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Economic trends and prospects

Industrial labour costs
Medium-term budget balance
and the public debt
The issue of protectionism

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'EUROPEAN ECONOMY' appears four times a year, in March, July, September and November. The November issue contains the Commission's proposal for the annual report on the economic situation in the Community. This report, which the Council adopts in the fourth quarter of each year, establishes the economic policy guidelines to be followed by the Member States in the year that follows. The November issue also contains the Commission's annual economic review, the background analysis to the proposed annual report. In March and July of each year, 'European Economy' gives a review of the current economic situation in the Community, together with reports and studies on problems of current interest for economic policy. The September issue presents a report on the Community's borrowing and lending activities in the preceding year.

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— Series A — 'Economic trends' appears monthly except in August and describes with the aid of tables and graphs the most recent trends of industrial production, consumer prices, unemployment, the balance of trade, exchange rates, and other indicators. This Supplement also presents the Commission staff's macroeconomic forecasts and Commission communications to the Council on economic policy.

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Contents

Abbreviations and symbols used

Countries

B	Belgium
DK	Denmark
D	Federal Republic of Germany
GR	Greece
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
UK	United Kingdom
EC	Total of the Member States of the European Community
EC 9	Community without Greece

Currencies

BFR	Belgian franc
DKR	Danish krone
DM	German mark
DR	Greek drachma
FF	French franc
IRL	Irish pound (punt)
LIT	Italian lira
LFR	Luxembourg franc
HFL	Dutch guilder
UKL	Pound sterling
ECU	European currency unit
USD	US dollar
SFR	Swiss franc
YEN	Yen

Other abbreviations

ACP	African, Caribbean and Pacific countries
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
NCI	New Community Instrument
OCTs	Overseas Countries and Territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SMEs	Small and medium-sized enterprises
SOEC	Statistical office of the European Communities

Economic trends and prospects 1983-84

Contents

List of tables

The Community economy

Introduction

The new forecasts for 1984 prepared by Commission departments[1] are particularly interesting: they show that the Community is emerging from the recession that began in 1979. Provisional results for 1983 confirm this impression: they show a distinct improvement compared with the forecasts made this time last year (see *European Economy* No 15). Real gross domestic product in the Community has expanded by 0,8% (forecast: 0,4%); the increase in consumer prices is much less than in the forecast (6,2% instead of 8,6%); the balance of payments on current account is virtually in equilibrium (forecast: a slight deficit of 0,3% of GDP). Unemployment, however, at 10,6% of the labour force, has developed precisely as predicted last year.

The improvement in domestic demand, especially private consumption, that had already been observed in several countries early in 1983 was reinforced and amplified in the second half-year by a clear acceleration in exports. Despite persistently weak demand from developing countries, the Community's sales abroad are climbing rapidly thanks to economic recovery in North America and the strength of the dollar.

The improvement in external economic conditions is having favourable effects on business investment despite high real interest rates. The continuation of economic policies designed to reduce inflation will allow private consumption to increase steadily in 1984.

The essential conditions for more rapid growth in the Community in 1984 (2,5%) are therefore apparently fulfilled. But there is still a danger that the incipient recovery will be checked. Inside the Community, trade between the Member States cannot play its dynamic role fully and continuously unless all the member countries manage to loosen the constraints imposed so far by domestic or external imbalances. Outside the Community, the future development of the dollar is problematic, because of US fiscal and monetary policies, while the financial situation of many developing countries is still precarious, so that there is no guarantee that world trade will continue to expand smoothly.

If the Community economy is to remain dynamic, it must make its own contribution to the development of world trade in conditions of new-found stability. The economic problems which arise in the search for such an outcome are examined in greater detail at the end of this chapter.

[1] For previous forecasts, see *European Economy* No 18, November 1983, Annual Economic Report 1983-84, Annual Economic Review 1983-84.

World economy, trade and international payments

Economic growth returned to the world in 1983. The first signs of recovery appeared in the United States late in 1982, following a sharp fall in interest rates.

In the course of 1983, other industrialized countries, notably Canada, Japan and, later in the year, some Community countries, gave a positive thrust to world trade.

The problem of the indebtedness of developing countries became less acute as rescheduling agreements were reached for the principal debtors, which led to a gradual attenuation of the fall in their imports.

The marker price of oil was reduced in March 1983 and remained stable thereafter, whereas the prices of other primary commodities showed a fairly strong upward movement.

Prospects for world trade in 1984 seem on the whole to be favourable. Import demand in the United States remains vigorous, and will strengthen in other industrialized countries, especially in the Community and other European countries. Even the purchases of developing countries, which declined for most of 1983, will begin to increase again in 1984.

The trend of primary commodity prices will continue to grow, in view of the firmness of demand, but a rise in crude oil prices is not to be expected unless an exceptional event arises.

The recovery commenced in the United States towards the end of 1983, when, following a relaxation of monetary policy, nominal interest rates fell rapidly. The reduction in interest rates imparted fresh impetus to residential investment, which increased quickly in real terms in the last quarter of 1982 and the first half of 1983. Personal consumption expenditure followed suit, achieving a 10% rise (s.a.a.r.) in the April-June quarter. Meanwhile the stock-cycle was turning upward, and in the third and fourth quarters of the year business investment registered substantial increases. Thus the economy followed a conventional recovery path. The principal brake on GDP growth has been the weakness of the external account, which manifested itself mainly in the second half of the year, when the trade deficit doubled to USD 45 000 million, as compared with USD 23 000 million in the first half, because of a very rapid increase in imports.

The force of the recovery was surprising as it had been thought that the level of interest rates, which were substantially higher—both in nominal and in real terms—than at the initial stages of earlier recoveries, would dampen the growth of consumer credit and industrial investment. While it is fairly clear that certain interest-sensitive and export-oriented industries and services have not participated fully in the expansion of activity, the underlying dynamics of the cycle were sufficiently powerful to ensure that the majority of industrial and service activities were able to expand normally, so that both capacity utilization and employment rose steadily during the year.

The level of interest rates, which drifted gently upwards during the year, owed much to the conflict between budgetary and monetary policies. In effect, little was done during the year to reduce the federal budget deficit, either for fiscal 1983 or for the future; monetary aggregates, after a disturbance due to the introduction of several new forms of interest-bearing sight accounts which led to an upward revision of the M1 target range early in the year, were eventually steered back within limits.

In effect the influence of the high and rising level of interest rates, the spectacular reversal of net international lending by US banks, the strength of the recovery, the fall in inflation, the buoyancy of the stock market and the security of investment in the United States were all factors supporting expectations for a strong dollar, and thus produced an inflow of capital which more than compensated for the deterioration in the current external balance. Thus the effective exchange rate of the dollar appreciated by 5,5% during the year.

Although upward pressure is still being exerted by the real interest rate differential between the United States and the other main investment markets, the deteriorating balance of payments situation is widely expected, sooner or later, to lead to a fall in the dollar. In 1984, interest rates are more likely to move upward than to fall, as there is little prospect of a satisfactory solution to the persistent problem of the conflict between budgetary and monetary policy.

The President's budget, presented on 1 February, forecasts a federal budget deficit of approximately the same magnitude as in 1983, and continuing deficits reaching into the future in the range USD 180 000 million to USD 220 000 million, on assumptions which, to the majority of observers, seem overly optimistic with regard to GNP growth, inflation and interest rates. Nevertheless, by 1989, even on these assumptions, the deficit will be wholly attributable to structural imbalance, due largely to the increase in interest payments on the accumulating national debt.

The Federal Reserve Board, on the other hand, has continually emphasized the importance of reducing the budget deficit, and indicated that monetary policy will not be relaxed in order to accommodate it. Indeed, the monetary targets announced for 1984 are somewhat lower than the expected growth of nominal GNP. In 1983 new private investment was financed mainly from the retained profits of companies, which were buoyant as a result of greatly increased sales and very moderate rises in labour costs. In 1984, however, enterprises are likely to make greater demands on external sources of finance. Thus, with a growing private demand for loanable funds added to the already large public demand, the upward drift of interest rates which occurred in 1983 will probably continue—and may be accentuated for a time—in 1984.

The strength of the dollar, which has substantially reduced the competitivity of United States industry, and the fact that the United States was the first country to recover from the recession, gave rise to a rapid penetration of the American market by imports of manufactured goods. The trade deficit, which reached almost USD 70 000 million in 1983, is widely expected to exceed USD 100 000 million in 1984, a deterioration which would in normal circumstances tend to diminish the stability of the currency. Overvaluation of the dollar has been variously estimated in the range 20 to 35%.

In Japan the authorities expected 1983 to be a lean year, because of the contraction of world trade, and hoped for an increase in internal demand which would compensate for the shortage of export opportunities. A fiscal expansion presented difficulties as the government had already embarked on a programme to limit public expenditure, a quarter of which is covered by borrowing. In the event, domestic demand rose by less than 2%, but merchandise exports recovered very rapidly, partly as a result of the growing US external deficit. The external trade surplus for the year 1983 was strongly positive at USD 31 600 million, notwithstanding the growing strength of the yen against currencies other than the US dollar, and the fact that a wide range of Japan's most competitive exports were subject to restraint. Towards the end of the year a proposal was made to stimulate internal demand by increasing direct tax allowances, but this move is likely to be counterbalanced by a rise in indirect taxes in 1984.

In 1984 the growth of exports is expected to continue, possibly at a reduced pace, giving some stimulus to investment and thus to internal demand. Fiscal policy is likely to remain conservative, with a fall in government consumption. It would therefore appear that the government is relying on the private sector to bring about the higher growth expected in 1984. Deregulation of financial markets is continuing slowly, and a quickly growing import penetration, though frequently discussed and to some extent fostered by government measures, seems difficult to achieve in practice because of various constraints.

In the course of 1983, the majority of European countries outside the Community returned gradually to an expansionary path. This trend, which allowed them, as a group, to achieve a growth rate higher than that of the Community was the result partly of a change in policy-mix by some of them, and partly of the effects of the recovery in North America. In some countries there was a substantial improvement in net exports: in Sweden, Portugal and Spain it was due mainly to better competitivity, and in Norway to an exceptional increase in oil production. The recovery was accompanied by a slow-down in inflation, which nevertheless remained significantly higher than the OECD average in all these countries except Switzerland and Austria, and also led in the majority to a progressive stabilization of the level of employment, but not by enough to avoid any increase in unemployment.

The expansion of activity is expected to continue in 1984, and strengthen somewhat in the majority of countries. In the absence of a dynamic increase in investment, the recovery will depend principally upon the pace of development of international trade and notably that of the OECD. The external balance of this group is expected to improve further, but less rapidly than in 1983. The inflation rate is likely to stabilize, but often at a high level, except in Sweden, where price increases will become significantly less. In most countries, the recovery should check the growth of unemployment.

After the steepest contraction of economic activity since the 1930s, Canada enjoyed a strong recovery last year triggered mainly by a significant decline in interest rates and an easing in fiscal policy. Inflation showed a sharp deceleration, while employment recovered and the current balance remained in slight surplus. In 1984 growth of real GNP should accelerate somewhat with unemployment falling a little further. Inflation gains should be consolidated as wage increases are expected to be in line with price evolution and the exchange rate of the Canadian dollar should only vary within a narrow range. This should enable the monetary authorities to maintain the present policy stance, while at the same time progress should be possible in reducing the huge budget deficit.

Australia, on the other hand, entered the recession relatively late. After a negative growth in the first half of 1983, a very rapid upturn occurred, aided by a devaluation of the Australian dollar implemented by the new government elected in March. Prospects for 1984 include a continuation of rapid growth, a further moderation of inflation, and an improvement in the external account.

The (mainly Latin-American) international debt crisis, which had become acute in 1982, was still dominating the world economic scene in 1983. There were signs, however, that the mechanism for rescheduling was beginning to work, even though it placed unaccustomed strains on the international banking system. The crisis has passed, but the problem remains. Mexico and Brazil, the two largest debtors, have already arranged a second rescheduling, but a number of other countries, notably Argentina, are still negotiating, having already failed to meet interest demands on time. Although more permanent solutions to the problems have been proposed, none has as yet been adopted. In the meantime all the major debtors, by restricting internal demand and by currency devaluations, have improved their external balance by a cut in imports, amounting sometimes to as much as 50%, which was not, however, sufficient to offset their debt-service payments. In 1983, the total external debt of Latin America is estimated as increasing from USD 290 000 to USD 310 000 million. Thus new credit will be required by the indebted countries, at least until the full effects of the improvement in world trade are felt and interest rates decline.

Nevertheless the flow of international bank lending was severely reduced in 1983 as a result of the perceived risks and the cessation of OPEC surpluses, a ready source of loanable funds in the past.

Not all developing countries have been in difficulties. Most Asian countries were either less indebted than those of Latin America, or had already taken remedial action in time, and were thus well-placed, by reasons of dynamically expanding manufacturing sectors, to take advantage of the export opportunity offered by the US trade deficit.

Following the readjustments in 1983 the prospect of a continuation of the world economic recovery in 1984 gives reason to hope that the situation of the indebted countries will continue to improve. However, it would be unwise to overlook the many protectionist measures that have been instituted during the recession, the persistence of the debt carried forward from the past, the growing queue of candidates for rescheduling, and the reluctance of banks, particularly the smaller ones, to continue to participate in lending to developing countries, or to count on the continued passivity of populations whose standard of living has been severely reduced.

The oil market was in turmoil at the start of the year as oil companies ran down their stocks in anticipation of a price cut. In March OPEC agreed on a new pricing structure around the marker price for Arabian light of USD 29 per barrel, a drop of USD 5 on the previous cartel price. To support this price decision, quotas were agreed restricting

OPEC output to 17,5 million barrels per day (mbd). An unusually mild winter in the northern hemisphere caused OPEC to reduce its production to less than 16,0 mbd in the first quarter, but thereafter production rose to average 18,1 mbd over the whole year. Free-world consumption of oil fell by about 2% to an estimated 43,3 mbd in 1983 while economic growth was about 2%.

This implies a fall in energy intensiveness of some 4%, as new investment made after the two oil price shocks continues to reduce the use of oil in economic activity. Strong economic growth in 1984 is expected to counteract this downward trend in oil consumption, but as non-OPEC countries will continue to produce at a high level, any shortfall in demand will be met by a reduction in OPEC output. OPEC's price and quota structure, which seemed precarious in March, has proved durable even though the rising dollar has cancelled out the effect of the price cut in Europe. A fall in the value of the dollar would help OPEC to maintain its prices through to the end of the year.

The dollar prices of commodities other than oil rose slowly in 1983, following the recovery of the world economy, particularly in the second half of the year. Starting from a very depressed base, prices recovered somewhat in the first half in anticipation of increased demand from the perceived upturn in economic activity. Price movements in the second half were dominated by two factors. First, the harvest of wheat, corn and soya in the United States were greatly reduced because of drought and the government's policy leading to a reduction of the growing area. Secondly, contrary to expectations, the economic recovery failed to boost substantially the demand for raw materials, in particular for certain base metals such as copper. Thus there was a mixed price performance with substantial increases for food and agricultural raw materials, particularly oils, while the prices of metals and minerals stagnated.

Taken together, the signs of recovery are now abundant in the world. In the United States it is now probable that the upward phase of the cyclical sequence will continue through 1984, limited to some extent by the effect of rising interest rates. As the American external deficit grows, as conditions improve in Europe and the developing world, and as dollar exchange-rate expectations become more one-sided, the comparative advantage of dollar securities as in investment is likely to diminish. The maintenance of the dollar exchange rate then becomes to an increasing degree dependent upon market expectations and confidence.

The risks to the recovery have lessened. The debt crisis is fading and the probability of a major default has declined, but the passing of the acute phase has left behind a chronic constraint on world trade as the indebted countries try to restrain imports as a means of improving the balance of their external accounts. The reduction of the current deficit of the non-oil developing countries in 1984, while smaller than in 1983, is expected to be counterbalanced mainly by the deterioration in the United States current balance, from which all the other major country groups are expected to benefit. The devaluation of the dollar, now widely expected, is unlikely to lead to any reduction in the United States trade deficit in 1984, but could start to improve American competitiveness in 1985. Thus the pattern of world trade which began to shift with the fall in the oil price in 1982, and the consequent cut in OPEC imports, may change again as the United States, the 1983/84 target for exporting countries, becomes a less absorptive market in 1985.

Table 1

World GDP and trade

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

	1979	1980	1981	1982	1983[2]	1984[3]	1982 I	1982 II	1983[2] I	1983[2] II	1984[3] I	1984[3] II
GDP or GNP, OECD total	3,4	1,2	1,7	−0,4	2,2	3,7	−1,0	−0,2	2,3	4,6	3,6	3,1
Imports of goods (volume)												
World	5,3	3,0	1,4	−0,1	1,7	5,0	−0,8	−3,9	2,5	6,6	4,7	4,6
EC 10[1]	10,7	1,9	−2,9	2,4	1,7	3,5	5,2	−5,1	3,4	5,3	3,3	2,1
World excluding EC	2,5	3,6	3,8	−1,3	1,6	5,8	−3,9	−3,3	2,0	7,3	5,4	5,9
of which:												
OECD excluding EC	2,2	1,0	−0,3	−0,6	6,1	9,9	−2,8	−2,0	6,1	14,3	8,9	7,9
OPEC	−11,3	12,0	27,4	1,2	−8,2	−4,5	−6,7	−7,5	−8,8	−7,8	−5,3	0
Other developing countries	10,0	6,0	4,3	−4,8	−2,1	4,1	−5,9	−6,6	−2,1	2,5	4,0	5,5
Other countries	3,2	4,2	1,7	−1,2	2,6	3,9	−2,0	0,1	3,0	3,9	3,8	4,1
Exports of goods												
EC total[1]	7,4	1,9	4,0	0,8	2,2	5,5	−1,3	−1,9	1,6	7,6	5,1	4,4

[1] Including intra-EC trade.
[2] Estimates.
[3] Forecasts.
Sources: OECD, IMF and Commission services.

Table 2

World export price developments

(% change over previous period, annual rate — USD)

	1980	1981	1982	1983	1984	1982 I	1982 II	1983[2] I	1983[2] II	1984[3] I	1984[3] II
Fuel	67,7	10,7	−3,8	−11,1	−4,5	−6,8	−2,3	−15,9	−9,6	−2,9	−2,4
Food	16,7	−11,1	−11,7	3,4	11,8	−4,3	−18,2	6,5	23,3	6,7	11,7
Other primary products	8,6	−8,3	−9,5	4,7	12,6	−5,8	−11,7	13,1	27,5	11,4	14,1
Total primary products (excluding fuels)	12,7	−9,7	−10,6	4,1	12,2	−5,0	−15,1	7,3	19,8	8,6	12,4
Total primary products (including fuels)	40,5	2,6	−6,2	−6,0	1,7	−6,2	−6,8	−8,7	0,3	1,5	3,4
Manufactured goods[1] (unit value)	9,6	5,2	0,8	−0,9	2,8	5,7	−10,0	3,0	1,0	1,2	7,8

[1] Non-EC developed countries.
[2] Estimates.
[3] Forecasts.
Sources: United Nations and Commission services.

The Community: current situation and outlook

The recession in the Community, which had lasted well over two years, appears to have bottomed out in the fourth quarter of 1982. The recovery since then has by no means been either regular or rapid. The Commission's economic forecasts for 1984 now point to more sustained growth of GDP but doubts persist as to the ability of the Community economy to reach a rate of growth sufficient to reduce unemployment.

Developments in 1983

The latest Commission estimates [1] for real GDP growth in the Community in 1983 suggest that it was about 0,8% (see Table 3), significantly higher than the forecasts made last year. The reason for this disparity is to be found essentially in the unexpected strength of demand in the second half of the year.

Table 3

Comparison of forecasts and provisional outcome for the Community for 1983

	Forecast or estimates at the following dates:			
	January 1983	May 1983	October 1983	February 1984
Volume				
GDP	0,4	0,5	0,5	0,8
Private consumption	0,1	0,5	0,4	0,9
Public consumption	0,6	0,8	0,8	1,1
Investment	−0,4	0,0	−0,3	−0,9
Stocks (as % of GDP)	0,5	0,9	0,9	0,7
Exports	1,5	0,4	0,6	1,8
Imports	0,8	0,8	0,5	1,3
Private consumption deflator (%)	8,6	6,4	6,3	6,2
General government net lending (% GDP)	−5,0	−5,4	−5,4	−5,7
Current account balance USD '000 million	−8,7	−6,1	−4,1	−1,5
Unemployment rate (%)	10,6	10,9	10,4	10,6

Source: Commission services

[1] Contained in the 1983-84 forecast dated 6 February 1984, with cut-off date for information on 31 January 1984.

Turning to individual components of demand, it is clear that earlier estimates of the growth of private consumption were too pessimistic. Real disposable income was expected to fall in 1983 (latest estimates indicate a decline of 0,8%), and it was in the light of this projected fall that little change in private consumption spending was forecast in January 1983. In the event the savings ratio of households fell even faster than was expected and private consumption grew throughout the year by almost 1% in real terms.

Part of the explanation for this unexpected development could well be that it reflects the working of consolidation policies in several Member States. Policies designed to simultaneously reduce public sector borrowing, and to improve the financial situation of the enterprise sector and the external balance, can only be successful at the expense of the household sector. The result has been little growth or even a contraction of real personal disposable income, and the real level of consumption could only be maintained by a fall in the savings ratio. The deceleration of inflation in 1982 and 1983 from over 10% in 1981 (annual average over previous year), to 8,8% in 1982 and 6,2% in 1983 (estimate) provided the conditions needed to enable this fall to take place by reducing the amount of savings needed to reach a given target in purchasing power terms and by reducing the erosion of the value of existing assets.

Other influences have also undoubtedly been at work to support private consumption. Part of the private sector's portfolio of assets has been revalued in real terms increasing its wealth considerably and raising its permanent income (equity and real estate for instance). In addition a backlog of demand for consumer durables, including cars, has built up over a period of several years during which the growth of real consumption was exceptionally low. Finally, specific factors tending to increase private consumption have been at work in individual Member States. The bunching of maturing savings contracts in Germany and the relaxation of hire-purchase regulations in the United Kingdom come into this category.

The second major source of difference between earlier forecasts and the estimated outturn concerns exports. After making a downward correction in May 1983 to the forecast of export growth to take account of the deteriorating prospects for demand in developing countries, the growth rate of Community exports for 1983 was revised strongly upwards at the end of the year in response to the strengthening of world trade notably due to growth of US demand, which became more apparent in the second half of the year. Community exports to the United States in the third quarter of 1983 were 20% higher in value terms than one year earlier, and fourth quarter exports are likely to be well up again. However, it is not only the US which is responsible for the upturn in EC exports; intra-Community trade increased in value by 10% over the same period, illustrating the gradual pick-up in activity within the Community.

This export performance reflects the greatly improved competitive position of the Community in world trade. Not only has the rate of increase in unit labour costs been falling over the last two years but also the European currencies have been devaluing against both the US dollar and the yen. This is reflected in the real effective exchange rate series calculated by the Commission, using wholesale prices and based on an average of the years 1970 to 1975 = 100. Whereas in the fourth quarter of 1983, the index for the United States was at 126 and that for Japan at 103, the Community index was as low as 86. Whilst such indicators must be treated with caution, it is nevertheless clear that EC products on world markets have a general advantage in terms of price, if not necessarily in terms of non-price, competitivity.

The forecasts for real investment in 1983 were, on the other hand, over-optimistic throughout last year. Although local factors, such as the investment premium scheme in Germany which led to an irregular profile for investment throughout 1983, played a certain role, the fall of almost 1% in real investment in 1983 probably owes more to the general problem of high interest rates and continuing uncertainty in some countries about the medium-term profitability of capital investments. The size of the fall in interest rates expected in January 1983 proved to be over-optimistic and, although long rates did fall in many Member States, they actually rose in Germany, the Netherlands and Greece. It is possible that in view also of the low rate of capacity utilization many investments were held back awaiting further falls in interest rates, which did not materialize. Some of the larger falls in rates also occurred in Member States where business confidence in the medium-term outlook was low and therefore the fall in the cost of capital was counterbalanced by uncertainty on the demand side.

Although there was a considerable reduction in the growth rate of public expenditure (from 12,5% in 1982 to 9% in 1983) partly as a result of restrictive budgetary policies introduced in some Member States, the volume of public consumption has grown more rapidly than initially expected. On the other hand, government receipts were depressed by the low level of economic activity and the level of general government net borrowing (as a percentage of GDP) did not improve in 1983.

The reassessment of the underlying strength of demand, both domestic and foreign, inevitably lead to revised estimates of the growth of imports, tempered in part by the continued weakness of energy imports as GDP became less energy-intensive and as the Community became more self-sufficient in energy supplies.

The effects on the balance of payments of the changes in the estimates of the volume growth of both components of foreign trade were amplified by an improvement in the terms of trade. As there was a modest reduction also in the deficit on services and transfers, the deficit on current account for the Community as a whole was reduced to USD 1 500 million from an estimated USD 11 000 million in 1982.

Finally the major problem of economic policy, the high level of unemployment, was not alleviated in 1983. Indeed at average annual rates the unemployment rate rose from 9,5% in 1982 to 10,6% in 1983. This does however cover up the important fact that unemployment stabilized from the spring of 1983 and that there were the first signs of employment in the non-manufacturing sector turning up towards the end of the year. However, it should not be forgotten that this stability was achieved largely through a fall in activity rates, which is a reversible phenomenon when the demand for labour begins to pick up.

Prospects for 1984

Turning now to the further prospects for 1984, it is expected that the recovery which began last year will continue and gather strength as the year progresses. The upturn in world trade is likely to be confirmed and it is not expected that the Community's competitive advantage will be lost rapidly over the year. With improving demand prospects, greater price stability and no further major deterioration in labour markets, it is expected that investment will recover and private consumption will continue to grow at last year's tempo.

The evidence from the Commission's surveys supports the thesis of a European upswing gathering strength throughout the year. Business sentiment has risen rapidly since the industrial confidence indicator reached a new trough at the end of 1982; it is today over 18 points above the November 1982 figure in terms of net balances. In contrast during the whole of the 'false' upswing of 1981, this indicator only rose by 10 points. Its components have all contributed to this rise; production expectations have risen 23 points since October 1982 and order books by 22 points since December 1982. In spite of uncertainty about what is today the 'normal' level of stocks of finished products, this indicator also supports the general pattern of recovery. The rise in the industrial confidence indicator has been especially sharp in those countries where adjustment policies have already borne fruit, Germany and the United Kingdom. The economic sentiment indicator, a leading indicator, which is composed of the

Table 4

EC 10: Supply and uses of goods and services together with main economic indicators, 1972-84

	1981 ECU '000 million at current prices	Annual data 1972-81	1982	1983[4]	1984[5]	Half-yearly data (s.a.) 1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
			% change over preceding period at annual rates at constant 1975 prices								
Private consumption	1 385,7	:	0,5	0,9	1,1	0,3	0,5	1,2	0,5	1,2	1,4
Public consumption	386,7	:	0,9	1,1	0,4	0,9	0,2	2,0	0,1	0,6	0,4
Gross fixed capital formation	438,1	:	−1,6	−0,9	2,2	−2,3	1,1	−2,4	0,2	2,1	4,3
Change in stocks[1]	−7,0	:	0,7	0,7	1,0	1,2	0,2	0,6	0,8	1,1	1,0
Domestic demand	2 203,5	:	0,9	0,6	1,5	2,7	−1,4	1,6	0,7	1,8	1,5
Exports of goods and services	643,2	:	0,8	1,8	5,2	−1,7	−1,9	1,2	6,8	5,0	4,1
Imports of goods and services	642,1	:	2,0	1,3	3,5	3,8	−4,5	2,1	5,6	3,2	2,0
GDP at market prices	2 206,0	:	0,6	0,8	2,0	1,0	−0,6	1,3	1,1	2,4	2,2
			% change over preceding period at annual rates								
GDP at current prices		:	9,6	7,2	7,2	12,6	3,5	7,7	9,7	5,9	7,5
Industrial production[2]		:	−4,0	1,6	3,5	−2,8	−7,2	5,1	3,7	3,4	3,4
Unemployment rate[3]		:	9,5	10,6	11,0	9,6	9,3	10,9	10,3	11,2	10,7
Compensation of employees		:	8,1	5,6	5,6	:	:	:	:	:	:
Money supply (M2/M3)		:	10,7	9,8	8,6	:	:	:	:	:	:
Implicit price indices:											
— GDP		:	9,0	6,3	5,1	11,5	4,1	6,4	8,5	3,3	5,2
— Private consumption		:	8,8	6,2	5,2	9,8	6,1	5,6	7,7	4,5	4,3
— Exports of goods		:	8,6	4,6	5,3	9,0	4,9	4,1	5,3	5,8	4,4
— Imports of goods		:	6,1	3,6	6,1	2,7	6,4	−2,3	12,9	1,1	10,1
Terms of trade		:	2,4	1,0	−0,8	6,1	−1,4	6,6	−6,7	4,6	−5,2
			As % of gross domestic product								
Trade balance (fob/cif)		:	−1,1	−0,7	−0,5	0,2	0,3	0,6	0,6	0,8	1,1
Current balance		:	−0,5	−0,1	0,3	−0,6	−0,3	−0,5	0,4	−0,5	1,1
Net borrowing of general government		:	−5,4	−5,7	−5,2	:	:	:	:	:	:

[1] As % of GDP.
[2] Manufacturing industry.
[3] Unemployment as % of total labour force.
[4] Estimates.
[5] Forecasts.

industrial, construction and consumer indicators as well as the share price index, has also risen throughout 1983, to reach its highest point since 1979.

The investment survey results are worth especially close study in terms of the broadening of growth during 1984. The results of the Community's investment survey carried out in October 1983 suggested that enterprises are expecting to expand their investment by as much as 10% in value during this year.[1] Whilst it would be normal for this figure to exaggerate the actual increase, it is nevertheless a promising indication.

It is expected that year-on-year GDP in real terms will grow by 2% in 1984, which represents a significant improvement on the 1,5 % contained in the Commission's autumn fore-

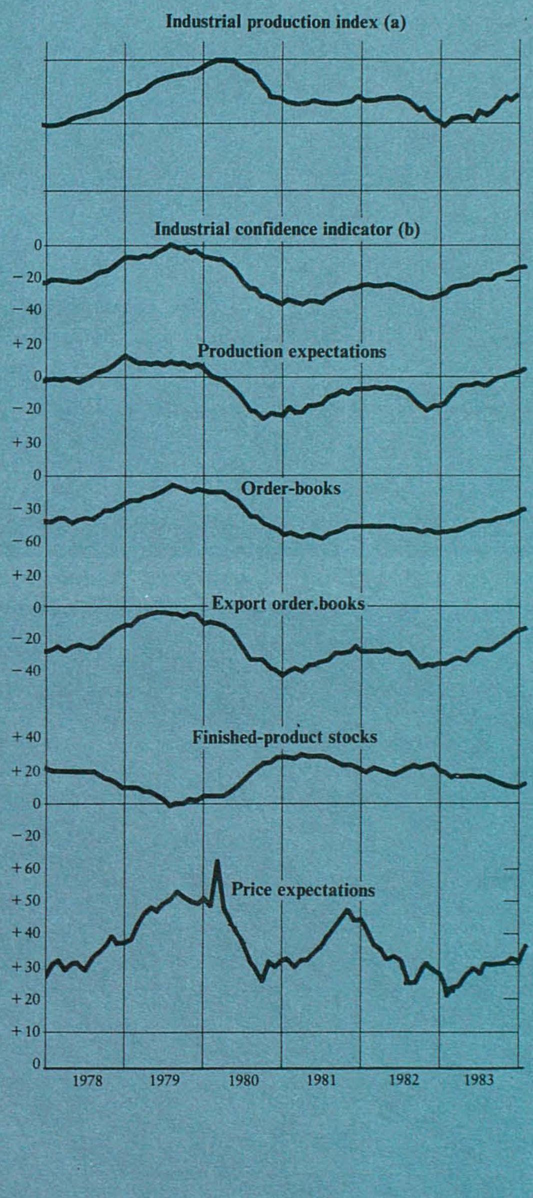
[1] *European Economy*, Supplement B, January 1984.

cast. All Member States with the exception of the United Kingdom are expected to experience higher rates of real GDP growth than in the previous year; although the growth rate in the United Kingdom (+2,5%) is below the exceptionally high growth of 1983 (+3,2%), it is still well above the Community average. In terms of the cyclical recovery, the United Kingdom which anticipated the upswing in the Community by a year is now expected to see growth slowing down though only gradually. German real GDP on the other hand is forecast to expand by 3% (after 1% in 1983) as the recovery gets under way and becomes more broadly based. In France and the Benelux countries however, the process of adjustment to internal and external imbalances is still proceeding and real GDP is therefore expected to grow less strongly (France +0,6%, Belgium +1,3%).

Of the 2% growth in real GDP in 1984, approximately half is expected to be contributed by domestic demand and 0,3 points by inventory adjustment. Private consumption is forecast to grow only slightly faster than in 1983. Savings ratios have been reduced very rapidly over the past two to three years and this decline is expected to slow down as continued disinflation serves to lower the appropriate level of personal sector savings. However, the forecast for real disposable income growth (+ 0,8%) in 1984 is the first significantly positive figure for 3 years and will support the continuation of real consumption growth, especially as the backlog of demand for consumer durables does not seem to have been met. Public consumption, on the other hand, is unlikely to grow significantly, as governments continue their efforts to cut expenditure and reduce public deficits.

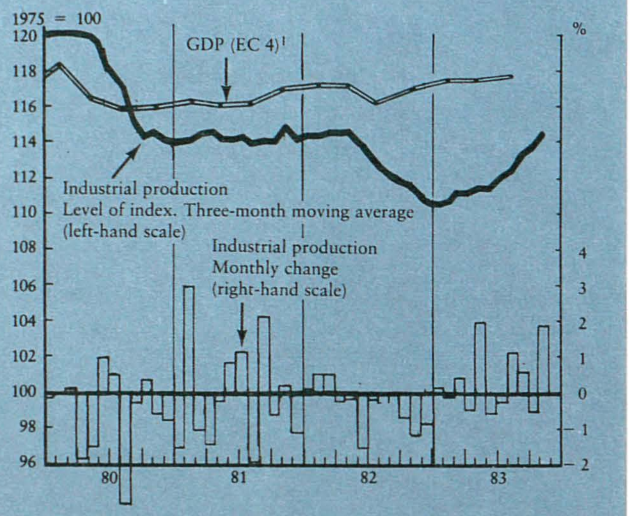
Gross fixed capital formation is forecast to grow in real terms by 2,5% in 1984, after the fall of 1983. This would be the first time that investment has risen since 1980, since when there has been a cumulative fall of some 7%. The forecast of a small recovery in investment is based on three main factors: improving medium-term demand perspectives, improved profitability of enterprises and, as with private consumption, a certain amount of deferred replacement demand. The investment losses of the past three years were experienced both in the construction and the vehicles, plant and machinery (equipment) sectors and the recovery is now also expected in both. The investment survey referred to above lends some support to the upswing in the latter sector, though the construction survey does not give that much encouragement to optimism. A reduction in interest rates is probably especially important in the construction sector, while greatly improved company earnings will support investment in vehicles, plant and machinery. Investment is expected to be especially buoyant in Germany, the United Kingdom and Denmark, where GDP growth will be strongest and where profitability has clearly improved.

GRAPH: **Monthly survey of manufacturing industry and related economic indicators; EC 9**
Historical data, 1978-84



(a) Industrial production excluding building and construction and, in the case of France, the foodstuffs and beverages industry. Three months' moving average, latest revisions included (EC 10).
(b) Composite indicator based on the survey questions on production expectations, stocks of finished products and order books. The indicator is an average of the net balances, i.e. the differences between the percentages of respondents giving positive or negative replies, with the sign inverted for stocks.
Sources: Eurostat and European Community business surveys.

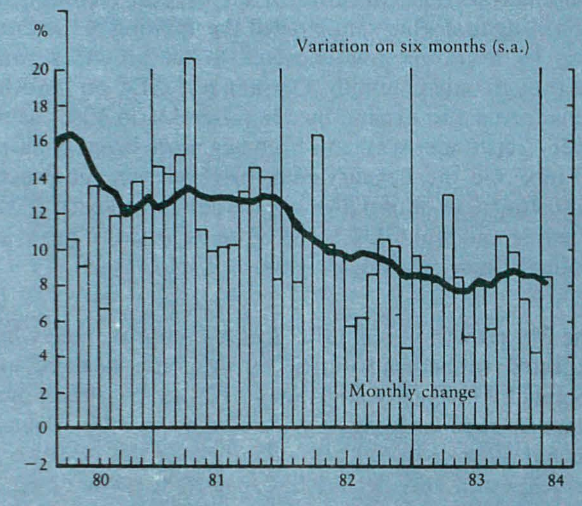
GRAPH 1: Industrial production and gross domestic product (s.a.) - EC total



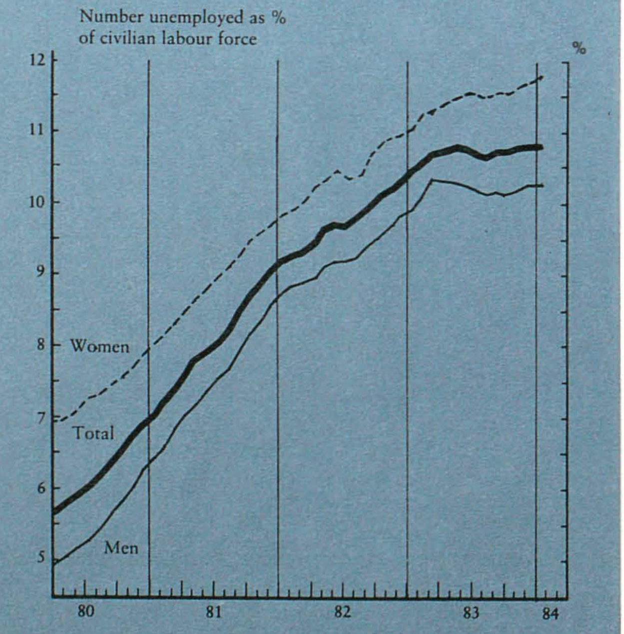
[1] France, Germany, Italy and UK; quarterly figures.

GRAPH 3: Consumer prices EC 10

Change: expressed as annual rate

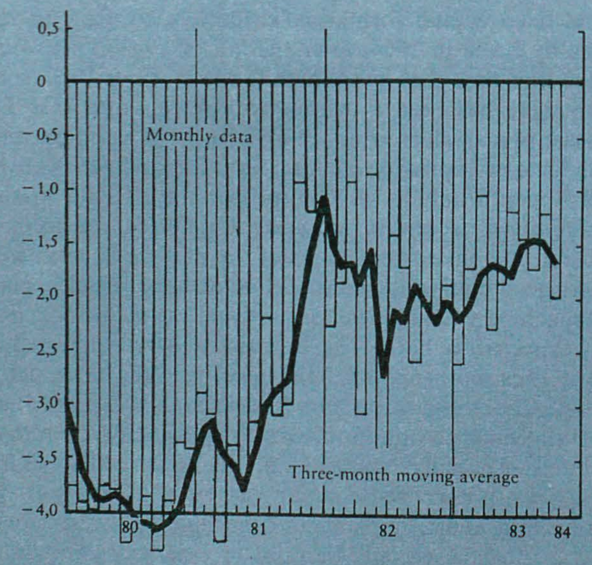


GRAPH 2: Unemployment (s.a.), EC9



GRAPH 4: Trade balance (s.a.) EC 9

EUA '000 million



After rising by just under 2% in 1983, exports of goods and services of the Community at constant prices are expected to increase by over 5% this year, while imports will rise by 3,5% after 1,3% in 1983, thus providing an important impulse to growth of real GDP in 1984. In spite of the extremely competitive situation of the Community's exporters, it is not expected that they will gain market share (world trade + 5%). This reflects the disadvantageous distribution of EC market shares in parts of the world which are growing less rapidly, non-EC Europe, OPEC, LDCs. Nevertheless the ability of exporters to swap markets should not be underestimated (e.g. the USA was 8,3% of the total German export market in November 1982, but was 11,2% one year later), nor should the increased attractiveness of the Community's product range as the world economic recovery picks up steam and broadens out into investment.

In spite of an expected loss on the terms of trade, due in part to the rise in raw material prices, an improvement is expected in the current account of the balance of payments which should be in surplus by some USD 8 000 million in 1984. The degree of divergence between Member States is likely to be reduced considerably as those countries with high deficits in 1982 and 1983 reduce them further. On the other hand small increases in the surpluses of Germany and the Netherlands in dollar terms are expected.

The recovery in demand is unlikely to bring any major reduction in unemployment, though a small fall in the second half of this year is forecast. The unemployment rate in 1984 is expected to be 11% of the civilian labour force, slightly above the average for last year. However, at the level of individual Member States improvements are to be seen. In Germany, for instance, unemployment is forecast to fall from 8,4% in 1983 to 7,8% in 1984, and a small year-on-year improvement is also expected in the United Kingdom. On the other hand unemployment is forecast to rise significantly in France, Italy and the Netherlands. This forecast assumes at the Community level a further small decline in participation rates, the total labour force as a percentage of the population of working age having declined by one percentage point since 1981, equal to 1,75 million people.

The short-term demand impact of fiscal policy is still relatively restrictive and with the recovery beginning to bring additional government revenues, the net borrowing of general government is expected to fall to 5,2% of GDP from 5,7% in 1983. Germany and the United Kingdom, already with deficits well below the EC average in 1983, are expected to reduce them by about one-third this year, whilst a large fall is also forecast in Denmark. Italy is expected to make no progress however in reducing its very high government deficit and the much smaller one in France is forecast to remain constant. It is significant that gross interest payments by EC governments are likely to exceed net borrowing in 1984.

Finally on a positive note, the rate of inflation (deflator of private consumption) is expected to fall yet again to reach 5,2% in 1984. Whilst a small increase is expected in the low inflation countries (Germany, the Netherlands, the United Kingdom) partly for technical reasons, the process of disinflation is forecast to continue in the higher inflation countries. In spite of an acceleration of the recovery of output and demand in the Community, it does not seem likely that the reduction of inflation achieved at considerable cost over the last three years is yet at risk.

Economic policy problems

The analysis carried out above shows that economic activity is gathering momentum in the Community; the most important question now is how to ensure a genuine recovery that will lead to a lasting increase in employment.

Obviously, a favourable external environment will be important: but present world economic trends show that the expansionary impetus must be developed and fostered principally within the Community itself.

Economic recovery began in Germany and the United Kingdom, where progress towards eliminating imbalances started earlier than elsewhere and economic policy concentrated on medium-term improvements to financial conditions and the supply side. These policies increased confidence which helped private consumption to recover and thus led to a return to growth. Economic developments in those countries furthest along the road to recovery had positive effects on the economies of other member countries. The initial impetus was later reinforced and spread to other Community countries as the world economic situation improved. These developments have stimulated capital formation, initially in the form of stock-building, but afterwards also in plant and equipment so that firms are now planning a marked expansion of investment in 1984.

Hopes for the balanced development of the economic cycle in 1984 and beyond are basically founded on this outlook for investment, together with the restrained nature of the recovery in households' consumption.

But two questions arise:

Is the recovery process solidly established in the countries where it got off to an early start?

What are the prospects of other member countries' returning to a positive growth path?

In reply to the first question, it should be borne in mind that despite the slow expansion of productive potential since the first oil crisis, capacity utilization is still very low, indicating that there is considerable room for manoeuvre. The question then arises whether demand will be sufficiently buoyant to enable expansion to continue. Subject to the reservations made below about the sustainability of the world economic recovery, it is most likely that the upswing in activity will continue spontaneously. The most important factor here is that business investment remains buoyant, helped along by favourable conditions: improved profit margins, consolidation of short-term debt, more stable taxation, a relaxation of the pressure of labour costs, etc.; moreover, external demand from both inside and outside the Community will remain strong. Clearly, the incipient upswing must not be allowed to be inhibited by rising costs and prices: cautious monetary policy, stable public finances and the cooperation of both sides of industry will be required.

A return to sustained growth in Europe depends almost as much on reactions in the countries where the recovery got off to a later start, for one reason or another, than in Germany, Denmark and the United Kingdom. An encouraging sign is that imbalances on current account, budget positions and inflation were tending to diminish in most of the countries concerned in 1983. Further progress is still required: however unpleasant the effort involved, it will be vital to underpin economic activity in 1984 and improve employment in 1985.

The stimulus afforded by world demand and the faster expansion of intra-Community trade should help at the very least to offset some of the adverse effects on domestic demand of the continued application of corrective measures. It is now more necessary than ever to maintain such measures: relaxation of index-linking in Belgium, France and Italy to bring inflation down, and rigorous fiscal policies in Belgium, Ireland, Italy and the Netherlands. Any relaxation of effort would compromise the chances of restoring a notably higher level of activity in 1985 and a lasting improvement in the employment situation.

But although Europe's economic recovery is based firmly on the smooth functioning of its own internal processes, mechanisms and policies, external developments could hamper its progress.

Economic developments at a world level are strongly influenced by the US budget deficit, which has reached excessive proportions (about USD 200 000 million in 1984), and is projected to remain equally large until the end of the decade, whereas there are no grounds as yet for supposing that any successful attempt to correct this structural imbalance will be made.

There is almost general agreement with the analysis that, in view of the cautious stance of US monetary policy, the budget deficit is entirely responsible for the high level of US interest rates and therefore indirectly for high rates in most of the industrialized countries.

The dollar's instability which could change into a protracted decline is a potential risk for the continued expansion of the world economy which benefited greatly from the upswing in the United States. The steady deterioration of the US balance on current transactions might indeed unexpectedly affect market expectations and induce holders of dollars to change the composition of their portfolios.

It is difficult to predict what this would entail, or how the monetary authorities would react, but in view of the sizable financing requirement of several sectors in the United States, a rapid weakening of the dollar could conceivably mean a fresh upward twist in interest rates, at least in the short run.

In those circumstances, two things are likely to happen: growth in the United States would slow down or grind to a halt, and the external financial position of the developing countries would worsen; both these factors would inhibit world trade. While it is true that cost and price trends in the Community would benefit from the weakness of the dollar, the combined effects of slacker exports, declining price-competitiveness and, possibly, rising interest rates[1] would be harmful to the Community's incipient recovery.

The best way to face this risk is to remedy as rapidly and as thoroughly as possible the accumulated imbalances still remaining in certain member countries as regards public finance and the remuneration of factors of production.

The restoration of a growth rate that can ensure a return to a healthier employment situation (a reasonable aim would be a rate of 2,5% to 3% a year) does not depend mainly on the recovery of demand, for the sustainability of that recovery will itself depend, in the last analysis, on how the Community countries manage to adapt their economic structures.

This point was dealt with in detail in the annual report and review for 1983/84 (see *European Economy* No 18); suffice it to draw attention here to the most urgent priorities for action.

Balanced economic growth can be sustained in the medium term only if certain conditions are fulfilled on the supply side; these conditions are not fulfilled in Europe, or at least not as well as in, for example, the USA and Japan.

The first condition is that the productive apparatus should be flexible and adaptable to the frequent shifts in both domestic and external demand. Adaptability would be en-

[1] Depending on how far the dollar falls, and how the forward market reacts.

hanced: first, by the elimination of the labour market rigidities the major effect of which at the moment is a tendency to hamper the sectoral differentiation of production costs; secondly, by the simplification of the rules governing firms' activities; and thirdly, by a decline in interest rates that would reduce the cost of borrowing.

The development of each member country's overall production potential will depend on how far the industrial fabric can be restructured by reducing capacity in ageing sectors while creating viable undertakings in the areas of more recent technological advance whilst avoiding too stringent social consequences. The most valuable, indeed indispensable, factors of success here are a climate conducive to investment and risk capital, a genuinely integrated internal market and tax schemes that suit the needs of dynamic firms.

Another important contribution to supporting the export drive will be improved competitiveness on non-members' markets, especially in view of the prospects that the dollar and other non-Community currencies associated with it may not long remain overvalued. Not only must the range of products exported be transformed, which is possible if self-financing margins are adequate to ensure new investment, but also and especially, costs must be restrained. The development of the 'own-product' real wage since the first oil shock in some of the member countries shows that, in relation to the USA and Japan in particular, large imbalances have accumulated; if they are not corrected, the result will be either undesirable currency depreciation or a lasting loss of competitiveness.

Experience in recent years has shown that a fundamental change is required in the authorities' approach to the economic recovery process: they can no longer see their role exclusively as that of a stabilizer offsetting cyclical fluctuations, as they often did until quite recently.

The Community's present economic problems are structural, and cannot at present be solved by a fiscal boost. The share of taxes and social contributions in national income is already considered excessive, a large part of the expansion of expenditure is determined automatically and, as a consequence, budget deficits are mounting. In most Community countries, the ratio of public debt to national income is rising more or less rapidly, engendering inflationary expectations or the anticipation of a lasting rise in interest rates. The burden of servicing the public debt is crowding out expenditures required to develop output and productivity. Against this background, fiscal expansion to stimulate economic growth lacks credibility.

There is no question of reconsidering the function of automatic stabilizers in public finance, but expenditure plans should be drawn up with due allowance for the margin of manoeuvre genuinely available in the public sector—a margin which has clearly been very narrow during the past four years of recession. In view of the excessive expansion of debt servicing costs, still a threat to stability in certain countries, it may be necessary to rethink some particularly expensive programmes so as to gain time until lasting and more balanced growth can bring about an improvement in the public finance situation. Only by eliminating the structural part of the deficit can public finance again act as an effective stabilizer (see also box).

Finally the efforts of Member States must be consistent at Community level in order to overcome the economic crisis. It is encouraging to note, as the country analyses in the following pages show, that economic policies in the Community countries were tending to converge in 1983. But it remains important that the economic policy guidelines decided at Community level for 1984 be respected. In particular the improving situation should not be used as an excuse to relax earlier efforts but should be turned to advantage to resolve structural disequilibria, modernize capacity and improve competitivity so as to help fight the problem of unemployment.

