ISSN 0379-0991

EUROPEAN ECONOMY

COMMISSION OF THE EUROPEAN COMMUNITIES • DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Economic trends and prospects

The Community's borrowing and lending operations — recent developments

No 8 March 1981

'EUROPEAN ECONOMY' appears three times a year, in March, July 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.

Three series of supplements accompany the main periodical:

Series A — 'Recent 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.

Series B — 'Economic prospects: business survey results', reports the main results (orders, stocks, production outlook, etc.) of opinion surveys of industrial chief executives in the Community. It also appears monthly, with the exception of September.

Series C — 'Economic prospects: consumer survey results', reports on the consumer survey, which is carried out thrice yearly (in January, May and October) throughout the Community (except Luxembourg) and measures consumers' opinion on the economic situation and outlook.

Subscription terms are shown on the back cover and the addresses of the Sales Offices are shown on page 3 of the cover.

Unless otherwise indicated the texts are published on the responsibility of the Directorate-General for Economic and Financial Affairs of the Commission of the European Communities, rue de la Loi 200, 1049 Bruxelles, to which enquiries other than those related to sales and subscriptions, should be addressed.

Commission of the
European Communities

EUROPEAN ECONOMY

March 1981 Number 8

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	Netherlands
UK	United Kingdom
EC	Total of the member countries of the European Community
EC 9	Community without Greece
BLEU	Belgo-Luxembourg Economic Union

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
FS, SFR	Swiss franc
SDR	Special drawing right

Other abbreviations, etc.

cif	Carriage, insurance and freight
EAGGF	European Agricultural Guidance and Guarantee Fund
EMCF	European Monetary Cooperation Fund
EMF	European Monetary Fund
EMS	European Monetary System
ESA	European System of Integrated Economic Accounts
Eurostat	Publication of Statistical Office of the European Communities
fob	Free on board (valuation basis for exports or imports of goods)
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDC	Less-developed country
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SOEC	Statistical Office of the European Communities
VSTF	Very short-term financing mechanism

( )	Estimate
:	Data not available
s.a.	Seasonally adjusted
,	Decimal point
—	Not applicable

Economic trends and prospects

Contents

List of tables

List of graphs

Note: Tables relating to 'Supply and uses of goods and services together with main economic indicators 1970-81' are given for each Member State, together with certain graphs and tables relating to individual Member States, in the relevant section of the text.

A table of changes in labour costs and ten tables of price and cost indicators, and a related chart, are included in the section on unit labour costs in manufacturing industry.

The Community economy

Introduction

The growth of economic activity in the Community decelerated sharply in 1980, gross domestic product (GDP) rising by only 1,3% after a 3,5% increase in 1979 (see Table 1).

The business climate in the Community, as measured by the *EC Business Surveys*, had already begun to weaken after mid-1979 under the impact of the oil-price shock. The cycle in activity reached a peak in the first quarter of 1980. The second quarter of that year saw a sharp and widely-based decline both in industrial output and in total output (gross domestic product). Gross investment and private consumption fell, while the changes in stocks and the foreign balance also made significant negative contributions to GDP growth. The decline in industrial and total output continued, although at a less rapid rate as private consumption recovered modestly, in the third and fourth quarters of 1980. In the second half industrial output was 3,4% lower than a year earlier; on the same comparison GDP was down by some 0,2%. The deterioration in business sentiment continued more or less throughout 1980 but may have been arrested around the turn of the year.

Despite cyclically-depressed productivity growth, there was hardly any increase in employment between 1979 and 1980, while the labour force continued to expand rather rapidly. The result was a sharp rise in unemployment: the average rate for the year was 6,2% (against 5,5% in 1979), and by the end of the year had reached 7,0% with the rate of increase continuing to quicken.

The deterioration in inflation performance which had begun in 1979 was accentuated in 1980; consumer prices in the Community rose by 12,1% in the latter year as against 8,9% in the former. The peak rate of increase in consumer prices was reached in the first half of the year. A deceleration followed, largely the lagged result of more moderate import price increases, but unit labour costs were rising more quickly in the second half of the year, as productivity fell at the annual rate of 2%, than in the first.

The Community's current account deficit in 1980, amounting to 1,3% of GDP, was the largest ever recorded. In contrast with 1979, exports in 1980 grew marginally faster than imports in volume terms. However, this was more than offset by a terms-of-trade deterioration (2,8%) considerably larger than that in 1979 (although still very much smaller than that suffered in 1974 after the first oil-price shock).

Intra-Community exchange-rate relations were less stable in 1980 than in 1979, but still considerably more stable than in the average of the six years preceding the introduction of the European Monetary System (EMS). The reduced stability in 1980 was largely the result of the rise in the UKL outside the exchange-rate mechanism of the EMS.

As regards external exchange-rate relations, developments for the average of 1980 were very different from developments through the course of the year. For 1980 as a whole the ECU again appreciated against the USD and the yen compared with 1979. However, by the end of 1980 the ECU was sharply lower than twelve months earlier against the USD and had lost even more value against the yen, the Community's competitive position thus tending to improve through the year, from a very unfavourable base, against both the US and Japan.

Prospects for 1981 have worsened since the previous round of Commission forecasts published in the Annual Economic Report for 1980/81 *(European Economy, No 7)*. The latest Business Surveys in the Community, however, provide the first evidence that the trough in manufacturers' production expectations may be in sight. The beginning of a recovery in manufacturing output could occur by mid-1981, but any such recovery is likely to be modest rather than very rapid as in 1976.

For 1981 as a whole, total industrial production is forecast to be 2,1% lower than in 1980 (Table 1). GDP could stabilize in the second quarter of the year, after falling for four quarters, the longest period of falling output in the Community's history. The second half of the year should be marked by a slow upturn (2,0% at an annual rate, after a fall of 1% at an annual rate in the first half), but GDP in the year as a whole is forecast to be 0,6% lower than in 1980. The change in stocks is likely to be the most strongly depressing factor in 1981, but final domestic demand is also likely to fall.

Employment could fall by nearly 1% in 1981 and the labour force will continue to grow. By the end of the year the unemployment rate in the Community could be above 7,5% and still rising.

The worsening of growth and employment prospects since the publication of the Annual Economic Report is not likely to be accompanied by a lower inflation rate than was previously foreseen since both import prices and productivity have developed more unfavourably than in the last round of forecasts. None the less, a significant slowdown in consumer prices can be expected during the course of 1981, as the effect of more moderate wage settlements in the first half of the year is reinforced by some rebound of productivity in the second half. Although consumer prices for 1981 as a whole could be up by around 10,5% on 1980 (Table 1), the annual rate in the second half of the year could, at 8,2%, be 4 ½ points lower than in the second half of 1980.

On current forecasts the Community's current balance (Table 1) is likely to change little during the course of 1981 and for the year as a whole could be slightly worse than the previous record deficit in 1980. A further worsening of the terms of trade in 1981 will slightly more than offset an improvement in volume movements.

Table 1

Key economic indicators for the Community

EC 9	1976	1977	1978	1979	1980 [1]	1981 [2]
GDP volume growth [3]	5,1	2,3	3,2	3,5	1,3	−0,6
Industrial production index [3]	7,4	2,4	2,3	4,9	−0,7	−2,1
GDP deflator [3]	9,7	9,6	8,5	8,8	11,5	9,9
Consumer prices (implicit index) [3]	10,2	9,8	7,3	8,9	12,1	10,4
Compensation per employee [3]	12,3	10,1	9,8	10,6	13,4	10,2
Real disposable household income [3]	1,8	0,2	3,9	3,2	0,9	0,1
Savings ratio [4]	18,0	16,8	16,8	16,7	16,3	16,5
Unemployment rate [5]	4,9	5,3	5,5	5,5	6,2	7,4
General government net borrowing [6]	3,8	3,3	4,0	3,6	3,6	4,0
Current account balance (1 000 million ECU)	−4,9	2,2	13,4	−9,2	−30,3	−34,5
Money supply [7]	12,9	12,3	12,7	11,2	10,1	8,2

1 Estimate.
2 Forecasts.
3 Percentage changes.
4 Disposable household income minus private consumption as % of disposable household income.
5 As % of civilian labour force — SOEC definition.
6 As % of GDP.
7 Average of money supplies of Member States weighted by 1978 GDP. December-on-December percentage increase.

Source: Commission services.

The European and other non-oil-producing countries are now undergoing the new readjustment process due to the second oil-price shock—whose impact on growth, prices and the balance of payments is similar to that of the first shock in 1973-74. The difficult task of governments, trade unions, employers and households lies in the need to avoid the policy errors and mistaken reactions that followed in 1974 and 1975. The consequences of the second heavy transfer of resources in favour of OPEC have to be accepted. This implies priorities for reducing the growth of nominal labour costs and for restructuring the productive potential of our economies through accelerated investments and energy substitution and savings. The scope for overall policy actions in the Community is very limited mainly because the high budgetary deficits after the first oil-price shock could not be reduced during the modest recovery period 1976-79, and because present inflation rates and inflationary expectations in most countries are still excessive. The limited policy contributions of governments could be widened if progress in countering inflation becomes more evident and if the structural policy efforts make rapid progress. Only in this way is it possible for Member States to help each other through having a coherent, collective programme for economic recovery and improvement in the employment situation.

