-term funds to meet its financing needs, a course which may have contributed to making the currency more vulnerable to speculative pressure. In recent years Germany's current deficit, like that of France, has been aggravated by a net outflow of private long-term capital, but unlike France it has not relied on short-term funds to cover its financing needs. Instead it has had recourse to a combination of official, mainly long-term, borrowing and use of its foreign exchange reserves.

3.16

Table 3.1

Terms of trade of major country groups

Index : 1975 = 100

	Oil exporting countries	Industrial countries Total	EC	Non-oil developing countries
1972	40	112	110	111
1973	45	110	109	118
1974	105	98	94	110
1978	95	100	101	110
1980	173	90	95	105
1981	193	89	95	103
1982(estimate)	184	90	96	100

Sources : I.M.F., Eurostat.

Table 3.2

Growth of volume of world imports

(annual average percentage rates of change)

	World	Industrial countries	Non-oil developing countries	Oil exporting countries
1969-1973	9.5	9.7	6.0	12.0
1974-1978	4.3	4.3	4.5	23.5
1979-1982	1.8	1.1	3.0	4.7
1974-1982	3.2	2.8	3.8	14.8

Source : I.M.F.

Table 3.3

Nominal and real external adjustment by major country groups

'000 million \$

	1970-72 average	1974	1978	1980	1981	1982	Changes Required	<u>1982</u> <u>1970-72</u> Achieved
<u>Oil exporting countries</u>								
i) <u>at current prices</u>								
Merchandise exports (fob)	22	118	142	297	275	220		
Merchandise imports (fob)	12	36	101	130	154	150		
Merchandise trade balance	+10	+82	+41	+167	+121	+70		
Services (net)	-8	-13	-33	-44	-40	-40		
Unilateral transfers (net)	-1	-4	-7	-12	-14	-15		
Current balance	+1	+65	+1	+111	+67	+15	+14	+14
ii) <u>at constant 1975 prices</u>								
Exports of goods & services	114	133	139	120	107	94		
Imports of goods & services	40	64	125	131	154	154		
Balance on goods & services	+74	+69	+14	-11	-47	-60	-134	-134
<u>Industrial countries</u>								
i) <u>at current prices</u>								
Merchandise exports (fob)	219	528	848	1211	1197	1195		
Merchandise imports (fob)	210	551	838	1276	1215	1200		
Merchandise trade balance	+9	-23	+10	-65	-18	-5		
Services (net)	+7	+14	+27	+29	+23	+23		
Unilateral transfers (net)	-8	-17	-24	-31	-30	-30		
Current balance	+8	-26	+13	-67	-25	-12	+25	-20
ii) <u>at constant 1975 prices</u>								
Exports of goods & services	575	720	865	970	990	980		
Imports of goods & services	615	745	860	920	900	890		
Balance on goods & services	-40	-25	+5	+50	+90	+90	+155	+130
<u>Non-oil developing countries</u>								
i) <u>at current prices</u>								
Merchandise exports (fob)	50	114	195	317	327	300		
Merchandise imports (fob)	58	147	228	388	402	365		
Merchandise trade balance	-8	-33	-33	-71	-75	-65		
Services (net)	-3	-6	-12	-25	-34	-36		
Unilateral transfers (net)	+4	+9	+14	+22	+23	+26		
Current balance	-7	-30	-31	-74	-86	-75	-48	-68
ii) <u>at constant 1975 prices</u>								
Exports of goods & services	118	138	179	201	210	210		
Imports of goods & services	148	186	222	250	255	240		
Balance on goods & services	-30	-48	-43	-49	-45	-30	+10	0

Sources : I.M.F., O.E.C.D., E.C. Commission.

3.18

Table 3.4

The Community current account

'000 million ECU

	1972	1974	1978	1980	1981	1982 (est.)
Merchandise exports (fob)	132.7	226.2	348.1	480.5	560.0	625.0
Merchandise imports (fob)	126.1	231.3	334.3	506.0	565.0	626.0
Merchandise trade balance	+ 6.6	- 5.1	+13.8	-25.5	- 5.0	+ 1.0
Services (net)	+ 3.6	+ 3.2	+10.0	+11.8	+ 4.0	+ 5.0
Unilateral transfers (net)	- 5.3	- 8.1	-11.8	-15.6	-19.0	-21.0
Current balance	+ 5.0	-10.0	+12.0	-29.3	-20.0	-17.0

Sources : Eurostat, E.C. Commission.

Table 3.5

Nominal and real adjustment in the European Community

	1970-72 average	1974	1978	1980	1981	1982 (forecast)	Changes		1982 1970-72
							Required	Achieved	
							'000 million ECU	as % of real GDP growth 1972-1982	
a) Current balance in '000 million ECU at current prices									
BL	+0.8	+0.8	-0.8	-4.2	-4.8	-3.5	-0.3	-4.3	
DK	-0.3	-0.8	-1.2	-1.8	-1.7	-2.3	+0.6	-2.0	
D	+0.8	+8.2	+6.9	-11.5	-6.8	+1.0	+3.2	+0.2	
GR	-0.3	-1.0	-0.7	-1.6	-0.7	-0.9	-1.3	-0.6	
F	+0.2	-5.0	+2.9	-5.4	-10.3	-14.0	+3.3	-14.2	
IRL	-0.2	-0.6	-0.3	-1.0	-2.0	-1.7	-0.5	-1.5	
I	+1.3	-6.7	+4.9	-7.0	-7.3	-4.6	+0.7	-5.9	
NL	+0.2	+1.7	-1.2	-1.9	+2.9	+5.7	+0.8	+5.5	
UK	+1.7	-6.6	+1.4	+5.1	+11.0	+3.7	+1.3	+2.0	
EC	+4.2	-10.0	+12.0	-29.3	-20.0	-16.6	+7.8	-20.8	
b) Current balance as % of GDP at current prices									
BL	+2.8	+1.8	-1.1	-5.0	-5.2	-3.9			
DK	-1.7	-3.0	-2.7	-3.8	-3.2	-4.1			
D	+0.4	+2.6	+1.4	-1.9	-1.1	+0.1			
GR	-2.8	-6.3	-2.8	-5.5	-2.2	-2.4			
F	+0.1	-2.2	+0.8	-1.2	-2.0	-2.6			
IRL	-4.5	-9.9	-3.3	-8.1	-13.1	-9.0			
I	+1.2	-4.7	+2.4	-2.5	-2.3	-1.3			
NL	+0.6	+2.9	-1.1	-1.6	+2.3	+4.0			
UK	+1.3	-4.1	+0.6	+1.4	+2.4	+0.8			
EC	+0.6	-1.0	+0.8	-1.5	-0.9	-0.7			
c) Goods and services balance in '000 million ECU at 1975 prices									
BL	+1.0	+0.5	0	0	+1.5	+2.5	+4.5	+1.5	15
DK	-0.8	-0.5	-1.0	+1.3	+2.0	+2.1	+4.3	+2.9	55
D	+4.0	+18.0	+8.5	+5.0	+15.0	+19.0	+17.5	+15.0	20
GR	-1.5	-1.3	-1.2	-1.2	-1.3	-1.5	+0.2	0	0
F	-1.5	-1.5	+3.5	+2.0	+3.5	+0.5	+12.5	+2.0	3
IRL	-0.7	-1.0	-0.8	-0.7	-0.7	-0.5	+0.7	+0.2	16
I	-4.0	-5.0	+3.0	-5.0	+1.0	+2.0	+10.5	+6.0	14
NL	-1.0	+2.0	0	+1.5	+4.5	+5.0	+3.5	+6.0	39
UK	-5.0	-6.0	0	-0.5	-1.5	-5.0	+0.5	0	0
EC	-9.5	+5.0	+12.0	+2.5	+24.0	+24.0	+54.0	+33.5	14

Sources : Eurostat, E.C. Commission

3.20

Table 3.6

Energy imports and the Community's balance of trade.

	Unit	1972	1974	1978	1980	1981	1982	Change 1972-1982
Volume of net energy imports	million TOE	595	616	540	527	445	437	-158
Unit price of energy imports	ECU per TOE	18.5	62.4	75.0	144.0	199.4	215.1	+196.6
Balance on energy trade	'000 million ECU	-11.0	-38.4	-40.5	-75.9	-88.7	-94.0	-83
Trade balance (goods and services) at current prices	'000 million ECU	+10	-2	+24	-14	-1	+4	-6
Balance on energy trade at 1975 prices	'000 million ECU	-39.5	-41.0	-36.0	-35.0	-29.5	-29.0	+10.5
Trade balance (goods and services) at 1975 prices	'000 million ECU	-13.5	+5.0	+12.0	+2.5	+24.0	+24.0	+37.5

Source : E.C. Commission.

Table 3.7

Trade-weighted nominal and real⁽¹⁾ exchange rate movements in four major Community countries

Indices : 1970-1975 average = 100

	1970	1974	1978	1980	1981	1982 (January/August)
D nominal	89	100	136	144	137	144
D real	93	106	106	101	91	
F nominal	98	97	98	101	92	86
F real	100	96	100	105	99	
I nominal	110	89	62	58	51	48
I real	105	94	89	98	94	
UK nominal	110	92	69	81	81	78
UK real	104	93	92	126	130	

(1) The measure of real exchange rate movement used here is relative GDP prices corrected for exchange rate changes.

Source : E.C. Commission.

Table 3.8

The share of price-elastic goods and services in the exports of four major Community countries

	1970-1971		1980-1981	
	exports	imports	exports	imports
D	78	56	73	53
F	61	54	54	46
I	68	46	72	42
UK	59	43	58	56

Source : E.C. Commission.

Table 3.9

Net foreign investment income of Community countries, 1972-1982

	1972	1978	1981	1982 (estimate)		Change 1972-1982
	'000 million ECU				as % of exports of goods and services	'000 million ECU
BL	+0.15	+0.49	-0.19	-1.0	-1.1	-1.2
DK	-0.11	-0.69	-1.78	-2.5	-10.0	-2.4
D	+0.31	+1.79	-0.44	-1.5	-0.6	-1.8
GR	-0.05	-0.11	-0.25	-0.3	-3.3	-0.3
F	+0.32	+1.11	+0.70	0	0	-0.3
IRL	+0.04	-0.19	-0.30	-0.5	-4.8	-0.5
I	-0.08	-0.87	-2.87	-3.5	-3.3	-3.4
NL	+0.14	-0.03	-0.32	-0.2	-0.2	-0.3
UK	+1.20	+0.89	+2.08	+2.0	+1.3	+0.8
EC	+1.92	+2.39	-3.07	-7.5	-0.8	-9.4

Sources : Eurostat, E.C. Commission.

Table 3.10

Financing current imbalances.

ECU '000 million

	1974-1976	1977-1978	1979-1981	1974-1981
BL Current balance	+1.3	-1.4	-11.5	-11.7
Private long-term capital (net)	-0.4	+0.2	+3.4	+3.2
Private short-term capital (net) ⁽¹⁾	-0.6	+0.4	+4.4	+4.2
Total requiring official financing	+0.3	-0.8	-3.7	-4.2
Official capital (net)	-0.2	+1.1	+3.7	+4.2
Change in reserves (+ = decrease)	-0.1	-0.3		
DK Current balance	-2.9	-2.7	-5.5	-11.1
Private capital (net) ⁽²⁾	+2.4	+4.6	+4.8	+11.8
Total requiring official financing	-0.5	+1.9	-0.7	+0.7
Official capital (net)	+0.1	-0.1	0	0
Change in reserves (+ = decrease)	+0.4	-1.8	+0.7	-0.7
D Current balance	+14.9	+10.1	-22.3	+2.7
Private long-term capital (net)	-9.0	-4.7	-5.5	-19.2
Private short-term capital (net) ⁽¹⁾	-5.6	+7.0	-3.3	-1.9
Total requiring official financing	+0.3	+12.4	-31.1	-18.4
Official capital (net)	+1.8	+1.0	+19.0	+21.8
Change in reserves (+ = decrease)	-2.1	-13.4	+12.1	-3.4
GR Current balance	-2.6	-1.7	-4.1	-8.4
Private long-term capital (net)	+1.3	+1.3	+3.0	+5.6
Private short-term capital (net) ⁽¹⁾	+0.6	+0.3	+1.2	+2.1
Total requiring official financing	-0.7	-0.1	+0.1	-0.7
Official capital (net)	+0.4	+0.3	-0.1	+0.7
Change in reserves (+ = decrease)	+0.3	-0.2		
F Current balance	-10.6	0	-14.5	-25.1
Private long-term capital (net)	-2.0	-2.1	-15.7	-19.8
Private short-term capital (net) ⁽¹⁾	+13.3	+4.8	+33.8	+51.9
Total requiring official financing	+0.7	+2.7	+3.6	+7.0
Official capital (net)	0	+0.1	-1.1	-1.1
Change in reserves (+ = decrease)	-0.7	-2.7	-2.5	-5.9

Table 3.10 (continued)

ECU '000 million

	1974-1976	1977-1978	1979-1981	1974-1981
IRL Current balance	-0.9	-0.6	-4.0	-5.5
Private long-term capital (net)	+0.8	+0.7	+1.0	+2.5
Private short-term capital (net) ⁽¹⁾	+0.1	+0.1	+0.3	+0.5
Total requiring official financing	0	+0.2	-2.7	-2.5
Official capital (net)	+0.8	+0.2	+2.7	+2.5
Change in reserves (+ = decrease)	-0.8	-0.4		
I Current balance	-9.7	+7.0	-10.3	-13.0
Private long-term capital (net)	+3.5	+0.3	+5.6	+9.4
Private short-term capital (net) ⁽¹⁾	+0.8	+1.9	+3.6	+6.3
Total requiring official financing	-5.4	+9.2	-1.1	+2.7
Official capital (net)	+5.4	-1.6	+6.8	+10.6
Change in reserves (+ = decrease)	0	-7.6	-5.7	-13.3
NL Current balance	+5.5	-0.9	-0.4	+4.2
Private long-term capital (net)	-4.5	-3.0	-2.8	-10.3
Private short-term capital (net) ⁽¹⁾	+0.6	+3.6	+3.4	+7.6
Total requiring official financing	+1.6	-0.3	+0.2	+1.5
Official capital (net)	-0.9	+0.2	-0.7	-1.3
Change in reserves (+ = decrease)	-0.7	+0.1	+0.5	-0.2
UK Current balance	-10.7	+1.4	+14.2	+4.9
Private long-term capital (net)	+4.0	-1.6	-23.5	-21.1
Private short-term capital (net) ⁽¹⁾	+1.8	+8.2	+3.1	+13.1
Total requiring official financing	-4.9	+8.0	-6.2	-3.1
Official capital (net)	+0.9	+3.0	+4.3	+8.2
Change in reserves (+ = decrease)	+4.0	-11.0	+1.9	-5.1
EC Current account	-15.7	+11.2	-58.4	-62.9
Private long-term capital (net) ⁽²⁾	-3.9	-4.3	-29.7	-37.9
Private short-term capital (net) ⁽¹⁾	+11.0	+26.3	+46.5	+83.8
Total requiring official financing	-8.6	+33.2	-41.6	-17.0
Official capital (net)	+8.3	+4.1	+41.6	+17.0
Change in reserves (+ = decrease)	+0.3	-37.3		

(1) Net private short-term capital includes errors and omissions.

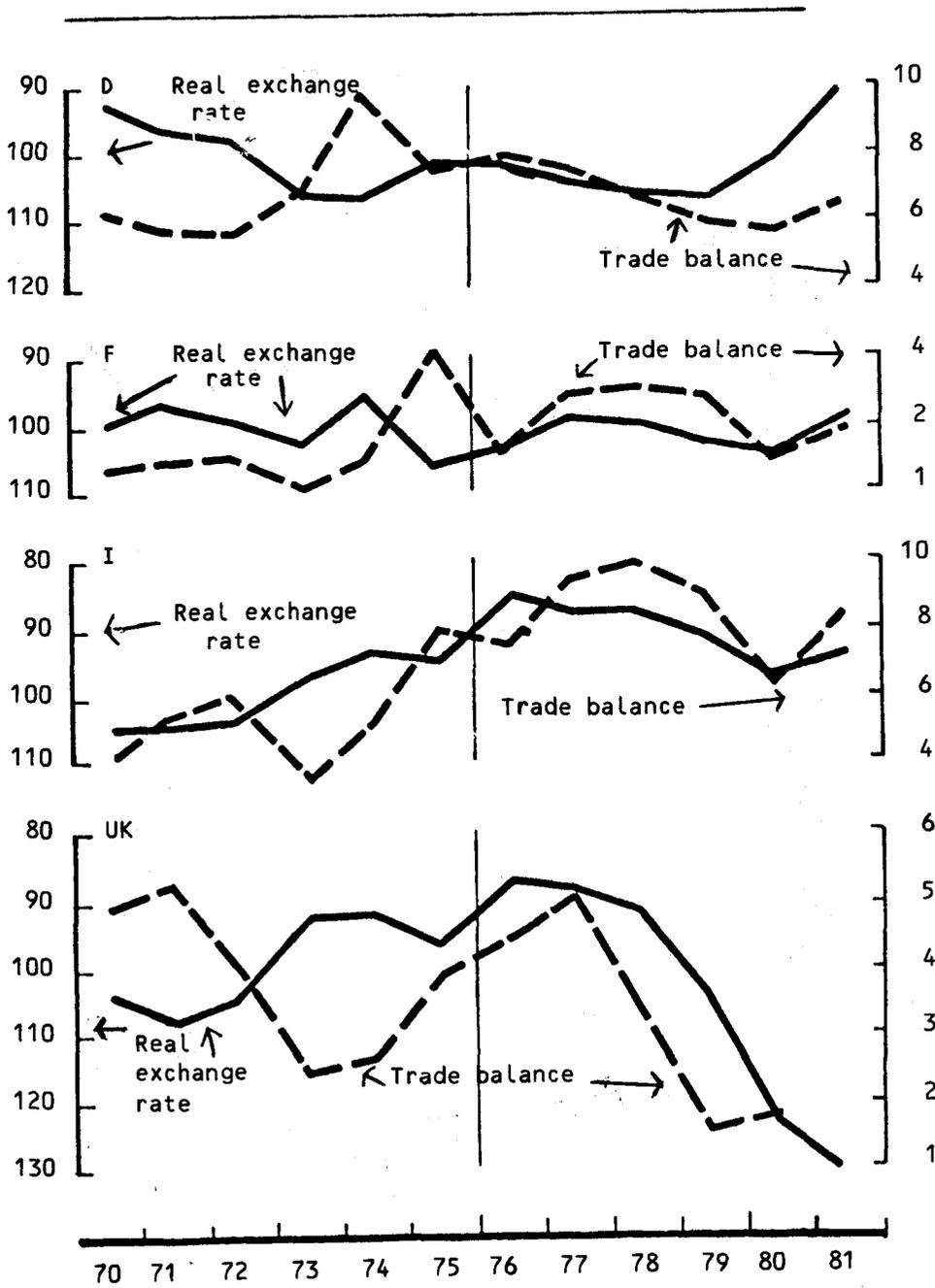
(2) No break-down between private long and short-term capital is available for Denmark. In the total for the EC as a whole the net capital flow for Denmark is included in private long-term capital.

Source : Eurostat.

GRAPH 3.1

Real exchange rate movements and trade in price-elastic goods and services

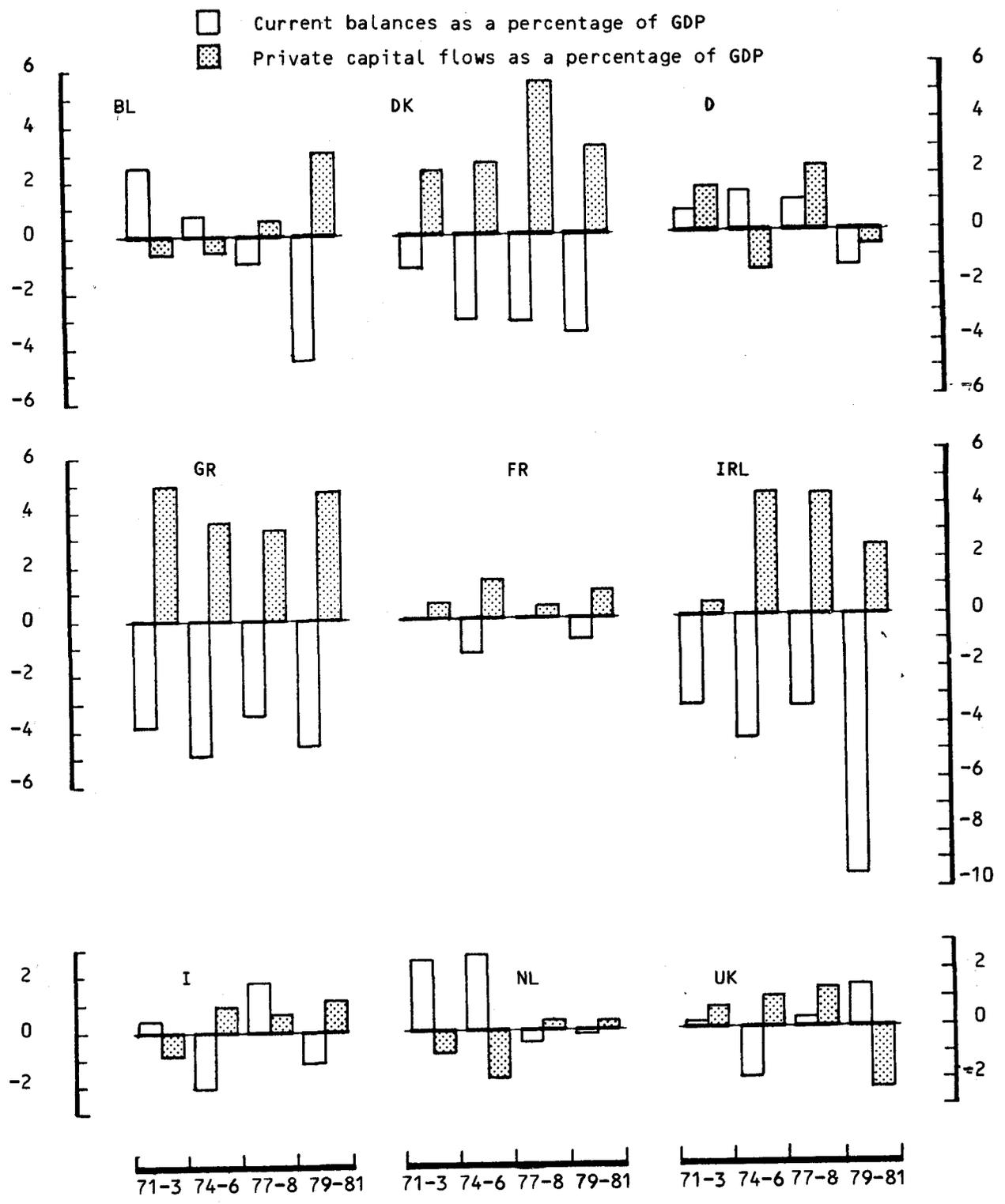
———— Real exchange rate index measured by relative GDP prices (left-hand scale)
 - - - - - Trade balance in price-elastic goods and services as a percentage of GDP (right-hand scale)



64

GRAPH 3.2

Current balances and private capital flows in EC countries



4. Prices and Costs

Although no rapid slowdown in Community inflation occurred in 1982, in contrast to progress made in the United States and more notably, Japan, important strides have been made in some countries as a result of which the trend rate of inflation in the United Kingdom, the Federal Republic of Germany and the Netherlands is low or much reduced. Elsewhere the slowdown in prices is taking considerably longer to appear than after the first oil price rise, reflecting the gradualist approach adopted in some countries as against a more severe policy prescription in others. Contributions to inflation by commodity grouping have shifted somewhat recently, with energy prices less of a factor and higher food prices beginning to become important. This could be important for the adjustment process because of the greater impact which prices of non-discretionary goods have on perceived inflation, price expectations and wage moderation. As regards wage adjustments, greater flexibility has been evident in the United States and in Japan than in the Community. Member States have varied substantially in the speed and magnitude of their adjustment to the energy price and terms of trade shocks of recent years. In 1981 in particular, real wages were adjusted sharply downwards in the Federal Republic of Germany, the Netherlands and Belgium while they continued to grow significantly in that year in France, Italy and the United Kingdom. The adjustment in incomes which has so far been achieved has not been sufficient to restore previous competitiveness levels for the Community as a whole and it has only been the substantial depreciation in effective exchange rates which has eased the pressure on European industry.

4.1 Price inflation in the Community

The disinflation process in the Community continued in 1982 after ceasing for a while in 1981 when, in the first seven months of that year, the dollar appreciated sharply against EMS currencies. The reversal of the dollar's movement with respect to the ECU in the second half of 1981, together with the continued sharp decline in the dollar price of non-oil commodity prices, as well as falling oil prices have resulted in a general decline in European inflation rates in the first half of the year. From a high point of just over 16% in May 1980, the deceleration in inflation, interrupted during most of 1981, continued apace in 1982 until in May the rate had fallen below 10%. Estimates for 1982 (Table 4.3) suggest some fall in inflation, as measured by the deflator of private consumption, to 10,5% for the year as a whole. Forecasts for all countries in 1983 show that further falls in inflation are expected for all Community countries, bringing the Community average down to 8,8 %.

4.2

Comparisons of the performance of Europe, the United States and Japan, during the periods following the first and second oil shocks, are instructive in assessing the performance of current stabilisation policies.

Comparing first the inflationary peaks of those two episodes - 1975 and 1981 - the European Community on the whole did somewhat better on the second occasion in limiting the rise of inflation (to 10,6% compared to 15,0% in the earlier year, for the GDP deflator). This reflects the stricter financial policies followed in the second case, and is related, no doubt, to the more moderate wage reaction (to be analysed further below). In the United States the inflationary peaks were similar in both years. In Japan, however, while substantial inflation was experienced in 1975, a dramatically better performance was managed after the second oil shock. In 1981 the GDP deflator in the latter country rose by less than 3%, which means that the second oil shock was kept from having any adverse impact on domestic inflation.

With respect to the periods of disinflation following those peaks the comparisons cannot yet be fully conclusive. The disinflation phase after the first oil shock lasted four years - from 1975 to 1978, whereas in the present episode the disinflation process is still under way. In the Community, inflation was cut almost by half from 1975 to 1978 (the rise in the GDP deflator falling from 15% to 8,3%), and substantial progress was made also in the US and Japan - proportionately less, but down to lower levels in 1978 (7,4% for the US and 4,6% for Japan). In the present episode, the US has made equally fast progress in reducing its domestic inflation rate to a forecast of 6% for 1983 (moreover an even better price performance is conceivable), while Japan seems to be retaining an impressively low and steady 3% rate. Europe, on the other hand, has on the whole had much greater difficulty in reducing its core average inflation rate significantly below the 10% rate. Throughout 1981 and 1982 the weakness of European currencies against the dollar and yen inevitably aggravated relative consumer price trends through their import price content. However the relative stickiness of the GDP price deflator trends in Europe, compared to the US and Japan, has much more to do with internal rigidities in cost pressures and cost-price links

Within the Community, the reaction to the second oil shock has also been more divergent than after the 1973-74 oil shock. In the Federal Republic of Germany, the Netherlands and the United Kingdom, a repeat of the 1975 spiral was avoided. In the first two countries this was achieved by a continuous process over the 'seventies of trying to wind down inflation expectations. In the United Kingdom, after accelerating inflation in the late 'seventies, a very strong financial stabilisation policy was introduced at the time that the second oil shock was occurring; the petro-currency role of sterling then led to strong external stabilisation influences through the exchange rate, reinforcing domestic stabilisation pressures. As a result inflation (measured by the GDP deflator) has been reduced from nearly 19 % in 1980 to under 7 % now forecast for 1983. As a consequence, in the United Kingdom the inflation rate projected for 1983 is significantly lower than at any time during the second half of the 'seventies. In Belgium, Luxembourg, Denmark and Ireland, price rises in the recent episode have also been slower, to varying degrees, than in 1975, but in all cases a new acceleration has occurred in 1982 (on an annual basis). For Italy and France, inflation rates have been of similar orders of magnitude as in the previous episode although progress in reducing inflation is expected to be seen in 1983. Greece is the only instance in which the current rate of increase in prices (above 20 %) is very significantly above that recorded in the mid 'seventies.

The overall European Community experience is reflected in the evolution of the standard deviation of inflation rates, which is the best single measure of divergences in inflation performance. In 1981 the standard deviation for the GDP deflator was 5,6 %, substantially above the 1978 low of 3,5 %, but still less than the 1975 point of extreme divergence of 7,4 %. Some progress in stabilizing this standard deviation was seen in 1982, and a lower level of 5,2% should again be seen in 1983.

Measured on the level of consumer prices the divergence has however, not fallen as rapidly since 1979 as in the years after 1975.

As regards the commodity breakdown of inflation, fuel and energy price rises have now fallen back closer to the average of other commodities (see graph. 4.2). Manufactured goods' price rises also experienced a steady deceleration in the last 24 months as greater efforts were made to maintain market shares and cut production costs. The rate of growth of food prices, after rising significantly less than the overall rate of inflation, climbed steadily through 1981 and into 1982 even before the recent agricultural price settlement which could prolong this trend through 1982. The prices of services moderated during 1981, principally due to the significant energy component in this category. Rents behaved erratically mainly because of the timing of permitted increases which have increasingly become subject to control, to annual adjustments in public authority housing rents and also due to the fact that the rent component in some countries covers mortgage interest rate charges, which rose quite sharply.

An alternative method of looking at the components of inflation, is based on the contributions of the principal inputs (imports, labour costs, indirect taxes and other factors) to the rise of total final expenditure prices (see Table 4.2). The contribution of imports to the rise in the total price level continued at a high level in 1981, as the dollar shock replaced the second oil price rise as a causative element, so that the contribution from import prices was of the same order of magnitude in 1979-81 as in 1973-74. The contribution of labour costs per unit of output was milder than in the earlier of these periods but was still a significant determinant of the Community's inflation rate. Indirect taxes (less subsidies) also show a markedly different reaction to the oil price rise than previously. Governments have been far less reluctant to raise indirect taxes than in the previous period when they had tried to cushion the impact of the rise in energy prices on the consumer. This shift in policy also coincided with general increases in value added tax in the UK and the Federal Republic of Germany in 1979 and in Italy in 1980, and general attempts to limit budget deficits in most countries. Graph 4.2 shows the respective contributions of wage costs and import prices to price

rises by country, in the past decade and in the forecast period. It illustrates quite clearly the difference in the reaction of the domestic economy to the external shocks in 1973-74 and more recently. Thus unit labour costs contributed 7,1 % and 8,0 % to price rises on total expenditure in 1974 and 1975 compared to 5,0 % and 4,1 % in 1981 and 1982.

On the important question of inflationary expectations, Graph 4.3 give some encouraging signs. The expectations of heads of industry on prices in the months ahead has moved favourably since October 1981. The modest upward movement in May can be ascribed to an adverse movement in France where industrialists have become less confident on future price developments. According to the July survey, consumers, who in their role of wage earners are an important factor in future inflation movements, expect it to fall marginally in the next twelve months in the Community as a whole; the index of their expectations is now lower than at any time since January 1979, although rises were recorded in Belgium, France and Denmark. However, judging from these data a decisive break in inflationary expectations has not yet been achieved.

4.2 Wages and income distribution

A fall in the growth of nominal wages and salaries per head to 10,8% was recorded in the Community in 1982 (after 12,8% in 1981) and a further reduction is expected in 1983 (Table 4.4). Although wage behaviour in most Member States has become more responsive to the labour market situation and increasingly at industry level negotiations the financial position of companies has been taken into account, experience among Community countries has not been uniform, given the substantially different size and nature of the wage response to lower inflation and weak labour market conditions. At the beginning of 1982, the year-to-year increase in nominal wages varied

4.6

from just over 5% in the Federal Republic of Germany to over 20% for Italy and Greece. Some narrowing of overall differentials are expected for 1982 as a whole, as is shown in the lower standard deviation of nominal wage increases in the Community in the first part of Table 4.4. In 1983, some further overall convergence is also forecast but, nevertheless, dispersion between the highest and lowest rates could remain similar. Moreover, the degree of divergence would be narrower in 1982 and fall more in 1983 if figures for Greece are excluded. In this country compensation per head increased by 27,4 % (or just over 3% in real terms) as a result of measures, introduced at the end of 1981 and beginning of 1982, to favour the lower paid and introduce automatic indexation of public (and, subject to negotiation, private) sector wages.

After the first oil shock real compensation in the Community and Japan rose fast, with rates of 4% being recorded in 1975 as inflation slowed down while nominal wage claims were being pitched at a high level (Table 4.4). In the United States, on the other hand, considerable restraint was exercised with little change in real incomes. The adjustment to lower increases in real purchasing power was, however, rapid in Japan after 1975 while in the Community, as a whole, wage-earners continued to gain substantial increases in real incomes. A further adjustment was made in the United States in the period 1979-1980 with successive falls in real compensation (0,6 and 1,1 % respectively). A marked slowdown was registered in real wages in Japan in 1980, indicating a substantially more disciplined adjustment than in the earlier period. It is only in 1982 that signs of an overdue Community wage correction have generally begun to emerge and even now small real increases are still expected on average in both 1982 and 1983.

Among the Community Member States results have been mixed. In the Federal Republic of Germany two years of real wage adjustment have been recorded in 1981 and 1982 and in Luxembourg a similar movement has been in evidence.

In the Netherlands and Denmark, where modifications have been made to indexation systems in 1980 and 1981-82 respectively, real compensation has fallen over a period 1979-1981, although in the former country some increase in real wages is expected in 1982 and 1983. In Belgium, where indexation practices have recently been modified (in line with the Commission's Communication of July 1981 (1)), a fall of 1,9 % in real purchasing power should be recorded in 1982, following a period of large increases up to 1980, particularly in the years following the first oil price shock when they were even as high as 7 % in one year (1976). A similar picture emerges for Ireland with falls in 1982 and 1983 coinciding with a return to free bargaining, in a period of soft labour market conditions, after the breakdown of the system of nationally negotiated agreements which had been in force since 1971. In the United Kingdom no adjustment in real purchasing was recorded in 1982 after rapid increases in the years since 1977 but recent settlements suggest that a more pronounced downward revision is being made to real wage expectations. For France, although the massive real wage increase of 10 % in 1975-76 has not been repeated in the current period, the increases up to 1982 have nevertheless been high and it is only in 1983 that some moderation in real wage claims is expected. In Italy no adjustment has yet taken place and real increases in incomes of 2 % per annum have been the norm. In 1983 present forecasts suggest that an acceleration to 2,3 % could even occur, although some downward pressure on incomes could result from the decision of the Confederation of Italian Industries to suspend indexation from January 1983. In Greece real per capita compensation is likely, after a growth of 2 % in 1981, to rise by 3 1/2 % in 1982 and then is forecast to stabilize in 1983.

(1) "Commission Communication to the Council on the principles of indexation in the Community" reproduced in European Economy n°10, November 1981

A rise in real compensation may, however, be met to some extent through productivity increases without giving rise to changes in the income distribution. It may therefore be more appropriate to assess distributional issues on the basis of the "normalised labour income ratio" which measures labour income as a percentage of net domestic product at factor cost, including an imputed labour income for the self employed in order to adjust for changes in the structure of employment. This measure of the "real wage" in the Community as a whole increased in 1979 to 1981 but not nearly as sharply as in 1973-1975. A fall was recorded in 1982 and may also be expected in 1983; nevertheless, the level will still be nearly 4 percentage points higher than the average level of the 1960s (Table 4.5).

A cross-country comparison of normalised levels can be hazardous, given the fact that in some economies wage and salary earners account for a relatively low proportion of total employment, and given the assumption made that the self-employed receive the average wage. Thus considerable caution is needed in drawing hard and fast conclusions from the absolute level of the figures contained in Table 4.5. Despite these reservations, certain striking results do emerge on how countries are proceeding to solve their income adjustment problems of the 1970s.

- In the forecast and estimation period (1982 and 1983) a uniform decrease in the labour/income share is foreseen in all countries, except in Greece where a further large increase is expected in 1982, in Italy where rises are expected in both years and in the United Kingdom where some rise is forecast in 1983. In the latter two countries the level of the labour/income ratio will be nearly 8 percentage points higher than in the sixties.
- The steady progress of the most recent adjustment process in the Federal Republic of Germany has been quite remarkable with the labour income share falling back to the level of the sixties in the period 1981-1983;
- In Denmark the rapid rise in the period 1973-1975 has been reversed since 1979 and the level has now dropped back considerably;
- The Netherlands too has shown a similar trend but the labour/income share is still substantially over that recorded in the 1960s;

- Ireland is expected in 1982 and 1983 to make substantial progress after the rapid upward movement in 1979 - 1981 although the situation here is complicated by cyclical movements in agricultural incomes which partly account for the erratic behaviour of this series;

- In Belgium and Luxembourg the labour/income share remains substantially above the levels of the sixties although some slow decrease is forecast.

4.3 Relative cost performance

A new and different light on cost and price performance may be obtained when measurement is done of costs in competing countries. The method used for the calculation of relative costs is described in detail in European Economy N^o 8, March 1981. This measure of relative costs gives unit labour costs in each country in relation to the weighted average of unit labour costs of 17 competitor countries, taking account not only of bilateral trade but also of the intensity of competition in third markets and in the domestic market of each country. Data has now been incorporated for the years back to 1960 and the whole series is reproduced in the Statistical Annex.

For the Community as a whole, the data show a progressive worsening of its competitive position. On the basis of unit labour costs, over the period until the first oil crisis, the index (base 1970 = 100) moved from 89 in 1960 to 116,5 in 1973, more because of a 28 % rise in domestic labour costs than because of substantial movements in effective exchange rates (appreciation of 2,6 %). Developments thereafter have tended to move along similar lines until 1980, i.e. an exchange rate appreciation of 2,1 % overshadowed by a 13,3 % increase in relative costs in national currency (1).

(1) The index of relative labour costs in national currency equals the index of relative costs in a common currency divided by the index of effective exchange rates; the changes are cumulated over the whole period.

4.10

In 1981 and so far, in 1982, the improvement in Community competitiveness back to the level of the early seventies has primarily been a result of substantial falls in effective exchange rates, but also due in part to more moderate wage behaviour, as is shown by the modest growth in relative costs in national currency of 0,7 % in 1981 and the projected fall of 1,2 % in 1982.

In the United States, relative labour costs in national currency fell by just under 20 % (cumulated figure) in the period 1960-73. This decline was supplemented by a fall of 15 % in the effective exchange rate concentrated in the early seventies, and gave an improvement in relative competitiveness in common currency terms of over 30 % from 1960 to 1973. This trend continued up to 1978, with continuing falls in relative labour costs up to 1977 and an exchange rate fall in 1978 to give a high point in competitiveness in 1978 when the index for the US had fallen to 63. Since then, there has been a progressive decline in US competitiveness as higher relative costs in national currency have been considerably reinforced by a strong appreciation in the effective exchange rate of the US dollar in the past two years. Nevertheless, the relative competitive position of the US economy is still more favourable than at any time prior to the first oil shock, the index in 1982 standing at 81.

For Japan, relative costs increased in national currency terms by nearly 7 % between 1960 and 1973, and were reinforced by an effective appreciation of the yen of 20 %. However in contrast with the Community, the major part of the increase in relative costs has resulted from the exchange rate appreciation rather than a rise in domestic costs. Since 1974, Japanese relative labour costs in national currency terms have improved massively, and more than compensated for the increase in the effective yen rate on competitiveness with the result that the index in 1982 at 114 was well below the 136 figure of 1974.

Within the Community in the period 1974-82 all countries, except the Federal Republic of Germany and the Netherlands, experienced depreciations in their effective exchange rates, principally concentrated in 1976 and 1981.

These countries registered substantial relative reductions in domestic labour costs which enabled them to improve competitiveness even while revaluing their currencies. In the remaining countries, it was only in Belgium and, to a considerably lesser extent, in Denmark, that domestic labour costs declined. Elsewhere, increases in costs in national currency terms were only in Italy compensated for by exchange rate depreciations, although in France and Ireland the average annual changes in common currency costs were minimal. In the UK, substantial cost rises in national currency up to 1979 were only partly compensated for by exchange rate movements and were followed up in 1979 and 1980 by a rapid exchange rate appreciation. It was thus only in 1981 and 1982 when the competitiveness index in common currency terms declined from the high point of 139 (Base 1970 = 100) recorded in 1980 to 134 and 126 respectively.

The outlook for 1983 on the basis of currently expected exchange rates suggests that common currency relative unit labour costs in manufacturing will grow by 1,4 % in the Community, as against a decline of 2 % in the US and a marginal increase of 0,2 % in Japan. Within the Community, falls in relative costs are expected in Belgium/Luxembourg (6 1/2 %), Federal Republic of Germany (0,4 %) and Denmark (0,2 %) with all other countries experiencing increases ranging from 0,3 % in the United Kingdom to 3,7 % in France.

Major developments in prices and incomes policy

Belgium. In conjunction with the devaluation of the Belgian franc a temporary modification of the system linking wages and salaries to the consumer price index was adopted on 20 February. Except for the statutory minimum, wage indexation was suspended until the end of May. From 1 June to 31 December 1982 there will be a flat rate increase of BFR 536 each time the increase in the index exceeds the trigger point of 2%. These arrangements apply to both public sector and private sector workers. Action was also taken to influence various categories of non wage incomes, notably by freezing directors' fees at their 1981 level, by limiting the extent to which doctors' and other medical fees may be increased and by introducing a solidarity levy on the self employed. In March the Government decided to cut ministerial salaries by 10%.

As a further accompanying measure to the exchange rate adjustment a price freeze was introduced maintaining prices at their level on 15 February up to 31 May with possibilities for certain selective exemptions from 1 April. At the end of May the Government decided to prolong the selective price freeze until the end of 1982, widen the scope of the special system under which small and medium-sized firms could apply for exemption from the freeze, and limit profit margins in absolute value to their previous level. Controls on rents were extended in December 1981 for another year, the authorised increase for 1982 being maintained at 6%.

Denmark. No direct government intervention in the wage determination process occurred in the year under review. In 1982 flat rate increases in wages are provided for by the biennial agreement between the social partners as well as certain cost of living adjustments. The expiry of the wage drift freeze at the end of 1981 has not led to any major increase in this component of wages. Negotiations between the social partners for a new two-year agreement will begin on 15 November 1982.

