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European Dimensions in the
Adjustment Problems

Michael EMERSON

Internal paper



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Report presented at the Conference organized by the College of Europe (Bruges) and the Institute of European Studies (Bruxelles) on "EUROPEAN MONETARY SYSTEM AND INTERNATIONAL MONETARY REFORM"

Bruges, June 1981

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1. Introduction

The title which the conference organisers have given to my paper is not particularly transparent. 'Adjustment' is an ugly and loosely used part of the economist's lexicon. Moreover, when one looks at what it means in practice it is a rather uncomfortable business.

I interpret adjustment to mean changing an economy's performance and structure in order to lessen disequilibria such as in inflation, in the balance of payments and in labour markets, and to improve competitiveness and productivity when this is falling behind the standards of a relevant peer group of countries.

Its European dimensions may cover on the one hand those adjustment problems which are in some way special to Europe, and on the other hand techniques of policy action or coordination which may be organised at the level of the European Community to supply some remedy.

The central part of this paper concerns in fact both these aspects in the type of adjustments needed for a beneficial use of the European Monetary System. This concerns price stabilisation, balance of payments performance and monetary policy coordination, especially through the interdependence of interest rates for the latter.

While important, the EMS dimension does not give a rounded treatment of our subject. The paper therefore begins with a broader account of how the Community's economic policy system is developing, and where it may be heading. And a later section discusses a wider spread of adjustment policy issues that concern much of western Europe.

In discussing action in the framework of the European Community I distinguish three types:

- . 'Community action' through external negotiation, or functions based on Community legislation, financial instruments or other mechanisms;
- . 'hard coordination' in the sense of action by Member States linked closely to Community mechanisms, Decisions or Directives;
- . 'soft coordination' in the sense of action by Member States subject to influence by mutual demonstration effects and Community texts that define a common philosophy, or quantitative or qualitative policy guidelines.

2. Forms of Community action and coordination

2.1 The broad brush

Table 1 provides a schema of how the Community dimension affects the main domains of economic policy at present.

The external monetary functions are represented by the European Monetary System (EMS) and the Community's collective role in influencing policy of the IMF and in monetary relations with the other economic powers. I classify the EMS principally as hard coordination, since it operates through the interventions of national central banks according to precise Community rules. In part, however, it becomes a matter of Community action when central rates are realigned, when its credit mechanisms are used, or when the rules are changed.

In domestic monetary policy there is an element of hard coordination in that interest rate policies tend to follow very substantially from the dictates of the EMS commitment (we shall analyse this more precisely below). Softer coordination is seen in debate on the role and rigour to be given to domestic monetary policy, and in the choice of techniques in the setting of money supply or credit objectives having in mind the EMS exchange rate commitment.

Budgetary policy sees some Community action in the sense of the Community budget's small (2 1/2%) weight in the totality of public expenditure and taxation. It is occasionally the subject of hard coordination in the sense of a collectively organised and calculated shift in policy (e.g. July 1978 concerted action), or the negotiation of policy-conditional balance of payments loans. It is more often the subject of soft coordination in the annual adoption of budget policy guidelines by the Council.

Trade policy is the subject of negotiation by the Commission with third countries and in the GATT. This does not exclude activity at the Member State level, but where trade promotion or restraint efforts go beyond certain limits they are circumscribed by common rules. Competition policy sees certain legal powers vested in the Commission and Court of Justice.

Structural policies cover a mixed bag of activities - energy, sectors and industrial branches, regional problems, the promotion of investment etc.

Table 1: Schema of domains of Community action and coordination in economic policy

<u>Domain of policy</u> <u>requiring adjust-</u> <u>ment</u>	<u>Form of action with Community dimensions</u>		
	Community action ⁽¹⁾	hard coordination ⁽²⁾	soft coordination ⁽³⁾
external monetary	some	yes	-
domestic monetary	-	some	yes
budgetary	some	some	yes
trade and competition	yes	some	-
structural (energy, industrial, regional...)	some	some	some
incomes	-	-	some

(1) Community action ... external negotiation or functions based on Community legislation, financial instruments or other operational mechanisms.

(2) Hard coordination ... action by Member States linked closely to Community mechanisms, or Decisions or Directives.

(3) Soft coordination ... action by Member States subject to influence by mutual demonstration effects and texts defining common philosophy, and policy intentions in quantitative or qualitative forms.

Community action started with the vesting of large legal and financial intervention powers in the Commission and Council for steel, coal and agriculture. More recently, it has been growing through the investment financing in the domains of regional and energy policy (European Investment Bank, New Community Instrument for loans, as well as the Community Budget for interest-rate subsidies and grants). Hardish coordination is in evidence in the energy sector in the working out of quantified targets for energy interdependence, and in the monitoring of national regional aids. The present mandatory steel quota system is a strong Community action, preceded and likely to be followed for a while through hard coordination in the form of voluntary production quotas production quotas. Soft coordination (with hard edges) is present in the debate over degrees of interventionism in industrial policy more broadly.

Incomes policy is a major domain of soft coordination through mutual demonstration effects; it is arguable that the Community is and should be moving towards harder coordination over such questions as wage indexation and the adjustment of the working-time.

2.2 Macroeconomic policy coordination in more detail

The form of economic policy coordination has been continuing to evolve. In 1974, at the time of the move to the then-called 'second stage' of the programme for Economic and Monetary Union the general system of macro-economic policy coordination was considerably extended under the "Council Decision of 18th February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community".

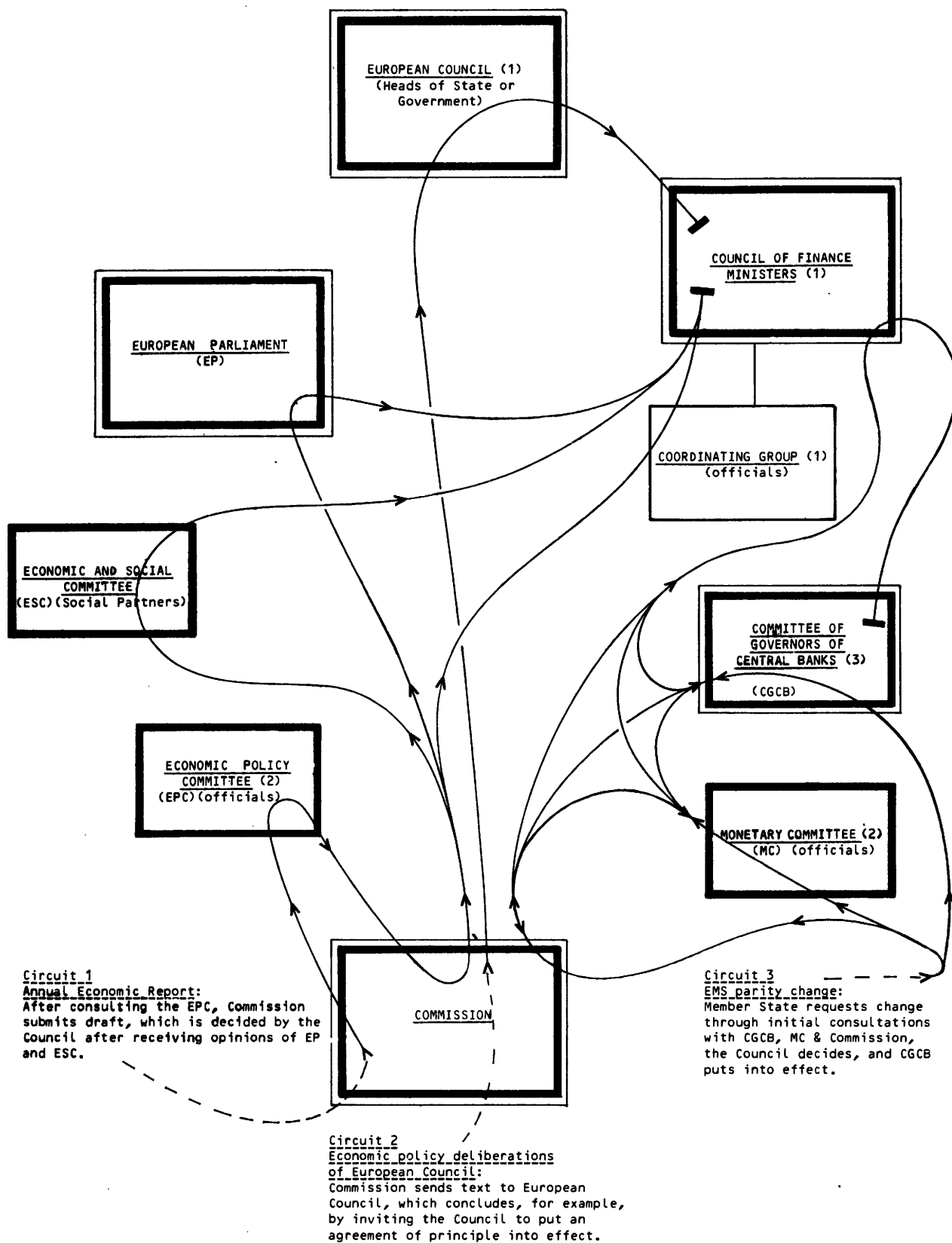
According to the Convergence Decision the Council of Finance Ministers shall meet monthly, preceded by preparatory meetings of the Coordinating Group (of high finance ministry officials, restricted to one per Member State). The yearly time-table of work is divided into the three seasons adopted in the Community's work: the autumn round (September to Christmas, the spring round (new year to Easter), the summer round (Easter to the August recess).