This programme of policy coordination implies for the Community:

— maintenance of the generally convergent monetary and budgetary policy orientations approved in December 1980 and progress in strengthening the European Monetary System;

— stronger cooperation between the Community and the United States in monetary and exchange-rate policies;

— limited scope for demand-stimulatory actions through a qualified acceptance of automatic budget stabilizers, but more support for investment, a quicker restructuring and energy substitution policy, and improved labour retraining and mobility schemes.

World trade: trends and prospects

The growth of world trade in 1979 and 1980 has been very unequally distributed as between the main regions: imports of the OPEC countries, which fell sharply in 1979 as a consequence of the events in Iran, rose quite considerably in 1980, whereas imports of the OECD countries (including the

Community) after a rise of 9 % in 1979 are estimated to have fallen slightly in 1980. The stagnation of OECD imports in 1980 is attributable mainly to the decline in imports of the United States (−4,7% in volume terms), Canada (−4,8%) and Japan (−7,7%). In sharp contrast to trends in North America and Japan, however, imports of OECD Europe (excluding the EC) rose by as much as 5,9% in 1980 after a rise of 10,2% in 1979. Since the latter group of countries are relatively important trading partners for the Community, the growth of the Community's export markets (non-EC countries imports weighted according to their share in the Community's exports) in 1980 was faster (4,5%) than the unweighted growth in non-EC imports (1,8%).

In 1981 the pattern of world imports may be less favourable to the Community: imports of non-European countries are expected to recover somewhat while imports of the European OECD countries may decline. EC export markets may thus grow by only 1,8%. These annual figures are a reflection of a half-yearly profile showing a marked decline in world imports in the second half of 1980 followed by an upturn in the course of 1981, although the recovery of imports of the European OECD countries (excluding EC) may be slower than elsewhere in the world (Table 2).

Like the growth of volume imports world market prices have shown rather large divergences in the course of 1980. World export prices of food showed some degree of acceleration (due principally to an upturn of prices of food exports of the developed countries) while the rate of increase of prices of primary non-oil products slowed down considerably on an annual basis; indeed, a decline took place between the first and the second half of 1980, with a pronounced drop in prices of base metals. The price of fuels for the year 1980 as a whole rose by 66% in dollar terms as against 41,4% in 1979. However, the half-yearly figures show a very pronounced deceleration from a rise of 85,6% in the first half of 1980 (annual rate) to 18,2% in the second half.

This slowdown of the Community's import prices was, however, considerably tempered by the depreciation of the Community currencies (on average) against the dollar (see the section on exchange-rate developments below). In fact, between June and December 1980 the ECU depreciated by almost 9% against the dollar adding thus considerably to the import prices measured in national currencies, except in the case of the United Kingdom where, due to the appreciation of sterling against the dollar, import prices in national currency rose less than world market prices.

As shown in Table 3 the Commission services (in January) forecast a relatively low rate of increase in commodity prices through 1981. Due to these violent exchange-rate fluctuations the outlook for world market prices, however, now looks more uncertain than a few months ago. The rise in the dollar may in the course of 1981 exert a dampening influence on many commodity prices (expressed in dollar terms). It therefore cannot be excluded that a more pronounced slowdown in commodity prices could occur in 1981. Even so, as shown below, the rise in import prices of the Community measured in ECU will be substantial in 1981.

Table 2

World output, foreign trade and EC export markets

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

	1976	1977	1978	1979	1980	1981 [3]	1979		1980		1981 [3]	
							I	II	I	II	I	II
GDP/GNP, OECD total	5,2	3,7	3,9	3,6	1,5	0,9	3,0	3,4	1,6	−0,3	0,5	2,5
Imports of goods (volume)												
World	11,5	5,0	5,5	6,9	1,9	0,5	6,3	7,6	2,4	−4,4	1,2	4,4
World excluding EC	10,7	6,7	5,1	4,8	1,8	1,4	4,2	6,5	1,7	−2,4	2,1	4,1
of which:												
OECD excluding EC	12,9	6,8	5,1	7,1	−2,3	−0,7	7,5	3,1	−2,7	−7,1	0,5	3,4
OPEC	19,5	14,6	5,3	−15,0	18,2	13,0	−25,0	32,0	20,0	3,5	14,5	20,0
Other developing countries	5,0	6,6	7,5	9,0	3,5	1,5	10,4	5,0	3,0	2,8	1,0	1,2
Other countries	1,0	1,1	2,2	4,0	2,5	1,0	3,5	4,0	2,5	1,1	1,0	0,9
EC export markets [1]												
Intra markets	13,4	4,1	6,2	10,3	1,8	−1,1						
Extra markets	9,6	5,4	4,5	3,6	4,5	1,8						
Total	11,6	4,7	5,4	7,2	3,1	0,2						
Exports of goods, EC total [2]	10,8	5,2	5,2	6,7	1,9	0,1						

1 Imports to the various markets weighted together according to their share in EC exports (goods).
2 Including intra-EC trade.
3 Forecasts.

Source: Commission services.

Table 3

World export price developments (in USD), 1976-1981

(percentage change over previous period, annual rates)

	1976	1977	1978	1979	1980	1981 [2]	1979		1980		1981 [2]	
							I	II	I	II	I	II
Fuels	4,5	10,5	1,0	41,4	66,0	18,7	39,6	95,3	85,6	18,2	21,2	14,4
Food	−2,0	14,5	1,5	12,4	17,3	8,9	12,0	23,7	15,3	15,6	6,9	6,8
Other primary products	9,5	9,5	5,5	20,4	5,8	3,5	21,8	14,2	9,4	−8,0	3,4	16,4
Total primary products (excluding fuels)	2,3	12,5	3,1	15,5	12,8	6,8	15,8	20,0	13,0	6,4	5,5	10,5
Total primary products (including fuels)	3,4	11,5	2,1	28,4	39,4	12,7	27,7	57,6	49,3	12,3	13,4	12,5
Manufactured goods [1] (unit value)	3,0	6,5	12,6	12,8	10,0	7,5	10,3	10,7	9,0	11,0	6,0	8,0

1 Non-EC developed countries.
2 Forecasts.
Source: United Nations and estimates of Commission services.

Output and demand

The trend of economic activity in the Community in 1980 was strongly influenced by the fall in domestic demand following the second oil-price shock in less than ten years. The rate of growth of GDP fell back to 1,3%, less than half the rate achieved in 1979, although this was slightly higher than had originally been forecast due to a stronger than expected first quarter, notably in the Federal Republic of Germany. The subsequent slowdown, however, was particularly rapid with a sharp drop in the second quarter followed by further falls in the third and fourth (see Table 4). As a result, GDP growth of 1,9% in the first half gave way to a fall of 2,4% in the second half (see Table 8).

Industrial production in the Community, after rising steadily throughout 1979, reached a peak in the first quarter of 1980, then fell back markedly over the rest of the year (see Tables 1, 4, 5). Although the slowdown in the first quarter of 1980 compared with the last quarter of 1979 can be largely attributed to the fall in industrial production in the United Kingdom, the downturn in the second and third quarter was general for the Community as a whole. Some signs of an upturn, however, became apparent in the fourth quarter. In October, all Member States actually registered an increase in industrial production, and in November, the three-monthly average turned up for the first time since January (see Graph 1). Another fall in December, however, brought the result for the year to −0,7%, and industrial production in the fourth quarter of 1980 was 3,9% lower than a year ago.

While manufacturing industry provided most of the steam behind the upswing in 1979, compared with the other main sectors (agriculture, construction and services), it also bore the brunt of the recession in 1980 (Table 5). Likewise, the fast expansion in the intermediate goods sector in 1978 and 1979 was followed by a sharp fall in 1980. This was particularly true of those industries which had stepped up production for stocks in early 1979 in anticipation of raw material price increases, and which were then hit by a sharp drop in demand and consumption following the oil-price shock: chemicals, man-made fibres and oil refining, where oil is the principal input. The metal-processing industry also contributed to the decline in this sector: the steel strike in the United Kingdom in the first quarter merely exaggerated an already weakening trend in the European steel industry which was confirmed by a further large fall in the third quarter.

Production in consumer goods industries also fell sharply in the second and third quarters, as the squeeze on household disposable income gathered pace, and the only industry to have maintained relatively stable production was that of food, drink and tobacco, while footwear, clothing and textiles all saw sharp falls over the second two quarters.

Output in services (measured by gross value added (Table 6)) was also hit in 1980 in line with the slowdown in private and public consumption, but less so than industry and construction. The situation in the construction industry also worsened as the year progressed, largely due to the cutbacks in public expenditure on housing construction and the decline in investment expenditure by enterprises (see below).