In January the Government announced its intention to reinforce the law on price control (the Monopolies Act of 1955) with a view to extending the period required for prior notification of price increases and modifying the composition of the board of appeal. In June it was decided to index excise duties on beverages, tobacco and electricity until the end of 1983.

Federal Republic of Germany. Wage settlements continue to be negotiated directly by unions and employers. After intensive negotiation a wage settlement emerged in the metal industries in March which provided for a growth in earnings somewhat below the expected inflation rate. Other settlements, in particular in the chemicals industry, have been influenced to a considerable degree by the concern of trade unions for job security and employment. The wage settlement in April with the public service unions provided for wage increases approximately 1% below settlements in the private sector.

Greece. Automatic indexation of public (and indirectly private) sector wages was introduced to apply from 1 January 1982 and adjustments will take place after the end of each period of four months. Indexation is complete only for wages up to DRA 35 000 per month; for the amount between DRA 35 000 and 55 000 the increase will equal half the inflation rate and for that between 55 000 and 80 000 it will equal one quarter of the inflation rate. There will be no indexation increases above that level. The index is provisionally that of the consumer price index and applies to salaries as they are on 1 January 1982, i.e. after the first increase (between 4 and 25%) which was granted to cover inflation in 1981 and to favour the lower paid. At the end of May legislation provided that automatic indexation granted by the Government to the public sector would

only apply to the private sector where it was provided for in collective agreements.

The Government decided in October 1981 to tighten up the price control system by adopting more strict control on industrial production costs of both consumer and intermediate products, the maintenance of price fixing on basic products, quality control of all products but especially foods and medicines as well as controls on publicity. Measures implementing this decision in February 1982 fixed ceilings on the increases in certain categories of industrial goods. In cases where increases in costs necessitate an increase in prices exceeding 10% for 1982 a special authorisation will be required both for national and imported products.

France. In November 1981 a contractual system for the development of wages and salaries, in order to break the price wage spiral, was proposed. This suggestion envisaged that in the public sector a calendar of quarterly rises in accordance with the Government price objective would be proposed and that rises at the beginning of the period would anticipate the development of prices. No overall consensus was found on this proposal. On 23 June the Government suspended provisionally the law of February 1950 on the freedom of negotiations and adopted a draft law to block all wage increases in the public and private sector (except for the statutory minimum wage) during the period 1 June to 31 October 1982. Controls were also introduced on distributed profits, fees and commission. It is proposed to introduce on 1 November 1982 a system of anticipated rises in salaries in accordance with the official price objective in the public sector and this has been recommended also to the social partners in the private sector.

On 5 October 1981 the prices of services and the retail prices of certain important food products were frozen for six and three months respectively. In addition importers' margins were pegged in absolute value for three months. Rent increases were limited for six months to 80% of the rise in the INSEE construction cost index and a pledge was given that the increase in public sector charges would be limited to between 8 and 10% in 1982. The prices of industrial products were not controlled but a recommendation was issued to firms and wholesalers that the annual rise in prices of products should be limited to 8%. In January 1982 food prices were liberalised and price controls on services were lifted in April. In June 1982 rents were frozen until 31 October 1982 at their level of 11 June 1982. Following the EMS realignment of 12 June measures were taken to freeze producers and distributors prices until 31 October. Importers' margins were also frozen as well as prices of services. In addition all variation and revision clauses were suspended in the public and private sector and margins on various food products were fixed. The only categories excluded from the freeze were oil, steel and coal, prices governed by international agreement and public authority charges. On 25 August different measures were adopted to ensure a smooth transition from the price freeze with an objective of an 8% rise in prices in 1983. These include limits on increases in public sector charges and a request to firms not to exceed the 8% level.

Ireland. In December 1981, after the breakdown in negotiations for a national pay agreement, the Government granted public service workers increases over 15 months of between 13 1/2 and 21% (for the lower paid). The average increase for the year 1982 is approximately 12%. This agreement has tended to be adopted as a headline for settlements in other sectors.

Italy. The Confederation of Italian industries announced on 1 June that it intended to cancel the agreement of 25 January 1975 concerning automatic indexation. This will not have a direct effect on wages until the end of January 1983.

A new method was introduced at the beginning of the year by which the Interministerial Committee on prices fixes the prices of oil products.

Luxembourg. The Government temporarily suspended the price/wage indexation mechanism up to the end of 1982 on 9 March. The measures taken limit wage and salary increases to two tranches of 2,5% (on 1 September and 1 December) independently from the price level. Indexation was maintained for the minimum wage, a 5% solidarity contribution was levied on the net income of the professions and Ministers' salaries were cut by 10%.

On 22 February the Government decided, with immediate effect, to freeze prices at the level of 19 February. On 9 March it was decided to extend the selective price freeze up to the end of 1982. In addition it was decided to postpone for three months the planned rise in VAT on liquid energy products.

Netherlands. In December 1981, when the two sides of industry were unable to reach an agreement on wage increases in 1982, the Government took measures under the wage law to prolong the 1/2% cut in the holiday bonus and to limit automatic wage indexation to earnings under HFL 60 000 per annum. These measures which will apply until the end of 1982 aim to limit the rise in wages and salaries in 1982 to 6%. If this increase is exceeded the Government maintains the right to intervene.

The Government lifted price controls from 1 January on six industrial sectors (paper, textiles, clothing, wood, furniture and basic metals) and in three commercial sectors (household, audio and photographic appliances). In other branches of industry and commerce the maximum increases were set at up to 5 1/2%. The maximum increase for public utility charges was fixed at 4%. With effect from 1 July 1982 rents can be increased by between 4 and 6%.

United Kingdom. The principle of free collective bargaining was maintained in the past year in the UK. Action on the incomes side has concentrated on measures which have been taken to reduce labour market rigidities and to cut non-wage labour costs. In May the authorities agreed to pay increases of around 6% for civil servants, doctors, dentists and the armed forces. This outcome was about 2% above the original target.

Table 4.1
Price and cost indicators EC 10

	(% change over preceding year, annual averages)										
	1970-79	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
(forecast)											
Prices											
GDP price deflator	9,4	12,5	15,0	10,5	9,8	8,3	9,3	10,8	10,6	10,6	8,8
Consumer price deflator	9,1	14,1	13,7	10,8	9,9	7,1	9,1	11,1	11,8	10,5	8,8
Export price deflator (1)	8,8	25,0	9,1	10,8	8,8	3,9	9,7	11,3	12,6	10,9	8,8
Import price deflator (1)	9,6	38,5	5,0	12,8	8,5	0,9	10,4	15,0	14,7	9,2	6,7
Costs											
Unit labour costs (3)	10,0	14,7	16,4	7,0	8,1	6,9	8,1	11,9	10,0	8,5	7,4
Per capita compensation of employees	13,3	17,5	18,2	13,7	11,2	10,7	11,1	12,8	11,9	10,8	9,8
Real per capita compensation of employees (4)	3,9	3,0	4,0	2,6	1,2	3,4	1,8	1,6	0,9	0,2	0,9
Real unit labour costs (5)	0,5	2,8	2,8	-2,0	-0,7	-0,4	-0,7	0,4	1,1	-1,2	-0,6
Productivity (2)											
Real GDP per person in employment (6)	3,0	1,7	-0,4	5,2	2,0	2,4	2,4	1,4	0,9	1,4	1,4
Relative price adjustment (7)	0,3	-1,4	1,1	-0,4	-0,1	1,2	0,1	-0,2	-0,3	-0,3	0,3
Tax rate adjustment (8)	0,2	0,6	0,9	-0,6	-0,3	-0,0	-0,5	-0,3	0,2	-0,3	0,1
Warranted real wage (9)	3,5	0,9	1,6	4,2	1,6	3,6	2,1	0,9	0,7	0,8	1,8
Real wage gap (10)	0,3	2,1	2,3	-1,6	-0,3	-0,2	-0,2	0,7	0,2	-0,6	-0,9
Change in dollar value of ECU	3,0	-3,2	4,0	-9,9	2,1	11,7	7,6	1,6	-19,8	-12,2	-3,8

(1) Goods and services.
 (2) EC 9.
 (3) Compensation of employees, including social insurance contributions, per employee, divided by GDP at constant prices per person in total employment.
 (4) Compensation of employees, including social insurance contributions, per employee, deflated by the consumer price index.
 (5) Per capita compensation of employees per unit of output deflated by the GDP price deflator.
 (6) GDP at constant factor cost per person in total employment.
 (7) The difference between the price deflator of GDP at market prices and that of private consumption. See Technical Annex.
 (8) The difference between the price deflator of GDP at factor cost and at market prices.
 (9) The growth rate of real wages which would maintain constant factor shares.
 (10) The difference between the actual growth in real wages and the warranted growth.

Source: Commission services.

Table 4.2

Origin of price increases (final expenditure), EC10

(contribution to the increase in the deflator of total final expenditure)

	Imports	Unit labour costs (1)	Indirect taxes (1)	Other factors (residual)(1)	Total (2)
1972	0,1	3,3	0,3	2,0	5,6
1973	2,5	4,3	0,4	2,1	9,2
1974	7,2	7,1	0,6	2,5	17,3
1975	1,1	8,0	0,8	2,9	12,8
1976	2,5	3,9	1,2	3,3	11,0
1977	1,8	4,2	1,0	2,5	9,5
1978	0,2	3,6	0,8	2,2	6,7
1979	2,1	3,9	1,1	2,4	9,4
1980	3,2	5,1	1,2	2,2	11,7
1981	3,3	5,0	0,9	2,3	11,6
1982 (3)	2,1	4,1	1,1	3,0	10,3
1983 (4)	1,7	3,5	1,0	2,3	8,5

(1) Per unit of output. Indirect taxes are net of subsidies.

(2) Total = deflator of final expenditure.

(3) Estimate.

(4) Forecast.

Sources: Eurostat and Commission services.

Table 4.3

Consumer prices and the GDP deflator		(national currencies, % increase)										
1961-74 (average)		1975	1976	1977	1978	1979	1980	1981	1982 (estimate)	1983 (forecast)		
Consumer prices												
B	4,3	12,5	7,9	6,8	3,9	3,9	6,5	9,1	9,2	8,5		
DK	6,7	9,9	9,4	9,9	9,8	9,6	11,5	10,7	9,9	7,0		
D	3,9	5,9	4,4	3,9	2,4	4,0	5,3	6,1	5,0	3,6		
GR	4,8	13,0	14,0	11,6	12,6	17,7	23,7	24,4	23,0	21,0		
F	5,3	11,4	9,9	9,2	8,8	10,9	13,2	12,6	10,9	9,0		
IRL	6,6	22,3	18,8	12,5	7,5	13,4	18,3	19,6	18,5	13,0		
I	5,8	17,6	18,1	18,2	12,9	15,0	20,4	19,1	16,6	15,0		
L	3,5	10,2	9,5	5,8	3,5	5,8	7,7	8,1	11,0	9,0		
NL	5,5	10,7	8,8	5,9	4,3	4,3	6,6	6,5	6,3	4,5		
UK	5,7	23,5	15,5	15,1	8,9	14,3	15,5	10,9	8,8	6,9		
EC 10	5,2	13,7	10,8	9,9	7,1	9,1	11,1	11,8	10,5	8,8		
Standard deviation	1,8	5,4	4,5	4,3	3,6	4,9	6,1	5,9	5,4	5,0		
USA	3,5	7,9	5,1	6,0	6,8	9,2	10,2	8,3	6,4	5,8		
JAP	7,2	11,6	8,9	7,1	4,6	3,4	7,1	4,5	4,3	3,7		
GDP deflator												
B	4,7	12,6	7,5	7,1	4,1	4,2	4,3	5,4	7,3	7,4		
DK	7,2	12,8	8,7	8,8	10,3	7,7	8,4	9,6	10,5	6,9		
D	4,3	6,4	3,4	3,8	3,7	3,8	4,7	4,1	4,9	3,7		
GR	5,6	12,3	15,4	13,0	12,9	18,7	18,4	19,7	21,7	20,7		
F	5,3	13,4	10,1	8,9	9,8	10,6	11,5	11,7	12,4	9,7		
IRL	7,1	22,3	20,2	12,3	10,6	12,4	14,1	17,8	19,2	12,8		
I	6,3	17,5	18,0	19,1	13,9	15,7	20,4	17,6	17,5	15,7		
L	5,2	-1,0	12,9	0,9	5,8	6,9	6,8	5,0	8,7	7,7		
NL	6,2	11,2	8,9	6,3	5,2	4,2	5,3	5,6	6,1	3,6		
UK	5,8	26,9	14,7	14,0	10,9	15,1	18,9	12,1	8,4	6,4		
EC 10	5,5	15,0	10,5	9,8	8,3	9,3	10,8	10,6	10,6	6,8		
Standard deviation	2,3	7,4	4,9	5,1	3,5	5,1	6,0	5,6	5,6	5,2		
USA	3,7	9,3	5,2	5,8	7,4	8,4	9,0	9,2	7,2	6,0		
JAP	6,8	7,8	6,4	5,7	4,6	2,5	3,1	2,8	3,0	3,1		

Note : Consumer prices = implicit price index of consumers expenditure; GDP deflator = implicit price index of GDP
Sources : Eurostat and Commission services

Table 4.5

Normalised labour income ratio (1)

	1960	1970	1979	1980	1981	1982	1983
B	77,9	77,4	86,7	88,1	89,1	88,0	86,5
DK	78,2	84,9	86,2	86,3	85,2	83,4	82,5
D	77,8	81,1	82,6	83,6	83,8	82,2	81,2
GR	109,0	94,5	96,5	93,7	98,4	103,7	103,2
F	82,2	79,5	85,2	87,1	88,2	86,8	85,9
IRL	93,3	98,2	93,9	100,6	102,9	98,9	97,4
I	89,9	86,5	92,2	90,8	94,2	94,4	96,1
L	77,2	76,5	91,4	94,2	99,4	99,1	96,1
NL	71,6	80,9	82,9	83,8	81,8	79,7	78,3
UK	79,5	84,5	86,4	89,2	88,9	88,6	89,1
EC 10	82,6	82,8	86,2	87,2	88,1	87,3	87,0

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

Source : Commission services.

TABLE 4.6
Effective exchange rates and relative cost performance of manufacturing industry, 1974-82

	(% change on previous year)										
	B/L	DK	D	F	IRL	I	NL	UK	EC	USA	JAP
Effective exchange rates (1)											
1974	1,8	0,7	6,3	- 6,5	- 2,7	- 9,6	5,6	- 3,4	- 2,7	2,2	- 6,5
1975	1,5	3,4	1,9	9,9	- 5,4	- 4,1	2,5	- 7,8	2,4	- 0,8	- 2,8
1976	2,2	2,3	5,9	- 3,7	- 10,1	- 17,3	2,8	- 14,7	- 8,4	5,2	4,9
1977	6,1	- 0,3	8,6	- 4,7	- 3,1	- 7,7	5,9	- 4,8	0,9	- 1,2	10,7
1978	3,6	0,3	6,7	- 1,2	1,3	- 5,8	3,0	1,1	2,9	- 9,7	21,7
1979	1,5	- 0,7	5,2	0,7	0,4	- 3,2	1,7	6,6	5,9	- 2,6	- 7,1
1980	- 0,4	- 8,1	0,4	0,3	- 2,6	- 3,7	0,1	9,9	2,2	- 0,0	- 4,2
1981	- 6,1	- 7,6	- 6,3	- 8,6	- 9,8	- 12,2	- 4,9	- 0,1	- 14,9	12,1	13,6
1982 ³	- 10,0	- 4,6	5,6	- 7,7	- 4,0	- 9,7	5,2	- 4,4	- 5,8	7,1	- 1,3
1961-73 Annual average	0,5	- 0,1	2,7	- 0,7	- 1,5	- 0,9	0,8	- 2,4	0,2	- 1,3	1,4
1974-82 Annual average	0,1	- 1,7	3,7	- 2,5	- 4,1	- 8,3	2,4	- 2,2	- 2,2	1,2	2,8
Relative labour costs calculated in common currency (2)											
1974	5,9	1,9	- 1,2	- 9,0	- 2,1	- 5,7	3,6	2,6	- 5,3	1,2	4,0
1975	0,9	- 5,5	- 8,6	14,2	3,5	12,1	1,9	7,2	6,0	- 10,4	- 3,7
1976	0,9	2,2	1,4	0,2	- 4,8	- 12,6	- 2,4	- 9,1	- 6,6	4,4	- 2,7
1977	4,5	- 0,0	5,6	- 3,9	- 1,5	2,2	3,3	- 0,9	3,6	- 2,4	6,1
1978	- 1,4	0,7	4,3	0,7	1,8	- 1,1	- 0,4	7,3	4,7	- 7,1	11,7
1979	- 4,0	0,3	0,8	4,1	1,0	- 0,4	- 1,8	16,7	7,7	1,1	- 14,6
1980	- 3,3	- 10,0	- 2,3	1,8	5,6	1,6	- 5,3	24,7	6,1	2,2	- 12,5
1981	- 11,1	- 6,8	- 9,4	- 3,9	- 2,3	- 3,5	- 10,6	- 3,2	- 14,3	12,9	8,2
1982	- 15,6	- 1,9	- 0,4	- 2,5	0,7	- 2,4	- 0,2	- 6,1	- 6,9	10,1	- 6,5
1961-73 Annual average	0,7	1,5	3,6	- 1,3	1,4	1,2	2,1	- 1,5	2,1	- 2,9	1,9
1974-82 Annual average	2,9	- 2,2	- 1,2	0,0	0,2	- 1,3	- 1,4	3,9	- 0,8	1,1	- 1,5

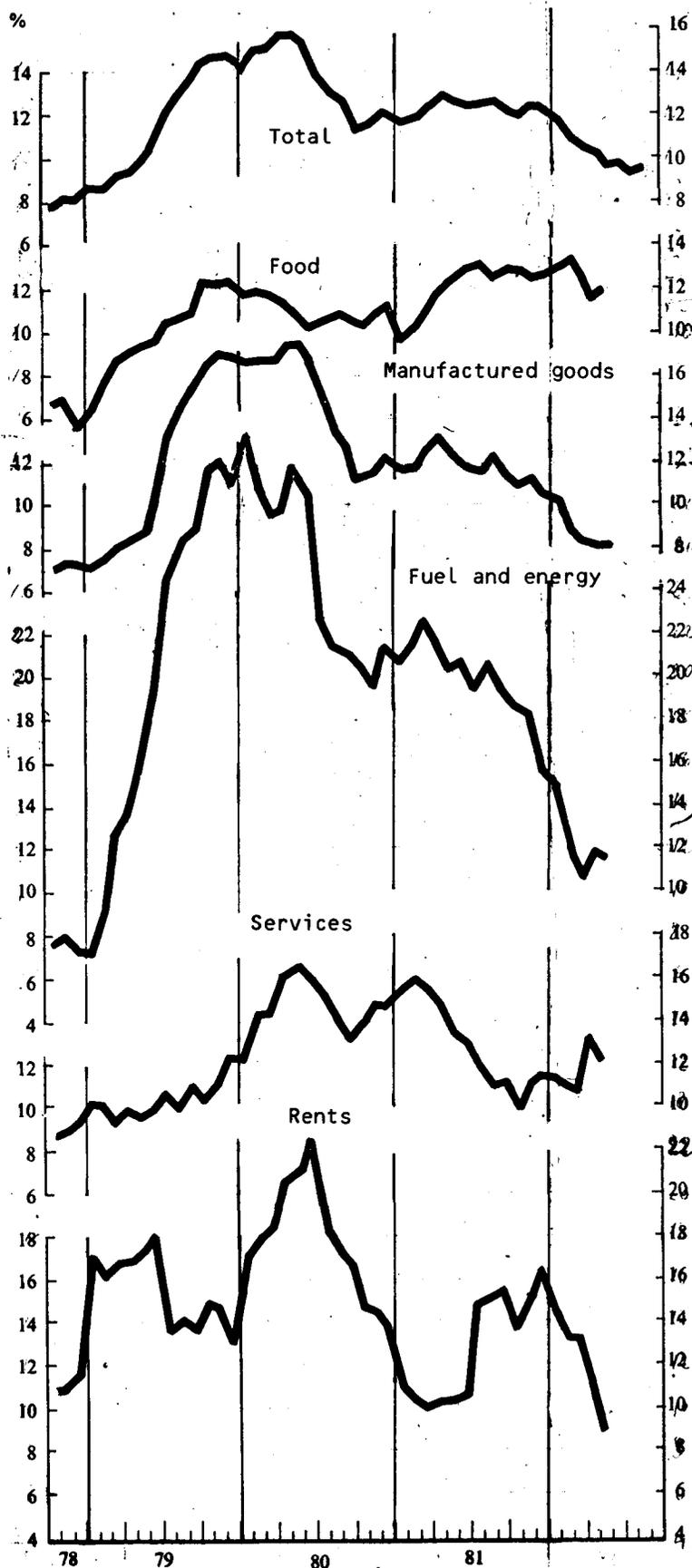
(1) A positive figure denotes an appreciation in the effective exchange rate

(2) Unit labour costs in manufacturing industry in common currency by reference to the weighted average for the 17 main competing countries

(3) Provisional forecasts on the basis of September 1982 exchange rates

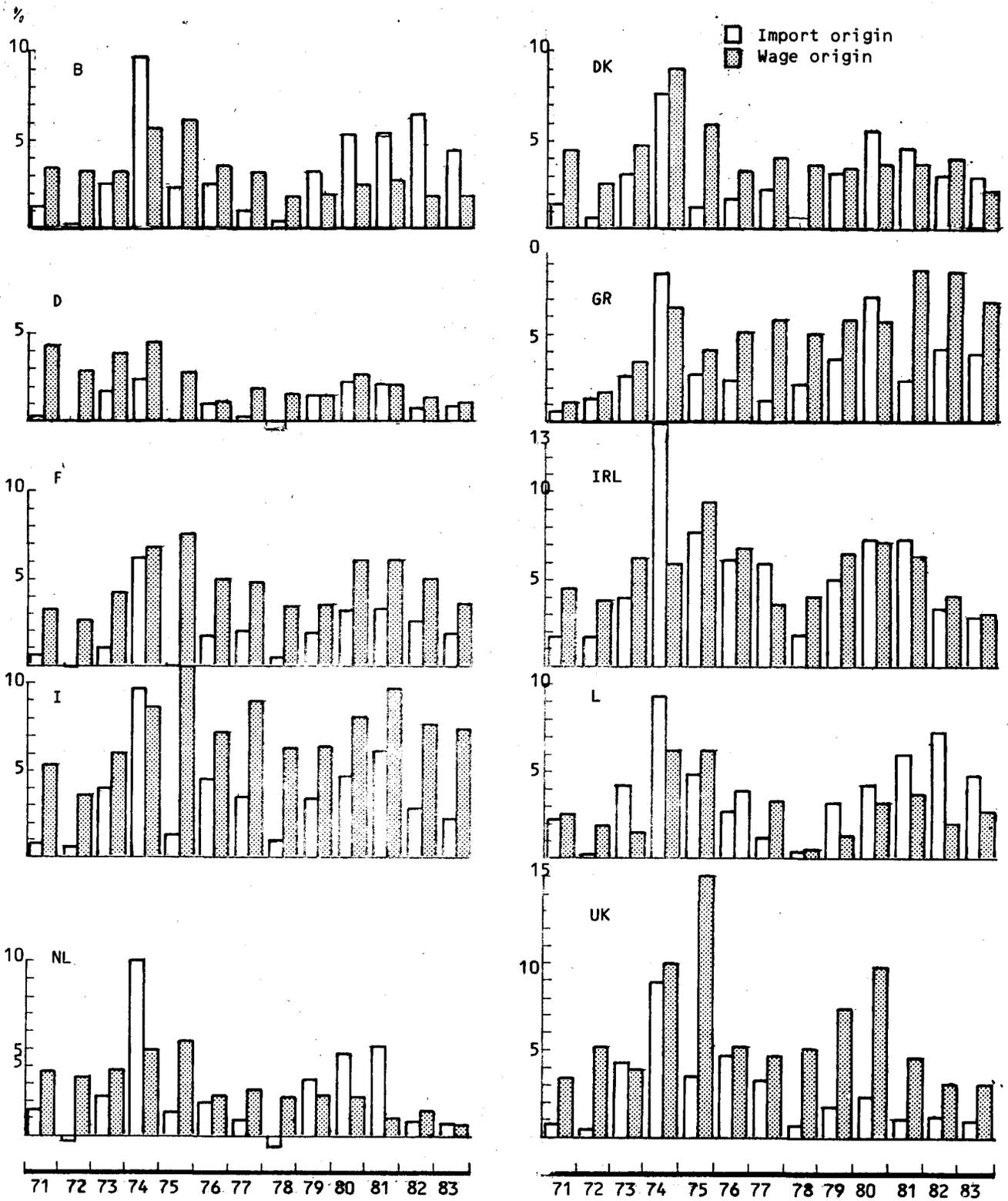
Source: Commission services.

Graph 4.1: Consumer prices and main components, EC 9
Change on six months (s.a.) expressed as annual rate



Source: Eurostat, OECD and Commission services.

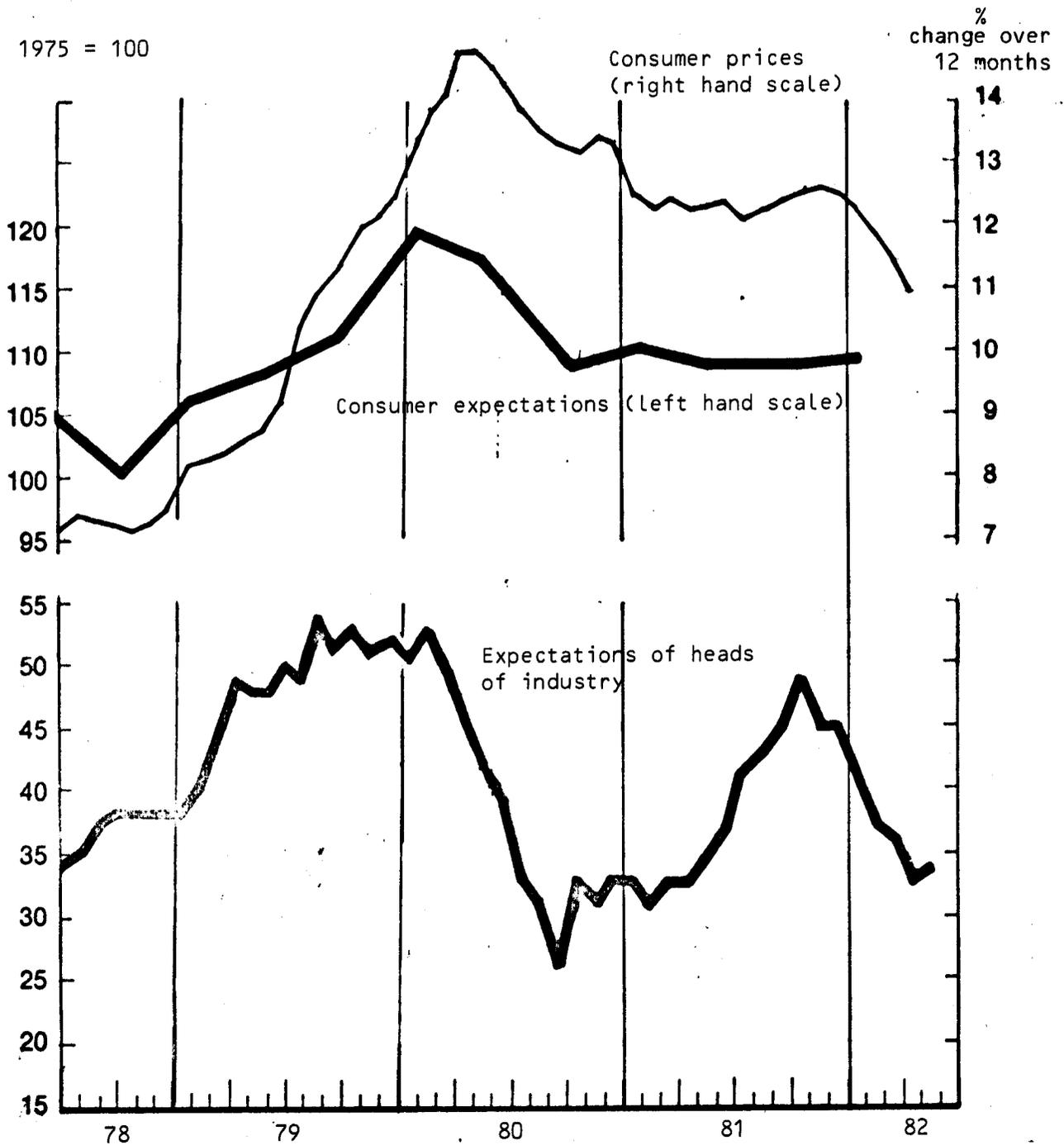
Graph 4.2: Origin of price increases by country (1)



(1) Contribution of import prices and wage costs per unit of output to percentage change in deflator of total final expenditure.

Source: Commission services.

Graph 4.3 : Price expectations and actual price increases



5. Monetary policy and the European Monetary System

The tendency noted since 1979 for monetary growth to slow down in the Community continued in 1981. This success in regaining control over the monetary aggregates has prevented a price explosion in the wake of the second oil shock and of the rise of the dollar and has already permitted a degree of success in the fight against inflation. The scope for the monetary authorities to switch to less restrictive policies depends on a return to external equilibrium and on an easing of internally generated inflationary strains. In those countries in which inflationary pressures are still great, any relaxation of the pressures exerted by monetary policy would raise expectations both of inflation and of currency adjustment and would not permit a lasting reduction of real interest rates, save at the cost of relaunching the spiral of devaluation and inflation. The monetary authorities of the countries which have secured an appreciable improvement in their external position should continue to make full use of their room for manoeuvre and reduce further the level of their interest rates to encourage a renewal of economic growth. A more substantial and lasting reduction in interest rates in those countries cannot, however, go further than is consistent with the need to maintain the external value of their currencies and to consolidate the progress made in adjusting budgets and real wages and salaries.

The rise of the dollar has added to the inflationary pressure of domestic origin in Community countries, and reinforced the need for monetary stability. The reaction of the European authorities in the face of volatile US interest rates has been balanced : they have managed to keep the path of money market interest rates smooth, while attempting to limit the extent of fluctuations in the dollar exchange rate by intervening on the exchange markets. Since the autumn of 1981 the European Monetary System has been passing through a hazardous phase. While the adjustments to the central rates in October 1981 and June 1982 were a partial reflection of divergences in national costs and prices, the devaluation of the Belgian franc in February 1982 arose from the need to stabilize the Belgian economy. Success of the realignments and restoration of greater stability within the EMS can be achieved only through continued application and reinforcement of domestic stabilization measures in the weak-currency countries.

5.1. Conduct of monetary policies in 1981 and 1982

The broadly defined money stock rose 10.5 % in 1981 (December on December) on average over the Community as a whole, as against 11.3 % in 1980; a similar calculation covering the countries participating in the exchange rate mechanism of the European Monetary System shows a growth rate virtually unchanged between 1980 and 1981 at 9.2 %. Following the upsurge during the 1970s and the appreciable slowdown in 1979 and 1980, money supply growth has thus returned to the average rate recorded during the 1960s (see Graph 5.1).

5.2

The evidence so far and Commission forecasts suggest that the stabilization of the growth of the money supply in the Community between 10 and 11% should, with slight differences from one country to another, continue in 1982 and 1983 (see Table 5.1). This success in regaining control over money supply growth is the fruit of the policies launched at the end of the last decade. It has prevented the second oil shock and the appreciation of the dollar from causing a sharp rise in inflation rates in the Community, as happened in 1974 and 1975 (see Graph 5.1); it has also contributed to the process of disinflation noted since the end of 1981.

A major element of the discipline imposed by monetary policies in most Community countries has been the fixing of targets for the growth of the money supply or of credit which - in 1981 - involved at the very least the continuation if not a fall in the growth rate for the target variable compared with the 1980 outturn (see Table 5.2). Besides such quantitative objectives, the Community monetary authorities must, in executing their policies, take account of external factors, particularly movements in the exchange rates of their currencies. This is a consequence of the high degree of openness of the European economies.

In the Federal Republic of Germany and more recently in the United Kingdom, for example, the monetary authorities have been using the margin left them by the fixing of a range for the target variable to adjust the supply of money not only in the light of domestic policy but also on the basis of their currencies' position on the foreign exchange market. Such action does not put in question the need to control the growth of monetary aggregates if there is to be lasting success in the struggle against inflation - quite the reverse.

In the Federal Republic of Germany, the measures taken in February 1981 by the Bundesbank to restrict the creation of bank liquidity and raise its cost were motivated mainly by signs that the German mark was weakening

on foreign exchange markets, both in relation to the dollar and within the EMS. This renewed demonstration by the Bundesbank of its commitment to stability, together with the improvement in the balance of payments on current account and the reduction of inflation, subsequently reinforced confidence in the German mark. External inflationary factors are currently being held in check by the appreciation of the German mark against European currencies and thus also by the relative stability of the mark in relation to the dollar; this has meant that the Bundesbank has been able gradually to ease domestic monetary conditions since the autumn of 1981 and so allow a more rapid expansion of the broadly defined money stock (M_3). The rate of growth of the target variable (MZ) was at the upper limit of its range during the first half of 1982. In the United Kingdom the authorities wished to be able to present a flexible response to unusual shifts in the demand for money and therefore fixed targets for three monetary aggregates (M_1 , sterling M_3 and private sector Liquidity - PSL2) while also taking account of other indicators such as rates of interest and the exchange rate. Without in any way fixing an exchange rate objective, they consider it desirable to limit fluctuations in the effective exchange rate. Thus, in mid-September 1981 the Bank of England reacted to signs of weakness in the pound sterling by tightening money market conditions and allowing a large rise in interest rates. The balance of payments surplus and progress on internal adjustment subsequently made it easier to maintain the external value of sterling and allowed a gradual fall in interest rates. However, the fixing of quantitative objectives remains the key instrument of anti-inflationary policy, notably because it helps to stabilize expectations concerning the internal and external value of sterling.

In the other countries, the exchange-rate discipline imposed by the European Monetary System has had the effect of regulating the money supply. In France, 1981 and the early months of 1982 saw an upsurge in the domestic creation of liquidity, largely to meet the Treasury's increased borrowing requirement, but the destruction of liquidity via the external deficit made it possible to curb the growth rate of the money

5.4

supply during this period; this rate was 11.4 % over the twelve months to December 1981, as against an initial target of 10 %, and currently stands at between 12 and 13 % (i.e. within the range of 12.5 % - 13.5 % fixed for 1982). Italy, Ireland and Greece fix quantitative objectives for lending. In Italy and Ireland, which are members of the EMS, observance of the targets is complementary to the exchange rate objective. The same applies to Denmark, where the controls on lending resulting from agreements between the banking sector and the national authorities are more stringent than the official assumption for the growth of the money stock. Enforcement of the lending targets and, more generally, control of domestic liquidity creation are means of exerting direct pressure on domestic demand and thus of speeding up the external adjustment process. They may also eliminate the risk that monetary policy will exert its stabilizing influence mainly through the exchange rate, to the detriment of sectors exposed to external competition. Belgium and, since 1982, the Netherlands do not fix quantitative objectives. These two countries pursue primarily an exchange-rate policy within the framework of the EMS. In the Netherlands, the extension of an objective for domestic liquidity creation into 1981 became inappropriate because of the appearance of a balance of payments surplus in the non-banking sector.

In the countries with an external deficit, the choice between direct action on domestic liquidity and intervention on the foreign exchange market need not be resolved by referring only to the level of reserves or the availability of credit under EMS arrangements. The authorities can in fact ease the monetary constraint imposed by the EMS by borrowing abroad, either directly or indirectly. The proceeds from this borrowing can be used to replenish foreign exchange reserves and to support the currency on international markets where necessary. Such a policy of financing external deficits has been pursued increasingly in recent years by all the European countries, with the exception of the Netherlands and the United Kingdom. Figures published by the central banks and by the Bank for International Settlements (1) show that only Greece and Italy were

(1) See the annual report of the Bank for International Settlements 1982, p. 108 (English text).

able to finance part of their current account deficit in 1981 through private sector imports of capital. In all the other countries, the figures show net exports of private capital, which, coming on top of current account deficits, have lead either to an increase in external public sector indebtedness or to a fall in the official reserves. The Federal Republic of Germany is in a special position, however. Foreign borrowing by the Federal Government is all denominated in German marks and is therefore competing with private capital imports. It is therefore reasonable to assume that, with monetary policy unchanged, public capital imports partially replace rather than supplement private capital imports. In the United Kingdom, the policy of repaying the external public sector debt has been continued.

By providing support for the exchange rate and hence the terms of trade and by relieving pressure on the domestic credit market, the external borrowing policies pursued by the public authorities have helped to stabilize real demand for goods in Community countries following the second oil shock. While this stabilisation has had valuable short-term effects, it is nevertheless clear that, when used systematically, such policies are not without danger. They delay necessary domestic adjustments, both in the budgetary field and in real incomes, and postpone the reduction of external deficits.

5.2. The internal constraints on monetary policy

The monetary authorities have only limited scope for encouraging the desparately needed upturn in investment while steadily reducing external deficits and restraining inflationary pressures. Monetary policy is vulnerable to the repercussions of budgetary policies and the effects of the growth of nominal incomes. The cost to the private sector of excessive budget deficits when a strict policy of price stabilization is pursued is particularly clear in Belgium and Denmark. In these two countries, the size of the public sector borrowing requirement is such that the flow of bank lending to the private sector is appreciably less than the flow of lending to the public sector (see Table 5.3). The measures to control the

money supply, which bear only on the private sector, have thus a particularly restrictive effect. In Italy, because of the growth in the budget deficit, the 1981 target set was exceeded by more than 2 percentage points, whereas the expansion of credit to the private sector was within the norm laid down. In Ireland, where domestic liquidity creation (1) is extremely high, the rate of investment has stabilized or has even increased, but this has been achieved at the price of an external deficit and a rate of inflation which are much higher than the Community average. In France, the growth in domestic liquidity creation in recent months has been due mainly to monetary financing of the budget deficit, whereas the expansion of lending to the rest of the economy has fallen slightly. These examples show that the very credibility of monetary policy may be called into question if the level of the budget deficit is not contained; the pressures which are already being exerted on interest rates because a growing proportion of savings must be invested - directly or through the banking system - in public debt instruments would then be aggravated by the inflationary expectations which feed on such a loss of credibility.

While public sector borrowing requirements largely determine the degree of restrictiveness of monetary policy, there is another field where events interact strongly with the stabilisation policies pursued by the monetary authorities, namely the growth of incomes. A rise in the investment ratio - and hence growth on a sound and lasting basis - requires not only the availability of savings for private sector investment, but also an adequate return on capital employed. Thus if monetary policy aims at stability and reduces the amount by which prices can rise, then a failure of income from employment to adjust adequately or in due time will add to the cost of the process of eliminating inflation.

Given the constraints, it is clear that laxity on the part of monetary policy would jeopardize the initial success which has been achieved in reducing inflation and could not lead to a sustained rise in the growth

(1) In Table 5.3, this includes external public sector borrowing.

rate. Expectations of rising prices and currency depreciation would be rapidly reflected in both interest rates and the growth of income from employment. This would contribute nothing to the reduction of real disequilibria and there would be a risk of a cumulative inflationary process. This is why in countries such as France, Italy, Ireland and Greece, which have inflation rates which are still high in relation to the Community average and/or in which only limited progress has been made in reducing inflation, continued efforts to control domestic liquidity creation are necessary. The same is true in Belgium and Denmark, where monetary policy will have to continue to hold the rate of inflation below the Community average. However, the better the balance achieved in the budgetary and incomes policy fields, the less restrictive will be the effects of such a monetary policy on overall demand. This is also essential for a better allocation of savings to productive investment and a steady reduction of external deficits. The economic situation in the Community suggests, however, that the three countries which run a surplus on their current accounts and which have made progress on domestic adjustment - the Federal Republic of Germany, the Netherlands and the United Kingdom - should make full use of the room for manoeuvre available to them in the monetary field to promote the upturn in growth expected in 1983. In these three countries there are nevertheless clear limits to the scope for a relaxation of monetary policy. First, the external value of their currencies must be maintained sufficiently to restrain external inflationary factors and, secondly, sustained efforts are required to consolidate the internal adjustment which has been achieved. A renewed tightening of monetary conditions might otherwise become necessary.

5.3. Nominal and real interest rates in the Community

Owing to the highly integrated nature of international financial markets, nominal interest rates for the European currencies were largely influenced in 1981 and the early months of 1982 by the level of interest rates in the United States, but their movements in relation to each other were determined mainly by the economic performances of the various countries, particularly in the areas of inflation and the balance of payments on current account (see Graphs 5.2). In the Federal Republic of Germany and the Netherlands, for example, short-term rates - after reaching a record level

5.8

in 1981 (an average for the year of 12.4 % and 11.8 % respectively) - have returned to roughly their average 1980 level (9.5 % and 10.6 % respectively) or even lower. In the United Kingdom, short-term interest rates have also fallen after reaching a maximum of 16.9 % in September 1981; in June, 1982, they had returned to the level obtaining during the first few months of 1981.

In the other countries, where inflationary pressures remain strong and the current account outlook unfavourable, a similar fall in interest rates has not been recorded. In Italy and Ireland, the monetary authorities have not relaxed money market conditions and interest rates have risen appreciably since 1981, at least in relation to the average level for the EMS area. The maintenance of relatively high interest rates is necessary in these two countries owing to their inflation rates. In France, and to a lesser extent in Belgium, money market rates have moved more violently. In France, they have reflected partly the monetary authorities' wish to reduce interest rates for domestic reasons and partly the need to respect the constraints of the European Monetary System. Between the October 1981 realignment and that in February 1982, the one-month money market rate thus fell from 18.6 % to around 15 %. It then rose again between March and June 1982 to approximately 16.5 % before again beginning to fall following the June realignment. The Belgian monetary authorities have, for domestic economic reasons, held their interest rates at as low a level as possible, while at the same time accepting a weaker position for the Belgian franc within its margin of fluctuation. In Denmark, the monetary authorities pursued, from the autumn of 1980 to September 1981, a policy of uncoupling the cost of domestic credit from the cost of credit on international markets. This policy led economic agents to switch wherever possible from foreign borrowing to the Danish banking system. The result was a net outflow of private sector capital which in due course forced higher intervention by the National Bank on the foreign exchange market. It was this which led the National Bank to allow the interest rate differential in

favour of the Danish krone to widen as from the autumn of 1981. This experience shows the limited extent to which domestic and external interest rates can be disconnected in countries having a high external borrowing requirement if private operators engage in currency arbitrage both when borrowing and when investing. Generally speaking, the weight of fundamental factors in the determination of nominal interest rates has probably been accentuated by the more frequent adjustment of central rates within the EMS : these make it more risky for financial operators to invest short-term funds purely on the basis of nominal interest-rate differentials. The tendency for the EMS to equalize nominal interest rates has thus weakened appreciably in recent months.