The public debt and the interest burden

How the public debt took off

Since the end of the 1970s, the increasing size of the public debt has reached disturbing proportions in several Community countries; the corresponding interest charges now account for an excessively large proportion of public expenditure. The origin of this situation is twofold. Both the slow-down in economic growth and structural factors caused the public deficits, which had previously fluctuated essentially for cyclical reasons, to follow an almost unbroken upward trend. Even if interest rates had remained constant, this development would have been sufficient to produce a marked increase in the interest charges. However, from the beginning of the decade long-term interest rates have hardened significantly compared with the level which obtained during most of the 1970s. Moreover, in parallel with the disinflation which came about almost everywhere in Europe, notably as a result of more strict monetary policies, real interest rates have increased to a degree where they have often become strongly positive, whereas they were negative in the past. As a result the claim on the real resources of the economy also increased at the very time when growth was slowing down significantly.

The risks inherent in the growing size of the public debt

As stressed in the opinion of the Economic Policy Committee published in the current number of *European Economy* on the 'problem of medium-term budgetary balance and the public debt', a rapid increase in the public debt relative to the national revenue (or to gross domestic product) should be considered as unhealthy. If it persists, there is the danger that it will induce among investors an assessment of risk which can only be offset by a corresponding increase in real interest rates. The alternative is large-scale recourse to monetary financing with the supervening inflationary pressures. In very open economies, the public deficit is often accompanied by dissaving at the national level. As a consequence, it becomes necessary to have recourse to foreign borrowing to finance the deficit and possibly also to finance private capital outflows indirectly caused by the existence of high Exchequer borrowing requirements.

Thus charges which are significant debit items in the balance of payments—reimbursement of principal and the associated interest payments—grow heavier. The possibility of a depreciation of the currency is an additional risk.

An outline of the situation in the Member States

The table below allows an appraisal of the existing situation in the various Member States. As the information on the public debt is not altogether homogeneous, the reader should pay special attention to the notes at the bottom of the table in order to interpret the statistics correctly.

The table allows the following main conclusions to be drawn:

In all Member States, except the United Kingdom, the public debt expressed as a proportion of GDP is rising steadily; in some of them (Belgium, Denmark, Ireland, Italy, Netherlands), it is increasing rapidly and is approaching or has even exceeded 100% of GDP. As a consequence, spending in respect of the public debt interest is rising relative to current spending and, in six countries out of 10, accounts for between 10 and 20%. The excessive increase in interest payments also shows up equally clearly through the ratio (average of several years) of the annual increase in interest payments to the increase in current revenue; in the last few years, the ratio ranged from one quarter to one third in six countries out of 10. During the 1980s the average effective interest rate has been much higher than in 1975; this mainly reflects an increase in rates in capital markets, but also, to some extent, a reduction of the relative share of very long term debt negotiated at particularly low interest rates.

It is very striking to see that the 'real effective interest rates' have become positive in all Member States except Greece and Italy and have become high in those countries where inflation rates have been the lowest.

Constraints imposed on budgetary policy by the debt and related interest charges

These facts call for a number of observations regarding the pre-eminent role played by the interest rate burden in relation to action to improve the budget balance and its limitations.

The interest burden is, by definition, a function of the accumulation of public deficits and it becomes more onerous as nominal interest rates increase; similarly, a close link is established between higher interest rates and higher deficits once the public debt assumes large proportions, and monetary financing is at a relatively low level.

The question is under what conditions can we break the vicious circle in which interest payments fuel the deficit, which then swells the public debt and, in a second phase, forces up interest payments, without raising substantially the burden of taxation and social contributions.

A very simple numerical example will illustrate just how difficult it is to break out of this vicious circle. In a country where the public debt was equivalent to 100% of GDP and where GDP was growing at 8% in nominal terms, the debt/GDP ratio would not increase if the public deficit (= increase in the public debt) did not exceed 8% of GDP. However, if the effective interest rate were 10%, interest payments alone would produce a deficit equivalent to 10% of GDP and, assuming a constant tax burden, other expenditure would have to be cut by 2% in nominal terms to keep the debt/GDP ratio stable.

It seems virtually impossible to make such deep cuts in the short term. Consequently, a middle way has to be chosen and the reform spread over a number of years. In carrying out an operation of this kind, we cannot however lose sight of the fact that any falling behind with the reform causes interest payments to climb rapidly. Following our example we see that if the debt/GDP ratio is 120%, interest payments would represent 12% of GDP. Now, as Table 5 below shows, an increase of 20 points is not exceptional as this has actually happened over a period of four years in several Community countries.

The last column in the table reveals that debt interest can absorb much of the economy's resources. Where the real interest rate is of the order of 4%, as it is at present in several countries, and where the debt/GDP ratio is between 50 and 100%, the economy must grow by 2 to 4% if the real interest burden is to remain unchanged at a constant level of indebtedness. Since the medium-term projections available suggest that an average growth rate of the order of 2,5% between now and the end of the decade is not a pessimistic assumption, it follows that any country where the debt/GDP ratio exceeds 60-70% should expect to incur a heavier real burden of debt-interest payments, that is to say, a burden that will not become any lighter even if further headway is made in reducing inflation, something which in the normal course of events, would bring down nominal interest rates. A decline in real interest rates is unlikely if monetary policy is not accommodating and as long as public deficits remain high.

During the 1970s, some countries managed to limit the increase of their debt/GDP ratio by having recourse to excessive monetary financing. As a result, however, their inflation rate became substantially higher than the average for the Community. The significant reduction in real interest rates which was associated with this policy enabled these countries to finance part of the increase in public expenditure by a reduction in the real value of the outstanding debt, but often only at a cost of a disturbance in financial markets. Evidently these implicit transfers due to inflation which benefit the public sector, at the expense of the other sectors of the economy, are not a sound method of financing.

If, on the contrary, fiscal and monetary policies are directed towards greater stability, a fundamental change appears as the burden of interest to be paid on debt incurred during periods of high inflation becomes particularly heavy. If the government aims at stabilizing or reducing the fiscal deficit in relation to GDP, without raising substantially the burden of taxation and social charges, interest on the public debt will crowd out other public expenditure, and very often that of the most productive kind.

In addition, a high level of interest payments will induce instability in market behaviour once public debt becomes excessive. In such a case it will become unlikely that the totality of interest payments, as well as amortization, made to other sectors of the economy and abroad will easily flow back to the domestic capital market, or that holders of public debt will not change their inflationary expectations. In such conditions governments would be obliged to offer high interest rates to encourage market operators to invest in government securities, unless the authorities made greater use of monetary financing, a means which is not used, according to the assumption above.[1]

To sum up, it can be said that in almost all Member States, to varying degrees, the growing public debt and consequent interest burden is a matter of major concern to the budgetary authorities; it raises the problem of the complete re-examination of budget priorities as the interest burden directly depends on any additional accumulation of debt. The higher the ratio of public debt to GDP, the heavier the real interest burden, the larger the external debt, and the weaker the economic growth rate—then the more urgently a solution is needed.

[1] To keep this paper short, we do not consider the very complex but hazardous consequences of increasing external indebtedness.

Table 5

Public debt and interest paid

	Situation at 31 December	Public debt[1] Total	Public debt[1] of which: central government	Structure in %[2] Long term int.	Long term ext.	Short term int.	Short term ext.	Total debt as % of GDP[3]	Interest paid (general government) In national currency[1]	As % of current expenditure	As % of GDP	Share of increase in receipts[4]	Average interest rate[5]	Real interest rate[6]
B	1975	1 382,8	928,8	84,3	0,5	15,1	0,0	59,8	82,4	8,4	3,6	6,5	6,3	−5,5
	1980	2 660,2	1 956,8	67,9	4,3	24,3	3,5	76,2	211,5	12,4	6,2	47,5	8,6	1,5
	1981	3 202,3	2 439	55,0	7,5	28,5	8,5	88,6	286,6	14,7	7,9	83,5	9,8	0,8
	1982	3 787,1	3 085	49,0	10,8	30,1	10,0	96,1	360,8	16,8	9,2	36,9	10,3	2,7
	1983	[4 430]	3 716	49,9	11,8	27,9	10,4	105,7	[405]	17,7	9,7	44,2	9,9	2,0
DK	1975	25,8	10,8	60,9	39,1	[7]	[7]	11,9	2,6	2,8	1,2	3,9	12,9	2,5
	1980	125,2	106,0	60,5	39,5	[7]	[7]	33,5	14,7	7,6	3,9	13,6	13,4	2,0
	1981	177,6	157,9	64,6	35,4	[7]	[7]	43,3	21,6	9,5	5,3	44,0	14,3	2,2
	1982	246,1	225,3	65,3	34,7	[7]	[7]	52,4	27,8	10,4	5,9	23,6	13,1	2,4
	1983	320,7	300,0	65,9	34,1	[7]	[7]	62,2	41,4	13,8	8,0	39,2	14,6	7,4
D	1975	256,4	108,5*	97,1	2,9	[7]	[7]	25,0	14,2	3,3	1,4	11,6	6,3	0,4
	1980	468,6	232,3*	91,1	8,9	[7]	[7]	31,6	28,8	4,7	1,9	10,6	6,5	1,0
	1981	545,6	273,1*	87,8	12,2	[7]	[7]	35,4	35,4	5,2	2,2	21,6	7,0	1,3
	1982	614,8	309,1*	87,1	12,9	[7]	[7]	38,4	43,6	6,1	2,7	23,7	7,5	2,1
	1983	669,0	341,0*	86,8	13,2	[7]	[7]	39,9	50,0	6,7	3,0	22,8	7,8	4,7
GR	1975	:	150,8	65,8	34,2	[7]	[7]	22,4	9,3	5,2	1,4	6,7	7,0	−5,3
	1980	:	473,8	76,6	23,4	[7]	[7]	27,7	41,3	8,0	2,4	12,6	9,5	−10,4
	1981	:	671,9	75,7	24,3	[7]	[7]	33,0	65,3	8,9	3,2	27,6	11,4	−10,5
	1982	:	928,3	74,7	25,3	[7]	[7]	36,9	68,0	7,3	2,7	1,3	8,5	−10,4
	1983	:	1 299,8	71,1	28,9	[7]	[7]	42,4	111,0	9,4	3,6	20,2	9,5	−9,1
F[8]	1975	389,2	237,5	:	:	:	:	26,8	18,6	3,3	1,3	8,3	5,3	−5,4
	1980	:	442,2	:	:	:	:	:	46,1	4,0	1,7	4,8	7,3	−5,3
	1981	795,9	521,1	33,2	4,0	62,7	—	25,6	69,8	4,9	2,3	11,9	9,1	−3,4
	1982	986,1	707,6	34,8	7,3	57,8	—	27,7	78,9	4,7	2,2	3,8	8,5	−2,1
	1983	1 255,2	841,0	32,8	10,1	57,1	—	32,2	111,0	5,8	2,8	16,8	9,5	0,0
IRL[9]	1975	:	2 744	75,4	20,7	4,0	—	73,5	196	14,7	5,2	—	8,3	−11,4
	1980	:	7 896	68,5	28,0	3,6	—	89,0	699	18,9	7,9	20,5	9,7	−6,7
	1981	:	10 195	59,6	37,2	3,2	—	95,8	938	19,8	8,9	29,2	10,4	−7,6
	1982	:	12 700	55,4	41,7	2,9	—	100,9	1 323	22,4	10,6	41,4	11,6	−4,7
	1983	:	[15 600]	49,5	47,9	2,6	—	111,8	1 554	23,3	11,1	28,8	11,0	0,2
I	1975	81 858	67 015	33,5	0,7	65,8	—	45,3	4 984	10,4	4,0	29,7	6,8	−9,2
	1980	221 320	205 971	33,1	1,0	65,9	—	65,3	21 173	15,1	6,2	17,1	10,5	−8,1
	1981	274 357	258 637	29,2	1,7	69,1	—	68,4	28 986	15,6	7,2	26,3	11,6	−6,2
	1982	349 686	330 223	28,2	2,4	69,4	—	74,4	39 286	17,2	8,4	27,4	12,6	−3,6
	1983	438 000	418 000	:	:	:	—	82,6	50 348	18,6	9,5	26,3	12,8	−1,7
L	1975	15,7	10,8	70,4	6,5	23,1	—	15,4	0,74	2,3	0,9	—	4,7	−5,0
	1980	18,3	10,4	76,9	2,9	20,2	—	11,1	1,13	2,1	0,9	2,0	6,3	−1,3
	1981	20,4	11,4	81,6	1,7	16,7	—	14,2	1,27	1,8	0,9	2,6	6,6	−1,0
	1982	[22,8]	11,8	80,5	0,9	18,6	—	14,9	[1,44]	1,9	0,9	2,2	6,7	−3,0
	1983	[26,5]	[13,5]	84,7	—	15,3	—	17,7	[1,63]	2,0	1,0	2,2	6,6	−1,6
NL	1975	91,1	46,8	83,6	—	16,4	—	41,4	6,5	6,4	3,0	4,1	7,5	−2,9
	1980	154,6	99,5	81,9	—	18,1	—	46,0	12,4	7,1	3,7	15,2	8,6	1,8
	1981	177,6	118,5	84,2	—	15,8	—	50,3	15,6	8,2	4,4	27,8	9,4	3,0
	1982	[205,6]	144,6	86,2	—	13,8	—	56,0	18,9	9,2	5,2	36,0	9,9	4,0
	1983	[237,5]	[175,0]	87,9	—	12,1	—	63,4	[23,0]	10,5	6,1	30,1	10,3	7,4
UK[10]	1975	75,7	57,0	55,4	6,5	38,1	—	71,8	4,6	10,5	11,4	9	6,6	−13,0
	1980	136,4	111,8	74,6	1,7	22,7	9,9	58,2	11,9	12,3	5,1	15	9,4	−2,9
	1981	147,9	121,1	77,2	2,0	20,8	—	57,8	13,8	12,6	5,4	12	9,7	−1,3
	1982	157	132,2	77,9	2,0	20,0	—	55,7	14,5	12,0	5,1	6	8,7	3,6
	1983	:	[145,5]	:	:	:	:	:	14,5	11,2	4,8	—	8,1	2,6

* Bund. : = not available. — = 0. [ ] = estimates.

1 '000 million BFR, DKR, DM, DR, FF; million IRL; '000 million LIT, LFR, HFL, UKL.
2 Belgium, Luxembourg, United Kingdom, Ireland, Greece: central government.
3 Greece, Ireland: central government.
4 Increase in interest paid ($t - t_{-1}$) as a percentage of the increase in receipts ($t - t_{-1}$).
5 The rate is obtained by dividing the interest paid by the total public debt ($t + t_{-1} : 2$). In essence, this should express the development of the effective interest cost of the debt, which itself depends on several factors, notably the debt structure, the rates at which the outstanding debt was contracted, the market rate for new debt, etc.
6 Deflator: implicit price index of private consumption.
7 Short term included in the long term.
8 Central government: without PTT.
9 Interest paid: Exchequer.
10 Level of public debt at 31 March of the following year. Interest paid: financial year.

The economies of Member States

Belgium

Trends and prospects

As a result of the policy of economic recovery embarked upon in Belgium in 1982, further progress was made in 1983 towards restoring external balance, while export growth was boosted by improved company competitiveness and increased external demand. In addition, the low level of domestic demand led to a marked fall in the volume of imports. Despite some deterioration in the terms of trade, the balance of payments deficit was cut from 3,6% of GDP in 1982 to 1,5% in 1983.

Owing to the appreciable decline in personal disposable income in real terms, private consumption, particularly of durable goods, decreased, as also did business investment and activity in the residential construction sector.

Overall, gross domestic product remained at roughly the same level in volume terms as the previous year, while industrial production grew considerably for the first time since 1979. Unemployment again increased, although at a much slower rate in 1983 thanks to recruitment resulting from the reduction in working hours and the extension of part-time working. The average number of registered unemployed persons amounted to 14,5% of the civilian labour force, compared with 13,1% in 1982.

Consumer prices continued to increase fairly rapidly in 1983 (an annual average rate of 7,7%) as a result, amongst other things, of increases in some indirect taxes and higher agricultural and import prices.

In the budgetary field, it was not possible to reduce the net borrowing requirement as forecast in the initial budget. While expenditure was roughly as forecast, the substantial shortfall in tax revenue, due partly to income restraint and the disappointing economic climate, again meant that the target could not be met. The Treasury's cash deficit in 1983—adjusted for exchange losses—reached BFR 525 000 million, i.e. BFR 82 000 million more than forecast in the draft budget tabled at the beginning of October 1982. The general government cash deficit is likely to amount to 14,4% of GDP, as opposed to 14,8% in 1982.

In 1984, the reintroduction of proportional indexation—whereby the mechanism is triggered once the threshold has been crossed by the price index moving average over four months instead of over one month as under the old system—will probably lead to faster growth of per capita remuneration, which will also be influenced by increased social security contribution by employers. Unit wage costs will increase even more sharply as a result of the reduction in working hours. Despite a further substantial growth in non-wage incomes, real personal disposable incomes will fall slightly (by 0,5%) as a result of increased taxation and para-fiscal charges. As it is thought that the personal savings ratio will not vary greatly, private consumption will probably show a similar fall to that of disposable income.

The draft 1984 budget, tabled with a net borrowing requirement of BFR 507 000 million, should stabilize the general government cash deficit, provided that any overrun of expenditure, particularly because of adjustment of expenditure to prices and of the debt and unemployment burdens, is adequately compensated. In relative terms, the cash deficit should then be cut by one percentage point of GDP compared with 1983. The draft budget thus provides for a significant increase in direct taxes and social security contributions and for reductions in expenditure, for example through a change in the dates on which wage payments to public employees are made. According to the 1984 budgets, public investment (in value terms) should remain roughly stable, although this means a fairly sharp fall in real terms. Whereas in 1983 the cuts were mainly borne by local authorities, they will, in 1984, be felt more by the central authorities, particularly in the roadworks sector. Activity in the educational and administrative buildings sector will show a less pronounced decline.

Thanks to the improvement in the economic climate, sales prospects on foreign markets and profitability in recent years—reflected in the fall in the adjusted wage and salary ratio in the business sector (1981: 76,4; 1982: 74,9; 1983: 73,4)—business investment should accelerate (approximately 4% in volume terms). Furthermore, its financing will be helped by the 1982 and 1983 corporation tax reductions, and by measures designed to stimulate recourse to risk capital; such measures have enabled a significant amount of new capital to be raised. Investment in plant and equipment and, to a lesser extent, in industrial buildings should show particular improvement.

Gross investment in volume terms

(% change)

	1979	1980	1981	1982	1983	1984
Investment: total	−2,1	5,0	−14,5	−2,6	−6,0	1,3
— business	2,4	7,1	−3,3	−0,6	−3,0	3,8
— housing	−12,6	−1,0	−40,3	−6,5	−9,7	−1,0
— public sector	6,3	9,5	−8,3	−5,5	−12,9	−6,6

Sources: INS, National Accounts and Commission estimates.

Per capita earnings in manufacturing industry in 1983 and 1984 (excluding variations in working hours and productivity)

(% change)

	1983			1984			1983 + 1984		
	In national currency	Effective exchange rate variation	In BFR	In national currency	Effective exchange rate variation	In BFR	In national currency	Effective exchange rate variation	In BFR
EEC (0,88)	6,1	1,7	7,9	6,4	—	6,4	12,9	1,7	14,8
Non-EEC (0,12)	5,1	12,5	18,2	6,0	—	6,0	11,4	12,5	25,3
Total	6,0	2,9	9,1	6,4	—	6,4	12,8	2,9	16,1
Belgium	7,7	—	7,7	8,3	—	8,3	16,6	—	16,6

Sources: Commission services, 1983-84 Economic Forecasts, January 1984; OECD and National Bank of Belgium.

The high level of interest rates and the unfavourable trend of personal disposable incomes will continue to depress activity in the residential construction sector, which will remain low despite tax concessions such as the increase in the amount of mortgage interest which is deductible and the retention of VAT on new building at 6% instead of the normal rate of 17%. Similarly, there is unlikely to be any upturn in the public housing sector owing to financial difficulties in this branch of activity and to problems connected with the regionalization of the national housing associations.

The upturn in the world economy should lead to a marked acceleration in Belgian exports (+4% in volume) if exporters succeed in consolidating their competitive position, which has improved considerably in recent years. Imports will grow much more slowly (+1,5% in volume terms) owing to weak domestic demand. The terms of trade will probably worsen as a result of the rise in raw material prices. Overall, the trade balance, having improved sharply over the previous two years, could well show a surplus of some BFR 30 000 million or 0,7% of GDP. This will lead to a major reduction in the current account deficit, particularly as the balance of factor incomes will no longer worsen as before. The overall deficit will amount to 0,5% of GDP, compared to 1,5% in 1983.

Gross domestic product will increase in real terms by almost 1,5%. Employment, however, will decline further as a result of productivity gains. Nevertheless, the rise in unemployment will be much less than in previous years thanks to the new recruitment arising from the sectoral agreements to reduce working hours. As an annual average, the unemployment rate will rise from 14,5% of the civilian labour force in 1983 to 14,9% in 1984.

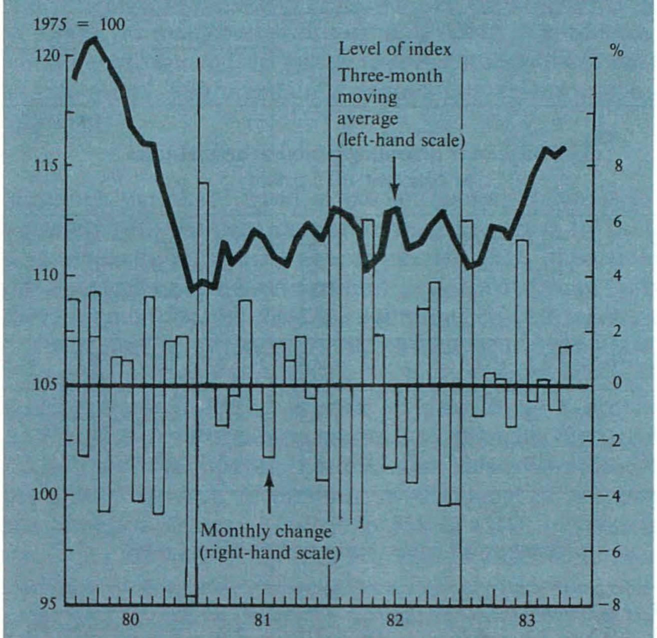
A number of factors—the rapid rise in wage costs and import prices and the increase in public service charges and rents—suggest that consumer prices will continue to rise fairly sharply. The annual average rise is likely to amount to some 6,5%, with a slight deceleration in the implicit index in the second half of the year.

Problems of economic policy

If Belgium is to profit fully from the world economic upturn, one of its prime tasks will be to consolidate the progress made in recent years in terms of its trade competitiveness, which is reflected in recent gains of market shares. This is essential if the trade balance is to provide the necessary surplus to finance part of the very heavy burden still imposed by external debt. This consolidation presupposes in particular that the increase in wage costs does not deviate too far from that of Belgium's trading partners. The achievement of this objective has been made more difficult by the reintroduction of wage indexation in 1983. The Belgian authorities have therefore reserved the right to take measures under the Finance Act of 11 April 1983 if the increase in wage costs in 1984 exceeds the average increase, expressed in a common currency, recorded by the country's seven main trading partners. The same should apply if, at the end of 1984, the economy-wide agreements threaten to undermine the competitiveness of the Belgian economy in the years to come.

The above table compares the growth of per capita earnings in Belgium with that of its trading partners on the basis of the Commission's most recent estimates and by applying the method used by employers and unions, which does not (among other things) take into account possible changes in effective exchange rates in 1984. The table implies some deterioration in 1984, although the target for the entire period 1983-84 will probably be met.

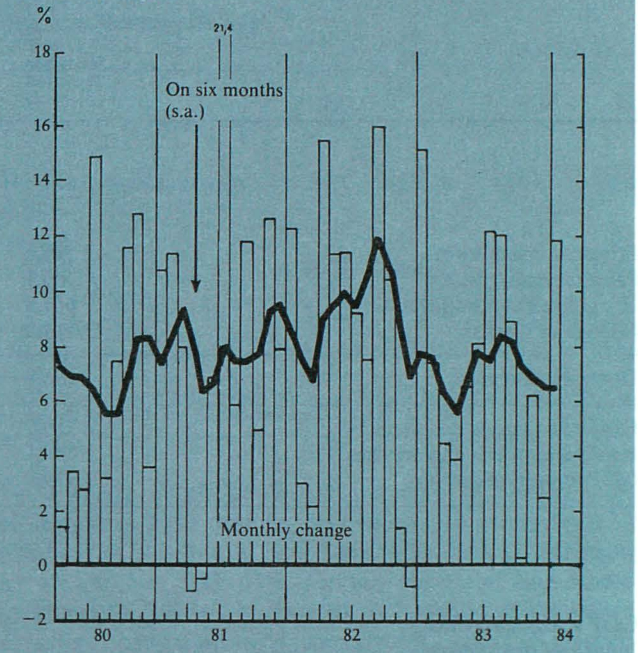
Belgium: Industrial production (s.a.)



Source: Eurostat.

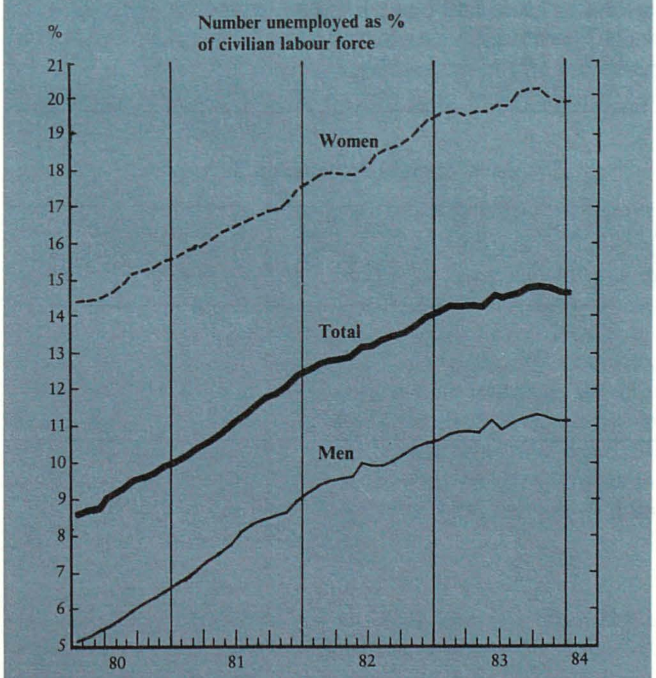
Belgium: Consumer prices

Change expressed as an annual rate



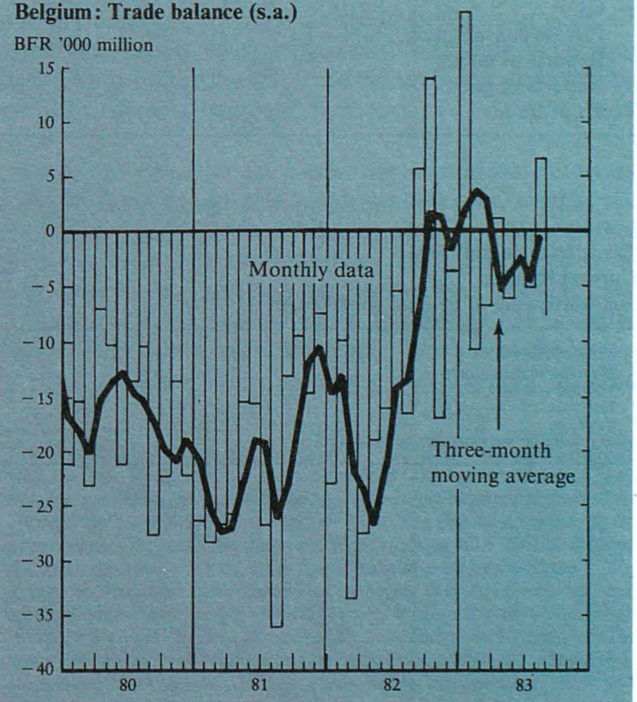
Source: Eurostat.

Belgium: Unemployment (s.a.)



Source: Eurostat.

Belgium: Trade balance (s.a.)



Source: Eurostat.

Belgium: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	BFR '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	2 599,6	3,4	1,1	−2,8	−0,6	2,3	−0,5	−3,8	−3,1	−0,3	1,2
Public consumption	740,1	3,6	−1,6	−1,5	−0,8	−1,9	−2,1	−1,5	−1,0	−0,7	−0,6
Gross fixed capital formation	667,9	0,7	−2,6	−6,0	1,3	2,0	−0,4	−8,5	−6,1	2,4	7,0
Change in stocks[1]	−10,8	0,6	−0,3	0,2	0,3	−0,4	−0,3	0,1	0,3	0,3	0,2
Domestic demand	3 996,8	2,5	−0,1	−2,6	−0,3	1,4	−0,4	−3,6	−2,7	0,1	1,6
Exports of goods and services	2 729,2	5,3	2,0	2,2	4,0	1,7	1,4	2,1	3,2	4,1	4,5
Imports of goods and services	2 786,1	5,1	0,2	−1,9	1,6	0,9	−1,1	−2,7	−1,0	2,0	3,5
GDP at market prices	3 939,9	2,8	1,0	0,0	1,3	1,9	1,1	−0,6	0,0	1,5	2,3
		% change over preceding period at annual rates									
GDP at current prices		9,9	8,1	6,4	7,3	:	:	:	:	:	:
Industrial production[2]		1,8	0,5	2,5	4,6	0,6	1,5	2,4	3,7	4,7	5,1
Unemployment rate[3]		6,4	13,1	14,5	14,9	12,6	13,6	14,3	14,7	14,8	14,9
Compensation of employees		11,7	6,0	4,0	7,3	:	:	:	:	:	:
Money supply (M2)		10,7	5,9	5,5	6,7	:	:	:	:	:	:
Implicit price indices:											
— GDP		6,9	7,0	6,4	5,8	:	:	:	:	:	:
— Private consumption		7,4	7,4	7,7	6,5	7,1	7,3	8,0	7,6	6,4	5,6
— Exports of goods		7,6	14,7	6,5	5,5	16,8	11,4	5,3	4,3	5,7	6,2
— Imports of goods		8,9	14,9	7,6	6,6	16,0	11,0	6,7	6,0	6,8	6,8
Terms of trade		−1,2	−0,2	−1,0	−1,0	0,7	0,4	−1,3	−1,6	−1,0	−0,6
		As % of gross domestic product									
Trade balance (fob/fob)		−3,1	−2,3	−0,3	0,7	:	:	:	:	:	:
Current balance		−1,0	−3,6	−1,5	−0,5	:	:	:	:	:	:
Net borrowing of general government		−6,3	−11,6	−11,6	−10,9	:	:	:	:	:	:

1 As % of GDP.
2 Manufacturing industry.
3 Unemployment as % of total labour force.
4 Estimates.
5 Forecasts.
Source: Eurostat and Commission services.

In considering which course should be followed, it should be borne in mind that while increases in costs must be limited in order to ensure external equilibrium, this is no less essential if internal disequilibria are to be eliminated. A more marked slowdown in inflation than currently forecast is one of the main preconditions for a fall in interest rates, which in turn would help greatly to correct the public finance situation and help maintain economic growth through investment.

Although the recent trend in public finances contrasts favourably with the deterioration during the period 1975-81, and although the overall net cash deficit shall stabilize in absolute terms and fall, as a percentage of GDP, from 14,4% in 1983 to 13,3% in 1984, the enormous cost of servicing the debt is seriously hindering efforts to control expenditure. Moreover, the ease with which the borrowing requirement was financed in 1983 has made it possible to postpone new budgetary reform measures and to abandon the target initially set in the budget; this relaxation means that the aim set at the beginning of the present parliament of reducing the central government deficit to 7% of GDP by 1985 is now out of reach. Without lasting cuts in expenditure, the deficit/debt interest/borrowing spiral is likely to become self-perpetuating and to prevent a permanent correction of the public finance situation.

If improvement is to be achieved, two conditions must first be met: firstly, the burden of debt interest must be stabilized if not reduced; secondly, overall expenditure must be limited in order to cut the deficit to reasonable proportions, since the tax burden on the Belgian economy cannot be increased appreciably without this having serious repercussions for investment and competitiveness.

The reduction in interest charges is linked directly to the reduction of the deficit, and it is therefore inevitable that expenditure other than that relating to the public debt will be sacrificed for a few years, until a better balance can be established between the different categories of expenditure. As already pointed out, however, a fall in the inflation rate would help to bring nominal interest rates down, thereby increasing to some extent the room for manœuvre available for other expenditure. In any case, one objective over the next few years should be to put an end to the increase in the public debt as a proportion of national income and so break the spiral referred to above.

Circumstances appear to be more favourable than for a number of years to permit further retrenchment: a sustained upturn in the European economy would enable sacrifices to be borne more easily than in recent years, when the cuts began.[1]

Changes in Treasury funding[1]

(BFR '000 million)

	1980	1981	1982	1983
Net borrowing requirement (cash)	*−296,8*	*−454,9*	*−508,4*	*−524,6*
Funding				
(a) in BFR	*+204,4*	*+240,6*	*+283,9*	*+390,6*
1. short-term	+134,9	+213,9	+223,9	+106,9
2. long-term	+69,5	+26,7	+60,0	+283,7
(b) in foreign currency	+92,4	+214,3	+219,5	+134,0

[1] Excluding exchange losses and debts not served through the budget but included in the central government debt on 1 January 1982 and 20 May 1983.

The structure of public deficit financing was much more favourable in 1983 than in 1982 thanks to an appreciable reduction in short-term and foreign currency borrowing and to the fact that 55% (in net terms) of the central government's deficit was covered by consolidated domestic borrowing, compared with scarcely 6% and 12% respectively in 1981 and 1982. The ease with which the public authorities were able to obtain funds from the domestic capital market, despite the high number of companies raising capital, was due to financial intermediaries and institutional investors reorganizing their security portfolios in response to the restoration of appropriate differentials in interest rates to an anticipated decline in rates on longer-term capital and to a slowdown in capital outflows.

It would be desirable to create the conditions necessary to enable these favourable trends to continue, so that the government can achieve its aim of discontinuing external borrowing from 1985. However, as the recent trend in interest rates shows, the monetary authorities will still have very little room for manœuvre so long as the public sector continues to borrow on a large scale, because of the resulting need to maintain at all times a differential between

[1] On 14 March the government adopted a programme designed to ensure that the 1984 budget would be implemented without overshooting, and that the net central government budget borrowing requirement would be reduced to 7% of GDP by the end of 1986. The financial impact of the programme is estimated by the government at about BFR 230 000 million; the main measure involved is the application of a levy amounting to 2% a year on one indexation instalment of wages and social benefits, and an equivalent levy on the self-employed. It also includes reductions in operating expenditure, interest costs, investment and social benefits (unemployment benefits, health care, maximum invalidity allowances, etc.), some tax measures and provisions on the adaptation of rents and increases in directors' attendance fees.

interest rates in Belgium and those on foreign money and financial markets.

Given the continuing difficulties on the employment market, the maintenance of special job-creating measures and early retirement are inevitable. Similarly, reductions in working hours which enable additional workers to be taken on should be encouraged, provided that they do not affect the wage costs and price competitiveness of the firms concerned.

The process of adaptation of economic structure is now taking place in a more favourable climate. Improved business profitability in recent years and the capital increases which have taken place owing to tax incentives have enabled firms to reduce their debts considerably and to create healthier financial conditions which have paved the way for new initiatives and the commitment of risk capital. The development of new products is made all the more important by the fact that a very open economy such as Belgium's must be able to adapt the range of its products and services to the opportunities offered by international markets. Furthermore, job and production capacity losses in the long-established industries will be even greater in the years ahead.

Denmark

Trends and prospects

During 1983, the economic situation in Denmark improved considerably as a result of the measures taken by the Danish authorities in the autumn of 1982 and of the more favourable international economic context. The improvement was in particular reflected in a marked slowdown of inflation (the average increase in consumer prices was reduced from 10,5% in 1982 to 6,7% in 1983), and a rapid reduction of the external deficit from 4,1% of GDP in 1982 to 2,1% in 1983; the long-term rate of interest [1] fell from 19,4% in December 1982 to 12,6% in December 1983; the general government deficit, which had been on an upward trend in previous years, was reduced from 9,2% of GDP in 1982 to 8,2% in 1983; gross domestic product increased in real terms by 2,0% in 1983 against 3,6% the year before. The average rate of unemployment, however, rose to 10,5% against 9,9% in 1982.

After falling slightly early in the year, domestic demand recovered significantly in the latter half of 1983. Despite the moderate increase in nominal earnings agreed in March, private consumption expanded at a somewhat higher rate than expected. The increased value of private assets accruing from lower inflation and cheaper, more abundant consumer credit at the end of the year apparently stimulated consumption. As a result of declining nominal interest rates and rising prices on the existing stock of houses, new construction became more attractive and residential building began to pick up towards the middle of the year. Improved profitability and confidence underpinned business investment in machinery and other equipment. However, gross fixed capital formation in other sectors slowed down. The fall in agricultural revenue due to the poor harvest had a negative impact on investment plans. As the infrastructure for exploitation and distribution of oil and gas from the North Sea is almost completed, investment in the energy sector levelled off after the big increase since 1980. Finally, the restrictive policy stance hampered public investment, in particular public construction.

Improved competitiveness and buoyancy of demand abroad underpinned exports of manufactured goods; agricultural exports, however, developed at a slow rate. Although imports picked up momentum in the second half of the year, the average increase in volume terms was slower than a year before. Improved terms of trade and lower interest rates abroad helped to reduce the current account deficit.

[1] Weighted average of government paper and mortgage-credit bonds.

Prospects for 1984 are largely determined by the measures taken since the end of 1982 in the field of budgetary policy and incomes policy. The government budget for 1984, proposed last autumn, is consistent with the previous policy stance, designed to obtain balance on the public accounts in the medium term and to allow the productive sectors of the economy to expand. The rise in public expenditure is for the most part due to the cost of servicing central government debt, which has increased, despite the fall in interest rates on domestic and foreign capital markets; other expenditure categories will hardly grow in real terms. Receipts are very much influenced by the automatic impact of stronger domestic activity, a rise in taxable corporate profits, and higher social contributions—a small rise in local taxes being offset by higher personal income tax allowances. The general government net borrowing requirement might consequently amount to 6,9% of GDP. [2]

The statutory abolition of wage indexation until March 1985, and recommendations made by the government with a view to reduce nominal wage increases to some 4% annually, determined the provisions of the biennial wage agreements concluded by the two sides of industry in March 1983. At the end of the year wages had risen by only some 4,5% over the previous twelve months, wage drift having been marginal. The average wage increase in 1984 should be of the order of 5%, including some individual adjustments at enterprise level as well as a minor adjustment of public sector wages in October provided for in the agreements.

The tight budgetary policy in 1983 partially eased the strains on monetary policy as reflected in the gradual reduction of the official discount rate from 10% at the end of 1982 to 7% a year later. Furthermore the falling interest levels abroad, a smaller spread between domestic and foreign interest and lower inflation helped to reduce domestic interest rates. The spread between after-tax bond yields and deposit rates in the banking system narrowed, which led to a large increase in money supply (M2) during the year (see table below). The counterparts to the expansion of liquidity were a steep increase in bond portfolios held by the banks, and a strong expansion in bank lending towards the end of 1983, in excess of the official target of 8%. Monetary expansion will probably slow down during 1984 after the shift in the level of the money stock seen in 1983 and as a result of a smaller rise in bank lending for private consumption and a further reduction of government drawings on the central bank.

[2] More details on fiscal policy can be found in the box following this chapter.

Money supply and counterparts

Change over 12 months as % (end of period)	1982 March	1982 June	1982 September	1982 December	1983 March	1983 June	1983 September	1983 December
Money supply (M2)	11,6	11,1	11,8	11,7	14,9	21,0	23,6	25,4
Some counterparts (weighted average increase)[1]:								
— government drawings	6,9	10,6	11,0	7,9	8,4	9,3	4,2	−0,1
— bank lending	10,5	9,8	10,6	9,5	7,9	6,8	6,2	10,5
— bond purchase	4,2	3,8	6,4	9,4	12,5	15,0	21,5	22,8
— foreign factors	−10,6	−11,9	−14,0	−13,7	−13,8	−8,2	−5,5	−4,1
For comparison:								
average bond yield[2]	20,6	21,2	21,2	19,4	14,7	14,3	13,7	12,6
short-term interest[3]	16,5	16,5	17,3	16,3	14,5	10,0	10,8	11,8

[1] Excluding other domestic factors.
[2] Weighted average of all bond series.
[3] Three-month interbank deposits.
Source: Danmarks Nationalbank.

The moderate increase in wages will mean a slight fall in real disposable earned income after the 2% drop last year despite the lower rate of inflation and the unchanged level of personal income taxation. Social security pensions and other social benefits might show a minor rise in real terms. Income other than wages and salaries should increase again. All in all, the increase in private consumption may be expected to be small during 1984, in particular as another upward adjustment of households' propensity to consume of the same order as last year can hardly be expected. Residential construction, where the rise in building starts in the second half of 1983 will continue to influence activity this year, should also edge upwards.

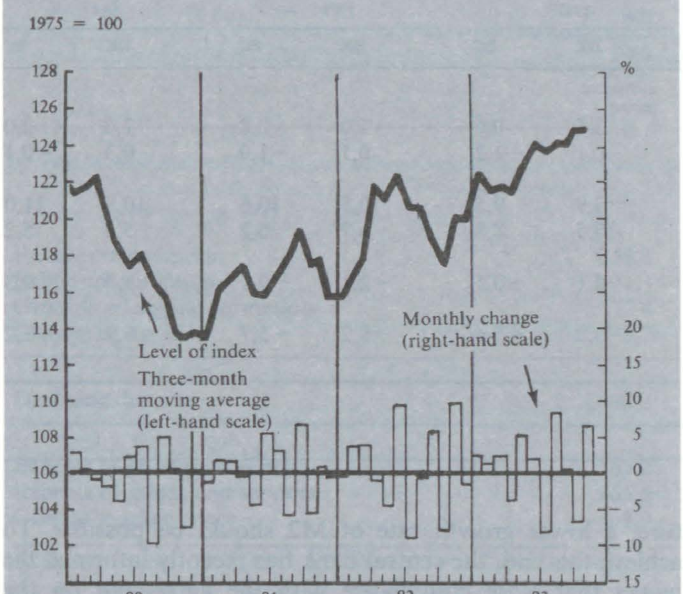
Owing to the general improvement of the economic climate and of business confidence, industrial investment did well in 1983. As a consequence of higher productivity and the slowdown in wages, the labour income ratio continued to fall to a level considerably below the average of the 1960s, implying a further real wage adjustment. The resulting increased propensity to invest should be maintained in 1984, according to the latest surveys. Profitability in the enterprise sector could rise again after the good results last year. The net return on fixed capital could thus exceed that on portfolio investment considerably, entailing further flows of funds into the enterprise sector. Moreover, some changes in the tax system could favour investment in enterprises (e.g. dividends are exempt from the new tax on the real interest accruing to pension funds). Not only should investment in machinery continue to grow, but industrial construction may begin to recover, and investment in ships might also rise a little. In the public sector, however, investment will be further cut.

As a result of the domestic cost and price performance, there could be further gains in the export market shares of manufactures, particularly on the United States market, but also on the German market. Agricultural exports on the other hand will continue to suffer from the effects of the poor harvest in 1983. Finally exports of oil should fall as a growing part of total output from the North Sea is taken ashore. After the rapid growth of imports at the end of last year, some slowdown could occur during 1984 owing to reduced investment in the energy sector and to increased substitution of domestic energy for imported oil. Thus despite a pickup in imports of industrial investment goods, the volume of total imports of goods and services could increase by only some 1,5% or 2%. Although the terms of trade should deteriorate, the balance on goods and services could show some improvement on 1983. Debt servicing will, however, rise further on account of the higher dollar exchange rate and slightly higher interest rates abroad. Consequently the current deficit on the balance of payments will not change very much compared with 1983.

On the whole, gross domestic product in 1984 might grow by 2,6%, somewhat faster than in 1983. This expansion will have a positive impact on employment in manufacturing industries, construction and certain market services. Thus, despite some cutback in public employment and a further rise in the total labour force, the rate of unemployment should remain stable somewhat below 11% of the labour force.

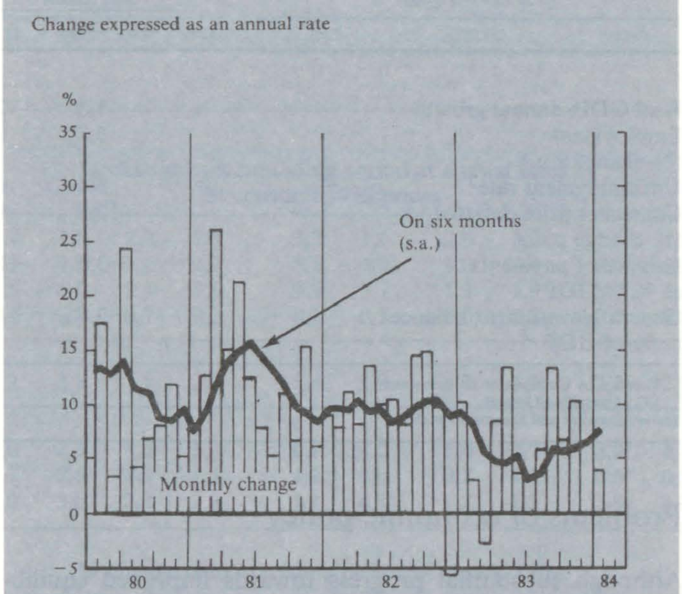
As the following table shows, economic performance in Denmark should converge more closely with developments in other Community countries.

Denmark: Industrial production (s.a.)



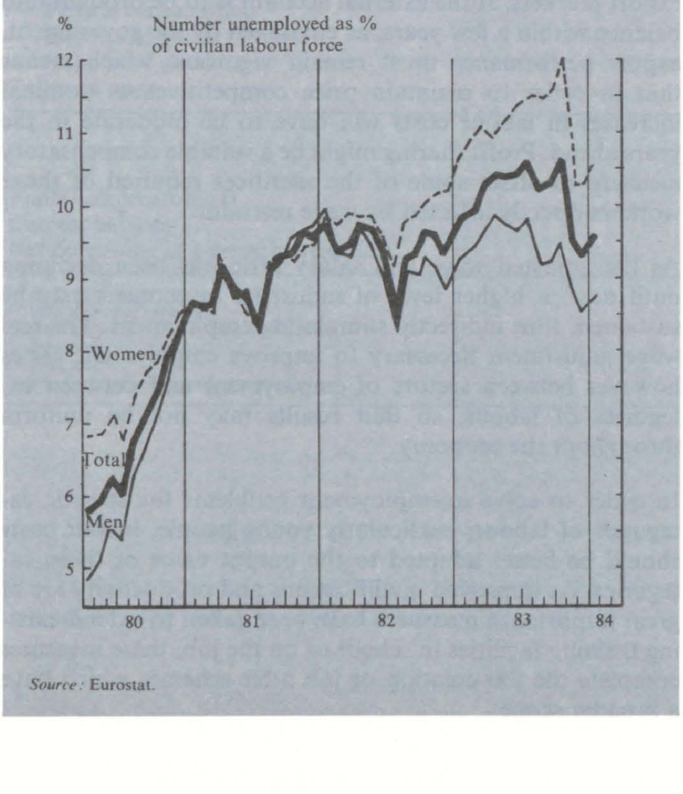
Source: Eurostat.

Denmark: Consumer prices



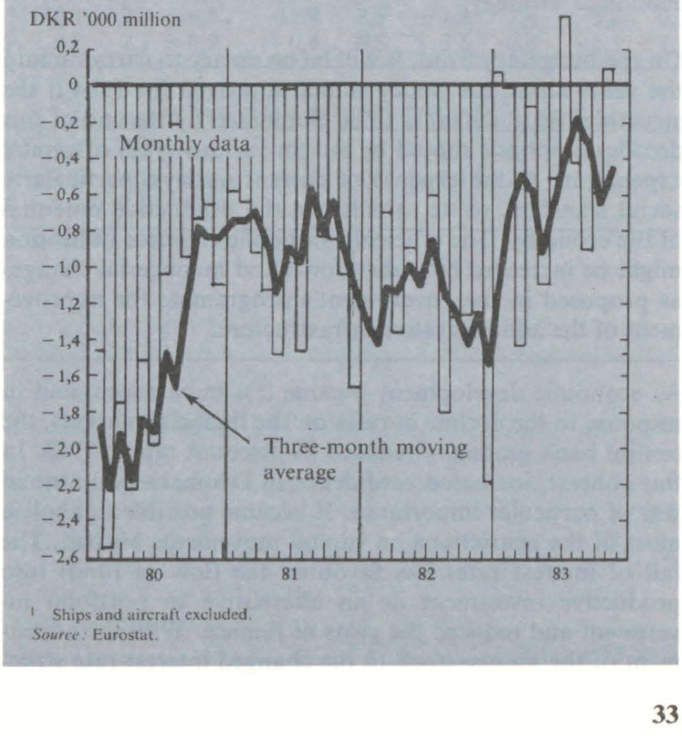
Source: Eurostat.

Denmark: Unemployment (s.a.)



Source: Eurostat.

Denmark Trade balance (s.a.)[1]



[1] Ships and aircraft excluded.
Source: Eurostat.

Economic performance in Denmark and the Community

	1976-81		1982		1983		1984[1]	
	DK	EC	DK	EC	DK	EC	DK	EC
Real GDP: annual growth	1,3	2,0	3,6	0,6	2,0	0,8	2,6	2,0
Employment (% change p.a.)	0,1	0,0	0,1	−1,2	0,1	−1,0	0,3	−0,1
Unemployment rate[2]	6,4	6,0	9,9	9,5	10,5	10,6	10,8	11,0
Consumer price deflator (% change p.a.)	10,2	9,4	10,5	8,8	6,7	6,2	5,3	5,2
Balance of payments as % of GDP	−3,6	−0,4	−4,1	−0,5	−2,1	−0,1	−1,9	0,3
General government balance as % of GDP	−2,6	−4,5	−9,2	−5,4	−8,2	−5,7	−6,9	−5,2

[1] Forecast by Commission departments.
[2] EC 9 (excluding Greece).
Source: Eurostat and Danmarks Statistik.