In 1980, domestic demand grew at exactly the same rate as GDP, at 1,3% in volume terms, reflecting the stabilization of the foreign trade sector after the increase in speculative imports of 1979. Private consumption, which makes up more than half of total domestic demand remained strong in the first half of the year (+2,9%), and particularly in the first quarter. Since real disposable household incomes accelerated by only one point between 1979 and 1980, this was probably financed out of reduced savings. In the second half of the year, however, this trend seems to have reversed: consumer spending fell sharply (−0,8%), despite a slowdown in the rate of increase of consumer prices, and the savings ratio was

almost restored to its previous level: there was a fall of only 0,4 percentage points in the household savings ratio for the year as a whole.

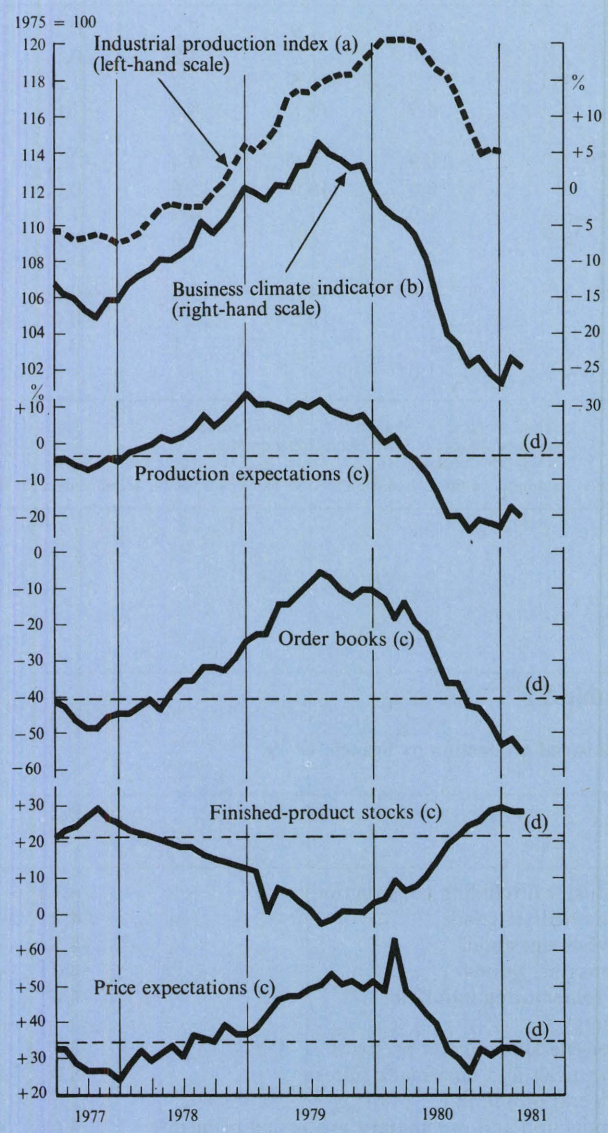
The slight slowdown in the rate of growth of public consumption for 1980 as a whole conceals a sharp drop between the two halves of the year. Expansion of some 2,9% in the first half of 1980 was replaced by a decline of 0,8% in the second half, as governments in most Member States stepped up their efforts to reduce expenditure and budget deficits in spite of the difficulties attaching to such an operation in times of declining activity and rising unemployment.

In 1980, as in 1979, gross fixed capital formation grew faster than GDP, although this was concentrated entirely in the first quarter, before the financial situation of enterprises deteriorated in the face of high interest rates and a general tightening of financial conditions as the authorities continued to give overriding priority to anti-inflation policy. By the second half of the year, investment was falling at a rate of some 3% on an annual basis; as demand and production fell, investment in equipment and machinery slumped, particularly in the United Kingdom, Italy and Denmark. The fall in investment in buildings, which had been quite marked in some Member States in the first half of the year, slowed somewhat in the second half, however.

Inventory formation exerted a negative influence on activity growth in 1980, the result of a sharp fall in imported raw materials and a rundown in finished product stocks as the recession deepened. In fact, the build-up of imported raw material stocks in anticipation of further price rises, which had been very heavy in the third quarter of 1979 came to a complete halt in the fourth quarter of that year. On top of this drop in raw material stocks, the rise in finished product stocks came to a halt towards the end of the year with enterprises responding to falling demand and worsening financial conditions by cutting production and selling from stock.

The prevailing opinions of heads of enterprises in the Community is reflected in the monthly business surveys (see *European Economy*, Supplement B). From July to December 1980, the business climate indicator fell by 22 points, a more severe drop than in 1977, but much less than in 1974/75. The trend in the three major product categories at first behaved rather differently: the outlook for intermediate and investment-goods industries deteriorated much sooner than the outlook for consumer-goods industries, the indicator for those two industries falling by 10 points between the first and second quarters of 1980 compared with only 5 points for consumer-goods industries; by the third and fourth quarters, projected development of production in all three groups was at around the same level. Unsurprisingly, lack of demand was the principal cause of this decline in business sentiment: in December chief executives in all Member States surveyed

GRAPH 1: **Business survey indicators for manufacturing industry and the index of industrial production, EC 9**



(a) Industrial production excluding building and construction and, in the case of France, the foodstuffs and beverages industry. Three months' moving average.
(b) Composite indicator based on the replies to the questions on production expectations and stocks of finished products. The indicator is an average of the net balances: i.e. differences between the percentages of respondents giving positive and negative replies.
(c) Net balances: i.e. differences between the percentages of respondents giving positive and negative replies.
(d) Dotted line shows average for 1968-1977.
Source: European Community business surveys.

Table 4

Major supply and demand components, EC 9

(percentage change over preceding period, in volume, annual rates, seasonally adjusted)

	GDP	Imports [1]	Exports [1]	Foreign balance [1 2]	Domestic demand	Change in stocks [2]	Gross fixed investment	Private consumption	Government consumption	Industrial production index [3]
1978 1	2,9	7,9	7,6	0,1	3,4	−1,8	5,1	5,1	6,2	4,5
2	6,4	7,2	4,8	−0,5	6,8	1,4	8,2	5,1	2,6	3,2
3	2,2	10,5	2,7	−1,7	3,9	1,3	1,9	3,3	0,7	2,4
4	4,9	13,8	8,8	−1,0	5,9	1,9	5,2	3,4	3,9	10,0
1979 1	0,9	9,8	0,4	−2,2	3,4	1,0	−7,0	5,7	2,5	3,2
2	6,6	16,0	15,6	0,0	6,7	−1,4	16,6	7,0	2,8	7,0
3	1,9	13,0	4,9	−1,9	3,6	4,0	10,2	−4,3	1,5	3,2
4	4,8	6,6	2,9	−0,9	5,8	0,0	9,6	5,6	2,4	4,5
1980 1	4,9	14,8	13,6	−0,3	4,9	−0,6	2,5	7,5	2,8	2,0
2	−5,3	−10,5	−12,7	−0,6	−4,5	−1,1	−3,4	−5,4	3,4	−5,1
3	−1,7	−3,1	−1,1	0,5	−1,9	−2,7	−2,6	1,7	2,0	−10,1
4	(−1,0)									

1 Goods and services, including intra-Community trade.
2 Change as percentage of GDP of preceding quarter.
3 EC total (all Member States).

Source: Estimates by the Commission services based on national accounts data for the Federal Republic of Germany, France, Italy and the United Kingdom.

Table 5

Industrial production by branch, EC 9

(percentage change over previous period, seasonally adjusted)

	1971-74[1]	1975	1976	1977	1978	1979	1980		
							I	II	III
Industry (excluding construction)	4,1	−6,6	7,4	2,4	2,3	5,0	0,5	−1,3	−2,8
Intermediate goods	4,7	−9,5	9,9	2,1	2,9	6,3	0,1	−2,1	−3,9
Investment goods	4,3	−3,4	1,8	2,7	0,3	3,4	−0,9	1,0	−2,1
Consumer goods	4,0	−4,6	7,6	2,5	2,7	3,9	1,0	−1,8	−1,9
Manufacturing industries	4,4	−7,7	7,4	1,9	1,7	4,4	0,3	−1,2	−2,9
Energy [2]	:	−1,6	9,6	5,9	6,1	9,5	0,8	−1,8	−1,5
Non-metallic mineral products	3,7	−8,8	6,8	2,3	1,1	4,5	2,0	−2,5	−3,0
Chemicals and man-made fibres	8,0	−10,7	13,7	2,0	4,9	5,7	0,7	−3,8	−6,0
Mineral oil refining	2,5	−13,7	10,8	−0,9	−0,5	7,8	−2,5	−2,4	−4,0
Production and preliminary processing of metals	6,6	18,4	8,9	−2,0	3,6	5,3	−8,0	4,5	−6,6
Engineering and allied industries	3,8	−5,7	5,4	3,0	1,2	3,7	0,4	−1,2	1,3
— Motor vehicles, parts and accessories	1,1	−3,2	12,7	5,5	2,1	4,0	0,3	−2,7	−5,4
Food, drink and tobacco industry	3,3	−0,1	3,5	0,1	3,6	3,2	0,2	−1,7	1,5
Textiles industry	1,3	−7,6	10,0	−2,9	−2,9	5,1	1,8	−1,3	−5,2
Clothing industry	−0,7	−2,0	5,6	−1,8	−4,3	5,2	1,4	−6,7	−1,7
Footwear manufacture	0	−5,2	1,0	0,7	−3,7	3,3	−3,3	13,0	−4,1
Manufacture of paper and paper products	5,4	−16,1	11,4	2,2	3,8	5,6	0,5	−1,9	−3,0

1 Average change over the period indicated.
2 Including mineral oil refining.

Source: Eurostat and Commission services.