As a Community average, the real long-term interest rate was 2.9 % in 1981 compared with 0.7 % in 1980. Following its appreciable fall during the 1970s, it has thus returned to its average level of the 1960s (see Table 5.4). This rise in real interest rates has been evident in practically all the Community countries, the exceptions being Ireland and Greece. While real interest rates have returned to their level of the 1960s, their role in economic development has quite clearly changed : whereas at that time they served to attract the savings needed to finance the accumulation of productive capital they now reflect rather more a conscious decision on the part of national authorities to renounce monetary policies characteristic of the last decade which permitted budget deficits and adapted to external shocks. Parallel with this, the growth in output, which generates the surplus necessary to ensure an adequate return on capital, has slackened sharply. Since 1980, the rate of growth of real GDP has been appreciably lower than the real rate of interest in an ever increasing number of Community countries (see Table 5.4). If it continues, this pattern may pose increasing problems for sectors which are regularly in deficit, particularly the public sector.

5.10

Table 5.4 reveals with the help of a number of examples, the interactions between monetary policy, budgetary policy and the growth of incomes. Thus in Belgium and Denmark real interest rates have reached a particularly high level owing to the combination of a strict monetary policy, which has kept inflation below the Community average, and budget deficits of around 10 % of GDP. In Ireland, on the other hand, where monetary policy has exerted less pressure on domestic demand, real interest rates have remained negative at the cost of a rate of inflation which has been rising consistently since 1978 (consumer price index : + 7.5 % in 1978 and + 20.5 % in 1981) and of an external deficit exceeding 10 % of GDP. In Italy and the United Kingdom, where prices also exploded after 1978 and where the reduction of inflation is now - in differing degrees - under way, real interest rates, led by the monetary authorities, are again clearly positive, and close to the Community average. In France, the growth of budget deficits in 1981 and 1982 has been accompanied by a rise in real long-term interest rates. By allowing the price of capital to find its true level again, stabilization policies make it possible for investment decisions to be taken on a more rational basis. Indeed, it is only when all those involved in the economic process, and more particularly the budgetary authorities, take account of the real cost of internal or external savings in their decisions that the use of such resources will ensure a lasting improvement in the economic situation of the Community.

5.4. The external constraints on monetary policy

In 1981 and the early months of 1982 the economic policy of the United States added to the internally generated inflationary pressures on the European economies. The spectacular upsurge in the dollar between July 1980 and August, 1981, when it appreciated by 43 % against the ECU, which has aggravated the effects of the second oil shock (1) on the European economies did not continue at the same rate, but the fluctuations

(1) For example, the average cif price in ECU of a barrel of oil imported into the Community increased between 1980 and 1981 by 40 %, while its dollar price increased by only 10.6 %.

of the dollar (see Graph 5.3) since August 1981, did finally result in an appreciation against the ECU of 10.5 % (average for the first seven months of 1982 compared with the 1981 average). The sustained strength of the dollar over the last two years is largely explained by the implementation in the United States of a resolutely anti-inflationary economic - and especially monetary - policy. The associated increase in interest rates has, however, been aggravated by the difficulties encountered by the United States authorities in controlling the budget deficit. Furthermore, the techniques of monetary management - based on strict very short-term control of monetary aggregates, practically independently of any exchange-rate or interest-rate considerations - have so far been accompanied by highly volatile money market rates. In order to curb the rise in the dollar and thus contain its inflationary effects on their economies, they acted in 1981 to adapt money market conditions here to the level of corresponding interest rates in the United States. This upward movement in European rates was triggered particularly by the measures taken by the Bundesbank in February 1981. The European central banks have subsequently, though with slight differences from one country to another, allowed money market rates to develop smoothly; the fluctuations in United States interest rates have thus - where necessary - been reflected in exchange-rate fluctuations. In a bid to reduce the fluctuations caused by conditions on the United States money market, European monetary authorities also intervened significantly against the dollar on the foreign exchange market. Net sales of US dollars by the central banks of the EMS countries amounted in 1981 to USD 25 800 million or 87 % of their combined current account balance and, during the first six months of 1982 to USD 14 900 million. However, it is probable that the refusal of the United States monetary authorities to intervene to any significant extent on the foreign exchange markets - officially confirmed in May 1981 - diminishes the psychological effect of this intervention and hence its effectiveness.

The monetary instability of recent months may lessen once the financial markets have adapted to the latest indicators of the stance of economic policy in the United States and the first signs of success there in combating inflation. Improved cooperation between the major monetary powers might however enable better account to be taken of short-term factors liable to cause instability on international financial markets, thereby helping to make the international monetary system more stable.

5.5. Community currencies and the European Monetary System

Since September 1981, the pound sterling's exchange rate against the ECU has been steady with a slight upward trend (see graph 5.3).

Sterling has thus followed - though in a somewhat less marked fashion - the fluctuations of the EMS currencies against the dollar. Between November 1979 and July 1982, sterling nevertheless showed on the basis of monthly averages an appreciation of 22.4 % against EMS currencies, a rise which reinforced the restrictive effects of a tight monetary policy. Sterling's real exchange rate (1) against its main partner currencies, calculated on the basis of unit wage costs, thus increased by more than 40 % between 1978 and 1981. The progress made in bringing down inflation and the relative stability of sterling on foreign exchange markets should moderate the trend of this indicator. Between July 1981 and July 1982, the drachma depreciated by 7.5 % against the ECU, whereas the inflation differential between Greece and the Community stands at around 10 %. The drachma's relative stability is a reflection of official policy; it was particularly marked up to April 1982, which made it possible to limit external inflationary pressure.

(1) The real exchange rate adjusts the movement in the effective exchange rate for the movement in a country's relative costs or prices in relation to its trading partners.

The EMS has been going through a hazardous phase for a number of months now. Since it was introduced on 13 March 1979, there have been six realignments of central rates (see Table 5.7). The first two realignments, which took place in the autumn of 1979, met a need for adjustment revealed by the initial phase. However, within the space of nine months, from 5 October 1981 to 14 June 1982, there were three realignments of central rates, which led to substantial changes in bilateral rates. For example, between 4 October 1981 and 15 June 1982, the official bilateral exchange rate between the German mark and the French franc changed by 20.3 %, while that between the mark and the lira changed by 16.6 % and that between the mark and the Belgian franc by 20.2 %. A marked divergence in the movement of nominal exchange rates was the result (see Graph 5.2). A number of factors have contributed to the instability of the EMS in recent months. In particular, the reversal of the current account position in the Federal Republic of Germany and the new direction given to economic policy in France generated contrary expectations of the movements of the German mark and the French franc. However, such factors should not necessarily be an obstacle to the maintenance of exchange rates within the EMS. For prolonged periods a tight monetary policy which emphasizes the determination of the authorities in weak-currency countries to continue their stabilization efforts dampens the effect on expectations of economic performance while it is still unsatisfactory and avoids provoking speculative capital movements which limit the room for manoeuvre in deciding on the appropriate date for a realignment.

The variations in real exchange rates against EMS partners (on the basis of unit wage costs) between 1978 and 1981 may appear high for countries such as France, Italy or Ireland (see Table 5.5). However, this impression should be qualified in two ways. First, the effects on the total external trade of these countries have been partially offset by the advantages flowing from the appreciation of the dollar and the pound sterling. Secondly, in 1978 real exchange rates in these countries were relatively low compared with their level at the beginning of the 1970s (see Table 5.6), partly because of the monetary instability of the past. These countries therefore appeared to have some "room for

5.14

manoeuvre" in this regard when the EMS was introduced. However that may be, the realignments in October 1981 and June 1982 have appreciably curbed the increase in the real exchange rates of the French franc and the lira in relation to the other EMS currencies. In the medium term, a markedly divergent trend of real exchange rates is not desirable because of the distortions which it causes in trade flows. This is why a partial and retrospective adjustment of nominal exchange rates in response to divergent cost and price may sometimes prove necessary. Nevertheless, exchange-rate policy, which helps to contain externally generated inflation, remains an important element in the pursuit of stability. Its credibility and its restrictive effect on the economy depend mainly on how quickly the domestic adjustments are made during the stabilization period. The chances of a balanced upturn in economic growth and a future reduction in external deficits hinge on the extent of these adjustments. For the same reasons and in order to ensure that the devaluations of weak currencies are successful when realignments are made, such realignments should be accompanied in the countries concerned by measures to restore domestic equilibria and to prevent domestic prices from being affected by a deterioration in the terms of trade. It was with this in mind that the French Government decided, on the occasion of the June realignment, to introduce a price and wage freeze for a period of four months, to be followed by an active incomes policy. Within the strategy adopted, the budget deficit should not in future exceed 3 % of GDP. Similarly, Italy, while partially adjusting to the wide disparity between its inflation rate and those of its EMS partners through the use of the Lira's wider margin of fluctuation and changes in central rates (see Table 5.5 and Graph 5.4), continues its efforts in the field of domestic stabilization. Thus, the measures taken in 1981, which should make it possible to limit the monetary financing of the public deficit in Italy, and the reduction in the degree of wage indexation currently being negotiated could help, in the context of a tight monetary policy, to reduce inflationary strains.

When the EMS was introduced, the relative level of unit wage costs in Belgium was extremely high compared with the early 1970s. This reflected the uncontrolled upsurge of real wages and salaries in Belgium particularly between 1974 and 1978. Up until February, 1982, the time when the Belgian franc was devalued, the efforts to stabilize domestic costs and prices had helped to reverse this trend (see Table 5.5). However, the structural disequilibria of the Belgian economy, the size of the budget deficit and the extremely high wage ratio (see Table 5.4), meant that these efforts were insufficient to reduce the external deficit. Yet a devaluation of the Belgian franc to accelerate the adjustment of real exchange rates and, eventually, of the external deficit could be effective only if it formed part of a cohesive economic reform programme for the Belgian economy. In particular, the rigid wage indexation practised until its partial suspension in February 1982 would have had the effect of fully passing on the effects of a devaluation to prices and wage costs and would have prevented any further progress in reducing the real disequilibrium; at the same time, it would have fuelled inflation. This is why the success of the devaluation of the Belgian franc on 22 February 1982 depends on the continued application and, where necessary, reinforcement of the measures accompanying it, in both the budgetary and incomes fields. The examples given show how closely exchange-rate policy and domestic policy, both in the monetary field and in the incomes and budgetary spheres, should complement each other. Reaffirmation of the objective of stability through the continued application in weak-currency countries of concrete stabilizing measures would enable the European Monetary System to regain the stability it enjoyed until the autumn of 1981.

5.16

Table 5.1

Growth of money stock

		(Annual percentage change, end of year comparisons)					
Country	Definition	1959-	1970-	1979-	1980-	1981- ^{p)}	1982- ^{p)}
		1970	1979	1980	1981	1982	1983
B(1)	M2H	8,0	12,4	2,7	6,6	6,5	7,0
DK (1)	M2H	10,0	12,2	10,9	9,6	12,0	11,0
D	M3	10,4	10,1	6,2	5,0	7,0	5,0
GR	M3	17,9	22,4	24,7	34,7	29,1	23,0
F	M2	13,0	15,4	9,7	11,4	12,5	12,0
IRL(1)	M3	9,9	18,4	17,7	17,4	16,8	16,5
I	M3	13,9	21,2	17,0	16,0	15,8	16,2
NL (1)	M2	8,9	11,5	3,8	5,2	7,6	7,0
UK	£M3	5,6	14,1	18,6	13,5	10,0	10,0
EC 10(2)	M2/3	10,5	14,3	11,3	10,5	10,8	10,0
EMS (2)	M2/3	11,6	14,3	9,2	9,4	10,6	9,8

(p) Commission staff forecasts of September/October 1982.

(1) B : Up to 1964 : monetary claims on the main monetary institutions. IRL : revised series as from 1971. I : up to 1975 : M2. Linkage on the basis of growth rates.
 NL : 1976, 1977, 1978 : break in series. DK : up to 1975 : M2.

(2) Rate of growth of the geometrical average, weighted by GDP at 1975 prices and purchasing power parities, of the money stock indices of the countries concerned (1975 = 100). The weight of Luxembourg has been added to the weight of Belgium.
 EMS = EC 10 minus UK and Greece.

Source : Up to 1981, central banks.

Table 5.2

Intermediate objectives and outturns

Country	Key variable (3)	1980		1981		1982	
		Objective	Outturn	Objective	Outturn	Objective	Outturn in the 12 months to :
B	:	:	:	:	:	:	:
DK ⁽¹⁾	M2H	:	8,1	6,5	9,1	10,3	12,6 July
D	MZ	5-8	4,9	4-7	3,5	4-7	4,7 June
GR (4)	PSCE	16,0	20,4	19,3	30,0	23,0	27,2 April
F	M2	11,0	9,8	10,0	11,4	12,5-13,5	12,0 June
IRL ⁽²⁾	PSCE	13,0	20,9	15,0	15,6	14,0	14,1 July
I	TDCE	17,5	18,3	16,0	18,3	15,5	18,8 May
NL	DM2	7,5-8,0	7,6	6,5	2,7	:	:
UK ⁽³⁾	£M3	7-11	20,0	6-10	15,7	8-12	10,3 July

TDCE : total credit expansion of domestic origin; M2H : harmonized M2;
 MZ : central bank money; PSCE : domestic credit extended to the private sector;
 DM2 : money creation from domestic sources; £M3 : sterling M3. For further details,
 see methodological annex.

(1) Non-binding objective.

(2) Financial year from February to February.

(3) At an annual rate for the period from February of the current year to April of the following year. Targets have also been fixed for M1 and PSL2 (private sector liquidity).

(4) The Greek monetary authorities also fix a target for the rate of growth of the note circulation.

Source : central banks

Table 5.3
Counterparts of money creation (1)

Country	(as % of money stock at the end of the preceding period)									
	(1)		(2)		(3)		(4)		(8)	
	1981	1982	1981	1982	1981	1982	1981	1982	1981	1982
	Money creation = rate of growth of M2/3 (1 = 2+3+4)		Domestic money creation (2 = 5 = 6+7-8)		Creation (+) and destruction (-) of external liquidity		Other		Non-monetary Liabilities	
B	6,6	6,5	19,3	15,2	-12,3	-8,2	-0,4	-0,5	7,2	6,1
DK	9,6	12,0	19,9	23,9	-8,4	-9,3	-1,9	-2,6	-	-
D	5,0	7,0	6,0	3,8	2,1	0,2	-3,1	3,0	11,9	12,0
GR	34,7	29,1	40,9	35,3	-6,3	-6,2	0,0	0,0	8,2	5,1
F	11,4	12,5	17,6	17,7	-0,4	-1,1	-5,8	-4,1	1,7	3,8
IRL	17,4	16,8	44,2	37,2	-26,8	-20,4	0,0	0,0	-0,5	2,2
I	16,0	15,8	18,9	18,8	0,4	-0,5	-3,3	-2,5	4,2	4,0
NL	5,2	7,6	3,5	5,7	3,6	3,6	-1,9	-1,7	10,3	9,8
UK (2)	14,6	10,2	15,6	13,6	-2,5	-3,4	1,5	0,0	2,1	2,1
	Domestic money creation (5=2=6+7-8)		Lending to the public sector		Lending to the private sector		Other		Non-monetary Liabilities	
	1981	1982	1981	1982	1981	1982	1981	1982	1981	1982
B	19,3	15,2	20,8	17,8	5,7	3,5	3,5	3,5	7,2	6,1
DK	19,9	23,9	14,9	18,9	5,0	4,7	-	-	-	-
D	6,0	3,8	6,7	6,5	11,2	9,3	7,9	7,9	11,9	12,0
GR	40,9	35,3	22,6	18,8	26,5	21,6	16,2	16,2	8,2	5,1
F	17,6	17,7	2,4	3,8	16,9	17,7	15,0	15,0	1,7	3,8
IRL	44,2	37,2	26,8	28,4	16,9	11,0	8,0	8,0	-0,5	2,2
I	18,9	18,8	11,5	11,9	11,6	10,9	11,7	11,7	4,2	4,0
NL	3,5	5,7	1,0	2,2	12,8	13,3	14,1	14,1	10,3	9,8
UK (2)	15,6	13,6	-3,1	-1,2	20,8	16,9	12,6	12,6	2,1	2,1

(1) Money stock broadly defined (same definition as Table 5.1). The figures for the counterparts are generally difficult to compare between one country and another. For definitions, see methodological annex.

(2) Financial year. The single item appearing under the heading "other" reflects a break in the series in 1981.

Source : 1981 : Central Bank statistics.
1982-1983 : Commission staff forecasts of September/October 1982.

Table 5.4
Real interest rates in relation to selected macroeconomic variables

	Real long-term interest rates (1)					Rate of growth of real GDP				
	61-70	1975	1980	1981	1982	1961-70	1970-75	1975-80	1981	1982
B	3,2	-3,4	5,5	5,7	4,8	4,8	3,5	2,8	-1,7	-0,5
DK	2,1	1,7	6,3	7,1	9,1	4,9	2,0	2,6	-0,2	2,0
D	4,0	2,5	3,0	4,4	3,5	4,7	2,2	3,5	0,1	-0,5
GR	-	-5,9	-5,3	-5,0	-5,3	7,6	5,0	4,4	-0,7	0,7
F	2,2	-1,4	0,8	2,6	3,2	5,6	3,4	3,2	0,3	1,1
IRL	-	-4,4	-1,9	-1,9	-0,8	4,2	4,2	4,0	1,1	2,0
I	2,6	-5,2	-2,8	1,1	3,0	5,7	2,4	3,9	-0,2	0,8
NL	1,3	-0,6	4,2	5,0	4,3	5,2	3,2	3,6	-1,1	-0,5
UK	2,8	-5,2	-1,6	1,8	3,4	2,8	2,1	1,6	-1,9	0,6
CE	2,9	-1,8	0,7	2,9	3,4	4,8	2,8	3,1	-0,4	0,3

	General government borrowing requirements as % of GDP					Real wage position; indices (2): 1961-70 average = 100			
	51-70	1975	1980	1981	1982	1975	1980	1981	1982
B	-1,3	-4,4	-9,4	-13,4	-12,8	116,6	122,4	122,0	118,7
DK	+1,4	-1,9	-5,9	-7,1	-9,5	111,1	101,4	99,3	93,0
D	+0,6	-5,8	-3,5	-4,0	-3,9	110,5	107,6	107,3	105,3
GR	-2,6	-5,1	-5,4	-10,1	-9,2	-	-	-	-
F	-0,4	-2,2	0,5	-1,5	-3,0	107,1	103,9	111,9	110,3
IRL	-3,5	-12,8	-12,8	-16,9	-15,2	108,2	113,0	111,5	102,9
I	-2,2	-11,7	-7,8	-11,9	-11,6	117,8	113,4	113,7	119,0
NL	-0,9	-2,2	-3,4	-4,5	-5,7	115,3	116,7	113,4	110,2
UK	-0,7	-5,0	-3,5	-2,1	-0,9	116,4	110,2	103,0	105,4
CE	-0,4	-5,6	-3,5	-4,8	-5,0	112,5	110,1	110,9	108,2

(1) Yield of public sector bonds. Real rates calculated using a 25-month moving average of consumer price indices, except in 1982, for which the average of the first eight months is taken.

(2) Index of compensation of employees per employee, deflated by consumer price indices and adjusted for changes in the terms of trade, divided by labour productivity.

Source : Eurostat and Commission departments (1982 : forecast of September/October 1982).

5.20

Table 5.5

Effective exchange rates and relative unit labour costs (1) vis-à-vis EMS partners

	Effective exchange rate (2)			Unit labour costs					
	(a)			(b)			(c) = (a) x (b)		
	% change p.a.			Relative change in national currencies % p.a.			Relative change in common currency % p.a.		
	1970-1978	1978-1981	1982 ^{p)}	1970-1978	1978-1981	1982 ^{p)}	1970-1978	1978-1981	1982 ^{p)}
B	0,9	-0,2	-8,5	1,2	-1,8	-2,2	2,1	-2,0	-10,5
DK	-0,8	-3,1	-4,7	1,1	-0,3	2,4	0,3	-3,4	-2,4
D	4,4	2,5	10,0	-4,4	-4,9	-6,0	-0,1	-2,5	3,4
F	-1,5	-0,3	-6,4	0,6	4,2	6,0	-1,0	3,9	-0,8
IRL	-7,1	-0,3	-0,9	4,4	8,1	4,8	-3,1	7,8	5,7
IRL(3)	-2,8	-4,5	0,7	2,0	3,7	5,5	-0,9	-1,1	6,2
I	-8,8	-4,6	-5,9	7,0	9,2	8,8	-2,4	4,2	2,5
NL	1,3	0,5	6,5	0,3	-2,0	-1,9	1,5	-1,5	4,5
UK(3)	-6,2	7,7	-0,1	3,0	6,2	-1,5	-3,3	14,3	-1,5

(p) Forecasts of May/June 1982.

- (1) Compensation of employees per employee divided by productivity per person employed.
- (2) Export weighting, variable from year to year until 1979; 1982 exchange rates consistent with central rates in force on 15 June 1982.
- (3) Vis-à-vis Community partners as a whole.

Source : Eurostat and Commission departments.

Table 5.6

Level of relative unit labour costs in common currency vis-à-vis EMS partners - 1978 and 1982

	1978			1982 (o)		
	Base 100 :			Base 100 :		
	1970 average 1961-70	average 1963-72	average 1961-70	1970	average 1961-70	average 1963-72
B	117,8	111,4	115,1	99,0	93,9	96,9
DK	102,7	104,8	102,7	90,3	92,1	90,3
D	99,1	106,4	103,0	94,6	102,0	98,8
F	92,6	81,1	89,3	103,0	90,2	99,3
IRL	77,9	74,8	82,2	103,0	99,0	106,2
IRL(2)	97,3	101,4	100,6	96,0	100,0	96,6
I	82,7	81,4	80,2	95,7	94,2	95,8
NL	112,9	121,7	111,5	112,6	121,3	111,2
UK(2)	76,3	69,8	77,7	117,8	102,6	114,2

(p) Forecasts of May/June 1982.

- (1) Compensations of employees divided by productivity per employed person. The partners' index and the effective exchange rate are calculated on the basis of export weight variable from year to year until 1979; 1982 exchange rates are compatible with central rates in force on 15th June 1982.
- (2) Vis-à-vis Community partners as a whole.

Source : Eurostat and Commission departments.

Table 5.7
Changes in EMS exchange rates

Realignment of central rates (%) in relation to the group of currencies whose bilateral parities were not changed

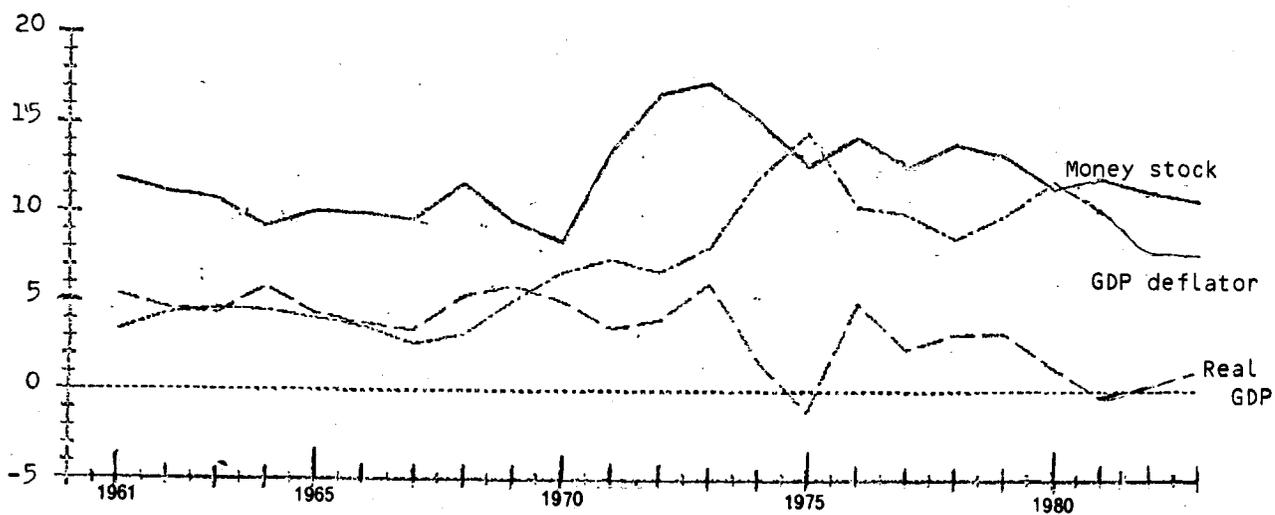
	Dates of realignments					
	24.9.79	30.11.79	22.3.81	5.10.81	22.2.82	14.6.82
BFR/LFR	0	+ 5	0	0	- 8,5	0
DKR	- 2,9	0	0	0	- 3	0
DM	+ 2	+ 5	0	+ 5,5	0	+ 4,25
FF	0	+ 5	0	- 3	0	- 5,75
IRL	0	+ 5	0	0	0	0
LIT	0	+ 5	- 6	- 3	0	- 2,75
HFL	0	+ 5	0	+ 5,5	0	+ 4,25

5.22

Graph 5.1

Broadly defined money stock (1), real GDP and GDP deflator.

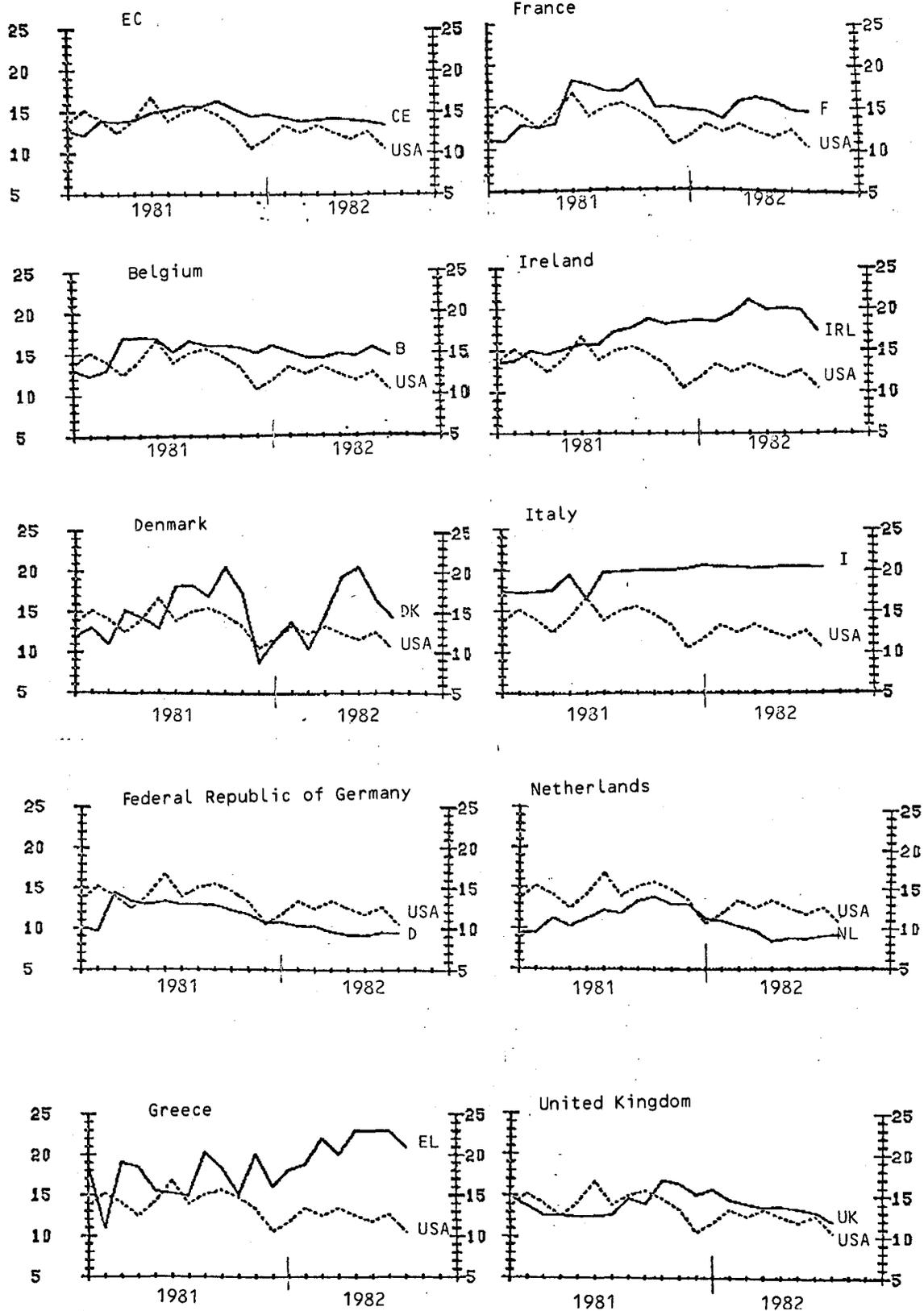
Average EC 10 - 1960-82 (annual percentage changes)



(1) For definitions, see Table 5.1. This graph is based on annual averages of money stocks.

Source : Eurostat and Commission departments - For 1982 : forecasts of September/October 1982.

Graph 5.2 : Nominal short-term interest rates in the Community (—) and in the United States (....)

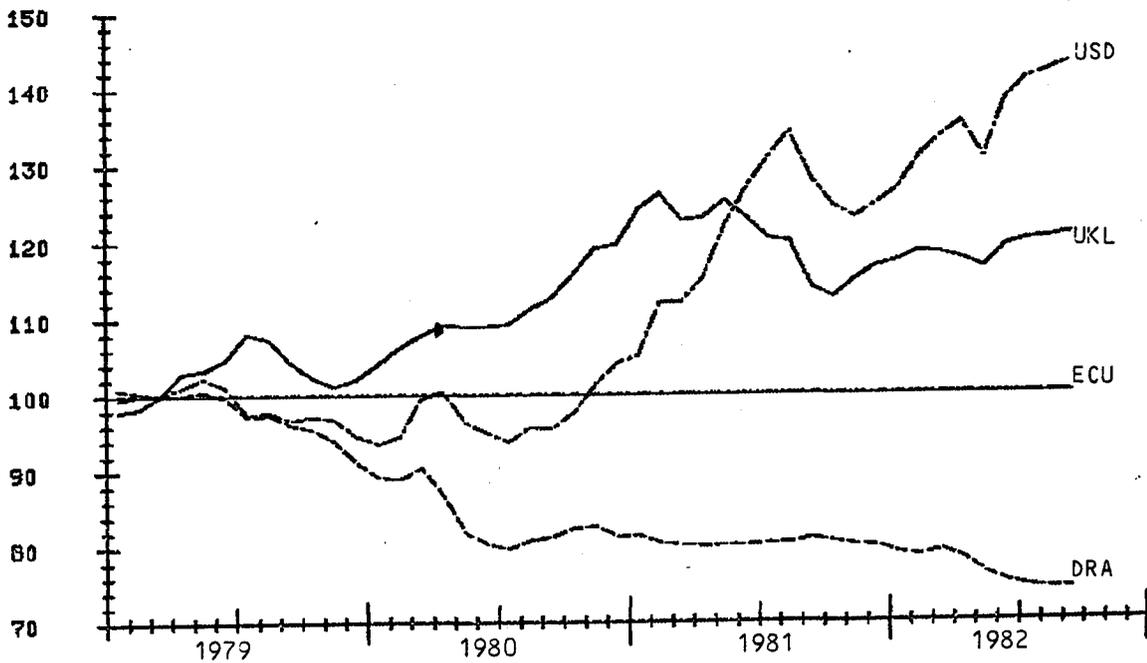


1) B : Four-month Fonds des Rentes certificates; three-month interbank deposit rates for D, NL, UK, IRL ; sight rates for I, DK, EL, F : rate for one-month sale and repurchase of private securities; EC : average weighted by 1975 GDP at 1975 prices and purchasing power parities ; USA : yield on three-month Treasury bills.

5.24

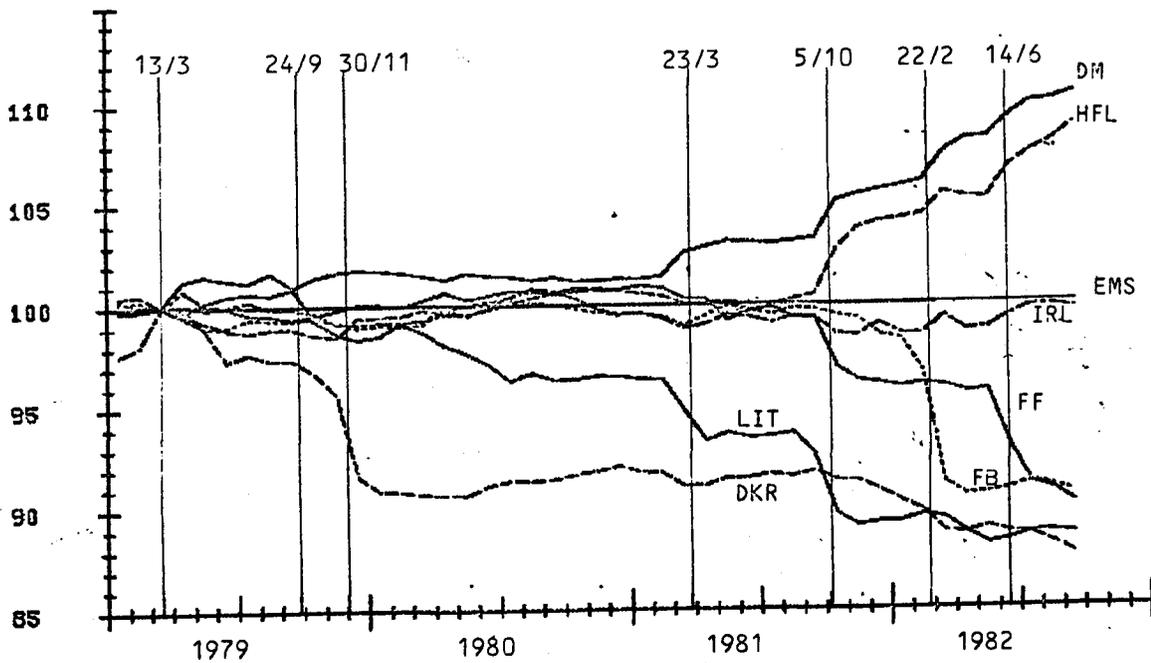
Graph 5.3 : Movement of UK pound, drachme and dollar against the ECU - 1979-82

March 1979 = 100 - Monthly averages



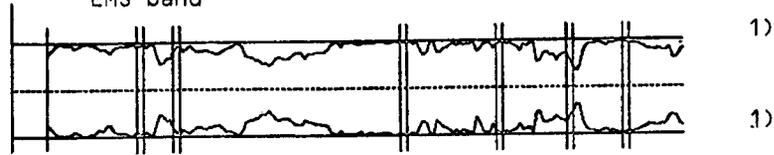
Graph 5.4 : Movement of EMS currency exchange rates against the EMS (i.e. ECU without sterling component)

March 1979 = 100 - Monthly averages

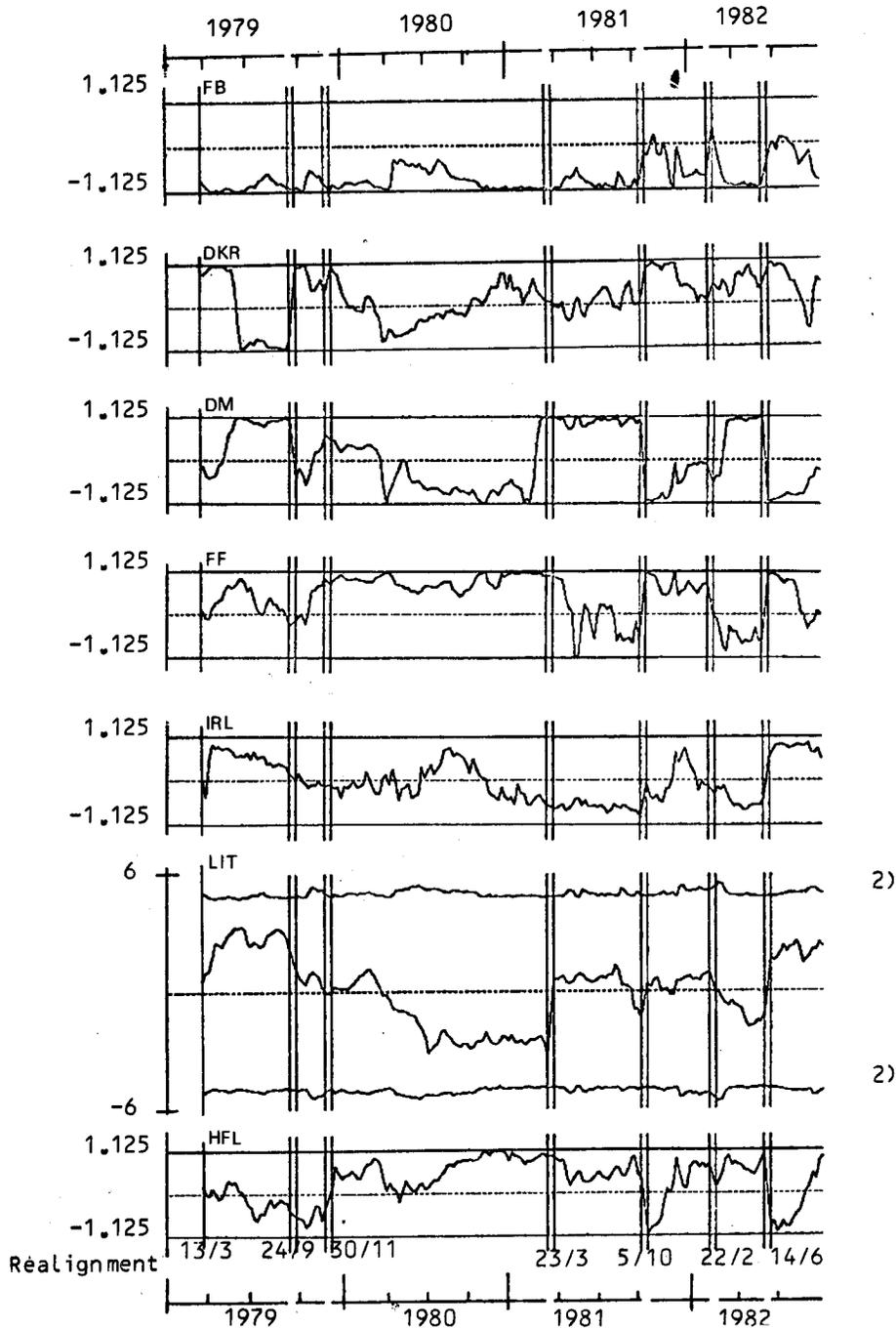


Graph 5.5 : BILATERAL SPREADS OF CURRENCIES IN THE EUROPEAN MONETARY SYSTEM

a) Positions of the strongest and the weakest currency in the EMS band



b) Position of each currency in the EMS band



- 1) The difference between the two curves represents the maximum spread on the basis of weekly averages between the strongest and the weakest currency in the EMS (excluding the Italian lira)
- 2) Maximum spread allowed for the Italian lira in relation to the weakest or the strongest currency in the EMS

6. Budgetary policy

Budget deficits as a proportion of GDP increased sharply in the Community in 1981 and rose somewhat further in 1982. Tax pressure rose slightly, mainly as a result of an increase in direct taxes and in social security contributions, and most of the Member States endeavoured to control the growth of expenditure, particularly transfers and public consumption. With the trend of activity once again tending to engender a spontaneous increase in deficits, the general stance of budgetary policy in the Community continued to be restrictive overall. However, the steady growth of general government resources and expenditure relative to GDP, the size of budget deficits, the growth of public indebtedness and the rising burden of debt servicing are becoming more and more worrying, particularly in certain Member States. In countries where it persists, inflation, though reducing the weight of the public debt in real terms, nonetheless weakens the effectiveness of budgetary policy and increases financial strains. In a communication on budget discipline and economic convergence which it presented to the Council in July 1982, the Commission stated that, in many Member States, the management of public sector finances was not making a sufficient contribution to the efforts being made to achieve economic stabilization and to put the economy on a sound footing. It called for better control of the budgetary aggregates, application of strict budgetary procedures and strict principles of budget management, and greater severity in the criteria applied in financing public deficits. In 1983, the modest revival in activity will be too weak to support efforts to reduce the net borrowing of general government as a percentage of GDP in the Community.

6.1 Recent budgetary developments

In 1981, the net borrowing of general government as a proportion of GDP increased in all the Member States except the United Kingdom. The Community average in 1981, at 4,8% of GDP, represented the heaviest budgetary disequilibrium since 1975. The figure is, however, two tenths of point lower than that estimated in March and, in particular, results from slightly lower-than-expected deficits in Denmark, the Federal Republic of Germany, France, Luxembourg and the Netherlands. Budgetary developments in the Community were clearly out of balance: a 15,5% rise in total expenditure contrasting with an increase of 12,7% in current revenue, which was directly affected by the decline in activity (see Table 6.1). The actual increase in total expenditure in 1981 was nearly one-and-a-half points higher and revenue more than a point higher than the forecasts made a year ago in the 1981-82 Annual Economic Review. Whereas in 1980 only one Member State

6.2

had a general government net borrowing requirement in excess of 10% of GDP, four Member States (Belgium, Greece, Ireland and Italy) found themselves in that position last year.

The most marked influence on budget outturns in 1981 came from the growth of current expenditure. Current transfer payments increased by more than 18% on average in the Community, and "other current expenditure" (which, to a large extent, consists of interest payments) rose by more than 26% (see Table 6.2). By contrast, gross capital formation increased by only 3,8%. The difference between this latter figure and the previous two figures indicates that, in determining the structure of budget expenditure last year, efforts were made to achieve some degree of built-in stabilization in budgetary policy pending the reversal of the economic cycle.