The most formal, general act of coordination is the process of adopting an Annual Report in the autumn round. Here the Convergence Decision required the fullest of Community procedures: proposal by the Commission, submission to Parliament and the Economic and Social Committee for Opinions, and finally Decision by the Council of Ministers.⁽¹⁾ Since the procedure takes about four months to complete (from preparation by the Commission of new economic forecasts by the end of September, to Decision on the text by the Council in December) it is hardly surprising that the Annual Report is not the vehicle for 'hot' coordinated decision-making. It should rather be seen as the vehicle for producing, through extensive participation of all the institutions, a common reference document, defining the current stance of policy in an ordered and comprehensive way with related economic forecasts and a quantification of budgetary and monetary policy objectives for the year ahead. It maintains a regular analysis and supply of selected statistics. In this way the Annual Economic Report is closer in function to the similarly named documents of the United States Council of Economic Advisers (CEA), or of the German federal ministry of economics.

The spring round is characterised by a simpler review of whether the policy stance adopted in the Annual Report is still appropriate;

(1) See circuit 1 in Graph 1.

Graph 1: Circuits of Economic Policy Coordination in the European Community



(1) Council presidency by Member State for six months, fixed country order for succession.
 (2) President elected from among officials of Member States for two years; Secretariat provided by Commission staff.
 (3) President elected from among governors for one year.

this is discussed in the Council of Finance Ministers generally in March. The summer round is characterised by a first confidential discussion of guidelines for budget policy for the following calendar year. All Member States now having a coincidence of calendar and budget years except the United Kingdom: a reform of U.K. budgetary practice at some stage, perhaps aligning both the tax and public expenditure processes together on the calendar year, would be helpful .

A new tier to these procedures was grafted on to the three annual phases of the Convergence Decision when the European Council (Heads of State or Government), decided in 1974 to install a fixed rhythm to their Summits, meeting towards the end of the three seasons in March/April, June/July and November/December. The established practice now is for the Commission to send a short Communication of the general economic situation to each of these meetings, and this conveniently emerges at end of each phase of work done in the framework of the Convergence Decision.⁽¹⁾

The summer European Council in turn now tends to be fitted in with the timing of the annual summit of the seven largest western industrialised countries, Bonn 1978, Tokyo 1979, Venice 1980, Ottawa 1981. The European Council tends to meet in June or July about 10 days before the western economic summit. Examples of the same economic dossiers being treated in the successive European and industrialised world summits are the budget policy adjustments of 1978, and the setting of energy policy targets in 1979.

The Convergence Decision of 1974 was perhaps over ambitious in that its procedures rested upon a now somewhat dated view of fine-tuning of budgetary policy, and an optimistic view the extent to which the locus of macroeconomic decision-taking that rests on national legislation and power might shift from the furnace of national politics to the conference chambers of Brussels. It may have misjudged budgetary policy to have been more of a candidate for hard coordination than seems to be the case. It nonetheless provides still the essential procedural infrastructure for general economic, as opposed to purely monetary, policy consideration.

Monetary and exchange rate policy has its own infrastructure, based on the twinned Monetary Committee (finance ministry and central bank representatives) and Committee of Governors of Central Banks (central banks

(1) See circuit 2 in Graph 1.

alone). The latter meets at the Bank for International Settlements at Bâle, despite a brass-plate location of the European Monetary Cooperation Fund(EMCF) in Luxembourg. The EMCF is essentially the accounting mechanism of the EMS.

Both these Committees meet monthly, handling a range of business that divides into three categories: (i) development and management of the European Monetary System, (ii) preparation of Community joint positions in negotiations in the IMF - for example over the role of the SDR and the adjustment quotas, and (iii) discussion of current issues of monetary policy coordination, for example interest rate policy.

When the European Monetary System was started, it was widely considered that the system of coordination should be strengthened. From the foregoing, it will be evident why it did not prove necessary to create any more Committees. More significantly, birth of the EMS had the following effects:

- (i) Exchange rate policy was brought back into the regular Community bodies, as opposed to being the preserve of a sub-club of central bankers meeting under the 'Snake' appellation (latterly only Germany, Belgium, Netherlands and Denmark);
- (ii) for the first time, Community budget and investment loan financing instruments were linked to the Community's monetary activities, notably to help the potentially weak currencies of the EMS ensure against adverse effects on their economic development;
- (iii) the divergence indicator was introduced, carrying with it two elements of Community doctrine:⁽¹⁾
 - (a) the objective of symmetry, or fair balance, for signalling which countries should be expected to adjust policy when exchange rates diverged;
 - (b) a sequence of possible actions for the divergent country, notably
 - interest rates
 - other policies
 - realignment;
- (iv) the emphasis put on the ECU, and on the use of Community currencies for central bank intervention (as opposed to the exclusive use of the dollar), has intensified awareness of the potential for a more strongly articulated policy vis-à-vis the dollar and yen, as regards exchange rates and interest rates.

(1) See circuit 3 in Graph 1 on the channels of consultation involved in EMS parity changes.

For completeness, one should add that the Economic Policy Committee has also tended to become more active, partly in preparatory functions in relation to the Council and Coordinating Group's regular cycles of work (e.g. reviewing short-term forecasts, partly with work on special tasks preparing, for example, as at present, a draft medium-term programme for 1980-1985, and in the recent past positions on aspects of energy policy, the adaptation of working time, and the role of the Community budget and loan finance in relation to the European Monetary System.

Looking to the future, I might hazard a few guesses as to how the European economic policy system in general might develop.

In the monetary area, the passing to the institutional phase of the EMS, with setting up of a European Monetary Fund (EMF) was scheduled for about now, but is already behind the time-table originally conceived. However, ideas have developed in the intervening period, and some of the potential next functions of the system are becoming clearer. They consist - in my schema - of passing more matter from the hard or soft coordination categories to Community action, centered round the potential functions of the ECU and the EMF. The ECU has potential for a fuller role in the transactions between Community central banks and in the structure of reserve assets; it has as yet unexploited potential for use in private international capital markets and for public bond issues by Community and national authorities in international markets; and for use in the coordination of Community central banking activity with that of other major monetary powers. These various functions would come together and have enormously greater potential if put together with an EMF having operational powers to execute market transactions in ECU denominated financial assets (see other conference contributors for more detailed ideas).

On budgetary policy, the experience of the mature federations suggests that the sharing of formal powers to decide state taxation and public expenditure is extremely difficult to arrange. Deficits financing by states tends to be heavily limited by the constitution or by the effective powers of the federal authorities. However, power to adjust local taxation and public expenditure tends to be left to decentralised decision-making, subject only to broad constitutional rules and to economic constraints (e.g. over-taxed localities lose population or enterprises through out-migration).