Table 6

Output and employment by sector, EC 9

(percentage change over previous year)

	Gross value added at 1970 prices and 1979 exchange rates						Wage and salary earners					
	1976	1977	1978	1979	1980	1981[2]	1976	1977	1978	1979	1980	1981[2]
Agriculture, forestry and fishing	0,0	3,7	4,6	1,5	3,1	2,0	−0,4	−1,3	−3,5	−1,9	−1,7	−1,4
Industry	7,5	2,2	2,3	4,7	0,3	−0,8	−1,6	−0,5	−1,0	0,6	−1,2	−2,6
Construction	1,5	0,9	2,5	3,2	1,4	−2,0						
Services	4,0	3,0	3,2	3,2	1,8	−0,3	1,4	1,2	2,0	2,2	1,0	0,2
Total [1]	5,0	2,5	2,9	3,5	1,2	−0,6	0,1	0,6	0,5	1,1	0,0	−1,0

1 Total gross value added at market prices differs from GDP at market prices primarily because the latter includes the value of taxes linked to imports.
2 Forecasts.
Source: Commission services.

were reporting insufficient demand as the major factor limiting output. While shortages of labour and equipment were cited as significant in some cases, their importance was clearly declining, as labour supplies and capital stock became more abundant in relation to weaker demand for industrial products.

Since the end of the year, expectations have improved: in January 1981 the business climate indicator rose by 5,5 points, particularly due to an apparently sharp turnabout in producers' expectations in the United Kingdom. Other Member States showed similar positive movements but on a more modest scale. The upturn in sentiment is not uniform across sectors however. Expectations seem to be improving in the consumer-goods and intermediate-goods industries but those in the investment-goods industries are still declining.

Other leading indicators also showed the same trend in January. Judgments on the level of finished-product stocks, which had deteriorated by some 26 percentage points in the course of 1980 improved by 3 percentage points in January, the first time the majority of chief executives considering that stock levels were above normal has declined since July 1979, although the level (+27) is still considerably above the average for the years 1968-77. Judgments on order books also turned up slightly (6 percentage points) in January, but this contrasts with a decline of 40 percentage points during 1980.

On the whole, therefore, these preliminary results would suggest that the decline in industrial production may reach its low point some time in the first quarter and that the underlying trend would be on the upturn by the middle of the year.

Some indications of the outlook for consumer behaviour during the first half of 1981 can be gauged from the EC consumer surveys (Table 7). According to the last survey carried out in January 1981 in eight of the Community countries, there was a slight deterioration in consumer confidence in the Community as a whole compared with the previous survey in October 1980. In line with their assessment of a deterioration in both the general economic

Table 7

Index numbers of consumer sentiment, EC 9

(index numbers 1975 = 100)

	Financial situation of households, next 12 months	Intentions to make major purchases	Saving intentions, next 12 months
1976	102	108	100
1977	103	107	99
1978	106	110	103
1979	105	108	104
1980	99	104	99
1978 May	106	112	103
October	106	110	103
1979 January	105	108	105
May	107	110	105
October	102	106	102
1980 January	98	107	101
May	99	104	100
October	99	101	96
1981 January	96	100	98

Source: European Community consumer surveys, *European Economy* Supplement C, No 3, December 1980.

situation and their personal financial situation, consumers have responded by reducing their intentions to make major purchases while at the same time their savings expectations are on the whole lower. Given that consumer confidence is currently at a very low level, comparable to that of 1974, this would nevertheless suggest that consumer spending in the Community will remain weak throughout the first half of 1981.

Assuming no change in savings behaviour, private consumption growth is forecast to fall to 0,2% in 1981 as a whole, with an absolute decline in the first half, followed by positive growth of 2,0% in the second half as real disposable incomes rise in the wake of a slowdown of price increases (see Table 8). A failure for prices to rise less fast than expected could, however, trigger a rise in savings which would seriously retard the revival of private consumption in the second half of the year, especially since on current forecasts, disposable household incomes only rise by 0,1 percentage point for 1981 as a whole.

A severe drop in the rate of growth of government consumption is forecast for 1981, with a continuation of the modest rate reached in the second half of 1980 (0,8%). Even so, public consumption will still grow faster than all other components of domestic demand.

The downward trend in gross fixed capital formation begun in the second half of 1980 will continue in 1981: for the year as a whole, investment expenditure is forecast to fall substantially faster than GDP (−2,5%). Given the usual lag in investment relative to the trend in overall activity, the trough in the investment cycle will probably not be reached until sometime in the second half of 1981: for the first half of the year investment will still fall at the same rate as in the second half of 1980, and indeed, for some Member States, including the Federal Republic of Germany, the United Kingdom and Belgium, investment growth is forecast to remain negative throughout the year.

Stockbuilding will again contribute the largest negative impact to GDP growth in 1981. While the negative influence of investment expenditure will be offset to a certain extent by both public and private consumption growth so that the

Table 8

Demand, output and external balance, EC 9

	1960-69 [3]	1970-80 [3]	1977	1978	1979	1980	1981 [3]	1980	1981 [3]	
	Annual averages							II	I	II
					% change at 1975 prices					
Private consumption	4,6	3,4	2,3	3,9	3,7	1,6	0,2	−0,8	−0,3	2,0
Public consumption	3,6	3,1	1,0	3,7	2,7	2,2	0,8	0,8	−3,0	0,7
Gross fixed investment	5,7	2,0	0,8	3,0	4,0	2,0	−2,5	−3,0	−3,0	0
Stockbuilding [1]	1,3	1,0	1,2	0,8	1,7	1,2	0,6	0,7	0,4	0,8
Final domestic demand	4,7	3,0	1,6	3,3	4,6	1,3	−0,9	−3,0	−1,3	2,4
Exports [2]	8,0	6,2	5,0	4,7	6,1	2,1	0,1	−5,3	0,8	4,4
Imports [2]	8,2	5,9	1,9	5,8	10,3	2,4	−0,9	−7,9	−0,4	4,6
Gross domestic product at market prices	4,7	3,1	2,3	3,2	3,5	1,3	−0,6	−2,5	−1,0	2,0
					Contributions to changes in GDP					
Domestic demand (excluding changes in stocks)	4,6	2,8	1,6	3,4	3,5	1,7	−0,3	−1,1	−0,7	1,3
Stockbuilding	0,0	−0,0	−0,1	−0,2	1,0	−0,5	−0,6	−1,9	−0,6	0,8
Foreign balance	0,0	0,1	0,7	−0,2	−1,0	0	0,2	0,6	0,2	−0,1
					as % of GDP					
Trade balance (fob/cif)	−1,0	−1,0	−0,6	−0,1	−1,6	−2,5	−2,5	:	:	:
Current balance	0,5	0,0	0,2	0,8	−0,5	−1,5	−1,5	−1,4	−1,5	−1,5

1 As % of GDP.
2 Goods and services.
3 Forecasts.
Source: Eurostat and Commission services.

contribution of domestic demand (excluding stocks) to the fall in GDP growth is limited to 0,3 percentage points, the continuing rundown in stocks of both raw materials and finished products, particularly in the first half of the year, will contribute a further 0,6 percentage points to the fall in GDP.

The overall negative contribution from total domestic demand of 0,9 percentage points will be slightly offset by a small positive contribution of 0,2 percentage points from the foreign balance, after a neutral contribution in 1980. Import growth is expected to decline, particularly in the first half of the year while export growth will expand in the first half already, and should expand marginally faster than the growth of export markets.

The trend of output in 1981 is expected to follow the same general profile as the demand components. No significant improvement in the underlying trend of industrial production is expected in the early months of 1981, and in the first half of the year it is expected to decline by a further 1,2% (annual rate). In the second half, modest positive growth of some 3,0% (annual rate) is forecast, but even so, industrial production for 1981 as a whole is expected to fall by 2,1% relative to 1980. On a sectoral basis, manufacturing industry (plus fuel and power) will provide most of the decline in 1981 with a further fall in output compared with 1980 (see Table 6). The highest output growth is again expected in the agricultural sector, but construction and services, both of which were less hard hit than industry in 1980, are forecast to show absolute falls in output in 1981.

Following this profile, the downward trend in activity is expected to come to a halt during the first half of 1981, with the Community economy on the upswing by mid-year. GDP is forecast to fall by some 1,0% in the first half, but should turn round strongly in the second half to achieve 2,0% growth (annual rates). For the year as a whole, however, GDP is forecast to fall by 0,6%.