The estimates for 1982 suggest that the Community's net borrowing requirement as a proportion of GDP will increase slightly (5% as against 4,8% last year). There is expected to be a significant reduction in the rate of increase in total expenditure (up 12,5% as against 15,5%), while the growth of current revenue is expected to be half a percentage point lower than in 1981 (12,2% against 12,7%). Tax pressure, particularly that of indirect taxes and, above all, social security contributions, has increased, with the result that the sum of taxes and social security contributions in 1982 will probably be equivalent to 42% of Community GDP as against 41,3% last year (Table 6.2). However, the shift in budgetary policy in 1982 is evident mainly on the expenditure side, with slower growth in current transfers, other current expenditure and public consumption. However, inflation is slowing down only gradually, and the degree of rigidity displayed by these expenditure components remains high. The 1.6 percentage point reduction in the rate of increase in current transfer payments (most of which go to households) and the 3.6 percentage point reduction in the rate of increase in public consumption reflect the efforts being made by the authorities to contain the growth of budgetary expenditure. However, the persistent disequilibrium between the growth rate of expenditure and that of revenue has the effect of maintaining the momentum of dissaving

(29 100 million ECU in 1982 as against 17 600 million ECU in 1981), so that despite a continued squeeze on capital expenditure (gross capital formation up 4,6% in 1982), the net borrowing of general government in the Community as a percentage of GDP has risen. At the same time, budgetary capital expenditure as a proportion of GDP is declining.

In 1982, the majority of Member States should see a reduction in their net borrowing as a proportion of GDP. However, in Denmark, France, Luxembourg and the Netherlands, the increase in the public deficit will be greater than the increase in nominal GDP. In Denmark, the relative level of current expenditure, particularly transfer payments, is rising steadily (this is true of unemployment benefits in particular), while the slow growth of real incomes is affecting budgetary resources, particularly the yield of indirect taxes. In June, a programme to support employment was introduced and financed by an increase in excise duties, which were already very high, but the increase in revenue does not fully cover the increase in expenditure. The cost of debt service is also becoming an increasing burden for Denmark. Calculating net borrowing after deduction of net interest payments (see Table 6.1), the adjusted balance will probably increase by only six-tenths of a point as a proportion of GDP as against an increase of 2.4 points for the unadjusted balance. In France, where in 1981 general government net borrowing as a percentage of GDP was low, the increase in 1982 was also due to the fact that the rise in current expenditure outstripped that in current revenue, despite the increase in indirect taxation (changes were made in VAT rates). The balance adjusted for net interest payments also increased. In Luxembourg, the high level of capital transfers explains why there is a net borrowing requirement, although gross saving is substantial and the scale of interest payments received by general government explains the size of the borrowing requirement net of interest payments. In the Netherlands, 1982 has seen only a very modest increase in receipts from direct and indirect taxes while current expenditures, particularly transfers, have increased substantially. In the other Member States, adjustment efforts are in the form of tighter control over the growth of expenditure, often combined with an increase in revenue. In Belgium, an attempt has been made to cut back on current expenditure, which should make it possible to limit the current deficit in the central government budget to BFR 252 000 million and to eliminate the deficit in the social security budget in 1982.

In the Federal Republic of Germany, the 1982 budget also included a series of measures to curb expenditure on health, housing and support for employment. Ireland raised social security contributions and significantly increased VAT rates and excise duties. These two types of taxes were also adjusted upwards at the end of July 1982 in Italy, where a law granting a tax amnesty together with an increase in direct taxes payable should also boost budget revenue. In the Netherlands, a temporary increase in tax on wages and other personal incomes was introduced with effect from 1 July 1982.

6.2 Budgetary policy situation

In 1982, nearly all the Member States were confronted with a number of common difficulties in budgetary management, though the acuteness of the problems varied from one country to another. Finance laws were prepared in the summer of 1981, except in Ireland and the United Kingdom, where the procedure applies to the financial year. There were delays in adopting the budget in several Member States. This was the case in Belgium, where the budgetary procedure spilled over well into 1982, in Denmark and Greece, where the budgets were adopted in February and April respectively, and in Italy, which had to apply the provisional twelfths procedure until April. The growth rates of activity assumed in the draft finance laws generally proved to be higher than the rates actually achieved. Consequently, budget revenues increased less than anticipated. This effect was combined with a swelling of transfer expenditure, mainly as a result of the continuing sharp rise in unemployment. In pursuing their policies the authorities were therefore obliged to try and avoid or limit, as far as possible, any straying off course. This phenomenon was sufficiently general to affect not only those countries with large budget deficits but also those with more moderate deficits. Table 6.3 gives the components of changes in budget deficits, distinguishing between the effect of changes in activity, the effect of changes in net interest payments and the residual change, which represents the discretionary component of budgetary policy. While the figures must be interpreted with caution, they do none the less indicate that the change in activity, though contributing less to the change in the Community

deficit in 1982 than in 1981, continued to make for an increase in that deficit as the growth rate was generally lower than the potential growth rate. (The potential growth rate for the Community was estimated at 2,6%. The methodology used is set out in the methodological annex).

Accordingly, the discretionary component (net of interest payments) continued to have a restrictive impact (+1,4% of GDP in 1982 as against +0,8% in 1981). Another, much more summary, indication of the stance of budgetary policy is provided by the figure for net borrowing after deduction of net interest payments (Table 6.1). In so far as net interest payments largely reflect the present cost of past budget management, the net positions after deduction of interest payments give a truer reflection of the current thrust of budgetary policies. The Community average of the deficits can thus be seen to decline by four tenths of a point between 1981 and 1982, whereas the average inclusive of interest payments falls by only two tenths of a point. The question which therefore arises is whether the budgetary policies pursued have been adapted to the present economic situation in the Community. Until very recently the main problem was to decide to what extent the built-in stabilizers should be allowed to operate. As the recession in evidence since the second half of 1980 had been expected to give way to an adequate recovery in 1982, it might have seemed a reasonable option to allow some role to economic stabilizers, albeit in differing degrees given the specific situation of each Member State.

Since the recovery has not taken place, however, the budgetary and financial situations of the Member States have in general deteriorated. In a period of two years, several Member States saw their public debts increase considerably as a proportion of GDP: between 1979 and 1981, the total public debt in Belgium rose from around 72% to almost 89% of GDP, central government debt in Ireland rose from 90,6% to 99,1%; general government net debt in Denmark rose from 1,8 % to 16,3 % of GDP. The financial constraints on these Member States have been aggravated by two factors, namely the rise in interest rates, which adds further to the

6.6

cost of debt servicing, and the rise in the dollar, which increases repayments of external debt. It is therefore not so much the position of these economies in the economic cycle which now largely determines their budgetary policy stance, as the scale of the financial problems facing them.

A brief examination of the budgetary situations of the Member States might suggest that, in contrast to those in which the budgetary situation is the most imbalanced, the countries which are better placed in terms of public finance should continue to frame their budgetary policy mainly in the light of their position in the economic cycle, thereby making sure that the counter-cyclical effects of the built-in stabilizers are not offset. Yet this argument fails to appreciate that a combination of factors is restricting the room for manoeuvre for budgetary policy to support activity. The first factor, which is now becoming particularly significant, is the steady rise in general government revenue as a proportion of GDP. This is a general phenomenon affecting all the Member States and one which has been gaining momentum since the first oil shock and the slowdown in growth. The increase in the proportion of national resources appropriated and redistributed by government was less directly perceptible by economic agents during periods of strong growth. The slowdown in activity has had the effect of speeding up the process and making it less controllable. Initially, it was possible to consider that the social function of government in the areas of redistribution and social transfers (particularly unemployment benefits) remained the budgetary priority in the eyes of all economic agents. However, there is reason to wonder whether, in some cases, the level of redistribution by government has not now gone beyond what is implicitly accepted. General government current revenue in Luxembourg, the Netherlands and Denmark is now equivalent to more than 50% of GDP and is above 40% in all the other Member States except Greece, where it is around 30%. During a period when the growth of their nominal incomes is slowing down and, in some cases, their real incomes are actually falling, private households tend to be less ready to accept the burden imposed by government levies. In such circumstances, cuts in budgetary expenditure become the key priority. At the same time, the reluctance of economic agents to accept the

burden of the "oil tax" has certainly in a number of countries been an important factor of confrontation in the distribution of national income among enterprises, households, governments and the rest of the world. This attitude has, in important degree, led to the maintenance of excessive absorption and thus to external deficit and inflation. In these circumstances budgetary policy evidently cannot seek a recovery of activity in the Community through demand support.

For the reasons set out above, it appears that the use of budgetary policy for short-term regulation of the economic cycle is an extremely delicate operation. The United Kingdom and the Federal Republic of Germany are certainly, from the point of view of inflation and external trade, the Member States in the most favourable position. But in Germany too, recurrent budget deficits and the resulting increase in public debt increasingly restrict the scope for action.

In France, on the other hand, it is not the scale of budget deficits or the public debt, but the level of inflation and size of the trade deficit which have induced the authorities to restrict the growth of the budget deficit.

The medium-term trend of the major budgetary aggregates, like that of the budget balances, is not particularly reassuring. Graph 6.2 shows the share of public expenditure in the Member States over a period of a little more than 20 years, and the upward trend seems inexorable. In its communication to the Council dated 1 July 1982, entitled "Budget discipline and economic convergence", reproduced as an annex to this Review, the Commission stated that, in many Member States, the management of public sector finances was not making a sufficient contribution to the efforts to achieve economic stabilization and put the economy on a sound footing. Action had to be concentrated in the area of public expenditure, whose growth would have to be strictly limited and whose structure would have to be improved.

6.8

The Commission therefore requested the Council to accept four main guidelines which should be implemented in each Member State while of course taking into account individual situations: control of the budgetary aggregates, application of strict budgetary procedures, application of strict principles of budget management and more severe financing criteria. The Commission believes that achievement of a sounder budget situation must be the objective throughout the Community.

The budget forecasts drawn up by the Commission departments for next year form an integral part of the economic forecasting exercise. An improvement in activity and slowdown in inflation are expected to be accompanied by a reduction in general government net borrowing expressed as a percentage of GDP (4,8% in 1983 as against 5,0% in 1982). After deduction of interest payments, there should be an improvement of four tenths of a point in the net borrowing requirement. Table 6.3 shows that the change in activity will have the effect of increasing the budget deficit by nearly one point, and the discretionary component of the change in the deficit will be strongly positive (1,2 points of GDP), reflecting a further tightening of the budgetary policy stance in 1983. Achieving these forecasts requires an increase (eight tenths of a point) in general government current revenue as a percentage of Community GDP, that is, a continuation of the upward trend in that percentage despite the efforts made to end it. More and more budgetary authorities are setting themselves short-term or medium-term targets to control the growth of budget deficits. This is particularly the case in Belgium, which is seeking to reduce the central government net borrowing requirement as a proportion of GDP by 1 - 1,5% over a period of two or three years; in France, which hopes to limit the central government net borrowing requirement to 3% of GDP; and in the United Kingdom, which, as part of the medium-term financial strategy, has set budgetary targets for as far ahead as the financial year 1984-85. Most of the other Member States also set themselves technical objectives for limiting expenditure and/or deficits in preparing their 1983 budgets.

6.3 Public debt in the Community

Since 1973, public-sector debt as a percentage of GDP has risen - though to varying degrees - in all the Member States except the United Kingdom, where it had fallen to 58,8% of GDP in 1981 from 71,5% in 1973 (Graph.6.2 and Table 6.4). The division into countries with a large public debt and countries with a more moderate public debt did not change fundamentally during that period. While differences of definition make it difficult to compare the figures for public debt as a proportion of GDP, it is possible to assess the various rates of increase in the level of public-sector debt within the economies of the Member States. This level has doubled in Greece, almost doubled in Ireland and in the Federal Republic of Germany and has increased by about 50% or a little less in the Netherlands, Italy and Belgium; it has remained virtually stable in France, Luxembourg and the Netherlands. In Denmark, net public debt was negative in 1973 and substantially positive in 1981. The increase in the public debt as a proportion of GDP was fairly steady during the period in the Federal Republic of Germany, Ireland and Italy; it accelerated distinctly from 1978 onwards in Belgium, Denmark and Greece. The rise in the external component of the public debt was generally sharper than that of the debt as a whole. In eight years, the external debt rose from 0,6% of GDP to 10,9% in Belgium and from 4,7% to 35,7% in Ireland; there was also a significant increase in the Federal Republic of Germany (0,4% in 1973, 4,3% in 1981) and a somewhat smaller one in Greece (from 5,1% to 7,8%). If the debt is divided into short-term and long-term instruments, it can be seen that there was a very marked shift towards short-term indebtedness in Belgium and in Italy.

Economic analysis of the public debt situation is inevitably complex. This is because it is difficult to determine when the size of the debt and its composition become too costly for the economy. Moreover, attempts to achieve a substantial reduction in public debt as a percentage of GDP are inevitably a long-term exercise. A number of analytical criteria must be applied to obtain a clearer picture of the various situations.

6.10

Firstly, it should be remembered that in some countries the sum of monetary and financial assets in the economy has consistently tended to increase more rapidly than GDP in nominal terms. Thus, between 1972 and 1979, i.e. within the very short space of seven years, the ratio of monetary and financial assets to GDP rose from 3.6 to 4.4 in Belgium and from 2.7 to 3.5 in the Federal Republic of Germany. This means that, assuming no change in the distribution of assets and liabilities as between institutional sectors, the general government debt in these economies increased as a proportion of GDP without entailing any distortion in the financial structure of the country. In the Federal Republic of Germany for example, the gross indebtedness of general government as a proportion of total indebtedness in the economy rose from 6,8% to 9,7%. This increase is much lower than the virtual doubling of indebtedness as a percentage of GDP over the same period.

Another criterion which is also somewhat ambiguous is the external component of the debt. It is not possible to compare the trend of the debt in the United Kingdom or the Federal Republic of Germany acquired by non-residents with the external debt in Belgium, Denmark or Ireland, virtually all of which is financed by banks. In the first two countries, it reflects spontaneous acquisition of securities denominated in currencies that have something like a reserve currency status; in the other three countries, the debt is the result of borrowings initiated by the authorities in order to finance budget deficits and/or balance-of-payments deficits.

Lastly, a breakdown of indebtedness into short-term and long-term instruments gives us some idea of the degree of acceptability of public debt securities in financial markets. The shortening of the maturity of securities issued indicates erosion of the credibility of the issuing authority. This tendency was very clear in Belgium between 1973 and 1981 and in Italy where, in 1981, the short-term debt accounted for a little over two thirds of the total debt as against a little over half in 1973.

This indicator may be set alongside that obtained by breaking down the financing of the budget deficit into the proportion financed by the banking system and the proportion absorbed by the financial markets (see Table 6.5). In Belgium, monetary financing of the budget deficit in 1981 amounted to 14,1% of GDP as against the amount equivalent to 1,2% of GDP absorbed by the financial markets. In Greece, the relevant figures were respectively 14,3% and 0 % of GDP and in Ireland 18,2% and 3%.

However, the rise in public expenditure is financed not only by the current (and visible) revenue of general government budgets, but also, to varying degrees, by the effect of inflation on the real value of the existing public debt. In some Member States, notably Italy, the effect of inflation since the first oil crisis has been such that the growth of the public debt as a proportion of GDP has remained relatively modest despite a very high apparent budget deficit. In Germany, by contrast, the apparent level of budget deficits has been appreciably below that in Italy, but the growth of the public debt has been practically of the same order: because of the low inflation rate and the relatively modest level of the public debt initially, the effect of inflation on the real value of the public debt in Germany has remained negligible (see Table 6.6).

A rapid increase in public debt as a proportion of GDP may be accompanied by signs of strain on the financial markets, particularly if the level of financial assets in the form of bonds is already high. Market operators see the risk that inflation may subsequently reduce the real value of their assets and they demand a growing premium.

Given the complexity of the financial markets and the importance of market confidence, it is hardly possible to establish any simple link between the growth of the public debt (measured by the budget deficit, adjusted for the effect of inflation on the level of the existing public debt) and the real interest rate. As shown by Graph 6.1, there is, however, a distinct tendency for a high level of budget deficit adjusted for inflation to go hand in hand with a high level of interest rates. The exceptions

6.12

to this rule might partly be attributable to institutional differences or to other specific factors: the deductibility of interest payments in tax returns might explain the relatively high level of interest rates in Denmark; a certain degree of isolation of financial markets in Ireland and Italy might be the reason for the exceptionally low level of interest rates there; the exceptional monetary restrictions in the United Kingdom in 1981 would seem to be the reason for the real interest rate being out of all proportion to the real public sector borrowing requirement; and the relatively low level of the real interest rate in Germany (in relation to the size of the budget deficit adjusted for inflation) might be due to international confidence in the German mark and an extension of its international monetary role.

Thus, study of the trend of the public debt (and of budget deficits adjusted for inflation) provides additional information that is essential in analysing budgetary developments and in establishing a framework for the preparation of a medium-term financial strategy aimed at putting the budgets in order; the basic principles for this process have been outlined in the Commission's communication on budget discipline.

Main budgetary policy measures in Member States affecting the financial years 1982 and 1983

In Belgium, the government presented the 1982 provisional draft central government budget in August 1981. It decided at the time to limit the central government current deficit to BFR 201 000 million and the net borrowing requirement to BFR 354 000 million, equivalent to 9% of GDP. The net borrowing requirement for the public sector as a whole was planned not to exceed 12% of GDP. The resignation of the government meant that the budget could neither be tabled nor adopted according to schedule and, following the general election, the Social Christian Party and the Liberal Party agreed in December on a government pact aimed at reforming public finances. The planned current deficit for the 1982 budget was maintained at BFR 200 000 million and was to be achieved solely through expenditure economies (BFR 120 000 million). Under the special powers granted to it early in 1982, the government introduced in February a number of measures including, in particular, a reduction in the VAT rate on construction work from 17% to 6%. Following the devaluation of the Belgian franc on 21 February, the system of linking wages and salaries to the consumer price index was modified and a price freeze, subsequently extended until the end of the year, was imposed. In March, the Government decided to trim central government current expenditure in 1982 from BFR 1 469 800 million to BFR 1 393 000 million, to limit the current deficit to BFR 252 000 million and to reduce the social security deficit to BFR 42 500 million. The draft budget for 1982 was tabled on 1 April. In April, a Royal Decree introduced substantial tax cuts for firms deciding to invest (between 5% and 25% of the amount of investment could be deducted from taxable income, depending on the kind of investment). On Commission estimates, the central government net borrowing requirement could amount to more than 13 % of GDP in 1982, as against 13,5% in 1981. At the beginning of August, the Government presented its provisional 1983 draft budget. Total revenue was projected to be BFR 1 277 000 million and total expenditure BFR 1 702 000 million, representing increases of 9,5% and 7,5% respectively over the figures in the 1982 central government budget. The net borrowing requirement is expected to be BFR 445 000 million, equivalent to 10,5% of GDP. The draft budget, which, apart from a few details, is in accord with the intentions cited, was tabled on 8 October.

In Denmark, the government placed its 1982 draft budget before Parliament in August 1981; the draft provided for a central government cash deficit of DKR 39 900 million. However, the government lost the support of Parliament in November. It was decided to hold a general election on 8 December and Parliament granted the government temporary powers to raise taxes and to meet current expenditure in 1982 until the budget was passed by the new Parliament. In February, Parliament passed

the 1982 budget, thereby cancelling the provisional budget adopted in November 1981. Compared with the 1981 budget, planned revenue was 1,2% higher and planned expenditure 20% higher, raising the planned central government net borrowing requirement to DKR 47 600 million. In June, Parliament adopted the final part of the government programme designed in particular to improve the employment situation and to support investment. The total cost of the programme, put at some DK 7 500 million, was to be financed by an increase in indirect taxation, by a tax on interest receipts and by an increase in certain excise duties. In its report on the 1982 budget, published in May, the Finance Ministry acknowledged that the central government deficit might turn out higher than planned. On 16 August, the government laid before Parliament its 1983 draft budget. The total deficit (current account, capital account and lending) was first put at DKR 73 700 million, then in September at DKR 80 200 million, or DKR 22 700 million higher than the most recent estimate of DKR 57 500 million (12% of GDP) for the 1982 deficit. The new government, in office since 6 September, presented its new economic policy programme on 5 October. It envisages, as well as a wage freeze and the suspension of indexation of incomes, a reduction in certain social transfers subsidies.

In the Federal Republic of Germany, the 1982 draft budget approved by the government in September 1981 provided for a substantial reduction in the Federal government borrowing requirement, which was estimated at DM 26 500 million, or around DM 7 000 million less than the outturn expected for 1981. The package of measures proposed was designed to reduce the Federal budget deficit by DM 12 500 million, as compared with the initial estimate, through spending cuts totalling DM 10 000 million and revenue increases amounting to DM 2 500 million. The main features of the measures as adopted by Parliament in December were a reduction in current expenditure (notably on health services, employment promotion and housing), cuts in social security benefits, increases in a number of excise duties and reductions in certain tax reliefs. At the same time, an increase in capital allowances was adopted. The objective was to hold the Federal government deficit to DM 26 800 million. The authorities decided at the beginning of February, when the annual economic report was published, to introduce a range of additional measures, to boost investment in 1982, which were to have their main budgetary impact in 1983. In May Parliament approved the government's proposal for the introduction of a 10% investment grant. The target for the Federal government deficit was subsequently revised upwards. In June, the government approved a supplementary budget involving expenditure of DM 7 100 million and raising the projected Federal government deficit to DM 33 900 million. General government net borrowing could be equivalent to 4% of GDP in 1982, as against 4,5% in 1981. On 30 June the Federal government adopted the general guidelines for the preparation of the 1983 budget. The Federal government borrowing requirement was to be held to DM 28 500 million. At the end of September the new coalition government formed by the CDU/CSU and the FDP presented a series of proposals for the 1983 budget which includes, in particular, the principle of a one-point increase in the rate of VAT from 1 July 1983 and the imposition of a compulsory loan from high-income households to the government. Taking account of these proposals, the Federal government deficit for 1983 was estimated at DM 37 000 million.

In Greece, the central government budget deficit including government trading accounts was virtually stable up to 1981, at around 5-6% of GDP. In 1981, an expenditure explosion produced a two-fold increase in the deficit, taking it to 12% of GDP. The new government formed after the October 1981 general election prepared the 1982 budget with the aim of reducing the deficit to 9% of GDP. The budget, which was adopted by Parliament in early April, provided for a substantial increase in revenue (58,5%) notably from indirect taxation (new taxes and increases in existing taxes) and direct taxation (new taxes and a drive against tax evasion) and from the European Agricultural Guidance and Guarantee Fund. The increase in expenditure was put at 35%. As a result, the general government borrowing requirement should, on Commission estimates, be equivalent to 9,2% of GDP in 1982, as against 10,1% in 1981.

In France, the 1982 draft budget was passed by Parliament at the end of 1981. The planned central government cash deficit was fixed at FF 95 400 million, or around 2,6% of GDP, and the tax burden was increased a little. Expenditure, geared primarily to boosting employment and investment, was planned to rise by 27,6% and revenue by 18,9%. The higher level of spending involved among other things the creation of 61 000 civil service jobs, direct employment subsidies costing FF 18 600 million and a substantial increase in the minimum old-age benefit. Personal income tax bands were widened by 13,5% and a tax on large fortunes was introduced. Taxes and social security contributions for both employers and employees were raised significantly in November as part of a plan for financing the social security deficit. In May, the Government agreed on a supplementary budget that was subsequently adopted by Parliament. This supplementary budget, under which new expenditure and new revenue were in balance at 11 900 million, was designed to finance assistance to private firms (reduction in the business tax) and to the newly nationalized undertakings, notably through an adjustment of VAT rates, the standard rate being raised from 17,6% to 18,6% and the rate for basic foodstuffs lowered from 7% to 5,5%. According to Commission estimates, the central government cash deficit will probably be around FF 105 000 million in 1982, equivalent to 3% of GDP, compared with FF 81 000 million or 2,6% of GDP in 1981. In July, a plan for pruning social security spending by FF 10 000 million was adopted by the Cabinet. On 1 September the government adopted its 1983 draft budget, which provides for much slower rates of increase in central government expenditure and revenue than in 1982 (11,8% and 10% respectively). The central government budget deficit was put at FF 117 000 million (this includes 20 000 million set aside as a contingency reserve). The burden of taxation will probably be unchanged from the previous year.

In Ireland, a draft budget for 1982 was laid before Parliament in January and rejected. Parliament was then dissolved and a general election was held in February. The new government's budget was presented to Parliament on 25 May and subsequently adopted. Its main thrust was similar to that of the draft budget presented in January; however, as promised during the election campaign, a number of measures such as the charging of VAT on clothing and footwear and the abolition of certain food subsidies were dropped. The objective in the Finance Act was to restrict the current

budget deficit and the Exchequer borrowing requirement to 6% and 14% of GDP respectively, compared with the figures of around 8% and 17% recorded in 1981. The main tax measures in the 1982 budget were some small direct tax concessions for those on low incomes and substantial increases in VAT rates and excise duties. It was also decided to raise social security contributions. In April, the government decided to make further income tax concessions (at a cost of IRL 45 million) to compensate wage earners for the increase in social security contributions. In August, the authorities put forward a plan for cutting government expenditure by IRL 120 million by the end of the year. The Commission departments estimated in October that the Exchequer borrowing requirement could be equivalent to 15,2% of GDP in 1982, i.e. slightly lower than the figure of 15,8% recorded in 1981.

In Italy, the government, when presenting its estimates for 1982 on 30 September 1981, had announced that it would make every effort to restrict net borrowing by the enlarged public sector to LIT 50 000 000 million. The 1982 Finance Law was passed by Parliament on 26 April 1982; this was later than scheduled, so that the provisional twelfths (or monthly supply vote) procedure had to be applied until then. At the beginning of May, a press release from the Treasury Ministry put the same aggregate at LIT 65 000 000 million, the overrun being made up of an amount of LIT 7 500 000 million to allow for a downward revision of revenue estimates, an amount of LIT 5 000 000 million to cover higher-than-expected interest charges and an amount of LIT 2 500 000 million to finance extra spending. The estimate for net borrowing by the enlarged public sector was raised to LIT 68 000 000 million in June. On 31 July, the government approved a package of measures for bringing the mounting public deficit under control. The main measures to be implemented immediately were increases in public service charges and indirect taxes (VAT, excise duties and the settlement of income tax disputes through payment of tax on an assessed amount increased by a flat 30%). The authorities hoped that this would enable the deficit of the enlarged public sector to be held to around LIT 60 000 000 million in 1982. On 30 September the government presented its provisional economic report to Parliament. The second part of the report set out the draft budget for 1983. Because of shortfalls in tax receipts and a revision of expenditure and revenues, the deficit of the enlarged public sector could be around LIT 74 000 000 million in 1982. For 1983, preliminary estimates by Commission departments put this deficit at around LIT 90 000 000 million.

In Luxembourg, the draft central government budget for 1982 was presented by the government on 31 July 1981 and adopted by Parliament on 16 December. The Finance Law provided for expenditure totalling LFR 55 900 million, a 6,4% increase over the adjusted 1981 budget, while total revenue (including LFR 2 000 million in borrowing) was estimated at LFR 54 600 million, a 7,5% increase. The total deficit was expected to amount to LFR 1 300 million, but a surplus of around LFR 4 000 million was anticipated for the current account alone. As in Belgium, the government decided, following the February devaluation of the Luxembourg franc, to impose a selective price freeze until the end of the year, to suspend for a time the system of wage indexation and to impose a rent freeze. As a percentage of GDP, general government net borrowing will probably be slightly higher in 1982 than in 1981 (1,9% as against 1,8%). In August, the Government drew up its 1983 draft budget providing for increases in expenditure and revenue of 6,4% and 8,2% respectively. In 1983, total expenditure is thus expected to be LFR 59 700 million, with revenue amounting to LFR 59 300 million. This would leave net borrowing of LFR 400 million.

In the Netherlands, the government presented its 1982 draft budget on 15 September 1981. The budget deficit was put at HFL 15 800 million, equivalent to 4 3/4% of net national income (6% in 1981). The general government borrowing requirement was fixed at 6,5% of net national income (7 3/4% in 1981). The government resigned on 15 October and the new government decided in November to prepare an employment programme aimed at creating between 25 000 and 35 000 jobs and at restraining the growth in incomes. On the budget front, the target of a total public finance deficit equivalent to 6,5% of net national income was maintained but significant amendments were made to the draft budget (increases in expenditure and revenue, notably through an increase in indirect taxes). The employment programme, the cost of which was put at some HFL 3 000 million, was adopted by the government in March 1982. In April, it was decided to raise temporarily, with effect from 1 July, the wage and personal income tax. On 12 May, the Socialist ministers resigned from the government because of disagreement with their Christian Democrat and Progressive Liberal partners over budgetary policy in 1982 and 1983. It was decided to hold fresh elections. A minority government took office and set the date of the general election for 8 September. On 21 September the outgoing government presented a draft budget for 1983. It was characterized by only modest growth in revenues as a result of retrenchment (amounting to HFL 12 100 million) in the social security and central government budgets. The pressure of taxes and social security contributions was estimated to increase by 1,1% of net national income. The cash deficit of general government for 1983 was put at 10,8% of net national income (as against 10,2% in 1982).

In the United Kingdom, the Chancellor of the Exchequer announced at the beginning of December 1981 revised public expenditure plans for 1982/83, with expenditure UKL 5 000 million higher (at UKL 115 000 million) than planned in the previous White Paper published in March 1981. Some of the measures announced concerned revenue (increases in social security contributions, National Health Service charges and higher council house rents). In March 1982, the Government presented its 1982/83 budget and published a revised Medium-Term Financial Strategy. The public sector borrowing requirement (PSBR) was forecast to be UKL 9 500 million (equivalent to 3,5% of GDP), slightly above the illustrative figure given in the previous year's Medium-Term Financial Strategy. Income tax thresholds were increased by 14%, and increases were announced in certain excise duties and indirect taxes. All in all, the budget reflected a slight easing of budgetary policy as compared with the targets set a year earlier, but the first priority was still to bring down inflation. Even so, the target of UKL 9 500 million remained below the figure of UKL 10 500 million fixed for the financial year 1981/82. The actual outturn for the PSBR in 1981/82 was at UKL 8 800 million lower than the target of UKL 10 500 million. As the latest developments on the monetary front permitted a more pragmatic approach, the new Medium-Term Financial Strategy at the same time set a target range of 8-12% for monetary growth in 1982/83, compared with the range of 5-9% envisaged in March 1981 for the same period. On the basis of a number of indicators, it appeared in October that the target of UKL 9 500 million for the PSBR in 1982/83 would be met.

Table 6.1

General government budgetary aggregates, EC and Member States, 1981-83

	Total expenditure % increase (1)				Current receipts % increase (1)				Gross saving (+) or dissaving (-) as % of GDP				Net lending (+) or borrowing (-) as % of GDP (2)				Net Lending (+) or borrowing (-) net of interest payments (2) as % of GDP			
	1981	1982(3)	1983(4)	1984	1981	1982(3)	1983(4)	1984	1981	1982(3)	1983(4)	1984	1981	1982(3)	1983(4)	1984	1981	1982(3)	1983(4)	1984
B	12,8	8,5	8,5	10,2	5,5	10,5	10,2	-8,4	-8,1	-13,4	-12,8	-12,1	-6,9	-5,0	-3,2	-6,9	-5,0	-3,2	-3,2	
DK	11,8	15,2	10,8	10,8	9,6	15,7	10,8	-3,2	-5,7	-7,1	-9,5	-9,6	-6,4	7,0	-5,3	-6,4	7,0	-5,3	-5,3	
D	9,0	4,7	5,3	4,9	8,0	5,0	4,9	+1,0	+0,6	-4,0	-3,9	-4,1	-2,9	-2,7	-2,6	-2,9	-2,7	-2,6	-2,6	
GR	(33,5)	29,8	24,1	26,9	17,0	35,8	26,9	-5,4	-5,3	-10,1	-9,2	-8,6	:	:	:	:	:	:	:	
F	18,7	18,9	13,3	13,4	13,9	15,4	13,4	+1,6	+0,1	-1,5	-3,0	-3,0	0,0	-1,2	-0,9	0,0	-1,2	-0,9	-0,9	
IRL	29,1	23,4	17,3	20,5	24,5	25,8	20,5	-6,5	-6,6	-15,4	-14,7	-14,4	-7,4	-5,4	-4,6	-7,4	-5,4	-4,6	-4,6	
I	31,6	21,9	19,7	22,1	21,6	23,8	22,1	-7,2	-6,9	-11,9	-11,6	-11,0	-5,1	-3,9	-3,2	-5,1	-3,9	-3,2	-3,2	
L	9,0	8,5	8,7	8,5	11,0	8,5	8,5	+9,8	+9,8	-0,8	-0,9	-1,0	-4,3	-4,5	-4,7	-4,3	-4,5	-4,7	-4,7	
NL	7,6	7,7	4,9	5,3	5,7	5,5	5,3	+1,2	0,4	-4,5	-5,7	-5,5	-1,6	-2,3	-1,5	-1,6	-2,3	-1,5	-1,5	
UK	13,5	9,7	8,6	9,7	17,7	12,7	9,7	+0,2	+1,3	-2,1	-0,9	-0,5	+1,3	+2,6	+2,8	+1,3	+2,6	+2,8	+2,8	
CE	15,5	12,5	10,7	11,1	12,7	12,2	11,1	-0,8	-1,2	-4,8	-5,0	-4,9	-2,0	-1,8	-1,4	-2,0	-1,8	-1,4	-1,4	

(1) Including consumption of fixed capital

(2) National accounts definition, excluding loans, advances and equities

(3) Estimates

(4) Previsions

Source: Estimates of Commission services.

Table 6.2
Income and outlay transactions of general government (1), EC 10

	1 9 8 1		1 9 8 2 (2)		1 9 8 3 (3)	
	'000 mill- ion ECU	% change from 1980	'000 mill- ion ECU	% change from 1981	'000 mill- ion ECU	% change from 1982
Indirect taxes	307,7	11,7	343,4	11,6	378,6	10,3
Direct taxes	278,7	11,8	310,8	11,5	345,6	11,2
Social security contributions	324,8	12,8	367,8	13,2	415,2	12,9
Total taxes and social security contributions	911,2	12,1	1.022,0	12,2	1.139,4	11,5
Other current resources (4)	80,2	19,2	90,6	12,8	97,0	7,0
Total current resources	991,4	12,7	1.112,6	12,2	1.236,4	11,1
Current transfers	491,7	18,1	560,4	14,0	623,6	11,3
Other current outlays (5)	89,0	26,6	110,4	24,1	131,7	19,3
Government consumption (4)	428,3	13,6	470,9	10,0	510,6	8,4
Total current uses	1.009,0	16,8	1.141,7	13,2	1.265,9	10,9
Gross saving	-17,6	-	-29,1	-	-29,7	-
Net capital transfers	20,6	-1,4	21,8	5,4	23,6	8,5
Gross capital formation	68,0	3,8	71,1	4,6	77,5	9,0
Net lending (+) or borrowing (-)	-106,2	-	-122,0	-	-130,8	-

(1) National accounts definition, excluding loans, advances and equities

(2) Estimates

(3) Forecasts

(4) Including consumption of fixed capital

(5) Interest payments and miscellaneous

Source: Commission services.

13

Table 6.3
Components of changes (1) in budget deficits, EC and Member States, 1981 - 82 (2)

	Actual change			Effect of change in activity			Effect of change in net interest payments			Residual change		
	1981	1982(3)	1983(4)	1981	1982(3)	1983(4)	1981	1982(3)	1983(4)	1981	1982(3)	1983(4)
B	-4,0	+0,6	+0,7	-2,2	-1,6	-0,9	-1,5	-1,3	-1,1	-0,3	+3,5	+2,7
DK	-3,8	-2,3	-2,2	-1,5	-0,1	+0,2	-0,9	-1,5	-1,9	-1,4	-0,7	-0,5
D	-0,5	+0,1	-0,2	-1,2	-1,7	-0,8	-0,2	-0,1	-0,3	+0,9	+1,9	+0,9
GR	-4,7	+0,9	+0,4	-2,3	-1,7	-1,2	:	:	:	-2,4(5)	+2,6(5)	+1,7(5)
F	-2,0	-1,5	0,0	-1,6	-1,1	-1,2	-0,4	-0,3	-0,3	0,0	-0,1	+1,5
IRL	-2,6	+1,7	+0,1	-1,4	-0,8	-0,7	-0,9	-1,3	-0,5	-0,3	+3,8	+1,3
I	-4,1	+0,3	+0,6	-2,1	-1,7	-1,6	-1,4	-0,9	-0,1	-0,6	+2,3	+2,3
NL	-1,1	-1,2	+0,2	-2,5	-2,1	-1,7	-0,5	-0,5	-0,6	+1,9	+1,4	+2,5
UK	+1,4	+0,7	0,6	-2,1	-0,6	+0,1	-0,1	-0,1	+0,2	+3,6	+1,4	+0,3
EC	-1,4	-0,2	+0,1	-1,7	-1,3	-0,9	-0,5	-0,3	-0,2	+0,8	+1,4	+1,2

(1) Plus sign indicates a reduction in general government net borrowing, a minus sign indicates an increase

(2) For methodology, see text and methodological annex

(3) Estimates

(4) Forecasts

(5) Including the effect of changes in net interest payments

Sources: Commission services.

Table 6.4
Comparison of the structure of public debt in 1973 and 1981

	1 9 7 3			1 9 8 1						
	Total debt	Domestic	External	Short-term	Long-term	Total debt	Domestic	External	Short-term	Long-term
B (4)	64,2	63,6	0,6 (5)	6,9	57,3	88,6	77,7	10,9 (5)	24,9	63,7
DK	-13,6 (8)	-18,6	5,0	0 (9)	7,4 (9)	16,3	1,2	15,1	7,2 (9)	36,1 (9)
D (2)	17,8	17,4	0,4	1,9	15,9	35,1	30,8	4,3	4,2	30,9
GR (1)	19,5	14,4	5,1	8,0	11,5	40,4	32,6	7,8	(14,1)	(26,3)
F (1)	16,9	16,2	0,7	13,0	3,9	(17,3)	(16,8)	(0,5)	(12,2)	(5,1)
IRL (1)	53,0 (6)	48,3	4,7	:	:	98,4	62,7	35,7	:	:
I (3)	46,1	:	:	25,3	20,8	64,9	:	:	44,8	20,1
L (1)	21,5	17,9	3,6 (5)	1,4	20,1	22,1	(20,1)	(2,0)	(0,8)	(21,3)
NL (1)	41,4	:	:	3,5	37,9	(47,2)	:	:	(5,8)	(41,4)
UK (4)	71,5 (6)	60,9	10,6	26,1	30,7	58,8 (7)	51,8	7,0	18,6	30,9

EC

(1) Central government

(2) General government

(3) Treasury

(4) Public sector

(5) Foreign currency debt

(6) Debt as at 31 March 1974

(7) Debt as at 31 March 1981

(8) Debt as at 31 December 1974

(9) Short-term or long-term debt as % of GDP

Note: The breakdown as between short-term and long-term debt is carried out by type of debt instrument. The definition of short-term debt may vary from Member State to Member State.

Sources: National sources and Commission services.

4

Table 6.5
Financing of public sector borrowing requirements (1), % of GDP, EC and Member States, 1981 - 82

	1 9 8 1 (2)		1 9 8 2 (2)		1 9 8 3 (2)	
	Total Non-monetary	Monetary	Total Non-monetary	Monetary	Total Non-monetary	Monetary
B	15,3	1,2	14,1	12,0	13,7	11,0
DK	10,2	4,6	5,6	6,9	15,1	7,2
D	5,5	2,3	3,2	3,1	5,5	3,2
GR	14,3	0	14,3	13,2	11,1	11,1
F	1,9	0,8	1,1	1,7	3,1	1,9
IRL	21,2	3,0	18,2	17,9	17,1	14,4
I	13,4	8,5	4,9	5,3	12,0	5,1
NL	7,4	7,1	0,3	0,6	8,6	0
UK	3,6	4,5	-0,9	-0,4	2,3	0,9
EC	6,5	3,7	2,8	3,0	6,3	3,2

(1) Budgetary definitions, including loans and equities. Sector coverage by country as follows:

B: general government; DK: central government; D: general government; GR: public sector;
F: central government, cash basis; IRL: public sector; I: Treasury; NL: public sector;
UK: public sector.

(2) Monetary and non-monetary financing consistent with monetary forecasts (see Chapter 5).

Source: Estimates of Commission services.

Table 6.6

Loss in real value of public debt held by residents, 1973-83 (% of GDP)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
B(1)(3)	4,2	9,6	6,9	4,8	4,1	2,7	3,7	5,4	(6,1)	(7,0)	(6,8)
DK	:	-2,9	-0,6	-2,0	-1,8	-0,9	-1,1	-0,7	0,1	(0,4)	(0,7)
D(1)	-0,5	-0,3	-0,1	0,1	0,2	0,2	0,5	0,6	(0,9)	(0,8)	(0,6)
GR(2)	4,4	2,0	2,3	1,9	2,2	2,8	5,5	5,6	7,3	(7,8)	(7,3)
F(1)	0,6	1,1	0,8	0,9	0,8	0,9	1,2	1,3	(1,3)	(1,1)	(0,9)
IRL(2)	6,1	9,9	10,0	11,8	6,4	5,2	11,1	12,0	14,7	(11,5)	(8,0)
I	5,6	10,5	5,9	12,0	7,0	6,8	11,0	(12,2)	(11,2)	(10,5)	(9,8)
L(2)(3)	1,1	1,6	1,8	1,4	0,8	0,7	1,1	(1,3)	(1,6)	(2,1)	(1,8)
NL(1)(4)	3,5	4,2	3,6	3,3	2,1	1,6	2,2	3,1	(3,4)	(3,2)	(2,4)
UK(1)	4,1	6,8	9,5	5,6	5,0	3,1	(6,4)	(5,2)	(4,5)	(3,3)	(2,6)
	2,3	3,9	3,6	3,8	2,7	2,3	3,9	4,1	3,9	3,5	3,1

(1) Losses calculated on the basis of the net debt of general government.

(2) Losses calculated on the basis of the gross debt of central government.

(3) Calculation carried out on the basis of domestic-currency debt.

(4) Calculation carried out on the basis of the total (domestic and external) debt.