Problems of economic policy

Although substantial progress towards improved equilibrium was made during 1983 the Danish economy is still confronted with considerable imbalances. The growing burden of servicing the government and the external debt involves an element of risk which continues to constrain present policies. The most recent development of the balance of payments shows that a firm policy stance is called for. It is particularly important to prevent a substantial rise in private consumption from jeopardizing the success of overall economic strategy.

On the budgetary front, it will be necessary to carry on into the years ahead the policy stance approved for 1984 if the structural fiscal deficit is to be eliminated by the end of this decade. Emphasis should be put on various types of capital expenditure at the expense of current outlays, particularly social transfers, so as to enhance the productive potential of the economy. The efficiency of public resource utilization might be increased by institutional and managerial changes as proposed in the government's programme for improvement of the administrative infrastructure.

As economic development became less imbalanced, and in response to the decline in rates on the financial markets, the central bank gradually reduced its discount rate in 1983. In this context, increased confidence in Denmark and abroad was of particular importance. It became possible to abolish most of the restrictions on capital movements abroad. The fall of interest rates has favoured the flow of funds into productive investment as an alternative to portfolio investment and reduced the costs of finance. With the adjustment of the money stock to the changed interest-rate structure, a lower growth rate of M2 should be possible. To achieve this end, the central bank has recently informed the banks that close compliance with the agreement on the expansion of bank lending will be required, and that loans for private consumption should be treated with special caution.

Incomes policy, applied through biennial wage agreements, helped to improve cost performances and contributed to the improvement in Denmark's competitive position on major export markets. If the external account is to be brought into balance within a few years, as envisaged by the government, export performance must remain vigorous, which means that in order to maintain price competitiveness nominal increases in labour costs will have to be moderate in the years ahead. Profit sharing might be a suitable compensatory measure to offset some of the sacrifices required of those workers directly affected by wage restraint.

As the adjusted wage and salary ratio has been declining until now, a higher level of industrial investment may be sustained, thus indirectly stimulating employment. The real wage adjustment necessary to improve employment varies however between sectors of employment and between categories of labour, so that results may not be uniform throughout the economy.

In order to solve unemployment problems for specific categories of labour, particularly young people, labour costs should be better adapted to the output value of those categories. As improved qualifications and productivity are of great importance measures have been taken to extend existing training facilities in school or on the job; these measures complete the job creation or job offer schemes which have a broader scope.

Denmark : Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	DKR '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982		1983[4]		1984[5]	
						I	II	I	II	I	II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	258,8	1,7	1,8	2,2	1,8	3,2	1,6	2,0	3,3	1,4	1,0
Public consumption	131,3	4,1	4,1	1,6	−0,2	5,1	4,0	1,0	0,4	0,0	−1,2
Gross fixed capital formation	77,4	−2,5	6,0	2,1	3,6	9,9	3,7	1,3	1,9	3,7	5,0
Change in stocks[1]	0,7	0,4	0,2	−0,7	−0,2	−0,1	0,5	−0,6	−0,8	−0,5	0,0
Domestic demand	468,2	1,2	3,8	1,1	2,0	5,4	3,8	−0,7	1,9	2,1	2,0
Exports of goods and services	167,2	5,0	2,3	3,9	3,2	0,9	8,2	5,4	2,7	3,0	4,1
Imports of goods and services	165,5	2,1	2,8	1,4	1,5	1,2	1,0	0,2	4,2	0,6	0,5
GDP at market prices	469,9	2,0	3,6	2,0	2,6	5,1	4,1	1,2	1,5	2,8	3,2
		% change over preceding period at annual rates									
GDP at current prices		12,1	14,4	9,8	7,7	16,0	13,5	9,6	6,7	7,8	8,3
Industrial production[2]		1,7	2,5	2,8	3,5	5,2	−2,6	6,3	1,6	3,1	6,1
Unemployment rate[3]		4,5	9,9	10,5	10,8	9,8	9,9	10,4	10,6	10,8	10,9
Compensation of employees		12,4	12,2	7,8	5,7	9,2	10,5	6,9	6,0	5,4	4,2
Money supply (M2)		11,9	11,7	25,4	7,5	:	:	:	:	:	:
Implicit price indices:											
— GDP		9,9	10,5	7,7	4,9	10,3	9,0	8,0	5,8	4,5	4,9
— Private consumption		10,4	10,5	6,7	5,3	10,6	9,7	6,0	5,1	4,9	6,3
— Exports of goods		9,6	11,0	5,1	5,5	12,4	9,2	1,6	8,0	4,2	6,0
— Imports of goods		11,7	10,1	2,9	6,5	12,9	8,3	−1,8	7,4	5,8	7,2
Terms of trade		−1,9	0.8	2,1	−0,9	−0,4	0,8	3,5	0,6	−1,5	−1,1
		As % of gross domestic product									
Trade balance (fob/cif)		−5,1	−2,0	−0,3	−0,3	−2,3	−1,8	−0,3	−0,4	−0,4	−0,2
Current balance		−3,0	−4,1	−2,1	−1,9	−4,0	−4,3	−2,1	−2,2	−2,0	−1,9
Net borrowing of general government		−0,2	−9,2	−8,2	−6,9	:	:	:	:	:	:

[1] As % of GDP.
[2] Manufacturing industry.
[3] Unemployment as % of total labour force.
[4] Estimates.
[5] Forecasts.
Source: Eurostat and Commission services

Denmark: Progress towards a healthier budget position

A deterioration in public finances from 1973 to 1982 ...

For 10 years, the budgetary situation deteriorated seriously in Denmark. There were considerable surpluses in the early 1970s: net lending of general government (national accounts definitions) amounted to about 5% of gross domestic product in 1973. A deficit appeared in 1975, and it expanded steadily, thereafter, especially after 1979, to reach 9,2% of GDP by 1982, when net borrowing for the Community as a whole was 5,4% of GDP.

The deterioration in Denmark's budgetary situation coincided with a period of growing overall imbalance more pronounced in Denmark than in the Community as a whole. In 1982 the deficit on current account, in excess of 4% of GDP, was considerably larger than in other Community countries. Average consumer price rises at 10,5% were also higher than the Community average. At 3,6%, however, economic growth was the highest in the Community, and the rate of unemployment remained below the Community average despite a continuous expansion in the labour force.

The growing imbalances induced the authorities to shift the scope of fiscal policy from the traditional approach centred on demand management towards a more mixed policy including measures to improve supply conditions.

(i) The obvious need to adjust domestic demand, in particular private consumption, to a level compatible with improved external equilibrium was met through higher indirect taxation rather than increases in direct taxes, while social security contributions were raised gradually. Furthermore, extensive application of excise duties helped to switch domestic demand away from imports, particularly energy.

(ii) In view of the deterioration of the employment situation, some measures were taken to slow down total labour supply growth (in particular the early retirement scheme introduced in 1979) and to increase job opportunities (especially by job-offer schemes largely dependent on the public sector). Taken together, the above measures may have reduced the unemployment rate by some 4 percentage points in 1982.

(iii) In parallel to the employment programmes, various measures were adopted to sustain investment and exports and to promote energy conservation. The measures were based on temporary or specific tax allowances to investment, selective low-interest loan arrangements based on State-guaranteed borrowing abroad, special financial measures by sector (e.g. building, agriculture). The measures may have marginally lowered the cost of capital expenditure.

(iv) The rise in labour costs resulting from indexation adjustments was curbed by granting compensatory allowances to employers, or government contributions to workers' industrial pension accounts to cover wage adjustments.

From 1976 to 1982, public revenue expanded by an annual average of 12%, slightly faster than nominal gross domestic products, mainly because of increased indirect taxation and social security contributions. Expenditure grew by an average of 16% a year. In particular, transfers to households expanded very rapidly, especially unemployment contributions and bridging pensions. Expenditure on staff, in particular in the areas of education and social services, also increased rapidly. The major increase in the burden of debt servicing was due to much heavier borrowing and very high rates of interest, particularly in the latter half of the period under review.

The following table shows the most important factors in recent budgetary developments.

General government revenue and expenditure

(as % of GDP)

	1976	1979	1982	1984
Revenue	47,6	51,5	51,5	53,9
— Tax revenue	40,8	43,7	42,6	44,3
— Social security contributions	1,5	1,6	2,4	3,2
— Other revenue	5,2	6,2	6,5	6,4
Expenditure	47,8	53,2	60,6	60,8
— Current transfers to households	13,6	15,5	18,1	17,5
— Other current transfers	4,1	4,8	4,9	4,6
— Interest payments	1,4	3,5	5,9	8,8
— Public consumption	24,1	25,0	27,9	26,6
— Capital expenditure	4,6	4,3	3,8	3,3
General government net borrowing	−0,2	−1,7	−9,2	−6,9

... and a slight improvement in the budgetary situation in 1983 and 1984

The government that took office in the autumn of 1982 gave top priority to restoring domestic and external balance. Its budgetary strategy, in particular, is designed to solve a number of cyclical and structural problems.

With a view to restoring balance to government finances towards the end of the decade, one of the government's concerns has been to reduce the cost of the welfare state, either through higher social security contributions, increased payment for use of social institutions and services, etc., or through a more restrictive application of social transfers (unemployment benefits and social assistance) including a temporary freeze of certain ceilings. Various non-compulsory expenditure items have been reduced by 2% in 1983 and again in 1984, grants-in-aid to local government were cut by DKR 3 000 million in 1983 and a further DKR

1 350 million in 1984, which has resulted in local expenditure cuts. Finally certain excise duties were adjusted upwards in 1983, public service charges increased and a tax on real interest accruing to pension funds was introduced.[1] The basic idea of these measures during 1982-83 was to shift a larger part of public expenditure on to the beneficiaries and to avoid a general increase in taxation.

The second tier of fiscal policy concerned the improvement of the economic and administrative infrastructure. Five major areas were identified by the government: public investment and subsidies should be geared to promoting the development and the application of advanced technology in the private sector; tax measures should be adopted to facilitate the provision of venture capital; the tax system should be revised in order to reduce tax-induced diseconomies; the use of public resources should be improved in order to combat expenditure drift, particularly by shifting resources between sectors and increasing the cost/price element in payment for public services and benefits; the administration of public resources should be based on optimal use of appropriations in each sector. These guidelines are intended to dismantle certain obsolete mechanisms implied in public resource allocation and to abolish diseconomies built up by a vast system of taxes and benefits.

Recent figures show that the above strategy brought about an absolute improvement in the budgetary situation in 1983, and it is expected that the general government borrowing requirement will decline further in absolute terms in 1984. As a percentage of GDP, this requirement should fall from 9,2% in 1982 and 8,2% in 1983 to 6,9% in 1984. Between 1982 and 1984, revenue will have expanded faster than expenditure, itself expected to increase at an annual average rate of 8,8% during the period concerned (compared with 16,5% in 1980-82). Obviously, these figures should be assessed against a background of rapid disinflation (10,5% in 1982; 5,3% in 1984). The most marked slowdown in expenditure was in the area of transfers to households and firms, and in that of remunerations, where moderation was achieved by limiting pay rises provided for in collective agreements for 1983 and 1984 to 4%, and by suspending indexation. Similarly, the considerable decline in interest rates substantially limited the expansion of debt servicing charges, although it did not prevent a considerable increase in these charges from 1982 to 1984.

[1] A 22% capital tax payable in 1983 was replaced by a tax on real interest in excess of 3,5 %.

Federal Republic of Germany

Trends and prospects

The economic recovery in the Federal Republic of Germany has become firmly based in the last few months and the upswing is expected to be self-sustaining during this year. Real GDP increased by 1% last year and will probably grow by about 3% on average in 1984. Several factors have contributed to the turnaround in economic development and to the more optimistic assessment of economic prospects.

The most surprising development of the last year was the performance of real private consumption. After having declined from 1981 onwards (1981 −1,3%, 1982 −2,2%), real private consumption increased by 1% last year. This change in trend occurred despite wages and salaries rising by only 1,3% in nominal terms, implying a continued fall in real wages. Several factors contributed to the recovery of private consumption. The most important seems to have been that overall consolidation policy was considered by private households to be of a lasting nature, leading to a lower level of household saving. As this was accompanied by a permanent fall in inflationary expectations, private households reduced their savings ratio by about 2 percentage points. This was underpinned by the fact that there was some deferred demand for durables. For example, purchases of automobiles rose by more than 10% last year.

In the course of 1983, the upswing was supported by exports which—after a decline in the first half of the year—started to rise from mid 1983 onwards. Two factors mainly account for this favourable development. Firstly, the depreciation of the real effective exchange rate of the D-Mark improved Germany's international competitiveness. Secondly, as the economic upswing in the USA became more broadly based, German exports of finished goods gained considerably. Despite foreign competitors losing some ground in domestic markets, import growth of goods was slightly above GDP growth last year, mainly because of the turnaround in the stock cycle. All in all, the surplus on the trade balance fell by DM 4 000 million to DM 55 000 million in 1983, but the current balance surplus improved by DM 3 000 million to some DM 12 000 million.

The labour market reacted unexpectedly quickly to the economic upswing, with the number of unemployed persons having fallen since August (on a seasonally adjusted basis). However, total employment has not yet risen, partly as measures were taken to encourage people to accept early retirement. Furthermore, migration programmes led to a decline of the potential labour force.

The forecast for 1984 presented here (see table) takes account of the budgetary and monetary decisions announced by the authorities. They imply a continuation of the restrictive budget policy stance (with Federal Government net borrowing falling probably below DM 30 000 million) and a target range of the growth of the Central Bank Money Stock (CBM) between the fourth quarters of 1983 and 1984 of 4-6%. Hence monetary policy will continue to remain cautions, and a substantial decline of short-term interest rates cannot be expected. However, long-term interest rates might well be affected by the future rate of the dollar.

Public deficit

	1980	1981	1982	1983	1984[1]
General government deficit					
— DM '000 million	−47	−60	−55	−50	−32
— % of GDP	−3,5	−3,9	−3,5	−3,0	−1,8

[1] Forecast.

Wage settlements for the economy as a whole in 1984 are expected to be hardly different from those observed in the previous year. However, this assumption (which implies a rise in total compensation of employees of 4,2% in 1984, as against 1,5% in 1983, reflecting the different movements in employment) is subject to considerable uncertainties, in particular with respect to the reduction in working hours being sought by most unions, to be negotiated together with possible increases in wages and salaries and, secondly, final settlements for the public sector.

The forecast for 1984 points to an increase in real GDP of 3% on a year-on-year comparison, which also implies an underlying trend during the year of about 3%, thus in line with that observed in 1983.

As labour market conditions are expected to improve somewhat, the fall in the savings ratio might still continue. Together with an expected increase of total compensation of employees of about 4%, real private consumption should increase by 1-2% this year.

Private consumption and households savings

	1980	1981	1982	1983	1984[1]
Private consumption (% change)	1,8	−1,2	−2,2	1,0	1,5
Savings ratio (% of disposable income)	12,8	13,6	13,0	11,7	10,8

[1] Forecast.

The investment climate has also become favourable in the recent past as medium-term sales expectations have become more optimistic and capacity utilization has risen somewhat. On the supply side, scrapping of old machinery due to economic and technical obsolescence calls for higher replacement investment. With wage moderation likely to continue and productivity growth returning to normal, profit margins are rising with improving sales prospects. In addition, fiscal policy measures aimed at improving the financial position of companies have contributed to a more optimistic assessment of the future. The expected rate of return on new investment projects has therefore improved, in particular in relation to that on financial assets. Investment in equipment, showing a downward trend since 1980, increased in 1983 by 4½% (see graph). This development could become more sustained as self-financing of enterprises continues to rise.

Investment trends

(% changes)

	1980	1981	1982	1983	1984[1]
Gross fixed investment	3,7	−3,8	−5,4	2,4	5,7
— Equipment	2,5	−3,5	−6,6	4,4	5,9
— Construction					
— private	3,7	−4,7	−4,5	0,9	5,5
— public	1,5	−8,2	−8,2	−7,8	2,5

[1] Forecast.

Real export growth might continue strongly this year, underpinned not least by the dynamic development in the second half of 1983. The balance on current account should continue to improve slightly to about DM 18 000 million in 1984 mainly due to an improvement of the trade balance reflecting strong exports. However, for the first time since 1981 there will be a change in the trend in the invisibles balance pointing to a somewhat higher deficit. Some uncertainties are attached to the development of the balance of unilateral transfers, as private unilateral transfers might decrease because of significant migration while official transfers will probably continue to grow.

Exports of goods and services 1980-84

(% changes)

1980	1981	1982	1983	1984[1]
5,8	8,1	3,5	−1,1	6,2

[1] Forecast.

The favourable trends observed on the labour market in 1983 are expected to continue this year in spite of the increasing number of school-leavers. Notwithstanding a significant rise in production, however, employment might increase only slightly. This view is supported by the strong decline of short time working over the last year. The number of unemployed persons is expected to be about 2,1 million this year, which corresponds to an unemployment rate of somewhat below 8%.

Labour market indicators

	1980	1981	1982	1983	1984[1]
Labour force, millions	27,2	27,3	27,4	27,4	27,3
Employment					
— millions	26,3	26,1	25,6	25,1	25,2
— % change	−0,9	−0,7	−1,9	−1,7	0,2
Unemployment					
— millions	0,9	1,3	1,8	2,3	2,1
— in % of civilian labour force	3,3	4,7	6,8	8,4	7,8

[1] Forecast.

Inflation should continue at a slow pace during 1984. There might, however, be some acceleration, due to higher wage settlements and some rise in import prices. All in all, the cost of living index is expected to rise by somewhat more than 3% this year. However, this is subject to the uncertainty relating to the movements of the dollar exchange rate.

Cost and price trends 1980-84

(% changes)

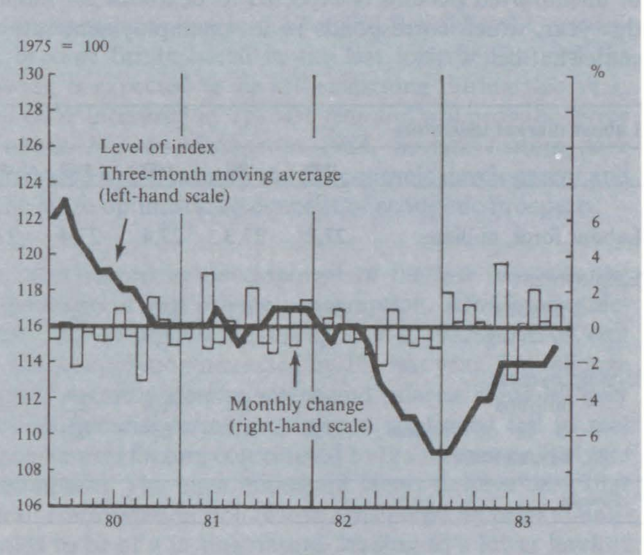
	1980	1981	1982	1983	1984[1]
Import prices	3,2	3,3	2,2	−0,4	3,7
Unit labour costs	5,1	5,0	3,3	0,7	1,1
Consumer prices	5,3	6,0	5,3	3,0	3,3

[1] Forecast.

Problems of economic policy

Economic policy applied by the authorities has on the whole produced favourable results in 1983. The public finances, which had seemed at one point to be moving into significant imbalance but started to improve in 1982, were further adjusted during 1983. The progress towards containing the structural part of the deficit—irrespective of how this is measured—has been considerable. This overall restrictive fiscal stance was combined with selective measures to stimulate demand, which contributed to a rise in company investment and a turnaround in private housebuilding.

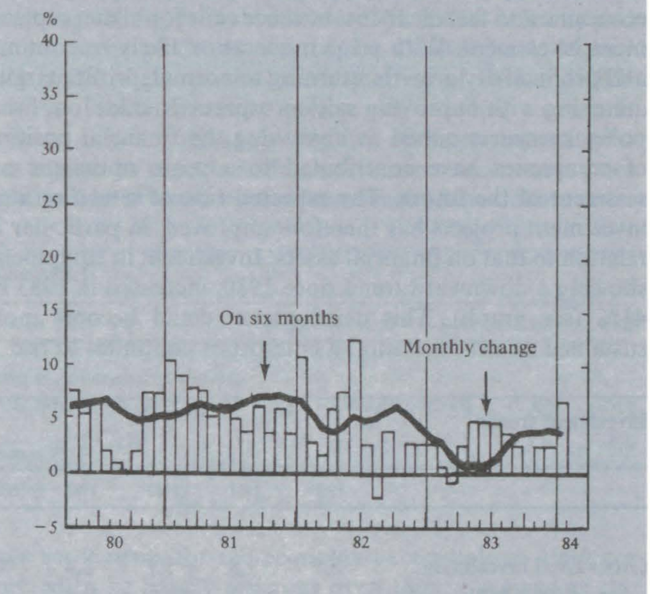
Federal Republic of Germany: Industrial production (s.a.)



Source: Deutsche Bundesbank.

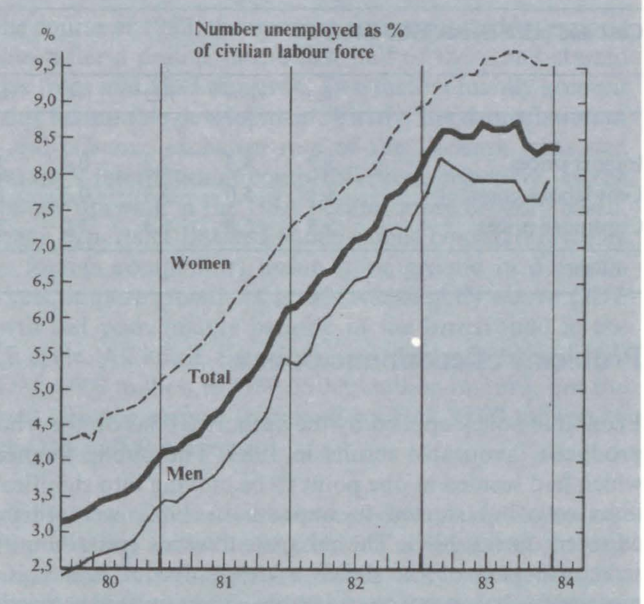
Federal Republic of Germany: Consumer prices

Change expressed as an annual rate



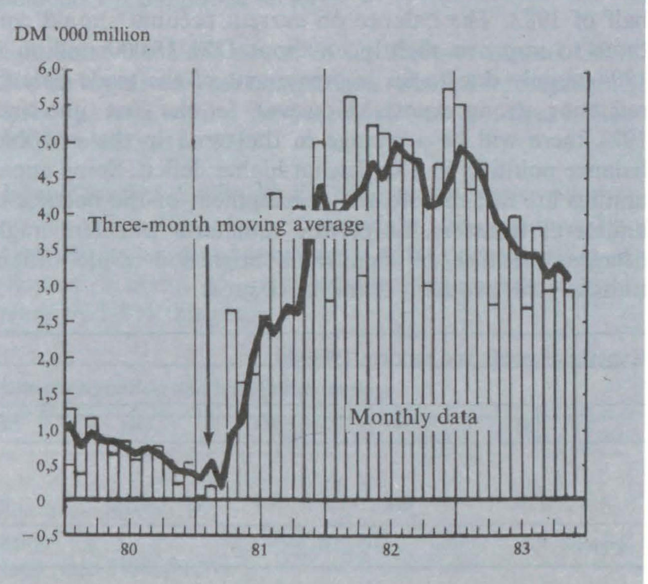
Source: Eurostat.

Federal Republic of Germany: Unemployment (s.a.)



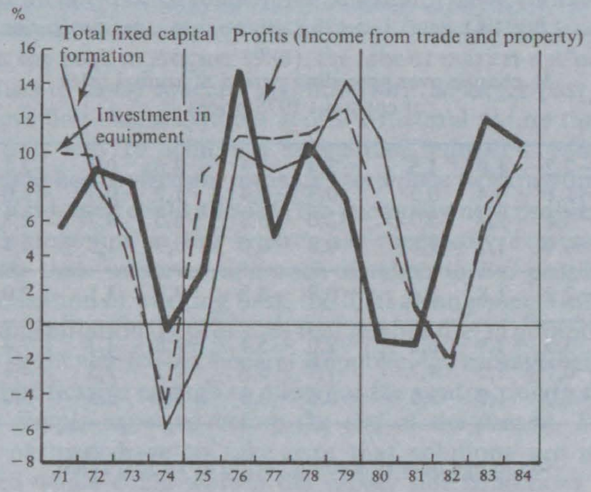
Source: Eurostat.

Federal Republic of Germany: Trade balance (s.a.)



Source: Eurostat.

Federal Republic of Germany: Profits and investment



Source: Statistisches Bundesamt and Commission services.

Despite doubts expressed in some quarters about the speed with which the budgetary consolidation was undertaken this process does appear, on balance, to have underpinned the restoration of more viable medium-term prospects and has thus favourably influenced the propensity to spend of both consumers and investors. The firm determination of the authorities to continue on the declared path contributed to an improvement in business confidence and expectations which were further boosted during the later part of 1983 by the strong revival in orders from abroad.

Thus the policy which has helped to bring the economy out of recession consisted of a comprehensive approach aiming at a smaller public sector, better medium-term profit expectations and a switch of resources into productive investment. The upward revision of the projected growth for 1984 reflects both the success of this approach and the improved outlook for exports; the latter came at an opportune time for German industry, as domestic forces alone would scarcely have been strong enough to ensure such a firm recovery.

Fiscal policy has been a matter of considerable concern for a number of years in Germany, as in other Community countries, and has in fact lost virtually all room for manœuvre. This was due to the fact that there was excessive deficit spending during the 1970s so that expansionary fiscal policy measures, given their interest rate repercussions, in the end became self-defeating. The objective of consolidation policies was to restore better conditions for fiscal policy. It is a regrettable fact that during the most serious downswing since the Second World War this important policy instrument was practically unusable. The period in which the short-term demand-side effects of fiscal consolidation have been particularly problematic is, however, now coming to an end. From now on, beneficial long-term supply-side effects will clearly predominate. The consolidation course of fiscal policy has also contributed to a deceleration of inflation directly via demand effects and indirectly via related labour market effects, through induced moderate wage increases.

Monetary policy, less constrained by the balance of payments and by the outlook for public expenditure and borrowing, made an important contribution to the success of the chosen policy mix. Despite recurrent weaknesses in the DM/USD exchange rate in 1983 and the resulting sharp increases in import prices, the Bundesbank continued its policy of maintaining downward pressure on interest rates, even though there was in September a modest rise in the Lombard rate, which had gone out of line with money market conditions. With this policy the Bundesbank succeeded in closing the year with the central bank money stock (CBM) just falling within the target range.

The Bundesbank has set the target range for the growth of CBM in the year to the fourth quarter of 1984 at 4 to 6%. On average, this monetary target is consistent with the official projection announced in the annual economic report (5½%) between 1983 and 1984. When announcing this policy target, the Bundesbank made clear that its considerations continued to be guided by its concern to maintain price stability (the main objective entrusted to the bank by law) and that uncertainty about the outlook for production and business confidence had receded.

Particular care must be taken to ensure that the recovery which is now under way will not be short-lived but will produce sustained growth permitting the necessary structural adjustment, investment in new products and technologies, creation of new firms and of new and competitive jobs. In order to maintain business confidence and to encourage high risk investment, the turnaround in the income distribution in favour of company profits should not be endangered. Income from trade and property increased—admittedly from a very depressed level—by almost 12% in 1983 and the Commission's outlook for 1984 is for a further increase of about 10½%. Past experience has clearly shown that investment can only prosper under conditions which permit a sufficient return on capital. It is therefore of crucial importance that settlements between the social partners should not result in undesirable cost increases which would jeopard-

Federal Republic of Germany: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982 DM '000 million at current prices	Annual data 1972-81	1982	1983[4]	1984[5]	Half-yearly data (s.a.) 1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	899,4	2,3	−2,2	1,0	1,5	−2,4	−3,1	3,6	0,1	2,1	1,8
Public consumption	325,3	3,0	−1,1	−0,4	0,5	0,3	−3,4	1,2	−0,7	1,0	0,8
Gross fixed capital formation	327,9	0,1	−5,4	2,4	5,7	−12,0	5,3	−2,5	9,7	2,8	7,6
Change in stocks[1]	7,2	0,7	0,4	1,2	1,4	0,8	0,0	0,9	1,5	1,4	1,3
Domestic demand	1 559,7	1,9	−2,2	1,8	2,4	−0,8	−3,2	3,7	3,1	2,0	2,6
Exports of goods and services	496,9	5,8	3,5	−1,1	6,2	2,0	−5,4	−1,8	4,7	7,4	5,3
Imports of goods and services	457,5	4,4	−0,1	1,5	4,7	1,7	−5,5	2,2	7,3	4,1	3,3
GDP at market prices	1 599,1	2,3	−1,0	1,0	3,0	−0,6	−3,3	2,4	2,5	3,0	3,2
		% change over preceding period at annual rates									
GDP at current prices		7,2	3,7	4,2	5,9	3,2	3,3	3,8	5,7	6,0	5,7
Industrial production[2]		1,6	−2,8	0,8	5,0	−2,4	−8,8	4,3	4,1	5,8	4,3
Unemployment rate[3]		3,1	6,8	8,4	7,8	6,4	7,2	8,3	8,5	8,4	7,2
Compensation of employees		7,8	2,3	1,5	4,2	:	:	:	:	:	:
Money supply (M2/M3)		:	7,1	5,3	5,3	:	:	:	:	:	:
Implicit price indices:											
— GDP		4,8	4,8	3,2	2,8	3,9	6,9	1,4	3,1	2,9	2,3
— Private consumption		5,2	5,3	3,0	3,3	4,6	5,3	1,8	2,9	3,7	2,7
— Exports of goods		5,4	4,4	1,5	2,7	3,3	4,3	−0,2	2,0	3,0	2,7
— Imports of goods		8,1	2,0	−0,8	3,7	−1,1	1,0	−4,4	4,7	3,5	3,0
Terms of trade		−1,6	2,4	2,3	−1,0	4,4	3,3	4,4	−2,6	−0,5	−0,3
		As % of gross domestic product									
Trade balance (fob/cif)		2,8	3,2	2,5	2,6	3,7	3,7	3,3	3,2	3,4	3,6
Current balance		0,5	0,6	0,7	1,0	0,2	0,9	1,2	0,3	0,9	1,1
Net borrowing of general government		−2,4	−3,5	−3,0	−1,8	:	:	:	:	:	:

1 As % of GDP.
2 Manufacturing industry.
3 Unemployment as % of total labour force.
4 Estimates.
5 Forecasts.
Source: Eurostat and Commission services.

ize the improving investment climate. Modest wage settlements would also contribute to an easing of the pressure for the introduction of labour saving production techniques and stimulate the demand for labour.

Despite an unexpected reduction in unemployment, (in January, unemployment, seasonally adjusted, was 130 000 lower than at the peak in August 1983), the labour market outlook continues to cause concern. As, however, the larger part of the prevailing unemployment is of a structural nature there is no easy way to achieve a substantial reduction. Much discussion has centred on measures to reduce working time, which it is hoped could alleviate the unemployment problem. The Commission, in this regard, has repeatedly expressed the view that, whatever approach is taken to the possible reorganization of working time, the final arrangements must offset any inflationary pressures that might arise; in addition, and in particular for the Federal Republic, the arrangements should be flexible enough to allow for the contraction in the labour supply expected before the end of the decade. The social partners have to take care that solutions are not adopted which could worsen the supply side conditions of the economy.

The authorities have announced their intention to decide, in the months to come, on the general outline of a major income tax reform. In particular, the provision of income tax relief, amounting to about DM 25 000 million, is being considered. It is important that the timing of such a reform should be consistent with a further reduction of the government borrowing requirement. One should also bear in mind that some of the apparent deficit reduction is the result of abnormally high profit transfers from the Bundesbank, which to this extent do not permanently reduce the deficit. The income tax reform should stimulate physical and financial investment in risk capital. Some of the incentives presently directed towards private housebuilding—which does not add to the productive capital stock—may have to be reconsidered. As the readiness to adjust to structural change appears to have weakened, the necessary modification of the tax system should also encourage labour mobility and technological change.

An important contribution to the process of structural adjustment could also be made by achieving greater transparency with regard to subsidies, and by ensuring that regional and sectoral policies do not contribute to the hardening of economic structures. Adjustment subsidies should, whenever possible, decrease over time and be of limited duration, thus enabling the market process to play its role in efficient allocation of scarce resources. Such areas where government or public enterprises act as suppliers should also be subject to competitive market forces.

Subsidies in the Federal Republic of Germany

1. Definition of subsidies

The Federal Government has published Subsidy Reports at two-yearly intervals ever since 1967; the most recent was the Ninth Subsidy Report, adopted on 6 September 1983. [1] These documents contain a considerable amount of statistical and other information which makes the complex phenomenon of subsidies in an advanced economy much more transparent than is the case in all other Community countries, where such information is not available; in this respect only the position of the UK comes anywhere near that of the Federal Republic of Germany.

Total subsidies provided by the Federal Government in 1984 are expected to amount to some DM 29 000 million, equivalent to 1,7% of GDP; some DM 16 000 million will be in the form of tax relief. The structure of the reports and the definitions have remained largely unchanged since 1967, enabling the policy on subsidies to be analysed over time using a consistent data basis. However, for an assessment to be made of the effects of subsidies on economic structure, competition, growth and public finance, the concept of subsidies must first be clarified, since there is no uniform definition of the term.

The Federal Government's reports on subsidies have to be produced pursuant to the Law on Stability and Growth (Article 12). The law does not define exactly what is meant by subsidies. It describes subsidies as 'Federal resources allocated for specific purposes to bodies outside the Federal administration' [2] and refers to the terms 'financial aid' and 'tax relief'. However, a uniform definition has been developed since the first report was drawn up. It covers financial aid for the bussiness sector as well as for private households, and tax reliefs, which are quantified in terms of the estimated revenue loss that they entail. These allocations must be consistent with certain objectives and principles, which will be examined later. The law also requires subsidies to be broken down into 'aid for continued operation', 'adjustment aid' and 'productivity aid'. However, this classification has become increasingly difficult to apply and covers only part of the subsidies (see Table 1).

Table 1: Federal Government subsidies by means and objective

(DM '000 million)

	1981		1982		1983		1984	
	DM	%	DM	%	DM	%	DM	%
Financial aid	13,6	49	13,2	49	13,7	48	13,4	46
of which:								
aid for continued operation	3,1	11	2,4	9	2,3	8	2,2	8
adjustment aid	2,2	8	2,4	9	2,8	10	2,7	9
productivity aid	1,7	6	1,6	6	1,6	6	1,8	6
other aid	6,6	24	6,8	25	7,0	24	6,6	23
Tax relief	14,0	51	14,0	51	14,9	52	15,7	54
of which:								
classified aid [1]	5,5	20	5,6	20	5,9	20	6,0	21
other aid	8,5	31	8,4	31	9,0	32	9,7	33
Total	27,6	100	27,2	100	28,6	100	29,1	100

[1] Aid for continued operation, adjustment aid and productivity aid target figures.

Financial aid is subdivided into three groups: grants, refunds, allocations (G), debt servicing aid (D) and loans (L), thus revealing the nature of the budgetary burden which subsidies place on the Federal Government. There is indeed a difference between outright grants and loans. In the case of loans, only the interest rebate that may be granted on the capital market rate can be called a subsidy. This aspect is also taken into account in the Subsidy Report. Diagram 1 shows the interrelationship of the various types of subsidies discussed in the Subsidy Report and provides the order of magnitude of their levels, using 1983 figures.[3]

[1] Report by the Federal Government on the trend of Federal Government financial aid and of tax concessions in the period 1981 to 1984, drawn up pursuant to Article 12 of the Law to promote Stability and Growth of the Economy of 8 June 1967, (Ninth Subsidy Report), published by the Federal Ministry of Finance, Bundestag publication 10/352.

[2] Article 12(1) of the Law to promote Stability and Growth of the Economy.

[3] Data on subsidies provided by Länder and Local Authorities are not readily available. Total tax relief by Länder and Local Authorities together in 1984 is estimated to be DM 17 600 million. Data on financial aid by Länder and Local Authorities are provided with a considerable time lag: the relevant figure for 1980 for Länder amounts to DM 2 900 million; the latest available figure for Local Authorities, DM 800 million, refers to the year 1976.

The Subsidy Report in addition provides a breakdown by branches of economic activity and, to some extent, by regions, making it possible to assess the implications of the subsidies for income distribution and competition.

The concept of subsidies used here differs in some respects from definitions used in the national accounts, in other countries or in public finance theory.

The concept of subsidies as used in the *Subsidy Report* covers aid to firms and households and therefore includes certain welfare benefits (e.g. exemption from wealth tax and trade tax for hospitals, old people's homes, residences for old people and nursing homes). By contrast it does not include payments for the railways and the postal administration, which despite separate budget management are bodies within the Federal administration.

In contrast to the Subsidy Report, the *national accounts* classify only current transfers as subsidies, excluding tax reliefs. But there are exceptions: current interest aids are always considered to be subsidies, while one-off interest aids are classified as capital transfers in the national accounts and do not therefore come under subsidies. The general rule in the case of tax relief is that the smaller the group of recipients, the more they tend to be regarded as subsidies. In the Subsidy Report, payments received not from government, but directly from households or firms are considered not to be subsidies. This applies to the charge in support of coal that is paid by gas and electricity users ('Kohlepfennig') and will apply to any possible similar charge in support of the forests.

For all these reasons, German figures are difficult to compare directly with those of other Community countries.

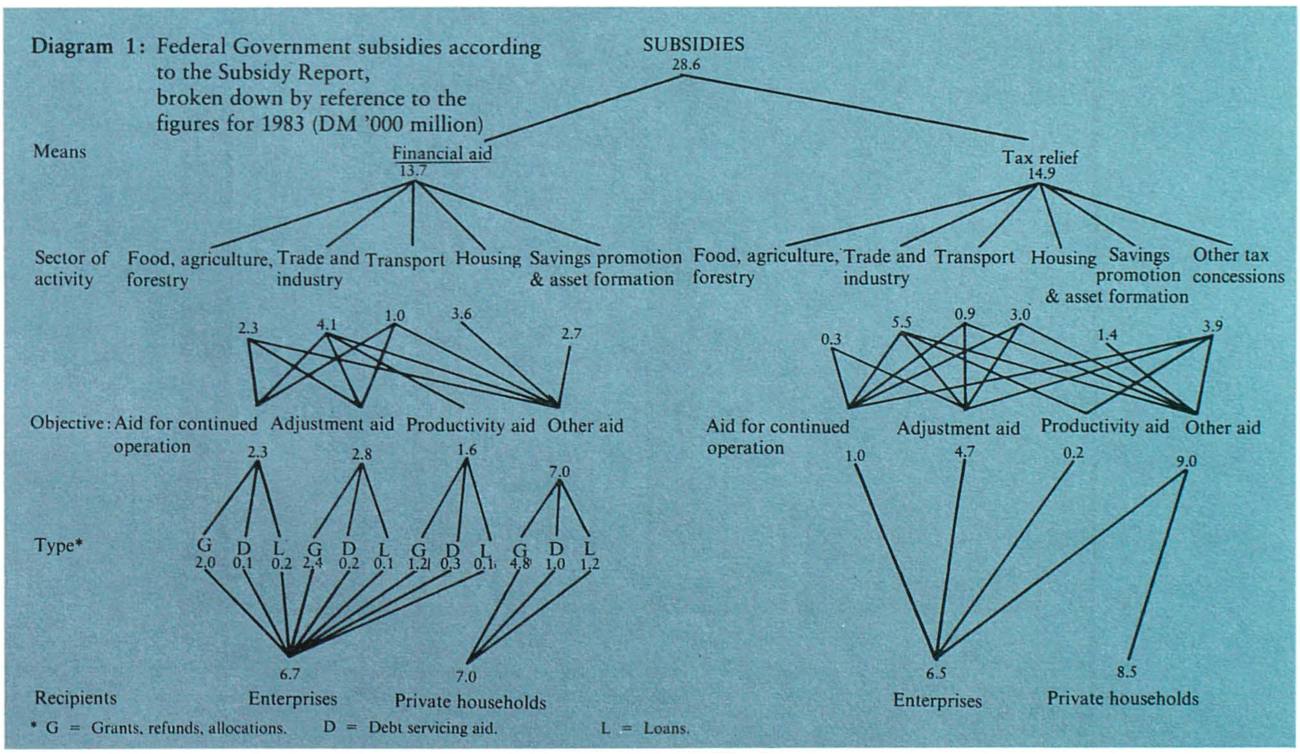
2. Objectives and principles

Subsidies are granted in pursuit of various objectives which should serve an essential overriding interest.[1] These may be non-economic as well as economic objectives, provided that they are consistent with the macro-economic goals laid down in the Law on Stability and Growth. This very general formulation of objectives is made somewhat clearer by the division into aid for continued operation, adjustment aid, productivity aid and other aid.

(i) *Aid for continued operation* is granted in agriculture and mining particularly for reasons to do with income distribution and the safeguarding of supplies. Nevertheless, different objectives may underlie individual subsidies. In agriculture, for example, in addition to the safeguarding of supplies, which is pursued

[1] Subsidy Report, para. 7, p. 7.

Diagram 1: Federal Government subsidies according to the Subsidy Report, broken down by reference to the figures for 1983 (DM '000 million)



* G = Grants, refunds, allocations. D = Debt servicing aid. L = Loans.

through investment-promoting or productivity-increasing aid, the income distribution aspect is also relevant, i.e. the objective of allowing those working in agriculture to participate in the general rise of incomes. In coal mining, in addition to the objective of maintaining a certain degree of independence in the energy field, subsidies are also intended to promote regional development.

(ii) *Adjustment aid* is intended to facilitate changes in existing structures. Examples include the special measures in favour of the steel industry. An important feature of adjustment aid is the fact that it is supposed to become superfluous once the adjustment has been carried out. However, it often happens that some of these subsidies acquire a life of their own and come to be regarded as established rights.

(iii) *Productivity aid* is intended to improve productivity and promote growth. This type of aid is granted almost exclusively to trade and industry.

(iv) *Other aid* is distinguished from the above three categories by institutional criteria; it covers payments that are not channelled directly to firms.

Where subsidies are the proper means of achieving the above-mentioned objectives, a number of basic rules [1] must be observed but the examples below show that large discrepancies have developed between policy intentions and economic realities.

[1] Ninth Subsidy Report, para. 8, p. 7. The Länder governments have adopted similar rules in July 1982, laid down in a 'Länder Subsidy Code'.

Subsidies should in principle:

(i) only provide the initial impetus: 'help' permitting 'self-help' (This principle does not seem to have been applied to the Saarland steel industry);

(ii) leave the distribution of wealth and incomes primarily to market forces. (Examples of this principle not being observed are to be found in agriculture);

(iii) not cause any distortion of competition. (This principle is clearly violated in certain industries.);

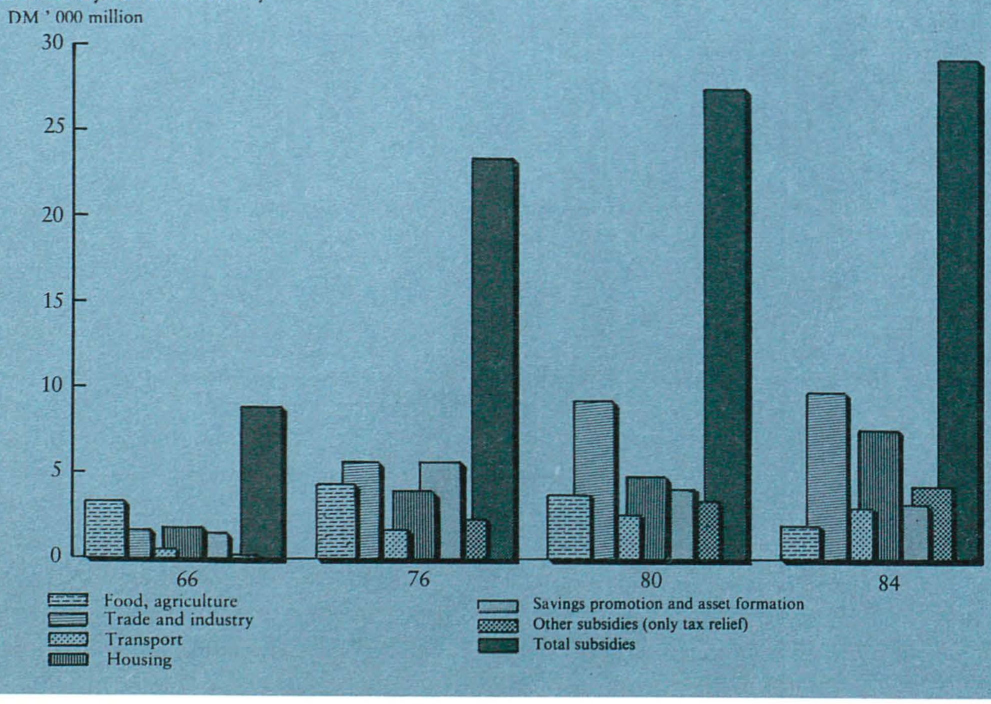
(iv) be mutually coordinated. (However, the promotion of the zonal border area 'Zonenrandgebiet' and the promotion of Berlin are to some extent in competition with each other);

(v) as far as possible not be provided in the form of outright grants. (However, in 1983, out of the total amount of DM 13 700 million of financial aid, DM 10 400 million was in the form of grants);

(vi) be limited in time. (However, only 52 out of 118 subsidies granted in 1984, accounting for DM 4 100 million out of a total of DM 13 400 million in financial aid, are limited in time, with the time limit in some cases stretching to over 10 years);

(vii) restricted as to the amount. (An example of this principle not being observed is the successive subsidies for the Saarland steel industry.)

Chart 1: Subsidies by sector of activity



3. Size and main areas of subsidies

The trends in subsidization can be seen from long series contained in the Subsidy Report. Absolute values, subsidy ratios and degrees of subsidization (for the whole economy and disaggregated) can then be used as indicators for the analysis. The following ratios are often calculated as overall indices for Federal Government subsidies:

(i) total amount of Federal Government subsidies/gross national product;

(ii) financial aid/expenditure;

(iii) tax relief/tax revenue.

The following ratios help to measure the subsidizing of individual branches of economic activity:

(i) subsidies/gross value added (degrees of subsidization);

(ii) subsidies/numbers employed;

(iii) subsidies gross value added minus subsidies.

From 1966 up to and including the government's draft for 1984, total subsidies fell in absolute terms in only three years, 1969, 1978 and 1982 (Chart 1). The chart also shows that there have been distinct shifts in the proportion of Federal Government subsidies going to the individual recipient sectors.

There has been a steady decline in subsidies for agriculture. However, this must be seen in connection with the EC Agricultural Guarantee Fund, expenditure which is not included in the Federal Government's Subsidy Report. The proportion of total subsidies received by German agriculture from the EC Agricultural Guarantee Fund rose from 23% (DM 1 400 million) in 1971 to 65% (DM 4 900 million) in 1982. In trade and industry—where subsidies are mainly concentrated on regional development— housing and town planning and other subsidies showed sustained increases in their relative volumes. Subsidies for transport and for promotion of saving and for asset formation showed the opposite trend. Their relative shares and their absolute amounts have declined, particularly since 1978. The amounts going to transport are the lowest amongst all the subsidies, with a volume of DM 2 000 million in 1983, roughly the same as in 1977 (Table 2). In the case of subsidies for savings promotion and asset formation, two periods of drastic cutback stand out. Between 1977 and 1979, assistance was cut by almost half from DM 7 300 million to DM 4 100 million, bringing its

Table 2: Subsidies by Federal Government

(DM million)

Sector of activity	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983[1]	1984[1]
I — Food, agriculture and forestry	3 299	3 155	3 876	2 782	4 755	4 889	4 070	4 382	4 095	4 172	4 292	4 052	3 926	3 858	3 673	2 751	2 658	2 582	2 786
II — Trade and industry (excluding Transport)	1 619	2 939	3 114	3 017	3 702	4 234	4 762	5 369	6 119	5 564	5 607	5 742	7 109	8 024	9 163	9 116	8 884	9 578	9 674
of which:																			
1. Mining	366	865	1 080	618	532	428	597	990	1 373	1 019	897	1 087	2 177	2 241	2 587	2 155	1 445	1 356	1 267
2. Energy and raw materials supplies	255	164	50	19	19	81	32	50	229	357	214	238	174	258	278	400	459	543	568
3. Technology and the promotion of innovation[2]	43	50	63	75	150	179	176	243	211	143	127	175	156	459	527	583	682	733	742
4. Aid for specific industries (shipbuilding, aircraft, steel)	26	32	58	123	178	220	247	278	333	379	367	180	348	519	675	819	1 042	1 297	1 330
5. Regional structural measures	462	1 378	1 474	1 760	2 051	2 469	2 868	3 083	3 256	2 954	3 358	3 252	3 409	3 699	4 249	4 397	4 458	4 573	4 707
6. Credit industry	156	183	107	115	196	231	244	210	260	294	154	155	171	190	207	—	—	—	—
7. Other general measures	311	267	282	307	576	599	598	515	457	418	490	655	674	658	640	762	798	1 076	1 060
III — Transport	521	516	756	939	906	937	1 093	1 245	1 296	1 403	1 626	1 980	2 300	2 276	2 467	2 192	1 976	1 958	1 912
IV — Housing and town planning	1 789	1 855	1 859	1 448	1 610	1 899	2 551	2 859	3 302	3 490	3 939	4 000	3 963	4 598	4 774	5 745	5 934	6 548	7 434
V — Savings promotion and asset formation	1 414	1 429	1 644	1 972	2 695	3 772	3 873	3 534	4 231	5 076	5 588	7 283	5 292	4 120	3 996	4 007	4 012	4 024	3 143
VI — Other subsidies[3]	136	190	1 357	1 478	1 285	1 383	1 390	1 661	1 774	2 051	2 268	2 511	2 795	2 842	3 308	3 840	3 723	3 893	4 114
Total I. - VI.	8 776	10 084	12 606	11 636	14 953	17 114	17 739	19 050	20 817	21 756	23 320	25 568	25 385	25 718	27 381	27 651	27 187	28 583	29 063

[1] Target figures.
[2] 1967 to 1974, including promotion of electronic data processing.
[3] Tax relief.

share in the total amount of subsidies down from 29% to 16%. A second period of cutbacks is planned to start in 1984, when the relevant subsidies will be trimmed to DM 3 100 million or 11%.