Labour markets

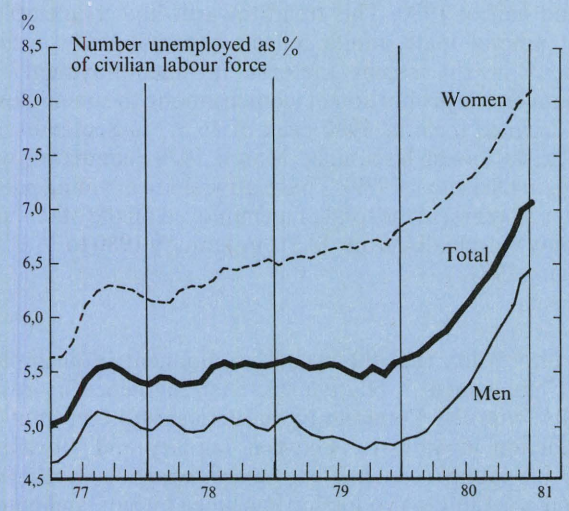
The labour-market situation in the Community worsened during the course of 1980: unemployment reached new record levels and the number of available jobs declined as labour-force growth outstripped the growth of employment. By the end of 1980, there were 7,7 million people unemployed in the Community, equivalent to just under 6,2% of the occupied population (seasonally adjusted), the major contributory factor being the sharp recession in economic activity.

The sharp fall in GDP growth, from 3,4% in 1979 to 1,3% in 1980 showed clearly in its effects on employment. After growing strongly, by some 0,6% in 1979, employment failed to expand at all in 1980, the worst result since 1976, but there was no repeat of the absolute falls which occurred in the 1974/75 recession, since there was also a parallel slowdown in productivity growth. The bulk of this contraction has been borne by manufacturing industry, in the wake of sharp declines in industrial production in most sectors, and particularly the labour-intensive ones, such as textiles, footwear, and clothing. At the same time, however, employment growth in the service sector which is essentially consumer-orientated, has suffered from the squeeze in real disposable incomes in the middle quarters of the year, as well as an increasing trend towards the use of labour-saving technology. As a result, it has failed to act in its traditional role as safety-net in times of slack labour demand, and the employment growth which has occurred has been insufficient to compensate for the shortfall in the other two sectors.

Labour-force growth, on the other hand, has continued at a relatively high rate: after reaching 0,9% in the boom year of 1979, it slipped back slightly to 0,6% in 1980, but even this is far in excess of the growth of employment. To a certain extent this rapid growth is due to demographic factors: a higher than average number arriving at school-leaving age combined with a lower than average number reaching retiring age. On the other hand, preliminary indications on participation rates give conflicting results for different Member States: in some there has been a rise in the size of the labour force, due to increased unemployment registration of women, while in others there has been a decline in the measured labour force due to lower registration behaviour.

Overall, unemployment in the Community by the end of 1980 was some 27% higher than it had been a year

GRAPH 2: **Unemployment (s.a.), EC 9**



Source: Eurostat.

Table 9

Employment and unemployment, EC 9

	1980 in 000	1976	1977	1978	1979	1980	1981 [4]
		(Percentage changes over previous year)					
Active population [1]	114 880	0,6	0,8	0,6	0,9	0,6	0,6
Employment total	108 080	−0,1	0,3	0,4	0,6	0,0	−0,9
Wage and salary earners	91 414	0,1	0,6	0,6	1,0	0,5	−1,0
Unemployed [1]	6 804	13,6	9,5	4,1	1,5	12,3	24,0
— Unemployment rate (%) [1]		4,9	5,3	5,5	5,5	6,2	7,4
Vacancies [2]	600	−2,9	2,8	11,6	16,4	−15,7	:
GDP volume growth		5,1	2,3	3,2	3,4	1,3	−0,6
Productivity growth [3]		5,2	2,0	2,8	2,8	1,3	0,3

1 SOEC definition (% of active civilian population).
2 Excluding I and IRL.
3 Index of GDP volume divided by employment index.
4 Forecasts.
Source: Eurostat and Commission services.

previously. The tendency, noted in the Annual Economic Report 1980/81, for women and young people under 25 years to be more seriously affected by unemployment continued, but by the end of the year, the biggest increases in unemployment were among male adult workers, a significant number of whom are probably construction workers: recent results from the EC business surveys show a marked drop in employment expectations in the construction industry in the second half of 1980. This trend towards higher unemployment among male adults reflects the essentially cyclical element in the recent increase in unemployment. By December, the proportion of women among the unemployed had declined from its 1980 peak of 45,6% in September, to 43,1%, its lowest level since March 1979 (compared with 45,8% in December 1979). The relative share of young people (under 25 years) in the total of unemployed on the other hand fell only marginally, from 38,2% in January 1980 to 37,9% in January 1981.

The impression that the cyclical component in unemployment has gained in relative size is strengthened by recent results from the Community business surveys on limits to production in industry. Between January and November 1980 the number of chief executives reporting shortage of labour as a limit to production has fallen by half, and among the Member States this trend is even more marked in the United Kingdom, the Netherlands and Ireland.

No early improvement in the overall labour-market situation is expected in 1981. The rate of unemployment is now forecast to reach 7,4% on average for the year as a whole, 0,5% higher than was forecast in the Annual Report, with the upwards revision attributable principally to the downward revision of the forecast for output (GDP is now expected to decline by 0,6% as against a rise of 0,6% forecast in October). Assuming an upswing in activity in the second half of 1981, unemployment may still not stabilize before mid-1982. Given the forecast increase in the labour force, employment growth must in fact achieve levels in excess of 1,0% per annum if unemployment is actually to decline. For 1981, employment is forecast to fall by 0,9%. The low level of productivity growth in 1980 and 1981 would also seem to indicate that the labour 'shake-out' during the present recession is somewhat less than might be indicated by the absolute unemployment figures, although the increase in the numbers unemployed in 1980 (12,3%) and in 1981 (24,0%) is much less than in 1975 (50,4%). Comparing productivity growth with output growth in 1980 and 1981 suggests, however, that while employment was probably being protected more than productivity during the downturn in 1980, the trough of the recession in the first half of 1981 is likely to see a much more severe employment effect alongside a relatively better performance of productivity compared to output in 1981. In addition, the immediate effects of any upturn in the second half of the year are also likely to be reflected by a rise in productivity rather than a rise in employment.

Prices and incomes

After accelerating in 1979 and in early 1980, the rate of increase in the consumer price index slowed down during the second half of 1980. On a twelve-month basis, the rate fell from 14,9% in May 1980 to 13,3% in December.

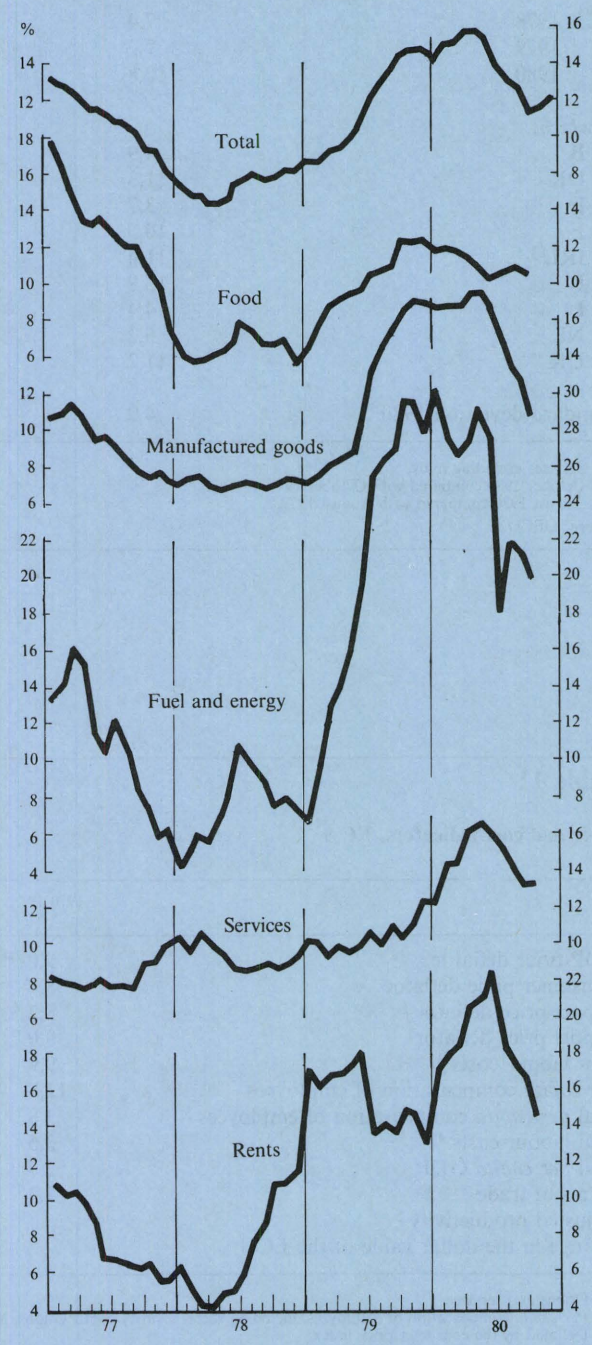
Among the major expenditure items, energy and electricity prices showed the most marked acceleration, rising by 22,8% between October 1979 and October 1980, compared with an average figure of 16,1% for 1979 and 7,1% for 1978. Unlike in 1978, the increase in rents outstripped the average increase in consumer prices in 1979 and 1980. However, taking the average for 1980, food prices had a moderating influence overall (Table 10). Even so, the upward movement in food prices showed only a modest deceleration during 1980 while non-food prices, energy prices, the prices of services, and rents have lost a great deal of momentum since the spring of 1980—witness the seasonally adjusted six-month increase (Graph 3).