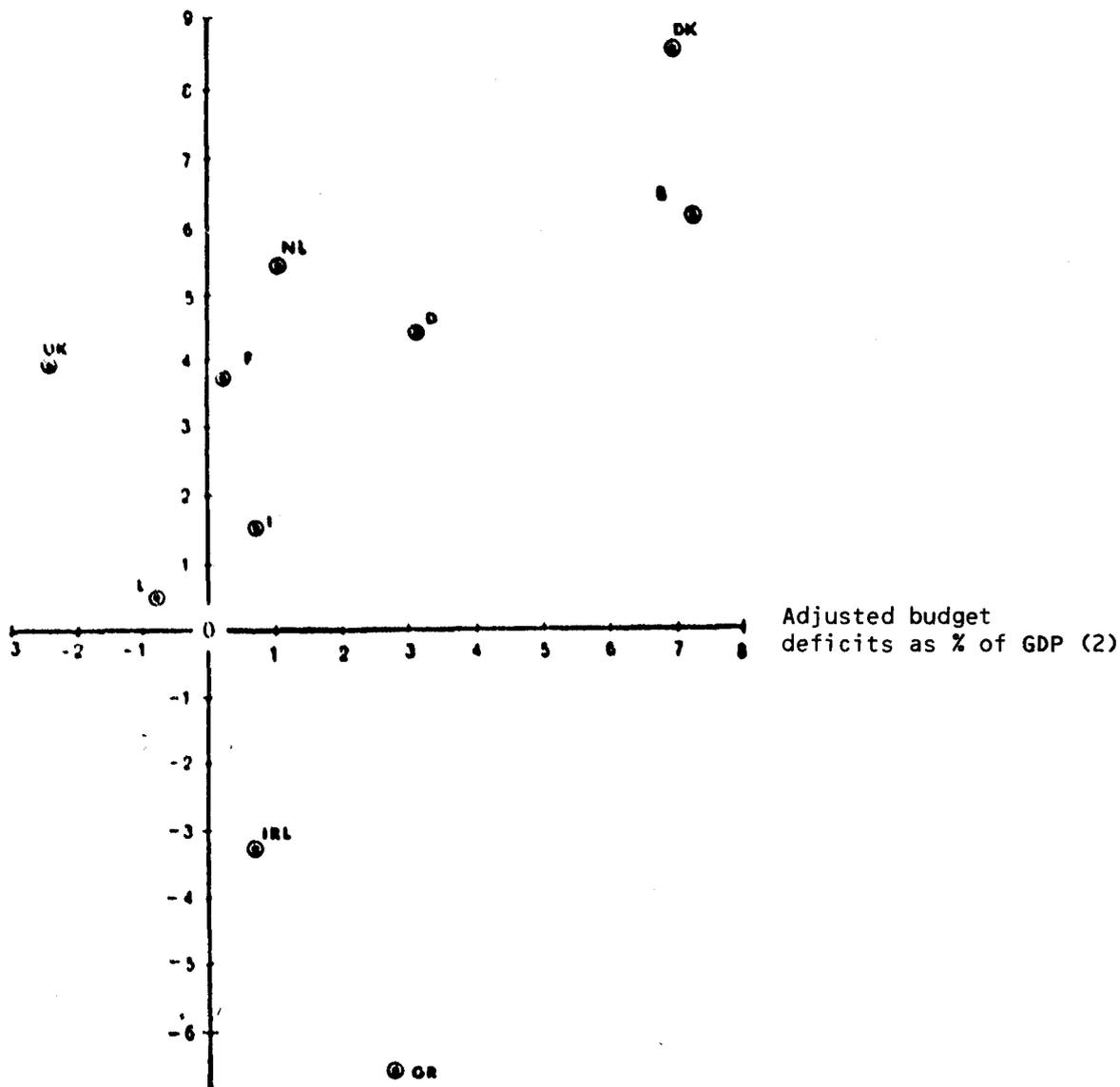
Source: Commission services. Estimates are consistent with the Commission's economic forecasts.

NOTE: The estimate of the loss in real value of public debt is obtained by multiplying the amount of the debt by the rate of change in the consumer price index during the year.

25

Graph 6.1: Real long-term interest rates and budget deficits adjusted for the effects of inflation on public debt as % of GDP.

Real interest rates (1)



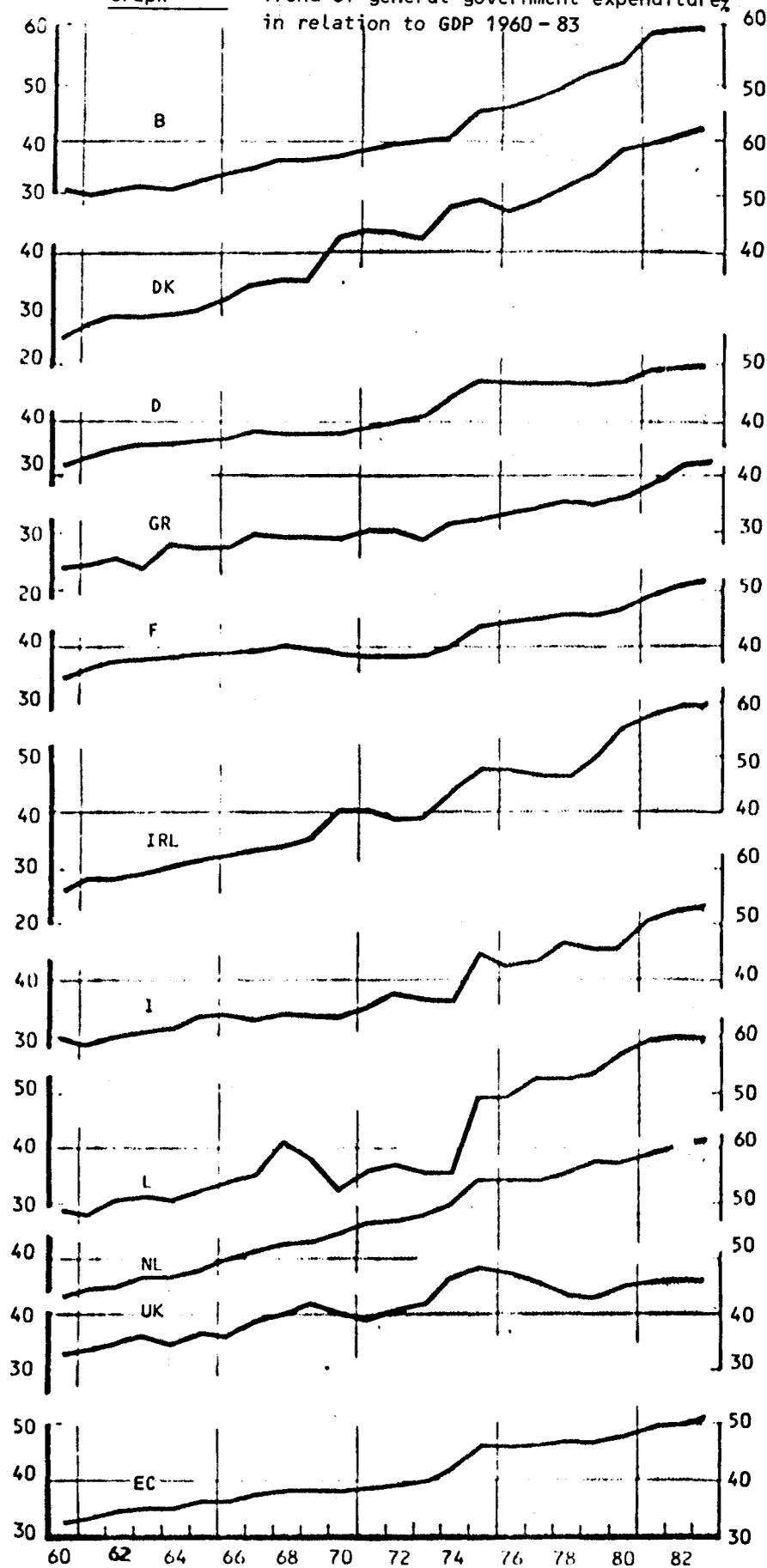
(1) Annual average yield of government bonds minus the annual change in the implicit price deflator for private consumption.

(2) Net lending (+) or borrowing (-) of general government minus the loss in real value of public debt holdings as % of GDP.

Sources: Commission services.

Graph 6.2 : Trend of general government expenditure in relation to GDP 1960 - 83

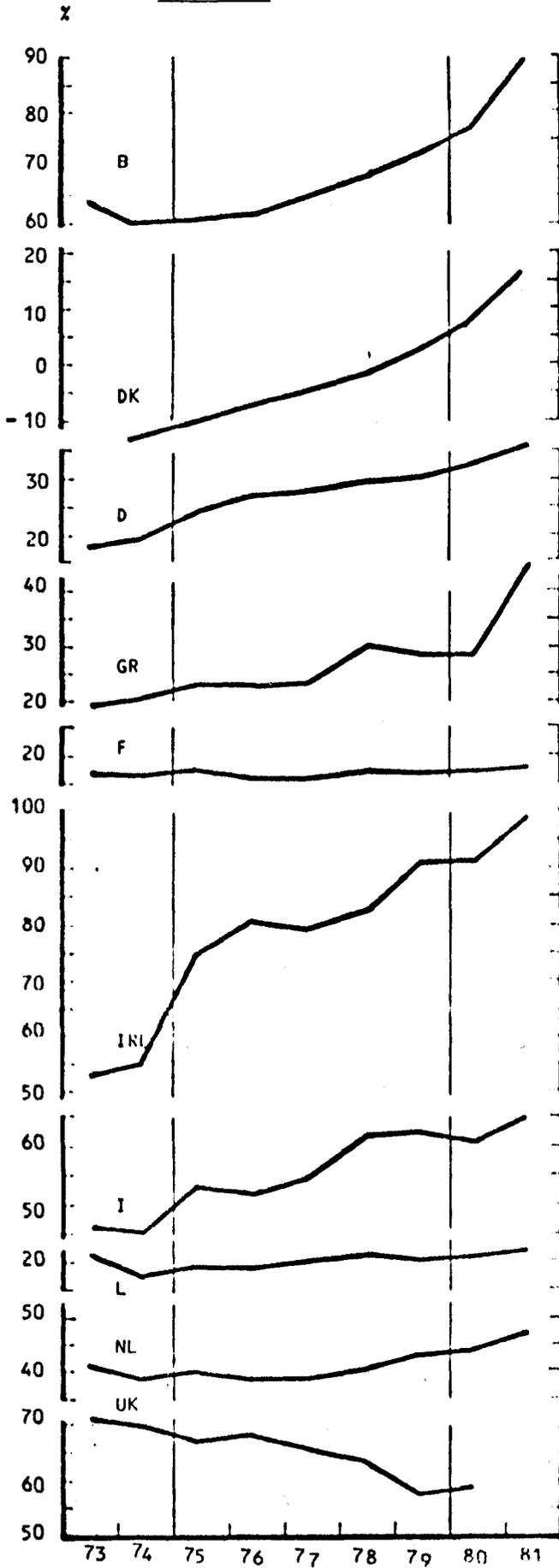
6.25



Sources: Commission services.

6.26

Graph 6.3: Trend of public debt as % of GDP since 1973 (1)



(1) Central government debt for GR, F, IRL, L; general government debt for DK, NL, D; Treasury (Settore Statale) debt for I; public sector debt for B, UK.

Source: Commission services.

7. Labour Markets

Labour market trends in 1981 and 1982 continued to be characterised by high and rising unemployment due to low rates of employment growth and high rates of labour force growth. The Community's record in creating jobs over the last ten years has fallen far short of that achieved by United States and Japan, particularly when labour force trends are taken into account. Instead, the Community has achieved a faster growth of productivity than the United States, particularly in manufacturing industry, which has been shedding labour continuously since 1973. Employment growth has been occurring in the services sector, but on a far less scale than in the United States, and also at a rate insufficient to compensate for the continuing decline of employment in agriculture and manufacturing. Increasing interest has been focussed on the role of real wages in the recent upsurge of unemployment, and various measures have been used to determine the strength of the relationship between real wages and employment.

7.1 The Community's employment performance

In 1982, the Community's labour markets, in common with those of the other principal industrialized countries, were still experiencing a continuation of the trends of the last two years : the slump in GDP and employment growth in 1981 and 1982 was equal to that experienced in the 1974-75 recession. In the Community, unemployment averaged 8,1 % in 1981 for the year as a whole and is estimated at some 9,2 % for 1982. In the United States, despite a short-lived recovery in the first three quarters of 1980, unemployment is expected to reach 9,5 % in 1982. Even in Japan, although unemployment remains at the relatively low rate of 2,2 %, it has still nearly doubled from its average rate of the 1960's (Graph. 7.1).

The steep rise in the level of unemployment in the Community over the last two years is principally due to the failure of employment growth to compensate for the unusually high pressures arising from adverse demographic movements. Over the period 1980-82, the average rate of employment growth in the Community was - 0,9 %, with a particularly large fall in 1981 (-1,3 %). At the same time, there was a rapid expansion in the working-age population (at around 1 % a year in the period 1980-83), comprising mainly young school-leavers arriving on the labour market for the first time. Given the relative stability of the activity rate, which has fluctuated by no more than 0,3 % points since 1971, this has resulted in abnormally large rises in the labour force in the last 3 years. This combination of events

is unique to the Community at the present time, when overall world activity is least conducive to a rapid recovery of employment growth, but the situation currently facing the Community in terms of labour force growth and demographic pressure is exactly the same as that experienced by the United States from the middle sixties until the end of the seventies. The post war baby-boom there, which lasted from 1946-1962, reached its peak in 1955, and by 1970, this "bulge" was just arriving on the labour market. During the rest of that decade, the American economy had to cope with a 25 % increase in its labour force while at the same time the rate of output growth was being nearly halved by the effects of the 1973 oil shock. In the period 1973 to 1981, real economic growth in the United States averaged just over 2 % a year and employment rose by more than 2 % annually. In the Community, in the same period, real output rose by less than 2 % a year and employment declined by 0,2 %. If the Community had achieved only half the employment growth of the United States, this would have been sufficient to ease the unemployment problem: annual employment growth of 1 % a year from 1973-81 would have meant 8 1/2 million extra jobs; in the same period the number of jobless rose by 7 1/2 million.

The difference in the performance of the two economies can be seen in Graph 7.2. This shows the trends in the activity rate, which is the proportion of the working-age population in the labour force (employed and unemployed), and the employment-population ratio, which is the proportion of the working-age population who are employed, for the Community and the United States in the period 1960-1981. If the activity rate is taken as an expression of the proportion of the population who wish to work, and the employment-population ratio as indicating the ability of the economy to provide them with work, then the difference between them shows how successful these two economies have been.

In the United States, with the exception of 1975, employment growth was sustained at a very high rate throughout the period 1971-79, and it is only in 1982 that the growth rate falls below that of the Community. Thus, despite a progressive rise in the activity rate, from 58 % in the early 1960's to 63 % in 1981, the ability of the US economy to provide employment for a growing proportion of its population did not deteriorate until after 1979. In the Community, by contrast, a steady decline in the activity rate

has been matched by an even sharper decline in the proportion of the working-age population which is employed : by 1981 the employment-population ratio was down from over 67 % in 1960 to less than 63 % and by 1983 it is forecast to fall to nearly 61 %. The marked differences in the apparent ability of economies to create employment - between 1973 and 1981, 15 million jobs in the United States, 3 million in Japan, and stagnation in the Community - are of course, reflected in the trend of productivity growth. The arithmetic relationship between output, employment and productivity necessarily means that a fall in output growth may be absorbed in one of two ways : by a fall in productivity growth or by a fall in employment growth (or a combination of the two). The developments in the Community and the United States over the last twenty years and particularly since 1973 are clear examples of the two extremes of this dichotomy : in the Community the slowdown in the rate of growth of output has clearly been borne by the fall in employment, while in the United States, a similar fall in the rate of output growth has been absorbed by a large fall in productivity growth, which slowed almost to zero on average for the period (Table 7.2).

7.2 Structural and Sectoral Trends in Employment

Sectoral employment trends in both the Community and the United States in recent years have been characterised by three main features : the continuing decline of agriculture as a provider of employment, the decline in the share of industry, and particularly manufacturing, and the marked rise in the service sector to the position of largest employer. The scale of these developments between the two economies however, has been quite different. (Table 7.3)

The vast majority of the 15 million new jobs created in the United States in the period 1973-81 are in the services and government sectors. By 1980, 66 % of all employment was in this sector compared with 63 % in 1973. By contrast, the employment share in both agriculture and industry had declined over the same period. An analysis carried out by the US Bureau of Labour Statistics suggests that the relatively successful employment

performance of the American economy in the face of the recent recessions may be explained by a shift in the mix of employment towards less cyclically sensitive industries especially service-producing industries, which have improved their employment performance in all recent recessions. The relative buoyancy of services employment is very unevenly distributed across industry categories. The principal sectors which posted strong gains in recent years were government employment and the services industry : legal, health and business services, hotels and motels, auto repair, amusement and recreation. These are the sectors which generally exhibit low productivity growth, less technological advancement and a high ratio of direct labour to machines, hence employment growth is not surprising, even during an economic contraction.

It has also been suggested that the jobs boom in the United States since the Second World War is a form of indirect government employment. In the 1950's this occurred through the expansion of education, in the 1960's (and up to the mid-70's) in the increase in social services, and since 1975, the growth of health care. It has been estimated that since 1975 social and health services funded by Medicare and Medicaid have been generating 800.000 new jobs a year.

The other striking structural phenomenon about the US economy is its capacity to absorb women into the workforce. Between 1960 and 1981, the share of females in the labour force rose from one-third to nearly one-half. In the same period the female participation rate rose from 43 % to 60 %, and the vast majority of these jobs for women are to be found in the services sector and in health, education and welfare : exactly those sectors which have registered the strongest employment gains in the last 8 years.

In the Community, by contrast, the expansion of the female labour force was much slower, rising from around 34 % of the total labour force in 1970 to 37 % in 1981. Similarly, the female activity rate also rose much slower than in the United States, from an estimated 44 % in 1960 to 50 % in 1981, although the expansion slowed down after 1979 as the growth in the working age population accelerated.

Overall employment trends between the three main sectors, however, have not been dissimilar in the Community from those in the United States : the drift from agriculture continued, but at a much slower pace as the scope for adjustment in agriculture became much smaller after the large movements off the land in the large agricultural employing countries in the early sixties. Even so, the decline was almost entirely due to a drop in the number of self-employed and unpaid family workers who make up the majority of agricultural workers in the Community as a whole.

The decline in employment in industry in the Community, from nearly 40 % of total employment in 1973 to less than 37 % in 1981, was largely due to the contraction in manufacturing. In some of the Community countries the pace of "de-industrialisation" has been staggering (Table 7.4): in the United Kingdom between 1970-81 the share of manufacturing fell 8 % points, in the Belgium by 7,6 % points and in the Netherlands 5,2 % points. The very sharp rise in unemployment in Belgium and the United Kingdom, (which have the two highest rates of unemployment in the Community), may be closely connected to this phenomenon: over the period since 1973, and particularly in the last two years, these two countries have demonstrated high rates of productivity growth. These are the result, principally, of the decline in employment in traditional heavy industries - steel, coal, and heavy engineering - which results in an immediate improvement in overall productivity and profitability in the average for manufacturing industry, but which has no positive effect on employment prospects; it is simply a result of the reduction in numbers employed. Services sector employment expanded in all Member States, the sharpest increases being in Italy, France and Belgium.

A detailed analysis of employment in services for those Community countries for which sufficiently comparable data exist indicates some striking differences, both between Community countries and between the Community and the United States. (Table 7.5).

In the wholesale and retail trade, (including repair services), and in transport, employment declined in the Federal Republic of Germany while in all other countries except Italy it remained fairly stable. In hotels and catering, all countries except Italy and Belgium showed low rates of increase. In banking and insurance and communication there were strong growth rates everywhere except in the Federal Republic of Germany and in the United Kingdom in communications. All countries showed sharp increases in employment in "other market services" and there has been a disproportionately rapid growth in the government sector, which together with domestic services and services provided by private non-profit making institutions account for some 16-21 % of employment in non-market services.

The three sectors which increased most rapidly in the United States, legal services, business services and health care, probably also showed the largest gains in the Community, since they fall into the two sectors which also grew substantially : "other market services" and "non-market services". It must be recognized, however, that the system of health care varies considerably on the two sides of the Atlantic and also between Community countries, so that a direct comparison in this sector is complicated by questions of definition. On the other hand, two sectors which did well in the US performed badly in the Community, namely hotels and catering, and the distributive trades (including repair services). The most notable feature, however, is the extent to which developments in one Community country, Italy, closely match those in the United States. It is the only Community country in which the share of total employment in manufacturing did not decline over the decade as a whole although it peaked in 1974 and declined slowly thereafter. At the same time, however, Italy also registered the fastest growth in services employment in the Community, (with average growth of nearly 2 1/2 % a year between 1973 and 1980). Among the various service sectors it posted strong growth in wholesale and

retail trade, hotels and catering, banking and finance and "other market services". Moreover the trend of unemployment since 1973 has also been very similar to that of the United States, rising from 4,9 % in 1973 to 9,6 % in 1982.

In the economy as a whole, productivity growth in the Community has fallen about half since 1973, while total employment has actually declined. In 1982, with a fall in employment of some 1 %, the slight growth in activity will result in a modest rise in productivity growth, rather than in any immediate effects on unemployment : after more than two years of recession in output and demand, it is to be expected that there is some spare capacity in the economy, both in terms of capital stock and short-time working. Employers are likely to react initially to any upturn with caution by taking up the slack in these two areas before recruiting new labour. This trend is expected to continue in 1983: with only modest growth in activity a further fall in employment is forecast, with a similar rise in productivity growth. An area of uncertainty here is the extent to which spare capacity of the capital stock really exists, or whether the decline in profitability has induced accelerated scrapping (see section 7.3).

In manufacturing industry, a similar pattern can be observed. Manufacturing output growth slowed everywhere after 1973, and usually more sharply than overall growth. In contrast to the reaction in the United States, Japan and particularly the Community countries have not responded to this slowdown in output growth with a large fall in productivity growth: in the period after 1973, the rate of growth of productivity per head and per hour has fallen by less than half (Table 7.6).

While in all countries the decline in the rate of growth of productivity per head and per hour has been roughly parallel, some differences in the magnitude of the reaction do exist. In the United States, average weekly hours have declined in the period since 1973, while employment has increased significantly. As a result, the rate of hourly productivity-growth has slowed much less than the rate of growth of per capita productivity: the response of American industry to the slowdown in demand and output appears to have been to employ more workers for fewer hours. In the Community the decline in average weekly hours continued at much the same pace, although there are divergences among the Member States, with much faster declines in Germany, and to a lesser extent the United Kingdom and France, than in Italy and Denmark. Total hours worked in the Community as a whole declined much faster during the second period, but this is almost certainly due to the reduction in employment rather than in hours. These trends accelerated in 1981, when both manufacturing output and employment fell sharply, and productivity per hour rose because employee hours declined more than output.

The result of this "choice" which countries appear to have made in responding to the adjustment problem imposed by the various shocks of the 1970's is the subsequent rise in unemployment. Over the 1970's, the rise in unemployment has been much greater (relative to its 1960's average) in the Community than in either the United States or Japan, and in the last 3 years has worsened further (Graphs 7.1 and 7.3). Since the beginning of 1980, the rate of unemployment in the Community as a whole has risen steeply to reach 9,9 % by August 1982 (seasonally adjusted). Despite some tentative signs of a slowdown in the rate of increase during the first half of 1982, unemployment is not expected to fall before the end of 1983; the small rise in output growth in the Community in 1983 will still be insufficient to offset a further marginal fall in employment, while the high rate of labour force growth will continue.

7.3 Employment and the Adjustment of Real Wages

It is apparent that the recent increases in unemployment in the Community are due to a wide range of contributing factors : the upsurge in inflation, weak real demand, structural problems arising from the rise in the relative price of oil, a general lack of business confidence, labour force and productivity trends. It has also been suggested that the sharp increases in real wages which have occurred in recent years but which were not justified by productivity increases, have further increased unemployment levels through the accompanying falls in profitability.

A combination of these factors may indeed be the most relevant explanation of the present European situation. If a sharp fall in productivity is associated with a fall in demand from a terms of trade loss and real wages do not adjust sufficiently quickly, then there can be a lack of demand and at the same time real wages can be too high for long-run full employment. In these circumstances, too high real wages and the correspondingly low profitability reduces the incentive to invest in new machinery and the investment that does take place will be highly capital intensive. As a result there will be an increasing mismatch between the labour supply and the employment necessary to fully utilise the capital stock.

The measurement and analysis of the real wage problem is fraught with difficulties. No simple straight-forward measure exists and the potential problem must be examined in the light of several indicators. Two of the more frequently used measures are factor income shares and the real wage gap.

If wages are at their appropriate level then the share of profits should be such as to encourage firms to fully utilise the present capital stock and encourage further investment. Therefore the wage share and any change in it should provide a valuable indicator of any wage problem. But the figures are affected by the assumptions made about self-employment income. National accounts do not distinguish between that portion of

self-employment income which is profits and that portion which is an implied wage payment. If it is assumed that all self-employment income is profit, then the labour income ratios will be biased downwards, the problem being particularly acute for those countries with a large self-employed population.

Partly to overcome some of the problems with the labour income share and partly to analyse the reasons for any changes in factor shares, the concept of the real wage gap has been developed. It shows the difference between the actual growth in real wages (defined as wages divided by consumer prices) and that growth rate in real wages which would maintain constant factor shares (the so-called warranted growth in real wages). This latter depends mainly on the rate of growth of productivity and changes in the terms of trade.

Graph 7.3 shows the real wage gap for the Community, the USA and Japan over the period 1960 to 1982, and compares it with employment growth. For the Community, it shows clearly the different trends before and after the oil price shock. During the 1960's there was relative stability in the share of wages but between 1972 and 1975 the real wage gap increased by over 4 % partly because of a slump in productivity growth and partly because of a deterioration in the terms of trade. Over the subsequent four years the real wage gap narrowed as productivity growth recovered and the terms of trade improved. However, during the 1980-81 oil induced recession the real wage gap widened again reaching about the same level as the previous peak in 1975. (The absolute size of the real wage gap is somewhat arbitrary since it depends on the base year).

For the United States the picture is somewhat different. In the early 1960s, there was a significant shift in income shares in favour of profits which was fully reversed between 1967 and 1970. Since then factor shares have remained more or less constant although there are some indications that 1982 may lead to the development of a significant real wage gap.

In Japan, up to 1969 there was a sharp improvement in the share of profits, mainly because of a very high rate of productivity growth. Between 1969 and 1975, there was a reverse movement of the real wage gap due to a massive deterioration in the terms of trade and a slowdown in productivity growth. The high real wage gap reached in 1975 has been maintained through-out the rest of the 1970s and has widened somewhat more in the 1980-81 recession.

The graphs for the USA and the EC provide some evidence of a negative correlation between the real wage gap and employment but Japan does not seem to fit into this pattern. However, although real wages in Japan rose faster than warranted in the 1970s, the share of wages and salaries in manufacturing value added remained considerably lower than in the EC or the USA. This may be part of the explanation of Japan's continuing high rates of investment and low levels of unemployment compared with both the US and the Community.

Graph 7.4 shows changes in the real wage gap and employment in the individual Community countries except for Greece and Luxembourg. Among the countries shown, those with the highest real wage gap in 1981 were Belgium (118) and France (110). In both cases, real wage increases of more than three per cent per annum since 1973 were not warranted despite relatively high productivity growth (2,4 % per annum in France and 2,3 % in Belgium). For 1982, the real wage gap is forecast to decline in all Member States except Italy, where it will remain roughly stable : this is largely due to the continuing rise in productivity consequent upon the contraction in employment discussed in section 7.1.

Taking the period 1970-82 as a whole, certain characteristics stand out : while the impact of the 1973 oil price shock and the subsequent wage explosion can be clearly seen, developments in the real wage gap and employment have varied widely from one Member State to another. To take only the two extremes, the relative performance of Italy and Belgium show the effects of differing policies following the fall in productivity growth and terms of trade loss in 1973. In Belgium, a strong exchange rate policy constrained output prices so that firms had to rely on above average productivity gains to reduce real unit labour costs (particularly given the

rigid labour market and wage indexation system). Despite sharp increases in productivity over the period, a substantial (and rising) real wage gap has been accompanied by a steady decline in employment. In Italy, on the other hand, the real wage gap widened in 1974-75 mainly because of negative productivity growth. Over the next three years, moderate real wage increases and reasonable productivity growth resulted in a substantial improvement in the real wage gap. However, a depreciating currency and unconstrained output prices has meant that inflation has been a serious problem. Despite all this, there has been steady growth in employment throughout the period, the only Community country to have achieved such a result.

Despite the wide variations in the experiences of different countries, a number of them seem to have had a sizeable and sustained real wage gap during the latter part of the 1970's. In itself, this does not prove that adverse trends in real wages have significantly increased unemployment in the 1970's, but the trends in output, productivity and real wage movements strongly point to a role for the real wage in output determination and unemployment. The evidence from econometric simulations is inconclusive, probably because they tend to capture short-term effects rather than longer term consequences. In the longer run real wages affect employment because of their influence on profitability and investment. Such effects on the capital stock are inevitably slow.

Overall, the timing of the emergence of a real wage gap (Graph 7.1) suggests that it was associated with the major changes in the economies of the advanced countries which took place in the late 1960s and early 1970s. The rapid, and historically exceptional, growth of the post war period ended. There was a sharp increase in upward pressure on wages. Shortages of raw materials, in particular oil, emerged. These changes were, for a time, masked by the synchronous expansion of 1972-73 which collapsed in the wake of the first oil price shock.

Looking back, it is not difficult to see how falling productivity growth, terms of trade losses and expectations that living standards would continue to rise, produced an unwarranted growth in real wages. More worrying is the way in which this "real wage gap" has persisted in Europe. There has been less real wage flexibility than elsewhere. This seems to have resulted from deep-seated social attitudes, with wage bargaining being more explicitly or implicitly linked to price movements than elsewhere. To reduce the real wage gap, increases in real wages must fall short of increases in productivity. The outlook for the immediate future suggests that this will indeed be the case. Unfortunately, the large increases in productivity growth are mainly the result of falls in employment.

7.4 Conclusions and labour market policy issues

The experience of the last decade has shown a clear distinction in the response of various countries to the upheavals engendered by the oil price shocks. While unemployment has everywhere risen sharply compared to the 1960's, the Community's performance in terms of employment growth has been among the worst in the industrial world. This is all the more worrying when labour force trends are taken into account and it is realised that in essence, the 1970's were a period of relative calm on the demographic front : the major surge in the labour force is to occur in the early 1980's.

The evidence presented in this chapter so far has illustrated the way in which the experience of the Community has been almost completely opposite to that of the other major industrialized countries, and the United States in particular. Employment growth, productivity growth labour force trends, activity rates, sectoral employment patterns, real wage trends : all have been sharply contrasted.

It has been suggested that the diametrically opposed trends in employment and productivity in the two economies are the result of a "choice" of how to respond to the required adjustment problem. But the outcome of this choice is itself conditioned by the whole economic and social environment of the two economies, which is reflected in differences

in attitudes, and the resulting behaviour. In this respect, it would appear that a major failing in the Community economy compared to the United States is a lack of flexibility which creates rigidities in response to change and the need to adapt. Nowhere is this more damaging in its impact than on the labour market : the more open attitude to risk-taking and change in the United States has resulted in a somewhat better performance in terms of employment growth.

As only one example of the effects of excessive rigidities, the evidence presented by the use of the real wage gap concept, while far from conclusive, does suggest that the lack of real wage flexibility may have played some role in preventing a more positive employment response.

The policy-issues raised by these considerations are far from clear-cut. It may be suggested that a fundamental change in attitudes and behaviour is required, but this would itself require a change in objectives and desires as perceived by society as a whole.

In these circumstances, policy-makers have been obliged to concentrate their attention on alleviating rather than curing the unemployment problems by "targetting" action towards the most hard-hit groups : young people (especially school-leavers), older workers, and the long-term unemployed. With regard to the problem of youth unemployment, in the foreword to the Fifth Medium-Term Economic Policy Programme the Commission called for Member States to set up machinery and arrangements to ensure that, on leaving school, all young people obtain either a paid job or access to a vocational training course, or both together. By the middle of the year three Member States had announced plans for such schemes (see Box), which will come into force gradually over the next two years. Most Member States also stepped up the volume of resources devoted to more

"conventional" labour market measures such as direct job-creation in the public sector, employment subsidies to the private sector, either in the form of tax concessions or, in the case of young people, direct wage subsidies. In others, the emphasis has been placed on stimulating the private sector to create jobs itself by channelling available resources into investment programmes, and particularly investment in new technologies, energy saving and the environment, as well as regional subsidies, although the scope for global stimulation measures has been severely restricted.

A new emphasis which has appeared this year has been the move towards a redistribution of working-time as a means of sharing out available work among the unemployed. In two Member States this has taken the form of a reduction in the normal working-week, in exchange for additional employment. Several have also increased the number of annual paid holidays, and early retirement schemes have become more firmly established as a means of reducing the number of people in the labour force. Measures to encourage part-time work and short-time working have become more popular, and in one novel experiment, in the Netherlands, a subsidy is paid when one full-time job is converted into two part-time jobs. A similar scheme is now being considered in the United Kingdom.

Labour market policies

Belgium. Since the middle of 1981, labour market policy has been increasingly directed towards the twin problems of youth unemployment and long-term unemployment. In August 1981, the existing schemes based on job-creation in the public sector were supplemented by the "de Wulf transitional plan". The "special temporary scheme" has been modified and lengthened in the public sector (2 schemes, of 2 years and 5 years) and now extended to the private sector (if employers can guarantee to provide a job for 5 years). The temporary employment premiums paid under the Work Experience Programme for young people under 30 were also increased. In February, further measures aimed at facilitating part-time work and short-time work were implemented as well as incentives to employers who employ young people. In the draft Budget presented on 2 August, the Government announced plans for specific measures to create employment.

Denmark. On 4 June Parliament adopted the measures proposed in the Government's Economic Policy Programme 1982-85, which aims at creating 50 000 jobs annually during this period (of which 11 000 in the public sector), and provide a job or training possibilities for all young people with full effect from 1984. This package of measures comprises various incentives to encourage business investment as well as expansion of already existing direct labour market measures such as vocational training and vocational guidance, the job-offer scheme for the long-term unemployed, job creation by local authorities and job creation subsidies in the private sector for 18-25 year olds.

Federal Republic of Germany. During 1981, no new labour market measures were announced, but additional funds were allocated during the year to existing measures, which emphasize vocational training and vocational guidance for young people as well as selective measures to improve the economic outlook in specific areas and create employment through stimulating private investment. In February 1982, in the face of rapidly increasing unemployment, the Government announced a new employment creation package, containing three main elements: investment incentives to private industry, including a 10% subsidy for investment which exceeds the average level of the Last 3 years; additional funds for investment in energy, innovation and the environment; and DM 400 million for the youth training programme. In March, the Government also announced that it would introduce a bill to allow early retirement (at 58 years).

Greece. In the past, the low official rate of unemployment was often used as an argument for not implementing specific employment measures, but the new government immediately announced a series of measures designed to improve the operation of the Labour Administration as well as the collection of statistics. At the end of 1981 it introduced its first economic policy package which included a reduction of the legal working week to 41 hours and the introduction of 4 weeks paid holiday for everyone. In May 1982 it promulgated the instrument entitling private-sector workers to 24 working days holiday per year.

France. In December 1981, the Government adopted a "Programme for young people between 16 and 18 years of age", whereby organised actions on vocational guidance, training and the transition to working life would be provided in public establishments. On 25 November 1981, the Government passed the Law on Social Measures to be adopted by Order, which contained the following principles:

- changes and reduction in hours of work, with the target of 35 hours by 1985.

- reduction of the optional retirement age to 60.
- longer paid holidays for all workers.

The Orders implementing these principles were introduced progressively over the early months of the year: in January, there were Orders reducing the statutory working week to 39 hours in all branches, and imposing limits on overtime and shift-working; granting all workers the right to 2 1/2 days paid holiday per month of work; limiting the recourse of employers to temporary or contract work, encouraging recruitment and restricting casual work; and permitting those over 55 years to work part-time. At the same time they provided the legal basis for the "Solidarity Contracts" between firms, the governments and local groups, designed to step up efforts at job creation with particular emphasis on young people and the long-term unemployed. In March a further 6 Social Orders were passed, including the provision for early retirement at 60 from 1 April 1983 onwards. In April the Government announced a set of measures to assist enterprises. In addition to various fiscal incentives it also provided for greater flexibility in the reduction of working hours. In future these would no longer be legislated by Parliament but left to the initiative of management and unions.

Ireland. As part of its electoral programme the new Government which took office in February announced that it would implement an IRL 200 million job creation plan which is now being examined in the context of an overall medium-term strategy. At the same time, plans are going ahead on the Youth Employment Agency, announced in July 1981, which is funded by a 1% levy on public sector incomes and which will integrate and extend Youth employment schemes. The Government is also extending the scheme of training courses to provide skilled manpower for industry with the implementation of the programme to set up 6 new centres.

Italy. No new labour market measures were introduced by the government in either 1981 or 1982. The draft law on the reform of the employment service, which provides for the wide-ranging decentralisation of some government functions and more coordination between placement and training authorities, introduced in August 1980 has passed the Chamber of Deputies and is now before the Senate.

Luxembourg. The special labour market measures aimed at the specific problems of iron and steel workers had already been strengthened in 1981, but by early 1982 the imbalance in the labour market - too many workers in the "anti-crisis unit" and too few in the new industries - was progressively worsening. At the beginning of March, therefore, the government announced a reinforcement of measures to encourage the mobility of workers and the setting-up of new firms, particularly small and medium-sized enterprises.

Netherlands. In addition to the existing schemes to stimulate employment via subsidies to the private sector dating from the end of 1980, in March 1982 the government adopted the Employment Programme 1982-83, whereby HFL 3 000 million would be allocated to measures aimed at reducing youth unemployment and achieving a better distribution of available work. It is expected that 30 000 jobs will be created in 1982 and 1983. The government had previously announced that under the programme a premium of HFL 2 000 would be paid whenever a full-time job was transformed into two part-time jobs in 1982.

United Kingdom. In November 1981, in presenting its programme to Parliament, the government promised that further employment measures to supplement the wide-range of existing schemes would be introduced, with particular reference to unemployed young people. At the beginning of December, the Chancellor of the Exchequer announced revised expenditure plans for 1982/83 which provided for an additional UKL 800 million for special employment schemes. On 15 December it announced plans for the development of industrial training of young people. Under these plans the existing Youth Opportunities Scheme would be replaced by the Youth Training Scheme: from September 1983, all minimum age school leavers would be guaranteed one year of vocational training combined with further education. In June 1982 it was announced that plans to withhold social security benefit from young people refusing to join the scheme would be withdrawn and that the allowance to be paid would be raised from UKL 16 to UKL 25 per week. In the March Budget, the Chancellor also announced plans for voluntary "Community Work" for the long-term unemployed. In July, the Chancellor also announced that from January 1983, subject to meeting certain conditions, employers who "split" a full-time job into two half-time jobs would qualify for a subsidy.

Table 7.1

Population, employment and unemployment in the Community

	1970-79 (average)	1980	1981	1982 (1)	1983 (2)	1970-79 (average)	1980	1981	1982 (1)	1983 (2)
	Working age population (3) % change					Total: Labour force % change				
B	0,6	0,6	0,7	0,9	0,9	0,9	0,3	0,2	-0,1	0,3
DK	0,4	0,6	0,8	0,7	0,5	1,2	1,3	0,3	0,9	0,7
D	0,5	1,2	0,8	0,7	1,1	-0,2	1,0	0,9	0,2	0,4
GR	0,7	:	:	:	:	1,3(1)	2,3	1,2	1,1	1,3
F	0,8	1,0	1,2	1,2	1,1	0,8	0,4	0,3	0,9	0,9
IRL	1,7	1,7	1,6	1,6	1,5	0,9	1,5	1,0	1,0	2,0
I	0,5	0,8	0,9	1,1	1,1	0,9	1,4	1,3	1,1	1,1
L	1,1	0,0	0,6	0,6	0,6	1,5	0,6	0,5	-0,7	0,6
NL	1,4	1,5	0,5	0,2	1,0	1,0	2,6	2,2	1,3	1,4
UK	0,2	0,7	0,8	0,7	0,7	0,5	-0,3	-1,1	0,0	0,2
EC	0,6	1,0	0,9	0,9	1,0	0,5	0,8	0,4	0,6	0,7
USA	1,8	1,5	1,4			2,7	1,9	1,6	1,0	1,6
Japan	0,9	0,9	0,9	1,2	1,1	0,8	1,0	1,2	1,0	0,4
	Total employment % change					Unemployment rate % (4)				
B	0,3	-0,1	-2,5	-2,3	-1,1	2,2	9,4	11,6	13,9	14,8
DK	0,8	-0,4	1,9	0,1	0,2	1,0	6,2	8,3	9,1	8,8
D	-0,4	0,9	-0,7	-2,0	-1,1*	0,6	3,4	4,8	6,9	8,3
GR	0,4	1,7	1,1	0,4	1,0	:	(2,8)	(3,1)	(3,8)	(4,0)
F	0,4	0,2	-0,7	-0,2	-0,2	1,3	6,4	7,8	8,3	9,3
IRL	0,9	1,6	-1,9	-0,8	-0,6	5,3	8,3	10,4	12,1	14,0
I	0,5	0,0	0,4	-0,1	0,4	4,4	8,0	8,8	9,9	10,5
L	1,4	1,3	-0,0	-0,9	-0,6	0,0	0,7	1,0	1,2	1,3
NL	0,2	0,4	-1,3	-1,8	-1,7	1,0	4,8	7,2	10,4	13,1
UK	0,1	-1,6	-4,8	-1,8	-0,1	2,5	6,9	10,6	12,2	12,5
EC	0,2	-0,1	-1,5	-1,1	-0,3	2,0	6,2	8,1	9,4	10,2
USA	2,6	0,5	1,1	-1,2	1,0	4,8	7,1	7,6	9,5	10,1
Japan	0,8	1,0	0,8	0,6	1,0	1,1	2,0	2,2	2,3	2,2

(1) Estimate
(2) Forecast

(3) Population aged 15-64 years

(4) Number of unemployed as percentage of civilian labour force.

Source: Eurostat, OECD and estimates of the Commission services.