Looking at the two principal means by which subsidies are granted in financial aid and tax relief, there has been a trend in recent years towards an increasing share of tax relief (see Table 1). However, underlying this trend there are clear differences of emphasis between individual sectors. Thus, the vast majority of payments to agriculture is in the form of financial aid, while regional structural assistance, representing over 50% of aid to trade and industry, is granted almost exclusively in the form of tax relief. Financial aid to trade and industry is primarily for mining or declining industries (steel, shipbuilding).

Table 3 shows the breakdown for all the recipient sectors.

Table 3: Federal government subsidies to recipient sectors: Percentage breakdown between financial aid (FA) and tax relief (TR)

	1981		1982		1983[1]		1984[1]	
	FA	TR	FA	TR	FA	TR	FA	TR
Agriculture	85	15	87	13	89	11	90	10
Trade and industry	45	55	41	59	43	57	41	59
of which:								
mining	94	6	91	9	91	9	90	10
specific industries	100	0	97	3	95	5	92	8
regional structural measures	6	94	5	95	5	95	6	94
Transport	60	40	55	45	53	47	50	50
Housing	61	39	58	42	55	45	54	46
Savings promotion	60	40	66	34	66	34	60	40
Other subsidies	—	100	—	100	—	100	—	100
Total	49	51	49	51	48	52	46	54

[1] Target figures.

The available data permit further analyses by industrial sector showing the objective and type of subsidies granted over time. Chart 2 gives an example for the period 1982 to 1984, taking three sectors that are in the forefront of discussion, namely mining, steel and shipbuilding. It will be seen that all the financial aid to mining was in the form of grants and that the bulk of the subsidies are aids for continued operation. Although the volume of the subsidies has declined in recent years, the aim of policy for the mining industry is clear from this breakdown. Analysis of financial aid for the steel and shipbuilding industries shows that in 1983 a proportion of 97% of financial aid to the steel industry is in the form of adjustment aid and only 3% in the form of productivity aid. Moreover, all of this financial aid is in the form of grants. In the shipbuilding industry, most of the financial aid is also in the form of grants, but here debt servicing aid and outright loans are also granted by way of aid for continued operation.

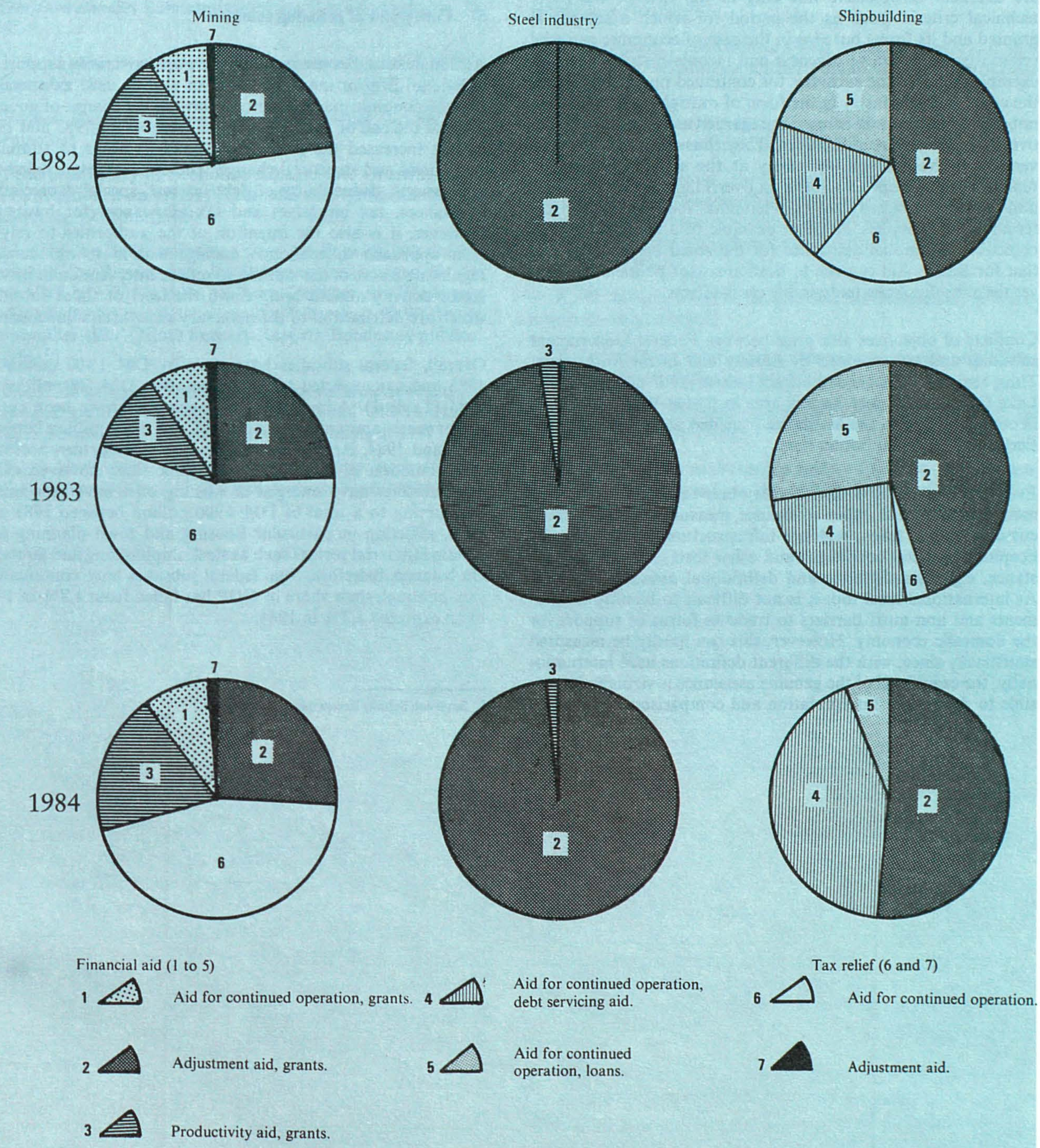
4. Conflicts of objectives

Government subsidies have become increasingly controversial and the need has arisen for a stricter monitoring of the entire subsidy programme. This may be carried out in the form of target/outturn comparisons, cost-benefit studies or impact analyses, though such exercises should always be applied to individual cases and not across the board to subsidies generally. Yet even individual case studies will inevitably remain a matter of much controversy as it is virtually impossible to compare the actual economic trends with what would have happened if subsidies had not been granted or to ascertain exactly the secondary effects of subsidies. Furthermore, in the case of tax relief (in contrast to that of financial aid), it is not even possible to indicate exactly the volume of the subsidies provided, since quantification of such tax relief can only be based on rough estimates. Nevertheless, the authorities concerned do try to monitor results with regard to the objectives that the subsidies are supposed to help to achieve. Investigations of this kind have been carried out in respect of regional structural policy, housing policy, the programme for more energy-efficient heating, and agricultural policy.[1]

The list discussed in section 2 showed that there were wide differences between the way the objectives were perceived and the measures actually taken to pursue them. It is therefore not

[1] See Eighth Subsidy Report, paras. 59-65.

Chart 2: Subsidies by objective and type in selected industries



surprising that there are conflicts between objectives, although such conflicts are often discernible only when two or more subsidies are compared directly with one another. Thus, there are conflicts of objective not only in the case of the more technical criteria (such as the period for which a subsidy is granted and its form) but also in the case of economic or social criteria (such as competitiveness and income distribution). An example of this is the subsidies for continued operation paid to the coal mining industry in the form of outright grants that are not limited in time and cannot be regarded as being designed to overcome temporary difficulties. They thus run counter to several objectives of subsidy policy at the same time and yet represent an attempt to achieve an overriding and, in this case, non-economic objective, namely potential independence of external energy supplies. Another example of a conflict between objectives is regional assistance for the zonal border area and that for Berlin. Aid is given to both areas for political reasons, yet the subsidies have undesirable cross-effects.

Conflicts of objectives also arise between Federal Government subsidies and aid provided by Länder and Local Authorities. Thus, regional assistance to attract industry, for example in the Lake Constance/Upper Swabia area in Baden-Württemberg, is in competition with the assistance provided at Federal level for Berlin and the zonal border area.

Even more complex is the interplay between Federal Government subsidies and other assistance measures. These include customs duties, taxes, regional infrastructure (roads, schools, hospitals), general conditions and other forms of indirect assistance, e.g. administrative and definitional assistance criteria. At international level too, it is not difficult to identify inducements and non-tariff barriers to trade as forms of support for the domestic economy. However, this can hardly be measured statistically since, with the different definitions used internationally, the exact level of the genuine assistance is virtually impossible to determine. Interpretation and comparison of subsidies between countries is particularly difficult when no account is taken of tax relief.

5. Policy aim of reducing subsidies

Although subsidies are usually given with a view to support an individual firm or industry, they can also be used as a tool of macro-economic management. Following the change of government at the end of 1982, the Federal budgets for 1983 and 1984 in fact increased the level of subsidies in order to stimulate investment and structural change. These measures included tax concessions, deductibility of debt interest, special depreciation allowances, tax incentives and tax allowances for business.[1] However, it is also the intention of the authorities to rely in their approach to economic management more on the self-regulating forces of the market, to reduce intervention in private sector activity and to bring down the level of those subsidies which are detrimental to the necessary structural adjustments.

Overall, federal subsidies have risen by DM 1 400 million in 1983 and are expected to rise by another DM 500 million in 1984 (Table 1). Admittedly, some subsidies have been cut in recent years (amounting to a total of DM 3 500 million between 1981 and 1984, largely concentrated on mining, transport and the promotion of savings). At the same time, however, other new subsidies have emerged or existing ones have been raised (amounting to a total of DM 4 900 million between 1981 and 1984, affecting in particular housing and town planning and certain industrial sectors such as steel, shipbuilding and aircraft). On balance, therefore, total federal subsidies have continued to rise, although their share in GDP has fallen from 1,8% in 1981 to an expected 1,7% in 1984.

[1] See Ninth Subsidy Report, para.22 and Annex 2

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Greece

Trends and prospects

In 1983, the Greek economy managed to achieve a substantial improvement in the real trade balance as a result of the considerably lower rate of expansion of wages relative to 1982, slack investment demand and the firmer trend of world trade in the second half of the year combined with a substantial depreciation in the real exchange rate. This improvement more than offset the negative impact of slack domestic demand on activity, so that gross domestic product appears to have expanded slightly, by about 0,3% in relation to 1982, despite a fall in agricultural output.

Contribution to changes in real GDP

	1979	1980	1981	1982	1983[1]
Domestic uses	4,3	−1,2	0,3	0	−0,8
External balance	−0,6	2,7	−1,0	−2,0	1,1
GDP	3,7	1,5	−0,7	0	0,3

[1] Estimates.

However, these developments were not accompanied by any notable progress towards attenuating imbalances. Unemployment continued to rise rapidly, to an annual average of 7,4% in 1983. The rate of consumer price inflation did not fall significantly but remained around 20% both in terms of the annual average and in terms of the year-on-year trend. Neither did the improvement in the real balance on goods and services lead to a corresponding improvement in the current balance of payments. Bank of Greece settlements statistics indicate that the deficit remained in excess of 5% of gross domestic product.

The reasons were that the terms of trade once more deteriorated slightly, while the surplus on the balance on tourism contracted sharply in real terms and the growing burden of interest on the external debt considerably reduced the surplus on factor incomes. Finally, aggregate investment remained inadequate, for, while the building industry recovered slightly, the equipment goods industry declined as a result of the persistent weakness of the propensity to invest in the business sector.

The major changes of trend in the real economy were reflected in the financial sector. The trend of the general government borrowing requirement as a percentage of GDP rose once again, in particular as a result of the slower rate of expansion of tax revenue and the increase in interest costs. On the other hand, demand for financing on the part of firms declined sharply as their demand was weak. The net result of the divergent effects of these developments was considerably slower expansion in the money supply M3, to a rate of hardly more than 20%; this stabilized the liquidity ratio after the very rapid rise of earlier years.

Certain aspects of economic policy in 1984 look set to be less restrictive than in 1983. The rate of increase of private disposable incomes will probably rise somewhat with the return to normal index-linking and a major uprating of the brackets in the scale of degressive indexation. The expansion of current expenditure will once again be kept in check by budgetary policy measures, so that a further major increase in real capital expenditure will be possible, especially as revenue is expected to rise and measures to combat tax evasion will be reinforced. However, the measures taken are hardly likely to prevent a further increase in the public deficit as a percentage of gross domestic product. In the circumstances, monetary policy will no doubt have to remain fairly accommodating—for it must also contribute to the recovery of investment—and this may well lead to a fresh increase in the rate of expansion of the money supply M3.

In view of actual and probable economic policy arrangements for 1984, substantially firmer domestic demand can be expected. As well as a clear recovery in consumption, the main factor in this development, a better investment performance is also probable due not only to the continued improvement in activity in public works and residential building, but also to the effects on the propensity to invest of industrial firms that are expected to result from the law passed in 1982. Firmer domestic demand will probably boost imports, but now that world demand has taken a turn for the better, exports could expand even faster.

Nevertheless, this outlook does not imply a rapid restoration of equilibria. Inflation seems unlikely to slow down very much despite the inhibiting effects that could result from the expected—but probably not sizeable—appreciation of the real exchange rate. As to the current balance of payments, despite the improvement expected in revenue from tourism and shipping, it will still be adversely affected by the terms of trade and the increase in the burden of interest on the external debt; the deficit is likely to remain in the region of 5% of gross domestic product.

Indices of price competitiveness

average for 1970-75 = 100

1979	1980	1981	1982	1983
103,1	93,1	95,6	102,3	93,0

[1] Calculated on the basis of unit labour costs in 19 industrialized countries, and of the effective exchange rate. An increase in the index reflects a deterioration in competitiveness and vice versa.

Economic policy problems

Firmer world demand should thus make for some recovery of activity in 1984, although this will not mean any lasting relaxation of the external constraint. The prospect of a still considerable current balance of payments deficit reflects the persistent severity of the constraint which can be relaxed only gradually, and at the price of a major effort to adjust production structures to developments in the international economic environment. Only on this condition can sufficiently strong growth be ensured in the medium term to improve both productivity and employment.

The Five-Year Economic and Social Development Plan 1983-87, the guiding principles of which were approved by Parliament on 21 November 1983, is intended to channel this effort in the right direction and to ensure that it is coherent with social aims. The growth-rate target range for the period as a whole is 3,5% to 4%, to be achieved through an average expansion of investments of 8,5%; it is hoped that this will bring unemployment down to about 4% by the end of the period. The achievement of these aims is based on a supply-side policy where the central government plays the main role not only in the improvement of the institutional framework and the development of intellectual and material infrastructures, but also in channelling the private sector's productive effort and in promoting high-risk activities, in particular by public sector firms. Throughout the period covered by the plan, therefore, the burden on public finance will grow rapidly in real terms. It is planned to offset this burden by very strict management and by improving the yield of the tax system, in particular by thoroughly overhauling the indirect tax system with the introduction of value-added tax and tighter controls. An attempt will also be made to keep the required check on the expansion of private consumption by restraining incomes; priority will go to speeding up the rate of increase of purchasing power of low-income groups and recipients of social benefits.

However, it will be difficult to achieve all these aims in full, and in particular to reconcile the vigorous growth that they imply with a reduction in imbalances—also recognized as a necessity. Two major problems will probably beset the programme: on the one hand, even if the expected productivity gains help to slow down inflation, indexation and a persistently large public deficit will boost incomes, so preventing the deceleration from reaching, during the period covered by the programme, the point where the economy is sufficiently stabilized to ensure normal consumer and investment behaviour. On the other hand, there is no guarantee that structural action to improve the basis for foreign trade equilibrium will take effect fast enough to prevent the momentum of domestic demand from setting off an opposite reaction, at least temporarily, at a time when accumulated liabilities towards the foreign sector are already very sizeable. The emerging picture of developments in 1984—supposedly a year of transition towards much higher growth rates—would seem to confirm that these problems should be taken seriously.

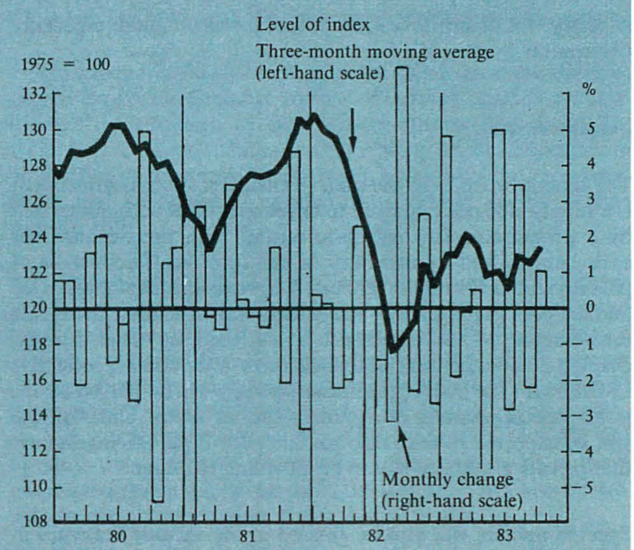
On the whole, the five-year programme is the more likely to succeed as economic policy manages first to control inflation, concentrating to this end on deliberate action to hold nominal incomes in check, to reduce the public deficit, to restore real positive interest rates and to limit exchange-rate depreciation as far as possible, and secondly to attract enough foreign capital to bring the increase in the burden of external debt back down to manageable proportions.

Greece: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	DR '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	1 745,7	4,1	0,6	0,0	1,3	:	:	:	:	:	:
Public consumption	464,5	6,4	1,0	3,0	1,5	:	:	:	:	:	:
Gross fixed capital formation	488,4	1,1	−1,0	−4,1	1,2	:	:	:	:	:	:
Change in stocks[1]	147,6	4,4	4,2	3,5	3,6	:	:	:	:	:	:
Domestic demand	2 846,2	3,6	1,9	−0,8	1,4	:	:	:	:	:	:
Exports of goods and services	360,1	10,9	−5,8	6,0	4,7	:	:	:	:	:	:
Imports of goods and services	688,4	6,0	5,9	−1,7	2,6	:	:	:	:	:	:
GDP at market prices	2 517,9	3,9	0,0	0,3	1,6	:	:	:	:	:	:
		% change over preceding period at annual rates									
GDP at current prices		19,9	23,8	21,8	21,8	:	:	:	:	:	:
Industrial production[2]		5,7	−2,8	0,5	1,7	:	:	:	:	:	:
Unemployment rate[3]		:	5,8	7,4	8,6	:	:	:	:	:	:
Compensation of employees		19,8	25,7	18,6	21,5	:	:	:	:	:	:
Money supply (M2)		23,8	31,5	20,0	21,3	:	:	:	:	:	:
Implicit price indices:											
— GDP		15,4	23,8	20,9	19,7	:	:	:	:	:	:
— Private consumption		15,6	21,1	19,8	19,2	:	:	:	:	:	:
— Exports of goods		14,8	23,4	17,5	19,5	:	:	:	:	:	:
— Imports of goods		18,2	21,9	18,0	20,5	:	:	:	:	:	:
Terms of trade		−2,0	−1,8	−0,3	−0,8	:	:	:	:	:	:
		As % of gross domestic product									
Trade balance (fob/cif)		−12,4	−11,9	−10,5	−10,7	:	:	:	:	:	:
Current balance		−2,6	−3,9	−3,8	−4,1	:	:	:	:	:	:
Net borrowing of general government		:	−8,3	−9,2	−9,8	:	:	:	:	:	:

1 As % of GDP.
2 Manufacturing industry.
3 Unemployment as % of total labour force.
4 Estimates.
5 Forecasts.
Source: Eurostat and Commission services.

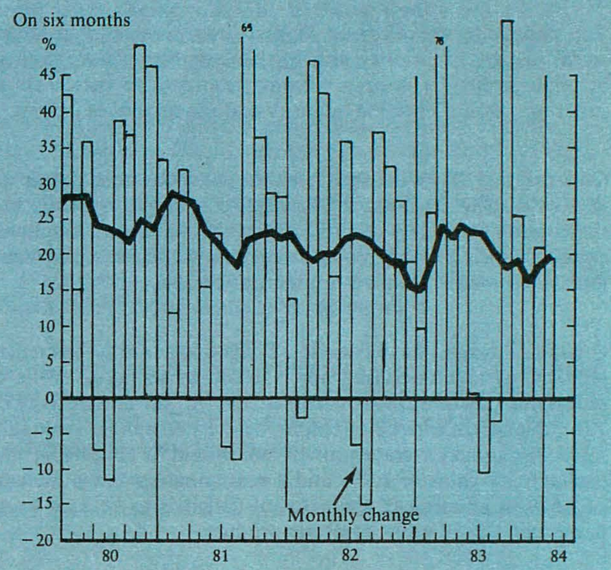
Greece: Industrial production (s.a.)



Source: Eurostat.

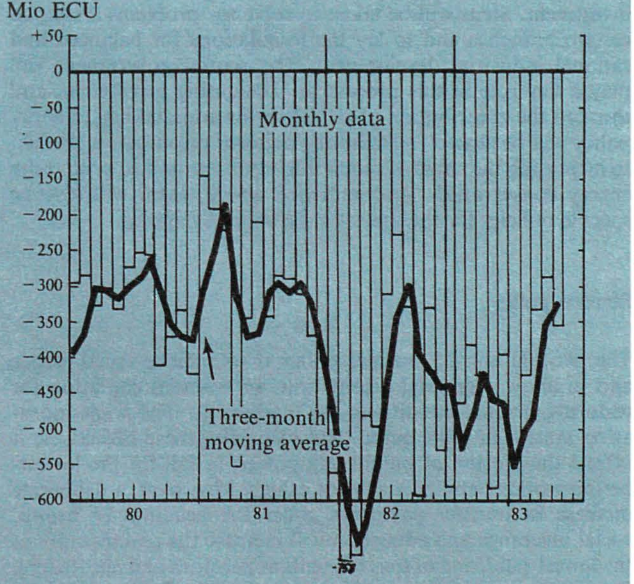
Greece: Consumer prices (s.a.)

Change expressed as an annual rate.



Source: Eurostat.

Greece: Trade balance (s.a.)



Source: Eurostat.

Five-year economic and social development plan (1983-87)

General aims

The main concern of Greece's five-year plan is to promote social justice; its priority aim in this connection is to control unemployment, by putting national resources to better use in order to increase both the quantity and the quality of output.

Over the past few years, the Greek economy has been characterized by a growing disparity between consumption trends and the country's capacity of production; this has led to a sizeable external deficit and to high rates of inflation and unemployment-imbalances which the plan is intended to reduce.

Quantified targets have been set: 270 000 jobs are to be created (120 000 in manufacturing and 150 000 in services), so as to reduce the rate of unemployment to 3,9% of the labour force by 1987; this means expanding employment by an annual average of 1,1%; the annual average growth rate should be about 4%, with productivity gains of 2.9% and a real annual average increase of 8,5% in investment; the external deficit is to be kept to no more than 6% of gross domestic product.

Foreign trade

The deterioration in visible foreign trade over the past few years was due both to external and to domestic factors: the second oil shock, and sluggish world demand on the one hand, specific structural factors inherent in the Greek economy on the other: the predominant share in Greek exports of products for which international demand is growing only slowly, the inadequacy of standardization and marketing, the declining competitiveness of national output compared with equivalent foreign products, and the shift in domestic demand away from available domestic supply.

Inflows from services and current transfers have also been slackening off, particularly earnings from the tourist industry and shipping, and transfers from abroad by emigrants. Net private capital inflows have also tended to slow down. Despite the contribution of new transfer revenue from the Community, invisible resources can no longer be relied upon to cover so large a share of the visible deficit.

Foreign trade policy must therefore aim at reducing the trade deficit by stimulating exports and inhibiting the penetration of imports. Among the means to this end are measures to increase the share in output of products for which international demand is stronger and value added is higher, and measures to develop the output of key products to replace imports. All structural policy measures to reinforce the productive apparatus, improve productivity and foster innovation will contribute to the effort. They will be backed up by a specific export drive, and by changes in the organization and operation of incentives.

Measures will also be taken to promote activity in the tourist industry and in shipping by improving the quality and the quantity of the services provided.

A policy will be introduced to attract foreign capital, especially risk capital.

Supply-side policy

The general weapon of the plan to ensure economic adjustment is a supply-side policy geared to development. It is characterized by a programme for aggregate output with precise aims for each branch, and by measures to enhance the effectiveness of government and public services, improve the exploitation of human potential (general and vocational education, integrate the unemployed and immigrants), raise the level of technology, develop and modernize infrastructures and boost productive investment. The major role in this strategy will be played by the public sector. Among other things, public sector undertakings will be expected to take responsibility for high-risk investment that private enterprise would be unwilling to assume.

Specific policies will also be applied in the various branches of activity. Agricultural policy will aim at fostering economic and social progress among the rural population while increasing self-sufficiency in the country's food production and developing exports of high-value-added food products. Structural measures to improve productivity and competitiveness will include encouraging cooperation and raising the level of culture. Fisheries will also be the object of a specific policy. The task of industrial policy will be to ward off the threat of regression that has been looming large for some years owing to the decline in traditional sectors, the weakness of firms' structures and the slackness of investment. Steps will be taken to solve the problems arising in certain branches and to lay the foundations for balanced and rational industrial development. The central government will play a key role in this process by stimulating investment, and through the contribution of public sector undertakings. Energy policy will be geared to exploiting national resources to the full, to increasing the share of renewable resources and to promoting energy conservation. As mentioned above, there will also be specific policies for the tourist industry and shipping.

Incomes policy

The twofold aim of incomes policy is to achieve social justice and to allow a gradual disinflation, an essential condition for restoring normal conditions for investment. The wage-indexation system in force since 1982 reconciles these objectives: it offsets the erosion of purchasing power, in full for the lowest-period workers and partially for others. Moreover, a deliberate increase in transfer payments under the headings of health, social insurance and education will increase the real incomes of the lowest-paid, and of the recipients of pensions and allowances. Real incomes elsewhere in the economy will rise only as far as productivity gains justify.

Tax and fiscal policy

Public finances will play a key role in the implementation of the plan; they will have to satisfy collective needs as fully as possible, while helping to expand the economy's capacity of production.

Public expenditure will be reorganized to increase the share of capital expenditure relative to that of current expenditure, and to shift the emphasis of current expenditure towards health, social insurance, education and the quality of life. Expenditure on staffing will be held in check by administrative reorganization, and the share of agricultural subsidies should decline considerably.

To offset the effects of increased expenditure on public finance equilibrium, overall taxation must rise. Moreover, the share of direct taxation in revenue will increase in relation to that of indirect taxation. The plan includes the abolition of certain unnecessary direct tax exemptions, higher property taxes, annual indexation of the personal income tax scale and higher penalty payments for attempted evasion. The application of VAT will simplify the system of indirect taxation, and make it more progressive, since it involves differential rates; it will also contribute to preventing evasion.

Financing policy

During the period covered by the plan, the economy's main source of financing will still be bank credit, but additional sources will be provided by certain forms of regional self-financing, and the issue of special certificates.

The credit system will be 'socialized' to eliminate inequality of access. The system will provide the public sector with the financing required to apply the investment programme; it will ensure that credit is rationally shared between private sector branches in line with development policy aims, and will initiate investment in specific areas. Public sector undertakings will be financed as far as possible by the issue of bond loans, while bank credit will be used only for non-depreciable expenditure.

The manipulation of interest rates for the purpose of providing subsidies will be discontinued; increasingly, subsidies to promote investment fulfilling industrial policy criteria will be granted directly from the budget.

Interest rate policy will be geared to the restoration of a single positive real rate.

France

Trends and prospects

External adjustment, the priority aim of economic policy in 1983, was achieved in the second half-year, much earlier than foreseen. The improvement, which was helped along by the recovery of world trade from mid-year and increased competitiveness due to the decline in the effective exchange rate since 1981, did not even entail a major contraction in domestic demand. The reinforced austerity package introduced to back up the currency realignment of 21 March only moderately accentuated the slowdown already recorded in households' consumption, which mainly affected purchases of durables other than cars, while the major improvement in the balance on tourism underpinned consumption during the summer months, so it still showed a certain expansion in annual terms in relation to 1982. Fixed investment, on the other hand, and especially stock-building declined fairly substantially. The overall decline in domestic demand in 1983 was probably less than 1%.

Contributions to changes in GDP (volume) [1]

	1979	1980	1981	1982	1983 [2]
Final domestic demand	3,0	1,8	1,0	2,6	−0,3
Changes in stocks	0,9	0,3	−1,8	1,1	−0,6
External balance	−0,6	−1,0	1,1	−2,0	1,1
GDP	3,3	1,1	0,3	1,7	0,3

[1] 1970 prices.
[2] Estimate.

The contraction, which affected the demand for products with a higher import content, was enough to bring about a marked improvement in the real balance of trade from the second quarter, due not only to a decline in imports but also to a recovery of exports; both these developments were the more marked as expectations of a further exchange rate adjustment had adversely affected previous magnitudes. Altogether, the positive impact on activity of the external component more than offset the negative impact of the domestic component, in annual terms, so that gross domestic product expanded slightly once more (by an estimated 0,3%) in 1983, despite the slightly weaker tendency in the second half of the year. Industrial output was fairly sustained, with small variations around a level somewhat higher than that recorded at the end of 1982.

The effects on trade equilibrium of the better real balance position were magnified by the continuing improvement in the terms of trade so that the deficit on goods and services virtually disappeared in the second half-year, and the deficit for 1983 as a whole was only half that recorded in 1982. In particular, the energy deficit declined sharply thanks to progress in substituting nuclear energy for oil, combined with a major running down of oil stocks; the surplus on agrifood products increased and a surplus on manufactures was tending to re-emerge. The deficit on current transactions correspondingly contracted owing to an improvement in certain invisible items, mainly tourism, that offset the substantial increase in the burden of interest payments. This deficit consequently declined in 1983 to about 1,5% of gross domestic product—from nearly 3% in 1982—or less than 1% according to the balance of payments concept. [1]

Despite a definite slowdown in the rate of increase of hourly wage rates during the year, progress with disinflation was not so clear; consumer prices rose by 9,3% in 1983, overshooting the target of 8%, but the tendency in the second half did slow down a little.

Priority will still be given, in the economic policy adopted for 1984, to efforts to achieve stabilization. Policy is aimed both at consolidating achievements in restoring external balance and at rapidly returning to a rate of inflation commensurate with those now prevalent in the main industrialized countries. To this end, it is also geared to encouraging a return to a more balanced financial situation for enterprises. It will therefore include measures to stabilize households' real disposable incomes, bringing pressure to bear equally on incomes and prices, and further tightening up on liquidity.

Prices and incomes policies are geared to the general aim of reducing the inflation rate to 5% in the course of 1984. Most prices will still be subject to controls, which have as yet been relaxed only for the industrial products in direct competition with foreign goods. Fresh regulation agreements have been concluded with the various occupational categories that should ensure an average price rise in line with the target; indeed, stricter limits have been imposed on firms that did not comply with previous commitments. Public service charges and dividends will be subject to the 5% limit on increases. The relevant target for wages and salaries involves restraining the increase in annual average earnings under all heads to the year-on-year increase planned for prices; in view of the carryover from the end of last year, this will not leave very much margin for further expansion. The extent to which these aims are achieved will depend on the outcome of negotiations in progress between the two sides of industry;

[1] The balance of current transactions with the rest of the world, on the national accounts definition, in fact overestimates the deficit, because of the method used, both in 1982 and in 1983.

these negotiations are now extensively decentralized, but their results might have a decisive influence on corresponding decisions for the civil service.

Monetary policy should contribute to control of nominal developments; the growth target range for the money supply M2 is 5,5% to 6,5%. This implies that private sector borrowing must expand approximately in line with GDP, and that non-monetary financing must once again expand strongly, so that nominal interest rates will decline less than inflation.

However, strict compliance with the monetary target also requires that public finance equilibrium does not deteriorate to any appreciable extent in relation to 1983, when the level was higher than the initially planned 3% of gross domestic product. The measures adopted in March 1983, and those taken in the framework of the 1984 budget, which reflect a determination to impose even greater austerity, should theoretically prevent any major deterioration. The burden of compulsory levies will be further substantially increased, with the extension of arrangements for the exceptional supplementary levy introduced in March 1983, various increases in personal income tax, the effects over a full year of the increased unemployment insurances contribution introduced on 1 July 1983 and the increase in employees' old-age pension contributions introduced on 1 January 1984. The expansion of expenditure on public consumption and transfer payments has been severely restricted in real terms: indeed, some items will actually decline, as will investment expenditure for the second year running. There is a risk, however, that a shortfall in revenues and extra social security expenditure caused by the recessive trend of employment will be a further burden on the budget balance.

In an international environment that continues to be favourable, this policy should lift activity out of its cyclical trough in the first quarter of 1984 and support a gradual rise throughout the year. Households' consumption will probably pick up before June, and the level for 1984 as a whole should be comparable to the average for 1983, but the price will be paid in terms of the savings ratio since real disposable incomes will contract slightly once again. Corporate demand should also tend to improve somewhat as firms' financial situations become healthier and amounts available for subsidized loans increase. Investment in industry is thus expected to recover considerably, more than offsetting the decline in investment in other sectors, and slightly improving aggregate investment in the course of the year. The tendency to run down stocks observed in 1983 should be reversed. However, the improved trend of domestic demand in 1984 will not, on balance, be sufficient to offset weakness in the early part of the year and ensure a positive contribution to growth over 1984 as a whole.

The real foreign trade position should develop in precisely the opposite direction. While its contribution to growth will still be well into positive figures for the year as a whole, thanks to the momentum carried over from last year, it will in fact tend to deteriorate somewhat in the course of 1984 as imports recover owing to gradually firmer domestic demand.

Altogether, real gross domestic product can be expected to expand by a little over 0,5% in 1984. The employment situation will deteriorate in these circumstances: numbers employed will decline by at least 1%, and the rate of unemployment could exceed the threshold of 10% of the labour force in the course of the year.

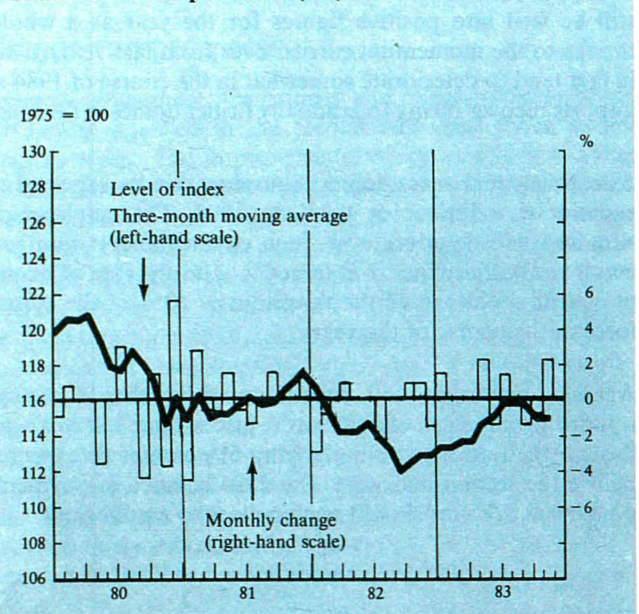
Against this background, disinflation policy should manage a more pronounced slowdown in prices than last year, although the return to an underlying 5% cannot be expected before the second half-year. The 1984 balance of payments on current account should remain close to equilibrium.

Economic policy problems

Since June 1982, economic policy has concentrated on restoring equilibria. Its primary and priority objective was met when the current balance-of-payments deficit was eliminated, although further progress will be required to achieve surpluses adequate to cover redemption of external borrowing and to finance long-term credit. Price and cost disinflation, however, is taking longer than was foreseen, partly because incomes continue in practice to follow the index fairly closely. Achievements on the external trade front, however, will not be consolidated until the rate of increase of unit costs has declined to a level comparable to that obtaining in most major industrialized countries.

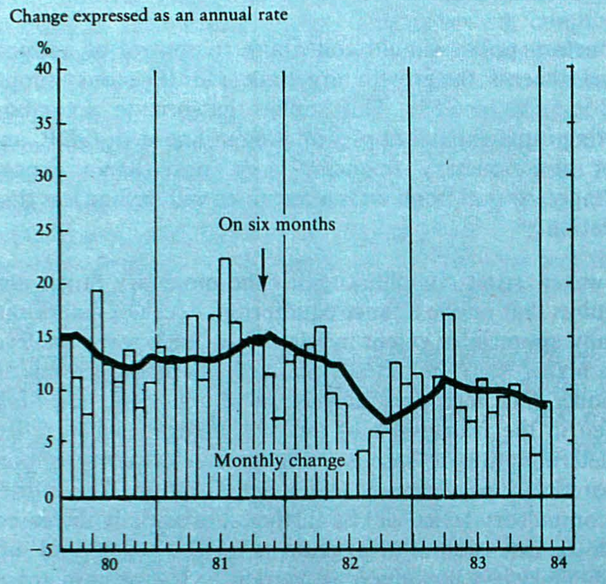
Faster disinflation is not only an immediate condition for the improvement of price-competitiveness for national output and of profitability in the sectors directly involved in international competition. It is also required to ensure a return to more stable consumption, stocking and investment behaviour, as well as the restoration of financial balance in firms, which stand to benefit from a decline in the rate of increase of unit labour costs, and from a reduction in the burden of interest payments resulting from a decline in rates. The recovery of business investment is thus very closely dependent on the current process of disinflation: the faster the latter, the stronger the former will be. Such a recovery is essential to the economy's structural adjustment to the constraints of the external environment and consequently to a lasting improvement in growth rates and an eventual reversal of the recessive trend of employment.

France: Industrial production (s.a.)



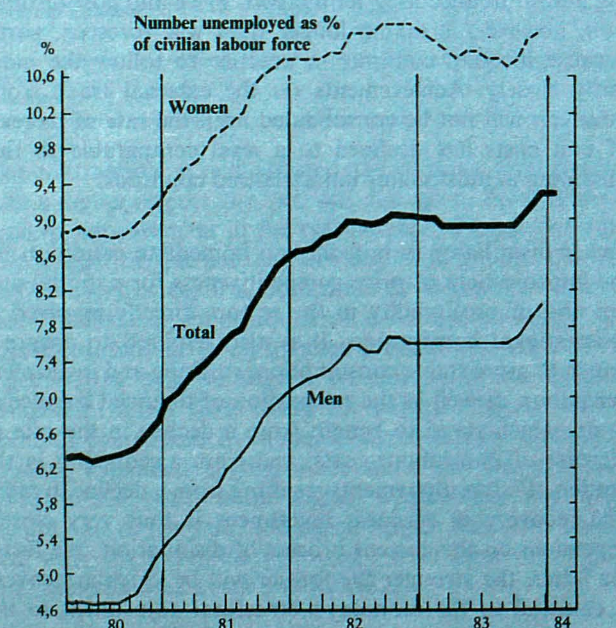
Source: INSEE.

France: Consumer prices (s.a.)



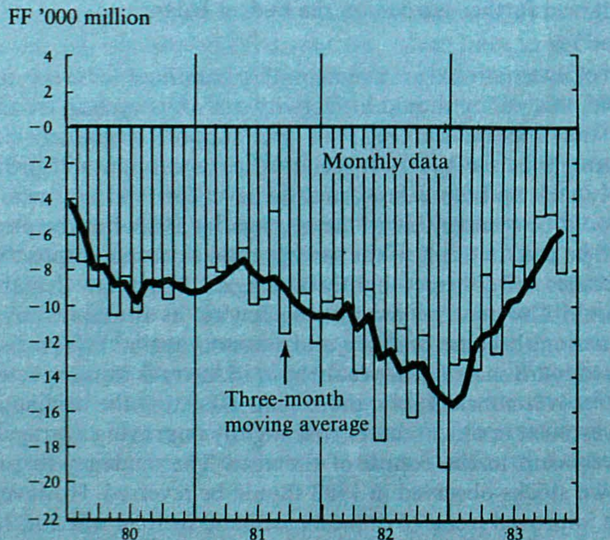
Source: Eurostat.

France: Unemployment (s.a.)



Source: Eurostat.

France: Trade balance (s.a.)



Source: Eurostat.

France: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982 FF '000 million at current prices	Annual data 1972-81	1982	1983[3]	1984[4]	Half-yearly data (s.a.) 1982 I	1982 II	1983[3] I	1983[3] II	1984[4] I	1984[4] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	2 291,2	3,9	3,4	0,6	0,0	:	1,6	0,8	−0,6	−0,4	1,4
Public consumption	583,1	2,9	1,6	−0,2	−0,2	:	1,1	0,3	−2,2	0,3	1,1
Gross fixed capital formation	741,1	2,0	1,1	−3,2	−2,3	:	−1,3	−3,2	−5,1	−2,0	0,1
Change in stocks[1]	22,7	0,7	1,1	0,6	0,6	:	0,7	1,3	−0,2	0,5	0,7
Domestic demand	3 638,2	3,1	3,8	−0,8	−0,4	:	−0,7	1,1	−4,8	0,8	1,6
Exports of goods and services	772,8	7,5	−3,7	2,3	5,4	:	5,6	−3,4	10,9	3,8	3,4
Imports of goods and services	868,8	7,7	4,8	−2,4	1,0	:	0,0	−1,0	−7,4	3,7	4,4
GDP at market prices	3 543,5	3,1	1,7	0,3	0,6	:	0,5	0,6	−0,7	0,8	1,4
		% change over preceding period at annual rates									
GDP at current prices		13,5	14,4	10,5	7,8	:	7,1	12,8	8,8	7,5	7,1
Industrial production		2,5	−1,8	1,4	1,0	:	−6,9	7,1	3,8	0,4	3,8
Unemployment rate[2]		4,4	8,7	9,1	9,9	:	8,9	8,9	9,3	9,6	10,2
Compensation of employees		14,9	13,6	9,6	7,4	:	:	:	:	:	:
Money supply (M2)		14,2	11,4	9,2	7,0	:	:	:	:	:	:
Implicit price indices:											
— GDP		10,1	12,4	10,2	7,1	:	6,5	13,2	9,6	6,7	5,7
— Private consumption		10,1	10,8	9,5	7,2	:	7,6	11,3	7,8	7,5	5,8
— Exports of goods		8,9	14,8	10,1	7,8	:	9,4	8,9	13,0	6,9	5,0
— Imports of goods		10,2	9,8	7,4	7,5	:	16,6	0,2	14,1	5,4	5,0
Terms of trade		−1,2	4,6	2,5	0,3	:	−12,8	18,2	−2,0	2,8	0,0
		As % of gross domestic product									
Trade balance (fob/cif)		−1,8	−3,9	−2,3	−1,4	:	−4,0	−3,2	−1,4	−1,3	−1,4
Current balance		−0,8	−2,9	−1,7	−0,8	:	−3,0	−2,7	−0,8	−0,8	−0,8
Net borrowing of general government		−0,7	−2,6	−3,4	−3,5	:	:	:	:	:	:

[1] As % of GDP.
[2] Unemployment as % of total labour force.
[3] Estimates.
[4] Forecasts.
Source: Eurostat and Commission services.

It is not, however, very likely that this reversal will occur in the near future. The present trend is part and parcel of a restructuring process the priority aim of which must be to achieve the productivity gains required to deal with international competition, so as to lay a firm foundation for future growth. The productivity requirement weighs heavily on the firms exposed to international competition (mainly but not exclusively manufacturing firms), which it inevitably leads not only to acquire new, more efficient plant and machinery, but also to phase out certain product lines or establishments. Such practices are not new, but the intensity of international competition has led to faster turnover at a time when slower growth was preventing new activities from developing strongly enough to ensure an overall expansion in employment. The measures to reduce working hours and direct support for employment introduced in 1981 and 1982, along with some firms' willingness to accept sizeable operating deficits, and by public aids to some of the sectors hardest hit by the crisis, have tended to slow down the rationalization process and buffer its adverse effects on employment. This applies especially to some of the major traditional industries: coal, steel, heavy chemicals, shipbuilding and the car industry; consequently, a major adjustment still remains to be made in those sectors.

Prices, wages, employment and productivity in industry

	1979	1980	1981	1982	1983[1]
Value added prices	10,5	10,9	10,0	12,0	8,4
Hourly wage rate	12,8	15,3	15,7	15,3	11,2
Working week	−2,1	−1,6	−3,8	−3,9	−1,1
Manpower	−1,7	−1,2	−3,2	−1,5	−2,1
Hourly productivity	6,0	2,1	2,5	4,4	4,7
Unit labour costs	6,4	12,8	12,8	10,3	6,1

[1] Commission staff estimates.
Source: INSEE.

The extent of expected labour shedding has led the authorities to reinforce insurance arrangements to attenuate the social implications. The measures will be concentrated on fourteen industrial areas particularly seriously affected by the elimination of jobs; they aim to contribute to conversion by providing special facilities for the vocational recycling of workers, and a variety of incentives, including tax incentives, to create new jobs.

This action will necessarily be circumscribed, however, by the constraint exercised by disinflation policy on public finances, which are already facing increasing costs: the costs of the social security system, particularly old-age pensions and unemployment insurance, and those arising from general or selective provisions in favour of investment, employment and innovation, which are set to expand with the application of the relevant programmes in the Ninth Economic, Social and Cultural Development Plan.[1] As there is no prospect of relaxing credit controls, the required restructuring and redeployment of the productive apparatus will depend to a large extent on whether firms, and particularly industrial firms, can restore adequate self-financing margins. This means durably reversing the tendency of gross profits, which fell steadily from 1979 to 1982. The signs of improvement apparent in 1983 should be confirmed in 1984, although it is unlikely that profits will be high enough to do much more than cover the depreciation of installed capacity.[2] The policy of restraint on labour costs, including social security contributions, the gradual lifting of price controls and measures to improve labour market flexibility should, if pursued throughout 1984 and beyond, allow further essential progress on this front.

Indicators of the situation of firms (S10, S40, S50)

	1979	1980	1981	1982	1983[1]
— Gross savings (as % of GDP)	8,2	7,5	6,2	6,2	7,9
— Ratio of gross savings to depreciation	1,14	1,01	0,8	0,8	1,01

[1] Commision staff estimate.
Source: INSEE, national accounts.

[1] See box.
[2] Although the gross savings of non-financial corporate and quasi-corporate enterprises, credit institutions and insurance enterprises are tending definitely to improve in 1983 and 1984, they are still barely adequate to cover depreciation. The increase in the primary incomes of these sectors in 1983 was due exclusively to the rapid expansion in the income of credit institutions; moreover, their incomes are still less than half what they were in 1979.

The Ninth Plan for Economic, Social and Cultural Development (1984-88)

General features

France's earlier five-year plans were imperative; subsequently, the plans became gradually more indicative, and were based increasingly on incentives. The Ninth Plan marks a return to the activist approach to planning. The ground for it was prepared by the interim plan for 1982-1983, and it is to be a basic tool for economic and social development as well as an all-important benchmark for government action until 1988.

Pursuant to the reform of planning provided for in the Law of 29 July 1982, there will henceforth be two planning acts governing five-year plans. The first will define the strategic choices and aims for the nation over the period covered by the plan, and the main thrust of action; the second will define the means of implementation, i.e. the legal, financial and administrative measures required to achieve the aims. For the Ninth Plan, those aims are:

(i) to affirm France's authority in the world;

(ii) to modernize the productive apparatus;

(iii) to develop employment;

(iv) to ensure solidarity between French citizens.

The strategy adopted in the Ninth Plan is based on the modernization of the productive apparatus, and is intended both to restore high growth potential and to achieve the essential requirement of foreign trade equilibrium through an intense effort of research, training and investment.

New procedures have been introduced to achieve certain priority objectives defined as a function of this broad strategy. The Ninth Plan differs from earlier plans in three main ways: it is more closely interlocked with the budget, it involves the regions and public sector undertakings more closely, through 'plan contracts', and a procedure has been introduced for the regular monitoring of implementation.

Plans, programmes and budget

For the first time in the history of French planning, the medium-term paths of the Plan are to be rigorously adhered to in the central government budget. 1984, the first year of the Plan, respects this requirement. The relevant aspects of the Plan are grouped under twelve priority implementation programmes *(programmes prioritaires d'exécution: PPE)* which associate strategic actions with financing requirements broken down, operation by operation, for each of the five years. The difference between this approach and the priority action programmes *(programmes d'action prioritaires: PAP)* in the previous Plan is that the general financing provided for under the PAP arrangements was not allocated specifically to the different projects.

The 12 PPE concerned cover:

(i) industrial modernization through new technologies and a savings drive (1984 budget: FF 3 200 million; total financing under the Ninth Plan: FF 19 900 million);

(ii) further renovation of the educational system and the system of training for young people (1984 budget: FF 16 600 million; Ninth Plan: FF 91 500 million);

(iii) promoting research and innovation (1984 budget: FF 10 600 million; Ninth Plan: FF 64 200 million);

(iv) the development of communications industries (1984 budget: FF 3 600 million; Ninth Plan: FF 21 200 million);

(v) a reduction in dependence on external energy sources (1984 budget: FF 2 800 million; Ninth Plan: FF 15 500 million);

(vi) action in favour of employment (adaptation of working hours) (1984 budget: FF 5 400 million; Ninth Plan: FF 36 300 million);

(vii) promoting sales in France and abroad (1984 budget: FF 4 700 million; Ninth Plan: FF 27 700 million);

(viii) ensuring a favourable environment for families and a healthy birth rate (1984 budget: FF 200 million; Ninth Plan: FF 1 300 million);

(ix) successful decentralization (1984 budget: FF 2 600 million; Ninth Plan: FF 21 000 million);

(x) improving town life (1984 budget: FF 2 600 million; Ninth Plan: FF 15 100 million);

(xi) modernizing the health scheme and managing it better (1984 budget: FF 5 100 million; Ninth Plan: FF 28 700 million);

(xii) improving the judicial system and security (1984 budget: FF 1 300 million; Ninth Plan: FF 8 100 million).