In the United States, the federal authorities regard the expenditure intentions of state and local governments as hardly more susceptible to influence than those of the private sector. In Switzerland, the Confederal authorities address to the cantons only the broadest general recommendations by way of budget policy guidelines. Germany has a more elaborate system for cooperation between Bund and Länder, although it still seems difficult in practice to dissuade Land and local government from procyclical investment expenditure when their tax revenues rise cyclically. In some federations, state budget policy is subject to episodic agreements on specific, concerted policy moves, and regular 'jaw-boning' on desirable priorities. By comparison the Community's existing procedure (under the 1974 Convergence Decision) for setting budget policy guidelines annually for all Member States is an ambitious arrangement. The 'concerted action' decision of July 1978 was a significant policy move taken in this framework, linked, it should also be added, to the Bonn Summit of the seven major industrialised countries of the OECD area. The decision in autumn 1980 not to respond to the second oil shock with compensatory demand expansionary measures also amounted to a significant collective orientation of policy (see Annual Economic Report 1980-81, European Economy, November 1980).

In the Community one could conceive of a greater use of policy-conditional credits to Member States, although one would expect Community Member States generally to be able to avoid getting into situations of such grave financial crisis that call for such IMF-type credits. The Community's own balance of payments loan facility has been used by Italy and Ireland in the past. Moreover, in the recent renewal of this facility in February 1980, the regulations governing this instrument were adjusted in the direction of enabling it to be used with varied form of conditionality at earlier stages of financial difficulty. However, it can be argued that other types of conditional credit and subsidies have a more promising future in the Community's institutional setting: on the one hand, grants or loans linked to projects of programmes of specific policy interest to the Community (e.g. energy, regional, manpower retraining), or, on the other hand, such arrangements as seen in the EMS whereby the acceptance of an exchange rate commitment is accompanied by a multi-year programme of grants and loans to boost the economic development of the less prosperous Member States. In the fiscal domain there are proposals for harmonised initiatives beyond the major VAT reforms already achieved. An energy consumption or import tax initiative was floated in 1980, and there are negotiations under way

concerning some other major excises (e.g. on beverages and alcohol where there are issues of trade policy).

On incomes and employment policies one could envisage some extrapolation of the Tripartite Conference (of which there were some first experience in the mid-nineteen seventies) for arranging European 'understandings' on wage bargaining as part of some wider concerted economic policy, for example in response to common external shocks of which the oil price rises have given painful examples. One obvious issue for concertation between the social partners and government in a Community aiming at monetary integration is that of indexation, and not only of incomes but also of other forms of contract and monetary asset. The question of adjustments to working time has also been pursued vigourously at the European Trade Unions Confederation, and this could come to be treated more operationally at the level of its European dimension.

These examples suggest that the Community's policy system may tend to grow up in part around a considerable variety of 'hard' monetary, fiscal and financial instruments linked often to both sectoral or micro as well as macroeconomic policy. In addition there will no doubt be continuing efforts to strengthen the broader 'soft' coordination of economic policy. However, this is likely to develop more through the succession of ad hoc episodes concerned with particular needs, than some kind of smooth osmosis through different dosages of power-sharing over the main instruments of budgetary policy. More likely is a framework for coordination which can episodically go hard in circumstances that deliver a clear benefit for some or all, and without entailing a permanent loss of power for national governments. Monetary policy would be the exception case, likely to move more into both hard coordination and Community action.

More generally the Community may be expected to operate under the Pareto principle of agreeing collective action which increases the net welfare of the whole through benefiting at least some Member States without inflicting a significant loss on any, or, if there is the danger of the latter, compensating the loser.⁽¹⁾ This principle is of course fundamental to all organisations

(1) e.g. the budgetary compensation paid to Ireland and Italy in joining the EMS.

governed more or less by unanimity rules. The Community's particular potential here is that it is a multiple purpose and multiple instrument organisation that should be able to exploit many opportunities, created by increasing interdependence, for useful action obeying the Pareto principle. Thus complicated negotiation around linked issues, sometimes decried as a malady of the European Community, contrasting with concepts of ideal collective behaviour, are to be expected as long as there is refusal of more extended majority voting. This degree of complication, with its admittedly unpopular aspects (lack of transparency, unclear links to basic political objectives), should nonetheless permit the Community to be useful where single purpose, or single instrument international organisations get blocked. However, Community action can over-burden itself by aiming too often at a simultaneous combination of immediate benefits and correspondence with a future stage of constitutional development. To be more selective and practical could, for example, mean concentrating on monetary union as the major candidate for future constitutional changes. Indeed, this is already the case: in several other domains (energy, industry, regional) where a 'Community policy' is being sought, no basic change in the constitution is at present envisaged. Only in the foreign policy area is there talk of a new Treaty (viz. Herr Genscher's ideas).

3. Adjustment centered around the European Monetary System

The premises behind the commitment to fixed but adjustable exchange rates in the EMS are that:

- exchange rate changes have become a weak instrument of balance of payments adjustment in the highly interdependent European setting;
- internal adjustments are therefore to be favoured as the basic rule, notably through stabilising nominal incomes and directing public finance policy according to a disciplined balance of resource allocation, demand and income distribution objectives;
- exchange rate changes also need to be minimised in Europe since they may amplify inflation differentials and damage investment because of the uncertainty they represent for enterprises.

It is generally recognized that in its first two years the EMS delivered, technically, what it was designed to provide:

- less variability in nominal exchange rates (see Table 2). The much increased intra-European exchange rate stability contrasts with the volatility of the dollar, yen and pound sterling over this period, and also with the exchange rate instability of participating Member States over a comparable period following the first oil shock. The figures suggested are quite striking. EMS participants' exchange rates were on average about as unstable as the dollar and the pound sterling in the years 1974 to 1976 after the first oil shock. In 1979-80 by comparison EMS participants' exchange rates varied by nearly one third as much, whereas the dollar and pound sterling remain precisely as unstable as in 1974 to 1976. The Swiss franc, which has unilaterally pegged itself to the DM has seen a similar stability performance to the EMS average. The yen, however, became more unstable in the second period.
- manageability of central rate adjustments where necessary. There was a general realignment in September 1979, a Danish devaluation in November 1979, and an Italian devaluation in March 1981.

However, this short-run satisfecit should not be allowed to camouflage the fact that the pursuit of necessary internal economic adjustments still leaves a great deal to be desired. Indeed, intensified adjustments are now

Table 2: Variability of major currencies against the ECU ⁽¹⁾

	1974	1975	1976	average 1974-76	1979	1980	average 1979-80
BFR/LFR	20,9	9,6	38,5	23,0	8,4	9,0	8,7
DKR	15,6	5,7	33,8	18,3	32,7	4,5	18,6
DM	16,9	7,7	42,7	22,3	8,6	9,6	9,1
FF	22,0	26,9	30,1	26,3	7,4	6,1	6,6
IRL	19,2	28,3	63,5	37,0	7,7	9,2	8,5
LIT	33,9	14,3	55,5	34,6	9,8	17,9	13,6
HFL	17,1	6,4	39,0	20,8	9,0	4,4	6,7
average EMS ⁽²⁾	20,8	14,1	43,3	26,3	11,9	8,7	10,3
UKL	19,2	28,5	63,3	37,0	32,2	44,7	38,5
FS	:	22,6	43,5	:	10,5	13,0	11,6
USD	25,7	47,5	20,1	31,1	28,1	34,4	31,2
Yen	:	:	34,1	:	87,5	82,1	85

(1) Coefficient of variation (standard deviation of end-of-month rates for each national currency against the ECU divided by the average rate for the year). Results multiplied by 1000.

(2) Unweighted mean

Source: Commission services.

urgently called for if the achievements of the EMS are not to be eroded.

I propose to review these problems in terms of the three prime determinants of exchange rate stability:⁽¹⁾

- inflation differentials
- interest rates
- balance of payments current accounts.

A fourth factor is the exchange market interventions of central banks which can be important especially on month by month basis. Moreover the accumulation or erosion of central bank reserves can often allow the authorities to lean against the wind for periods of years. However, a clear account of the intervention policies must await a more detailed and earlier availability of the relevant statistics than is so far the case. For the other main determinants of exchange rates Table 3 and 4 give an assessment of the present situation, in terms of upward, or downward, or neutral pressures. The overall picture is a mosaic of conflicting pressures, but this is hardly surprising since the exchange rates of EMS participants are by their nature equilibrium market rates, maintained in nearly fixed positions by an interplay of private market forces and central bank action.

(1) For a theoretical and econometric review along these lines see Rudiger Dornbusch "Exchange Rate Economies: Where do we stand?"; Brookings Papers on Economic Activity, 1: 1980.