Table 7.2
Productivity per person employed - whole economy (%)

	1960- 1973 (1)	1973- 1980 (1)	1981- 1983 (1)(3)	1979	1980	1981	1982 (2)	1983 (3)
	Productivity per person employed							
B	4,2	2,3	1,4	1,1	2,6	0,8	1,8	1,6
DK	3,5	1,2	1,6	1,8	0,2	1,7	1,9	1,4
D	4,4	2,9	1,5	3,0	1,2	0,8	1,5	2,1
GR	8,2	2,6	-0,2	2,2	-0,0	-1,8	0,3	0,9
F	4,9	2,5	1,2	3,1	-1,0	1,0	1,3	1,2
IRL	4,3	2,3	2,9	-0,7	0,3	3,0	2,7	3,0
I	5,7	2,1	0,3	4,0	4,0	-0,6	0,9	0,6
L	3,3	0,4	-0,0	2,8	-0,6	-2,4	0,6	1,6
NL	4,1	1,9	1,0	0,6	0,2	0,1	1,4	1,4
UK	2,9	1,1	2,4	0,8	0,2	3,0	2,5	1,8
EC-10	4,4	2,1	1,2	2,4	1,5	0,9	1,4	1,4
US	2,1	0,1	0,5	-0,1	-0,6	0,9	-0,5	1,2
Japan	8,4	3,0	2,3	4,1	3,3	2,1	1,7	3,2

(1) Annual average growth rates

(2) Estimate

(3) Forecast

Source : Eurostat, OECD and estimates of Commission services

Table 7.3
Structural Features of the Labour Market, EC and US

	1960	1970	1973	1975	1979	1980	1981
Labour Force (000)							
US:	72 142	85 959	91 756	95 955	107 050	109 042	110 812
EC:	101 530	104 429	105 717	106 373	109 608	110 384	110 831
Total Employment (000)							
US:	65 778	78 678	85 064	85 846	98 824	99 303	100 397
EC:	99 218	101 854	102 509	101 639	103 650	103 901	103 567
Share in Total Employment %							
Agriculture	8,5	4,5	4,2	4,1	3,6	3,6	3,5
EC:	17,2	10,4	8,9	8,5	7,5	7,3	7,2
Industry (incl. construction)	35,3	34,4	33,2	30,6	31,3	30,5	30,1
EC:	42,7	42,4	40,7	39,8	38,1	37,8	36,8
of which manufacturing	26,8	24,6	23,7	21,3	21,3	21,4	21,2
EC:	29,7	30,1	30,3	29,2	27,9	27,3	26,6
Services	56,2	61,1	62,6	65,3	65,2	65,9	66,4
EC:	40,1	47,3	50,5	51,7	54,4	55,0	56,0
Female Activity Rate	42,6	48,9	51,1	53,2	58,9	59,7	60,4
EC:	:	44,2 (1)	45,5	46,5	49,0	49,2	49,5 (2)
Share of Females in Labour Force	33,4	38,1	38,9	39,9	42,2	42,6	42,9
Force	:	34,3	35,2	36,0	37,5	37,8	37,2

(1) 1971

(2) Estimate

Source : Eurostat, OECD, US Bureau of Labour Statistics, estimates of Commission services.

109

Table 7.4
Share of Manufacturing Industry in Total Employment

	B	DK	D	F	I	NL	UK	EC (1)	USA	JAPAN
1970	30,4	25,0	36,8	26,4	28,1	25,4	32,6	31,0	26,2	26,8
1971	30,1	23,9	36,5	26,7	28,1	24,8	31,9	30,7	24,6	26,9
1972	29,8	23,9	35,9	26,8	28,1	24,2	30,9	30,3	24,1	26,9
1973	29,7	23,9	36,0	27,1	28,3	23,8	30,3	30,3	24,6	27,3
1974	29,5	23,2	35,6	27,2	28,5	23,7	29,9	30,0	24,0	27,2
1975	28,2	21,6	34,6	26,7	28,4	23,0	28,5	29,2	22,4	25,8
1976	27,2	21,3	34,1	26,2	28,2	22,1	27,8	28,6	22,5	25,8
1977	26,2	21,0	34,0	25,8	28,1	21,5	27,9	28,5	22,4	25,4
1978	25,1	20,7	33,8	25,3	27,7	20,8	27,6	28,1	22,3	25,0
1979	24,1	20,7	33,6	24,8	27,6	20,2	27,1	27,7	22,3	24,8
1980	23,6	20,7	33,6	24,4	27,5	19,6	26,1	27,3	21,4	25,1
1981	22,8	19,8	33,5	23,3	27,0	19,2	24,6	26,6	21,2	25,1

(1) EC - 7.

Source: Eurostat and Estimates of Commission Services.

Table 7.5
Sectoral employment trends 1973-80

	Annual Average Growth rate %									
	B	D	F	I	NL	UK	EC 6			
Agriculture, Forestry and Fishing	-3,5	-3,5	-2,9	-2,3	-1,5	-1,6	-2,6			
Industry (total)	-2,3	-1,5	-1,2	0,2	-1,6	-1,8	-1,2			
- Manufacturing	-3,1	-1,5	-1,2	0,4	-1,9	-2,1	-1,3			
Services (total)	1,8	0,9	1,7	2,2	1,5	1,0	1,4			
- Distributive trades and repair services	0,0	-0,6	1,1	1,9	0,0	0,1 ⁽¹⁾	0,5			
- Hotels and catering	1,2	0,4	0,6	1,2	0,9	: (2)	0,7			
- Transport	0,7	-1,3	0,6	1,4	0,4	0,5	0,5			
- Communications	0,7	0,5	2,4	2,2	2,6	-0,1	0,5			
- Banking and finance	1,9	1,3	2,5	5,5	3,1	2,0	2,8			
- Other market services	4,2	3,0	4,1	3,4	3,7	2,0	2,8			
- Government (3)	3,1	1,9	1,2	2,5	2,3	1,1	1,7			
- Non-market services	2,2	2,1	1,2	2,2	1,2	1,1	1,7			
ALL Activities	0,1	-0,5	0,3	0,8	0,3	-0,2	0,1			

(1) Distributive trades only

(2) Included in Transport

(3) Including Armed Services

Source : Eurostat and estimates of Commission services

Table 7.6

Total hours and average hours, productivity per head and per hour: manufacturing industry

	Hours worked				Productivity				% change
	Total		Weekly average (2)		per head (3)		per hour		
	1960-1973 (1)	1973-1981 (1)	1960-1973 (1)	1973-1981 (1)	1960-1973 (1)	1973-1981 (1)	1960-1973 (1)	1973-1981 (1)	
B	-0,5	- 4,5 ⁽⁴⁾	- 1,0	- 1,0 ⁽⁴⁾	5,8	4,9	7,0	6,7 ⁽⁴⁾	
DK	-1,1	- 2,3	- 1,3	- 0,5	4,9	4,0	6,4	4,8	
D	-0,2	- 2,5	- 0,8	- 1,9	4,4	2,6	5,5	4,5	
F	0,6	- 2,2	- 0,5	- 0,8	6,0	3,8	6,0	4,6	
I	-0,1	0,3	- 1,5	- 0,3	5,5	2,5	6,9	3,6	
NL	-1,1	- 3,4 ⁽⁴⁾	- 1,1	- 0,9 ⁽⁴⁾	5,4	3,4	7,6	5,3 ⁽⁴⁾	
UK	-1,2	- 3,8	- 0,7	- 1,0	3,7	1,2	4,3	2,1	
EC 9	-0,4	- 2,5	- 0,9	- 0,8	4,8	2,6	6,0	4,2	
USA	1,6	- 0,6	0,1	- 0,1	3,3	1,4	3,0	1,7	
Japan	2,1	- 0,3	- 0,9	0,1	10,2	5,3	10,7	6,8	

(1) Annual average growth rate.

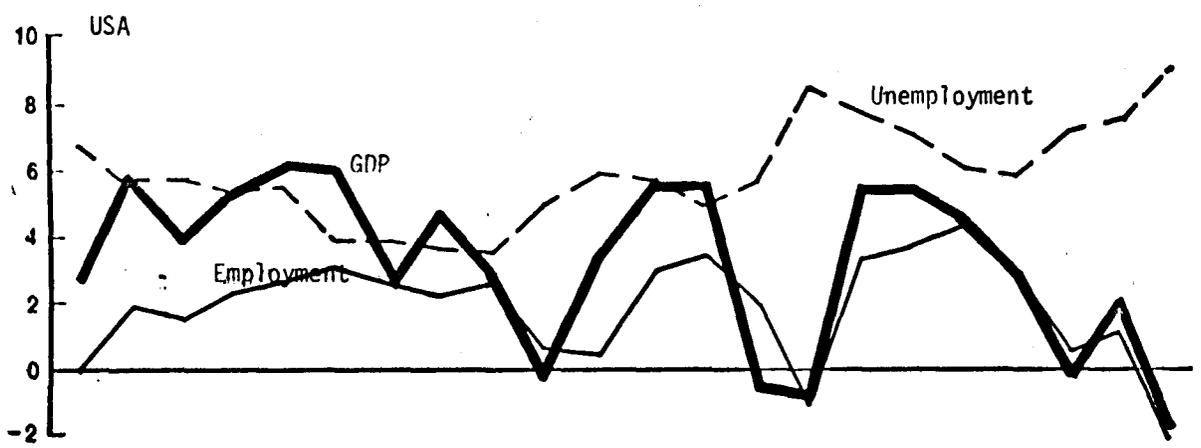
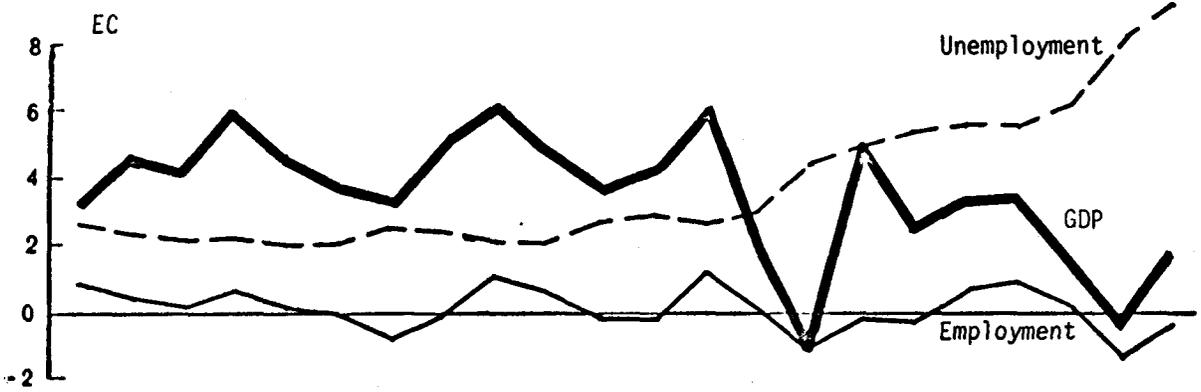
(2) Average weekly hours worked by employees (wage and salary earners), except for USA: all employed persons.

(3) Output per employee.

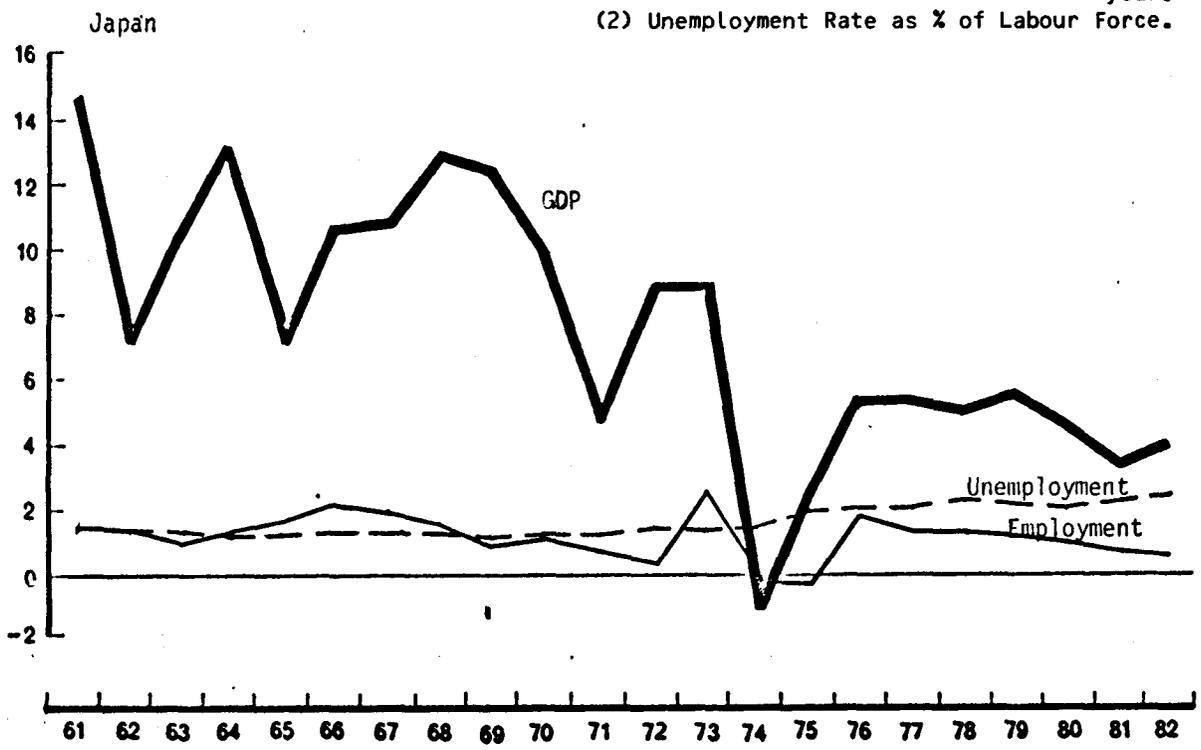
(4) 1973 - 1980.

Source: Eurostat, US Bureau of Labour Statistics, estimates of Commission services.

GRAPH 7.1 GDP AND EMPLOYMENT GROWTH (1) AND UNEMPLOYMENT RATE (2), EC, USA AND JAPAN, 1961 - 82

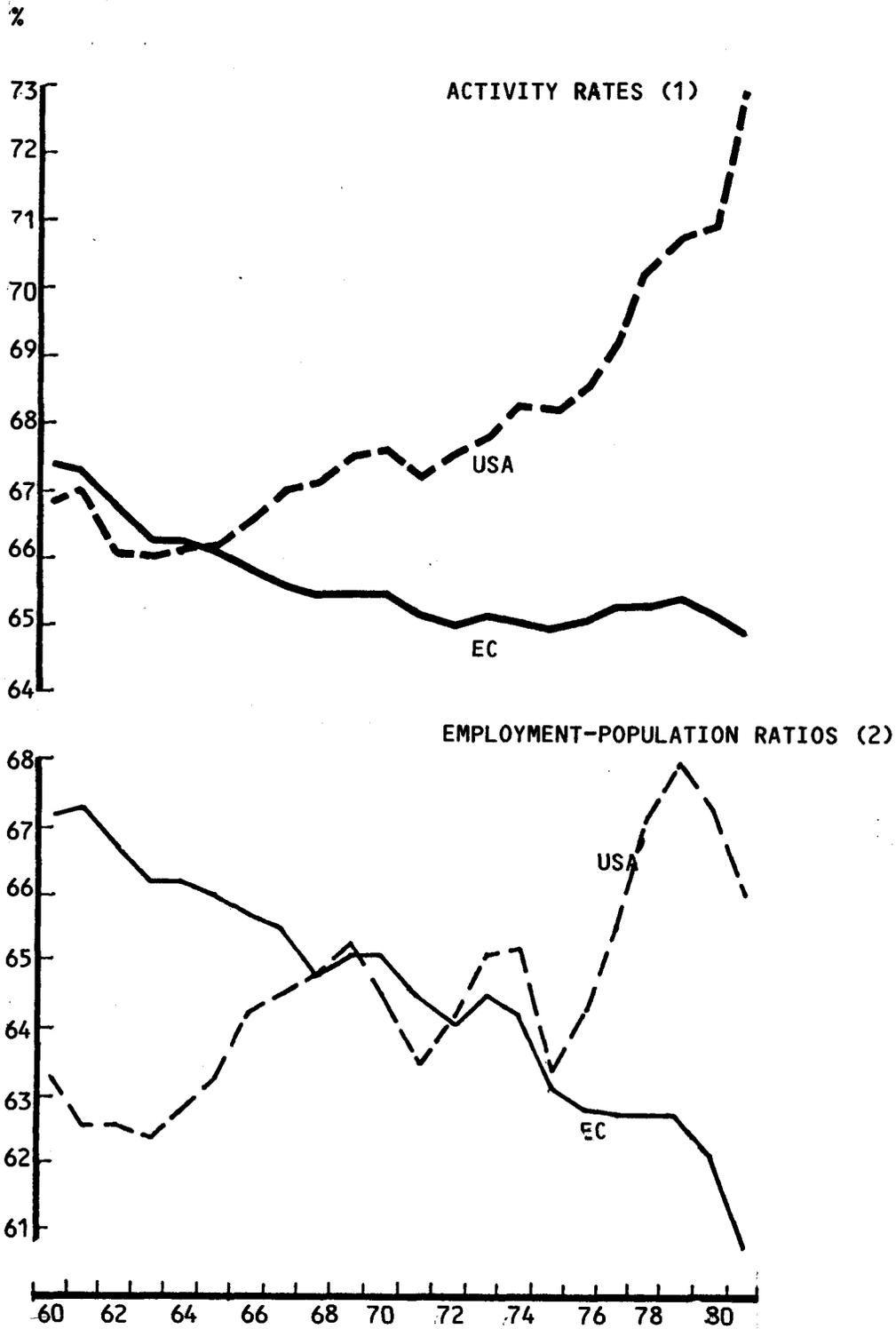


(1) GDP and Employment ; % change on preceding year.
 (2) Unemployment Rate as % of Labour Force.



7.26

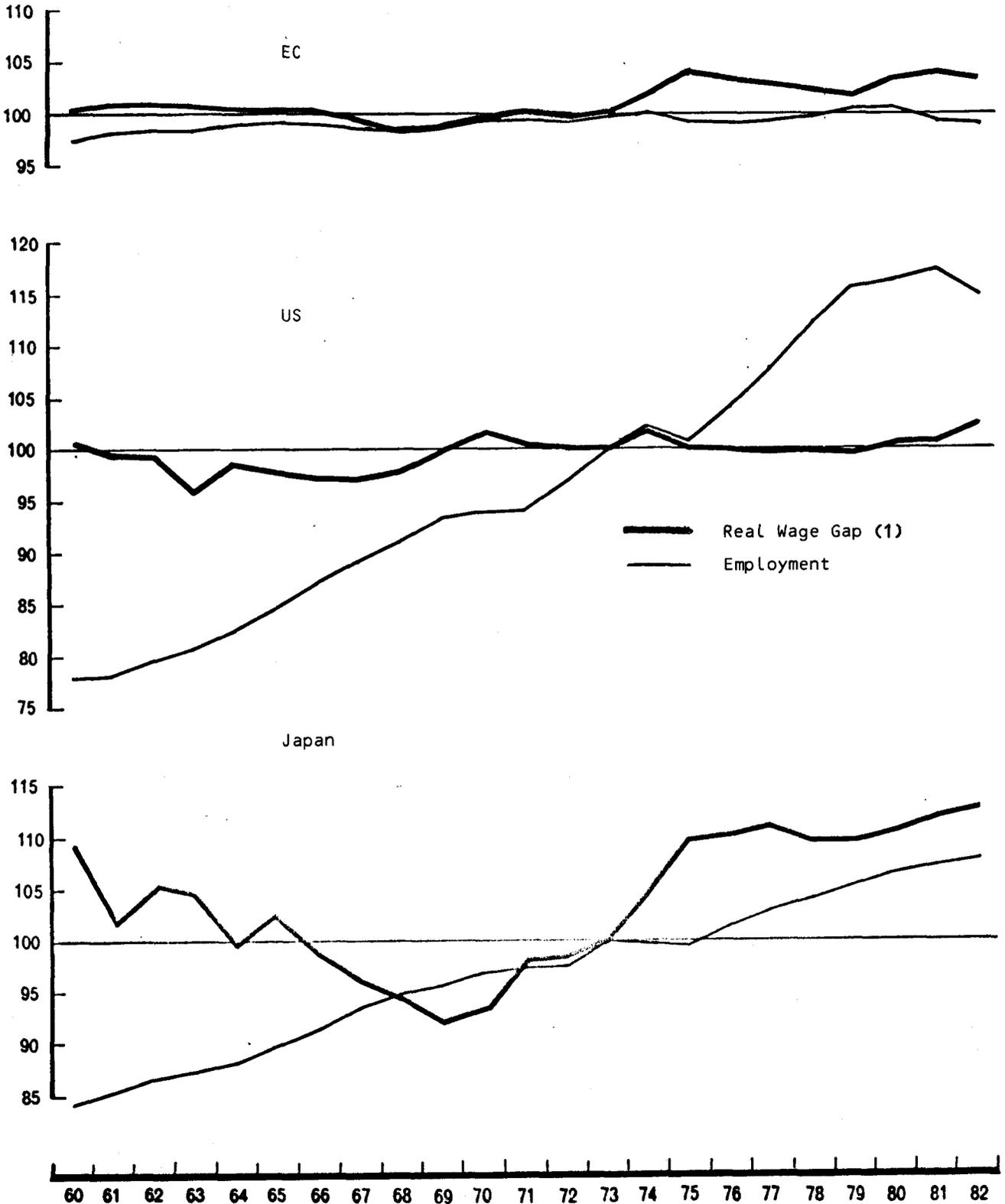
GRAPH 7.2 ACTIVITY RATES AND EMPLOYMENT POPULATION RATIOS. EC AND USA 1960 - 81 %



(1) Civilian Labour Force (Employed and Unemployed) as % of Population aged 15 - 64 years.

(2) Total Employment as % of Population aged 15 - 64 years.

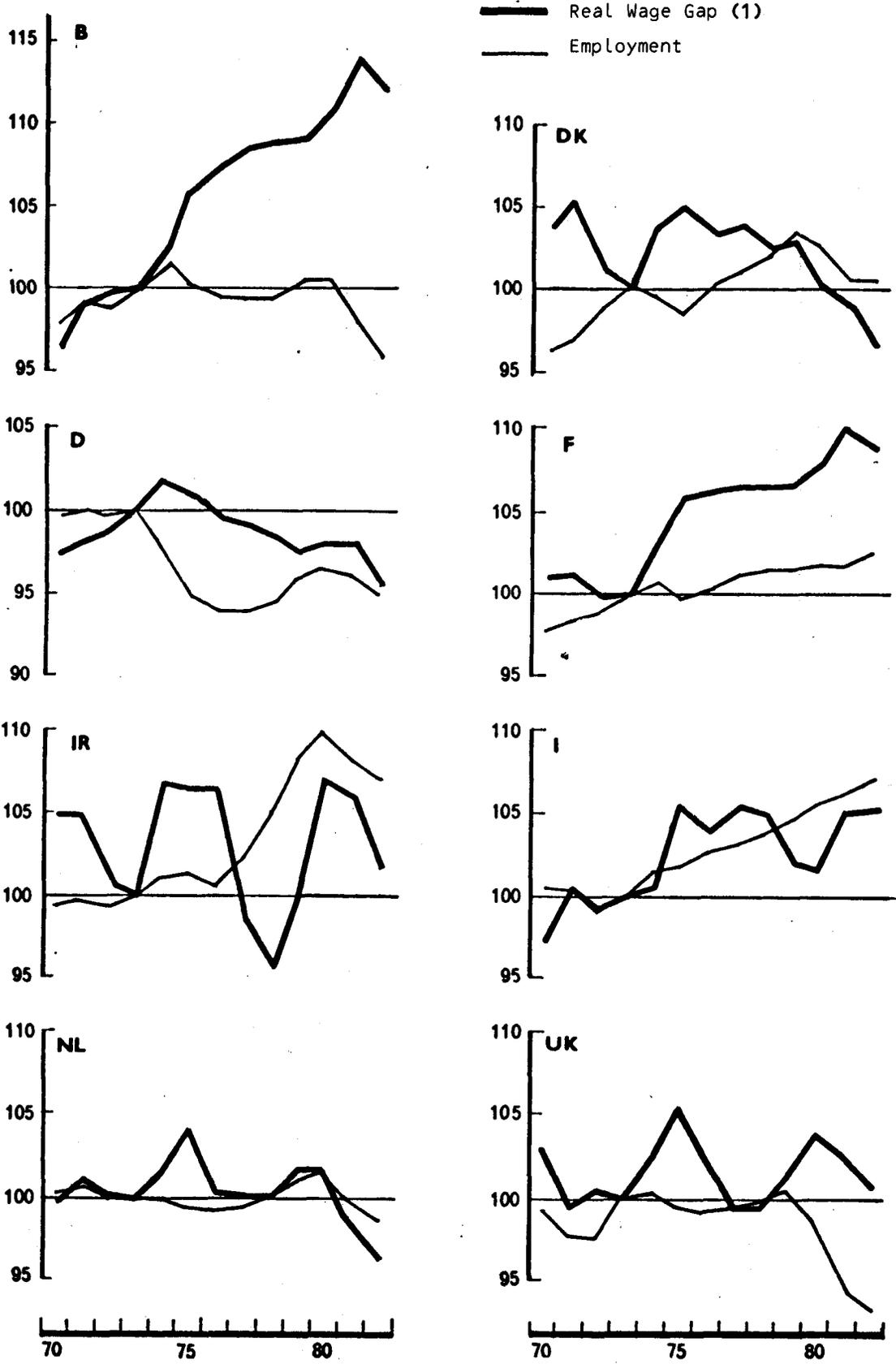
GRAPH 7.3 The Real Wage Gap and Employment. EC, US and Japan 1960-82



(1) Real Wage gap = Difference between actual growth in real wages (deflated by consumer price deflator) and that growth rate in real wages which would maintain constant factor shares (the warranted growth of real wages). For further details see Technical Annex.

7.28

GRAPH 7.4 Real Wage Gap and Employment. EC 1970-82



(1) See note to Table 7.3 and Technical Annex.

8. Capital Markets

The original goal of EC member countries to build a free and integrated capital market within the EC has not been achieved so far. In return, however, a well-organized, private Euro-currency market has come into existence, as a part of global international financial markets. This fact has to be taken into account in any attempt to analyse the present state of capital market affairs within the EC. Implications differ, however, according to the point of view taken. Judged from a purely technical point of view, private Euro-currency markets render the original goal of building an integrated European capital market less necessary. On the other hand, an increased necessity to promote that original goal and to consider ways of controlling private Euro-markets seems to be the upshot from the point of view of EC integration. To arrive at such a position, some theoretical considerations on capital mobility in a world of fixed and floating exchange rates are utilized in order to discuss the basic policy mix question. It is argued that national monetary policy is inevitably constrained by capital mobility and efficiently functioning Euro-markets, irrespective of the existing exchange rate regime. From this position, general and specific observations on controls are made, followed by a short discussion of options available towards a fresh start in European capital markets policy. Two appendices give more descriptive and detailed information on the present situation of national capital market controls and on the private use of the European Currency Unit (ECU).

8.1 Introduction

Twenty-five years ago, the representatives of the six founder states of the European Community, in signing the Treaty of Rome, also approved the principle of liberalized capital markets: the obstacles to freedom of movement for capital in the Community were to be progressively abolished (Articles 3 and 67 of the EEC Treaty). This goal was connected, among other things, with efforts to proceed towards free trade and free movement of persons and services.

The latter aims have by and large been realised. But after the initial successes in liberalization in the early 1960s, the construction of a free, integrated European capital market has become increasingly bogged down. It is true that some countries such as the Federal Republic of Germany, the United Kingdom and, to a lesser degree, the Netherlands have, in the meantime, almost completed the liberalization of their national capital markets. The same holds true for Belgium and Luxembourg; both countries have, however, split their foreign exchange markets, thereby exposing payments transactions for international capital movements to a larger risk of exchange rate fluctuations. Other Community countries such as Denmark, France, Ireland and Italy have, in recent years, introduced new restrictions on capital movements, or have reintroduced old controls which had been dropped as early as the 1960s (for a detailed account of the current state of affairs, see box 1).

8.2

Today, there is no integrated EC capital market; institutionally unconnected national capital markets are existing side by side and regulated with varying strictness. The question of whether the "absolute" degree of liberalization existing in the Community as a whole today is essentially different from the situation achieved in 1960 and 1962 after two liberalization directives is one which is difficult to answer; apart from measurement problems, the greater number of member countries also causes difficulties of comparison. However, one thing can probably be established: the differences in the degree of liberalization between capital markets of member countries are more marked today than in the mid-1960s. To that extent, the original aim of building a European capital market has, if anything, actually suffered a setback.

A rational analysis of this situation, on the basis of Community principles, must resist the temptation to apportion blame and to demand that existing treaty obligations be fulfilled without any genuine attempt at understanding. But, on the other hand, it must also avoid using primarily national arguments to defend the existing situation as virtually unavoidable or even as the only one possible, without taking account of the logic of the liberalization principle. It must rather concentrate on learning, with as little prejudice as possible, from the reasons why the construction of a European capital market has foundered: this should stimulate considerations for a fresh start to a Community-wide policy for European capital movements.

An attempt at analysis of this kind must answer a number of basic questions: for instance, given the marked change in international financial markets in the meantime, has perhaps the original, official goal of a free European capital market long been overtaken? Or is there still the need, on the capital markets of the Community countries, for coordinated liberalization measures, which are thwarted by persistent - or even growing - preferences for as tight as possible national controls of domestic financial markets? The present contrast between a stagnating rudimentary official EC capital market and fully integrated, rapidly expanding private Euro-currency markets is striking; it stimulates further questions: should perhaps the principle of the free movements of capital be reformulated, to exclude short-term flows of capital via international financial markets, which have in past years at times been huge, and which today, on the whole, represent a central problem for the international monetary system? Or should the principle of liberalization be completely rejected today because there is, given free trade, a basic analytical

inconsistency between fixed but adjustable exchange rates (EMS), capital mobility and nationally independent ("autonomous") monetary policy?

The attempt to answer these points leads to a macro-economic analysis of open economies and to basic questions of monetary policy cooperation in the Community in general. Below, these questions will be briefly touched upon to indicate their interrelationship with the subject matter. We start with some observations on Euro-currency markets, and then go on to discuss theoretical and political aspects.

8.2 Euro-currency market:

Size and institutional features

In the course of the last 5 years, the gross size of the Euro-currency market has more than doubled from \$ 374 billion in 1977 to \$ 840 billion in 1981 (for these and the following figures, see Table 8.1). From 1977 to 1981, the average yearly expansion surpassed the \$ 100 billion bench-

mark. Even if the considerable double-counting due to redepositing among participating Euro-banks in the order of magnitude of 40 % (gross figures) is subtracted, the estimated net size of the Euro-currency market (\$ 479 billion at the end of 1981) is still impressive. Behind the strong market growth during the past years were ample supplies of new loanable funds by OPEC countries and (lately again) by major western industrial countries. At the same time, demand for syndicated Euro-credits in its various forms and Eurobond-issues by private and public borrowers in Europe and overseas continued to be high.

To put the Euro-currency market size in perspective, it may be compared with world-wide international financial markets ("Xeno-markets"); to assess its dimension from an EC point of view, the share of EC countries in the Euro-currency market may be examined separately. The figures for the last 5 years reveal that the Euro-currency market continues to encompass more than one half of all international financial markets (i.e. total external claims and international bond issues of banks in the U.S., Canada, Japan, and the off-shore centres); the Euro-currency market share has remained at an average of 55 % (gross figures, see Table 8.1). On the other hand, the share of EC countries in this market is predominant. In 1981, external assets of banks in EC countries (without Greece) in foreign currency accounted for more than 90 % of the Euro-market total (\$ 786 billion as compared

8.4

with \$ 840 billion, gross figures; net figures yield the same order of magnitude for the percentage figures). One reason for this situation lies in the institutional fact that the major Euro-market centres in London and Luxembourg are situated within the EC area, with London traditionally playing the dominant rôle. Taken together, it seems safe to conclude that banks in EC countries comprise nearly all of the Euro-currency market and roughly one half of total international financial markets.

Having said this, it may be questioned whether, from a financial point of view, the above-mentioned goal of liberalized national capital markets in the EEC makes sense any more. Is it true that national financial markets have progressively lost importance, in a simple quantitative sense, relative to the Euro-currency market? To answer the question, the relative size of national and international (Euro-) markets should be compared. This is, however, a statistically difficult task, as no complete matrices of balance-of-payments capital flows between EC countries are available. There are several ways of approximation, all carrying a certain degree of arbitrariness.

One method of comparison might be to focus on national volumes of domestic bank loans and securities to domestic borrowers vis-à-vis the total stock of Euro-currency bank credits and loans. The resulting picture would, however, be distorted by traditional institutional differences of the various national credit and capital markets, aggravated by the fact that national credit aggregates are a major intermediary target of domestic monetary stabilization policies.

Therefore, another method of comparison has been used below. It is based on the hypothesis that the quantitative importance of Euro-markets relative to individual national financial markets can be roughly approximated by the volume of bank's external assets in foreign currency relative to external assets in domestic currency. Hence, the share of foreign and national currencies in external assets of European banks is taken as the criterion in assessing the relative magnitude of Euro-markets. In effect, denomination in foreign currency has been taken as the defining feature of the figures on Euro-markets mentioned above.

Tables 8.1 and 8.2 show the overall figures corresponding to the approach just outlined; they comprise short- and long-term funds as well as public and private ones. In Table 8.3, the same method has been applied to bond

markets only. All in all, the evidence tends to confirm the view of strong and increasing importance of Euro-markets relative to national financial markets in the Community. The totals in Tables 8.1 and 8.2 indicate that the Euro-market considerably outweighs its counterpart in domestic currency. In 1981, the (gross) relation was USD 786 billion Euro-market size in the EC (Table 8.1) to USD 114 billion in domestic currency external markets (Table 8.2); this is a relation of nearly 7 : 1, as compared to roughly 5 : 1 in 1977. Obviously the relative weight of the Euro-currency market has increased. Secondly, we may look at bond markets separately, i.e. at a small long-term part of overall financial markets (the "capital market" in its most narrow sense, if syndicated Euro-credits are neglected). The comparison between (gross) Euro-bond issues and (gross) "classical" foreign issues in Table 8.3 corroborates the evidence assembled so far, i.e. the relative dominance of the Euro-market within the EC area. The figures reveal, however, a less pronounced quantitative discrepancy: in 1981, the gross amount of Euro-bond issues (USD 5.4 billion) was just double that of classical foreign bond issues (USD 2.6 billion). The ratio has not increased, as compared to 1977 (USD 4.4 billion against USD 1.9 billion).

The large volume and continuing growth of Euro-currency markets reflect some basic institutional features as well as specific recent developments. The former consist, for example, in an absence of national controls, which implies a general cost advantage for Euro-banks in countries with non-interest-bearing minimum reserve requirements; there is no obligation for Euro-banks to deposit legally required reserves for Euro-market liabilities at zero interest rates with any central bank. The latter include, for example, the recycling of petro-dollars; there is a continuing necessity for international banking to create liquidity for financing world trade, and to channel (recycle) funds between highly industrialized nations, less developed countries and oil-exporting countries.

There are reasons to expect international lending on Euro-markets to be associated with increasing risk. As there are no controls, there is a higher country risk today; some countries have serious difficulty in dealing simultaneously with a deteriorating balance-of-payments situation and continuing public sector deficits on a large scale. Continued recession in several countries, and recent failures of large firms and banks have augmented the uncertainties. Technically speaking, intermediation via debt rescheduling tends to be associated with a higher risk component. In addition, and connected with country risk, is the present tendency of shorter lending terms and maturities.

International financial capital is extremely mobile. With the establishment, de facto, of complete convertibility among major currencies, Euro-currency institutions are important intermediaries for currency conversions. Therefore, they are potentially able to originate and transmit financial disturbances on a large scale. To put it differently, today the Euro-currency market is a highly efficient means of implementing capital mobility in the very short run. Low transaction costs, quick communications and nearly instantaneous price adjustments of financial instruments around the globe characterize this efficiency. Technically speaking, we are witnessing today the successful marriage between computer and telecommunications technologies; large international banks are rapidly becoming financial information corporations on a global scale.

8.3 Euro-markets and EC policy

Taken together, the facts are conducive indeed to raise doubts on the continued desirability of the 25 year old goal of European capital market integration. Specifically, the original economic and financial ideas for building an integrated European capital market within the Community (see above) are practically fulfilled today by the existence of efficiently functioning, private Euro-markets. It should be acknowledged that the emergence of private Euro-markets benefited from the absence of a European capital market. Although geographically within the Community, these Euro-markets are not subject to official regulations or policy.

However, the argument so far has been pursued in terms of economic and financial reasoning only. This is insufficient, as it neglects the economic policy aspects which are vital and decisive in the discussion of capital market liberalization. Indeed, from the point of view of monetary policies - in single member countries as well as on a Community level - the original goal of building an integrated European capital market is still a valid aim. It is a major prerequisite not only for the optimal, inter-Community allocation of real resources, but, most importantly, for the implementation of any major step towards the final monetary goal of the Community, i.e. towards monetary union. As long as this basic aim is not abandoned, capital market liberalization and integration remains essential.

To arrive at this proposition, it has to be taken into account, firstly, that a basic consistency is needed between the European Monetary System (EMS) and the present state of national capital markets in the EC. Secondly, it should be acknowledged that there is hardly any way to avoid external constraints on national monetary policies with fully liberalized capital flows (capital mobility). Both points are developed in the following section 8.4

Before going into detail, it should be kept in mind that absence of controls on Euro-markets means that national monetary policy actions can be circumvented in principle, and in various ways, via international lending and borrowing activities. To this extent, the very existence of Euro-markets constitutes a basic threat to the independence of national monetary policies. For example, Euro-markets may significantly add to the magnitude of destabilizing short-term capital flows, thus interfering with domestic stabilization efforts. Moreover, free availability of international liquidity via Euro-markets may seduce a country with severe balance-of-payments problems to ignore the drain on their reserves, and to conduct policies which may not be directed towards stability in the longer run. These potential dangers underline the importance to be attached to the question of controlling Euro-markets, e.g. by means of appropriate national and/or EC actions. The topic clearly surpasses the scope of this chapter; it constitutes, however, a "memorandum item" not to be forgotten.

8.4 Capital mobility and interdependence of domestic monetary policies

Since March 1979, most EC countries have joined the currency area of the European Monetary System (EMS). Hence, member countries face a mixture of fixed and flexible exchange rate regimes in their external monetary relations with other countries. Obviously there is some contrast between the EMS, which provides free convertibility of European currencies at fixed exchange rate margins, and the continued existence of nationally regulated European capital markets. On the one hand, the EMS contributes to a closer inter-relationship of national money via an increased role for interest rate differentials and interest rate effects on financial capital transactions and exchange rate movements (within the given margins). On the other hand, it is exactly these short-term capital transactions which are subject to the most rigid national controls. This situation may give rise to a harmful inconsistency.

8.8

Related to the EMS is the fact that most national governments, in the Community as well as outside, rely heavily on monetary action in order to achieve domestic stabilisation goals - much more so than 20 years ago. Hence, there is a strong desire to control national monetary aggregates; many countries have officially announced targets for monetary growth. Therefore, massive flows of short-term financial capital, forcing central banks to intervene and (thereby) to create additional internal bank liquidity, may interfere with money stock control. This is, of course, not necessarily so, as many EC countries try to incorporate possible exchange-rate developments in their decision about monetary targets. Smaller countries, in particular, conduct their monetary policies within the constraints imposed by foreign exchange markets; they obviously try to cope with the basic fact that their economies are "open" and that international capital flows react sensitively to international interest rate differentials and exchange rate expectations. This suggests taking a closer look at the theoretical and practical rôle of capital mobility, with specific reference to the exchange rate regime.

Recently, the conventional theory of "insular" economies and the corresponding analysis of external constraints on the policy mix (at given capital mobility) has been modified in an important way. In reaction to theoretical developments as well as factual experience, it is held that full insulation from external influences is impossible, even with floating exchange rates. It is maintained that national authorities, in a world of capital mobility and flexible exchange rates, are not much more independent in policy-making than in a world of capital mobility and fixed exchange rates. There are three basic points:

- Some main determinants of exchange rates, like interest rates, balance of payments, and inflation rates, operate consistently in the long run only. In the short run, exchange rates may be pushed in different directions, away from their fundamental equilibrium level, by changing expectations of exchange rates itself, as well as of the "fundamentals" just mentioned.
- Short-run changes in exchange rates are brought about by massive flows of short-run financial capital, generated in and transmitted via efficient international financial markets (Euro-markets, as described above).

- The divergence of exchange rates from their "normal" level, i.e. their over- or under-shooting, has important "real" effects on domestic economic activity - on domestic industries, export and import-competing sectors.

From these three points, it follows directly that national authorities cannot afford a 'benign neglect' as regards exchange rate fluctuations. Hence, the level and fluctuations of exchange rates continue to be a matter of concern to national monetary authorities; in practice, there are good reasons for stabilizing exchange rates. This is precisely so because capital mobility provides an effective linkage for the international transmission of macroeconomic influences, even in a regime of floating exchange rates. As this proposition holds anyway in the case of fixed exchange rates, financial and "real" inter-relationships between national economies obviously exist irrespective of the exchange rate regime actually adopted. With capital mobility as it is existing nowadays, monetary policy is inevitably constrained by international capital flows. Hence, the ability of central banks and governments to pursue independent monetary policies appropriate to their internal economies is always restricted. The constraint is felt more severely, and accepted more readily (see above), by the smaller countries in the Community. But it applies, in principle, to the "big" member countries as well.

Finally, the new environment of Euro-markets ensures that international capital mobility must to a large extent be taken for granted - at least, as long as capital flows between national and Euro-markets continue to remain uncontrolled. Until now, governments seem to consider those capital flows advantageous from a purely national point of view (see the remarks in section 8.3 above). It may sound somewhat paradoxical, but the low degree of overall liberalization within the EC simply accentuates the contrast with an ongoing process of more and more global capital mobility.

Hence, there seems to be no way of avoiding the mutual interdependence of national monetary policies just described, but as a last resort selective direct controls on capital flows and/or on the accompanying international payments may be considered as a means to preserve autonomy in national monetary policies. In countries like France, for example, there is a long-standing tradition in using such controls actively as an instrument of exchange policy. Other countries like Germany have at their disposal the power to introduce controls (see Aussenwirtschaftsgesetz). Some thoughts on controls therefore seem to be warranted.