The appropriations for these programmes over five years amount to FF 350 000 million at 1984 prices; appropriations in the 1984 budget amount to FF 60 000 million.

These programmes form the hard core of the plan, and the achievement of essential priorities depends on their implementation. They account for 60% of discretionary budget expenditure.[1]

As they must be financed throughout the five-year period covered by the Plan, irrespective of cyclical ups and downs, other items of expenditure may have to be adjusted. Moreover, the funds are allocated to specific projects; they are no longer subdivided into broad categories to be spent at the discretion of the recipients (ministries and regions). Their share of the budget is thus exclusively devoted to modernization, and may not be

[1] i.e. the budgetary margin of manœuvre once compulsory expenditure has been covered.

used to cover current expenditure on management. The stimulus afforded by the PPE will be enhanced by the arrangements for 'plan contracts'.

Plan contracts with regions and public sector undertakings

The new approach introduces contracts with the regions and with public sector undertakings in order to enhance the effectiveness of the Plan and create conditions conducive to efforts to achieve its priority aims.

This constitutes decentralized planning, since it introduces permanent dialogue between the central government and the local authorities on the basis of reciprocal commitments under which the regions participate in the application of the priority programmes and the central government undertakes to part-finance regional projects, usually providing half the requirement. The available financing is not shared out between regions beforehand; it is allocated on the basis of projects put forward by the regions themselves, with the central government paying particular attention to education, social affairs and regional planning. Nevertheless, the regions must accept heavy responsibilities, sometimes committing up to 50% of their own budgets for five years.

The contracts with public sector undertakings are intended to ensure that the undertakings' strategies are in line with the central government's guidelines, in particular for industry and energy. The contracts are also meant to associate the public sector in the achievement of general aims such as restoring foreign trade equilibrium and full employment.

Monitoring the implementation of the Plan

Finally, annual examinations will be held throughout the period covered by the Plan to assess progress on each of its aspects:

(i) each of the general economic objectives in the Plan is associated with macro-economic indicators, designed in particular to gauge growth and inflation differentials in relation to other OECD countries, the expansion of productive investment and the development of employment;

(ii) each individual PPE will be monitored with the help of a set of indicators designed to measure progress in the relevant field and to identify sensitive aspects of its application.

Ireland

Trends and prospects

In 1983, domestic demand fell sharply for the second successive year, but good export growth continued and creditable progress was made in reducing the imbalances on the external accounts and in the public finances. Inflation also moderated considerably during the year but these favourable developments were accompanied by a further increase in unemployment.

Private consumption fell by an estimated 3,5% making a fall of almost 9% over the the three years 1981-83, a development associated both with the continued decline in real disposable income, itself a reflection of the painful but necessary process of adjustment, and a rise in the personal savings ratio. Investment fell by 9,3% (−9,5% in the volume of construction and −9,1% in the volume of equipment). The fall of nearly 15% in real terms in the Public Capital Programme (56% of total investment in 1983), due mainly to autonomous factors, and the winding-down of work on certain major capital projects in the private sector reinforced the dampening effect on aggregate investment activity of a surplus supply of commercial and industrial premises and a recession-induced slowdown in direct investment from abroad.

Despite the sharp fall in domestic demand, GDP did not decline in 1983 but grew slightly, by 0,5%, thanks to favourable trade developments as in the previous year. The counterpart of the decline in domestic demand was a low level of imports although a strengthening in the last quarter, reflecting mainly increased imports of industrial raw materials and investment goods, should result in some small positive growth for the year.

Export volume grew by about 11%. A particularly welcome feature was the recovery of agricultural exports which grew by an estimated 3%, but industrial exports accounted for the bulk of export growth and, aided by improved international demand, increased by as much as 13% in volume. The terms of trade improved further by some 3%, reflecting the importance of dollar denominated exports of many multinational companies in Ireland. As a result, the deficit on the current account of the balance of payments fell dramatically by no less than 5,5 percentage points of GDP in 1983.

The average rate of consumer price inflation for the year moderated considerably from 17,1% in 1982 to 10,5% but still remained above the EC average (8,5%).

Unemployment[1] continued to increase in 1983 but at a slower rate than in the previous year. Indeed, in the 12 months to December 1983, unemployment rose by 15,5% as against 27,5% in the preceding twelve months, giving an unemployment rate, at end 1983, of about 16%.

The reduction of 3% of GDP in the Exchequer Borrowing Requirement (EBR) in 1983 constituted solid progress in restoring balance to the public finances. However, budgetary policy in 1983 once again stressed large increases in taxation, with less emphasis on expenditure cuts, which would have been preferable given their respective economic costs.

The budget of 25 January 1984 aims at reducing the EBR by the more modest margin of 1,1% of GDP to 12,2% of GDP. A significant part of the reduction in the EBR reflects autonomous factors depressing the demand for capital expenditure. A volume fall of about 5% is foreseen in the Public Capital Programme. The current budget deficit is scheduled to fall by 0,7% of GDP. As the planned share of taxation in GDP rises from 33,6% of GDP to 35,0%, the burden of adjustment is again falling heavily on the revenue side. The additional revenue however comes mainly from carryover from 1983 and fiscal drag on the direct tax side since, apart from broadening the VAT base somewhat by the imposition of an 8% charge on clothing, excluding young children's clothing, the budget avoided new large general increases in indirect taxation. A small real increase in current expenditure due to increasing unemployment and demographic factors is anticipated even discounting interest payments on the public debt; the burgeoning size of this latter item, rising to 10,3% of GDP, or 30% of tax revenue this year, reflects the large accumulated public debt which now stands at about 120% of GDP. No provision was made in the budget for a wage increase in 1984 for public service workers, beyond payment of the final phase of the current round of wage increases agreed last year plus some previously postponed special pay increases.

One of the most encouraging features of recent trends in the public finances has been the success of the authorities in reducing the share of foreign borrowing in Exchequer financing and in raising the contribution of domestic non-monetary sources. The table below summarizes the trend.

Recent trends in Exchequer financing (EBR)

(IRL million)

	1981	1982	1983
Foreign	1 255	1 130	828
Domestic monetary (Banks, etc.)	187	228	207
Domestic non-monetary	280	587	721
Total EBR	1 722	1 945	1 756

[1] Live Register definition.

The forecast for 1984, made in the wider context of a forecast for all the EC countries, has a basic assumption that average earnings will follow the prudent path taken last year and will more or less mark time with inflation, taking account of the fact that the provisions of the 1983 wage round already imply an increase in wages of about 5,5% in 1984. Given the marked element of fiscal drag, real disposable income is therefore unlikely to grow much, if at all. After its sharp fall in previous years, private consumption should begin to stabilize but the pattern of savings behaviour will be an important determinant of whether it will show any positive growth. The forecast assumes that growing economic confidence will bring about a reduction in the personal savings ratio resulting in a small increase in private consumption. Investment activity however, will decline, partly reflecting the fall of 5% in the Public Capital Programme. Nevertheless, there were encouraging signs in the final quarter of 1983 of a pick-up in private house building activity and in investment in equipment. The former can be expected to continue in 1984 while certain large building projects still at the planning stage could exert an influence towards the end of the year. The existing high level of under-utilization of capacity in industry suggests a cautious view at this stage of the extent of recovery in investment in equipment. However, it seems reasonable to expect that the fall in overall investment in 1984 will be small.

The conditions are again present for a continued strong performance by industrial exports, as export markets expand by some 4,5%. The likelihood of a broadening in the export base should offset any weakening of the structural factors boosting industrial exports in recent years. The physical conditions are also present for agriculture to make a larger contribution to exports this year. However, the effect on agricultural confidence of proposals currently before the EC Council concerning the levels of milk production and agricultural pricing policy in 1984 could cause production to be uncertain. Strong export growth and recovery in domestic demand implies significant growth in import volumes. The lagged effect on import prices of the strong USD and UKL in the latter half of last year implies some deterioration in the terms of trade. Nevertheless, the improvement in the current balance is likely to be sustained and the deficit may fall to less than 2% of GDP this year.

In spite of import cost trends, the avoidance of large general increases in indirect taxation and moderate wage developments should ensure that inflation falls somewhat further during the year to about 9% on average, and perhaps under 8% in the last quarter.

Given the strong underlying rise in the Irish labour supply, unemployment is unlikely to decrease in 1984 and in fact a further increase is probable to an average rate for the year of about 16,5%. While the marked recovery in industrial output recorded in 1983 (5,5%) is expected to be substantially repeated in 1984, it is salutory to bear in mind that this growth is still relatively narrowly based and that in 1983 as in previous years redundancies in industry accounted for over half of the total.

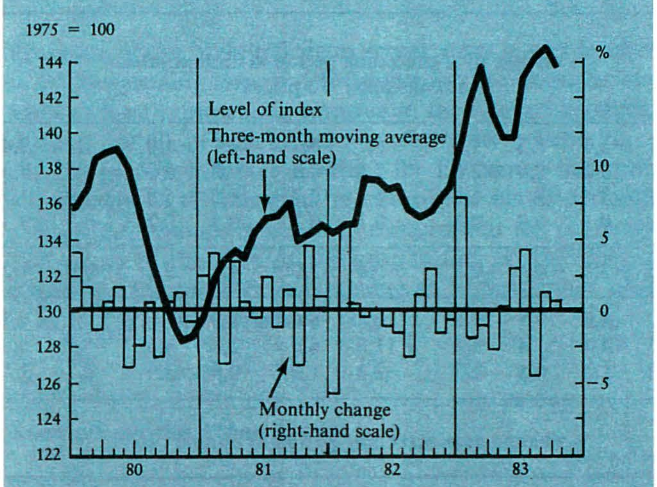
Problems of economic policy

Considerable progress has now been made in correcting the external and internal imbalances. The process of curbing excessive fiscal stimulus, begun in July 1981, has been adhered to by successive governments and in 1983 the Exchequer Borrowing Requirement (EBR) was reduced by the substantial margin of 3% of GDP. Particularly noteworthy was the success of the authorities, for the first time in several years, in meeting the planned budgetary targets. A better balance was also achieved between labour costs and productivity while the deficit on the current balance of payments has been considerably reduced. Nevertheless, important qualifications need to be made in order to underline the sustained efforts still required.

The authorities recognize that the level of the EBR planned for 1984, 12,2% of GDP, remains high and must be reduced significantly over the medium term. A significant part of the reduction in the EBR both this year and last year reflects an autonomous fall in certain types of capital expenditure rather than discretionary government policy decisions. In the past three years budgetary policy has stressed large increases in taxation in order to curb the current budget deficit (CBD) and although no reduction in nominal terms in the CBD is planned this year the tax burden will again increase by about 1% of GDP. Aggregate current expenditure continues to rise despite the fact that the near doubling of current spending in the past ten years from 25% to 46% of GDP has been a key factor behind the very high deficits. Demographic influences and the growing debt burden have largely contributed to this growth. Interest payments on Exchequer debt now amount to over 10% of GDP and to 30% of total tax receipts.

While current high marginal rates of taxation would produce strong revenue buoyancy in a sustained upturn in demand, this would not be sufficient to restore the current budget to balance on feasible medium-term growth assumptions. Over the next few years, the present high level of unemployment may fall only relatively slowly, implying sluggish adjustment in unemployment related public expenditures. The current level and structure of taxation also involve economic costs and over time these may obstruct potential growth

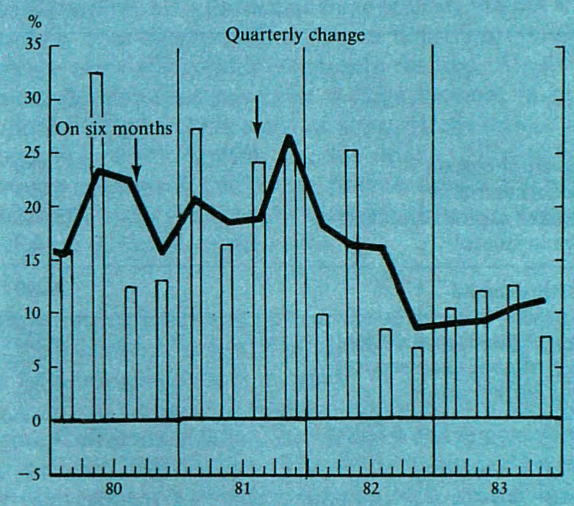
Ireland: Industrial production (s.a.)



Source: Eurostat.

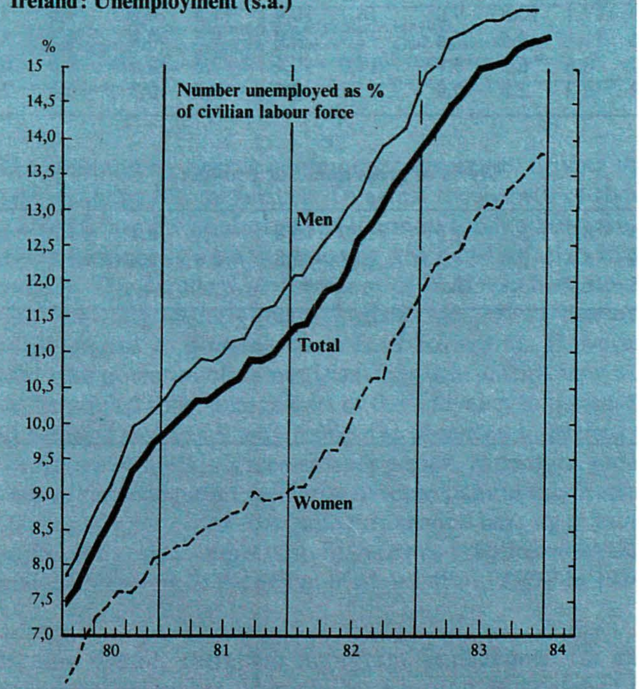
Ireland: Consumer prices (s.a.)

Change expressed as an annual rate



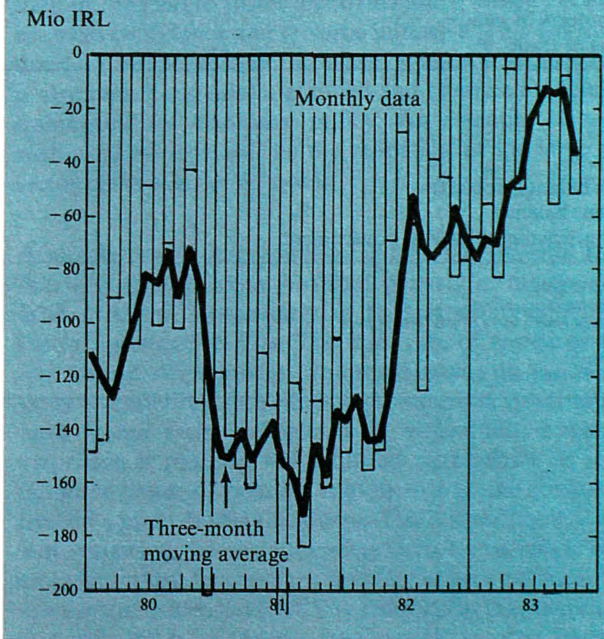
Source: Eurostat.

Ireland: Unemployment (s.a.)



Source: Eurostat.

Ireland: Trade balance (s.a.)



Source: Eurostat.

Ireland: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	IRL '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	7 490	2,7	−5,3	−3,5	1,0	−6,7	−4,7	−4,1	−1,0	1,3	2,4
Public consumption	2 793	5,7	3,3	0,0	−2,0	2,5	0,0	0,0	0,0	−2,5	−3,0
Gross fixed capital formation	3 213	5,3	−8,4	−9,3	−1,9	−16,4	−10,2	−10,5	−5,8	−1,6	1,7
Change in stocks[1]	−6,0	0,8	0,1	0,3	0,3	0,1	0,2	0,3	0,2	0,3	0,3
Domestic demand	13 490	4,3	−3,5	−4,1	−0,3	−5,6	−5,0	−4,5	−2,1	0,0	1,2
Exports of goods and services	6 373	7,2	4,0	9,8	9,6	0,8	6,6	9,9	12,6	9,2	7,5
Imports of goods and services	7 280	6,5	−4,4	1,4	5,5	−11,0	−4,5	2,8	4,5	5,7	6,0
GDP at market prices	12 583	4,0	1,2	0,5	2,3	−2,4	1,0	−0,8	2,5	2,3	2,1
		% change over preceding period at annual rates									
GDP at current prices		19,1	18,3	11,0	10,3	15,7	16,2	10,3	11,7	10,5	8,5
Industrial production[2]		4,3	−1,0	5,5	5,0	−5,1	0,6	6,8	8,0	4,2	3,7
Unemployment rate[3]		7,9	12,3	14,7	16,6	11,5	13,1	14,2	15,3	16,2	17,0
Compensation of employees		20,9	13,4	8,6	7,9	:	:	:	:	:	:
Money supply (M2/M3)		19,6	12,9	7,5	11,4	:	:	:	:	:	:
Implicit price indices:											
— GDP		14,4	16,8	10,5	7,8	10,5	15,1	12,1	8,9	8,0	6,2
— Private consumption		14,9	17,1	10,8	9,0	18,7	10,4	11,3	10,0	9,0	7,9
— Exports of goods		15,6	11,1	9,5	7,8	17,7	9,9	8,5	10,9	8,5	3,8
— Imports of goods		17,7	8,6	6,5	8,8	14,0	0,4	7,5	10,6	9,0	6,6
Terms of trade		−1,9	2,3	2,8	−0,9	3,2	9,5	0,9	0,3	−0,5	−2,6
		As % of gross domestic product									
Trade balance (fob/cif)		−10,5	−8,7	−3,1	−1,5	−6,9	−15,8	−4,1	−2,1	−1,3	−1,6
Current balance		−5,6	−8,4	−2,8	−1.3	−10,8	−5,8	−3,8	−1,8	−1,3	−1,3
Net borrowing of general government		−9,3	−16,2	−13,4	−12,3	:	:	:	:	:	:

[1] As % of GDP.
[2] Manufacturing industry.
[3] Unemployment as % of total labour force.
[4] Estimates.
[5] Forecasts.
Source: Eurostat and Commission services.

much more than well chosen expenditure cuts. If the current budget is to be brought back into balance, the restructuring of public expenditure programmes cannot be postponed too long. This means taking a selective approach to the provision of services and establishing priorities between expenditure programmes competing for scarce funds.

The price of the high deficits in recent years is now evident in the burgeoning size of debt servicing. The domestic element at least represents a transfer to the internal economy some, if not all, of which could be reborrowed. Servicing of the foreign debt however on which the Exchequer had come increasingly to rely to finance excessive levels of domestic absorption, represents a loss of resources to the economy. The extent of this loss, in the near future, on the basis of Exchequer foreign debt outstanding at 30 September 1983, is set out in the table below:

Scheduled servicing of foreign debt[1]

(IRL million)

	1983	1984	1985	1986	1987
Principal repayments	374,0	626,0	483,5	763,6	802,9
Interest repayments	579,0	578,7	523,9	483,5	420,6
Total servicing	953,0	1 204,7	1 007,4	1 247,1	1 223,5
P.m. as % GDP[2]	6,8	7,9	5,9	6,6	5,8

[1] At exchange and interest rates prevailing at 30 September 1983.
[2] (Assumption 1985-87: average GDP growth of 3,0 %, GDP deflator 8 %).
Source: Central Bank Quarterly Bulletin, Winter 1983 and Commission services.

The outstanding debt is continuing to increase, driving the debt servicing bill up further. To arrest the growth of these costs requires the continued reduction of foreign borrowing which essentially means reducing the level of the EBR quickly. The excellent performance of domestic non-monetary financing recently might suggest that greater recourse could be had to domestic sources of borrowing. However, while the potential of domestic savings instruments may not yet be tapped fully, a large part of the buoyancy experienced in the past two years may reflect the absence of alternative investment outlets in a recessionary period. Moreover, problems of crowding-out could arise at some stage in the circumstances of a sustained economic turnaround bearing in mind particularly that important State-owned bodies are also major borrowers to the extent of about 4% of GDP in 1984.

In this regard, there are important implications for the balance of payments. Though the reduction of the deficit in 1983 has been impressive, it must be recognized that this was not only due to buoyant exports but also to a sharp reduction in domestic demand which is not expected to continue. In the 1979-82 period foreign borrowing financed the series of large deficits. Reducing foreign borrowing implies that absorption patterns must be adjusted to warranted levels so that the economy can continue to import the capital goods required at its particular stage of development without running into balance of payments constraints. This will require more effort than commonly realized. A significant recent development has been a large increase in residual capital outflows. This may to some extent reflect under-recording of the current account deficit. Although direct inward investment and hence private capital inflows may pickup from the present subdued level, they may not quickly return to the levels of the 1970s.

Some doubts have been voiced about the cost effectiveness of the generous schemes of incentives offered to attract such investment, particularly in regard to the long run benefits, in terms of domestic linkages, reinvestment of profits and spin-off effect on employment. While it will remain necessary to maintain sufficient profit incentive to attract investment or reinvestment by foreign companies, a greater onus will fall on domestic enterprises in future, to supply the output and growth needed to provide employment for a labour force now expanding by almost 2% annually. This requires that industrial policy become more selective and developmental, concentrating on firms with the best potential for output growth, high domestic value-added and export or import competing potential. It will also be more important than in the past to foster an environment which encourages business confidence and rewards initiative. This has implications for tax policy and for labour market management but it also makes essential a planned and credible medium-term framework for economic policy. An essential element of such a framework will be the reduction of the large public sector deficit-financing needs.

A strong export performance should not obscure the fact that a competitiveness problem persists in many areas of Irish industry, particularly in the import competing and labour intensive sectors. The high rate of company failure and loss of employment in manufacturing in the past two years is ample evidence. Recent tight trading conditions may have forced many companies to adjust but it would be surprising if more is not required particularly in view of the importance of possible movements in the currencies of Ireland's main trading partners. The authorities are at present reviewing the cost of energy used by industry, but the most important factor is the need for continued deceleration in wage and price inflation. Pay restraint in the public service in particular is of course also central to any attempt to reduce public expenditure.

The authorities have avoided a precipitate approach to the solution of Ireland's economic problems and, bearing in mind the social and institutional constraints, have avoided a once-and-for-all sharp shock approach. The essence of such a gradualistic policy however, is that it requires to be pursued consistently over a number of years. A recovery in economic activity will ease the task of the authorities but it will not remove the need for fundamental, and in the case of the budget fairly rapid, adjustments. In fact, if these adjustments are not made soon, an upswing in domestic demand and expectations could exacerbate certain of the problem areas discussed above.

IRELAND: Recent Trends in the Energy Sector

The macro-economic framework

Energy constitutes an important constraint on the Irish economy:

(i) The economy is comparatively poor in indigenous energy resources (Figure 1). In the late 1970s, imports accounted for about 80% of total primary energy demand[1] and although this proportion has declined significantly since 1978 it was still about 62% in 1983 but, given significant increases expected in primary energy demand in future years, its proportion is likely to rise again.

(ii) Energy is therefore an important factor in the balance of payments. The net energy import bill rose from 2,6% of GDP in 1973, to a high point of 8,8% in 1980 and 1981, falling to 6,5% in 1983. It has been estimated[2] that between 34 and 59% of the trade deficit in the years 1975/81 was due to the increases in energy prices experienced after 1973.

(iii) The oil shocks contributed substantially to the severe adverse trends experienced in the terms of trade until 1982—a 25 % decline between 1973 and 1981—and some 2,7% out of the annual average increase in the GDP deflator of about 14% in the 1974/81 period, has been attributed to direct energy price effects.[2]

How the economy reacted

The economy should have reacted by reducing either the amount of energy consumed or, on a broader basis, the level of domestic absorption relative to exports. In fact it did neither quickly. Energy consumption appeared to be surprisingly price inelastic. Indeed, in the face of a tenfold price increase between 1973 and 1980 the import tonnage increased from 6,5 million in 1973 to 7,2 million in 1980. In 1981 however, with a further 19% cost increase, the import tonnage fell to 6,2 million and in 1983 was 5,9 million. Figure 2 suggests that an initial response by the household sector to cut energy consumption soon lapsed while the other sectors, in the period to 1979, recorded no sustained energy saving either. The pattern is similar in some respects to that recorded for the Community but whereas primary energy demand in the Community rose by 6% in the 1973/79 period, it increased in Ireland by about 22%.

Adjustment of domestic absorption was made all the more urgent by the fall of 19% in the effective exchange rate in the 1973/79 period (which fell again by about 16% in 1979/83) and developments in the balance of payments. Private consumption rose strongly as real per capita wages increased by 16% in the 1975/79 period; buoyant receipts from the EC, mainly under the CAP, in the period to 1979 cushioned the economy from balance of payments disturbances and, subsequently, increasingly large amounts of foreign borrowing, mainly by the public sector, financed the growing deficits.

Since 1979 however, new trends in energy use have appeared. For reasons to be explored below, energy demand has fallen and the proportion of imported fuels, though still high, has declined significantly. From the macro-economic point of view, this development has been reinforced by a process of fiscal adjustment put in hand in 1981 which is intended, *inter alia,* to reduce foreign borrowing and help correct the external imbalances.

Changes in the pattern of energy demand

Table 1 and Figure 3 set out the changes in the pattern of primary energy demand in recent years. Provisional figures for the first three quarters of 1983 indicate a continuation of the salient trends. The important aspects are:

(i) Total demand has fallen by some 8% in the period 1979/83; this is still, however, smaller than the fall in Community demand in 1979/82, 11,5%.

(ii) Oil use, however, has fallen from 71% of the total in 1979 to an estimated 49% in 1983. The absolute fall of 1,768 MTOE[3] to 1982 was accounted for substantially by a reduction of 0,946 MTOE in oil use by the ESB (the state-owned electricity utility) in electricity generation; the ESB, which in the 1970s accounted for about a quarter of total oil consumption is engaged in a major programme of fuel diversification, in particular by switching to natural gas. The balance of the reduction in oil use, 0,822 MTOE, is attributable mainly to the industrial sector and to a lesser extent to the transport sector. Table 2 shows that they are by far the two main users of oil in final demand.

(iii) The share of natural gas has risen rapidly and in 1983 was probably about 20%. This reflects the coming on stream of a small natural gas field (proven reserves estimated at 34,0 MTOE; lifetime 20 years) off Kinsale Head, in Co. Cork.

The construction of a pipeline grid to the cities of Cork and Dublin and an extension, now under way, to Northern Ireland will enable more widespread use of natural gas as a fuel by domestic and industrial consumers. Together with a less spectacular rise in the production of peat, as marginal reserves are brought into production, gas has pushed up the share of indigenous fuels in total primary energy supply.

(iv) The use of coal has increased to about 12% of the total. This is accounted for mainly by fuel switching in the household sector—the main user (Table 2). In 1981, solid fuel was the primary means of heating in 72% of households but its use is increasing in industry.

[1] Energy supplied to consumers for energy purposes (final demand) *plus* consumption by the energy sector.
[2] E.W. Henry, ESRI 1983.
[3] Million tonnes oil equivalent.

The reduction in total demand and the steep fall in oil use are obviously satisfactory trends. The change in oil import structure in the period—in 1983 about 80% of oil and petroleum derivative requirements came from the UK compared with 56% in 1979—suggests greater security of supply. However, significant qualifications need to be made. The continued heavy weight of energy imports in the balance of payments, 6,5% of GDP in 1983, implies that much more needs to be done to reduce energy demand. There are three important factors to bear in mind; (i) the bulk of coal is imported so that a large part of fuel switching leads to a lessening but not a major fall in the imported fuel bill; (ii) some of the fall in oil demand recorded in the industry and transport sectors could be reversible as output recovers and (iii) indigenous energy sources are at present limited.

In relation to the last factor, while the authorities are encouraging the development of renewable energy sources, they have pinned their main hopes on finding additional hydrocarbon resources offshore. Exploration activity by oil companies has continued for some years but, although the presence of oil and gas has often been confirmed, it is only recently—August 1983—that what appears to be a small commercial oil field has been discovered. While quite strong oil flows were registered from the initial exploratory well, further test drilling is required before it can be confirmed whether the field is commercial and its probable size. At any rate the field is likely to be small and while easing the import bill for a number of years it would not make a major strategic difference. For instance, recoverable reserves of 100 million barrels would only be about three times primary oil consumption in 1982. During the 1970s, the authorities considered building a nuclear power station but this ran into environmentalist opposition while later economic objections led to the nuclear option being effectively shelved for the future.

Implications for energy policy

It is possible to distinguish conceptually three factors accounting for the recently observed trends: (i) a conservation effect, implying greater efficiency in the use of energy; (ii) an activity effect related to the recession, and (iii) a structural effect related to a fall in the contribution to total output made by more energy intensive types of production. In practice however, they are difficult to disentangle.

In assessing the extent of conservation it is important to take into account not only reductions in actual fuel use but the slowdown in the buoyancy of demand for specific forms of energy. For instance Figure 4 shows that electricity consumption in Ireland remained relatively stagnant in recent years in sharp contrast with the Community as a whole where the use of primary electricity increased by 82% between 1973 and 1979 and by 51% in the 1979/82 period. This undoubtedly reflects a more efficient use of electricity in the face of large price increases—up by almost 200% in the 1976/83 period. Table 3, which sets out ratios for energy intensity by main sector, suggests efficiency in energy use particularly in industry has improved sharply since 1979, but lags somewhat behind the Community experience until 1982. However, no sustained improvement for the household sector is evident but it must be remembered that in the 1971/81 period the housing stock, for demographic reasons, increased by 23% and it is reasonable to suppose that each household requires a minimum, price inelastic, amount of fuel.

There are other reasons why considerable conservation savings could be expected in the current period. Conservation may have occurred with a considerable lag given the cost of replacing specialized appliances, etc. and as public incentives and information programmes have effect. Secondly the squeeze on disposable incomes and certain tax increases imposed in recent years must have acted as an additional incentive. Finally, firms caught in a tight competitive position in a recession can be expected to try to cut costs where possible and can no longer pass higher energy costs so easily onto the consumer.

Another aspect to be noted is the fact that industrial output has increasingly come from the newer high-technology sectors. It is thus arguable that the recent increase in energy efficiency in industry is due significantly to the weight of these sectors, a view given some support by an increase of 5,5% in manufacturing output last year at the same time as a continued sharp fall in primary energy demand.

Nevertheless, in spite of this strong *prima facie* evidence for a considerable degree of sustainable energy saving it is likely that oil use in the industry and transport sectors would be sensitive to a marked increase in economic activity. In addition the balance of payments constraint remains. This mean that further conservation savings must be made or that levels of domestic absorption must move in a way compatible with the health of the external balance. The degree of commitment to wage moderation and fiscal correction will, in the next few years, be an important factor in this regard.

The cause of long time lags in the achievement of energy savings in Ireland has been factors like the cost of adapting specialized appliances, etc., and lack of awareness of new technical possibilities. The Irish authorities devote a much smaller amount of funds to the promotion of conservation than do the EC partners. In 1982 only 0,4 ECU per head was spent compared with an EC average of 8,6 ECU and in the case of Denmark and the Netherlands in particular there is a striking relation between high expenditure levels, 22,8 ECU and 17,0 ECU per head respectively, with large falls in primary energy consumption, 17,2% and 17,5%. However, the much lower level of expenditure in Ireland has already achieved substantial results giving support to the view that the market price mechanism, even if lagged, is a powerful means of encouraging conservation. This also underlines the importance of an appropriate pricing policy for natural gas so that its energy value is taken into account as far as possible within the context of the expansion and optimization of natural gas use.

Table 1: Primary energy input 1976-1982

('000 toe)

	1976	1977	1978	1979	1980	1981	1982	% change (82/79)
Peat	1 186	1 235	1 182	1 160	1 141	1 120	1 217	+4,9
Coal	491	518	551	828	782	860	869	+5,0
Oil	5 200	5 534	5 777	6 151	5 704	5 069	4 383	−28,7
Hydro	162	204	185	215	214	222	202	−6,0
Natural Gas	—	—	—	258	492	896	1 410	+46,5
Total	7 039	7 491	7 695	8 612	8 333	8 167	8 081	−6,2

Source: Energy in Ireland 1982; Dept. of Industry and Energy, 1983.

Table 2: Structure of final energy demand, 1982

('000 toe)

	Total	Households	Commercial	Industry	Transport
Peat	659	585	64	10	—
Coal	843	627	69	147	—
Oil	3 426	255	309	1 186	1 676
Electricity	732	311	162	259	—
Gas	325	141	22	139	23
Total	5 985	1 919	626	1 741	1 699

Source: Energy in Ireland 1982; Dept. of Industry and Energy, 1983.

Table 3: Energy intensity by main sector — ratio of energy use and value added

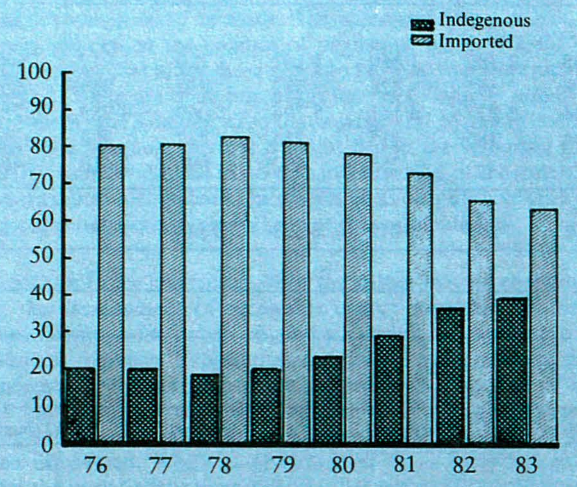
(At 1975 prices)

	Households[1]	Industry (Incl. Agriculture)	Transport, Commerce, Services	Total Economy
1973	0,662	1,052	1,464	1,760
1974	0,641	1,046	1,369	1,685
1975	0,627	0,915	1,298	1,546
1976	0,656	0,937	1,272	1,569
1977	0,665	0,985	1,050	1,570
1978	0,607	0,848	1,324	1,507
1979	0,686	0,971	1,344	1,632
1980	0,653	0,910	1,240	1,521
1981	0,656	0,889	1,208	1,531
1982 (est)	0,685	0,803	—	1,413
P.m. % change 1973/81				
— IRL	−1,0	−15,5	−17,5	−13,0
— EC 10	−20,7[2]	−22,8	n.a.	−18,9

[1] Ratio of energy use to consumers' expenditure.
[2] Household/tertiarysector.

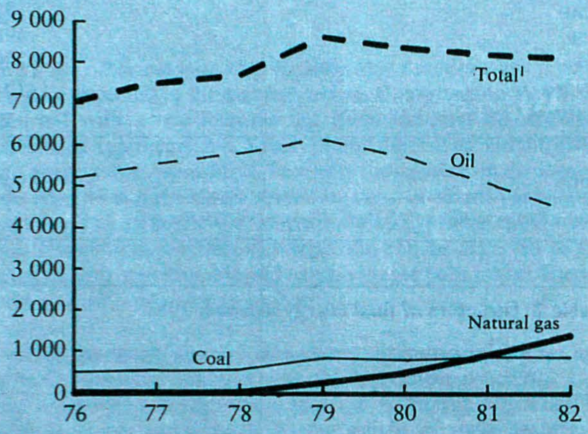
Source: E.W. Henry, ESRI, 1983; Commission services.

Figure 1: Indigenous and imported fuels



Source: Energy in Ireland 1982, Dept. of Industry and Energy 1983; Commission services.

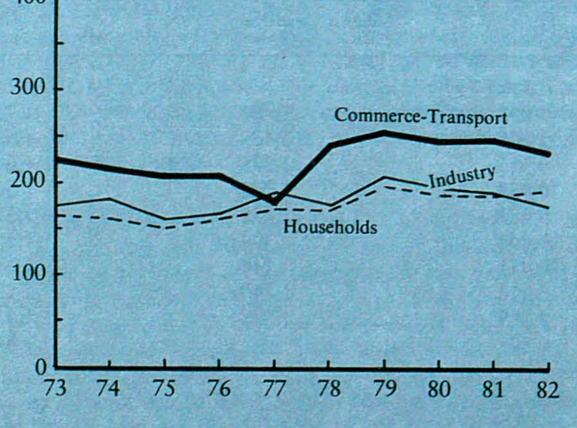
Figure 3: Primary energy input



[1] Including hydro-electricity and peat

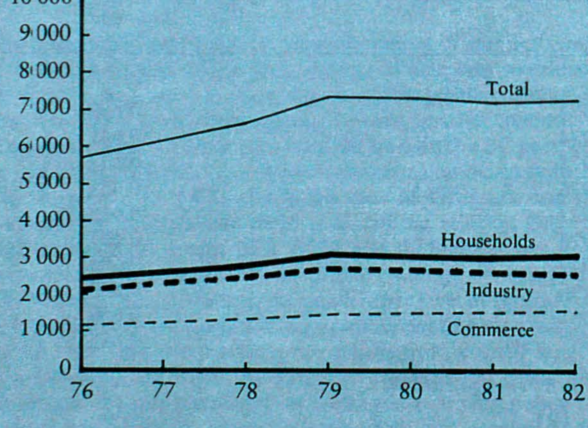
Source: Energy in Ireland 1982, Dept. of Industry and Energy 1983; Commission services.

Figure 2: Final energy demand by sector



Source: Energy in Ireland 1982, Dept. of Industry and Energy 1983; Commission services.

Figure 4: Electricity sales



Source: Energy in Ireland 1982, Dept. of Industry and Energy 1983; Commission services.

Italy

Trends and prospects

External adjustment in the Italian economy has been achieved thanks to the sharp fall in domestic demand in 1983 and the recovery of world trade in the second half of the year. Economic policy still gave priority to the restoration of equilibrium, and pressure was maintained both on consumption and on investment. The restrictive measures in the tripartite agreement of 22 January 1983 governing increases in money incomes combined with a large rise in taxation,[1] led to a pronounced fall in households' real disposable incomes with adverse effects on consumption. Monetary policy continued to keep interest rates high, which meant rigorous stock management and accentuated the declining trend of investment in plant and machinery.

Contributions to changes in GDP (volume)

	1979	1980	1981	1982	1983[1]
Final domestic demand	4,6	4,5	0,3	−0,4	−1,2
Changes in stocks	0,8	2,2	−3,0	0,2	−0,9
External balance	−0,5	−2,8	2,5	−0,1	0,7
GDP	4,9	5,9	−0,2	−0,3	−0,4

[1] Provisional estimate.

Against this background, the real balance of trade improved particularly when world trade recovered significantly from the middle of the year. However, the improvement was not sufficient to offset the adverse effects of slacker domestic demand, so that gross domestic product contracted for the third year running, with a decline of 1,4% from 1982 to 1983.

Industrial output was particularly hard hit by the contraction in aggregate demand: it contracted by about 5% in the course of the year. But the recession bottomed out during the summer, and the closing months of 1983 saw a clear upswing.

Major progress was made to restoring equilibria, thanks to the slackness of domestic demand. The annual average rise in consumer prices was still 14,7%, but the tendency was slowing down during the year, gradually falling to about 1% a month. Wholesale prices slowed down even more, to a rate of under 10% for the year as a whole. Current balance-of-payments equilibrium was restored, with a marked improvement in the real balance, a slight improvement in the terms of trade and a better performance on invisibles.

For 1984, policy is designed to ensure that past achievements in restoring equilibria are not sacrificed because of the recovery. It therefore concentrates on a further effort to reduce inflation, thus strengthening the basis for future growth.

Monetary policy is set to remain strict. It will be geared to keeping total domestic credit to no more than LIT 123 000 000 million—a smaller percentage of GDP than in 1983—which implies moderate and balanced restriction of both business and Treasury financing. Real interest rates will remain at least as high as last year, even though nominal rates will fall, both to moderate firms' demand for credit, and to increase further the share of non-monetary financing of the public deficit; this will tend to reduce the liquidity ratio of the economy in terms of M2.

The planned arrangements should therefore contribute to lower nominal growth while enabling the recovery to develop at a moderate pace. Whether this restrictive stance is commensurate with the looked-for recovery in firms' investment demand will depend, however, on the progress made in controlling the public deficit and labour costs.

Expenditure, revenue and position of general government (as % of GDP)

	1979	1980	1981	1982	1983[1]	1984[2]
Current revenue	36,3	38,0	39,3	41,7	44,9	45,4
Current expenditure	41,6	42,0	46,6	48,5	51,1	51,3
(*of which*: interest)	(5,8)	(6,2)	(7,5)	(8,4)	(9,5)	(9,3)
Capital expenditure	4,2	4,4	4,6	5,2	5,7	6,0
Borrowing requirement	−9,5	−8,4	−11,9	−11,9	−11,9	−11,9
Treasury borrowing requirement	−11,2	−10,9	−13,2	−15,4	−16,6	−15,9

[1] Estimate.
[2] Probable outcome given unchanged policy.

Budgetary policy will attempt to reduce the Treasury borrowing requirement to about 15% of gross domestic product, i.e. no more than LIT 90 800 000 million. Some of the

[1] See *European Economy* No 15 of March 1983, pp. 59 and 60.

decisions required to achieve this aim were adopted before the end of 1983, either as Decree-Laws or as part of the 1984 Finance Act. They include increases in corporation tax and taxes on investment income, a further rise in the tax on oil products and, for the first time, major spending cuts, in particular on health and social security, as well as a further step towards integrated cash management for general government; the latter should reduce the Treasury borrowing requirement by LIT 5 000 000 million. A bill to settle outstanding disputes on unauthorized building should increase resources by a similar amount once it has been adopted. Finally, the clamp-down on tax evasion should substantially increase revenue. Further measures will, however, probably be required in the course of the year to keep the deficit within the planned limits.

The main object of wages policy is to align the rise in hourly rates with the programmed inflation rate of 10%. This is one of the aims of the three-year disinflation plan; it has meant a further change in the 'scala mobile' system of indexation. Tripartite negotiations began early in January to persuade unions to accept this derogation from the norm of the system in exchange for a commitment on the part of the authorities to limit the increase in administered prices, undertake further action against unemployment and ensure a more equitable tax system. The main decisions required to achieve the aim, in particular a weakening of wage indexation [1] and a rent freeze, were finally adopted by way of legislation in February. At the same time, as a contribution to the achievement of the price objective, the trades concerned once more undertook voluntarily to limit the increase in the prices of certain sensitive goods and services.

In these conditions, the economic outlook for 1984 implies a clear improvement in activity accompanied by substantial progress towards disinflation. The components of final domestic demand should improve considerably, confirming the tendency observed at the end of 1983. In particular, private consumption will be supported by the recovery, now under way, in households' real disposable incomes, reinforced by, among other things, the high level of public investment, the decline in interest rates, investment in plant and machinery, the increased pressure of demand on production capacity and the better trend of profit margins. As final demand improves, moreover, stockbuilding should also pick up. The real balance on foreign trade should continue to make a positive contribution to growth, but less than in 1983. Altogether, gross domestic product should expand fairly rapidly in the first half-year and more slowly in the second, rising by over 2% in the year as a whole.

Prices will probably develop approximately in line with official targets, so that the underlying trend rate should decline in the course of the year from 12% to 9%. The return to balance-of-payments equilibrium on current account should be confirmed.

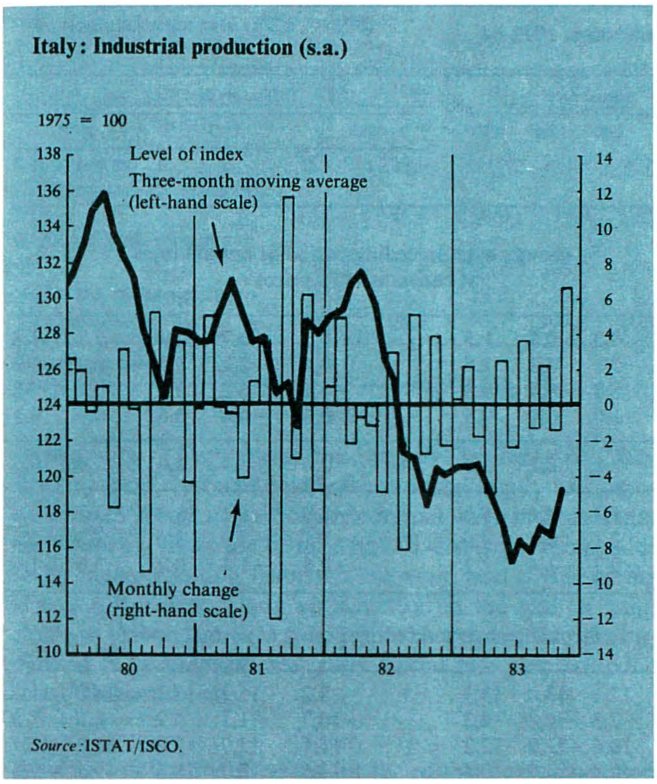
Economic policy problems

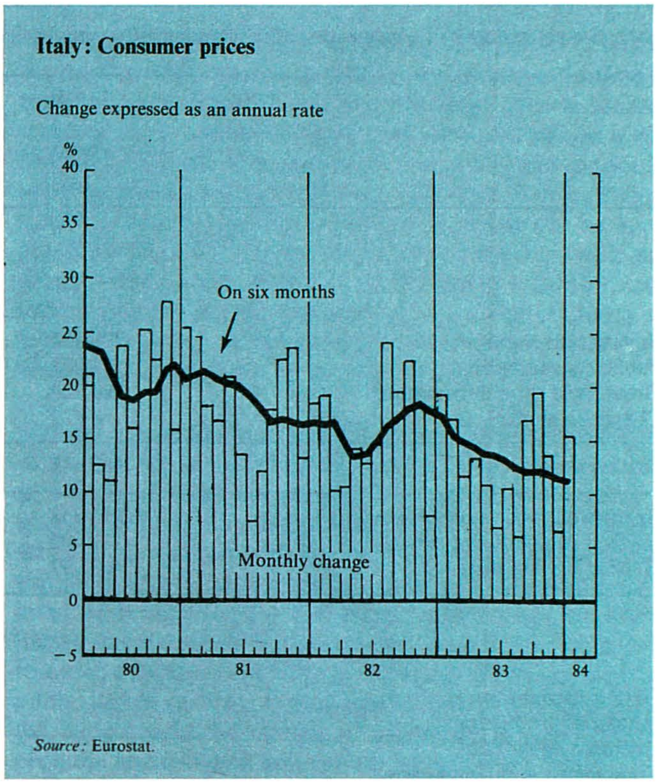
The economic outlook for 1984 is fairly satisfactory, implying a considerable improvement in activity after three years of stagnation and even decline, without compromising external equilibrium. But there are no grounds for concluding that the economy is already well on the way to sustained long-run growth. Competitive production capacity may well soon become inadequate to deal with much firmer aggregate demand, so that the external account could deteriorate once again.

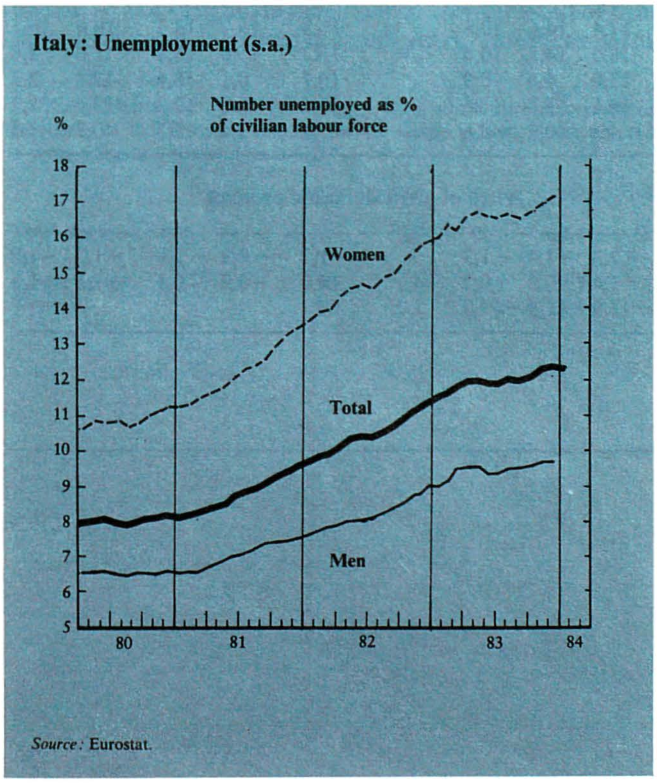
The potential inadequacy of capacity results from the steady decline in investment, especially industrial investment, over the past ten years, while obsolescence was gathering speed as a result of ever fiercer competition. Moreover, in the face of that competition, the investment that was carried out by firms served the purpose of conversion or streamlining rather than of an extension in capacity. Finally, opportunities for redeployment towards advanced industries with high value added were limited by the scarcity of financial resources. The adverse effects on employment of these developments were disguised or limited for some time, but could not be deferred indefinitely; when they emerged, during the recent long period of economic weakness, they were extremely severe. Unless the long-term tendency of investment is rapidly reversed, the economy may well find itself facing a dearth of suitable production capacity and a further deterioration in employment.

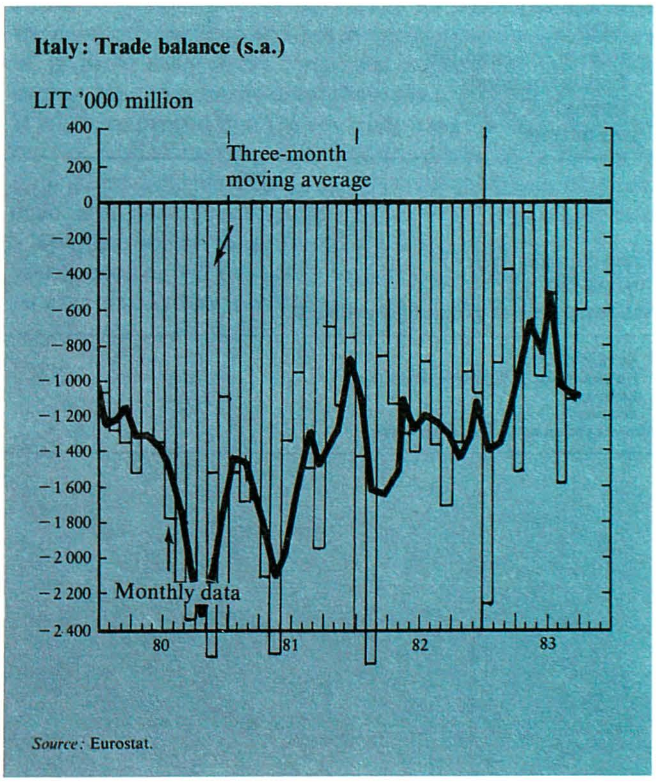
Thus the overriding priority of economic policy must be to restore investment capacity enabling the economy to recover and preserve lasting and sustained growth; this is also the main concern of the disinflation effort. This is not simply a matter of ensuring that external equilibrium is consolidated without a further deterioration in price competitiveness in addition to that of 1983.