Table 3: A quantitative assessment of influences on exchange rates in spring 1981

	Inflation ⁽¹⁾ performance: in percentages	Interest rates			Balance of payments current accounts: % of GDP		
	1981 (forecasts)	<u>nominal rates</u>	<u>real rates</u>		1981 (forecasts)	1981 comp- ared to 1970-80 average	1970-80 average
		short ⁽²⁾	long ⁽³⁾	long ⁽⁴⁾			
Germany	4,5	13,4	10,3	5,5	-1,6	-2,2	0,6
France	11,8	12,9	15,0	2,9	-1,7	-1,3	-0,4
Italy	18,7	19,0	18,1	0,5	-1,4	-1,3	-0,1
United Kingdom	11,0	12,6	13,4	2,2	0,3	1,0	-0,7
Belgium	6,2	17,0	13,6	7,0	-6,6	-7,1	0,5
Netherlands	6,3	10,3	11,4	4,8	-0,9	-1,9	1,0
Denmark	9,0	15,2	18,4	8,6	-3,6	-1,2	-2,4
Ireland	16,0	14,6	16,1	0,1	-11,4	-6,9	-4,5
Greece	21,5				-2,9		
EC	10,4	13,8	13,4	2,7	-1,5	-1,5	0,0

Source: Commission of the European Communities, European Economy, N°7 November 1980 and N°8 March 1981, and Supplement A, N°5 May 1981.

(1) private consumption deflator

(2) three-month rates at end of March 1981

(3) bond rates, average in March 1981

(4) deflated by 1981 forecast as in first column.

Table 4: A qualitative assessment of influences on exchange rates in spring 1981

	Relative inflation performance: $\pm 2\%$ over EC average	Relative interest rates $\pm 2\%$ over EC average			Relative balance of payments		
		<u>nominal rates</u>	<u>real rates</u>		current accounts $\pm 1\%$ of GDP over EC average	medium-term oil import dependence, projected trend	
	1981	short	long	long	1981	1981 compared to 1970-80 average (1)	1975-1990
Germany	up	-	down	up	-	down	down
France	-	-	-	-	-	-	up
Italy	down	up	up	down	-	-	down
United Kingdom	-	-	-	-	up	up	up
Belgium	up	up	-	up	down	down	down
Netherlands	up	down	down	up	-	-	-
Denmark	-	-	up	up	down	-	down
Ireland	down	-	up	down	down	down	down
Greece	down				down		

'up' = factor representing an upward influence on the exchange rate

- = factor representing a neutral influence on the exchange rate

'down' = factor representing a downward influence on the exchange rate

Note: All assessments are based on data appearing in Table 3, except for the last column which is based on Table 7.

(1) i.e. each country's change in 1981 compared to its 1970-80 average, compared to the corresponding change for the Community average.

3.1 Inflation differentials

The purchasing power parity (p.p.p.) theory holds that exchange rate changes will tend to cancel out differences in inflation rates. In the long-run (beyond 10 years) p.p.p. theory holds up quite well. On a short-run basis (say one year) it may be no guide at all. The important questions here are in what degree deviations from p.p.p. mean building up inevitable future exchange rate changes, and in what degree they reflect structural factors that can enable such changes in the terms of trade to be sustained.

The record of the Member States in relation to all industrialised countries over the 1970s is summarised in Table 4 using unit labour cost data. Of the four large Member States, the p.p.p. rule applied most exactly to Italy and France. In the Italian case unit labour costs rose on average 6,7% faster than in competing countries, against which the effective exchange rate depreciated 6,5% annually. In the French case (as in that of Denmark) a near average unit labour cost performance corresponded with approximate stability of the effective exchange rate. Germany, however, sustained a 2% annual average real increase of unit labour costs, with the 5% effective exchange rate gain going beyond the 3% relative decline in unit labour costs in DM compared to competitors in their currencies. The United Kingdom emerges from the decade as a whole with an even larger 4% real annual average increase in unit labour costs, the 7% relative unit labour cost rise in pounds being offset by only a 3% effective exchange rate depreciation. This real increase in costs occurred entirely in 1979 and 1980, after many years in which the exchange rate depreciated by more than the United Kingdom's relative unit labour cost increases. This reversal in exchange rate performance is much due to the combination of the oil price rise and a severe domestic stabilisation policy.

Among the smaller Member States, the Benelux countries have accumulated real unit labour cost increases of about 1% per annum, reflecting low cost increases but even stronger exchange rates. The Dutch case, like that of the United Kingdom more recently, reflects large terms of trade gains through the rise in the price of its natural gas, and so has not, unlike in the Belgian case, been accompanied by the emergence of a large balance of payments deficit. But since the Dutch gas reserves are now sharply declining, both countries are faced now at the outset of the 1980s with major problems of adjusting from positions of weak industrial competitiveness.

Table 5: Exchange rate changes in relation to differential trends in unit labour costs, 1970-80

	1.	2.	3.	4.
	Unit labour costs (1)	Relative unit labour costs (1) (2)	Effective exchange rate change(2) - = appreciation + = depreciation	Real relative unit labour costs (3)
	———— annual average percentage changes ————			
Germany	5,3	-3,0	-5,2	2,0
France	8,7	0,6	0,2	0,4
Italy	14,5	6,7	6,5	0,2
United Kingdom	15,2	7,3	3,1	4,0
Belgium	6,5	-1,3	-2,2	0,8
Denmark	8,1	-0,4	-0,2	-0,2
Ireland	14,9	4,6	3,2	1,2
Netherlands	6,2	-1,7	-2,8	1,0

(1) In national currencies.

(2) Relative to 17 principal OECD countries, trade-weighted.

(3) Column 3 less column 2 (more precisely, index numbers are multiplicative).

Source: Commission of the European Communities, "Unit labour costs in manufacturing", European Economy N° 8, March 1981.

Turning to present price performance, Table 3 reminds us that Germany and the Benelux countries are at present significantly less inflationary in terms of consumer prices than the Community average; France, Denmark and the United Kingdom are about average, and Italy, Ireland and Greece are significantly more inflationary than the average.

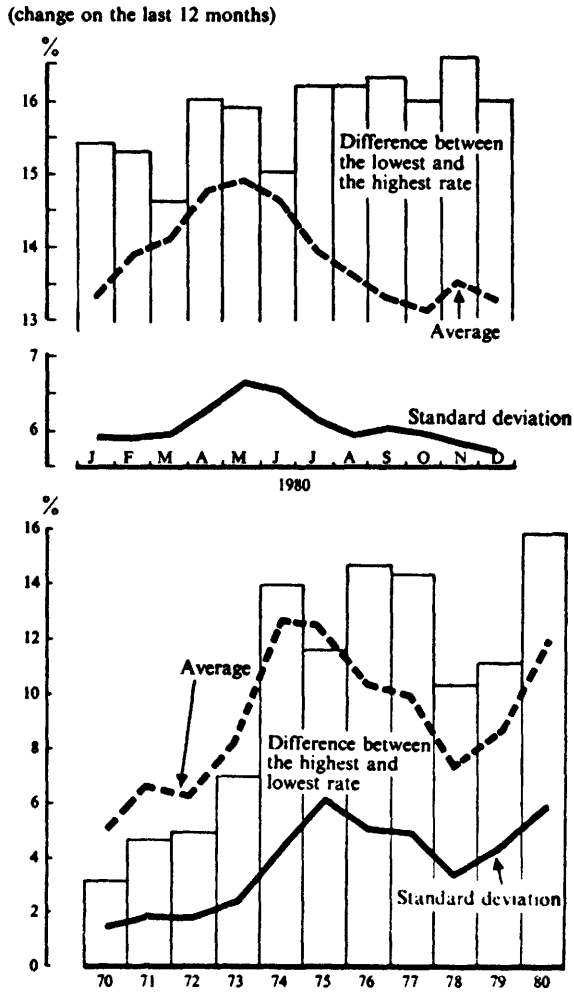
The Community's clear interest is in a downward convergence of inflation rates for at least three reasons: firstly, low inflation is a common economic objective, secondly, a convergence on low inflation is seen as a prerequisite for further monetary integration, and thirdly, the pattern of inflation differentials compensated by exchange rate changes is seen as being harmful to trade and investment within a highly interdependent economic structure like the Community. This makes it pertinent to examine trends in convergence performance of the Community as a whole, and the performance of individual Member States. Measured in terms of the standard deviation of consumer price increases, the average rate of increase, and the gap between the highest and lowest price increases, the evidence in Graph I points disturbingly to almost as severe a deterioration now in 1981 following the second oil shock as in 1974-75 after the first oil shock.