As the increase in consumer prices gathered pace in 1979 and in 1980, the spread between the lowest and the highest rate widened. Although the Community average fell and although the degree of dispersion (measured by the standard deviation) around this rate of increase narrowed slightly, the gap between the lowest and the highest rate did not narrow during 1980 (Graph 4).

In most member countries, the consumer price index traces movements in the prices of a basket of goods consumed by what may or may not be a specific type of household and thereby sheds light on the position of the average consumer. As a result, however, price movements are more volatile than those identified by the consumer price indices based on the macroeconomic aggregates of national accounts. The consumer price deflator rose by 12,1% in 1980, compared with 9,4% in 1979, and the GDP price deflator, which gives the overall change in domestic costs, climbed by 11,5% in 1980, compared with 9,5% in 1979 (Table 11). The fact that the consumer price deflator outpaced the GDP price deflator, the opposite of what happened in 1978, can be put down partly to changes in the terms of trade, which deteriorated by 3,3% in 1980 (following a 1% deterioration in 1979). Overall, the divergences in inflation rates in the individual member countries as pinpointed by the consumer price index are also reflected in the price indices calculated on the basis of the national accounts aggregates expressed in terms of national curencies. In this respect, the Member States fall into three groups: those experiencing relatively low inflation (the Federal Republic of Germany, the Benelux countries); those experiencing high inflation (Italy, the United Kingdom, Ireland); and those falling in between

GRAPH 3: **Consumer prices and main components, EC 9**

(Change on six months (s.a.) expressed at an annual rate)



Source: Eurostat, OECD and Commission staff.

Table 10

Components of consumer price developments

	Food	Non-food goods	Fuel and light	Services [1]	Rents	Total
EC 9 1978	7,4	7,3	7,1	9,3	6,4	7,5
1979	9,2	10,1	16,1	9,7	14,3	9,9
1980 [2]	10,8	13,6	22,8	14,4	17,3	13,1
of which:						
B	4,9	8,3	:	6,4	9,7	7,0
DK	11,3	10,7	22,8	9,8	7,4	10,7
D	3,7	6,1	7,1	4,9	4,8	5,1
F	10,5	15,6	21,8	14,2	13,6	13,5
IRL [3]	11,4	22,4	41,6	:	20,9	18,8
I	16,8	24,7	40,1	20,4	21,0	21,1
L	4,4	:	9,2	:	:	6,0
NL	5,2	9,4	21,9	5,6	7,5	6,6
UK	11,2	13,5	27,1	20,7	29,2	15,4
Standard deviation 1980	4,2	6,3	12,7	6,3	8,0	5,0

1 Services excluding rents.
2 October 1980 compared with October 1979.
3 August 1980 compared with August 1979.
Source: OECD.

Table 11

Price and cost indicators, EC 9

	1970-79	1974	1975	1976	1977	1978	1979	1980	1981 forecasts
GDP price deflator	9,0	11,1	13,5	9,7	9,6	8,5	9,5	11,5	10,0
Consumer price deflator	8,7	12,7	12,5	10,2	9,8	7,3	9,4	12,1	10,4
Export price deflator [1]	8,2	23,1	7,7	9,6	8,3	4,0	9,7	11,6	9,9
Import price deflator [1]	9,0	36,1	4,4	12,0	8,5	0,9	10,9	15,4	10,9
Unit labour costs [2]	9,9	15,3	16,4	7,1	8,3	7,0	8,2	11,9	10,0
Per capita compensation of employees	12,8	16,9	16,3	12,3	10,1	9,8	10,7	13,3	10,1
Real *per capita* compensation of employees [3]	3,8	3,7	2,7	1,4	−0,3	2,1	0,6	−0,4	0,0
Real labour costs [4]	3,5	5,2	2,5	2,4	0,5	1,2	1,0	1,6	0,1
Real *per capita* GDP	2,7	1,4	−0,1	4,9	1,7	2,6	2,3	1,3	0,4
Terms of trade	−3,3	−9,6	+3,2	−2,1	−0,2	+3,1	−1,0	−3,3	−0,9
Adjusted productivity [5]	:	−0,6	0,9	4,6	1,8	3,4	2,2	0,4	−0,2
Change in the dollar value of the ECU	:	−3,1	4,0	−9,8	2,1	11,6	7,5	1,4	−3,6

1 Goods and services.
2 *Per capita* compensation of employees, including social security contributions, by unit of GDP at constant prices.
3 Deflated by the consumer price index.
4 Deflated by the GDP price deflator.
5 Adjusted productivity is defined as follows: GDP at 1975 prices plus exports at current prices, deflated by the import price deflator minus exports at 1975 prices = GDP adjusted for the terms of trade. This adjusted measure of GDP is then divided by total employment.
Source: Commission services.

(Denmark, France). The forecasts for 1981 point to a change in this classification, with the United Kingdom moving into the intermediate group (see below).

Since the exchange rates of the currencies participating in the EMS have remained virtually unchanged, inflation differentials were not offset to the same degree as in previous years, except in Denmark, where the krone showed an average fall in value against the ECU of close on 8,6% between 1979 and 1980. The Italian lira lost only 4,3% against the ECU, even though inflation in 1980 was running 8,2 points above the Community average. The position of the United Kingdom is different in that it does not participate in the exchange-rate mechanism and in that sterling rose by 7% against the ECU in spite of an inflation rate well above the Community average. Some countries such as the Benelux countries which urgently need to improve their competitiveness succeeded in this respect, with their performance in 1980 not having been offset by a relative appreciation in their currencies. Because of the trend in the exchange rate of sterling, the overall divergence in consumer prices in the Community calculated in ECU terms (7,3) was more marked in 1980 than that calculated in terms of national currencies (5,6).

Nominal wages (*per capita* compensation of employees) climbed by around 13,3% in 1980, as against 10,6% in 1979. This, however, was only a very modest increase compared with 1974 and 1975, and did not match the increase in consumer prices. In the United Kingdom, the reintroduction of free collective bargaining between the two sides of industry did not lead to any wage explosion in 1979 or in 1980. At the end of 1980 and in early 1981, settlements seemed to be being struck at a level that did not engender any marked distortions either, although the limit expressly indicated as being desirable by the Government (6,5%) was not observed in all cases. In some countries, the authorities are urging wage restraint but the indexation mechanism has not been seriously challenged in Italy or Belgium, although, in the case of Belgium, a freeze on wages and salaries over BFR 35 000 per month, envisaged in the recovery programme adopted in January, was part and parcel of the agreement signed between the two sides of industry in February, although the freeze applies only to increases over and above those warranted under the indexation mechanism. Real *per capita* compensation of employees declined by 0,4% in 1980, while productivity rose by 1,3%. However, in view of the serious deterioration in the terms of trade, adjusted productivity (GDP per person employed adjusted for the impact on national income of changes in the terms of trade) rose by only 0,4%, with the result that, even in 1980, the slowdown (discernible since 1976) in the upward movement of labour costs relative to the increase in real national income continued.

If the two sides of industry continue to show restraint in 1981, as is suggested by the level of settlements to date for 1981, producers will be better able to cope with the trend in their other costs and to climb out of the recession quickly. Even so, the price forecasts for 1981 compiled by the Commission staff in September 1980 have had to be revised upwards. The slowdown in activity at the end of 1980 and in early 1981 will permit only a small gain in productivity (0,4%). The ECU's appreciation against the dollar between 1977 and October 1980 served to offset in part the deterioration in the terms of trade.