[1] By cutting the increase of the index to be taken into account by two percentage points in February, and one in May; this reduces the total numbers of points taken into account during the year from 12 to 9, and perhaps to 8 if, as may be expected, this decision leads to a further slowdown in prices.


Italy: Industrial production (s.a.)
1975 = 100
Level of index
Three-month moving average
(left-hand scale)
Monthly change
(right-hand scale)
80
81
82
83
Source: ISTAT/ISCO.


Italy: Consumer prices
Change expressed as an annual rate
%
On six months
Monthly change
80
81
82
83
84
Source: Eurostat.


Italy: Unemployment (s.a.)
%
Number unemployed as %
of civilian labour force
Women
Total
Men
80
81
82
83
84
Source: Eurostat.


Italy: Trade balance (s.a.)
LIT '000 million
Three-month
moving average
Monthly data
80
81
82
83
Source: Eurostat.

Italy: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	LIT '000 000 million at current prices	1972-81	1982	1983[3]	1984[4]	1982 I	1982 II	1983[3] I	1983[3] II	1984[4] I	1984[4] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	298 192	2,9	0,3	−0,7	1,5	:	−0,3	−0,7	−1,1	2,7	1,8
Public consumption	88 878	2,8	1,8	2,3	1,5	:	0,4	2,2	4,3	0,9	0,0
Gross fixed capital formation	89 259	1,5	−5,3	−6,4	1,8	:	−4,7	6,2	8,5	5,4	5,8
Change in stocks[1]	6 612	1,7	1,0	0,1	0,5	:	0,6	−0,4	0,6	0,9	0,1
Domestic demand	482 941	2,6	−0,2	−2,1	2,0	:	−2,4	−3,4	0,6	3,4	0,5
Exports of goods and services	113 858	6,8	1,3	3,4	5,0	:	−8,9	5,4	12,3	3,7	1,4
Imports of goods and services	127 002	5,1	2,1	0,1	4,0	:	−8,1	−2,9	8,6	2,8	−2,4
GDP at market prices	469 797	3,0	−0,3	−1,4	2,2	:	−2,8	−1,4	0,2	3,6	1,4
		% change over preceding period at annual rates									
GDP at current prices		19,3	17,1	13,0	13,3	:	8,2	15,1	13,7	14,0	11,6
Industrial production[2]		3,3	−2,3	−4,8	4,2	:	−16,7	−1,1	0,9	6,5	3,2
Unemployment rate[2]		6,4	10,6	12,0	12,2	:	11,1	12,0	12,0	12,3	12,1
Compensation of employees		19,3	16,8	12,9	10,4	:	11,5	12,0	16,1	9,1	7,5
Money supply (M2)		18,8	16,9	13,0	12,8	:	:	:	:	:	:
Implicit price indices:											
— GDP		15,9	17,4	14,6	10,8	:	11,3	16,7	13,5	10,0	10,1
— Private consumption		16,1	16,5	14,8	10,4	:	17,7	15,0	11,8	11,6	8,8
— Exports of goods		16,5	15,0	6,6	10,9	:	10,7	0,1	16,6	12,8	2,3
— Imports of goods		19,7	10,1	5,8	11,6	:	11,9	−3,2	19,3	13,6	1,3
Terms of trade		−2,7	4,5	0,8	−0,6	:	−1,1	3,4	−2,3	0,7	−1,0
		As % of gross domestic product									
Trade balance (fob/cif)		−0,7	−2,3	−1,4	−1,3	:	−1,7	−0,9	−1,8	−1,7	−1,0
Current balance		−1,1	−1,6	−0,3	−0,2	:	0,0	−0,9	0,1	−1,6	1,3
Net borrowing of general government		−8,9	−11,9	−11,9	−11,9	:	:	:	:	:	:

[1] As % of GDP.
[2] Unemployment as % of total labour force.
[3] Estimates.
[4] Forecasts.
Source: Eurostat and Commission services.

The real exchange rate (1975 = 100)

	1979	1980	1981	1982	1983
GDP prices	185,4	223,9	263,3	309,4	359,5
GDP prices (1% competitors)	134,4	146,8	158,9	171,0	180,9
Inflation differential (1 : 2)	138,0	152,6	165,8	180,9	198,7
Effective exchange rate	69,9	67,7	59,6	55,5	53,3
Real exchange rate	96,5	103,3	98,7	100,4	106,0

Source: Commission.

Disinflation is also a prior condition for restoring profitability to a level that will enable firms substantially to increase their investment. In particular, nominal wage increases must slow down if firms are to take full advantage of the productivity gains resulting from the recovery, and if the adverse effects on profits of any appreciation in the real exchange rate are to be kept to a minimum. Moreover, the resulting decline in nominal interest rates would also help to reduce firms' financial costs.

A further policy requirement for the restoration of sustained and balanced growth is the gradual reduction of the public deficit, so as to attenuate the financial crowding-out of firms that has strongly increased in recent years, [1] without relaxing the monetary discipline required for successful disinflation. Although it is true that disinflation will itself tend to reduce the burden of interest payments on an unchanged deficit in terms of gross domestic product, the deficit is now so large that, far from remaining unchanged, the indebtedness is still increasing rapidly. The problem of crowding-out cannot be solved without a constant effort to keep the deficit (excluding interest) from expanding too fast. This effort will be hampered by the fact that the burden of taxation, which has grown substantially in recent years, cannot increase much further against the background of a systematic policy of incomes restraint, except through stricter measures to combat evasion or perhaps an increase in local taxation.

For some years to come, therefore, pressure must be brought to bear on the trend of real expenditure through new measures to impose stricter standards of management on government departments and public services, especially hospital services, to continue with the drive to improve the administration of social security schemes, and to phase out the costs involved in maintaining loss-making activities in the State-owned sector. Such improvements should lead to better resource allocation not only by reducing the pressure of the public deficit on the financial market but also by providing the budget with the margin of manœuvre it now lacks to promote research and innovation, among other things.

In the final analysis, the only hope for an improvement in the employment situation lies in reinforcing the foundations of growth, even if the structural adjustment this implies cannot but temporarily accentuate the present deterioration. It has been proved that the tendency towards more flexibility on the labour market, and certain measures in favour of young first-time jobseekers, could contribute to employment even in an adverse economic context. All the possibilities of a specific policy to promote employment, especially for young people, will probably need to be exploited to prevent an excessive further expansion of unemployment.

[1] This is illustrated by the following figures, which show the respective shares of the Treasury and the private sector in total domestic credit expansion as a percentage of GDP.

	1979	1980	1981	1982	1983
Total domestic credit	19,7	18,7	18,1	21,4	22,8
share of:					
private sector	9,2	8,6	6,9	6,9	6,9
Treasury	10,5	10,1	11,2	14,5	15,9

The indexation of remunerations — The 'scala mobile' method

1. Introduction and description

Since automatic cost-of-living adjustments for wages and salaries were introduced in 1957, there have been a number of major changes in the system, introduced in 1975, 1983 and 1984. The present system provides for adjustment four times a year by the non-linear method described below; it was laid down in the 1975 social agreements, which eventually replaced the former wide variety of arrangements with two main schemes, applying respectively to pensions and to public and private wages and salaries.

1.1 *The sliding measure for wages and salaries* is based on a weighted 'Laspeyres' index [1] that measures the cost of living according to a special basket [2] agreed to by both sides of industry in the immediate post-war period. With the introduction of new arrangements early in 1975, the three-month period from 21 July to 20 October 1974 was adopted for the new base period (the index for that period on the old base was 252,2, [3] while the basket remained unchanged. [4] Remunerations are adjusted for the increase in the cost of living four times a year, with effect on 1 February, 1 May, 1 August and 1 November, by a certain amount (the *'indennità di contingenza'*), calculated as a function of the difference between the average index for the three months ending on the 20th of the month preceding the adjustment (i.e. January, April, July and October respectively) and that for the previous three-month period (i.e. the increase granted on 1 November depends on the difference between the average index for 21 July to 20 October and that for 21 April to 20 July).

Under the system in force until 1974, the fixed amounts paid to compensate for each one-point rise in the index (to the nearest whole number of points) differed according to the occupation and skills of the recipients; the new system, which became fully operational in 1977, involved the payment of a standard amount of LIT 2 389 for each one-point rise in the index irrespective of occupational category or sector of employment. The amount of LIT 2 389 is equivalent to the highest adjustment paid under the old system (LIT 948) multiplied by the coefficient of 2,52 resulting from the change in the base period. The amounts payable to recipients in categories not previously eligible for the highest rate were increased by stages from February 1975 to February 1977.

1.2 The laws governing the indexation of pensions provide for a single adjustment annually. However, in practice, payments are made on account during the year. Pensions are thus increased on 1 January, 1 May and 1 September, on the basis of the change in the index over the four-month period ending six months earlier (i.e. the January increase depends on the change in the index from 21 March to 20 July, etc.). For pensions above the legal minimum, whether the recipients are former employees or former self-employed workers, the increase takes the form of a standard amount of LIT 1 910 for each one-point rise in the index (i.e. about 80% of the standard amount applied to wages and salaries). For minimum pensions, the increase is calculated as a percentage and corresponds to the rate of increase in the index during the reference period. [5]

1.3 The method described above was adjusted for the first time by the social agreements of 22 January 1983, signed at the request of the government, which oversaw negotiations. These agreements once more changed the base period, to the three months from August to October 1982 (re-basing coefficient: 3.35). The standard amount payable for each one-point rise was not fully adjusted to the new base, since the main purpose of the negotiations was to achieve disinflation. Each one-point rise in the new index thus leads to payment of an increase of LIT 6 800 in wages and LIT 5 440 for pensions under the general scheme − 15% less than the standard amounts that would have been obtained by simply passing on the effects of the change of base.

After the recent breakdown of negotiations between the two sides of industry to attenuate even further the impact of inflation on wages and salaries, the government promulgated a Decree-Law on 15 February 1984 halving the number of percentage points to be taken into account for the February adjustment and reducing by one third the number to be taken into account in May. These provisions (which are to be ratified by Parliament at a later stage) mean that only nine points of the expected twelve-point increase in the index for 1984 will be taken into account this year: a saving of about 34% in annual terms.

2. Economic repercussions of the method

The main purpose of the system was initially to make sure that the monetary erosion of earnings close to subsistence level was fully offset. The choice of a non-linear method meant, moreover, that wage differentials would narrow towards some central point where earnings would keep pace with prices. The value of earnings at that central point, and the distance separating them from average earnings must be estimated to measure the extent to which wages and salaries are insulated against inflation and thus to assess the secondary effects of the method, in particular its role in fuelling inflation, the reactions it generates in various social groups and its impact on the main macro-economic aggregates.

2.1 To measure the *degree of protection* from inflation accorded to wages and salaries, various authors [6] have suggested the

[1] *'Indice del costo della vita per la contingenza'*, or, *'indice sindacale'*.
[2] The composition of the basket corresponds to the expenditure patterns of a typical family of father (employee in employment), mother and two dependant children.
[3] The re-basing coefficient, or ratio between the old index and the new, is thus equal to 2,52.
[4] The basket was adapted shortly afterwards when subscriptions to newspapers, season ticket prices for suburban transport and flat-rate electricity charges replaced the unit prices of the goods and services concerned.

[5] The recent Finance Act for 1984 extended this system to private-sector pensions, which will henceforth be adjusted quarterly on the basis of the percentage change in the index. The increase granted will, however, be cut by 10% if the total pension exceeds twice the minimum pension, and by 25% if it exceeds three times the minimum pension.
[6] See 'Quarterly review' of the Banca Nazionale del Lavoro, in particular: Spaventa, December 1976 and June 1977; Faustini, September 1976; Filosa and Visco, March 1977.

following formal representation of the Italian method of indexation:

$$(1) \quad W^i t = W^i o + a\,(Pt - Po)$$

where:

$W^i t$ = monetary value of index-lined wage in period t
Wo = monetary value of wage at base period
a = standard amount (LIT 6 800)
Pt-Po = total change in the reference index (scala mobile) from base period to period t.

It is immediately clear from this formula that the absolute increase in any wage W^i is irrespective of the level of the wage ('a' is a constant adjustment term), but that the relative size of the increase (i.e. its ratio to the price index) is variable; more specifically, it declines as $W^i o$ increases.

Applying this formula to annual data, we may calculate the value of earnings at the point where inflation is precisely offset during the given year, on the basis of a linear relationship involving the standard amount; the ratio of this value to average per capita earnings in the sector considered reflects the extent to which average earnings are protected from inflation. Calculations carried out for 1977 show that the average wage in the economy as a whole was protected against inflation to the extent of 88,2%, and the average wage in manufacturing industry to the extent of 82,2%.

Since then, real wages both in industry and in the economy as a whole have risen for other reasons besides indexation: collective agreements, regional or sectoral advantages, seniority, wages drift and so on. Similar calculations for 1983 and 1984 [1] incorporating the new indexation arrangements show that average earnings in the economy as a whole were (or will be) protected to the extent of 65% and 64% respectively. However, this decline in the degree of protection has not sufficed so far to inhibit the rising trend of the share of wages and salaries in national income. When the arrangements were extended to cover pensions, it was agreed that indexation should be proportional to the theoretical rate for pensions in the general scheme (i.e. 80% of remuneration immediately prior to retirement). The standard cost-of-living increase was therefore set at 80% of the standard amount applied to wages. As the average level of pensions was in fact much lower than 80% of average wages, the adjustment of pensions leads to considerable over-compensation; this is at present one of the major factors in the recent deterioration of the public deficit.

2.2 The reduction of wage differentials resulting from application of the indexation arrangements was a deliberate aim of the 1975 agreements, since the differentials then existing were considered excessive in relation to those observed in more highly developed economies such as the USA and the Federal Republic of Germany.

The theoretical reduction in wage differentials can be measured by applying formula (1) to each class in a distribution of wages and salaries, [2] and following the development of the ratio between the lowest and the highest income classes.

This ratio apparently declined from 1 : 90 in 1975 to 1 : 43 in 1976 and to 1 : 35 in 1977. The rapidity of the process shows how a system based on a standard cost-of-living increase can, all other things being equal, squeeze differentials. Clearly, however, the results obtained depend closely on the fineness of the class breakdown.

2.3 *Inflation is fuelled both* by factors inherent in the indexation method and by exogenous factors.

The exogenous factors arise either as a result of increases in the prices of imports (due to an increased foreign-currency price or to national currency depreciation), or as a result of spontaneous pay claims from the sectors with the largest productivity gains. Apart from the oil crisis, there have been attempts by the most highly-paid workers to offset the erosion of their purchasing power by engaging in industrial action in support of their demands for special pay agreements to make up, at least in part, for the losses due to the application of the indexation system. Since these workers are employed in high-productivity sectors, their claims were often met in the years to the early 1980s, which led to a chain reaction that ratcheted wages and salaries up much faster than mere purchasing-power maintenance would have done.

The factors inherent to the indexation method are related to the spiral of prices, wages and costs: although this spiral does not of itself generate inflation, it perpetuates it just as the multiplier perpetuates the effects of growth. If costs are index-linked to prices in a system of mark-up where prices depend on costs, inflation will tend to be steadily self-perpetuating unless productivity gains moderate the process.

In an extremely simplified system where wage indexation offsets 66% of the cost-of-living increase, the mark-up coefficient is 1,9 and per capita productivity gains are 2%, a 1% exogenous increase in unit labour costs is multiplied in course of time by 2,7. [3]

2.4 *From the macro-economic point of view*, the direct, indirect and perverse effects of the indexation method have combined in such a way as to lead to a steady increase in real wages ever

[1] Commission staff estimates.

[2] Banca d'Italia: 'Redditi, risparmio e struttura della ricchezza delle famiglie italiane nel 1975'. Populations: ISTAT.

[3] On the basis of the following formula:

$$\Delta\ P_y = \frac{1}{\dfrac{1 - k.a}{q}} \times \Delta\text{ . exogenous shock}$$

where:

P_y = GDP implicit price deflator
k = mark-up
a = extent of indexation
q = productivity.

since its introduction, even during the recent world crisis.[1] In view of the trend of productivity, the Italian system probably tended on the whole to ensure wage indexation of at least 100%, if not more.

Because of this feature, the adjusted wage and salary ratio has increased steadily in Italy, in contrast with the trend observed in the Community as a whole since 1981,[2] a development quite contrary to the aim of improving convergence in the Community.

Other consequences of the system of a standard wage increase for each one-point rise in the index are summarized below:

(a) earning in sectors with different levels of productivity have indeed moved closer together, but within individual firms it has been necessary to restore differentials to take account of production requirements;

(b) social tension, too, has been attenuated, at least to judge from the number of labour disputes; however, other tensions that have appeared higher up the salary scale have led to a proliferation of independent organizations representing specific categories of workers, so that the three-yearly collective agreements have become increasingly difficult to reach;

(c) judging from the trend of unemployment over the past two years and from past and probable future dismissals in manufacturing, it would seem that the equilibrium wage rate on the labour market has not been brought under control. The services sector has, indeed, acted as a buffer, but the price has been paid in terms of a disturbing decline in productivity that has increased inflationary tensions in the economy.

In view of these pressures, the inescapable conclusion is that the reaction of wages to the two oil shocks has not only generated a disturbingly large inflation differential between Italy and the Community as a whole, but also extensively crowded out productive investment.

The Italian authorities, aware of those problems, changed the stance of wages policy in 1983; the effects of the change were apparent in the provisions designed to attenuate indexation adopted in January 1983 and February 1984.

[1] See *European Economy*, No 18, November 1983, Table 3.5, page 78.
[2] Id., Table 3.6, page 79.

Luxembourg

Trends and prospects

1983 was a somewhat disappointing year for the Luxembourg economy. There was a marked decline in economic activity (a 2,4% drop in real GDP after the 0,9% fall the previous year) and consumer prices continued to increase. Total exports declined in real terms, due to the deterioration of the steel market and despite better export performance in other products. Domestic demand also declined quite sharply. The volume of private consumption fell by 1,5%, mainly as a result of measures to moderate personal incomes and increase taxation, while general government consumption stabilized due to the restrictive budgetary policy. After its sizeable expansion in recent years, public investment fell back considerably, as did investment in housing.

The economic prospects for 1984 are dominated by the problems resulting from the restructuring of the steel industry and the need to make other sectors of the economy more competitive.

As far as incomes are concerned, indexation will again be suspended as it was in 1982 and 1983. Under provisions now in force, incomes will be indexed once only, in September 1984, irrespective of developments in consumer prices. This measure should make it possible to limit the rise in earnings to approximately 5,5%.

With regard to prices policy, the government has prolonged and slightly adapted the measures imposing a selective freeze on prices and profit margins.

In the area of budgetary policy, the prudent management of public expenditure, combined with the slightly faster-than-forecast expansion in tax revenue (in particular corporation tax revenue), has meant that, leaving aside the special measures to assist the restructuring of the steel industry, the 1983 budget outturn was more or less in balance. The special measures added over LFR 5 000 million net to the budget (expenditure: ± LFR 7 000 million and revenue: ± LFR 2 000 million). In 1984, continued austerity will enable budgetary equilibrium (excluding the steel measures) to be maintained and the extra net cost of these measures will be limited to approximately LFR 1 000 million.

Despite the recovery in world economic activity, Luxembourg exports will not expand greatly in 1984, because of the poor prospects for the steel industry. Other sectors, however, will probably benefit from more buoyant external demand and from their improved competitiveness resulting from the wage measures taken in 1983 and 1984. Import volume will again decline because of the contraction in domestic demand.

The fall in real personal disposable incomes will probably depress the volume of private consumption by 2,5%. Corporate investment, by contrast, is likely to increase slightly if, after last year's delay, the steel industry programme is implemented, while in other sectors investment will gather pace as a result of the policy of industrial diversification. The information available indicates that it is in the small traditional enterprises that the propensity to invest is increasing. Residential construction must again, however, be expected to decline. Similarly, a fall in general government investment is forecast, as a result of the very low levels of public investment funds and budgetary reserves which will impose severe constraints on the public authorities.

For the fourth year in succession, gross domestic product is thus likely to decline, by an amount currently estimated at 1%. Employment will again decrease slightly, due to the cutback in numbers employed in the steel and construction industries, while recruitment in the services sector will still be very sluggish.

Consumer prices will continue to rise rapidly (at an annual average level of around 7,5%), largely due to the delayed effects of increases in indirect taxation (VAT and excise duties) introduced in July 1983.

Problems of economic policy

The small size of the domestic market, which makes the Luxembourg economy extremely dependent on those of her chief partner countries, considerably limits the authorities' room for manœuvre. The restrictive policies and income moderation practised in most neighbouring countries have compelled the authorities to take comparable measures in order to safeguard competitiveness outside the steel sector. The decision to restrict indexation increases to a single rise of 2,5% in September 1984 means that the rise in wage costs is likely to be in line with that in the main competing countries.

The restructuring of the steel industry has for some years been one of the government's central concerns and will remain so in the future. Even though its relative importance in the economy has already been scaled down considerably, the industry is still very important in terms of the numbers it employs. In order to safeguard a high-performance and profitable tool, the State has stepped up its financial assistance considerably, temporarily tolerating a heavy budget deficit. The industry has also concluded rationalization agreements with Belgian firms with a view to closing down certain plants while maintaining others within the framework of a European plan for cutting back production capacities. Despite all these measures, the industry's future remains uncertain, since it is almost totally dependent on developments on the world market, where the structural crisis at present coincides with a cyclical recession.

Relative importance of the various sectors

(as % of total)

	Origin of gross domestic product by branch of activity (current prices)			Wage and salary earners by branch of activity		
	1960	1970	1981	1960[1]	1970	1983
Manufacturing industry	44,0	43,6	21,8	40,3	39,7	28,0
of which:						
Steel	31,1	28,5	9,2	25,4	22,0	10,8
Construction	7,1	6,0	5,5	10,0	11,9	10,3
Distributive trades, etc.	11,5	12,3	12,9	22,7	22,3	31,0
Banking and insurance	1,4	5,0	26,1	1,7	3,7	6,9
General government	8,8	8,5	10,7	10,6	11,7	12,6

[1] Estimate.

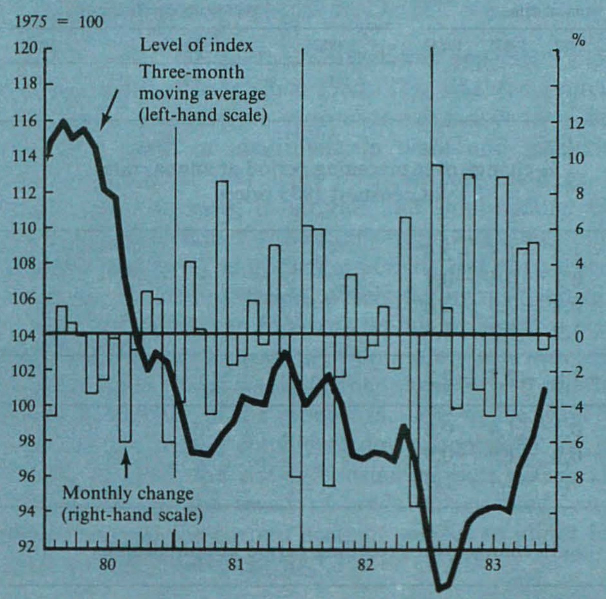
The Government is also pressing ahead with its efforts to diversify the economy and is endeavouring, by a variety of measures, to attract new industries and to create a favourable climate for existing firms; examples of such are the recent measures taken to encourage international reinsurance companies to settle in Luxembourg in order to diversify the financial services sector.

The establishment of a Luxembourg Monetary Institute (LMI) has given the country an institution which can issue and administer the circulation of coin and banknotes in the same denominations as Belgium, supervise the proper functioning of the financial markets, exercise the rights arising from international monetary and financial agreements and regulate credit policy. The Institute's credit operations will normally be backed by its own funds or third party deposits only and not by money creation, unlike those of the central banks.

Although the public finance situation is, on the whole, in balance, there are some clouds on the horizon, such as the increase in debt service charges and expenditure levels in the old age pension and health care sectors as a result of demographic trends.

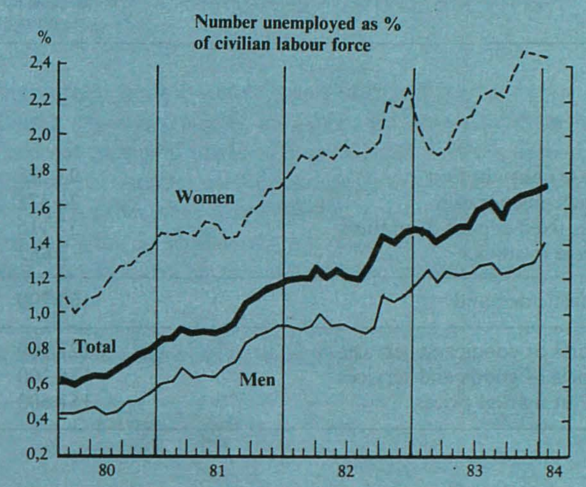
The growth in debt service charges, resulting from the budget deficits of recent years, is likely to revert to normal fairly quickly if budget management continues along its present course. Nevertheless, there is a risk that expenditure will again overshoot, notably in the health insurance and pensions sectors. In order to avoid a further increase in the tax burden, which is already amongst the heaviest in the Community, greater stringency in other areas of expenditure may become necessary, especially since the budgetary reserve is being rapidly consumed and more resources will be required for the investment funds.

Luxembourg: Industrial production (s.a.)



Source: Eurostat.

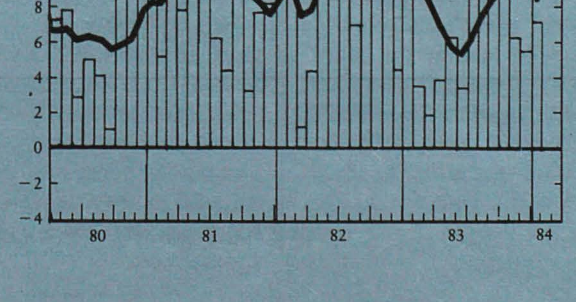
Luxembourg: Unemployment (s.a.)



Source: Eurostat.

Luxembourg: Consumer prices

Change expressed as an annual rate



Source: Eurostat.

Luxembourg : Supply and uses of goods and services together with main economic indicators, 1972-84

	1982 LFR million at current prices	Annual data 1972-81	1982	1983[4]	1984[5]	Half-yearly data (s.a.) 1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	93 725	3,5	−1,6	−1,5	−2,5	:	:	:	:	:	:
Public consumption	26 375	3,7	0,3	−0,3	−0,7	:	:	:	:	:	:
Gross fixed capital formation	37 115	−0,1	−0,1	−7,5	−2,6	:	:	:	:	:	:
Change in stocks[1]	2 985	−0,4	1,9	1,9	1,9	:	:	:	:	:	:
Domestic demand	160 200	2,7	−1,8	−2,7	−2,2	:	:	:	:	:	:
Exports of goods and services	127 500	2,9	0,3	−1,4	0,6	:	:	:	:	:	:
Imports of goods and services	136 100	3,2	−0,9	−1,9	−0,9	:	:	:	:	:	:
GDP at market prices	151 600	2,5	−0,9	−2,4	−1,0	:	:	:	:	:	:
		% change over preceding period at annual rates									
GDP at current prices		9,9	6,8	4,6	6,3	:	:	:	:	:	:
Industrial production[2]		−0,6	−4,0	−3,0	0,5	:	:	:	:	:	:
Unemployment rate[3]		0,4	1,2	1,6	1,9	:	:	:	:	:	:
Compensation of employees		12,2	7,3	6,3	4,6	:	:	:	:	:	:
Money supply (M2/M3)		:	:	:	:	:	:	:	:	:	:
Implicit price indices:											
— GDP		7,2	7,7	7,2	7,4	:	:	:	:	:	:
— Private consumption		7,0	10,0	8,4	7,7	:	:	:	:	:	:
— Exports of goods		5,6	15,3	3,5	5,8	:	:	:	:	:	:
— Imports of goods		6,8	15,2	5,0	5,5	:	:	:	:	:	:
Terms of trade		−1,1	0,1	−1,4	0,3	:	:	:	:	:	:
		As % of gross domestic product									
Trade balance (fob/cif)		−4,4	−16,5	−17,2	−15,9	:	:	:	:	:	:
Current balance		23,8	39,2	37,7	36,1	:	:	:	:	:	:
Net borrowing of general government		1,7	−1,4	−2,3	−0,6	:	:	:	:	:	:

1 As % of GDP.
2 Manufacturing industry.
3 Unemployment as % of total labour force.
4 Estimates.
5 Forecasts.
Source: Eurostat and Commission services.

The Netherlands

Trends and prospects

In 1983, real GDP in the Netherlands expanded a little (1%) for the first time since 1980. This was due primarily to a robust recovery in export demand and to a more favourable trend of investment in plant and machinery, although the latter was made up principally of huge, but exceptional investment in aircraft and shipbuilding. Contrary to initial forecasts, the volume of private consumption expanded slightly. The upturn in activity did not prevent a further rise in unemployment, which, taking the average for the year, affected over 15% of the labour force, a figure significantly higher than in the Community as a whole. On the other hand, there was a further slowdown in inflation. Mainly as a result of the modest increase in the wage and salary bill per person employed, down from 5,7% in 1982 to 2,8% in 1983, the rise in consumer prices was held to 2,7%. Although the terms of trade deteriorated, export growth boosted the current account surplus to about HFL 12 000 million, equivalent to 3,3% of GDP.

Further budget cuts were made in 1983, amounting to about HFL 2 000 million. The net deficit corresponded to 11,6% of net national income, much larger than in 1982 (10%), but none the less slightly down on the initial forecast. [1]

Judging by the latest developments, the 1984 budget, which is designed to limit the deficit to 12,1% of net national income, will probably exceed expectations provided that, with more favourable economic conditions, revenue continues to grow without there being any increase in the rate of spending.

The draft budget for 1984 implies a further, appreciable reduction in spending relative to spontaneous developments: HFL 10 600 million in cash terms, of which HFL 4 700 million will be in the form of cuts falling on public health and social security (some of the planned measures are not due to take effect until 1 July 1984), HFL 3 000 million will be achieved through the curbs imposed since 1 January 1984 on civil servants' and other public employees' pay, and HFL 2 800 million is to be saved on central government expenditure on goods. The draft also features tax concessions for firms worth HFL 2 000 million (notably a reduction in corporation tax from 48% to 43%), and a reduction in social security contributions, while tax increases amounting to HFL 3 000 million are planned (including a one percentage point increase in VAT rates).

[1] The percentages given include non-budget borrowing operations, equivalent to 1,3%, 1,2% and 0,2% of net national income in 1982, 1983 and 1984 respectively.

The economic recovery that got under way in 1983 will continue in 1984, producing growth of GDP in real terms of over 1,5%. The number of unemployed workers will probably continue to rise, but at a slower rate, partly because young people and older workers are no longer registering as job-seekers. Unemployment could affect about 17% of the labour force.

Since they have become more competitive in recent years, Dutch exporters will be able to make the most of the upturn forecast in world trade and to expand further their market shares; the volume of exports is expected to climb by around 4,5%. As the table below shows, the trend of wage costs in industry in the Netherlands relative to its main competitors was very favourable in 1983 and will continue so in 1984.

Relative unit wage costs (in dollars) in industry [1]

(average and as %)

	The Netherlands	Federal Republic of Germany	France	United Kingdom	Belgium	EC
1983	−2,7	−1,7	−0,9	−7,4	−2,5	−4,1
1984	−6,6	−1,4	+2,0	+1,2	−0,6	−1,6

[1] Compared with 20 countries.
Source: Commission departments.

The Netherlands' exports consist, to quite a large degree (just under 30% in 1983), of commodities and intermediate products, sales of which are particularly sensitive to changes in economic conditions; they could be boosted by the current restocking process. The geographical breakdown of exports was unfavourable in 1983, when some 80% of the total went to sluggish European markets. This export structure might, however, alter before too long under the impact of changes in price competitiveness; witness the very recent expansion in exports to the United States and the Middle East.

The improvement in business profitability, which has been under way for some time, and the growth in export demand are bound to produce a healthier investment climate in 1984. The results of the latest business surveys already bear this out. Among other things, investment in plant and machinery and in industrial and commercial buildings is expected to expand sharply. By contrast, after growing briskly in 1983, aircraft investment and shipbuilding will probably show a noticeable decline. Residential construction is likely to contract further (−1%) although in no event is this expected to match the falls recorded in 1981 (−10%) or 1982 (−8%). In the public sector too, the decline in investment (−2% in volume terms) will be less pronounced than in the years 1981-83. As the table below shows, the growth in the volume of aggregate investment will be much the same in 1984 as in 1983 (around 1%). The destocking that has taken place in the last three years is expected to make way in 1984 for some restocking, not least under the impact of the renewed increase in commodity prices that is generally expected.

Growth of investment

(volume, as %)

	1980	1981	1982	1983	1984
Housing	4,7	−9,8	−8,0	−1,0	−1,0
Industrial and commercial buildings	0,9	−14,6	−8,3	−4,4	2,0
Civil engineering	1,5	−5,4	−9,5	−4,4	−2,3
Transport equipment	−19,3	−15,5	6,5	25,1	−8,9
Plant and machinery	1,5	−6,5	−1,3	−0,9	10,0
Total investment	−0,9	−10,0	−5,0	1,1	1,1
of which:					
Business investment (excluding housing)	−4,4	−11,8	−2,9	3,2	3,2
Public-sector investment	3,1	−3,6	−7,2	−3,7	−2,0

Source: 'Centraal Bureau voor de Statistiek' and Commission departments.

It is to be feared that the volume of private consumption will fall in 1984 on account of the erosion of real disposable income consequent upon the very small increase in the wage and salary bill per person employed and a further decline in the number of wage and salary earners. In the private sector, the increase in the wage and salary bill per person employed will be limited to 0,5%, the main reason being the agreed reduction in working hours in a large number of branches of industry, coupled with an average 2% fall in wages in 1984, since the workers concerned have agreed to forego full or partial indexation. In the public sector, similarly affected by this 2% fall in wages and the associated reduction in working hours, gross wages and salaries will be further pruned by some 3% as part of the policy of public spending curbs. Social benefits have been cut by just over 3%. This will, among other things, have an appreciable effect on the volume of consumption since the lower-income groups, which spend a relatively high proportion of their incomes on consumption, will be hardest hit.

Wage costs are expected to decline significantly under the combined impact of the weak growth in the wage and salary bill per person employed in industry and the further improvement in productivity. This is bound to influence the trend of consumer prices favourably. Even so, the increase of more than one percentage point in the burden of indirect taxes and the acceleration in the upward movement of import prices will weigh more heavily with the result that, all in all, consumer prices are again expected to rise by over 3%.

The current account surplus will widen further, to around HFL 15 000 million, or 4% of GDP. Exports of natural gas are still of prime importance for the Dutch balance of payments. In this connection, the reader's attention is drawn to the special article entitled: 'Natural gas and the Dutch economy'.

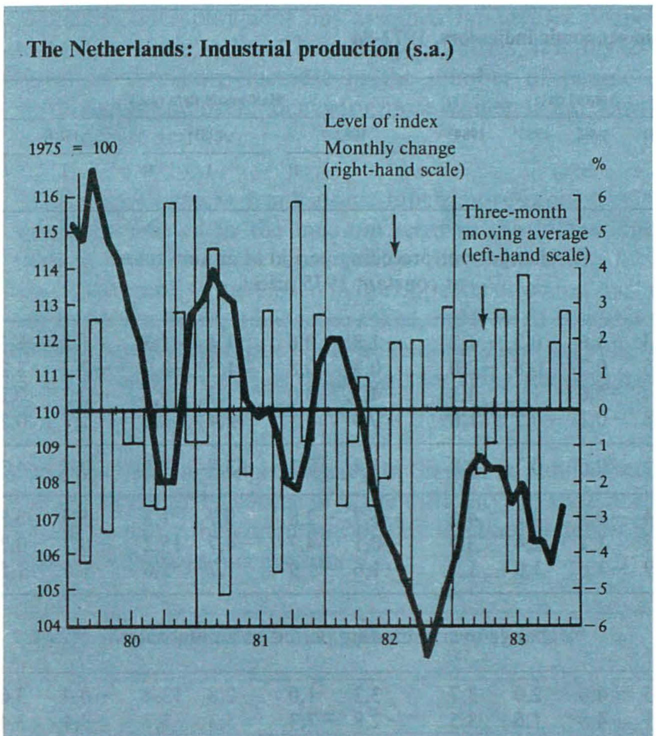
Problems of economic policy

Economic policy in the Netherlands is dominated by the desire to remedy the structural imbalances that have emerged over the last decades. Thus, the budget deficit is now such that a tighter grip on spending is inescapable. Similarly, a policy of wage restraint is needed in order to boost business profitability, which has deteriorated sharply, and thereby to secure a sustained recovery in private investment. While a strategy of this kind holds the key to better conditions for growth and employment in the medium term, it is none the less a fact that, in the short term, domestic demand and growth are suffering as a consequence. As the table below shows, the position of the Netherlands has worsened in the period 1978-84, the country having fallen behind the Community as a whole to the tune of some 5,5% of GDP and 10,5% of domestic demand.

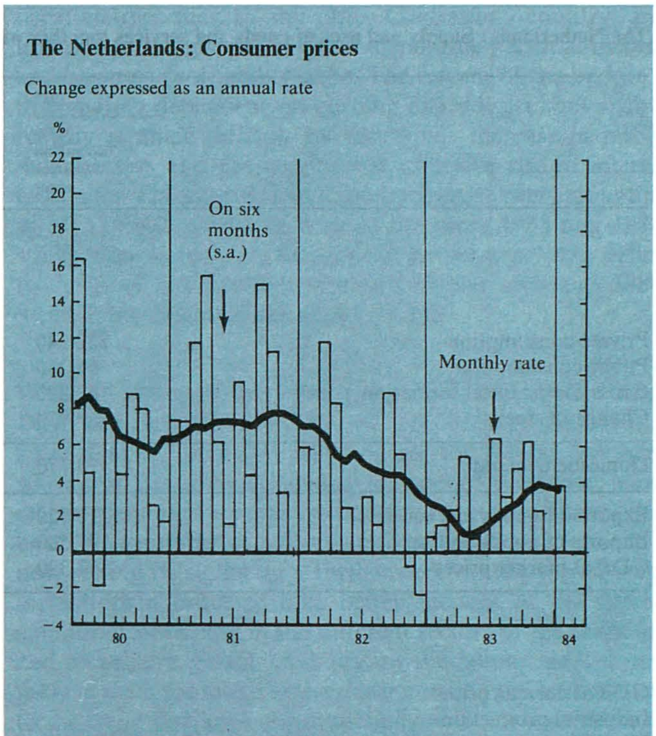
Trends in GDP and domestic demand (volume)

	1978	1979	1980	1981	1982	1983	1984	1978-1984	
								Aggregate	Difference
GDP									
— The Netherlands	2,7	2,1	0,9	−1,2	−1,6	1,0	1,7	5,7	5,6
— Community	3,2	3,3	1,3	−0,4	0,6	0,8	2,0	11,3	
Domestic demand [1]									
— The Netherlands	3,7	2,1	−0,5	−3,2	−1,8	0,5	−0,9	−0,3	10,5
— Community	3,6	3,6	1,5	−0,6	0,1	0,6	1,1	10,2	

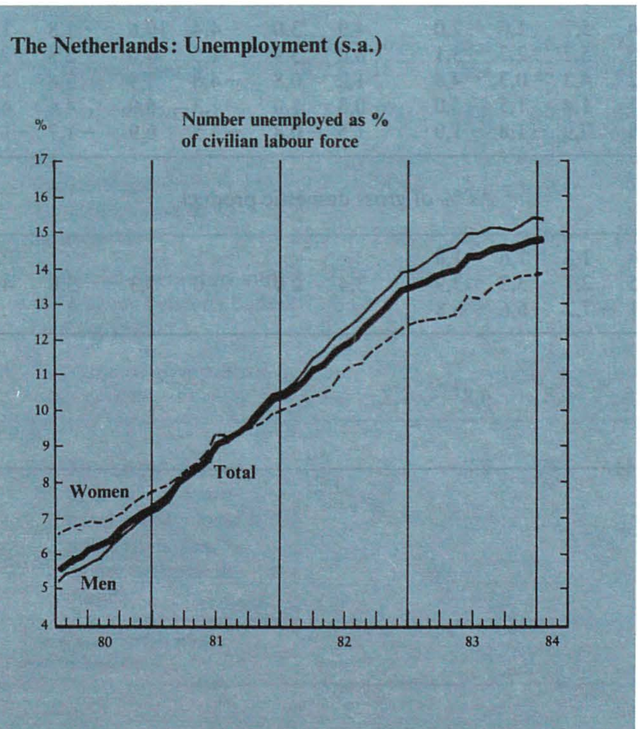
[1] Excluding stocks.
Source: 'Centraal Bureau voor de Statistiek' and Commission departments.



Source: CBS.



Source: Eurostat.



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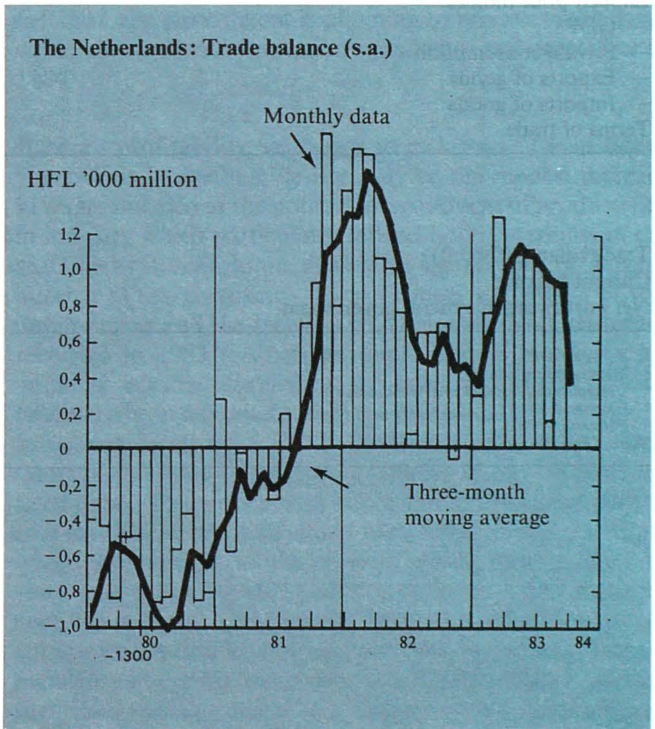


Source: Eurostat.

The Netherlands: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	HFL '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rates at constant 1975 prices									
Private consumption	222 140	3,3	−1,6	0,2	−1,2	−1,8	−0,6	1,4	−1,3	−1,2	−1,2
Public consumption	65 260	2,5	0,7	0,8	−2,0	0,3	0,8	1,3	−0,2	−2,2	−3,2
Gross fixed capital formation	67 280	−0,4	−5,0	1,1	1,1	−4,2	−3,0	1,2	5,3	−0,3	−0,2
Change in stocks[1]	−910	0,8	−0,1	−0,7	1,0	−0,3	0,1	−2,4	1,0	1,7	0,2
Domestic demand	353 770	2,1	−0,6	−0,1	0,8	1,4	−0,1	−3,7	7,3	0,4	−4,3
Exports of goods and services	211 120	4,4	−0,9	4,3	4,5	−1,7	−2,8	9,7	1,3	5,5	5,8
Imports of goods and services	197 500	2,7	1,1	2,4	3,1	−0,1	4,7	−4,7	15,2	−0,7	−0,3
GDP at market prices	367 390	2,9	−1,6	1,0	1,7	−1,6	−1,9	1,7	2,6	1,4	1,5
		% change over preceding period at annual rates									
GDP at current prices		10,5	4,0	2,0	3,7	3,3	1,0	−2,8	13,4	−0,4	3,0
Industrial production[2]		2,1	−4,0	1,6	3,5	−2,8	−7,3	5,3	3,7	3,4	3,4
Unemployment rate[3]		5,2	12,7	15,4	16,8	11,5	13,9	14,4	16,3	16,1	17,5
Compensation of employees		10,3	2,9	0,8	−0,5	:	:	:	:	:	:
Money supply (M2)		10,4	7,6	10,3	10,0	:	:	:	:	:	:
Implicit price indices:											
— GDP		7,4	5,7	1,0	2,0	4,9	3,0	−4,4	10,6	−1,8	1,5
— Private consumption		7,5	5,7	2,7	3,1	6,0	3,9	1,5	4,0	2,8	2,8
— Exports of goods		8,2	4,3	−0,3	4,0	1,2	0,8	−4,8	7,9	2,8	2,7
— Imports of goods		9,1	1,4	1,5	5,0	−0,3	1,0	−1,3	6,9	4,6	4,3
Terms of trade		−0,8	2,9	−1,8	−1,0	1,5	−0,8	−3,5	0,9	−1,7	−1,5
		As % of gross domestic product									
Trade balance (fob/cif)		1,4	1,3	1,6	1,8	:	:	:	:	:	:
Current balance		1,5	2,7	3,3	3,9	3,4	2,0	3,0	3,3	3,8	4,4
Net borrowing of general government		−2,1	−7,2	−6,6	−6,8	:	:	:	:	:	:

[1] As % of GDP.
[2] Manufacturing industry.
[3] Unemployment as % of total labour force.
[4] Estimates.
[5] Forecasts.
Source: Eurostat and Commission services.

Similarly, unemployment has assumed far greater proportions than in the other Community countries, notably as a result of the sharp increase in the number of people of working age and the tendency for more women to participate in economic activity.

On the employment front alone, much more rapid growth would be needed in the medium term in the Netherlands than in the rest of the Community. Since the above table shows the trend to have been in the opposite direction during the last seven years, it has to be asked under what conditions the structural constraints could be removed, bearing in mind that the restrictive effects of the policies being pursued have so far produced a squeeze on domestic demand.

Nevertheless, the budget deficit and the rise in public spending are an enduring source of acute difficulty. In spite of the efforts made by the Dutch authorities, the budget deficit has been very large in recent years.

General government revenue and expenditure as % of GDP

	1980	1981	1982	1983	1984
1. Net revenue	53,7	52,8	54,3	56,8	55,7
of which:					
taxation	28,0	26,8	26,2	26,1	25,7
para-fiscal charges	18,2	18,7	19,7	22,2	21,0
2. Net expenditure	57,7	59,0	61,5	63,4	62,4
of which:					
debt interest	3,7	4,4	5,2	6,1	6,7
transfer payments to households	26,3	27,3	29,1	30,0	29,3
3. Financial operations and differences between budget and net cash	2,2	1,5	1,4	1,4	2,1
4. Net general government cash deficit	−6,3	−7,7	−8,6	−8,0	−8,8
N.B.: Net cash deficit of central government and local authorities (as % of net national income) [1]	−7,1	−8,2	−8,7	−10,4	−11,5

[1] Excluding off-budget loans.
Source: Commission.

The situation is particularly worrying in that this large deficit is accompanied by a heavier burden of taxation and para-fiscal charges than in any other Community country, and this is increasingly eroding real disposable personal income and business profitability alike. The reform of the budget is thus mainly dependent on curbing expenditure, but such a remedy is made difficult by the rapid increase in public indebtedness and the consequent excessive rise in interest payments. The government's programme of cuts amounting to HFL 7 000 million in each of the years 1985 and 1986, which aims at reducing the general government cash deficit to 7,4% of net national income between now and 1986, exploits the available margin to the full.

With the policy of moderation that has been applied since 1978, the increase in wages and salaries has slackened a great deal in the early 1980s. Wage indexation has been wholly or partially suspended on several occasions, most recently as a *quid pro quo* for an agreed reduction in working hours in a number of sectors and firms. The government is now setting its sights on a further decentralization of wage formation in order to take better account of the special conditions obtaining in the different sectors of the economy and to achieve greater mobility on the labour market, notably in the hope that a better adaptation of real labour costs to the trend and level of productivity will also contribute to reducing unemployment. With consumer prices rising at a modest rate in spite of the easing of price controls introduced in 1983 and in view of the decline in wage costs discernible for 1984, the government is planning to remove virtually all constraints on price formation in industry and commerce in 1984.

Business profitability has begun to pick up a little in recent years. This is attributable not only to the modest increase in wages but also to the notable improvement in productivity in industry which particularly reflects both the results of the sustained rationalization drive and the closure of a large number of marginal firms. Even if, under the impact of this development and the recovery of foreign demand, the trend recorded in 1983 towards an improvement in private investment became established, the latter would still be well below the level recorded before the recession (a fall of 18,4% in volume terms since 1979). It would seem, in fact, that many firms are using their profits mainly to pay off accumulated debts. The government has begun in 1984 gradually to ease the burden of taxation and para-fiscal charges on firms, which will benefit to the tune of HFL 2 000 million in 1984 and probably HFL 6 000 million in 1986. Business confidence could also benefit from the simplification of administrative and legal procedures now under way. Recent business surveys on investment intentions for 1984 indicate that these developments and measures are beginning to produce results, and that a policy of incentives involving, as in other member countries, measures to promote risk capital could widen the range of available resources. In view of the efforts being made to improve public finance, the conditions now seem conducive in the Netherlands to fairly low interest rates relative to those obtaining in the other member countries.

In conclusion, while the most pressing problem is without doubt the very high level of unemployment, efforts to modify structures should be carried out in conditions which do not inhibit too severely demand and economic activity in the short term. The economic upswing in Europe and the consequent improvement in the outlook for investment hold out the hope that adjustment will be able to continue in a more favourable environment; the sacrifices required on the public finance and incomes fronts should be commensurate with the opportunities provided by these new factors.