8.5 On Controls

Restrictions on capital movements were, according to Art. 67 of the Treaty of Rome, to be progressively removed in order to facilitate the workings of the Common market. The Treaty of Rome itself (§§ 73, 108 and 109) and the liberalization directives specify circumstances when controls are to be considered a legitimate tool to deal with certain dangers in financial markets. However, controls should be the exception, not the rule, and their application should be limited in time.

These Community rules are obviously in conflict with national institutional settings which include controls as a normal tool of monetary management, even though there was general acceptance of liberalization directives in the early sixties (see above). Rather, it should be acknowledged as a matter of fact that national traditions tend to dominate, if conflict arises. Moreover, purely financial, short-term speculative flows of "hot money" are often considered detrimental if they are unrestricted.

The matter is controversial. It follows, nevertheless, that there is some reason to reopen the basic discussion on the objectives, functions and consequences of capital market controls in a non-dogmatic way. In the following paragraphs, three fundamental propositions are put forward as a stimulus for discussion. They are, of course, not exhaustive.

- When it seems impossible to conduct policies based on the usual relationship between instruments and targets within the existing framework of markets and institutions, governments are tempted to bypass this relationship, using administrative power to directly impose the desired state of affairs. This is the general essence of controls in terms of economic policy. It could mean that problems are of such a dimension that conventional measures are considered too weak to be effective in the desired way; it could, however, also mean that a traditional instrument is used, without indicating any particular magnitude of the problem.
- As a permanent feature of capital markets in the EC, direct controls are in danger of becoming ineffective. Firstly, while strengthening the grasp of governments on capital flows in the short run, controls may become less effective as they further encroach on the very same phenomena they are designed to overcome. If this happens, governments do not get rid of the problem but only of its symptoms. The relief may be temporary; as controls turn into a permanent feature, they are likely to be circumvented. Hence, new additional controls may become necessary.

- If restrictions on the free flow of capital and currency are used to stick to unrealistic exchange rates in a situation of serious domestic imbalances, there is a danger of a vicious circle, from increased controls to more divergence, more controls, and so on. This danger arises, in other words, if national governments wrongly accept, or contribute to, an accumulating external imbalance. Given the recent attempts to implement stabilization policies in EC countries, including policy measures taken in parallel with exchange rate realignments within the EMS, this danger at the moment is more theoretical than practical.

8.6 Possible policy approaches

Improvement of policy coordination is the way envisaged within the EC, but it is obviously very difficult to implement. In the present institutional framework the Community must, in order to have real effect, refer to other undertakings such as the capital market liberalization, further progress of the EMS and increased emphasis on the European Currency Unit.

To enforce capital market integration at a generally accepted, uniform degree of liberalization would mean a large step in the direction of turning the EC into an optimum regulation area. Its implementation might be attempted by enacting further liberalization directives and revitalising the legally established supervisory functions of the Commission and the Monetary Committee. Coordination of the Member States' policies on capital movements vis-à-vis third countries - in compliance with Art. 70 of the Treaty - would contribute to the success. The step conforms closely to the cooperation inspiration of the Community, and it carries the logic of enforcing policy coordination in an indirect way via institutionalisation, or organization, of a European Capital Market. There have been, however, long decision lags within the Community on these matters, reflecting the political unwillingness in moving ahead unanimously towards an integrated capital market.

8.12

Moving towards monetary union by means of further development of the EMS would mean progress in turning the Community into an optimum currency area. This approach is definitely related to the above-mentioned direct approach on capital market integration, as has been argued in section 8.4; and both proposals seek to enforce policy coordination (and, hence, economic divergence). As regards implementation, the EMS/monetary union approach looks more attractive at first sight as a few important institutional decisions might suffice to accomplish the framework for monetary union. Politically, the road to monetary union is at least as long as that to capital market integration alone. Indeed, the latter aim is somewhat less ambitious.

Thirdly, attempts might be made to establish the European Currency Unit (ECU) as a generally accepted unit of account in all inter-Community financial transactions, official and private (see box 2). This move could be combined with the planned further institutionalisation of the EMS especially as the prospect that Member States could use the ECU as a convenient means to gain better access to the international financial markets and liquidity provoked considerable criticism.

In conclusion, all approaches have their difficulties. A solution being acceptable to all member countries in the Community might include attempts to promote each of them in a stepwise fashion. But there can be no realistic hope unless the political willingness to move ahead has been revitalised. Renewed discussion on capital market policies in the Community might contribute to such an revitalization; the present study draws its legitimation out of this view. Analytically, it should be kept in mind that capital mobility and policy coordination, achieved directly or indirectly, mean a loss of national autonomy in economic (monetary) policies. Therefore any new, or renewed, European capital markets policy has to be based inevitably on a basic agreement as to the principles of monetary stabilization policies, including priorities for the achievement of final economic goals such as price stability, full employment or external (balance of payments) equilibrium. Last not least, the question of how to integrate Euro-markets into any new framework of European capital markets policy remains to be tackled and solved.

Table 8.1

External assets ⁽¹⁾ of European banks in foreign currency
(Euro-currency market)

Stocks at end of year in billions of US dollars

	1977	1978	1979	1980	1981
Belgium	23	32	40	52	59
Denmark	2	3	4	4	4
France	62	81	100	119	120
Germany	17	21	22	22	24
Ireland	2	2	2	2	2
Italy	15	22	28	30	36
Luxembourg	44	58	79	87	87
Netherlands	27	37	45	51	53
UK	159	203	270	334	401
EC-9 gross	351	459	590	701	786
Minus double-counting (2) (5)	135	185	237	272	307
EC-9 net (5)	216	274	353	429	479
=====					
For comparison :					
Total Euro-currency market (3) gross	374	502	640	751	840
Minus : double-counting (2) (5)	144	202	257	291	328
Total Euro-currency market (3) net (5)	230	300	383	460	512
All international finan- cial markets (4) gross	657	903	1.111	1.323	1.542
net	405	540	665	810	940

(1) External claims plus international bond issues.

(2) Double-counting due to redepositing among reporting banks.

(3) Reporting banks in EEC (9) countries plus Austria, Sweden, and Switzerland.

(4) Without banks (except US reporting banks) in the offshore centres Bahamas, Cayman Islands, Panama, Hongkong, and Singapore.

(5) Estimates by the Commission services, based on the hypothesis that double-counting in European banks is identical with the total share of double-counting in global international markets, i.e. 37.8% in 1977, 40.2% in 1978 and 1979, 38.8% in 1980 and 39% in 1981.

Source: BIS (Annual Reports) and Commission services

Table 8.2

External assets ⁽¹⁾ of European banks in domestic currency

Stocks at end of year in billions of US dollars

	1977	1978	1979	1980	1981
Belgium	2	3	3	3	3
Denmark	0	0	0	0	0
France (2)	12	18	23	24	23
Germany	32	40	48	52	51
Ireland	0	0	0	0	0
Italy	0	1	1	1	1
Luxembourg	1	1	1	1	1
Netherlands	5	9	11	11	12
UK (3)	12	15	16	23	23
EC-9	64	87	103	115	114

(1) External claims and foreign bond issues.

(2) Including buyer's credits.

(3) Including, in addition to loans, advances and overdrafts, all commercial bills and acceptances.

Source: BIS (Annual Reports)

Table 8.3

International bond markets

in billions of US dollars

I: Gross Euro-bond issues

	1977	1978	1979	1980	1981
Belgium	0.0	-	0.3	0.2	0.3
Denmark	0.3	0.4	0.2	0.3	0.4
France	1.1	0.8	1.3	1.8	2.0
Germany	0.2	0.3	0.4	-	0.1
Ireland	0.0	-	0.1	0.1	0.4
Italy	0.2	0.1	0.3	1.0	0.9
Luxembourg	0.5	0.3	0.1	0.0	0.0
Netherlands	0.4	0.2	0.5	0.9	0.3
UK	1.6	0.8	1.0	1.5	1.2
EEC (9)	4.4	2.9	4.1	5.8	5.4
Western Europe	9.0	5.4	7.4	9.1	7.6
World-wide total	19.5	15.9	17.4	20.1	26.5

II: "Classical" foreign issues

Belgium	0.2	0.0	-	0.0	0.3
Denmark	0.5	0.5	0.5	0.9	0.5
France	0.8	0.5	0.7	0.7	0.9
Germany	0.0	0.0	0.1	0.2	0.1
Ireland	0.1	0.1	0.1	0.2	0.1
Italy	0.1	0.1	0.1	0.1	0.1
Luxembourg	0.1	0.2	0.0	0.1	0.0
Netherlands	0.1	0.2	0.5	0.2	0.5
UK	0.1	0.7	0.3	0.1	0.2
EEC (9)	1.9	2.3	2.3	2.4	2.6
Western Europe	5.1	6.1	5.8	5.9	5.5
World-wide total	16.6	21.4	20.0	18.0	21.3

Sources: BIS, World Bank, OECD

Community obligations and capital movements: Situation in Member StatesCommunity provisions

The Council Directives of 11 May 1960 and 18 December 1962 for the implementation of Article 67 of the Treaty lay down the present framework for Member States' obligations with regard to the liberalization of capital movements.

The capital movements liberalized within the Community are given in Lists A and B annexed to the First Directive. They include direct investments, personal capital movements, short-term and medium-term credits related to commercial transactions or to supplies of services in which residents participate, transfers in performance of insurance contracts, and operations in securities dealt in on a stock exchange. Under the terms of that Directive, liberalization of these operations is unconditional and cannot be suspended except by invoking the protective clauses provided for in Articles 73, 108 and 109 of the Treaty.

The capital movements specified in List C annexed to the First Directive (notably issues of securities of a domestic undertaking on a foreign capital market and, conversely, of those of a foreign undertaking on a domestic capital market, operations in securities not dealt in on a stock exchange, and financial credits) were liberalized only on condition that a Member State may maintain or reintroduce such restrictions on these operations as were operative on the date of entry into force of the Directive or on the date of accession where such free movement of capital might form an obstacle to attainment of that Member State's economic policy objectives.

For the other operations, involving for the most part short-term capital movements (securities dealt in on the money market; opening and replenishment of current or deposit accounts, etc.), Member States remain free to decide whether or not to impose restrictions.

Situation in Member States

The degree of effective liberalization of capital movements varies appreciably between Member States. Exchange restrictions on all capital operations have been lifted in Germany, the United Kingdom, Belgium and Luxembourg, although the latter two jointly operate a two-tier exchange market. The Netherlands abides by its Community obligations and takes a liberal view of capital operations not subject to any liberalization requirements.

France, Italy, Ireland and Denmark continue to apply controls over all capital movements and have been authorized by the Commission to invoke protective clauses in order to place restrictions on certain capital operations liberalized under the 1960 and 1962 Directives.

Restrictions introduced under protective clauses

France: By Decision of 4 December 1968, the Commission authorized the imposition of restrictions on the full range of capital movements. France has since eased these restrictions, but, by way of derogation from the relevant Community provisions, controls continue to apply to the following operations:

- Direct French investments in the Community are free from restrictions where they do not entail any transfer abroad by a resident; where a transfer does take place, such investments over and above FF 1 million require authorization. The proceeds accruing from liquidation of such investments must be repatriated in full and surrendered on the foreign exchange market;
- Acquisition by residents of real property abroad is subject to a prior-authorization requirement;
- Acquisition by residents of foreign securities dealt in on a stock exchange is caught by the "investment franc" system (see below).

Italy: By Decision of 8 May 1974, as amended by the Decision of 26 May 1975, Italy is authorized by the Commission to require residents to lodge an interest-free bank deposit equal to 50% of the amount of investment transactions carried out abroad. In practice, however, this requirement is not applied to direct investment in Member States. Insurance companies and the acquisition of securities issued by Community institutions (up to an annual ceiling set at 45 million ECU in 1982) and of units in investment trusts authorized to do business in Italy are also exempt.

Ireland: By Decision of 3 May 1980 amending the Decision of 22 December 1977, the Commission authorized Ireland to maintain restrictions on the acquisition by residents of foreign securities dealt in on a stock exchange except where financed through the sale of other foreign securities. These restrictions do not apply to the acquisition of securities issued by Community institutions or, under certain conditions, to insurance companies.

Denmark: Under arrangements broadly similar to those applicable to Ireland, restrictions on the acquisition by residents of foreign securities dealt in on a stock exchange were authorized by the Commission Decision of 22 December 1977. These restrictions do not apply to the acquisition of securities issued by Community institutions or by international institutions of which Denmark is a member. Furthermore, on 5 February 1979, Denmark invoked the protective clause provided for in Article 73(2) of the Treaty to prohibit the sale to non-residents of government bonds issued after 1975.

Introduction of a two-tier foreign exchange market

More often than not, the requirement that certain transfers should be channelled through a specific foreign exchange market involves additional costs that may hinder the corresponding capital outflows. Subject to certain conditions, including the absence of any appreciable and lasting differences between the rates for capital transactions and those for payments relating to current transactions, the Community Directives permit the introduction of a two-tier foreign exchange market for capital movements.

Since 1954, Belgium and Luxembourg have operated a "free" exchange market alongside the official market. As a general rule, all capital transactions take place on the "free" market. Under certain conditions, direct investments may be made and liquidated on the official market.

In France since May 1981, residents have been required to finance the purchase of foreign securities out of foreign exchange accruing from the sale of other foreign securities ("investment franc" system). This closed market, which is compulsory only for residents, differs from the "free" market operated in Belgium and Luxembourg, to which non-residents are also admitted.

BOX 2Private use of the ECU

Although it had already been used for a number of years for current accounts held for the most part in the name of the Community institutions, the European unit of account (EUA) effectively assumed the rôle of monetary instrument for settling private transactions only when it was introduced under the ECU label in central banks' balance sheets for recording transactions under the European Monetary System. It is now possible, three years after this official act of recognition, to make a survey of the private use of the ECU and to clarify its status with regard to the different sets of exchange regulations in force in the Community.

Types of operations. The ECU is used by the private sector above all for recording and, in some cases, for settling financial and banking transactions; it is little used as yet for commercial transactions.

The banks treat the ECU as a currency in its own right and now offer a range of ECU-denominated financial services similar to those available in any convertible currency. The ECU is used for the following transactions :

- Deposits and overdrafts. In this area, the Community institutions, which hold substantial accounts in ECU, gave the lead first to the banks, whose participation in ECU-denominated issues led them to open ECU accounts in their own name, and then to business transactors, who, especially in Italy, make short term borrowings in order to finance exports. Over 200 banks now operate drawing accounts denominated in ECU and over 100 business have overdrafts in ECU.
- Bank loans : These loans, which have a maturity of between two and five years, carry variable rates. They are granted by a single credit institution where, as in Denmark, they involve small amounts of around 20 000 ECU for small businesses or private individuals. Where they involve large amounts, they are handled by a banking syndicate and can take on a sophisticated form, e.g. the 200 million ECU loan granted in July 1981 by the Crédit Lyonnais to the Crédit National. An amount of some 350 million ECU was outstanding in respect to such transactions at the end of July 1982.
- Public issues denominated in ECU : Since March 1981 when the first issue was floated on behalf of an Italian borrower, 18 issues have been placed on the market totalling nearly 1,200 million ECU. With the exception of the 500 million ECU loan issued by the Italian Government in February 1982, which was placed for the most part on the domestic market, they have all been floated on the Euromarket at fixed rates ranging between 13% and 14% and with maturities of 6 to 10 years.
- Settlement of ECU transfers : Until now, ECU transfers between banking institutions posed problems because, direct transfers being not possible, it was necessary to transfer all the currencies making up the ECU, causing a large handling charge that inhibited the development of the ECU market. A number of particularly active banks have circumvented this difficulty by steadily introducing what are in effect simplified settlement arrangements involving the execution of transfer orders in ECU between the increasingly large number of accounts opened in their books. These banks have now improved this process by opening with one another reciprocal accounts in ECU that are settled in national currencies over and above a certain ceiling. This purely pragmatic process makes it possible to execute transfer orders in ECU not only between accounts opened

in a bank's own books but also between such accounts and those opened in the books of all banks operating reciprocal accounts. This settlement system, which has the drawback of not treating all banks on an equal footing, embraces only part of the banking system. The banks are aware of the limitations of this system and are currently examining ways and means of institutionalizing a system that will ensure more efficient as well as more extensive settlement arrangements.

- Service offered to private transactors : With the expansion of the banking facilities operated in ECU and the reduction in costs, the minimum threshold for transactions has been lowered to a level that brings ECU-denominated operations within the reach of private transactors : reduction in the minimum amount for deposits (3 000 ECU in some countries) and for loans (20 000 ECU in Denmark); certificates of a standard unit amount of 1 000 ECU for ECU-denominated issues. In Italy, it is also possible to take out life-assurance policies denominated in ECU.

Status of the ECU with regard to national regulations. Wider private use of the ECU presupposed that this unit could be used in its own right, i.e. that it could be treated as a genuine currency and no longer as a basket of nine currencies each of which had to be handled separately in banking transactions. Member States have approached this problem in different ways. Reference to the ECU is still prohibited in Germany while Italy has granted the ECU currency status, which the Italian Government has confirmed by issuing a 500 million ECU loan in February 1982. Of the other Member States applying exchange regulations, France and Belgium have recognized the ECU as a currency by official decision; Ireland, Denmark and Greece have not yet gone this far but do authorize their banks to receive ECU transfers from abroad. The United Kingdom, which applies no exchange controls, and the Netherlands, which applies flexible exchange regulations, leave it to the banks to decide whether or not to treat the ECU as a currency.

Public issues, private issues of securities and certificates of deposit denominated in ECU (amounts outstanding at the 5th of Oct. 82 in million ECU)

Date	Beneficiaries	Amount	Rate	Maturity	Managers
I. Public bond issues					
21.04.81	SOFTE	35	13.00	6 years	Kredietbank
11.06.81	European Investment Bank	40	13 1/4	8 years	Kredietbank
16.09.81	Hydro-Québec	40	14 1/4	7 years	Kredietbank
28.10.81	European Investment Bank	45	14 1/4	8 years	Banque Nationale de Paris
03.12.81	Istituto San Paolo	30	14 3/4	7 years	Kredietbank, Crédit Lyonnais, Istituto San Paolo
15.12.81	Euratom	42	14.00	15 years	Banca Commerciale Italiana (private placing)
January 82	Nersa	30	13.975	8 years	Banque Nationale de Paris
23.02.82	Italian Republic	500	14.00	7 years	Banca d'Italia, Kredietbank
27.02.82	Council of Europe	25	14 1/4	8 years	Société Générale, Bruxelles-Lambert
20.04.82	European Investment Bank (1)	45	14.00	8 years	Banque Nationale de Paris
07.05.82	SDR (regional development corporation)	30	14.00	10 years	Société Générale
10.05.82	Hydro-Québec	50	13 1/2	7 years	Kredietbank
07.06.82	IMI	40	14.00	7 years	Kredit Lyonnais, Kredietbank
21.06.82	European Investment Bank	40	13 3/4	7 years	Kredietbank, Société Générale de Banque
05.07.82	Crédit foncier de France	40	13 3/4	7-12 years	Banque Indo-Suez, Kredietbank
		<u>1032</u>			
II. Bank Loans					
July 1981	Crédit National	200	variable	5 years	Crédit Lyonnais (syndicated bank loan)
December 1981	Turin - Genoa - Milan	30	"	7 years	Istituto San Paolo (from the proceeds of an ECU loan issue)
January 1982	Necchi	4	"	5 years	Istituto San Paolo
March 1982	SOFTE (STET)	50	"	"	Lloyds (syndicated bank loan)
April 1982	Parmalat	2	"	2 years	Banque de Paris et des Pays-Bas (Milan)
June 1982	Saint Gobain	100	"	7 years	Banque Nationale de Paris, Morgan Guaranty (syndicated bank loan)
June 1982	Miscellaneous	270	fixed	misc.	European Investment Bank (amount outstanding(2) from proceeds of an ECU loan issue)
		<u>656</u>			
III. Certificates of deposit					
April 1981	European Investment Bank	10	-	3 months	Lloyds
March 1982	European Investment Bank	10	-	3 months	Lavoro Bank International
		<u>20</u>			

(1) Warrant of 28 October 1981.

(2) The loans are denominated in the borrower's currency and paid out in a currency of the borrower's choice.

Source : DG II, Commission of the European Communities.

9. Energy

The situation on the energy market and its relationship with the economy as a whole were so profoundly altered by the second oil shock that earlier trends were completely disrupted. The decline in the consumption of energy and particularly oil as a result of price rises, increased investment, contracting economic activity and other factors, such as administrative measures, is in part structural and to that extent here to stay. But it is clear that these factors, and particularly pricing and investment policies, are not yet sufficiently coordinated to meet the continuing need for adjustment. Net energy imports are still making considerable inroads on the balance of payments which can be reduced only if top priority is given to implementation of the Community's energy strategy.

9.1 The Community's energy balance

Taken as a whole, the main components of the Community's energy balance (energy consumption, production and imports) have sustained quite dramatic changes over the last three years (as they have in most industrialized countries), the full implications of which are still far from clear. Whereas, following the 1975 recession, economic growth and the demand for energy returned fairly rapidly to relatively high levels in most countries, it has been a different story in the aftermath of the second oil shock:

- (i) the crisis is continuing in most of the OECD economies, with an average rate of growth for the three years 1980, 1981 and 1982 of just under 1% for the OECD area, close on 0.8% for the ten Community countries, and nil for the United States, while growth is still running at over 3% in Japan;
- (ii) demand for energy, especially oil, has shown a very marked downturn since 1980. (Tables 9.1 and 9.2). This represents a complete break with previous trends which, although it is too early to distinguish structural aspects from purely cyclical aspects with any certainty, is accompanied by a sharp reduction in energy consumption, especially oil, per unit of GDP. Thus gross inland consumption of energy per unit of GDP at 1975 prices and exchange rates (1975 = 100) has fallen from 99.9 in 1979 to 90.2 in 1981 and 88.7 in 1982, while over the same period oil consumption per unit of GDP fell from 96.1 in 1979 to 79 in 1981 and 75.8 in 1982 (Table 9.2). Changes such as these obviously include a considerable element of structural change and cast doubts on the reliability of most of the medium- and long-term forecasts made earlier.

To be more precise, while Community GDP increased by 2.5% between 1979 and 1982, gross inland consumption of energy fell by more than 8% and oil consumption by more than 18%. The oil share of energy consumption - which the Community aims to cut back to 40% by 1990 - has therefore come down from 54.5% in 1979 to 48.6% in 1982. At the same time, while consumption of solid fuels held level at around 220 million toe, and consumption of gas slipped slightly from 172 million toe in 1979 to 163 million toe in 1982, electricity speeded up its penetration of the market, consumption rising from 53 million toe in 1979 to 83 million toe in 1982 (an increase of 56.7%).

By contrast, Community energy production increased by 34 million toe (7.4%) between 1979 and 1982, largely owing to a rise of 21 million toe (23.5%) in North Sea oil production and of 30 million toe (81%) in nuclear-generated electricity, while the output of solid fuels grew by 5 million toe, and natural gas production continued its decline with a drop of 22 million toe (16%).

These trends in the Community's consumption and production of energy added up to a sharp fall in net energy imports, from 559 to 437 million toe between 1979 and 1982, i.e. a drop of close on 22%. Given the rise in net imports of natural gas (up 11 million toe) and solid fuels (up 4 million toe), the reduction in net oil imports is very substantial: from 487 million toe in 1979 to 350 million toe in 1982, i.e. down 28.1%. The Community's dependence on energy imports accordingly declined from 64.2% in 1973 to 55.2% in 1979 and 47% in 1982, and its dependence on imported oil from 61.8% in 1973 to 48.1% in 1979 and 37.6% in 1982.

9.2 Energy prices

The trend of energy prices, and more particularly the two successive jumps in oil prices, has quite clearly played a significant part in the Community's changing energy balance. The Commission now has access to reliable long-run (1960-80) price series for different energy sources in the various categories of consumption in six countries (B, D, F, I, NL and UK), which help put recent trends into better perspective.

To obtain an overall picture of the trend in energy prices, a weighted average index has been calculated which combines all products and all sectors. This index was deflated by the GDP implicit price index so as to show the change in the real price of energy over the long term. With base of 1960 = 100,

this clearly shows a substantial drop in the real price of energy in all the countries throughout the 1960s and up to 1972 or 1973 (Graph 9.1): energy therefore had a major anti-inflationary effect, and thus played a part in the expansion and direction of economic growth. The rise in prices from 1973 to 1975 broadly cancelled out the previous fall and brought energy prices almost back to their 1960 level relative to prices for other goods and services. The period 1975-78 was a time of stability or even of a renewed fall in the real price of energy. Then, as a result of the second oil shock, prices increased in real terms in 1979 and 1980 to finish up at a level which is generally, though only slightly, higher than the level of real prices in 1960.

The indices of energy prices by category of consumer - industry, road transport, households and services (small users) - show up fairly wide differences in trends which are worthy of comment. Firstly, it is evident that inflation is mainly responsible for divergent trends in nominal prices in different countries, which is why it is safer to rely on a study of real prices. This shows that, broadly speaking, the real price of motor fuel tended to fall further than the price of other energy uses until 1973, but especially that it has increased less everywhere since 1973 and is now in many cases lower than its real level in 1960, giving road transport a definite relative advantage. It should be pointed out here that the long-run series now available relate to prices inclusive of all taxes (series net of tax are in preparation, series net of VAT exist only for the period 1974-80 for industry). In the case of motor fuels, these "with-tax" prices are heavily affected by a specific tax (excise duties), whose rate of increase since 1973 has tended to fall behind inflation in timing and level; this explains the smaller real price rise of these products. A second point is that between 1960 and 1973 the real price of energy consumed by households and services (small users) fell everywhere to a lesser extent than real prices for industry or road transport. Subsequently, between 1973 and 1980, events took a different course in different countries: in some countries the real price of energy used by households and services remained higher (D, F, UK), while in others the real price of energy to industrial users increased the most (I, NL, B).

The average cost (cif) of oil supplies in the Community during the period 1970-82 is presented in Table 9.3 and Graph 9.2 in three different ways: in current dollars, in current ECU and in deflated ECU. This style of presentation offers a comprehensive picture of the main features of the trend in oil prices as it affected the Community economy during that period, as follows:

- (i) the magnitude of the two oil price shocks, which resulted in a virtual quadrupling of prices in current dollars in 1973-74, which in turn were almost tripled between 1979 and 1981, with the result that the average cif price of oil imported into the Community rose from USD 2.3 a barrel in 1970 to USD 36.5 a barrel in 1981 (a 16-fold increase) before declining to USD 34 in 1982;
- (ii) the effect of the dollar exchange rate over the period which was the changeover to floating exchange rates: when the dollar was weak (from 1970 to 1973 and from 1977 to 1980) oil prices expressed in ECU rose much less steeply than the same prices expressed in dollars; conversely, when the dollar was strong (from 1974 to 1976, in 1981 and above all in 1982) each rise in the dollar price of oil was amplified and each reduction absorbed by the movement of exchange rates. As a result of this process, in 1982 the drop in the dollar price of oil was more than offset by the rise in the dollar, to the extent that in that year the oil price index (1970 = 100) was higher in ECU terms than in dollar terms, for the first time since 1970. It would however be wrong to conclude from this that the price of oil in dollars is fixed without any reference to the exchange rate of the dollar against other major currencies;
- (iii) the role played by inflation (Graph 9.2: prices in deflated ECU) in moderating to some extent the real burden of the cost of oil supplies. The average real price in the Community in 1982, which is 6% down on 1981, shows a five-fold increase since 1970, compared with an increase by a factor of 15 in nominal terms. It should be noted that, in general, the country-by-country trends throughout the Community remain fairly comparable because purchasing power parities have changed little.

9.3 Energy investment

Any analysis of the trend of energy investment is beset by many difficulties of a statistical and theoretical nature as regards the definition of that category of investment. For instance, the national accounts provide satisfactory data on investment in energy production in the form of statistics of gross fixed capital formation by ownership branch, but give us no information about investment in the efficient use of energy (energy saving or fuel-switching) in any branch.

As regards investment in energy production, the trend from 1970 to 1980, as shown in Table 9.4, is certainly positive, but reveals no clear priority in favour of energy investment. The share of energy investment in total GFCF for the seven Community countries which have provided data broken down by sector (B, D, F, IRL, I, NL and UK) increased from 7% in 1970 to 8.4% in 1980. Two countries show a significant rise: France (where the share of energy increased from 6.2% to 8.5% of GFCF), and above all the United Kingdom (where the share grew from 10.9% to 14.1% of GFCF).

On the other hand, the trend in the volume of energy investment during the periods 1970-73, 1973-77 and 1977-80 shows hardly any increase in investment growth except, to some extent, in France and Germany. Admittedly, in a general context of declining investment ratios, energy investment stands out as a notable exception and plays a not insignificant supporting role to activity as a whole, but it does not constitute the motive force, which might have been expected. The growth of investment in energy production has been much stronger and faster in other industrialized countries, particularly in the United States, where its share of GFCF, which was already high at 13.5% in 1970, rose to 20.9% in 1979 and was probably close on 25% in 1980.

The forecasts by Euroinvest as regards capital formation suggest that the growth of investment in energy production has accelerated in the Community, especially in 1981 and 1982 in Belgium, Germany and France, but slowed down again in the United Kingdom.

These data go to confirm the observed expression of energy production - a sharp growth in North Sea oil production related to a growth in investment of 15.4% per annum in the United Kingdom from 1973 to 1977; an increase in the generation of electricity from nuclear fuel going hand in hand with sustained growth of investment in electricity generation in France: but the fact remains that the substantial decline in demand for energy per unit of GDP in the Community is partly due to a rationalization of consumption and thus to investment in energy efficiency. Much more information is needed about such investment in order to explain and above all to forecast the trend of demand for energy in the medium and long term.

9.4 Oil and energy bills

The sharp fall in demand for energy, together with the growth in Community production of energy and particularly of oil, have brought about a major reduction in the volume of net imports of energy, from 622 million toe in 1973 to 559 million toe in 1979 and only 437 million toe in 1982. However, with the explosion in energy prices, the volume cutback in imports has not been enough to hold down the Community's energy bill, particularly its oil bill (Table 9.2). The Community's oil bill increased from USD 16 300 million in 1973 (1.5% of GDP) to USD 97 000 million in 1980 (3.5% of GDP), before falling back to USD 85 000 million in 1982. However, the highest level as a percentage of GDP was reached in 1981, when the change in the dollar exchange rate raised the oil bill to 3.7% of GDP. The bill for all sources of energy increased steadily relative to the bill for oil alone largely because of the rise in net imports of solid fuels and natural gas. It rose from USD 16 900 million in 1973 (1.5% of GDP) to USD 105 600 million in 1980 (3.8% of GDP) and USD 94 000 million in 1982 (3.8% of GDP). These figures show clearly how important it is for the Community not only to replace oil by other sources but also to foster both its own energy production and energy efficiency so as to reduce still further the consumption of energy per unit of GDP.

The decline in net oil imports into the Community and into most industrialised countries, combined with the expansion of oil production by non-OPEC countries has caused major changes on the oil market since 1979-80. These changes have been accentuated since the third quarter of 1981, particularly in the first half of 1982, by the need for oil companies to adjust their stocks, in view of the lower world demand for oil and the very high cost of holding stocks in a period of high interest rates. As there is a glut on the market, most of the non-OPEC exporting countries have adjusted their prices in order to keep their market share, which has left the main burden of volume adjustment to the OPEC countries. These have sought, by imposing production ceilings and reducing the prices most out of line, to hold the market price of Arabian light at USD 34 a barrel. This policy has resulted in a further reduction in the quantities produced and exported by OPEC.

The upshot is that OPEC production has dropped from 31.6 million barrels a day (1 580 million toe) in 1979 to around 20 million barrels a day (1 000 million toe), i.e. a drop of more than 36%: this has led to a new shareout of the market whereby OPEC countries, which supplied more than 60% of demand in 1979, supplied just over 40% in 1982.

This new situation on the oil market has led to a sharp decline in the value of OPEC's exports and to a very rapid contraction in OPEC's current account surplus (see Chapter 3).

Table 9.1

Summary energy balance, EC 10

(million toe)

	1973	1975	1977	1979	1980	1981	1982 ⁽¹⁾
Energy consumption	969	890	942	1012	970	934	930
1. Gross inland consumption	932	859	912	985	944	907	905
of which:							
solid fuels	222	195	203	223	223	220	219
oil	566	487	507	537	494	450	440
natural gas	116	140	154	172	169	165	163
primary electricity etc.	28	38	48	53	58	72	83
2. Bunkers (petroleum products)	37	31	31	27	26	27	25
Primary energy production	348	370	415	458	462	484	492
of which:							
solid fuels	196	190	180	180	185	187	185
oil	12	13	49	89	91	102	110
natural gas	112	132	140	138	129	125	116
primary electricity etc.	28	36	46	51	57	70	81
Net energy imports	622	527	538	559	527	445	437
of which:							
solid fuels	19	26	28	34	47	42	38
oil (crude + products)	599	491	492	487	438	358	350
natural gas	4	9	17	36	41	43	47
electricity	0	1	1	2	2	2	2
Stock movements	+ 1	+ 7	+ 11	+ 5	+ 19	- 5	- 1

(1) Forecasts

Source: Commission departments.

Table 9.2

Energy and oil in the Community economy, EC 10

	1973	1975	1977	1979	1980	1981 ⁽¹⁾	1982 ⁽¹⁾
Cost of energy imports							
Average import price (cif) of crude oil in USD per barrel	3,9	11,6	13,7	19,5	33,0	36,5	34,0
Net import bill for crude oil and petroleum products in USD '000 million at current exchange rates	16,3	41,3	47,1	68,0	97,0	91,7	85,0
Net import bill for crude oil and petroleum products as % of GDP	1,5	3,0	2,9	2,8	3,5	3,7	3,4
Net import bill for energy in USD '000 million at current exchange rates	16,9	43,3	50,3	73,1	105,6	99,0	94,0
Net import bill for energy as % of GDP	1,5	3,1	3,1	3,0	3,8	4,0	3,8
Supply dependence							
Share of oil in the gross inland consumption of energy (%)	60,7	56,7	55,6	54,5	52,3	49,6	48,6
Share of Community oil production in the gross inland consumption of oil and petroleum products (%)	2,1	2,6	9,7	16,6	18,4	22,7	25,0
Dependence on imported oil ⁽²⁾	61,8	55,1	52,2	48,1	45,2	38,3	37,6
Dependence on imported energy ⁽²⁾	64,2	59,2	57,1	55,2	54,3	47,6	47,0
Consumption							
Gross inland energy consumption ⁽³⁾	108,5	100,0	106,2	114,6	109,9	105,6	105,4
Energy consumption per unit of GDP at 1975 prices and exchange rates ⁽³⁾	108,9	100,0	98,7	99,9	93,7	90,2	88,7
Oil consumption per unit of GDP at 1975 prices and exchange rates ⁽³⁾	109,2	100,0	96,8	96,1	86,6	79,0	75,8

(1) Estimates and forecasts.

(2) Net imports as % of gross inland consumption of energy plus bunkers.

(3) 1975 = 100.

Source: Eurostat and Commission departments

Table 9.3

Cif price per barrel of oil imported into the Community

	CURRENT DOLLARS PRICE	INDEX	CURRENT ECU PRICE	INDEX	DEFLATED ECU PRICE	INDEX
1970	2.3	100.0	2.2	100.0	2.2	100.0
1971	2.9	127.8	2.8	124.6	2.6	116.0
1972	3.1	136.6	2.8	124.4	2.4	108.6
1973	3.9	170.5	3.1	141.5	2.6	114.9
1974	10.8	475.8	9.1	407.8	6.6	298.1
1975	11.6	511.0	9.3	421.0	6.0	271.1
1976	12.6	555.1	11.3	507.5	6.6	297.9
1977	13.7	603.5	12.0	540.6	6.4	289.7
1978	13.8	607.9	10.8	487.8	5.3	240.7
1979	19.5	859.0	14.2	640.7	6.4	288.7
1980	33.0	1453.7	23.7	1068.3	9.6	431.4
1981	36.5	1607.9	32.7	1472.8	12.0	542.6
1982	34.0	1497.8	33.4	1505.5	11.2	506.0

Source: Commission departments

Table 9.4

Gross fixed capital formation by ownership branch: energy

	Share of energy in total GFCF		Average annual rate of growth in energy investment				
	1970	1980	1970-73	1973-77	1977-80	1981(1)	1982(1)
B	6,7	7,2	- 1,4	5,9	3,2	6,5	10,0
D	5,3	7,1	12,6	- 1,9	10,8	15,7	6,0
F	6,2	8,5	3,5	3,9	15,0	1,5	7,0
IRL	6,5	1,6	13,5	- 24,5	- 7,1	:	:
I	8,1	8,3*	- 2,0	- 2,1	9,6*	:	:
NL	7,4	7,6*	5,9	- 1,5	- 0,4*	:	:
UK	10,9	14,1	- 6,2	15,4	- 1,9	- 6,0	- 6,0
EC 7	7,0	8,4	3,1	3,4	4,9	6,6	4,2
USA	13,5	20,9*	:	:	:	:	:

Source: Eurostat

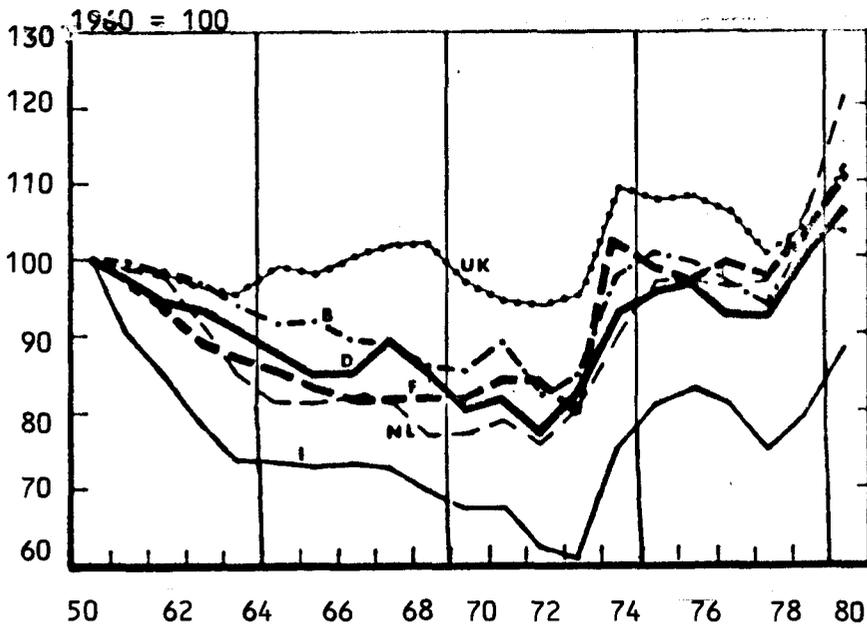
* = 1979

(1) = Forecasts by Euroinvest

Graph 9.1

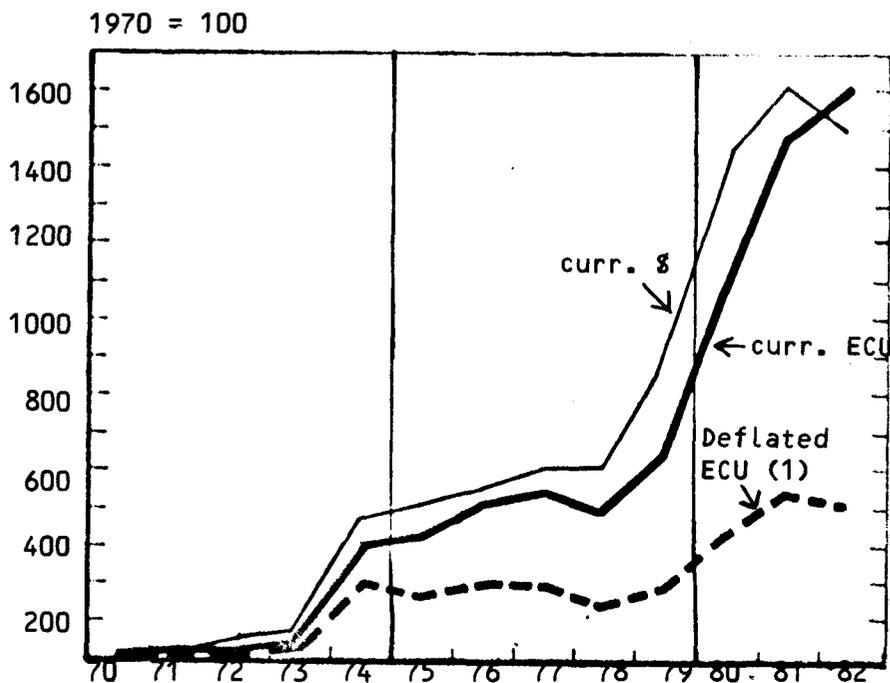
INDEX OF ENERGY PRICES IN REAL TERMS

(ALL PRODUCTS, ALL SECTORS)



Graph 9.2

PRICE INDICES FOR THE SUPPLY OF CRUDE OIL TO THE NINE



(1) Deflated by implicit GDP index at market prices

10. External trade and competitiveness

Measured retrospectively by the Community's and the Member States' shares in OECD trade, Europe's competitiveness, as compared with its major partners Japan and the U.S., appears less threatened on the international markets than within its own borders. In spite of the intense competition between the industrialized countries, the Community has since 1973 largely maintained its share in international exports. It has been forced, however, to rely on a growing flow of imports, particularly of equipment products, in order to satisfy internal demand for goods which domestic industry can supply only at too high a cost or not at all. This is a sign of the Community's increasing integration into an international division of labour which takes in not only the major industrialized countries but the newly industrializing countries (NICs) as well, with Japan participating in one role only, being one of the world's three major exporters of capital goods, along with Germany and the United States, and at the same time one of the smallest importers. The fact remains that the inadequate response of Community industry to the changing structure of internal demand, particularly for high-technology goods, is a consequence of its slowness to adapt, a process held back by the sluggishness of investment.

10.1 The Community, the United States and Japan

Recent examples of the grave difficulties encountered by sensitive industries such as textiles or motor vehicles have made the general public highly receptive to the idea that European products are becoming less competitive - witness the rising rates of penetration recorded for certain goods.