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

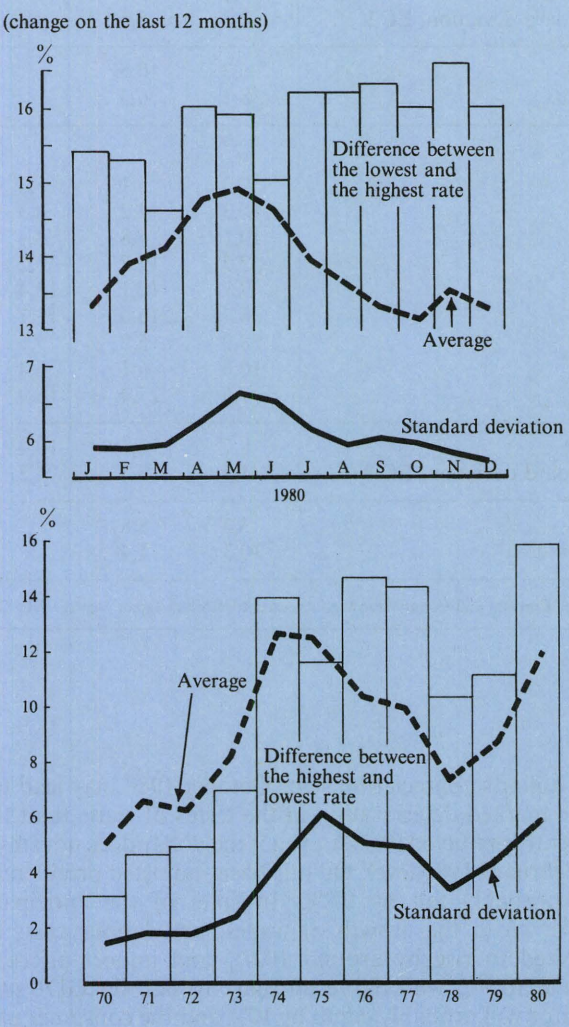


Table 12

Trend and divergence of prices and costs, 1970-81

	Consumer price deflator			GDP deflator			Unit labour costs		
	1970-79 average	1980	1981 forecasts	1970-79 average	1980	1981 forecasts	1970-79 average	1980	1981 forecasts
				(national currencies)					
B	6,7	6,2	6,0	7,2	5,1	6,1	9,2	6,5	6,9
DK	9,6	11,0	9,5	9,5	8,5	8,9	9,7	9,5	8,2
D	5,1	5,4	4,5	5,4	5,0	4,4	6,2	5,6	4,0
F	8,6	13,5	11,8	8,9	11,9	11,3	10,3	12,9	11,5
IRL	12,7	18,2	15,0	13,2	14,8	14,3	14,7	21,2	13,0
I	13,0	21,2	17,9	13,3	20,8	16,9	15,4	19,1	19,7
L	6,3	6,3	6,3	7,0	4,4	6,7	10,9	9,6	9,3
NL	7,4	6,5	6,3	7,7	5,6	5,2	8,3	5,3	3,6
UK	12,1	16,1	11,0	12,6	19,0	12,3	13,1	20,5	10,4
EC	8,7	12,0	10,4	9,0	11,5	10,0	9,9	11,9	10,0
Standard deviation, EC 9	2,8	5,6	4,3	2,8	6,0	4,1	2,8	6,1	4,6
USA	6,3	10,5		6,6	9,5		10,8		
Japan	8,1	6,3		7,2	2,0		−1,0		
				(ECU)					
B	9,3	5,1	5,3	9,8	4,0	5,4	11,8	5,2	6,2
DK	10,3	2,2	8,3	10,2	−0,1	7,7	10,4	0,6	7,0
D	10,1	4,8	4,4	10,5	4,4	4,3	11,3	5,6	3,9
F	7,5	12,7	10,2	7,8	11,1	9,7	9,2	12,4	9,9
IRL	7,7	17,1	13,4	8,2	13,7	12,8	9,7	21,2	11,5
I	6,7	16,0	13,7	7,0	15,6	12,8	8,9	15,7	15,5
L	8,9	5,2	5,6	9,6	3,3	6,0	13,6	8,9	8,6
NL	10,6	6,1	6,4	10,9	5,2	5,3	11,5	4,6	3,7
UK	7,5	25,4	16,9	8,0	28,5	18,2	8,5	27,6	16,2
EC 9	8,7	12,1	10,4	9,0	11,5	10,0	9,9	11,9	9,7
Standard deviation, EC 9	1,3	7,3	4,2	1,3	8,3	4,4	1,6	8,6	4,3
USA	3,2	8,8		3,5	7,8		3,7	9,1	
Japan	10,3	1,4		9,3	−2,8		9,9	−5,6	

Source: Eurostat and Commission services, except USA and Japan *(source:* OECD).

The dollar's appreciation since October 1980 may lead to a more marked deterioration in the terms of trade than that currently predicted (0,5%), even if the dollar does not stay at its February 1981 level. On this basis, adjusted productivity will probably fall by 0,2%. In spite of the anticipated slowdown in the growth of wages, unit labour costs are expected to rise by around 10,0% and import prices by around 10,9%, with the result that, overall, the GDP price deflator will probably climb by 10% and the consumer price deflator by 10,9%. All in all, the increase of 0,1% in real labour costs coupled with a fall of 0,2% in adjusted productivity will once again mean a slight discrepancy to the detriment of non-wage incomes, without there being any gain in employee's purchasing power.

For the above reasons, the slowdown in inflation in the different countries is also expected to moderate. If we still work on the assumption of exchange-rate stability within the EMS, the figures expressed in ECU will probably be little or no different from those expressed in national currencies.

Budgetary policy developments

Recent estimates of the expenditure and revenue aggregates for general government in the Member States result in a slight upward revision of the level of general government net borrowing in the Community in 1980, as compared with the estimate published in *European Economy* No 7.

The net result is that general government net borrowing in the Community remains unchanged between 1979 and 1980, at 3,6% of GDP, instead of falling very slightly as previously foreseen.

General government net borrowing rose in most Member States, France, Italy and the United Kingdom being exceptions. In France a surcharge on social security contributions was in effect in 1980, and incomplete indexation of the income-tax system led to an increase in tax pressure. In Italy, accelerated inflation increased receipts sooner than expenditure. In addition there was a significant reduction of fiscal fraud, VAT rates were raised towards the end of the year and income-tax payments were accelerated. In the United Kingdom, the result reflected the implementation of a medium-term programme to reduce the volume of public spending and government net borrowing as a percentage of GDP. However, a worsened financial deficit of public corporations and an increase in general government financial transactions led to a rise in the public sector borrowing requirement. The largest relative increase in net borrowing was recorded in Denmark despite restrictive budgetary measures introduced during the course of the year. Special factors, including statistical revisions and large military purchases, were important, as also were the fall in incomes and output and the rising cost of debt service.

In most member countries budgetary policy in 1980 was aimed at reducing or at least restraining the general government deficit as a percentage of GDP. In consequence, programmes of expenditure reduction or restraint, sometimes supplemented by tax increases, were announced in a number of countries. In some instances political or administrative difficulties prevented the full implementation of programmes of restraint of expenditure, particularly in the areas of public sector salaries and of expenditure only indirectly controlled by central governments. In addition, announced programmes of restraint were in some cases modified to provide support to particularly hard-hit sectors, notably the construction industry, and to stimulate private investment either through tax reliefs or investment incentives. None the less, discretionary changes in budgetary policy affecting 1980 operated to reduce deficits.

Table 13

Public finance aggregates, EC and Member States

	General government (percentage change)						General government (percentage of GDP)			Central government (percentage of GDP)		
	Expenditure			Receipts			Net borrowing [1 2]			Net borrowing requirement [1 3]		
	1979	1980	1981 [5]	1979	1980	1981 [5]	1979	1980	1981 [5]	1979	1980	1981 [5]
B	9,5	10,9	9,3	8,1	6,6	9,2	−7,2	−9,4	−9,7	−6,9	−9,0	−9,2
DK	13,4	14,9	12,7	13,2	12,2	10,8	−3,1	−4,6	−5,7	−5,0	−4,7	−5,0
D	8,0	8,3	5,2	7,7	7,2	4,5	−3,0	−3,5	−3,8	−2,9	−3,5	−3,4
GR	22,1	:	:	24,7	25,1	22,6	:	:	:	−3,6	−2,8	−0,9
F	14,0	15,9	14,8	18,0	16,6	11,7	−0,8	−0,6	−1,8	−1,6	−1,2	−1,4
IRL [4]	24,2	27,8	18,7	19,8	26,7	18,7	−11,9	−13,5	−11,7	−13,9	−14,5	−13,3
I	19,1	24,4	22,7	19,5	29,7	22,1	−9,4	−7,8	−8,4	−10,9	−10,6	−9,5
L	8,3	10,5	10,6	4,6	8,6	8,5	0,1	−0,9	−2,1	0,1	−1,1	−2,5
NL	11,7	9,5	7,0	9,8	8,1	6,5	−2,0	−2,8	−3,2	−4,4	−4,8	−5,3
UK	15,7	21,3	14,7	19,8	24,4	15,4	−3,3	−2,3	−2,2	−3,9	−4,8	−3,8
EC	12,6	14,7	12,0	13,6	15,0	11,0	−3,6	−3,6	−4,0	−4,2	−4,5	−4,3

1 Net borrowing (−) or lending (+).
2 National accounts transactions basis, excluding loans and participations.
3 Budgetary accounts including loans and participations. Financial year basis for UK.
4 1979 and 1980 figures reflect distortions in government financial transactions due to the 1979 postal strike. Net borrowing of general government and central government amounts to 13,8% and 15,4% respectively of GDP in 1981 if no account is taken of IRL 200 million private participation in public investment, an item which, according to standard definitions is not deductible.
5 Forecasts.

Source: Eurostat, estimates of Commission services.

Against this, the recession in economic activity operated 'automatically' to reduce tax revenues and swell current transfers, particularly unemployment benefits. Moreover, high nominal interest rates increased the cost of servicing a growing nominal public-sector debt. For the Community as a whole these two factors just balanced discretionary changes to produce the unchanged general government deficit, as a percentage of GDP, referred to above.

In qualitative terms, the forces affecting general government deficits in 1981 will be working in the same direction as in 1980, although the 'automatic' effects of the recession in activity will be intensified while on the other hand the increase in interest payments will be smaller than in 1980.