As regards individual Member States, the Benelux countries have kept closer to the German performance than in 1974-75 when they strayed for a while into more inflationary ways. The EMS and 'Snake' before it have certainly been important influences. Keeping to the 'Snake' in the mid-seventies prevented the Benelux countries from departing into a vicious circle of devaluation and inflation. But this also resulted, as mentioned, in their having to face the second oil shock in a weak competitive condition, and this in turn is curbing any new acceleration of inflation even more strongly.

France and Denmark have broadly speaking remained average performers on inflation, although a fairly strict incomes policy in Denmark may now be bringing somewhat improved results.

From the stand-point of the EMS, the trio Ireland, Italy, United Kingdom have offered a paradoxical spectacle. Ireland and Italy, have not improved their relatively bad inflation performance since joining the EMS. The United Kingdom, on the other hand, after staying out because of deflationary fears, has since introduced - with of course a change of government -

GRAPH 4: Consumer price index, average price increase and divergence indicators, EC 9



Source : European Economy N° 8, March 1981

the sternest anti-inflationary turn of policy of all Member States during the life to date of the EMS. An observer from Mars might be forgiven for assuming some accidental role reversal.

Income behaviour bargaining suggests a more favourable picture of convergence trends. One major difference between the 1980-81 episode, compared to 1974-75 after the first oil shock, has been de facto acceptance - revealed by the statistics - of an approximate pause in the growth of real wage incomes at present; whereas in 1974-75 real labour costs per unit of output grew in total by 5% causing a catastrophic fall in corporate profitability.⁽¹⁾ Moreover, the present real income pause is rather uniform as between Member States, as against big differences in 1974-75.

But the convergence in real wage bargaining results - while useful compared to the 1974-75 example, has not brought with it sufficient progress in adjusting nominal wage bargaining habits, or in accepting sufficient real wage adjustments in some of the least competitive and most inflationary Member States (e.g. Belgium and Italy respectively). Both these countries have not altered their comprehensive and rapid-acting systems of wage indexation on prices in spite of the new oil price shock. Denmark and the Netherlands, on the other hand, have taken some such steps to limit the repercussion of oil prices into wage inflation. A clear doctrine has been spelt out by the Community. Thus in the Annual Economic Report for 1980-81 the Commission argued in November 1980: "It remains highly desirable, nonetheless that such indexation mechanisms as do exist are used with sufficient flexibility or limitations to avoid passing on, into wages, unavoidable terms of trade losses, and to allow other necessary adjustments in income distribution or tax structure without causing extra inflation". The Finance Council for its part, adopted this language in its December Decision.

But by the spring of 1981 efforts to suspend wage indexation had brought the fall of the Belgian Government, while in Italy the Government has been endeavouring after the devaluation of the Lire on 23rd March 1981 to renew its efforts to persuade the social partners to limit wage indexation. The European Council of 23rd March 1981 for its part raised the issue very clearly in concluding: "High and divergent inflation rates are a threat both to the prospects of growth and to the economic and monetary cohesion

(1) "Annual Economic Review" 1980-81, Table 2.6, 'European Economy' N° 7, November 1980.

of the Community. In this context the European Council also discussed the effects caused by rigid systems of indexation of incomes and expressed the opinion that an adjustment of such mechanisms should be considered".

3.2 Interest rates

Interest rates have become the most powerful, short-term instrument of exchange rate policy in the European Monetary System. In principle, the monetary authorities try to maintain a relaxed enough exchange market situation to permit interest rate policy to be guided also by domestic economic objectives, including the pursuit of quantitative monetary or credit objectives. But two major factors keep interest rate policy in the front-line of exchange rate policy. Firstly, long-run interest rate differentials are needed to persuade international portfolio investors to discount inflation differentials and the likelihood at some stage of exchange rate adjustments; secondly, short-run interest rate differentials are the most powerful influence over the movement of foot-loose capital between convertible currencies. The amounts of capital moving across private international financial markets are often greater than those involved in central bank intervention and other officially organised capital movements.

Since no specific mechanism of interest rate coordination has been set up as a result of the EMS (the Bâle monthly gathering of central bank governors, and the Monetary Committee providing the continuing fora for discussions and exchange of information) it is worth examining whether there has been a de facto convergence in interest rate policies during the life of the EMS. Those close to policy-making feel this to be the case. Others may want more convincing. One compact way of presenting the evidence is through matrices of correlation coefficients between interest rates of the relevant countries, for both short and long-term assets, during the period before and since the EMS was set up. This data is set out in Table 6, in which the two-year period before the EMS begins with when France left the 'Snake', and the EMS period is from April 1979 to February 1981.

For short-time interest rates, which are the most crucial for exchange markets, the correlation of movements in the rates has been stronger. Indeed, as would be expected a priori, French and Italian rates have seen since the EMS started a radical increase in their correlation on average Community interest rates (from 0,13 to 0,96 for France, and from 0,29 to 0,79 for Italy). The increase in correlation of Franco-German rates has been equally imperative (from 0,05 to 0,84). Meanwhile the correlation of French and Italian rates on those of the United States fell from a high to a rather

Table 6 : Correlation coefficients between interest rates before and after introduction of the European Monetary System
 (Line 1 : March 1977 to March 1979 (before EMS)
 (Line 2 : April 1979 to February 1981 (since EMS)

Short-term interest rates (1)

	EC(2)	DK	D	F	IRL	I	NL	B	UK	US
EC(2)	-	.126	.535	.126	.534	.287	.537	.792	.628	.215
	-	.751	.917	.960	.460	.787	.794	.936	.904	.362
DK		-	.374	.234	.430	.067	.110	.019	.363	.196
		-	.558	.782	.629	.365	.619	.751	.790	.093
D			-	.049	.136	.641	.075	.245	.128	.240
			-	.844	.184	.833	.601	.794	.685	.445
F				-	.773	.579	.575	.309	.740	.803
				-	.557	.621	.791	.945	.866	.359
IRL					-	.375	.632	.495	.966	.782
					-	.080	.633	.651	.583	.185
I						-	.569	.136	.286	.800
						-	.483	.596	.668	.441
NL							-	.732	.633	.782
							-	.764	.779	.215
B								-	.558	.512
								-	.885	.385
UK									-	.723
									-	.153
US										-
										-

Long-term interest rates (3)

EC	-	.088	.779	.101	.451	.312	.700	.854	.614	.214
	-	.837	.903	.976	.366	.866	.950	.969	.765	.931
DK		-	.488	.433	.149	.278	.289	.213	.123	.365
		-	.651	.844	.213	.669	.770	.816	.739	.682
D			-	.623	.476	.111	.847	.745	.588	.319
				.817	.472	.677	.908	.808	.658	.825
F				-	.507	.701	.511	.204	.502	.865
				-	.395	.881	.914	.972	.693	.912
IRL						.548	.230	.370	.898	.410
						.003	.251	.221	.619	.274
I						-	.112	.251	.458	.878
						-	.824	.925	.490	.905
NL							-	.733	.331	.207
							-	.894	.640	.914
B								-	.453	.039
								-	.685	.925
UK									-	.345
										.639
US										-
										-

(1) Correlations were calculated on the basis of monthly average rates, for 3 month inter-bank money except for Italy and the United States (3 month Treasury bills), Belgium (yield of 4 month certificates of the Fonds des Rentes) and Denmark (day to day rates of the money market).

(2) National interest rates weighted according to their average effective weight in the ECU in 1979

(3) Correlations were calculated on the basis of monthly average rates of the yield of long-term bonds of the public sector.

low level. Some other, less dramatic increases in interest rate correlations call for a different interpretation, for example the stronger correlation of the smaller former 'Snake' currencies' rates on the DM, and the moderate increase in the correlation of United Kingdom rates on those of the Community average and DM. These weaker, more generalised increases in correlation would seem to reflect common influences originating outside the EMS, for example the need to respond to the new inflationary influence of the second oil shock. On the other hand, the collective decision to face this external shock with a concerted policy response was very much a matter of operational concern for the EMS. The EMS commitment having been established, the arrival of unexpectedly difficult circumstances in the shape of the second oil shock demanded of its participants a higher degree of policy convergence than in the preceding few years. Indeed, one could speculate whether the founders of the EMS might have had second thoughts on when to launch the venture, had they been armed with perfect foresight on the price of oil. However, that is now an academic matter, and in fact the policy response has been much more convergent and less accommodating. In the after-math of the first oil shock philosophies diverged fundamentally between on the one hand those who considered that the inflation impact was inevitable and that the demand impact should be compensated by fiscal policy, and on the other hand those who took a less accommodating view.