Natural gas and the Dutch economy

I. Introduction

In 1982 the production of natural gas in the Netherlands accounted for around half of Community production and for some 4% of world production. With this abundant domestic supply of natural gas, the Netherlands occupies a special position in the Community where energy is concerned. In 1982, for example, 49% of the country's gross domestic consumption of energy was met by natural gas, compared with a figure of only 18% for the Community as a whole. Taking the annual average for the period 1979-82, natural gas contributed 0,9 percentage point to the real growth of gross national income, which itself contracted by an average of 0,4% a year.

II. Economic importance of natural gas

Natural gas exploitation has also influenced very significantly the trend in the current account balance and public finances while the abundant nature of this source of energy has, to a large degree, determined the industrial structure and the employment situation in the Netherlands.

These three aspects of the role of natural gas in the Dutch economy are examined below.

1. Natural gas and the current account balance

Exports of natural gas rose sharply in the first half of the 1970s, from 25 300 million m³ in 1972 to 52 100 million m³ in 1976, an increase of 106%. By 1976, the Netherlands had become a net exporter of energy.

On account of the large oil price increases in the early 1970s, and the consequent danger of an energy shortage, the government decided in 1974 as a matter of principle to slow down the rate of natural gas extraction in order to be able to devote part of the existing reserves to domestic, notably household, consumption in the years ahead. Since then, no new contracts were concluded with foreign buyers and the government was no longer willing to renew contracts due to expire. Natural gas exports have since declined. In 1982, they stood at only 34 900 million m³ or 31% below their record, 1976 level. This decline was not only attributable to the government measures mentioned above and to the economic stagnation that gradually took hold of the economies of western Europe during the second half of the 1970s and that led to a fall in energy consumption. It was also due to the fact that foreign buyers took extensive advantage of the option provided by their contracts to defer deliveries.

Natural gas sales, though, still account for a large share of total Dutch exports (some 8% in value terms in 1982).

However, an assessment of the net contribution made to the current account balance by natural gas, the price of which follows, only with delay, changes in the price of heating oil, should take into account not only export earnings but also the fact that the balance-of-payments constraint is alleviated by the substitution of natural gas for imported energy. The magnitude of the substitution effect is evident from the reduction in the Dutch economy's dependence on imported energy,[1] which, standing at 52% in 1970, had fallen to 2% in 1982. The corresponding figures for the Community as a whole were 62% and 46%.

The direct impact of natural gas production on the Dutch current account balance, i.e. the combined effect of the associated export earnings and of the easing of the constraint brought about by the substitution process, amounted to some HFL 31 300 million in 1982. Alongside this direct, positive effect, there is the indirect negative effect resulting from the share of income generated by natural gas production that is spent on imports. The balance of these two opposite components which represents the net contribution of natural gas to the current balance has been estimated at HFL 12 500 million in 1982, in which year the total current account surplus was HFL 9 800 million.

2. Natural gas and public finances

The State has large interests in natural gas exploitation. Apart from its direct share of royalties on the sale of gas, it receives a portion of the profits accruing to 'NV Nederlandse Gasunie' (in which it holds a 50% interest), which is responsible for domestic as well as overseas natural gas sales. Moreover, the State levies a tax on the profits made by Gasunie's other shareholders and by the independent companies working the gas fields. At the moment, 80% of profits accruing from natural gas exploitation go to the State. Taken together, these sources of income accounted for some 2% of total State revenue in 1970 (HFL 600 000) and for 19,4% in 1982 (HFL 19 700 million), an annual increase of around 34%, compared with a figure of 9% for total State revenue. These receipts have helped in large measure to finance the sharp increase in public expenditure since the 1970s, and particularly general government consumption and current transfer payments.

3. Importance of natural gas for the industrial structure and for the employment situation

Production processes with a high energy content have always occupied a prominent place in the Netherlands, not only because of the country's geographical position and the scope it enjoys for importing raw materials, but also, until 1983 at least, because of the low cost of energy.

[1] $\dfrac{\text{net imports}}{\text{gross domestic consumption + shipping}}$

Exploitation of the vast natural gas fields in the 1960s had the effect of raising energy consumption in Dutch industry. This process was encouraged by the relatively low prices charged for energy used for new activities undertaken, in some cases on a very large scale, in sectors with a high energy consumption, such as the chemical industry and horticulture. Between 1960 and 1981, the share of natural gas in industry's final consumption of energy rose from 3% to 40%. Over 40 % of Dutch exports are produced by sectors whose energy consumption is high. Hence the emphasis on the damaging effects that would certainly result from an increase in energy prices.

The expansion in activity in the sectors with a high energy content (the chemical industry grew at an average annual rate of 13% in the period 1963-73) has had a very marked effect on employment in related sectors and, in many cases, on the use of highly skilled labour.

III. Longer-term prospects

In the years ahead, sales of Dutch natural gas will be largely determined by the continuation of energy conservation policies, hitherto applied in numerous client countries. In addition, revenue from natural gas exploitation is bound to be influenced by the prices on international oil markets; there is nothing to suggest a rise of any significance in such prices.

In view of these unfavourable prospects, the Dutch government has decided to relax the selective policy of reserving natural gas sales on the domestic market for high-value applications. Furthermore, it plans to step up exports of natural gas. In this connection, it should be noted that the countries in western Europe that are traditional importers of Dutch natural gas would like to raise the volume covered by current contracts in order to provide more effective security for their long-term energy needs. This could result in an increase in Dutch natural gas exports of between 150 000 million m^3 and 200 000 million m^3 for the duration of the period 1983-2007. This would represent substantial additional sales, bearing in mind that, in mid-1983, forecasts of sales abroad amounted to 440 000 million m^3.

The more liberal approach adopted by the Dutch authorities to the exportation of natural gas is also explained by the new estimates of reserves, which will probably be larger than was hitherto thought. Fresh negotiations with customers abroad will take place in 1984. They will open against a background characterized by the availability in western Europe of abundant supplies of Norwegian, Algerian and Soviet natural gas.

In view of the forecasts of natural gas sales, in volume and value terms and on the domestic and export markets alike, State revenue from natural gas exploitation will probably decline on average by some 5% a year during the period 1984-88. In cash terms, and on the basis of macroeconomic assumptions drawn up in 1983, it will probably amount to HFL 14 800 million in 1988, a fall of HFL 4 900 million over 1982, when natural gas exploitation brought in HFL 19 700 million, the highest figure recorded since the gas fields were first opened in 1964.

None the less, mainly because of foreign interest in Dutch natural gas abroad, the Dutch economy is expected to continue after the year 2000 to benefit from export earnings generated by this form of energy.

United Kingdom

Trends and prospects

1983 was the second year of expansion of economic activity from the lowest point of the recession in 1981. Consumer price inflation slowed to a rate not experienced since the late 1960s. Unemployment rose to record levels, but the labour market data suggest that the fall in employment and the climb in unemployment may have come to an end during the second half of 1983. The current account of the balance of payments remained in appreciable surplus in 1983 as a whole, although the surplus was not as large as in the previous year.

Real gross domestic product in the United Kingdom rose by some 3% in 1983, faster than in any other Community country. The main contribution to demand came from the rapid expansion of private consumption, which rose by more than 3,5%. Wages and salaries rose faster than the rate of inflation, and real disposable incomes were also boosted by relatively large personal tax concessions in the March 1983 Budget; at the same time, the personal saving ratio fell sharply from 10,8% in 1982 to an estimated 8,5% in 1983 and the expansion of consumer credit, which continued throughout 1983 following the relaxation of hire purchase controls in July 1982, helped to finance a very large rise in private spending on durable goods (+17% in volume, compared with only +2% for other goods and services).

Fixed investment also showed healthy year-on-year growth in 1983, although the path of development was rather irregular; the main increases occurred in investment in dwellings and in construction outside manufacturing industry. Stocks were added to in the early part of the year, but thereafter were drawn down as final demand ran ahead of production.

Government consumption and investment were also very strong in the early months of 1983. This was one of the reasons why the public sector borrowing requirement (PSBR), at UKL 9 200 million, for the financial year 1982/83 (ending in March) turned out to be UKL 1 700 million higher than estimated in the March 1983 Budget. Fears that public spending was still running ahead of planned expenditure, thus putting upward pressure on the projected level for the PSBR in 1983/84, UKL 8 200 million, set out in the Medium-Term Financial Strategy (MTFS) and restated in the March 1983 budget, led the government in July to announce measures to cut spending programmes by some UKL 500 million and to make an additional UKL 500 million sales of public sector assets. Although government spending does appear to have slowed down in the second half of 1983, government revenues were a little lower than forecast, and in his Autumn Statement in November the Chancellor of the Exchequer revised upwards the official forecast for the PSBR in 1983/84 to UKL 10 000 million (3,3% of GDP). In the light of the latest information this figure should be broadly achieved. In practice, therefore, budgetary policy in 1983/84 was not only less restrictive than in 1982/83 but also than had originally been planned for that year.

The other principal element of the MTFS is control of the monetary aggregates. The target range for 1983/84 of 7-11% growth in both narrow and broad measures of money (M1, sterling M3 and PSL2) was confirmed in the March 1983 Budget Speech. By January 1984 the annualized growth rate of the main indicator, sterling M3, since February 1983 was just within the upper limit of the target range, while the other two measures were marginally higher. A rapid growth in bank lending to the private sector has been partly offset by reduced bank lending to the public authorities, achieved through overfunding. There was a further downward movement in nominal interest rates during 1983, although not as marked as that which occurred in 1982. Generally, while remaining broadly consistent with the reasonably restrictive stance of the monetary targets, monetary conditions in 1983 were not notably tight.

The boom in consumer spending in 1983 was partly satisfied by rising imports. The volume of imports of goods rose by some 7%, compared with a rise in exports of goods totalling only 1,5% (buoyed up by oil exports) and a fall of 2% in the volume of exports of manufactures. The real foreign balance made a negative contribution of almost 1% to real GDP growth. However, after a poor performance earlier in the year, the volumes of exports of all kinds, and especially those to EC countries, did start to recover strongly in the final months of 1983. There was only a small terms-of-trade deterioration, import prices rising rather less than suggested by calculations based on exchange rate movements and the export prices of other countries, perhaps because suppliers to the UK market were obliged to adapt to the low rate of inflation by cutting their margins. In total, the trade balance moved from surplus into deficit, with an even sharper deterioration in the balance of non-oil trade, but the current account remained in a substantial, although reduced, surplus estimated at UKL 2 000 million.

(UKL '000 million)

	1981	1982	1983
Trade balance	3,0	2,1	−1,0
of which:			
Oil	3,1	4,6	6,9
Non-oil	−0,2	−2,5	−7,9
Invisible balance	3,5	3,3	3,0
Current balance	6,5	5,4	2,0

There remain some doubts about just how rapidly economic activity in the UK was growing during 1983. Although the main expenditure components have shown considerable strength, other ways of measuring real GDP, from the income and output sides, have indicated a somewhat less buoyant recovery. Manufacturing output, in particular, has been surprisingly slow to respond to rising demand.

(% change on previous year)

	1981	1982	1983
Real gross domestic product:			
Expenditure measure (at market prices)	−1,2	2,4	3,4 [1]
Income measure (at factor cost)	−1,7	2,1	3,1 [1]
Output measure (at factor cost)	−2,0	1,3	2,1
Manufacturing output	−6,4	0,0	1,4

[1] First three quarters of 1983 on same period of 1982.

However, despite these uncertainties and some additional doubts about the trend of employment, it is clear that labour productivity continued to rise rapidly in 1983. Output per person employed in the whole economy rose at an annual rate of 3% in the first three quarters of 1983, similar to the gain in 1982, and in manufacturing industry productivity grew at about 5½% per year over this period. The latest statistics suggest that the fall in total employment, which has been under way since the end of 1979, may have come to an end in the second half of 1983; employment in the service industries appears to have started rising again, while the decline in manufacturing employment has slowed markedly. At the same time the recorded figures for unemployment tended to level off in the autumn, in response to the improving output and labour market situation. None the less, the unemployment rate (11,9% in December, seasonally adjusted unemployed including school-leavers as % of civilian labour force) has in part been held down by the wide range of schemes for early retirement, work sharing and youth training. The Department of Employment has estimated that at the end of 1983 some 660 000 people were covered by such special measures, of whom some 470 000 might otherwise have been claiming unemployment benefit.

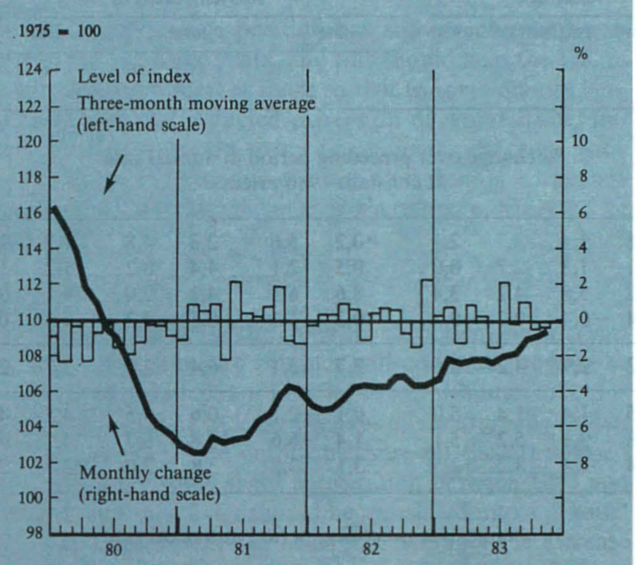
The principal objective of the government's economic policy has been to reduce the rate of inflation, so as to provide the foundations for sustainable growth in output and employment. The success achieved in bringing inflation down has been striking. The consumer price deflator is estimated to have risen by only 5½% in 1983 (just below the Community average), compared with the peak yearly rise of 16½% reached in 1980. Although earnings per head continued to rise faster than inflation in 1983, productivity gains kept the rise in unit labour costs down to about 4% in the whole economy and to less than 3% in manufacturing industry. However, during the year the slowdown in price rises came to an end and the inflation rate tended to stabilize.

In 1984 the government will no doubt continue to pursue its policies within the framework of the MTFS. The 1983 Autumn Statement confirmed the main features for 1984/85 which had been announced earlier in the year (planning total for public expenditure of UKL 126 400 million, projected PSBR of UKL 8 000 million, and a reduced target range for growth in the monetary aggregates of 6-10%). With gross domestic product rising, these plans would imply some further reduction in public expenditure as a % of GDP in 1984/85. In the February 1984 White Paper on the government's expenditure plans to 1986/87, the planning total for 1984/85 was again kept unchanged. The totals in cash terms announced for the following two financial years (UKL 132 100 million in 1985/86 and UKL 136 700 million in 1986/87) are intended to hold the level of public spending broadly constant in real terms.

Although in recent months average earnings have shown some tendency to accelerate, especially in manufacturing industry where earnings have been boosted by rising overtime and bonus payments, the level of wage settlements generally remains subdued, and in preparing the forecast for 1984 it has been assumed that the underlying increase in earnings per head continues at much the same rate as in 1983. On the conventional assumption of full indexation of personal income tax bands and based on expectations of some further slight fall in interest rates, modest growth in employment, and gradual upward pressure on consumer price inflation (see below), real personal disposable income is expected to rise in 1984 by just over 1%, a similar rate to 1983. The scope for further marked reductions in the personal saving ratio appears limited, however, given the already high level of personal debt/income ratios. As a consequence, the durables boom is expected to subside and total private consumption is forecast to rise more slowly than in 1983, by about 2%.

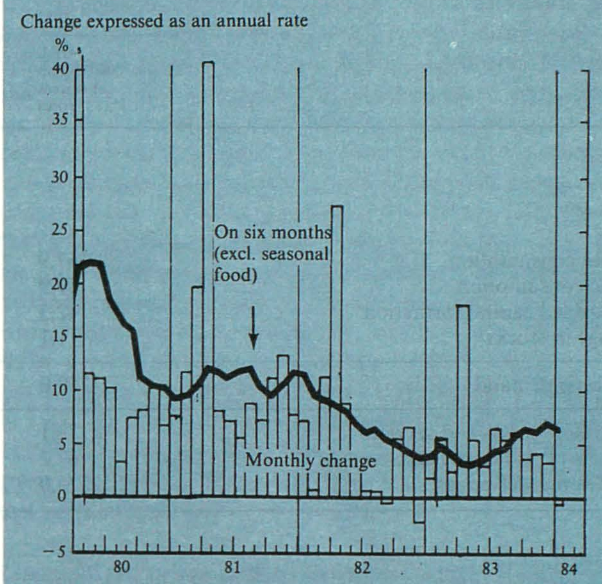
Some elements of fixed investment, based on investment intentions surveys in the manufacturing and service industries, are expected to show considerable strength in 1984, rising in volume by 6-8%, but a weaker outlook for investment in dwellings and public sector investment is likely to depress the total somewhat. With activity expanding and their cash flow positions healthy, enterprises should start adding to their stocks again, but in the light of continued

United Kingdom: Industrial production (all industries other than construction) (s.a.)



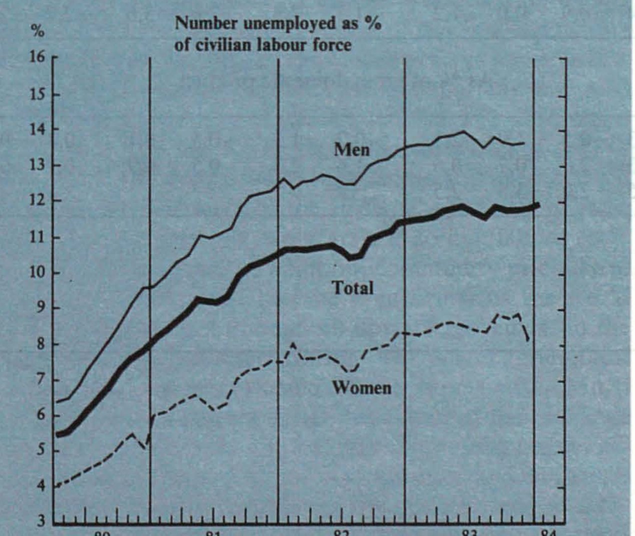
Source: CSO.

United Kingdom: Consumer prices



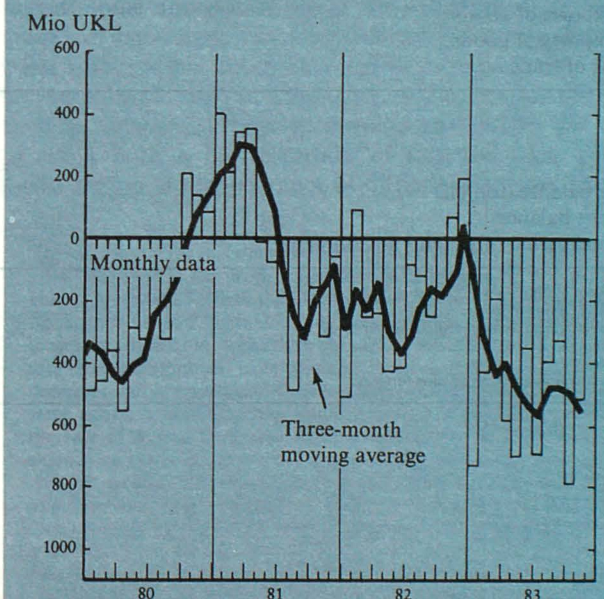
Source: Eurostat.

United Kingdom: Unemployment (s.a.)



Source: Eurostat.

United Kingdom: Trade balance fob/cif (s.a.)[1]



[1] Data for the period March-August 1982 are not available and the figures for the remaining months of the year have not been seasonally adjusted.
Source: Eurostat.

United Kingdom: Supply and uses of goods and services together with main economic indicators, 1972-84

	1982	Annual data				Half-yearly data (s.a.)					
	UKL '000 million at current prices	1972-81	1982	1983[4]	1984[5]	1982 I	1982 II	1983[4] I	1983[4] II	1984[5] I	1984[5] II
		% change over preceding period at annual rate at constant 1980 prices									
Private consumption	167,9	1,8	1,4	3,7	2,1	0,2	5,6	2,3	4,8	1,2	1,2
Public consumption	59,9	2,1	1,3	2,7	0,9	0,5	2,1	4,4	0,2	1,2	1,1
Gross fixed capital formation	42,3	−0,2	5,8	4,2	3,4	8,6	6,5	4,2	2,0	4,1	3,5
Change in stocks[1]	−1,1	0,4	−0,4	0,2	0,5	0,3	−1,1	0,5	−0,2	0,3	0,7
Domestic demand	269,0	1,2	2,9	4,2	2,5	2,7	2,1	6,4	2,0	2,7	2,4
Exports of goods and services	73,1	3,5	1,4	1,4	5,0	0,1	−2,1	0,6	6,5	4,5	4,3
Imports of goods and services	67,2	2,8	3,1	5,2	5,1	−1,4	−6,6	10,8	6,7	4,7	4,1
GDP at market prices	275,0	1,4	2,4	3,2	2,5	3,1	3,2	3,8	2,0	2,7	2,5
		% change over preceding period at annual rate									
GDP at current prices		15,8	9,8	8,8	7,9	10,0	9,7	8,5	8,4	7,6	7,9
Industrial production[2]		−0,8	0,0	1,0	2,7	−1,3	−2,1	2,3	1,8	2,8	3,6
Unemployment rate[3]		4,9	11,0	11,7	11,4	10,7	11,3	11,8	11,6	11,5	11,3
Compensation of employees		15,9	6,3	6,9	6,9	:	:	:	:	:	:
Money supply (Sterling M3)		14,8	9,2	11,5	8,9	:	:	:	:	:	:
Implicit price indices:											
— GDP		14,2	7,1	5,4	5,3	6,7	6,3	4,5	6,2	4,8	5,3
— Private consumption		13,5	8,3	5,4	5,5	8,2	5,9	5,4	4,9	5,5	6,0
— Exports of goods		14,3	6,2	7,7	5,5	2,7	7,1	9,7	4,3	5,8	6,0
— Imports of goods		14,8	7,2	7,7	6,8	4,1	4,7	12,6	1,3	8,7	8,5
Terms of trade		−0,4	−0,9	0,0	−1,2	−1,3	2,3	−2,6	3,0	−2,7	−2,3
		As % of gross domestic product									
Trade balance (fob/cif)		−1,3	−0,5	−1,9	−2,1	0,2	1,3	−0,5	−0,1	−0,4	−0,6
Current balance		0,3	2,0	0,7	0,6	1,6	2,3	0,5	0,9	0,7	0,5
Net borrowing of general government		−3,5	−2,0	−3,5	−2,5	:	:	:	:	:	:

[1] As % of GDP.
[2] Manufacturing industry.
[3] Unemployment as % of civilian labour force.
[4] Estimates.
[5] Forecasts.
Source: Eurostat and Commission services.

high real interest rates they may well behave relatively cautiously in this respect.

The UK's competitive position has shown some improvement in the last three years, and this should help the UK to broadly maintain market share so that export volumes benefit fully from the expected expansion of world trade. Imports are also expected to continue rising, although more slowly than last year, and the net contribution to growth from the real foreign balance is therefore unlikely to be significant.

In total, the outlook for the components of demand suggests that real gross domestic product will continue growing at a reasonably satisfactory rate in 1984, although, on this expenditure measure at least, perhaps at a marginally slower rate than in 1983. The output measure on the other hand could well show some slight acceleration between 1983 and 1984. The rise in activity should be translated into a gradual upturn in employment but in annual averages the increase from 1983 to 1984 in total employment is likely to be very small, while manufacturing employment will probably show a further fall. Unemployment should start to move downwards, but no sharp fall can be anticipated and on average in 1984 the number unemployed (including school-leavers) is likely to remain very high at about 3 million.

There are several factors which suggest that there may be some gentle upward pressure on the inflation rate during 1984. Average earnings show no sign of decelerating further and continue to rise faster than consumer price inflation. The impact of wage rises on costs was substantially mitigated by the large gains in productivity in 1982 and 1983 when employment was still adjusting to the earlier large falls in output; in 1984, while productivity should still perform well relative to the experience of the 1970s, it is unlikely to grow as fast as in the previous two years and so unit labour costs will tend to rise faster. In addition, commodity prices have started rising and could become even firmer as the world recovery progresses. Although no upward movement in the dollar price of oil is foreseen during 1984, dearer agricultural and basic material prices could add to import costs. Much will depend in this respect on the behaviour of the exchange rate: the Commission's forecast has been made on the assumption for sterling of a small appreciation against the US dollar from the early months of 1984 onwards and of stability against the average of the EMS currencies. All these considerations lead to a forecast for the rate of consumer price inflation which shows a slight acceleration in the two half-years of 1984, but in year-on-year terms little change from 1983 to 1984.

Problems of economic policy[1]

During the last five years the main goal of economic policy has been to achieve suitable conditions for sustainable non-inflationary growth of output and employment. The major elements in this strategy were a progressive reduction of monetary growth and of public sector borrowing as a proportion of GDP. These objectives have been pursued by announcing broad monetary and fiscal projections several years ahead in the Medium-Term Financial Strategy (MTFS) published with the budget each year. Over the medium term, policy also aims at reducing the tax burden in order to improve incentives and thus economic performance while maintaining restraint on public sector borrowing. Since the MTFS was first published in 1980, the level of the public sector borrowing requirement (PSBR) as a proportion of GDP has been lowered from some 5% (in financial year 1979/80) to 3-3,5% (1983/84), but total spending of general government has in fact risen, from 44% of GDP in 1979/80 to 45,5% in 1983/84.

Financial policy has undoubtedly been a major factor behind the remarkable improvement in inflation, the rate of increase of the GDP deflator having fallen from 19% in 1980 to 5% in 1983, although prevailing international conditions were also favourable. Furthermore, the rates of real GDP growth since 1982 have been satisfactory in comparison with previous years, indicating substantial progress towards the central policy objective. Nevertheless, there are other factors which suggest some uncertainty about the achievement of lasting growth of output and employment, and these may therefore influence economic policy decisions in the near future. Firstly, the strength and sustainability of the output recovery must be considered, bearing in mind particularly the need to avoid both a reacceleration of inflation and, over a longer period, a reappearance of difficulties on the external

[1] The manuscript for this chapter was completed at the beginning of March 1984. However at the proof stage information became available on the budget for 1984/85 which the Chancellor of the Exchequer presented to Parliament on 13 March. The main measures were: an increase in the income-tax threshold, well above the rate of inflation; a reduction in the rate of corporation tax, to be followed in the next three years by further decreases, but compensated by reductions in capital allowances over the same period; abolition of the National Insurance Surcharge; halving of the rate of Stamp Duty (payable on transfers of land, buildings and shares); an extension of the tax base for value-added tax. The measures are estimated to be revenue-neutral in 1984/85, when account is taken of inflation, but imply a significant reduction in revenue for 1985/86. The target level of the PSBR in 1984/85 is set at UKL 7 200 million (2,25% of GDP).
In a revised version of the MTFS the PSBR is projected to remain at UKL 7 000 million from 1985/86 until 1988/89, thus declining to 1,75% of GDP. Illustrative ranges for monetary growth have been set for two aggregates, sterling M3 and, for the first time M0, which consists mainly of notes and coins in circulation. Growth of sterling M3 is projected to slow from a target 6-10% in 1984/85 to 2-6% in 1988/89, and of M0 from a target 4-8% in 1984/85 to 0-4% in 1988/89.

account. Secondly, the prospects for the labour market should be reviewed, given the continuing very high level of unemployment. Finally, consideration must also be given to other longer-term policy issues, particularly in regard to improving the supply performance and potential growth of the economy.

As mentioned above, diverging statistical indicators show that an element of uncertainty is attached to the measurement of expanding economic activity during the last two years. In this period, indicators of output have shown rather weaker growth than those of expenditure, and manufacturing production in particular appears to have been very slow to respond to high levels of consumer demand, while there has been rapid growth of imports. The decline of manufacturing output in recent years and the deterioration of the trade balance in manufactures have to some extent been offset by the rapid growth of oil output and exports. This growth is now decelerating, and may even go into reverse within the next two years, so that any further deterioration of trade in manufactured goods could entail balance of payments problems. As long as the strong world trade recovery lasts, this deterioration should be limited, but the longer-term outlook is less favourable. Also of importance for the sustainability of the recovery is the maintenance of the improved cost and price performance. The sharp fall in the inflation rate, which was an important contributory factor to the strong growth of private consumption, has tailed off and, as indicated above, there are signs that costs and prices may again be subject to upward pressure.

The high level of unemployment remains a major problem. Although the underlying rate no longer appears to be increasing, there are no signs yet of any significant reduction. The data suggests, however, that the decline in manufacturing employment may be coming to an end, while employment in the service sectors and self-employment are rising. But even with smaller gains in labour productivity than in recent years, the likely rate of output growth in the short term will not have any significant downward impact on the level of unemployment.

In considering the appropriate policy response to these current or potential problems, a sound financial framework remains of prime importance. To abandon such an approach now would almost certainly put at risk the considerable gains achieved in price performance in recent years. On the other hand, a tightening of the financial framework in present circumstances would weaken the recovery, both by direct effects on the level of activity and indirectly by damaging confidence in growth prospects, with harmful consequences for employment. It would appear appropriate to maintain the broad policy stance of the last 18 months, thus avoiding a sharp reduction in public sector borrowing and allowing monetary expansion at a rate which is consistent with nominal GNP growth and with some further lowering of interest rates. Furthermore, the target figures for monetary growth and the public sector borrowing requirement (PSBR) should continue to be regarded as broad guidelines; indications that these projections may be exceeded should not necessarily lead to immediate corrective measures.

While maintaining the current financial climate, there may be scope for employing fiscal policy in such a way as to improve the prospects for lasting output and employment growth. Priority for tax reductions might in the short term be switched from the personal sector, which benefited substantially from income tax adjustments in 1983, to the enterprise sector, whose level of profitability, while having improved in the last two years, is still below that necessary to actively encourage investment and a normal level of risk-taking. A reduction in taxation and other corporate costs could also help to strengthen the export performance of industry whose weak competitive position in many international markets persists. In particular, the possibility of reducing business costs linked to numbers employed, such as National Insurance contributions and the National Insurance Surcharge, should be given serious consideration, as these effectively represent taxes on employment. Some alleviation of company taxation should be possible, without compensating increases in the personal sector, given the declared medium-term objective of reducing the overall tax burden.

Nevertheless, if public sector borrowing is not to rise, a reduced tax burden will only be possible if a lower level of public spending in relation to GDP can be achieved. This in itself depends largely on sustained economic growth, in order to avoid further rapid increases in categories of current expenditure such as unemployment and associated benefits. Even with a declining ratio of total spending to GDP, there should be room for higher public investment, which has been weak in real terms for many years. In particular, infrastructure investment (for example on roads) could contribute to improved economic efficiency, even though the gains are difficult to measure, while directly supporting output and employment.

Of critical importance in determining prospects for output and unemployment over the next few years, will be the behaviour of employers and employees with regard to wage settlements. A further reduction of labour costs is desirable, given the need to restore entrepreneurial incomes to satisfactory levels and given the more favourable trend in labour costs in competitor countries such as Germany and Japan. Average earnings have been rising at a rate well in excess of wage settlements, because of overtime and other bonus payments, and it is to be hoped that, as the recovery progresses, the likely slower increase in overtime working will be accompanied by a lower rate of growth of average earnings. While avoiding direct intervention in particular labour market arrangements, the authorities can assist in wage moderation by encouraging consensus between employers and employees with regard to their common interest. Some slight reduction in unemployment might also be achieved by measures facilitating part-time working (for example, by extending the Job Splitting Scheme), for which demand is strong, and early retirement.

In order to improve the prospects for sustained growth, it is important that, besides purely financial aspects, competitiveness and business confidence should be strengthened by making the institutional and legal framework in which business operates more conducive to enterprise. Education and training systems should be reviewed for possible improvements, more encouragement might be given to research and innovation, harmonious industrial relations must be assured and unnecessary barriers to competition removed. Progress has been made in some of these areas in recent years and has contributed to a more optimistic outlook for commerce and industry, the increase in self-employment being a further positive sign. Nevertheless, bearing in mind the weak record of growth over the last two decades and the particularly low point reached in the 1980-81 recession, economic performance still remains a long way below its potential level.

'Invisibles' in the UK current account

'Invisibles' are all those transactions in the current account of the balance of payments other than trade in goods. They thus cover a wide range of diverse transactions including payments for services (e.g. for shipping or tourism), interest and dividend payments, and transfers (e.g. remittances abroad by individuals or payments to international organizations by government).

The United Kingdom has for a long time enjoyed a strong position on invisible trade. This dates back to the nineteenth century when the UK was at the head of a large and growing empire with strong maritime links and London had already emerged as an important international financial centre through which substantial capital funds were channelled to developing countries. More recently, despite considerable changes in Britain's role in the world, this strength on invisibles has persisted. The UK has recorded a surplus on invisibles in every year since 1948, and in many years this has helped to offset a deficit on trade in goods, often pushing the current account also into surplus (see Graph 1).

Deficit on general government invisible transactions

Within the UK's total surplus on invisibles there is a clear distinction between the position of general government which is regularly in deficit on invisible transactions and that of the private sector (and public corporations) with a considerable surplus. Table 1[1] shows gross invisible credits and debits in 1982 for general government and the private sector separately and for each of the three main types of transaction—services, investment income, and transfers.

The general government sector ran a deficit in 1982 on each of the three categories:

(i) spending abroad on services (mainly military expenditure in Germany and elsewhere, and the cost of operating embassies, etc., abroad) exceeded receipt from services provided to foreign residents (principally receipts from European Community institutions for UK government activities as an agency for the collection of contributions to the EC budget and in connection with the JET project, and military expenditures by the US and other governments).

(ii) interest payments on general government borrowing from abroad were about double the interest receipts on lending abroad and from investment of the official reserves.

(iii) current transfer debits (which include contributions to the EC institutions and to other international organizations, bilateral aid and military grants, and other payments such as pensions and benefits paid to residents abroad) were larger than transfer credits; these latter amounting to UKL 2 200 million, were all received from the EC institutions under various EC budget headings (Agricultural Guidance and Guarantee Fund, Social Fund, Regional Development Fund) and they include the EC budget refunds to the UK; net UK transfers (debits less credits) to the EC institutions in 1982 represented UKL 700 million.

[1] The figures in Tables 1 and 2 have been rounded from figures originally expressed in UKL million, and so components may not always add exactly to totals.

Private sector in surplus

The private sector also had a small deficit on transfer payments in 1982, but recorded large surpluses on services and investment income. Further detail about the invisible earnings and expenditure by the private sector under these two categories is given in Table 2 for the years 1972 and 1982. Although still accountig for about one fifth of toal private sector earnings from services, sea transport has shown much less growth than other types of service earnings over the last decade, and in recent years there has often been a small net deficit on shipping. Earnings from civil aviation have grown rapidly and a net surplus has been maintained. Travel expenditures (spending abroad by UK residents and in the UK by overseas visitors, mainly for tourism) have grown much in line with civil aviation, but a deficit on the travel account emerged in 1981 and 1982.

The two main contributors to the net surplus on private sector services are financial services and other services. The foreign earnings of the 'City' are discussed further below. 'Other services' cover a wide variety of activities; areas where there has been rapid expansion in recent years include consultancy earnings, especially from construction work overseas, and services in connection with the exploration for and production of oil and natural gas, where, despite recent rises in credits, there was still a large net deficit of UKL 500 million in 1982.

Private sector investment income transactions can be classified into three main categories:

(i) earnings from direct investment, i.e. investment by enterprises in affiliated enterprises in another country;

(ii) dividends and interest paid on portfolio holdings of shares and bonds;

(iii) other income, mainly relating to interest payments on deposits with and loans by banks, but also including in the UK case the earnings in foreign countries by oil companies; since a substantial part of the exploitation of North Sea oil has been carried out by foreign-owned companies there was a large debit of UKL 2 600 million in this respect in 1982.

The private sector and public corporations showed a net surplus on each of these three categories in 1982.

Slow growth in volume of exports of services

Although there has been a large rise in invisible credits in nominal terms since 1972, this increase is much less pronounced when an attempt is made to take price rises into account. Table 3 compares the rises in the values of exports of goods and of total services between 1972 and 1982 and then the rises in these exports in volume terms.[1] The value of exports of goods has risen substantially more than the value of exports of services, and the same contrast is evident in volume developments. The volume of exports of services was only some 15% higher in 1982 than in 1972 compared with a 52% volume rise for goods. Services volumes performed particularly badly during the world recession between 1980 and 1982, falling back by some 8%, but even before their expansion had been relatively slow.

Foreign earnings in the 'City'

UK financial institutions, often referred to as the 'City' as the majority of these institutions are based in the City of London, make a very substantial positive contribution to the favourable invisible balance. Their net overseas earnings (from the provision of services and from net investment income) are estimated to have been some UKL 4 400 million in 1982. The largest net earners were banking institutions with net earnings in 1982 of UKL 1 700 million.[2] London is one of the world's most important international banking centres, and more foreign banks are represented there than in any other financial capital (391 in 1983). Deposits by non-residents with banks in the UK accounted for 30% of the total international deposit business of banks in the BIS reporting area at mid-1983. Net interest receipts by UK banks from lending and borrowing in foreign currencies grew especially rapidly in 1981 and 1982.

Insurance enterprises (Lloyd's underwriters, brokers, and insurance companies) are the other major overseas earners, with a positive balance of UKL 1 200 million in 1982, and it is only since 1981 that their position as the leading group of overseas earners has been overtaken by the banks.

The abolition of exchange controls in 1979 led to a marked shift in the portfolio investment policy of the investment institutions (insurance companies, pension funds, investment and unit trusts). During the three years 1980-82 these institutions invested some UKL 10 000 million in overseas securities, or 24% of their net acquisition of assets during the period compared with only 7% during the previous three years. A growing dividend and interest flow is now coming to the investment institutions from abroad; in 1982 their portfolio investment income was UKL 800 million compared with only UKL 200 million in 1979.

International comparisons

A regular analysis of trends in invisible transactions in the world is carried out by the UK Committee on Invisible Exports.[3] Their analysis has been updated in Table 4 using more recently published IMF balance of payments data. The figures should be treated with caution. Statistics on invisibles are inevitably less reliable than those for trade in goods. Although attempts are made by the IMF and other international bodies to harmonize concepts and presentation, considerable difficulties remain, evidence for which comes from the large world discrepancy observed in the sum of all identified invisibles transactions which should in principle add to zero. The gross flows of credits and debits may be even less comparable between countries, because of differences in the degree of 'grossness' of the measures; see, for example, the treatment in the UK statistics of interest flows on Eurocurrency business already mentioned.

With these limitations in mind, it can be seen from Table 4 that in 1982 the United Kingdom had the third largest invisible receipts (services and investment income, excluding general government) after the USA and France. Several countries, including France, had larger invisible debits than the United Kingdom, whose net surplus on invisibles was second only to that of the USA. The large invisible deficits of Germany and Japan are particularly noteworthy. The scale of invisible credits and debits relative to the corresponding flows of trade in goods varies considerably from country to country, but in most countries it is quite appreciable, and probably even higher than indicated in Table 4 as there is generally large-scale underrecording. This suggests that it can be very misleading to concentrate just on trade in goods when looking at current account developments.

While, in the global context, the United Kingdom retains a strong position on invisibles, there are none the less indications that the importance of the UK in world invisibles is being gradually eroded. Since 1969 the value of UK invisible credits has grown at a slower rate than in any of the other countries in Table 4. As a result the UK's share of total world invisible receipts has declined from 12,4% in 1969 to 8,5% in 1981 (full figures for the world are not yet available for 1982). At the same time, however, the value of UK invisible debits has also grown more slowly since 1969 than in most other countries, and this has made possible a rising invisible surplus.

Conclusion

The surplus on invisibles continues to make a very important contribution to the UK's current account position, and in particular the UK appears to have a comparative advantage in the provision of financial and certain other services. However, the value of the private sector's gross invisible earnings has risen more slowly than in most other countries over the last decade or so, in part no doubt because of the UK's larger initial position. The UK share of world invisible earnings has fallen over the years, analogous to the decline in the UK share of trade in manufactures. When exports of services are expressed in volume terms their growth appears very modest, and no faster than that of real output in the economy as a whole.

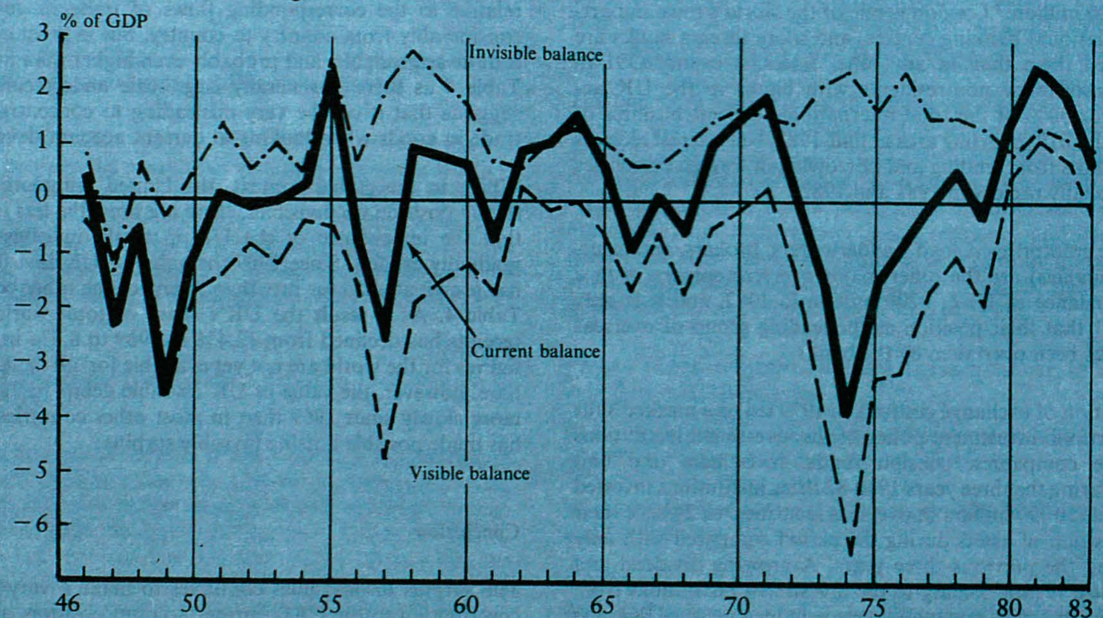
This has occurred during a period when a dramatic restructuring of the UK economy has been under way; employment in manufacturing industry has fallen from 31% of the employed labour force in 1973 to 24% in 1983, while employment in 'tradeable

[1] Investment incomes are not included in this comparison because conventionally no estimates at constant prices are available.
[2] Credits of UKL 4 200 million and debits of UKL 2 500 million, but since the interest flows on Eurocurrency borrowing and lending are only recorded on a net basis in the balance of payments accounts, these gross flows are underestimated.
[3] *World Invisible Trade*, June 1983.

services' industries[1] has risen from 32% to 38% respectively. This shift towards the service sector is likely to continue and it will be essential for the UK external balance, especially when earnings from the export of North Sea oil start to decline, that enterprises in the service industries take full advantage of opportunities for foreign earnings. In this respect, free movement of services within the Community is obviously of particular importance to the UK economy.

[1] Transport and communications; insurance, banking finance and business services; professional and scientific services; and miscellaneous services.

Graph 1: Balances of trade in goods, invisibles and current account in the United Kingdom, 1946-83



Source: CSO, *United Kingdom Balance of Payments*, 1983 Edition.

TABLE 1: Invisible credits and debits in the UK, 1982

(UKL '000 million)

	Credits	Debits	Invisible balance
Private sector and public corporations			
Services	17,1	12,5	+4,6
Investment income	10,2	7,8	+2,4
Transfers	1,0	1,3	−0,3
Total	28,3	21,6	+6,8
General government			
Services	0,4	1,2	−0,8
Investment income	0,8	1,6	−0,8
Transfers	2,2	4,0	−1,8
Total	3,4	6,9	−3,4
Total invisibles	31,7	28,4	+3,3

Source: CSO, *United Kingdom Balance of Payments*, 1983 Edition.

TABLE 2: Services and investment income credits and debits, private sector and public corporations, 1972 and 1982

(UKL '000 million)

	Credits		Debits		Balance	
	1972	1982	1972	1982	1972	1982
Services						
Sea transport	1,6	3,6	1,7	3,9	−0,1	−0,3
Civil aviation	0,4	2,5	0,3	2,1	+0,1	+0,4
Travel	0,6	3,2	0,5	3,7	+0,1	−0,5
Financial services[1]	0,5	2,1	—	—	+0,5	+2,1
Other services	1,1	5,8	0,6	2,9	+0,5	+2,9
Total services	4,2	17,1	3,2	12,5	+1,1	+4,6
Investment income						
Direct[2]	0,9	3,0	0,6	2,2	+0,4	+0,9
Portfolio	0,2	1,6	0,1	0,5	+0,1	+1,1
Other investment income	0,5	5,6	0,3	5,2	+0,2	+0,4
Total investment income	1,6	10,2	0,9	7,8	+0,7	+2,4
Total services and investment income	5,8	27,3	4,1	20,3	+1,7	+7,0

[1] Financial services are shown as credit entries only. Similar earnings in the UK by overseas financial institutions, which are considered negligible, are included in 'Other services' debts.
[2] Excluding the earnings of oil companies, which are included in 'Other investment income'.
Source: CSO, *United Kingdom Balance of Payments*, 1983 Edition.

TABLE 3: Exports of goods and services in value and volume, 1972-1982

	1972	1982	% change
Values (UKL '000 million)			
Exports of goods	9,4	55,5	+489
Exports of services	4,3	17,6	+310
Volumes (Index, 1980 = 100)			
Exports of goods	67	102	+52
Exports of services	80	92	+15

Source: CSO, *United Kingdom Balance of Payments*, 1983 Edition.

TABLE 4: International comparison of invisible transactions[1]

	Credits				Debits				Balance
	1982		% growth p.a. 1969-82	% of world credits 1981	1982		% growth p.a. 1969-82	% of world credits 1981	1982 USD '000 million
	USD '000 million	% of exports of goods			USD '000 million	% of imports of goods			
UK	46,3	47,7	13,0	8,5	35,5	38,0	13,2	5,9	10,8
B	34,8	74,8	23,8	5,9	33,6	66,6	23,5	5,4	1,2
DK	6,4	41,0	15,3	1,2	7,7	46,9	19,4	1,2	−1,3
D	38,5	22,4	16,2	6,8	55,1	37,6	16,3	9,1	−16,6
GR	3,6	87,2	19,1	0,7	1,7	18,9	16,2	0,3	1,9
F	63,7	69,9	21,3	9,5	56,4	52,7	22,0	7,9	7,3
IRL[2]	1,8	23,7	:	0,3	2,7	26,6	:	0,4	−0,8
I	26,0	35,9	13,4	4,3	24,1	30,0	15,3	3,6	1,9
NL	26,9	44,4	17,5	4,7	26,2	46,2	19,7	4,2	0,7
USA	120,4	57,1	15,3	20,7	71,5	28,9	14,2	10,5	48,9
JAP	33,0	24,0	21,6	5,5	49,9	41,8	20,1	8,1	−16,9

[1] Services and investment income, excluding identified general government transactions.
[2] Figures for Ireland are for 1981.
Sources: IMF, Balance of Payments Statistics; Committee on Invisible Exports.

Special studies

Unit labour costs in manufacturing industry and in the whole economy

The Community's unit labour costs for the whole economy in relation to its principal competitors in common currency terms fell by 5,4% in 1983, continuing the movement which began in 1981 (−12,7%) and was repeated in 1982 (−4,5%). Thus over this three-year period Europe's relative cost position has improved by upwards of 20%, cancelling out the adverse movement in the period 1977-80. Much of the swing between the periods was caused by movements in effective exchange rates, with the ECU appreciating in the first period and declining more recently. In fact, developments in domestic costs in the Community relative to the costs of competitors in national currency terms over the period 1979-81 had moved substantially out of line with those of competitors, registering an increase in relative terms of just under 9%. It would appear that this domestic cost surge has now abated and that the full effects of movements in exchange rates are being reflected on a one-for-one basis in relative unit labour costs in a common currency. Changes in manufacturing industry have been more muted, but this is primarily a reversal of adverse developments in the first half of the 1970s, reflecting substantial increases in per capita compensation, and which pushed the index of manufacturing relative costs in a common currency from 88,2 in 1970 to 114,1 in 1980. In addition, since the manufacturing sector is more exposed to foreign competition, it must, when its relative costs in common currency terms move out of line, either cut back the growth of compensation, which it only has succeeded in doing since 1981, or boost output per employee, which has been the case through much of the period up to 1981. However much of the productivity increase has been brought about, in the European case, by substantial labour shedding and factory closures, that is through a lowering of employment. The most recent figures suggest that the substantial exchange rate depreciation since 1981, together with some slowdown in the rise of compensation, should result in the common currency index for relative unit labour costs in manufacturing in 1984 falling below the 1970 level, although unexpected exchange rate movements can rapidly change the results for the current year.

In the United States, relative unit labour costs in common currency terms in the whole economy moved in the opposite direction to those of the Community, rising further in 1983 (5,8%) after the substantial increases recorded in 1982 (10,6%) and 1981 (13,2%). This took place after a long period through which relative costs had fallen consistently, partly due to the depreciation in the dollar's effective exchange rate, and partly due to a decline in relative unit labour cost in national currency terms, bringing the index of relative unit labour costs in common currency terms to an historic low in 1979. The improvement of the relative cost position in national currency continued in the period 1981-83 with falls of 1,2% on average per annum, as productivity improved and compensation per head decelerated, showing that the underlying labour cost performance of the United States has remained better than that of competitors. A similar picture emerges for manufacturing industry, which also saw an improved relative position in national currency but a worsening in common currency terms due to the appreciation in the effective exchange rate in the most recent period. In manufacturing, productivity gains were particularly pronounced in 1983 (7,6%) associated with the recovery in manufacturing activity, while the growth in compensation per employee was somewhat faster than for the total economy.