The trend observed in world trade between 1963 and 1980 appears to confirm this impression. The Community's share of the world export market has indeed fallen steadily since 1963, down to 16% of total trade in 1980.⁽¹⁾ But the United States' share has also fallen; only Japan regularly increased its share between 1963 and 1973, which levelled off thereafter at about 6.5% (Table 10.1). This redistribution of world market shares among the industrialized countries up to 1973, at the expense of the State-trading and developing countries, has been challenged by the growth of new exporting centres, the NICs and above all the petroleum exporting countries, which now account for 15% of world trade. Obviously all these developments were strongly influenced by changing prices in international trade, particularly those of energy products and raw materials, and a more thorough study of trade between the industrialized countries in the OECD area reveals important qualifications to be made to the first general impression.

During the 1960s and early 1970s, the Community's export market share in OECD external trade declined steadily from 29.3% in 1963 to 25.7% in 1973, the United States' share fell more sharply, from 23.7% in 1963 to 11.7% in 1972, and Japan's share increased smoothly from 5.6% in 1963 to 10% in 1972 (Graph 10.1).

Under the combined impact of the breakdown of the Bretton Woods system, the oil price increases, and the slowdown in the growth of world trade (from an annual average of 8% to 4% by volume), these smooth trends gave way to a much more irregular picture, which in the case of the Community was marked mainly by a succession of short periods of expansion and contraction. These abrupt changes reflect the intense struggle between the three major industrialized areas, which between them account for almost 80% of the value of OECD trade,⁽²⁾ to maintain or improve their positions on the markets of the rest of the world.

(1) See box

(2) Excluding intra-Community trade.

Yet none of these three economic powers can claim to have taken a decisive lead, and none has fallen very far behind; in each case the end result of the changes in their market shares is a positive figure, 0.8 percentage points for the U.S.A. and 0.95 for Japan from 1972 to 1980, and as much as 1 percentage point for the Community from 1973 to 1980. The United States and the Community have thus firmly consolidated their positions in OECD trade, ending the steady decline of the previous decade. This is further confirmed by the fact that the Community despite everything kept its clear lead as the world's largest exporter; in 1980 the total value of exports out of the Community was only slightly below the combined American and Japanese export figures.

This general improvement demonstrates the high overall export competitiveness of the three areas, operating at the expense of the other OECD countries; but a more thorough analysis reveals that these successes have been obtained in different categories of goods, thus accentuating a certain form of international division of labour.

Thus Japan, which between 1963 and 1973 had remarkable success with exports of both intermediate and equipment products, now bases its advance essentially on the latter. The market share of Japanese equipment goods in total OECD exports increased by 4 percentage points between 1973 and 1980, when it reached 17.3% - close to the U.S. share of 19% but still some way behind the Community share of 28.6%. Japan is increasing its share not only in the motor vehicle market (21.7% in 1980) but also in almost all industries producing investment goods: electrical goods (24%), data processing machines (17.4%), and agricultural and industrial machinery (10.6%). It must be borne in mind, however, that Japanese penetration is essentially confined to non-Community markets, frequently in areas where until very recently the Community countries were the only exporters. The increase in exports of equipment goods to the Community represents only 0.8 percentage points out of Japan's 4-point market share increase for this kind of product. The 11 percentage point increase in Japan's share of motor vehicle exports likewise includes a 4-point increase in exports to the developing countries, above all to the OPEC countries, a 4.5-point increase in exports to the U.S., but only a 1.3-point increase in exports to the Community.

The U.S.A. has increased its share more especially in intermediate products, such as steel and chemicals, and current consumption goods such as textiles and clothing. But on the whole its gains have been made in exports to the Community, even of equipment products (Table 10.5) - mainly office machines and transport equipment other than motor vehicles - which were offset by losses in exports to non-Community countries.

As for the Community, apart from good performances in particular industries such as building materials, wood, or more recently agricultural and food products (26% in 1980 as compared with 22.5% in 1979), it has been barely maintaining its position in manufactured goods as a whole and making gains only in exports of agricultural products and energy products.

These data modify somewhat the assessment of the Community's competitive position outlined earlier; in most of the main manufacturing branches the Community is at best maintaining its share, and suffering substantial losses in motor vehicles (27.9% in 1973 to 24.3% in 1980) and office machines (24.0% to 21.6%). However, this relative stability in terms both of overall market shares and of the breakdown by major categories of product disguises deeper shifts in the geographical distribution of exports from the Community. Thus the Community has lost one percentage point of its OECD market share because of a fall in exports to the United States; the loss affects all categories of product but particularly motor vehicles, where it is roughly equal to the corresponding Japanese gain, without any increase in the relative size of the Community's exports to Japan. On the other hand the Community has been able to secure a sizeable increase in exports to the OPEC countries, where a detailed comparison with the Japanese performance is interesting (Table 10.2). The data available show that the Community has taken much greater advantage of the increased absorption capacity of the OPEC market than has Japan. Furthermore, while Japan's progress on this market rests mainly on its exports of equipment goods, of only three categories - metal products, electrical goods and motor vehicles - the Community has performed well in all branches.

These results taken as a whole give total export market shares which are almost constant, and show that the Community's overall competitiveness has not declined. The Community would not otherwise have been able to assert itself on the OPEC market as it has. Nevertheless the losses on the American market, for example, suggest that the Community is there encountering difficulties which it is not easily able to overcome, and which are not unrelated to the more unfavourable movement of imports. For while the Community has been maintaining its positions in terms of exports, with very good performances in certain market segments, the import figures are more worrying. Where markets are very open, a country's ability to limit penetration by foreign products is a measure both of the match of domestic production to the structure of domestic demand, and of price competitiveness, offsetting any comparative advantages its main competitors may have.

In much the same way as its share of the extra-Community export market, the Community's overall share of the import market in products originating in non-Member countries fell drastically between 1963 (33.2%) and 1972 (21.3%), reflecting the Member States' shift to intra-Community trade; but from 1972 onward the broad stability of the Community's export market share has been accompanied by a regular increase in the share of outside imports, which indeed has been accelerating rapidly since 1977.

The Community's dependence on energy imports certainly explains the sudden increase in 1973 and 1974, and in 1979 and 1980; but the Community import market share for manufactured products also rose from 21.3% in 1972 to 25.1% in 1980, returning to its mid-sixties level. This development is quite unlike the trends for the United States and Japan. In the last fifteen years Japan's import market share for manufactured products has oscillated between 6% and 7% of the OECD total (or just a little over 50% of its export market share); in the United States the trend shows marked cyclical variations, but remains stable in the long term at around 17% or 18% (Graph 10.1).

It follows that in terms of export cover of imports (Graph 10.2), the Community's external trade in manufactured products, which was traditionally in surplus, has been substantially eroded. Having risen steadily from 1963 (1.16) to 1975 (1.57), the ratio has fallen steadily since, down to 1.25 in 1980, far short of what is needed to cover the deficits in agricultural products and above all energy products. Thus for all trade in 1980, exports from the Community covered only 84% of imports, the lowest percentage since 1964. We must bear in mind, however, that since 1973 coverage rates have fluctuated far more than in the past, so that it may well be in order to describe this 1980 result as a cyclical minimum, which should improve substantially in 1981 and 1982.

Over the same period the Japanese trade surplus in manufactured products has been growing almost constantly, and since 1975 the ratio has been greater than 2 (2.4 in 1977, 2.1 in 1980), though this was not enough to ensure equilibrium in the overall balance of trade either in 1974 and 1975 or in 1979 and 1980. The manufactured products surplus of the United States is a good deal more variable; in 1980 the ratio regained its 1976 level of 1.1, with the overall trade balance remaining generally in deficit.

This growth of Community import market shares applies to almost all industries - intermediate products, mainly steel, current consumption goods, particularly textiles and clothing (32.3% in 1980 compared with 24% in the early 1970s) and above all equipment goods (from 14% in 1972 to nearly 21% in 1980). The growing use of non-Community equipment products at a time when investment rates are stagnating or falling in the Member States confirms the Community's technology gap, which has to be filled by more sophisticated equipment of American or Japanese origin.⁽¹⁾ Even more than in the case of motor vehicles (10.9% in 1980), imports have become a necessary feature in the electrical goods sector (17.6% in 1971, 25.8% in 1980), machine tools (15.2% in 1972, 18.4% in 1980) and electronic equipment (22.4% in 1972, 29.4% in 1980). This too is a trait peculiar to the Community, as the U.S. share of the import market in equipment goods and current consumption goods between 1973 and 1980 stayed steady and Japan's share even fell.

(1) Between 1970 and 1980 the balance of trade in very high technology products rose from USD 6 000 million to USD 20 000 million for the Community, but from USD 1 900 million to USD 38 300 million in the case of Japan.

These two countries are not the only ones to increase their penetration of the Community market in equipment goods. Since the beginning of the 1970s goods originating in NICs have accounted for a rapidly growing share, which at 3.9% in 1980 was as big as that of Japan (3.8%) (Table 10.3). Here again Japan has practically no imports from the NICs. With only a 3% share of the total import market for capital goods, Japan is almost completely closed to foreign products, except for a small volume of American origin. The USA's and the Community's import market shares in this category of product are both 21%, and the Community's share is rising rapidly.

Thus it is far more in the form of a lower resistance to imports than that of a loss of export shares on world markets that the problem of European industry's competitiveness against the rest of the world emerges, and it does so in terms wider than straightforward differences of price, cost or exchange rates. This lower resistance to imports is only partially attributable to imports from Japan, and may be the result of the Community's entering more fully into the international division of labour. The volume of equipment goods supplied by developing and newly industrializing countries to the Community market, but also to the American market, seen together with the Community's satisfactory performances in these products on the OPEC market for example, suggests that there are different specializations for the two areas, and thus that there is in this field an accentuation of the division of labour. If this is the case, the Community's overall competitiveness is not being challenged, which does not mean that we should pay no attention to certain shortcomings in Community production which are currently making themselves felt. This also confirms the observation that over a long period competitiveness in terms of production costs has not declined, even if it has worsened at certain times, such as towards the middle of the 1970s (see Chapter 4). The fact remains that the Community's production resources appear better geared to meeting the requirements of growing external markets than certain types of demand on the internal market or other comparable markets such as the United States.

In this international confrontation the Member States' behaviour has not been uniform. This is not the place to consider in detail the extra-Community trade of each Community country, but certain characteristic features do emerge from the figures available.

As regards changes in export market shares in the course of the 1970s, three groups of countries can be distinguished: the largest one (Belgium, Denmark, Greece, Ireland, the Netherlands and the United Kingdom) comprises countries which in terms of manufactured products as a whole hold practically the same share in 1980 as at the beginning of the 1970s; France and Italy, which have both increased their shares; and the Federal Republic of Germany, whose share alone has fallen by 1.2 percentage points from its highest level, in 1974.

The position as regards imports of manufactured products from outside the Community is very similar: little change for the same countries, this time including Italy, while both France and Germany have seen outside penetration increase, by one percentage point and 1.5 points respectively.

Given the weight of Germany in extra-Community trade, that country's loss of export momentum and increased reliance on imported products together go a long way towards explaining the Community's poor performances. The overall effect is limited by Italy's gains in exports of current consumption goods and by France's gains in certain categories of equipment products, but the trade surpluses in investment goods, on which equilibrium in trade in manufactured goods has been based, have been falling since 1975 in all Member States except Denmark. This is especially true of Germany, which is by far the largest exporter but also the largest importer of these goods: its export/import ratio has fallen from 5.1 in 1974 to 2.7 in 1980. If we add an increase in the traditional deficit for current consumption goods, its balance of extra-Community trade for all products even became slightly negative in 1980 for the first time since 1963.

This is most striking in the case of Germany, but for most other Community countries too it represents a growing mismatch between Europe's industrial production and the requirements of Community demand, which might become structural if it were to continue. Thus it is not so much the rise of what is felt to be unfair competition from certain countries with abundant cheap labour that has caused most of the Community's difficulties in maintaining equilibrium in the balance of trade. Neither does the main problem lie in European industry's capacity to take advantage of

international demand, which is often more dynamic than on the internal market. The difficulty is first and foremost in the weakness of the equipment products sector, on which the Community has based its strength in international trade. In the last five years exports of equipment goods out of the Community have increased by 13.6% a year on average, while imports were rising by 23.5%.

The coverage rate in equipment goods remains high, certainly, but at the time of the first oil crisis in 1974 the surplus realized here represented 84% of the net energy bill; by 1980 and the second oil crisis, this percentage had fallen to 65.5%.

10.2 Trade within the Community

After showing a fairly moderate rate of increase in the first half of the 1960s, trade between Member States grew very rapidly between 1968 and 1973, increasing by 23% a year at current prices.

This spillover effect of the Community market had its greatest impact on the original Community of Six, up to the first oil crisis. From 1963 to 1973 trade within the Community rose from 23.7% to 28.1% of OECD trade, import market shares breaking down fairly equally between intermediate goods, equipment goods and current consumption goods (Table 10.5).

From 1973 onward the "common market effect" lost much of its force. In spite of the entry of the United Kingdom, much of whose trade shifted towards the Community, the rate of growth of intra-Community trade fell to 15.7% a year between 1973 and 1978, and was exceeded by the growth in extra-Community exports (17.3%), with many dynamic external markets such as the OPEC countries absorbing a growing share of European output.

Since 1978 intra-Community trade seems to be picking up, but there has been hardly any difference between the growth of exports to the rest of the Community and the growth of exports outside it, and, as we have seen, manufactured products originating outside the Community account for a growing share of Member States' imports. Indeed imports from outside have grown by 23% a year between 1978 and 1980, as opposed to 19% in the case of those originating within the Community (Table 10.7).

There has been a remarkable degree of parallelism in the development of the Member States' external trade, and the structure of their market shares is more or less the same now as it was in 1973. After a slight fall, mainly in the case of exports in 1975 and 1976, their market shares in 1980 were within a few tenths of a point of those of 1973, in all categories of product. Only the United Kingdom increased its export share (from 2.6% in 1973 to 3.5% in 1980), and it increased its import share even further (from 3.3% in 1973 to 4.5% in 1980); Italy increased its share of imported products from 4% to 4.5% although this was not matched by any increase in its exports to the Community.

This high level of stability in market shares in trade between Member States is clearly one of the major characteristics in the pattern of their economic relations. A dense network of trade has now been established for several years in which no one Member State is able to increase its penetration of its partners' markets beyond certain limits, definitive since the early 1970s.

This assessment is confirmed by an analysis of the trends in the export cover of imports, which with few exceptions remained constantly in surplus or in deficit throughout the period.

Intra-Community export cover of imports
(manufactured products)

Ratio constantly > 1

Federal Republic of Germany
(except in current consumption goods)

Belgium (except 1977 and 1978)
(except equipment goods)

Ratio constantly < 1

France
(except agricultural and food products, and certain industries such as motor vehicles)

Italy (except 1978)
(except current consumption goods)

United Kingdom (except 1969-71)
(except intermediate goods)

Netherlands
(except agricultural and food products, and intermediate goods since 1976)

Denmark (except 1980)
(except agricultural and food products)

Ireland
(except agricultural and food products)

This consistent profile, which also implies a high degree of stability in the competitive positions of Member States' industries, prompts the question whether the goods traded within the Community exhibit certain features which distinguish them from the goods traded with the rest of the world.

Recent research does tend to confirm this impression.⁽¹⁾ An analysis of Member States' export and import specialization choices has shown that the main categories of products traded between Member States are not the main ones sold in non-member countries. Classifying these products according to skill intensity of production and technological content, the study shows that trade within the Community has continued to consist more especially of products with a low skilled labour content, or has come to do so even more. As a general rule, however, the products of which relatively larger volumes have been exported out of the Community or imported from outside it have been those with a high skill and technological content.

The expansion of trade between the Member States has thus encouraged specialization in categories of products which are more exposed to international competition from countries with abundant labour and low labour costs, at the expense of more sophisticated products. Geographical proximity does have the effect of encouraging trade in products with a low value added content, but given the weight of intra-Community trade this tendency ought to be stabilized, if not reversed.

This is not encouraged by the measures providing partial protection of markets which have been taken in certain industries such as textiles or steel, and are being sought by certain manufacturers against Japanese products. They limit the inducement to adapt structures towards the industries of the future. This may be one of the major causes of the increasing scale of outside penetration of Community markets by higher-performance equipment goods.

(1) "Spécialisation internationale et orientation géographique du Commerce extérieur : une analyse des phénomènes de spécialisation bilatérale de la Communauté Européenne à 9, de la France, de l'Allemagne, du R.U., des U.S.A. et du Japon de 1963 à 1979." - Philippe ROLLET, Attaché de recherche au C.N.R.S., 30 October 1981, Centre Interuniversitaire de Recherches en Sciences Humaines, Lille.

1. Definitions of market shares

The export market share (or import market share) of country i in category of goods j is equal to the quotient of the value of exports (or imports) in that category of goods j by country i and the value of all exports (or imports) in the same category of goods j by all countries in the reference area, here all OECD countries; or:

$$PX_i^j = \frac{X_i^j}{X_{OECD}^j} \quad \text{or} \quad PM_i^j = \frac{M_i^j}{M_{OECD}^j}$$

i : exporting country

j : category of goods

X : exports, fob, USD at current rates

M : imports, cif, USD at current rates

2. Treatment of intra-Community trade

Total world trade (Table 10.1) and total OECD trade (Tables 10.2 ff.) include the total external trade of each Member State, and thus include intra-Community trade. Trade between the Community as a whole and the rest of the world, however, excludes intra-Community trade. Thus in Section 1Q1 the Community exports and imports discussed are those in extra-Community trade only.

There is thus a choice of approach to be made in calculating the shares of the Community or of any other country in total world or OECD trade. One might assume that in this kind of comparison intra-Community trade is not relevant and on that ground should be excluded from the world or OECD total. In that case there would be changes in the percentages given in Table 10.1, reflecting developments in the value of trade between Community countries:

Shares of the E.C., the U.S.A. and Japan in world trade excluding intra-Community trade

	<u>Exports</u>			<u>Imports</u>		
	1963	1973	1980	1963	1973	1980
E.C.	21.3	21.0	19.0	25.0	23.4	24.2
U.S.A.	7.5	15.4	13.5	12.6	15.2	15.2
Japan	4.2	8.0	8.0	5.0	8.6	8.9

This approach has not been adopted here, however; intra-Community trade is retained in the world and OECD totals and the total market shares of each Member State and of the Community are then subdivided into their two component parts, intra- and extra-Community (Tables 10.4 to 1Q6).

In Table 10.5 the entries for the United States and Japan show the share of their trade with the Community, and in Table 10.6 they show the share of their trade with the rest of the world.

Thus each percentage in Table 10.4 is equal to the sum of the corresponding percentages in Tables 10.5 and 10.6.

Table 10.1

Geographical structure of world trade (1)

%

	Exports			Imports		
	1963	1973	1980	1963	1973	1980
1. Industrialized countries	67.3	70.8	63.5	66.9	71.0	67.3
of which:						
- E.C.	33.8	36.6	33.3	34.7	35.7	34.6
of which:						
extra-E.C.	18.7	17.5	16.0	20.7	17.4	18.3
- U.S.A.	13.4	11.9	10.6	11.0	12.1	12.1
- Japan	3.4	6.4	6.6	3.7	6.0	6.2
2. Developing countries	20.6	19.2	27.5	20.5	17.6	23.2
of which:						
petroleum-exporting countries	5.9	7.3	15.0	2.9	3.5	6.5
3. State-trading countries	12.1	10.0	9.0	11.5	9.8	8.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

(1) Including intra-Community trade

Source: International Trade 1980/81, GATT, Geneva 1981

10.14

Table 10.2

Export market shares of EC and Japan in OPEC area

%

Products	EC			JAPAN		
	Market shares		Gain	Market shares		Gain
	1973	1980	1973-80	1973	1980	1973-80
All products	2.0	4.3	2.3	0.7	1.6	0.9
Manufactured products	2.2	4.5	2.3	0.7	1.9	1.2
- Intermediate products	2.1	3.6	1.5	1.0	1.8	0.8
- Equipment products	2.6	5.4	2.8	0.7	2.4	1.7
. Metal products	3.5	10.1	6.6	0.9	2.8	1.9
. Industrial machinery	3.5	6.4	2.9	0.7	1.8	1.1
. Office machines	1.2	2.2	1.0	0.4	0.9	0.5
. Electrical goods	2.5	5.4	2.9	1.0	3.3	2.3
. Motor vehicles	2.5	5.0	2.5	0.7	3.3	2.6
. Other transport equipment	1.8	3.3	1.5	0.6	1.4	0.8
- Food products	2.0	6.2	3.8	0.1	0.4	0.3
- Current consumption products	1.3	3.0	2.7	0.7	1.3	0.6

Source: Commission departments, based on OECD external trade figures

Table 10.3

Geographical distribution of import market shares in
equipment products

%

Country or area of origin	Imports					
	EC (external trade)		USA		JAPAN	
	(1)	(2)	(1)	(2)	(1)	(2)
EC	-	-	5.3	- 0.5	0.8	- 0.1
USA	6.6	0.8	-	-	1.6	- 0.1
Japan	3.7	1.7	7.3	2.1	-	-
Rest OECD	6.3	0.7	4.9	- 2.2	0.2	- 0.1
State-trading countries	0.5	0.0	0.0	0.0	0.0	0.0
DCs and NICs	3.8	2.4	3.5	1.5	0.	0.2
Total	20.9	5.7	21.0	0.8	3.1	0.0

(1) Market share in 1980

(2) Change in market shares between 1973 and 1980

Source: Commission departments, based on OECD external trade figures

Table 10.4
Market shares in OECD trade
(values USD at current rates)

(X)

	Energy			Total manufactured prods.			Intermediate prods.			Equipment products			Current consumer products			Total products		
	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980
	EXPORTS: TOTAL TRADE																	
B	5,7	4,8	7,1	5,2	6,0	5,2	9,8	10,4	8,4	2,9	3,5	3,3	5,4	6,4	5,6	5,0	5,7	5,4
DK	0,3	1,0	0,8	2,1	1,6	1,4	0,7	0,7	0,8	1,2	1,1	1,0	1,2	1,5	1,5	1,9	1,5	1,4
D	15,2	9,0	9,6	16,3	18,7	17,2	17,3	18,7	16,6	22,3	22,2	19,4	10,0	14,9	14,8	15,1	17,3	16,1
F	8,0	5,6	6,0	8,5	9,1	9,6	9,7	9,1	10,3	7,0	8,0	8,7	9,2	9,4	9,0	8,3	9,0	9,4
IRL	0,2	0,1	0,1	0,6	0,6	0,8	0,1	0,3	0,6	0,1	0,2	0,4	0,5	0,6	0,8	0,6	0,6	0,7
I	7,5	9,6	5,9	5,0	5,7	6,7	3,4	4,2	5,1	5,1	5,5	6,1	7,5	8,9	11,3	5,2	5,7	6,6
NL	12,6	23,9	21,7	4,6	5,4	5,1	4,1	5,8	5,8	3,4	3,3	3,1	4,2	5,6	5,1	5,1	6,1	6,2
UK	11,6	6,9	20,0	12,4	8,2	9,3	10,9	9,8	10,9	15,8	8,3	9,3	9,8	6,5	7,6	11,8	7,8	9,7
EC-9	61,1	60,9	71,0	54,7	55,2	55,3	56,1	59,0	58,4	57,8	52,2	51,2	47,8	53,8	55,7	53,0	53,8	55,5
USA	25,5	12,7	10,7	21,2	15,6	16,5	17,0	11,8	14,3	25,7	19,1	19,0	18,2	12,5	13,9	23,7	18,0	17,9
JAP	0,4	0,6	0,7	6,3	10,4	12,4	6,3	10,4	10,4	5,2	13,3	17,3	9,5	7,4	6,9	5,6	9,5	11,0
	IMPORTS: TOTAL TRADE																	
B	4,2	3,6	3,5	5,4	5,7	6,0	6,9	7,2	7,6	6,5	5,7	5,4	5,0	5,2	5,4	5,0	5,4	5,4
DK	2,0	1,7	1,2	2,8	2,0	1,6	2,0	1,7	1,3	2,7	2,2	1,4	2,3	2,4	2,0	2,1	1,9	1,5
D	10,5	12,9	11,6	11,4	12,7	14,3	12,8	13,9	14,2	8,1	9,9	12,4	13,4	15,3	17,0	12,8	13,4	14,0
F	11,4	9,1	10,1	8,2	9,3	10,4	8,9	10,0	10,8	8,7	9,4	10,1	7,7	8,8	10,4	8,6	9,1	10,1
IRL	0,7	0,4	0,5	0,8	0,7	1,0	0,6	0,6	0,7	1,1	0,7	1,1	0,8	0,9	1,1	0,8	0,7	0,8
I	7,9	8,2	7,7	7,7	6,7	7,5	8,4	7,1	7,8	8,3	5,4	6,8	6,4	6,0	6,9	7,4	6,9	7,4
NL	6,2	6,5	5,2	5,8	5,6	5,8	5,0	5,4	5,3	8,2	5,6	5,4	5,8	5,9	6,4	5,8	5,8	5,7
UK	13,6	8,9	4,5	12,8	9,5	10,6	9,7	9,4	11,3	6,4	7,9	10,4	14,7	9,9	10,0	13,2	9,5	8,9
EC-9	56,5	51,2	44,2	54,3	52,2	57,1	54,2	55,4	59,0	50,0	46,7	52,9	56,2	54,4	59,8	55,7	52,6	53,9
USA	16,2	17,0	23,2	17,4	17,6	17,8	18,3	14,5	15,1	10,6	20,2	21,0	18,7	15,7	15,5	16,6	17,1	18,9
JAP	10,5	17,4	19,7	5,7	7,3	6,7	7,3	10,5	9,3	4,1	3,1	3,1	7,2	11,2	8,3	6,6	9,3	10,6

Source: Commission departments, based on OECD external trade figures.

Table 10.5

Market shares in OECD trade
(values USD at current rates)

(%)

	Total																	
	Energy			manufactured prods.			Intermediate prods.			Equipment products			Current consumer products			Total products		
	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980
EXPORTS: INTRA-EC TRADE (1)																		
B	3,8	2,8	4,9	3,5	4,4	3,8	5,7	7,1	5,6	2,1	2,2	2,4	4,3	5,3	4,6	3,4	4,2	3,9
DK	0,1	0,2	0,2	1,1	0,8	0,7	0,2	0,2	0,3	0,3	0,4	0,4	0,4	0,6	0,7	1,0	0,7	0,7
D	10,5	5,4	4,6	7,1	8,8	8,1	8,2	9,0	7,8	9,2	9,5	8,4	4,4	7,9	7,9	6,7	8,2	7,6
F	3,2	3,1	2,9	3,8	5,0	4,9	4,6	4,8	5,4	2,7	2,0	3,8	4,4	5,4	5,4	3,7	5,1	4,8
IRL	0,2	0,1	0,1	0,5	0,4	0,6	0,1	0,2	0,4	0,1	0,1	0,3	0,4	0,5	0,6	0,4	0,4	0,5
I	2,1	3,9	1,7	2,0	2,8	3,2	0,9	1,9	2,2	2,0	2,5	2,5	3,7	5,1	6,6	2,2	2,9	3,1
NL	8,7	19,5	17,3	2,7	3,5	3,2	2,4	3,7	3,9	1,5	1,7	1,6	3,0	4,4	3,6	3,1	4,2	4,3
UK	7,0	3,7	13,2	3,1	2,6	3,5	2,9	3,2	3,9	3,7	2,5	3,1	2,6	2,2	3,5	3,1	2,5	3,9
EC-9	35,5	38,6	44,9	23,8	28,3	28,0	25,0	30,2	29,3	21,6	23,2	22,6	23,0	31,7	32,9	23,7	28,1	28,8
USA	9,3	2,8	2,9	4,3	3,7	4,1	4,5	3,0	3,7	4,2	4,1	4,4	4,4	2,8	3,6	5,4	4,1	4,3
JAP	0	+	+	0,5	1,2	1,6	0,5	0,9	0,6	0,4	1,8	2,6	0,8	0,8	0,9	0,5	1,1	1,4
IMPORTS: INTRA-EC TRADE (1)																		
B	1,5	1,2	1,2	3,6	4,3	4,3	4,1	4,6	4,6	5,2	4,8	4,2	3,1	4,0	4,1	3,1	3,8	3,4
DK	1,1	0,8	0,6	1,2	1,0	0,8	1,3	0,9	0,8	1,8	1,2	0,8	1,0	0,8	0,8	1,1	0,9	0,7
D	1,9	3,8	3,1	5,2	7,1	7,3	5,6	7,4	7,4	4,6	6,1	6,5	5,7	8,4	8,3	4,9	6,9	6,3
F	2,3	1,1	1,3	4,2	5,9	6,2	5,8	6,9	6,6	6,0	6,7	6,3	2,6	5,1	5,9	3,6	5,0	4,7
IRL	0,3	0,2	0,3	0,6	0,5	0,7	0,5	0,5	0,6	1,0	0,6	0,7	0,5	0,6	0,8	0,6	0,5	0,6
I	0,4	0,3	0,6	3,8	4,0	4,5	4,6	4,3	4,6	5,8	4,0	4,8	1,9	2,7	3,0	3,0	3,4	3,3
NL	1,8	0,6	1,0	3,9	3,9	3,9	3,7	4,1	3,8	6,2	4,2	3,7	3,7	4,2	4,3	3,4	3,4	3,0
UK	1,7	1,5	1,0	3,2	3,3	4,5	2,0	2,3	3,8	2,9	4,0	5,1	2,6	2,4	3,7	3,0	3,1	3,5
EC-9	10,8	9,4	8,9	25,7	30,0	32,0	27,7	30,9	32,3	33,5	31,4	32,1	21,2	28,0	30,8	22,6	26,9	25,4
USA	0,1	0,9	0,7	4,4	4,4	3,8	4,7	4,4	3,4	5,8	5,8	5,3	3,5	3,0	2,3	3,6	3,8	2,8
JAP	+	+	+	0,7	0,9	0,8	0,9	1,1	0,9	1,2	0,9	0,8	0,4	0,8	0,8	0,5	0,7	0,6

Source: Commission departments, based on OECD external trade figures

(1) For USA and Japan, trade with Community.

Table 10.6

Market shares in OECD trade
(values USD at current rates)

(%)

	Total manufactured prods.												Intermediate prods.						Equipment products						Current consumer products						Total products					
	Energy		1973		1980		1963		1973		1980		1963		1973		1980		1963		1973		1980		1963		1973		1980							
	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980	1963	1973	1980						
B	1,9	2,0	2,2	1,7	1,6	1,4	4,1	3,3	2,8	0,8	1,0	0,9	1,1	1,1	1,0	1,6	1,5	1,5	1,1	1,1	1,1	1,1	1,0	1,6	1,5	1,5	1,1	1,1	1,0							
DK	0,2	0,8	0,5	1,0	0,9	0,7	0,5	0,5	0,5	0,9	0,7	0,6	0,8	0,9	0,7	0,9	0,8	0,7	0,8	0,9	0,9	0,9	0,9	0,9	0,9	0,8	0,9	0,8	0,7	0,7						
D	4,6	3,6	5,0	9,2	10,0	9,1	9,1	9,6	8,8	13,2	12,8	11,0	5,6	7,0	6,9	8,4	9,2	8,5	5,6	7,0	6,9	6,9	6,9	8,4	9,2	8,5	8,4	9,2	8,5	8,5						
F	4,8	2,4	3,2	4,7	4,1	4,8	5,1	4,2	4,9	4,2	4,0	4,9	4,9	3,7	3,6	4,6	3,9	4,6	4,9	3,7	3,6	3,6	3,6	4,6	3,9	4,6	4,6	3,9	4,6	4,6						
IRL	+0	0	+0	0,1	0,1	0,2	+0	0,1	0,2	+0	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1					
I	5,4	5,8	5,2	3,0	3,9	2,5	2,5	2,3	3,0	3,1	3,0	3,6	3,9	3,8	3,6	3,0	2,9	3,5	3,9	3,8	3,8	4,7	4,7	3,0	2,9	3,5	3,0	2,9	3,5	3,5						
NL	3,9	4,5	4,3	2,0	1,8	1,8	1,7	2,1	1,9	1,9	1,7	1,5	1,3	1,2	1,5	2,0	1,9	1,9	1,3	1,2	1,5	1,5	2,0	2,0	1,9	1,9	2,0	1,9	1,9	1,9						
UK	4,7	3,2	6,8	9,3	5,6	5,8	8,1	6,7	7,1	12,0	5,9	6,1	7,2	4,3	4,1	8,6	5,3	5,8	7,2	4,3	4,1	4,1	4,1	8,6	5,3	5,8	8,6	5,3	5,8	5,8						
EC-9	25,6	22,3	26,2	30,9	26,9	27,3	31,1	28,8	29,1	36,1	29,0	28,6	24,8	22,1	22,7	29,3	25,7	26,7	24,8	22,1	22,7	22,7	22,7	29,3	25,7	26,7	29,3	25,7	26,7	26,7						
USA	16,2	10,0	7,8	16,6	11,9	12,5	12,4	8,8	10,6	21,5	15,0	14,6	13,9	9,7	10,4	18,3	13,9	13,6	13,9	9,7	10,4	10,4	10,4	18,3	13,9	13,6	18,3	13,9	13,6	13,6						
JAP	0,4	0,5	0,7	5,8	9,2	10,8	5,8	9,5	9,7	4,8	11,5	14,8	8,7	6,6	6,0	5,1	8,3	9,6	8,7	6,6	6,0	6,0	6,0	5,1	8,3	9,6	5,1	8,3	9,6	9,6						
EXPORTS: EXTRA-EC TRADE (1)																																				
B	2,7	2,4	2,3	1,8	1,5	1,7	2,7	2,7	3,0	1,3	0,9	1,3	1,9	1,2	1,3	2,0	1,6	2,0	1,9	1,2	1,2	1,3	1,3	2,0	1,6	2,0	1,6	2,0	2,0	2,0						
DK	1,0	1,0	0,7	1,0	1,0	0,8	0,7	0,7	0,5	0,9	0,9	0,6	1,3	1,5	1,2	1,0	1,0	0,8	1,3	1,5	1,2	1,2	1,2	1,0	1,0	0,8	1,0	1,0	0,8	0,8						
D	8,6	9,1	8,6	6,2	5,6	7,1	7,2	6,6	6,8	3,5	3,8	6,0	7,7	7,0	9,3	7,9	6,5	7,8	7,7	7,0	9,3	9,3	9,3	7,9	6,5	7,8	7,9	6,5	7,8	7,8						
F	9,1	8,0	8,7	4,0	3,4	4,2	3,1	3,2	4,2	2,7	2,7	3,8	5,1	3,8	4,5	4,9	4,0	4,5	5,1	3,8	4,5	4,5	4,5	4,9	4,0	4,5	4,9	4,0	4,5	4,5						
IRL	0,4	0,2	0,2	0,2	0,2	0,3	0,1	0,1	0,1	0,1	0,1	0,1	0,3	0,3	0,3	0,3	0,2	0,2	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,2	0,2	0,2	0,2	0,2						
I	7,5	7,9	7,1	3,9	2,7	2,0	3,8	2,8	2,7	2,5	1,4	2,0	4,5	3,4	3,9	4,4	3,5	4,2	4,5	3,4	3,9	3,9	3,9	4,4	3,5	4,2	4,4	3,5	4,2	4,2						
NL	4,4	5,9	4,2	1,9	1,7	2,0	1,2	1,3	1,5	2,0	1,5	1,7	2,1	1,8	2,1	2,5	2,4	2,7	2,1	1,8	2,1	2,1	2,1	2,5	2,4	2,7	2,5	2,4	2,7	2,7						
UK	11,9	7,4	3,5	9,5	6,2	6,1	7,7	7,1	7,5	3,5	3,9	5,2	12,0	7,5	6,3	10,2	6,5	5,4	12,0	7,5	6,3	6,3	6,3	10,2	6,5	5,4	10,2	6,5	5,4	5,4						
EC-9	45,7	41,8	35,3	28,6	22,2	25,1	26,5	24,5	26,7	16,4	15,2	20,9	34,9	26,4	29,0	33,2	25,7	28,5	34,9	26,4	29,0	29,0	29,0	33,2	25,7	28,5	33,2	25,7	28,5	28,5						
USA	16,2	16,2	22,5	13,1	13,2	14,0	13,7	10,1	11,7	4,8	14,4	15,7	15,1	12,6	13,1	13,0	13,3	16,3	15,1	12,6	13,1	13,1	13,1	13,0	13,3	16,3	13,0	13,3	16,3	16,3						
JAP	10,4	17,4	19,7	5,1	6,8	5,9	6,5	9,4	8,4	2,9	2,2	2,3	6,8	10,4	7,6	6,1	8,6	10,0	6,8	10,4	7,6	7,6	7,6	6,1	8,6	10,0	6,1	8,6	10,0	10,0						

Source: Commission departments, based on OECD external trade figures

(1) For USA and Japan, not including trade with Community.

Table 10.7

Exports: total manufactured products
(average annual growth rate at current prices and exchange rates)

%

	<u>Intra-Community</u>				<u>Extra-Community</u>			
	68-63	73-68	78-73	80-78	68-63	73-68	78-73	80-78
B	12,3	23,4	13,4	17,1	9,9	19,2	14,7	16,9
DK	3,7	19,1	14,1	20,6	10,1	17,9	13,2	15,1
D	11,6	24,0	14,6	18,2	11,4	20,9	16,5	12,6
F	10,9	26,3	15,6	18,6	8,2	19,2	19,3	20,2
IRL	7,9	21,5	22,3	20,0	12,9	25,9	21,6	33,4
I	18,2	20,4	19,5	17,7	14,6	14,9	21,3	17,5
NL	13,1	23,9	14,2	18,5	10,2	18,7	17,4	15,4
UK	6,1	20,5	20,7	24,7	5,6	13,4	16,3	20,7
EC-9	11,4	23,3	15,8	18,9	9,4	17,9	17,3	16,7

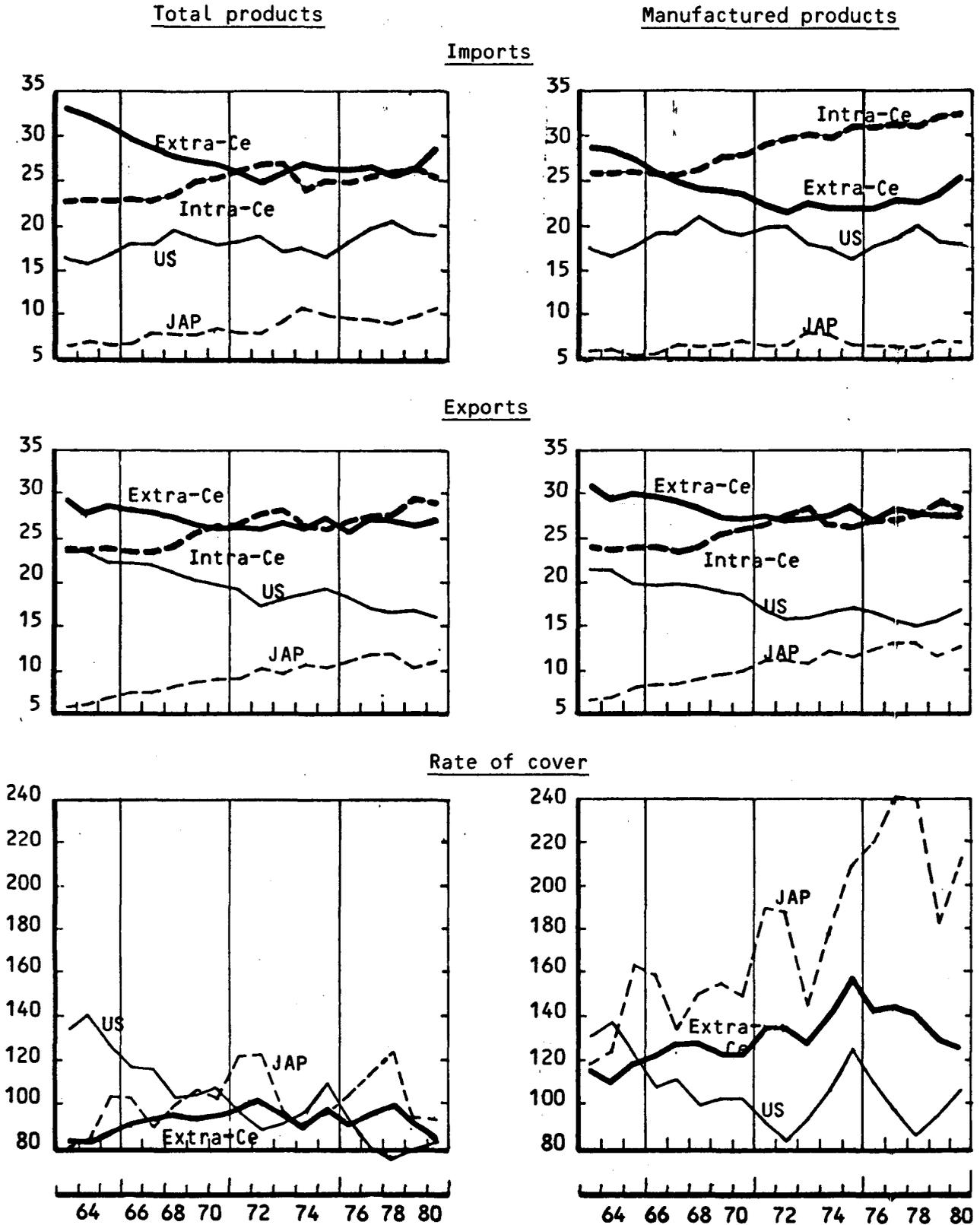
Imports: total manufactured products
(average annual growth rate at current prices and exchange rates)

%

	<u>Intra-Community</u>				<u>Extra-Community</u>			
	68-63	73-68	78-73	80-78	68-63	73-68	78-73	80-78
B	10,9	24,1	16,0	14,0	10,2	15,4	15,3	25,5
DK	7,8	18,5	14,1	8,7	11,0	20,6	11,0	9,9
D	13,8	24,4	15,5	16,7	8,5	20,3	18,1	23,1
F	15,7	23,1	14,6	20,3	6,2	21,0	16,3	26,9
IRL	7,0	20,3	19,6	21,4	8,7	18,7	23,1	21,4
I	6,5	26,4	12,5	30,8	3,0	20,0	11,2	33,2
NL	10,8	20,3	16,1	13,4	9,8	17,9	18,8	15,9
UK	10,0	21,5	20,2	21,8	7,3	13,8	12,7	21,8
EC-9	11,4	23,1	15,7	18,8	7,4	17,8	15,2	23,5

Source: Commission departments, based on OECD external trade figures

Graph 10.1 : MARKET SHARES IN OECD TRADE AND RATE OF COVER



Source : Commission services on the basis of OECD trade data