Movements in long-term rates have also become more strongly correlated, but here the greater intra-European convergence of movements has also been matched by closer transatlantic movements between European and United States rates. This would seem likely to reflect further, durable features of the economic scene, such as the rise in public sector deficits and the renewed acceleration of inflation.

Real interest rate differentials are fairly hazardous to compare, because of the uncertainty as to what period's inflation rate to use to deflate nominal rates; moreover, differences in tax treatment are also important but difficult to summarise simply. In spring 1981, high real interest rates were practised by Germany, Belgium, Netherlands and Denmark, reflecting strong defensive efforts to keep up the exchange rate and finance large balance of payments deficits. An extreme case was Belgium, with over 7% real long-term interest rates, helping finance particularly large balance of payments and public sector deficits. Denmark's long-term interest rates appeared to be highest in real terms, but this reflects income tax provisions which make for very much lower real after-tax rates in addition to balance of payments and public sector financing needs.

In the Irish and Italian cases the high rate of inflation is largely responsible for the negative real long-term rates: high nominal rates have disincentive effects on economic development even when the real rates appear to be low or negative. The United Kingdom and French real long-term rates were in early 1981 at the relatively 'normal' levels of around 2%, although the United Kingdom case is difficult to judge because of the rapidly changing inflation rate.

Illustrating the power of interest rate policy on exchange rates was the action of the Bundesbank in February 1981, when it decided that powerful action had to be taken to raise the DM's exchange rate from a position of weakness in the EMS and against the dollar. By various measures to limit the access of banks to central bank credit, short term rates were raised within two weeks by five points from 9 1/2% to 14 1/2% (thus raising real, short-term rates in Germany to the exceptionally high level of some 10%). With this action alone, and indeed long-term rates hardly increased at all, the DM was lifted from the floor almost to the ceiling of its EMS margins.

3.3 Balance of payments

One of the main features of aftermath of the second oil shock, compared to the first, is that almost all Community Member States have found themselves in heavy current account deficit - the only exception being the United Kingdom due to its oil endowment. Thus Germany, France, Italy and the Netherlands countries are all, in 1981, expected to have deficits of the order of 1 to 2% of GDP, while for Denmark, Belgium and Ireland very much larger deficits are forecast (3,6, 6,6 and 11,1% of GDP respectively). (See Table 3).

While the oil price rise has been a major influence, this should not persuade the Europeans (of the Community and other European OECD countries which are in similar situations) to ignore the disturbing fact that Japan and the United States have for their part much more balanced positions. The ECU's substantial depreciation against the dollar and yen over the twelve months to March 1981 (16% and 19% respectively) shows that exchange markets for their part have noticed this weakening in relative world trading performance of the Community.

As regards intra-European exchange rate movements, it is fairly evident how current account positions have been a major influence in the recent past, especially bearing in mind the thesis that exchange rate markets are particularly influenced by changes in traditional structural current account positions. Thus sterling's strength witnesses the relatively good balance of payments position of a country which traditionally has been deficit prone. Conversely, the DM's weakness until recently may have seemed surprising against a background of a current account deficit of a similar order of magnitude as those of France and Italy; but against Germany's traditional balance of payments strength the recent deficit experience has been relatively much more striking than that of several other countries. One may make analogous remarks on the Belgian and Danish situations. Belgian's new deficit experience (beginning in 1977, after a decade of uninterrupted surpluses) seems to have pushed the Belgian francs harder downwards than Denmark's experience of 'more of the same' (20 deficits out of the last twenty-one years) has affected the krone. The Irish pound's medium strength in the EMS despite Ireland's extremely large payments deficit seems to be explained in part by its structural familiarity (twenty-one deficits out of the last twenty-three years), but also by the fact that Community loans are covering a substantial

fraction of the deficit for investment project financing, and by the fact that the upward float of the British pound has meant a degree of effective exchange rate depreciation for the Irish pound.

Exchange markets are influenced by perceptions of how medium-term factors are likely to affect the evolution of balance of payments positions. The most notable and precisely observable of these at present is the trend of dependence on imported oil. Interesting data has recently been made available in the formulation of Community energy policy objectives for 1985 and 1990. Looking first at the Community's overall performance, the degree of energy dependence on imported oil is seen as declining quite substantially by 18 percentage points over a fifteen year period from 55% in 1975 to 48% in 1979, and 37% in 1990 (see Table 7).

Over the fifteen year period, the countries making most progress are Denmark (expecting to increase its indigenous gas and oil supplies) with a 48 point reduction in dependence on imported oil, United Kingdom with a 39 point reduction (but with the period of total energy independence in the mid-1980s not lasting to 1990), and France with a 29 point reduction (due essentially to its very ambitious nuclear programme). By comparison, Germany and Italy, both of whose nuclear programmes are subject to serious delays, are expected to achieve much smaller reductions in dependence on imported oil (11 and 14 points respectively).

Belgium and the Netherlands are also seen as falling behind the average energy independence position in the Community. The Netherlands, with Luxembourg, are the only countries whose degree of energy independence is likely to be weaker in 1990 than in 1975. In the Netherlands, the main explanation is the decline in natural gas production, insufficiently compensated by production from other indigenous supplies. The energy position of the Benelux countries underlines the urgency of these countries' needs to make rapid adjustments in other respects, notably to restore their industrial competitiveness and apply greater discipline to their public finances.

Table 7: Dependence of the Community on imported oil 1975-90 ⁽¹⁾

	1975	1979	1985	1990	percentages of total energy use
					change from 1975 to 1990
DK	90,7	73,8	50,5	42,7	- 48
D	50,6	50,8	43,3	39,5	- 11
GR	..	79,3	60,9	56,1	..
F	63,1	63,9	46,2	(34,0)	(- 29)
IRL	79,3	73,9	69,0	65,1	- 14
I	70,8	71,2	68,0	(56,4)	(- 14)
NL	45,4	51,3	(51,4)	(52,1)	+ 7
B	57,4	56,7	(51,4)	50,4	- 7
L	34,2	34,4	40,7	36,2	+ 2
UK	43,2	8,5	(-7,2)	(4,2)	(- 39)
EC	(55,0) ⁽²⁾	48,1	(39,4)	(37,2)	(- 18) ⁽²⁾

(1) Net imports of oil as per cent of gross inland energy consumption plus bunkers.

(2) 9 Member States.

Source: Commission of the European Communities, "Examination of energy policy objectives for 1990 and investment programmes of Member States", February 1981. Alternative projections for some countries were made for 1985 and 1990 and in the table the median point in the range is indicated for these cases (for which the figures are in brackets).

4. Other aspects of adjustment and convergence needed in the European economy

Important as monetary stability, and monetary convergence within Europe, is for the Community's sound economic development, it is not a sufficient or complete approach to our problems of economic maladjustment.

Europe is suffering some decline in world wide industrial competitiveness; the rate of growth of economic potential has slowed at a time that the demographic expansion of the work force has speeded up; its level of wage incomes and social benefits are among the highest in the world, and the momentum in the growth of public expenditure does not seem to have been arrested with the onset of slower growth. The very fast rise of unemployment, which is very likely to continue to 1985, poses an increasingly dramatic challenge, especially when viewed alongside another growth sector: that of the 'black' or submerged economy.

What is specifically European about this situation?