Japan recorded quite a large increase in relative unit labour costs (total economy) in common currency terms in 1983 (9,3%) following a decline of 8,7% in 1982. Since the overall trend of the effective exchange has been upwards, the level of relative costs in common currency has, on average, increased since 1980. Although the deterioration in the position of manufacturing was, at 9,6%, somewhat higher in 1983 than for the whole economy, this has not been the case in the whole of the period covered and the index for manufacturing, after the substantial improvements in 1979 and 1980, was, even in 1983, considerably below the total economy figure. The steady improvement in relative costs in national currency terms in manufacturing since 1975 is readily apparent from Table 15 Column 4. If it were assumed that the competitive position in manufacturing was in approximate balance in 1975, the figures would suggest an annual average appreciation of the effective exchange rate of the yen of 5,9% could have been afforded without any deterioration in relative manufacturing costs (in common currency). The assumption of a balanced 1975 position is, however, possibly extreme, since the Japanese cost position in the early part of the seventies deteriorated significantly partly due to a rise in national currency terms and partly due to exchange rate appreciation. Since 1975 increases in compensation per employee slowed down rapidly, marking a major turnaround from the rises of over 20% in 1973 and 1974. In the period 1978-83 the average increase in compensation per employee in manufacturing was under 5%, by far the lowest increase in any of the countries covered. In addition, productivity rises were large, particularly in manufacturing, but were still somewhat lower than those recorded in the 1960s.

Within the Community, developments in individual Member States have been uneven and movements in manufacturing and the total economy aggregates have sometimes diverged markedly. Relative costs in a common currency have improved in most Community countries over the 1980s as effective exchange rates dipped in all countries except Germany, the Netherlands, and, in 1980 and 1981, in the United Kingdom. A country by country analysis of developments shows that in Belgium, the continued fall in the relative costs in a common currency since 1979 in the total economy continued in 1983 with a decline of 2,6%. In manufacturing also the relative position continued to improve, principally due to large productivity gains.[1] After the substantial improvements in 1980-82 as far as manufacturing is concerned, and 1979-82 for the whole economy, Denmark recorded a marginal worsening of its relative cost position (in common currency) in 1983, with the small depreciation in the effective exchange rate (−0,2%) not compensating for the 0,7% rise in relative costs in national currency. In Germany relative costs in common currency improved in 1983 despite the appreciation of 4,2% in the effective exchange rate as relative costs in national currency fell substantially. This was brought about by the continued deceleration in compensation per head together with a pronounced increase in productivity (5,7% in manufacturing) which resulted in an actual decrease in unit labour costs in manufacturing industry, the first decrease recorded since 1967-1968. In Greece relative unit labour costs in common currency decreased in 1983, as a result of the depreciation of 17,5% in the effective exchange rate. This followed a rise in costs in the previous year which was particularly pronounced in manufacturing, presumably due to the measures taken at the end of 1981 to raise wages of the lower paid and the introduction of indexation on 1 January 1982. For France a decrease in relative costs in a common currency was registered in 1983 both for manufacturing and the whole economy. This improvement was less pronounced than in the previous two years, especially in manufacturing, which recorded a rise in relative unit labour costs in national currency terms of 6,0% (as against only 3,8% for the French economy as a whole). In Ireland common currency relative costs increased marginally in 1983 in the total economy but declined substantially (6,8%) in manufacturing, principally due to the large improvement in output per head resulting mainly from a substantial labour shedding (with employment declining 6%). On the other hand, in Italy, where the relative cost position in common currency showed a rise of 6%, productivity fell with approximately equal decreases in output and employment, while compensation per head rose at a rate of 13% in manufacturing and 13,7% in the total economy. In the Netherlands, despite an appreciation of the effective exchange rate, common currency relative costs improved by 3% as the rise in compensation slowed down noticeably and output picked up, despite a reduction in working hours. Finally in the United Kingdom relative costs in common currency fell further in 1983, by much the same amount as the decline in the effective exchange rate, as compensation per employee slowed down marginally and productivity grew by 3,8% in the total economy and 5,7% in manufacturing. In the latter case the increase in productivity was principally brought about through a decline of 4,4% in employment.

As was noted in previous issues of *European Economy*, a major problem in the assessment of relative competitiveness is the question of the base period chosen; absolute labour cost levels, on the other hand, are difficult to estimate since productivity levels differ importantly from one country to another. Table 1 presents absolute average hourly labour costs in ECU for Community countries plus the United States and Japan. Although such absolute figures cannot be taken in abstract terms without data on productivity, they do provide some useful pointers. Thus they suggest that up to 1982, despite the constant year by year improvement in relative unit labour costs in common currency in manufacturing in Belgium, absolute hourly costs in that country were substantially higher than in Germany and it was only as a result of the devaluation of 20 February 1982 and the accompanying modification in indexation arrangements that industrial costs were brought below those of Germany. In 1982 hourly costs in the Netherlands were the highest in the Community followed by Germany and Belgium with costs in these countries at much the same level as those in the United States. Hourly wage costs in France, which were on a par with Italy in 1975, have since then moved steadily upwards to join a middle group composed also of Denmark and Luxembourg. The other group of countries comprises Greece, Ireland and the United Kingdom, the latter two with costs of much the same level as Japan.

As far as the services sector is concerned, some fragmentary information is provided in Table 2 on absolute levels and changes in three service sectors compared to manufacturing. While such data can be significantly influenced by different starting dates of pay agreements in the various sectors, it does suggest that in certain countries some sectors, in particular the banking sector in Belgium and the United Kingdom, have been more insulated than others and have been able to maintain increases in remuneration above the going rate in other sectors. However in general apart from these isolated cases, there is no evidence that the services sector has managed to maintain wage increases above the general trend. This is consistent with the evidence that the overall Community indices for compensation per employee in manufacturing and in the total economy (see Table 3, last four rows) has not differed substantially over time. The divergence between total economy relative costs developments and those for manufacturing is therefore mainly attributable to the different rates of growth of measured productivity in the two sectors.

[1] It may be inappropriate for a country in a delicate competitive position to count all gains in productivity as factors improving competitiveness since a reduction in unit labour costs can be achieved by a reduction in employment. This difficulty in the interpretation of the figures may exist in reverse for other countries, i.e. labour hoarding may lead to a deterioration in measured competitiveness, but enable more significant gains in productivity, and hence competitiveness as measured here, to be made in recovery phases. Other problems associated with the interpretation of the data have been set out in previous articles in *European Economy* on international comparisons of costs and prices. See in particular *European Economy*, March 1982.

Table 1

Average hourly labour costs in manufacturing industry

(ECU)

	B	DK	D	GR	F	IRL	I	L	NL	UK	US	JAP
1975	5,89	5,74	5,75	:	4,69	2,66	4,26	5,93	6,46	2,95	:	:
1978	9,34	7,87	8,51	:	6,51	:	5,00	9,16	9,16	3,78	:	:
1979	10,10	9,05	9,16	:	7,34	4,14	5,53	9,51	9,86	4,38	:	:
1980	10,89	9,23	9,77	:	8,38	5,09	6,31	10,25	10,29	5,66	:	:
1981	11,61	10,03	10,28	:	9,32	5,89	7,28	10,48	10,65	6,85	:	:
	(10,47)	(8,54)	(9,97)	(3,15)	(7,93)	(5,06)	(7,70)	(–)	(9,38)	(6,37)	(9,95)	(6,50)
1982	11,12	10,71	11,53	:	10,13	6,61	8,12	10,28	12,28	7,70		
	(10,23)	(9,33)	(10,96)	(3,78)	(8,66)	(5,95)	(8,68)	(–)	(10,66)	(7,29)	(11,97)	(6,84)

Note: Figures for Community countries relate to labour costs and include all expenditure borne by employers in connection with the employment of workers and employees, i.e. direct pay, bonuses, paid annual leave, benefits in kind, social security charges paid by the employer, special levies, etc. (*Source:* Eurostat. *Hourly earnings: hours of work* IV 1982 and *Statistical Bulletin* 5-1983) Figures for 1982 are calculated on the basis of average gross hourly earnings. Data in brackets for certain Community countries, the United States and Japan covering earnings and fringe benefits from the Institut der Deutschen Wirtschaft, 6 May 1982, and data for 1982 are from IW Trends 29 April 1983.

Table 2

Level in 1981 and average annual changes 1978-81 in monthly labour costs in various sectors of the economy

(ECU)

	B		DK		D		GR		F		IRL		I		L		NL		UK	
	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%	ECU	%
Industry	1 615	8,3	1 379	6,0	1 547	7,3	665	10,6	1 445	13,5	987	17,3	1 062	13,7	1 397	4,7	1 498	6,0	1 188	24,1
Commerce	1 550	7,4	1 421	5,8	1 249	6,1	:	:	1 330	13,9	849	15,4	1 106	14,3	1 111	5,5	1 312	5,7	937	25,0
Banks	2 626	9,2	1 745	8,6	1 770	6,2	:	:	2 098	13,4	1 357	13,5	1 985	11,0	1 744	3,2	1 576	5,7	1 537	28,1
Insurance companies	2 066	6,2	1 760	6,3	1 881	6,5	:	:	1 763	12,1	1 285	17,0	1 732	10,0	1 925	6,5	1 778	4,8	1 472	26,5

Source: Eurostat; *Wages and Salaries* 7-1983; 22.12.1983.

Table 3

Labour cost indicators, EC

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	**Effective exchange rate**
	% change over preceding year										
1971	12,1	2,8	8,9	3,3	4,1	12,4	3,7	8,4	1,1	1,9	0,8
1972	11,2	5,6	5,2	1,5	2,8	10,9	4,3	6,3	0,5	1,8	1,3
1973	15,5	6,5	8,4	2,0	3,8	14,2	4,5	9,3	−0,1	1,8	1,8
1974	16,1	2,7	13,2	−3,2	−5,8	16,5	1,5	14,8	−0,1	−2,8	−2,7
1975	17,9	−1,7	19,9	5,8	8,3	16,4	−0,1	16,4	4,3	6,8	2,4
1976	14,6	8,7	5,4	1,3	−7,2	12,5	5,1	7,0	−0,8	−9,2	−8,4
1977	10,4	2,6	7,6	1,9	2,8	10,3	2,2	8,0	0,8	1,7	0,9
1978	10,0	2,9	6,9	1,8	4,7	9,8	2,7	6,9	0,0	2,9	2,9
1979	11,0	4,4	6,4	2,0	8,0	10,9	2,4	8,3	1,8	7,8	5,9
1980	12,9	1,7	11,0	3,6	5,9	13,5	1,3	12,1	4,0	6,2	2,2
1981	11,0	2,7	8,2	0,9	−14,1	12,1	1,3	10,7	2,7	−12,7	−14,9
1982	9,0	2,2	6,7	−0,4	−5,7	8,9	1,7	7,1	0,8	−4,5	−5,3
1983	7,5	3,8	3,5	1,4	−4,1	6,4	1,8	4,6	0,1	−5,4	−5,4
1984 [3]	6,8	3,9	2,9	1,5	−1,6	6,0	2,1	3,8	0,1	−2,9	−3,1
	Index 1975 = 100										
1960	21,8	52,6	41,4	82,1	80,3	22,3	56,3	39,6	92,7	90,6	97,8
1970	50,8	85,7	59,3	91,5	88,2	51,8	87,2	59,4	94,6	91,2	96,5
1980	174,4	121,9	143,1	111,0	114,1	171,6	114,4	150,0	105,8	108,9	102,9
1984 [3]	242,4	138,0	175,9	114,7	87,2	236,3	122,5	192,9	109,7	83,4	76,0

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 4

Labour cost indicators, Belgium

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	13,2	4,5	8,3	1,1	1,0	11,7	2,8	8,6	0,6	0,5	−0,1
1972	15,3	9,4	5,4	0,7	3,6	14,0	5,4	8,1	2,0	4,9	2,8
1973	12,9	9,4	3,2	−3,3	−1,9	13,0	4,8	7,8	−0,9	0,5	1,4
1974	20,5	2,5	17,6	4,4	5,9	18,2	3,0	14,8	1,3	2,7	1,4
1975	14,4	−0,7	15,3	−0,9	0,5	16,5	−0,6	17,2	3,1	4,6	1,4
1976	18,8	14,4	3,8	−1,1	1,2	16,1	6,4	9,1	2,0	4,4	2,4
1977	9,3	5,4	3,7	−3,0	2,6	8,9	0,9	7,9	0,3	6,1	5,7
1978	8,6	7,0	1,5	−5,0	−2,2	7,6	3,0	4,5	−2,5	0,4	2,9
1979	7,8	6,2	1,5	−4,3	−3,1	5,4	1,2	4,2	−3,1	−1,9	1,2
1980	9,6	1,6	8,0	−1,9	−2,4	8,8	3,1	5,5	−4,2	−4,8	−0,5
1981	6,2	3,7	2,4	−4,6	−9,7	7,3	0,3	7,0	−1,8	−7,1	−5,3
1982	5,5	4,5	1,0	−5,5	−14,2	8,0	2,8	5,0	−2,0	−11,1	−9,2
1983	7,7	4,7	2,8	−0,4	−2,5	5,8	1,6	4,2	−0,5	−2,6	−2,1
1984 [3]	8,3	5,1	3,0	0,4	−0,6	7,9	2,0	5,8	2,1	1,1	−1,0
	Index 1975 = 100										
1960	21,4	47,3	45,2	96,8	89,8	23,9	56,9	42,0	102,8	95,3	92,7
1970	49,2	78,5	62,6	98,1	91,6	50,5	86,0	58,7	94,1	87,8	93,3
1980	166,6	139,2	119,7	85,6	96,0	156,0	115,3	135,3	92,6	103,9	112,2
1984 [3]	217,8	166,1	131,1	77,3	72,2	206,4	123,1	167,7	90,5	84,5	93,4

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 5

Labour cost indicators, Denmark

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	14,5	6,0	8,0	0,6	−0,3	11,7	1,8	9,7	1,7	0,9	−0,9
1972	8,4	5,9	2,3	−2,3	−1,6	7,9	3,3	4,5	−1,9	−1,2	0,7
1973	14,9	4,1	10,3	3,9	10,2	13,1	2,6	10,3	2,0	8,2	6,1
1974	23,3	5,6	16,8	1,5	1,9	18,4	−0,4	18,9	4,1	4,6	0,5
1975	15,4	6,3	8,6	−8,6	−5,5	14,0	0,2	13,7	−1,7	1,7	3,4
1976	12,0	8,0	3,7	−3,0	−0,8	11,7	5,0	6,3	−1,8	0,4	2,3
1977	10,8	2,9	7,7	0,3	−0,2	9,7	1,2	8,5	0,2	−0,3	−0,5
1978	15,9	2,8	12,7	5,7	5,6	9,2	0,7	8,4	1,2	1,1	−0,1
1979	10,5	2,3	7,9	2,3	1,5	9,4	2,5	6,8	−0,5	−1,2	−0,8
1980	8,5	2,2	6,1	−3,8	−11,4	9,9	−0,6	10,6	0,2	−7,7	−7,9
1981	9,3	5,5	3,6	−4,3	−10,8	10,2	2,0	8,0	−1,1	−7,9	−6,8
1982	11,5	0,4	11,1	4,2	−0,1	11,7	3,5	8,0	1,1	−3,0	−4,0
1983	8,5	3,3	5,0	1,8	1,6	7,5	1,8	5,5	0,7	0,5	−0,2
1984 [3]	5,0	2,2	2,7	0,3	−1,4	5,2	2,3	2,8	−1,0	−2,7	−1,7
	Index 1975 = 100										
1960	19,0	47,8	39,8	89,9	87,0	20,0	64,0	31,2	76,6	74,1	96,7
1970	49,3	76,2	64,7	105,6	96,0	54,3	92,9	58,5	96,0	87,3	90,9
1980	172,4	119,5	144,2	101,1	94,0	160,8	108,9	147,6	99,3	92,3	93,0
1984 [3]	239,4	133,8	179,0	102,9	83,9	223,8	119,8	186,8	98,8	80,6	81,6

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 6

Labour cost indicators, Germany

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	10,7	2,1	8,4	1,2	4,2	12,6	3,0	9,3	1,5	4,6	3,0
1972	10,6	5,0	5,3	0,8	3,6	9,1	4,1	4,8	−1,6	1,2	2,8
1973	13,3	5,6	7,3	0,7	11,0	12,1	3,8	8,1	−0,9	9,3	10,2
1974	11,5	3,4	7,9	−6,7	−1,3	11,5	2,0	9,3	−5,1	0,4	5,7
1975	7,5	−0,2	7,7	−10,1	−8,6	7,2	1,3	5,8	−9,1	−7,6	1,6
1976	9,8	8,2	1,5	−4,2	1,3	7,9	6,2	1,6	−6,9	−1,5	5,8
1977	7,1	2,3	4,6	−2,6	5,4	6,6	3,3	3,2	−5,4	2,4	8,2
1978	6,2	1,5	4,6	−1,9	3,9	5,6	2,5	3,0	−4,7	1,0	6,0
1979	7,3	4,5	2,6	−3,6	1,0	5,9	2,7	3,1	−4,9	−0,4	4,8
1980	6,9	0,1	6,7	−3,3	−3,0	6,8	1,0	5,8	−4,6	−4,3	0,4
1981	5,6	0,1	5,5	−2,8	−7,8	5,3	1,0	4,3	−5,6	−10,5	−5,2
1982	4,9	1,1	3,8	−3,9	1,0	4,4	0,9	3,5	−4,4	0,5	5,1
1983	4,3	5,7	−1,3	−5,6	−1,7	3,5	2,7	0,7	−5,1	−1,1	4,2
1984 [3]	4,7	4,4	0,3	−2,7	−1,4	3,8	2,7	1,1	−3,4	−2,0	1,4
	Index 1975 = 100										
1960	26,1	53,6	48,7	110,6	74,1	26,7	56,5	47,2	120,2	80,5	67,0
1970	60,2	85,6	70,3	116,0	92,5	60,8	87,0	69,9	117,0	93,3	79,7
1980	143,1	117,7	121,6	85,3	108,7	137,3	116,7	117,7	76,2	97,1	127,5
1984 [3]	173,1	131,3	131,8	73,1	98,2	162,3	125,4	129,4	63,1	84,7	134,2

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 7

Labour cost indicators, Greece

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	:	:	1,8	−5,1	−7,1	9,2	8,1	1,0	−6,4	−8,3	−2,0
1972	:	:	4,9	0,4	−5,9	12,4	8,4	3,7	−2,3	−8,4	−6,3
1973	:	:	11,5	4,5	−2,9	17,6	6,8	10,1	1,1	−6,1	−7,1
1974	:	:	28,1	11,8	12,5	18,7	−3,6	23,1	7,5	8,2	0,6
1975	:	:	12,5	−4,5	−14,0	19,7	5,4	13,6	−1,0	−10,8	−9,9
1976	:	:	16,7	11,2	5,8	23,9	5,1	17,9	9,5	4,2	−4,8
1977	:	:	19,3	11,4	8,8	22,3	4,4	17,1	8,3	5,8	−2,4
1978	:	:	12,4	5,6	−3,6	23,1	5,1	17,2	9,1	−0,4	−8,7
1979	:	:	19,7	12,9	6,8	21,9	2,1	19,4	10,7	4,7	−5,4
1980	:	:	25,1	13,8	−1,5	14,8	−0,1	14,9	4,0	−10,0	−13,5
1981	:	:	26,7	17,4	6,3	23,9	−0,8	24,9	13,9	3,1	−9,4
1982	:	:	33,6	24,3	15,3	25,7	1,1	24,3	15,5	7,1	−7,3
1983	:	:	17,0	12,8	−7,0	18,6	1,5	16,9	10,9	−8,5	−17,5
1984 [3]	:	:	21,1	18,2	0,2	24,1	2,4	21,2	16,5	−1,2	−15,2
	Index 1975 = 100										
1960	:	:	44,4	97,8	124,8	19,2	35,3	54,4	132,1	168,7	127,7
1970	:	:	58,3	94,1	121,9	48,8	78,7	62,0	101,5	131,4	129,4
1980	:	:	234,3	168,0	116,7	261,0	117,5	222,1	149,0	103,5	69,5
1984 [3]	:	:	562,2	326,9	133,4	598,2	122,4	488,7	253,4	103,4	40,8

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 8

Labour cost indicators, France

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	11,5	4,6	6,6	−1,0	−3,0	11,5	5,0	6,2	−2,0	−4,0	−2,1
1972	8,9	5,0	3,8	−1,1	1,5	10,3	5,4	4,7	−1,8	0,8	2,6
1973	10,2	4,3	5,7	−1,2	2,9	12,8	4,1	8,4	−0,6	3,5	4,1
1974	11,3	2,4	8,6	−6,1	−12,1	17,6	2,5	14,7	0,1	−6,4	−6,4
1975	26,8	1,1	25,5	7,0	17,6	18,6	1,2	17,2	1,9	12,1	9,9
1976	15,1	7,2	7,4	2,2	−1,3	14,7	4,2	10,1	2,2	−1,4	−3,5
1977	13,2	4,5	8,3	0,9	−3,4	12,6	2,3	10,1	1,6	−2,7	−4,3
1978	13,8	4,9	8,5	1,9	0,9	12,5	2,9	9,3	1,8	0,8	−1,0
1979	12,7	4,7	7,7	1,3	2,2	13,1	3,4	9,4	1,3	2,2	0,9
1980	14,2	1,6	12,4	2,2	2,6	14,8	1,3	13,3	2,8	3,2	0,4
1981	14,0	3,5	10,1	1,8	−7,0	14,5	1,0	13,4	3,5	−5,4	−8,6
1982	12,5	2,4	9,8	2,2	−6,0	14,5	2,5	11,7	4,1	−4,3	−8,0
1983	11,6	1,9	9,4	6,0	−0,9	10,8	1,3	9,4	4,0	−2,7	−6,5
1984 [3]	9,4	2,2	7,1	4,7	2,0	8,7	1,7	6,9	2,8	0,1	−2,6
	Index 1975 = 100										
1960	22,4	46,0	48,7	111,0	116,0	21,0	51,9	40,6	101,0	105,5	104,5
1970	52,9	84,3	62,8	102,8	95,5	51,7	83,7	61,7	102,5	95,2	92,9
1980	190,9	125,1	152,5	108,8	100,9	188,8	114,8	164,4	110,0	102,0	92,7
1984 [3]	298,9	138,3	216,1	125,5	89,1	298,2	122,4	243,7	126,8	90,0	71,0

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 9

Labour cost indicators, Ireland

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	16,3	3,9	11,9	4,3	4,4	14,0	3,3	10,4	3,3	3,5	0,1
1972	17,7	5,7	11,3	6,7	4,6	16,9	7,0	9,2	1,5	−0,5	−1,9
1973	18,7	6,1	11,9	5,9	−1,1	19,8	4,0	15,2	6,5	−0,5	−6,5
1974	18,1	0,4	17,6	−0,1	−2,6	18,6	3,1	15,0	−1,1	−3,6	−2,5
1975	23,1	−6,9	32,2	8,6	2,8	27,0	1,6	25,0	4,6	−1,0	−5,4
1976	23,2	8,7	13,3	5,7	−4,9	19,3	2,8	16,1	7,2	−3,6	−10,0
1977	14,4	4,3	9,7	2,2	−1,4	13,8	4,9	8,4	0,1	−3,4	−3,5
1978	17,3	8,1	8,5	0,7	1,4	14,8	3,3	11,1	3,0	3,7	0,7
1979	17,1	6,9	9,5	1,4	1,6	18,1	−0,7	18,9	8,5	8,7	0,2
1980	17,6	−4,5	23,2	9,2	7,0	19,5	1,2	18,0	5,0	2,8	−2,0
1981	16,0	4,9	10,6	2,5	−6,0	18,5	3,1	15,0	4,9	−3,8	−8,3
1982	12,1	2,1	9,8	3,1	2,0	14,9	1,5	13,2	6,2	5,0	−1,1
1983	11,5	11,9	−0,3	−3,4	−6,8	11,6	2,3	9,1	4,2	0,5	−3,5
1984 [3]	9,5	7,0	2,4	−0,5	−3,4	9,1	3,1	5,8	1,6	−1,4	−3,0
	Index 1975 = 100										
1960	17,0	62,4	27,2	64,4	81,7	16,1	54,9	29,4	76,4	97,0	126,9
1970	42,4	91,8	46,2	78,2	92,4	41,6	83,0	50,1	86,6	102,3	118,2
1980	227,6	125,1	181,9	120,4	103,3	219,8	112,0	196,2	126,0	108,1	85,8
1984 [3]	361,4	160,4	225,4	122,3	89,1	364,3	123,6	294,8	148,5	108,2	72,8

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 10

Labour cost indicators, Italy

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	10,9	−1,0	11,9	5,0	4,1	13,1	1,7	11,2	3,4	2,6	−0,8
1972	11,1	4,9	5,9	1,4	0,9	11,1	4,4	6,4	0,3	−0,2	−0,5
1973	22,5	8,5	12,9	6,5	−3,6	19,6	6,2	12,6	3,7	−6,1	−9,5
1974	23,2	3,7	18,7	3,9	−6,4	22,1	2,6	19,0	4,4	−6,0	−9,9
1975	22,3	−9,4	34,9	16,7	12,2	21,0	−3,8	25,7	11,0	6,7	−3,8
1976	24,0	12,3	10,4	5,6	−12,7	20,9	5,0	15,1	7,6	−11,0	−17,3
1977	20,0	2,1	17,5	10,8	2,3	21,4	1,2	19,9	12,1	3,4	−7,7
1978	14,3	2,8	11,2	4,9	−1,5	16,2	2,0	13,9	6,8	0,3	−6,1
1979	16,4	6,2	9,6	3,6	0,2	17,9	3,9	13,5	5,9	2,4	−3,2
1980	20,8	6,3	13,7	3,7	−0,1	22,2	3,1	18,6	8,4	4,4	−3,7
1981	19,3	0,9	18,3	10,5	−3,0	22,0	−0,6	22,7	13,4	−0,4	−12,2
1982	16,9	0,7	16,1	9,0	1,7	17,1	−0,1	17,2	10,1	2,7	−6,7
1983	13,0	−0,5	13,6	10,7	6,6	13,7	−1,0	14,9	10,1	6,1	−3,7
1984 [3]	10,7	4,4	6,0	3,5	−0,5	10,2	2,1	8,0	4,1	0,0	−3,9
	Index 1975 = 100										
1960	16,0	52,9	30,2	63,8	82,3	16,5	49,7	33,3	79,5	102,5	129,0
1970	44,0	94,3	46,6	72,7	94,0	45,1	89,8	50,2	80,2	103,7	129,3
1980	239,1	133,1	179,7	131,9	88,1	245,7	116,2	211,6	147,7	98,7	66,8
1984 [3]	417,3	140,5	297,0	182,1	92,3	440,2	116,6	377,5	211,4	107,2	50,7

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 11

Labour cost indicators, Luxembourg

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	6.6	−2,8	9,7	:	:	9,3	1,2	8,0	:	:	:
1972	8,4	3,6	4,7	:	:	8,8	3,5	5,1	:	:	:
1973	10,0	7,1	2,8	:	:	12,8	8,7	3,7	:	:	:
1974	23,1	2,6	20,0	:	:	21,3	1,1	20,0	:	:	:
1975	11,8	−17.0	34,8	:	:	11,3	−7,6	20,4	:	:	:
1976	10,3	7,4	2,7	:	:	13,2	2,5	10,4	:	:	:
1977	7,7	1,7	6,0	:	:	9,4	0,4	9,0	:	:	:
1978	4,5	8,8	−3,9	:	:	5,6	4,5	1,0	:	:	:
1979	6,0	6,2	−0,2	:	:	6,0	2,9	3,0	:	:	:
1980	5,7	−0,4	6,1	:	:	7,8	0,6	7,2	:	:	:
1981	8,0	−5,2	13,8	:	:	7,7	−2,0	9,9	:	:	:
1982	7,1	−1,8	9,1	:	:	6,6	−1,0	7,7	:	:	:
1983	7,0	−0,5	7,5	:	:	7,1	−1,7	8,9	:	:	:
1984[3]	4,9	3,1	1,7	:	:	5,6	−0,1	5,6	:	:	:
	Index 1975 = 100										
1960	26,8	91,8	29,2	:	:	29,0	69,9	41,4	:	:	:
1970	57,1	109,0	52,4	:	:	55,2	93,9	58,7	:	:	:
1980	139,1	125,6	110,7	:	:	149,4	111,3	134,2	:	:	:
1984[3]	180,5	120,1	150,3	:	:	193,9	106,1	182,8	:	:	:

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 12

Labour cost indicators, The Netherlands

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	13,0	4,7	7,9	0,4	1,6	13,4	3,7	9,4	1,4	2,6	1,2
1972	12,9	5,9	6,6	1,9	3,7	12,9	4,3	8,2	2,0	3,8	1,8
1973	17,2	9,6	6,9	0,4	4,7	15,1	5,7	8,9	0,3	4,5	4,2
1974	15,6	3,6	11,5	−2,5	2,9	15,8	3,5	11,9	−2,0	3,4	5,5
1975	12,2	−3,2	16,0	−1,3	1,5	13,3	−0,4	13,7	−0,9	1,9	2,8
1976	12,1	12,1	0,0	−5,3	−2,5	10,9	5,5	5,1	−2,4	0,6	3,0
1977	8,2	3,5	4,6	−2,3	3,5	8,1	2,2	5,9	−2,0	3,9	6,0
1978	7,4	4,6	2,6	−3,7	−0,9	7,2	2,0	5,1	−1,8	0,9	2,8
1979	6,7	3,3	3,3	−2,5	−0,8	6,0	0,8	5,1	−2,2	−0,5	1,8
1980	7,4	3,1	4,1	−5,7	−5,6	5,5	0,4	5,0	−4,8	−4,7	0,1
1981	4,4	3,6	0,8	−6,7	−11,3	3,3	0,1	3,2	−5,6	−10,3	−5,0
1982	6,9	2,6	4,1	−2,5	2,8	5,7	0,9	4,7	−2,2	3,1	5,5
1983	3,5	5,0	−1,4	−4,8	−2,7	2,8	2,8	−0,1	−5,0	−2,9	2,2
1984 [3]	0,5	5,0	−4,3	−7,1	−6,6	0,2	2,5	−2,2	−6,3	−5,8	0,6
	Index 1975 = 100										
1960	20,1	51,2	39,4	86,7	70,6	18,9	57,5	32,8	79,0	64,3	81,4
1970	51,6	82,0	62,9	101,0	86,8	51,7	84,9	60,9	99,2	85,2	85,9
1980	149,2	129,2	115,4	82,0	93,7	143,7	111,3	129,1	87,5	100,0	114,3
1984 [3]	173,2	151,4	114,3	65,9	77,7	161,6	118,5	136,4	71,9	84,5	117,8

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 13

Labour cost indicators, United Kingdom

	Labour costs in industry: Compensation per employee (national currency)	Labour costs in industry: Productivity (output per employee)	Labour costs in industry: Labour cost per unit of output (national currency)	Labour costs in industry: Relative unit labour costs in national currency [1]	Labour costs in industry: Relative unit labour cost in common currency [2]	Labour costs, total economy: Compensation per employee	Labour costs, total economy: Productivity (output per person in total employment)	Labour costs, total economy: Labour cost per unit of output (national currency)	Labour costs, total economy: Relative unit labour cost in national currency [1]	Labour costs, total economy: Relative unit labour cost in a common currency [2]	p.m.: Effective exchange rate
	% change over preceding year										
1971	12,4	2,4	9,8	3,4	3,5	11,4	4,2	6,9	−0,5	−0,4	0,1
1972	11,2	6,1	4,8	0,5	−3,1	13,0	2,3	10,5	4,4	0,7	−3,5
1973	14,0	8,5	5,1	−1,4	−11,5	13,1	5,0	7,6	−1,2	−11,4	−10,3
1974	23,3	−0,1	23,5	7,4	3,4	18,8	−1,4	20,5	5,3	1,4	−3,7
1975	30,3	−1,8	32,6	14,8	5,9	30,9	−0,2	31,2	16,2	7,2	−7,7
1976	18,7	5,4	12,6	7,6	−8,1	14,6	4,3	9,9	2,0	−12,9	−14,7
1977	10,0	1,1	8,8	2,1	−2,8	10,4	1,0	9,2	1,5	−3,4	−4,8
1978	13,2	1,4	11,7	5,6	6,0	13,8	3,6	9,9	2,8	3,2	0,4
1979	15,8	1,3	14,4	8,7	15,4	16,4	0,7	15,6	8,0	14,6	6,2
1980	18,1	−3,7	22,7	12,9	24,3	20,2	−0,4	20,6	10,7	21,8	10,1
1981	13,3	4,3	8,7	1,0	2,2	14,7	3,5	10,9	1,9	3,0	1,1
1982	9,8	5,3	4,2	−3,0	−7,5	8,7	4,1	4,4	−2,8	−7,3	−4,6
1983	8,9	5,7	3,0	0,1	−7,4	8,1	3,8	4,1	−0,9	−8,3	−7,5
1984 [3]	8,0	3,5	4,4	2,3	1,2	6,7	1,9	4,7	0,8	−0,3	−1,1
	Index 1975 = 100										
1960	22,2	63,9	34,6	72,5	109,5	22,8	70,2	32,5	76,8	115,9	150,9
1970	43,6	86,4	50,5	79,1	102,8	45,1	90,7	49,8	79,7	103,5	129,9
1980	202,4	105,4	192,0	142,5	135,8	201,4	109,5	183,9	127,2	121,2	95,3
1984 [3]	296,1	126,6	233,9	143,0	120,3	289,8	124,9	232,1	125,8	105,9	84,1

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 14

Labour cost indicators, United States

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	6,8	6,7	0,1	−6,5	−9,0	7,2	3,5	3,5	−3,7	−6,2	−2,6
1972	7,2	6,8	0,4	−4,0	−10,3	7,4	2,9	4,3	−1,8	−8,2	−6,5
1973	7,2	5,4	1,7	−5,3	−13,0	7,0	1,4	5,5	−4,0	−11,8	−8,1
1974	9,0	−3,8	13,3	−3,2	−1,6	8,0	−2,2	10,4	−5,9	−4,4	1,6
1975	10,9	2,1	8,6	−8,0	−8,8	9,1	1,8	7,2	−7,4	−8,2	−0,9
1976	8,7	5,1	3,4	−2,0	3,6	8,0	2,1	5,8	−2,4	3,1	5,6
1977	8,9	3,1	5,6	−1,0	−1,3	7,5	1,8	5,7	−2,3	−2,6	−0,3
1978	8,3	0,9	7,4	2,0	−6,9	7,6	−0,4	8,0	1,6	−7,3	−8,7
1979	9,2	0,2	9,0	3,5	0,1	8,5	−0,9	9,5	2,0	−1,4	−3,3
1980	10,8	−0,5	11,4	2,1	1,8	9,7	−0,6	10,3	0,5	0,2	−0,3
1981	9,7	3,3	6,1	−1,6	12,2	9,6	1,4	8,1	−0,7	13,2	14,0
1982	7,6	0,4	7,1	−0,9	11,1	6,2	0,0	6,2	−1,4	10,6	12,1
1983	7,7	7,6	0,2	−2,4	4,8	5,8	2,2	3,5	−1,4	5,8	7,3
1984 [3]	6,0	3,4	2,5	0,6	2,8	6,8	1,9	4,8	1,1	3,3	2,2
	Index 1975 = 100										
1960	43,2	65,1	66,4	148,9	172,1	41,5	76,5	54,3	137,1	158,5	115,5
1970	67,3	84,7	79,5	132,1	156,9	68,9	92,9	74,2	126,4	150,1	118,8
1980	155,0	108,9	142,3	104,6	97,1	148,7	102,0	145,8	99,2	92,0	92,8
1984 [3]	208,8	125,7	166,2	100,2	130,3	195,5	107,7	181,5	96,8	125,9	130,1

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Table 15

Labour cost indicators, Japan

	Labour costs in industry					Labour costs, total economy					p.m.
	Compensation per employee (national currency)	Productivity (output per employee)	Labour cost per unit of output (national currency)	Relative unit labour costs in national currency [1]	Relative unit labour cost in common currency [2]	Compensation per employee	Productivity (output per person in total employment)	Labour cost per unit of output (national currency)	Relative unit labour cost in national currency [1]	Relative unit labour cost in a common currency [2]	Effective exchange rate
	% change over preceding year										
1971	13,9	4,5	8,9	4,7	6,4	15,2	4,0	10,7	4,8	6,5	1,6
1972	15,1	10,9	3,8	0,9	12,2	14,3	8,7	5,1	−0,5	10,6	11.2
1973	21,7	9,5	11,1	5,9	11,9	22,7	6,0	15,7	7,4	13,5	5,6
1974	25,2	−2,3	28,1	11,8	4,4	25,7	−0,6	26,5	11,4	4,1	−6,6
1975	13,9	1,2	12,6	−1,9	−4,7	16,1	2,6	13,2	0,6	−2,2	−2,8
1976	10,0	12,9	−2,5	−7,5	−3,0	11,3	4,4	6,7	−0,7	4,2	4,9
1977	10,1	7,5	2,4	−4,2	6,2	10,0	3,8	6,0	−1,3	9,3	10,8
1978	2,1	4,0	−1,8	−8,3	11,6	7,0	3,7	3,2	−4,0	16,8	21,7
1979	3,7	6,0	−2,2	−9,1	−15,5	6,0	3,8	2,1	−6,2	−12,8	−7,1
1980	8,4	10,6	−1,9	−12,0	−15,6	6,4	3,3	3,0	−7,1	−10,9	−4,1
1981	6,9	4,6	2,1	−5,2	8,1	6,2	2,3	3,8	−5,0	8,4	14,0
1982	4,8	0,8	4,0	−3,6	−8,3	5,1	2,0	3,1	−4,0	−8,7	−4,8
1983	4,0	3,2	0,7	−1,8	9,6	3,7	1,0	2,7	−2,1	9,3	11,7
1984 [3]	4,7	7,2	−2,3	−4,9	1,3	4,7	3,0	1,7	−2,6	3,8	6,6
	Index 1975 = 100										
1960	12,7	28,8	44,1	84,5	76,4	12,0	34,2	35,1	77,0	69,6	90,4
1970	44,0	79,7	55,2	81,5	75,2	42,4	81,7	51,9	79,6	73,5	92,3
1980	139,2	148,0	94,1	65,0	82,0	147,9	120,5	122,7	82,0	103,4	126,1
1984 [3]	169,9	172,8	98,4	55,4	90,3	179,3	130,7	137,1	71,3	116,2	162,9

[1] Unit labour cost in national currency by reference to the weighted average for 19 main competing countries.
[2] Unit labour costs in a common currency by reference to the weighted average for 19 main competing countries.
[3] Provisional forecasts.
Source: Eurostat, estimates and forecasts by Commission services.

Opinion of the Economic Policy Committee on the medium-term budget balance and the public debt

The Economic Policy Committee has examined the issue of the medium-term budget balance and the public debt, and presents the following opinion.[1]

Introduction

1. Persisting budget deficits in many countries have increasingly given rise to discussions about the management of public finance. Admittedly, the size of public deficits and the debt/GDP ratio show large variations over time and between countries, and it may be impossible to indicate any optimal medium-term balance which could serve as a general quantitative guideline. But many member countries are experiencing problems arising from a substantial increase in the interest burden of the public debt. Furthermore, concern has been expressed about the long-term consequences since the public debt could continue to rise due to a structural shift in factors determining the budget balance. This opinion focuses on some of the relevant economic problems connected with the continuous increase in internal public debt, and does not deal with deficit spending as such nor with the issue of external borrowing and external debt.

General considerations

2. The public budgets of many Member States show too large a deficit. Hence in many member countries the room for manoeuvre in budgetary policy is felt to be extremely narrow in the short term. The kind of budget balance governments should aim at in the medium term is, however, a more open question. In deciding this, governments should be concerned with the wider macro-economic consequences of any accumulation of debt.

3. Some public expenditures are at least partially self-financing in the medium term, and, therefore, can be financed by borrowing without requiring a corresponding increase in taxation to service interest payments. This may apply not only to investments which yield a direct return, but also to such expenditures on infrastructure which render real benefits to the economy and raise its taxable capacity over time. The same argument could apply to some expenditures traditionally classified as public consumption, but which improve human capital by educating the labour force.

4. At the macro-economic level a public deficit or surplus might be needed to match, at appropriate levels of output, employment and interest rates, any divergence between the private sector's propensity to invest and to save. But these propensities are subject to change since they are influenced by institutional and psychological factors such as the structure of the economy and of public budgets, of past economic performance and present expectations and also of the stance of economic policy in general. Such considerations can serve only, if at all, as a basis for quantitative targets for the medium-term budget balance under static conditions.

[1] This opinion was adopted and submitted to the Council and the Commission in December 1983.

5. These considerations indicate, however, that a zero budget balance has no intrinsic value as a policy objective. A persistent deficit would be harmful if the growth of the debt leads to an increase in the tax burden in order to finance interest payments or if it leads to excessive interest rates in the economy generally, or if it leads to fears of tax increases and thus adversely affects investment behaviour. Whether it will do this will in general depend on the effects of the public budgets on private expectations as well as on the return to the expenditure financed by the deficit and on the balance of private investment and savings. Whether higher interest payments on the debt will involve higher rates of tax will depend on the size of the deficit in relation to the growth of the economy.

Policy implications

6. Considering the present situation and the medium-term prospects, it should be borne in mind:

(i) that in many member countries budget deficits are too high and should be reduced;

(ii) that the financing of a deficit puts at risk the monetary stability of the economy if it adds to the money supply at a rate faster than that needed for the output of goods;

(iii) large persistent deficits may create inflationary expectations and raise interest rates to excessive levels and so have negative effects on the private propensity to invest;

(iv) that the absolute level of debt and debt service should not be allowed to grow so large that they significantly limit the margin for manoeuvre in budgetary policy and imply an excessive burden of taxation in the future.

7. When the rate of increase of the public debt exceeds the nominal growth rate of the economy, the interest burden will rise, other things remaining equal. In this situation, it may also become necessary to offer progressively higher rates in order to induce investors to hold progressively larger shares of public sector debt in their portfolios. In most countries this problem and the concurrent problem of a considerable debt service burden has become so urgent already that it calls for firm action to restrain further increases in public debt.

8. More moderate deficits, even if they persist, may not be a cause for concern, and in some countries it should be possible to allow for some increases in public debt in the medium term. The debt/GDP ratio may be a helpful indicator, but as it varies strongly between countries, any general

guideline of keeping it stable would mean in some countries and at some times a constraint on fiscal policy which would be too tight and which in others and in different situations would be too lax.

9. The composition of the debt may also cause problems. If in order to finance a deficit, governments borrow short because of low interest rates, they can create difficulties in the monetary field or find themselves with a dangerously liquid stock of debt. But provided that when the deficits are incurred, proper attention is paid to these monetary factors, the structure of the debts as a whole should not present major problems of economic policy and debt management.

Conclusions

10. Economic recession presents a serious challenge to budget policy. A primary political goal must be to establish steady, real growth with the greatest possible price stability, which can exploit the productive capacities of economy. Governments may continue to need to borrow to meet this objective.

11. When it is felt desirable to fix a medium-term target for the public budget balance, such a target must be assessed in the light of the economy's growth possibilities and the requirements of the policy of stability. The target should reflect the particular institutional structure of the economy.

12. An increase in public debt which matches the nominal increase in GDP does not necessarily represent an economic problem, especially if the level of debt and debt services burden is relatively low. Larger increases, however, could involve increases in the interest burden which could then lead to increases in taxation or crowding out of other public expenditure. Channelling expenditures into projects which generate cash flows will help to attenuate the consequences which a higher burden of interest on the public debt could otherwise have for taxation.

13. Especially at times when real interest rates are high and economic growth is weak, countries with a high debt/GDP ratio and a significant budget deficit will have no other alternative than to cut back public expenditures. For these countries a reduction of real interest rates would constitute an important step towards strengthening economic activity.

14. Medium-term budgetary policy should be directed, among other things, towards promoting growth possibilities by directing expenditures towards the most productive use. This requires a commitment to a progressive reduction of excessively high deficits over a realistic time horizon and a restructuring of public expenditure towards activities which increase the productive capacity of the economy.

Opinion of the Economic Policy Committee on protectionism

1. The Economic Policy Committee has examined the issue of rising protectionism and presents the following opinion.[1]

The economic background

2. Economic analysis shows that multilateral, free trade which enables and encourages individual countries to concentrate on what they are relatively best fitted to produce, yields the maximum advantage for the world as a whole. However, in order to reap these benefits it is imperative to accept the costs of continuous adaptation to new development.

3. A general rise in protectionism and attempts at economic autarchy in the past often worsened economic difficulties, while most of the prosperous periods were when trade and production expanded together. As international interdependence has strongly increased over the last few decades, protectionism would have even graver consequences today than in the 1930s.

4. The European Community is committed to the realization of free trade, not only internally but also in its external trade as stated in Article 110 of the Rome Treaty. The Community is the world's largest exporter, and the attainment of high employment and future growth therefore is directly dependent on the maintenance of an open multilateral trading system.

5. The European Community is also committed to a policy of support for the economic development of the less developed countries. A general recourse to protectionism would hurt these countries severely and the Community, therefore, has an obligation to counter the spread of protectionism.

The problems of the present economic situation

6. The Committee realizes fully that profound structural changes or fast technological developments can impose a severe burden on some economic sectors and that this burden might have to be more widely shared. But protectionism is not an answer to this problem as it will slow down the process of adjustment and tend to exacerbate the structural difficulties. Continuous adaptation to new technologies is essential for the maintenance of economic growth and international competitiveness.

7. These adjustments are particularly painful in a period of general recession and slack demand. Therefore, it is only natural that pressures arise for protectionism against fierce or unfair competition from abroad, and arguments are often put forward which make it tempting to give in to such pressures. Although temporary protection may ease the process of transition or keep basically sound industries alive during a short period of hardship, there is a danger that such temporary measures may turn out to last longer and become more restrictive than envisaged. In the longer term, welfare and economic progress is best served by maintaining the principle of free, multilateral trade and by carrying it out into practice.

8. At a time when unemployment is high and difficult to reduce, it is often argued that a move towards economic autarchy, of which protectionism is an expression, would increase employment temporarily in some countries by exporting unemployment to others. This argument, however, does not take into account the burden imposed on other sectors. Furthermore, it would provoke retaliation, and so would cause considerable disruption to existing trade patterns. At a world level, protectionism would therefore reduce rather than increase employment. A beggar-your-neighbour policy impoverishes all parties.

9. The European Community and its Member States cannot solve nor significantly ease the unemployment problem by resorting to protectionist measures such as an increase in the common external tariff or the imposition of general trade restrictions. Likewise, payments disequilibria on external accounts cannot be cured by attempts to restore balance in bilateral trade flows, but must be dealt with through the determination of relative exchange rates and efficient adjustment policies. In the view of the Committee, general macro-economic problems must be dealt with by coordinated demand and supply policies.

Response to 'unfair' competition

10. There has been an increase in non-competitive practices of all kinds in recent years. When faced with the likely or actual introduction of such practices by other countries, the Community must use all its powers of persuasion for the maintenance of a conduct in international trade which does not threaten the open trading system. The Community may need to pursue a policy of deterrence and, in exceptional cases, it must be prepared to retaliate forcefully, but such action should be taken with the utmost care in order to avoid trade warfare, which is damaging for all parties.

11. Likewise, temporary action to protect industries or firms which will be viable in the long run may slow down the general adjustment process and indeed increase rigidities within the ranks of both management and labour. Therefore, such action must be taken by means which support the

[1] This opinion was adopted and submitted to the Council and the Commission in March 1983.

adjustment process, e.g. by subsidizing early retirement, professional retraining, geographical mobility, etc.

12. During the last decade, the European economies may have lost part of their earlier adaptability and relative efficiency. These qualities cannot be regained by protecting the internal market from outside pressure. On the contrary, such a policy would only put the achievements of the common market at risk and result in a further loss of competitiveness. The best response to these pressures is to keep open the Community trading system and couple this with positive adjustment policies partly on a Community basis, which would open up new opportunities in high technology, and increase employment on a sustainable level, by dissipating inbred rigidities.

13. Special arguments may apply to new industries, especially in the field of high technology. In some cases, assistance may be appropriate, and it is sometimes argued that this should be done by temporary protection. But as such industries develop best in as competitive an environment as possible, any support should be provided by other methods.

The costs of protectionism

14. Protectionist measures taken against under-valued currencies would further unsettle the international monetary system. Indeed, such policies would make it more difficult to attain a stable system where exchange rates are determined and adjusted according to the fundamental factors of the economies.

15. Even when protectionist measures are used as part of the action against unfair specific practices by other countries or to help particular sectors, it must be borne in mind that such measures only shift the burden to other sectors either by raising costs, by strengthening monopolies or by encouraging over-production. Such selective trade restrictions will often lead to unintended trade shifts and to loss of competitiveness elsewhere which will give rise to further calls for protection. Seductive arguments for protectionism can sound convincing and be strongly promoted by vested interests. The wider costs are most often hidden but will have to be taken into account by the political leadership.

Conclusion

16. The EEC, being the world's biggest trading group, and having a large ratio of trade to GDP, has benefited and will benefit greatly from an open trading system. As the Community by its size is most likely to set a standard for trading behaviour in a troubled world, it should continuously put its weight behind attempts to keep international trade as free as possible in order to avoid a deepening of the recession.

17. Protectionist behaviour by the Community would impose considerable costs on its economy as well as on that of other countries. The macro-economic problems of the Community cannot be solved by protectionism, but only by appropriate demand and supply policies.

18. The Community should however keep a firm attitude towards threats and restrictions to free trade coming from other countries. In this respect, the Community must prove its coherence and show its determination in order to act in the commercial field in a concerted way.

19. It is the opinion of the Economic Policy Committee that only a policy of reinforced cooperation among countries in foreign trade and exchange, based on an open system, can serve as the necessary complement to such internal policies which will make it possible for each country to strengthen recovery in a non-inflationary way and to promote employment.

List of contents of European Economy Nos 1 to 18

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