It is distinct from that of the United States which made very large gains in cost competitiveness over the last decade through depreciation of the dollar. The price of real assets and of labour became distinctly cheaper than in Europe, at least by comparison with the geographic core of the European Community (Germany, Benelux, France) with its high wage and social security costs. The tide of transatlantic direct investment flows which Servan-Schreiber wrote of a decade ago as the "défi américain" has turned. This may have solved one problem, that of preventing Europe from being bought up by America, but at the expense of seeing another emerge in its place - that of insufficient competitiveness. The United States on the other hand, share with Europe the problems of managing the problems of decline of certain old industries - especially steel - and of old city centres. But already here some of the solutions will have to differ: for example, Europe with its linguistic frontiers, high population density and regional affinities, cannot contemplate a pattern of economic redevelopment similar to that seen in the United States in the expansion of the sun-belt states and the writing off of old urban communities. Enlargement of the Community to the south may open up an image of a certain European sun-belt development in due course, maybe towards the end of the century, but not tomorrow.

The European situation is different too of course to that of Japan whose super-competitiveness in industry, and increasingly in its new, high-technology branches - alongside the super-competitiveness of some newly industrialising countries in more basic branches - is the mirror image of the European problem.

What remedies should Europe consider? The simplest to suggest would be an exchange rate depreciation of the ECU against the dollar and the yen. Already a large adjustment took place over the last year, albeit from end-1979 levels which were extremely low for the dollar and yen. With the EMS now having provided more organised intra-European monetary relations, it is both natural and possible for Europe to think in terms of a more deliberate exchange rate policy in relation to third countries. (Other contributions to the conference will elaborate on this). On the economic implications of this option, as in all currency depreciations, the hypothetical case of Europe depreciating against third country currencies entails a measure of new opportunity for increased export sales and employment, and a measure of cost in terms of aggravating inflation and a worsening in terms of trade, especially from a dollar-denominated price of oil. Some calculations from the Commission's COMET econometric model suggest that a 10% depreciation of the ECU might have the following effects for the Community as a whole, compared to what otherwise might have been the case. Four years after the depreciation, the effects would have accumulated to a 1/4% higher output level, 2% higher consumer prices, 1/4% higher employment and \$ 2 1/2 billion better balance of payments current account. While these output and employment effects are not trivial, the impact on unemployment remains very small in relation to its present total level of 7 1/2%. More fundamentally, these orders of magnitude suggest the remaining presence of structural economic problems going deeper into the economy than can be handled by an exchange rate change alone.

economic problems going deeper into the economy than can be handled by an exchange rate change alone.

A second set of remedies might start from the view that Europe's private economy has become sluggish in performance because it is encumbered by the excessive claims of an escalating public sector and social security and regulation system on the one hand, and by excessive and rigidly structured pay claims on the other; hence a low investment ratio, and an increasing share of the smaller total on rationalising rather than expansion-oriented investment. To be sure, there are considerable differences between the Community Member States on these scores, and the German and French economies have avoided the most damaging excesses seen elsewhere as regards an unchecked growth of public expenditure taxation and/or public deficits (viz. Belgium, Netherlands, Denmark and Ireland)⁽¹⁾ or in a debilitating militancy and disorganisation in trade union bargaining performance (viz. Italy and the United Kingdom), or various particular mixes of these economic and political ailments. Notwithstanding the diversity within Europe, I would suggest that these ailments are serious and extensive enough to make a deeper remedy than mere exchange rate adjustment, necessary.

These issues may be illustrated with a number of examples relating to sectoral, incomes, employment and budgetary policies where the European dimension influences the adjustment process.

The interaction of Community and national policy-making can be seen most clearly at present in trade and industrial policies affecting particular sectors. Thus in the steel industry, to take the most dramatic example, Member States and the Community have been deciding together on the degree and duration of restraint on internal and external trade to be accepted as a component of a strategy for reducing redundant capacity and redeploying labour into new industries. The Community dimension further extends into rules for limiting the subsidisation of operating losses, and into the provision of subsidies and loans for inciting new industries to move into the old steel regions and for retraining the ex-steel workers. Although the Commission's formal powers of intervention are particular in the steel sector, the same basic issues arise across a range of major old industries (ship-building, textiles etc.). The rules of trade, competition, and official financial intervention need to be set together and having done this together in the Community, part of the framework of a much wider set of policies has been conditioned.

(1) See Table 8 below.

On incomes, I have already discussed the inflation aspect above in the context of the stability of the EMS. Unfortunately, the problems run deeper than the objective of securing low nominal wage increases to achieve a low rate of price inflation. The Belgian case, in which the high unemployment now substantially exceeds the low inflation rate (10% to 6% respectively) is an example. Several types of evidence suggest that renewed attention be given also to the level of real wages in relation to the return on capital, on the fixing of wage relativities between skills on the level of real wages in relation to those in competing economies. The circumstantial evidence includes the high level of unemployment going together with the apparent exhaustion of Keynesian demand expansion as an efficient antidote, the rapid growth of the 'black' or 'submerged' economy, and the increasing tendency for the weaker investment performance to be itself devoted more to rationalisation rather than expansion (rationalisation, as reported by business surveys, largely meaning labour saving technology). If this diagnosis is correct, the antidote will have to be sought accordingly in a more flexible adjustment of wages to (a) the needs for higher corporate profitability (b) the needs for more flexibility in setting income differentials according to skills, and work experience, in addition to (c) the need for wage moderation to reduce inflation. The difficulties of a policy of this type would be acute in the early years when personal incomes would have to be depressed in real terms, until the positive employment response builds up, and so creates a renewed expansion of private consumption demand together with expansion-oriented investment. Other difficulties for the trade unions would be in a lesser uniformity in wage settlements, allowing wage differentials to move towards market-clearing levels. Some governments have tried subsidy measures aimed at bringing real wage costs for some categories more into line with economic realities,

ranging from permanent regional wage subsidies (a decade ago in the United Kingdom, now abolished), to 'temporary' employment subsidies for averting dismissals from companies or sectors in difficulty. The problem with such measures are ones of scale, cost and effectiveness. If the problem of unemployment is a massive one, the wage subsidies must either aim at a redistribution of unemployment more evenly across the population which may be useful but does not resolve the overall problem, or become extremely expensive. Over time there is scope for wage bargainers to absorb the benefit of the subsidy by adjusting upwards pay rates for the groups concerned. This then becomes symptomatic of the original problem of wage negotiation practises having failed to come to terms with economic realities at the enterprise or macroeconomic level.

This issue is typically one that needs analysis, debate and understanding at a European level, because it affects the overall mix of policies (monetary, exchange rate, budgetary, incomes) to be prescribed in response to stagflation and unemployment. However, the adjustment in behaviour over pay essentially calls for more decentralised, varied and market-oriented solutions.

The same is true for another prescription now commonly advocated to relieve unemployment problems: the adjustment of working time. There is no doubt that there is here a collection of techniques (the length of the working week, extent of overtime, length of holidays, flexible or earlier retirement, extension of part-time work, leave of absence from professional work) which could potentially have a very large impact on both the sharing of work more or less evenly between the population, and on the competitive capacity to provide employment in conditions of stability. In any discussion of work-sharing issues three principal conditions for a successful distribution of work between more employees and less unemployed have to be faced .

(i) Do the employees accept that hourly labour costs should not increase more than the resultant productivity gain? (ii). Is manpower with the right skills available at the time and place required to make up the shorter working time of others? (iii). Can work organisation be so arranged to avoid an increase in capital costs (e.g. can shift-work be adapted to prevent equipment and other overhead facilities being used less intensively?).

These conditions are demanding, but none less than common sense; especially if it is recognised that the European economy faces problems of weak

competitiveness and inflexibility to the needs of adjustment to economic efficiency. The issue of work-sharing practices has been put at the European level by the European Trade Union Confederation. It is again a paradoxical subject in terms of the level of bargaining unit at which it should be handled. The principles need to be debated and established at the European level, because of the scope for seriously affecting competitiveness if divergent approaches are followed. On the other hand, the conditions for a successful adjustment of working-time have to be worked out at the decentralised level of the individual shop, office and factory, subject to certain framework provisions at a national level (on pensions, the standard working week, etc.), themselves decided with a clear view of competitiveness considerations.

On public finance there are needs for adjustment of several types, ranging from some problems common to virtually all Member States to a number of seriously imbalanced situations. The first general problem is that the upward rise of public expenditure as a share of Gross Domestic Product does not yet seem to have been halted. The share rose from 32% in 1960 to 38% in 1970 and to 47% in 1980. There is no doubt about the genuineness of the social wants represented by these trends, with public health, income security and redistribution being the heaviest and fastest-growing classes of expenditure. The problem, of course, is to judge how fast or fully the satisfaction of these wants can be financed by the public sector without undermining the growth of productive potential of the economy, and thus the capacity to pay for social services and objectives in non-inflationary ways. A related problem is how far these trends can go before inducing two serious labour market ailments that weaken economic potential. The first of these is an increase in the volume of voluntary unemployment or withdrawal from the labour force where social security incomes have become a substantial or high fraction of the post-tax income of the available wage income. The second is the inducement to work in the 'black' economy in ways that escape social security contributions and taxation, which often means work of a very low level of productivity. This malady is particularly grave in the extreme case, which reportedly exists in Italy in more than trivial numbers, whereby government employees obtain social security coverage from their official employment, while combining abstenteeism and spare time to take also 'submerged' employment.

Table 8: Public finance aggregates in 1980, percentages of GDP

	<u>General government</u>			<u>Central government net borrowing requirement ⁽²⁾</u>
	<u>Expenditure</u>	<u>Receipts</u>	<u>Net borrowing ⁽¹⁾</u>	
Germany	46,4	43,3	- 3,0	- 3,3
France	46,5	45,6	- 0,9	- 1,1
Italy	46,0	37,4	- 8,5	-11,1
United Kingdom	43,9	41,2	- 2,8	- 3,6
Belgium	53,4	45,2	- 8,2	- 6,9
Denmark	56,2	52,7	- 3,5	- 6,1
Ireland	55,1	42,3	-12,8	-13,6
Netherlands	59,3	57,0	- 2,3	- 3,9
EC	47,3	43,8	- 3,9	- 4,3

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

(2) Budget accounts, including loans and participations

Source: Commission of the European Communities, "Annual Economic Review 1980-81",
Table 4.2, European Economy N° 7, November 1980.

The small Member States (Denmark, Belgium, Netherlands, Ireland) now stand out for the extremely high levels to which they have carried public expenditure (all in the range of 53 to 59% of GDP), and various manifestations of how this has affected the labour market are evident enough: in Belgium, married women have until recently been entitled to unemployment benefits without time limit and without income constraints based on family income; in the Netherlands, the percentage of persons registered and compensated as being handicapped has risen to an extraordinarily high fraction compared to other countries (this has happened too in Italy); in Denmark, there are sizeable group of unemployed persons complaining about problems of dispatch of their benefits to Majorca. The adverse employment effects of exceptional largesse in public finance policies are probably only to a small degree reflected in various unemployment anomalies like those quoted, compared to the macroeconomically more significant effects coming through with very high taxation and interest rates.

Italy, Ireland and Belgium stand out for the exceptionally high levels of their public sector deficits, now approaching 10% of GDP or more. The deficits have grown for a combination of reasons: commitment to investment and employment oriented policies (Italy and Ireland) and difficulties in maintaining governmental majorities (Belgium, Italy) able to take restrictive measures to counter the automatic tendencies of current public expenditure to grow very fast. It now seems beyond any reasonable doubt that the sustainable, employment-boosting potential of public finance policy at this level of deficits is reduced to zero or even less. The disincentive effects of very high real interest rates for private investment are undoubtedly very serious in Belgium. In the cases of Italy and Ireland where inflation and the nominal rates are high but the real rates are low, interest rate payments in the budget have come to represent a large share of the total public sector deficit; since these payments largely represent compensation to bond holders for the erosion of the real value of their bonds, they may more correctly be interpreted - economically - as advance repayments of capital by the public sector. Thus the real stimulatory value for the economy of these rising deficits is highly questionable.

The case of the United Kingdom at present stands on its own, by contrast, as the most strenuous example of an adjustment policy combining severe public finance policies with a very high exchange rate which thus forces exceptionally hard adjustments on the private sector exposed to international competition. The particular combination of policies is made feasible by the favourable impact of the oil sector on the balance of payments. The policy accepts the transitional costs of adjustment. In the course of so doing, we learned recently, for example, that the productivity of the Welsh steel sector has been doubled in the course of the year. While this example is hardly typical of the economy as a whole, it is a reminder of the scale of an effort which might in a few years raise British industrial productivity an enormous step up to the level of the European average - where it has every reason to be in any case.

Conclusions

I summarise by trying to answer three questions.

(i) Who is trying to adjust in relation to whom in Europe? Who should be adjusting on whom? The adjustment standard within the Community seems to be a mixture of on the one hand the Community average and on the other hand Germany. A country with a Community average performance in terms of inflation, the balance of payments and interest rates can expect to lie relatively comfortably in the middle of its EMS margins, and various mechanisms give some normative status to the average, for example the functions of the ECU as numéraire for EMS parities and in the divergence indicator. But the German model has the great merits of representing the best performance for stabilisation, employment and living standards. Germany's economic policy philosophy has gained adherents in recent years such that it is now regarded widely as a balanced mixture of monetarism, supply side and demand policy, coupled to an active but non-interventionist pursuit of social consensus over income bargaining. As regards the wider world, the Community has to adjust in relation to the competitive strengths of the United States, Japan and the newly industrialised countries, and certainly to strengthen its global performance. However, each of these three groups seems to offer only partial and in several senses more distant models for the Community to relate to.

(ii) Is Europe succeeding in its processes of adjustment and coordination? As regards its most concrete objective of nominal exchange rate stability and the techniques of central banking policy to assure this (through interest rate management and market intervention), the answer is so far yes, although there is ample scope for more developed techniques of coordination here. The same is true of the management of central rate realignments. As regards balance of payments performance, the major countries are in relatively compatible situations. But some of the smaller countries need to adjust harder and faster; this is also true, in milder degree, of the whole Community vis-à-vis the rest of the world. As regards energy adjustment, substantial progress is under way, taking a ten-year view, but there are some laggards. As regards basic perceptions of what mix of monetary, budgetary and structural policies are now called for, the situation has been far more convergent than after the first oil shock. A multi-policy philosophy predominates along the lines of the German model, with the extreme propositions of single-policy predominance (monetarist or Keynesian) having now relatively few adherents. However, the gap between policy attitudes and policy performance is wider, and some countries need now to adjust budgetary policies and rigidities in pay bargaining practices (indexation etc.) harder and faster if reality is to keep touch with objectives. Given that the EMS virtually imposes a convergent set of monetary policies, failures to control budgetary policy as firmly has led to some badly distorted policy situations, with inflated budget deficits representing neither an effective demand management policy nor a productive investment for national savings.

(iii) Should the Community's coordination system work around a more elaborate set of negotiated, quantified targets for policy variables (money supply, public finance) or the final objectives of policy (stabilisation, output, employment)? In terms of hard, collective commitments, the exchange rate is probably enough. Several Member States also set objectives for money supply, but there has to be an element of compromise for money supply and exchange rate objectives to live together: in Germany this is assured to the extent the DM tends to carry the EMS with it in floating against the dollar. Moreover, the Bundesbank thus sets the main point of reference for monetary policy in Europe. But otherwise there are too many determinants of exchange rates, and too many unknowns in the course of the economy to make it a plausible proposition to seek to bind national economic policy into multiple fixed commitments at a Community level, for example for the budget deficit. Moreover the track record of governments in setting growth, price and unemployment targets for multi-year periods has

become so poor as to have made this too an unattractive proposition for the time being. On the other hand the Community continues to forecast or project all these variables for the purpose of monitoring policy, and discussing options. Governments need too to make medium-term public finance plans, but their implementation has to remain a national responsibility alongside the legislative powers concerned. There should be continuing scope for episodic bursts of hard coordination to produce better solutions to specific problems; I would stress 'episodic' because of the need to avoid overstretching the very concept of coordination, or confusing it with a transfer of powers. Policy responsibilities should be kept close to the instruments of action. Power-sharing is not easy to arrange efficiently. The Community can and does help set several of the major rules of the game (trade, competition, exchange rates) but Member States then have to work out their own political and economic preferences within these constraints. Thus soft coordination remains a basic part of the present European constitution; hard coordination will tend to be specialised by policy domain or episodic; Community action is infiltrating into several policy functions (monetary, structural). This process at times reaches road-blocks which can only be surpassed by major political decisions on Community mechanisms (the EMS was the most recent, and an EMF could be the next), but there are also recurrent opportunities for useful Community action that can be reconciled with the basic constitution of powers, or at least a controlled shift towards a more substantial European dimension.