Current forecasts by the services of the Commission for 1981 (Table 13) suggest that the growth of both general government receipts and general government expenditure in current price terms will slow down in 1981 as the increase in nominal incomes in the Community decelerates quite markedly.

Total current resources in 1981 are none the less forecast to rise by 11,0%, against an increase of 9,3% in nominal GDP. Among the major categories of general government receipts (Table 14), indirect taxes will rise more rapidly than nominal incomes, reflecting the full-year effect of increases in average VAT rates or in excise duties introduced during 1980 in a number of countries and the first-year effects of similar increases in the 1981 budgets in the Netherlands and Ireland.

Despite the implementation of the direct tax reductions in the Federal Republic of Germany decided last year, direct tax payments in the Community as a whole will also increase more rapidly than nominal incomes, adjustment of allowances and bands of taxable incomes again incompletely compensating for inflation in most countries, while the increases in direct tax rates applied from mid-1980 in Denmark will have a full-year effect. In addition, some further success in combating fiscal fraud is assumed in Italy and Belgium. Social security contributions will rise less

Table 14

Income and outlay transactions of general government, EC 9

(000 million ECU) [1]

	1978	% change	1979	% change	1980	% change	1981 [4]
Indirect taxes	203,8	15,7	235,8	15,8	273,1	10,9	302,8
Direct taxes	192,1	10,4	212,1	15,6	245,3	11,3	273,1
Social security contributions	219,0	14,6	250,6	13,9	285,4	10,5	315,2
Other current receipts [2]	50,0	14,6	57,3	14,2	65,4	12,8	73,8
Total current resources	664,8	13,7	755,8	15,0	869,2	11,0	964,9
Current transfers	329,5	11,8	368,5	12,5	414,5	13,8	471,7
Other current outlays	45,6	20,2	54,9	26,9	69,7	18,4	82,5
Government consumption	283,5	12,6	319,1	15,3	368,0	10,6	406,9
Total current uses	658,5	12,8	742,6	14,8	852,1	12,8	961,1
Gross saving	6,4		13,3		17,1		3,9
Net capital transfers	16,4		18,4		21,0		20,7
Gross capital formation [3]	52,7	9,9	57,9	14,2	66,2	8,0	71,5
Net lending (+) or borrowing (−)							
— in 000 million ECU	−62,6		−63,0		−70,0		−88,3
— as a percent of GDP	−4,0		−3,6		−3,6		−4,0

1 Unless otherwise indicated.
2 Including consumption of fixed capital.
3 Including net purchases of land and intangible assets.
4 Forecasts.

Source: Commission services.

Table 15

Budget indicators, EC 9

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 [1]
GDP constant prices, % change	3,5	4,0	5,9	1,7	−1,4	5,0	2,3	3,0	3,4	1,3	−0,6
Government consumption, constant prices, % change	4,2	3,6	3,6	2,2	3,9	2,7	1,1	3,5	2,7	2,2	0,8
Social benefits, % of GDP	13,3	13,9	14,2	15,0	17,0	17,3	17,6	17,7	17,0	17,2	17,7
Taxes and social security contributions, % of GDP	36,0	36,0	36,9	37,9	38,0	39,2	39,9	39,6	39,1	39,9	40,4
Actual change in general government net borrowing, % of GDP [2]	−0,8	−1,0	0,7	−1,0	−3,9	1,8	0,5	−0,7	0,4	0,0	−0,4
less: change due to the automatic impact of cyclical fluctuations, % of GDP [2 3]	−0,3	−0,2	1,0	−0,5	−2,3	1,1	−1,2	0,2	0,4	−0,8	−1,9
equals: residual change (discretionary changes plus change in net interest payments), % of GDP [2]	−0,5	−0,8	−0,3	−0,5	−1,6	0,7	0,7	−0,9	0,0	0,8	1,5

1 Forecasts.
2 A minus sign indicates an increase in net borrowing.
3 See *European Economy*, No 7, p. 72 for methodology.
Source: Eurostat and estimates of Commission services.

rapidly than direct tax payments, but will still account for a higher proportion of nominal incomes than in the previous year. The main discretionary influences on this category of receipts are an increase in contributions in the Federal Republic of Germany and the United Kingdom. These increases more than offset, in the Community aggregate, the removal of the 1% surcharge on contributions in operation in 1980 in France and a further fiscalization of employers' contributions in Italy. Other current receipts, including general government factor income, rise rapidly as a result of relatively sharp increases in government prices and property charges.

Total current expenditure by general government is expected to rise by 12,1% in 1981. All the main categories of general government expenditure decelerate, with the exception of current transfers. The sharp forecast rise in unemployment is the major factor behind the higher rate of increase in current transfers. In addition, increases in social benefits are being implemented in France and the Federal Republic of Germany and rates of unemployment benefits are being increased in Ireland. Against this, the real value of most social benefits, including unemployment benefit, is being reduced in the United Kingdom, economies in social benefits are being effected in the Netherlands, and the conditions of payment of unemployment benefits are being tightened in Belgium. Current transfers to companies (subsidies) are rising relatively slowly or being reduced in nominal terms in a number of countries, thus reversing a trend apparent throughout the 1970s. 'Other current outlays' (mainly interest payments) is still the fastest-growing category of expenditure in 1981 as the nominal amount of public debt to be serviced increases, but the forecast reduction in nominal interest rates in 1981 and the effect of lengthening the average maturity of new debt in postponing payments in Italy imply a deceleration from the extremely rapid 1980 rate of growth of interest payments.

Governments' attempts to restrict the growth of their consumption can be clearly seen in the forecasts for 1981. In France and the Netherlands, compensation of employees rises more slowly than do current purchases of goods and services. In the other countries, however, the private sector seems to be bearing the brunt of the first-round impact of the stringency forecast in government consumption. For the Community as a whole, compensation of general government employees is forecast to rise noticeably faster than total compensation of employees. Although a breakdown within the general government sector into employment and compensation per head is not directly available for the Community it seems likely that compensation per head in general government will be rising faster than compensation per head in the rest of the economy (the Netherlands and Ireland may, on current forecasts, prove exceptions to this general tendency).

On capital account, net capital transfers from general government fall in nominal terms, reduced transfers to some public utilities more than offsetting, on currently announced expenditure plans, growing aid to certain industrial sectors, including publicly-owned industries. Gross capital formation almost certainly falls again in real terms.

The difficulties of budgetary developments in the current recession are brought out in Table 15. In the deep recession year of 1975, the volume of government consumption was sharply boosted as a counter-cyclical measure. In 1981, government consumption is forecast to grow by only 0,8% in volume, a rate of growth probably below what might be expected to be its trend rate even given worsened medium-term prospects and, in some countries, an intention to reduce the share of expenditure accounted for by the public sector. Clearly, an important influence tending to depress government consumption is the desire of governments to limit their budget deficits. Similarly, whereas the share of social benefits in GDP increased by about 2 points in 1975, the increase in 1981 is expected to be about ½ point, the difference being considerably bigger than is explained by the somewhat smaller increase in unemployment in 1980 as compared with 1975. Further, the need to limit the expansion of deficits has, at least in part, frustrated the desire of governments to avoid increases in tax pressure, as measured by the share of taxes and social security contributions in GDP. The impact of attempts to steer as close as possible to the desired medium-term course of budget deficits despite the recession can be seen by comparing the final three lines in Table 15. The operation of the automatic stabilizers in 1981 would tend to increase the general government net deficit for the Community by an amount equivalent to 1,9% of GDP. The forecast increase in the deficit is 0,4% of GDP (the deficit excluding net interest payments, which, as a rough first approximation to an 'inflation-adjusted' deficit, may be more relevant both to the demand impact of the budget position and to the real indebtedness of the public sector, in fact hardly changes as a percentage of GDP). However, the 'cyclically-adjusted' deficit is reduced on these forecasts by an amount equivalent to 1,5% of GDP. In other words, about three-quarters of the impact of the automatic stabilizers in 1981 would be offset by discretionary action. These figures suggest that governments in the Community may have difficulty in keeping the expansion of budget deficits in 1981 within the limits currently forecast.

Monetary trends and policies

The slowdown in money creation came to a halt in the second half of 1980. In the third quarter of the year, the quarterly growth rate of the money supply in the Community, seasonally adjusted, which had fallen back to 1,7% in the previous quarter, started to climb again, to reach 2,6%, under the impact of renewed monetary expansion in Denmark, Ireland and the United Kingdom. In the fourth quarter, this tendency was confirmed in these three countries and became apparent in the Netherlands and in the Federal Republic of Germany (Graph 5).

Taking 1980 as a whole, the rate of monetary expansion in the Community was none the less slower than in 1979 (10,1% as against 11,2%). The growth in the money supply in France, Italy and Belgium slackened significantly. The outturns recorded in the Federal Republic of Germany and in the Netherlands were similar to those in 1979, while Denmark and, above all, the United Kingdom were the only Member States to witness an acceleration in monetary expansion.

In sum for the Community the authorities' desire to see a slowdown in the rate of money creation was fulfilled. Even so, the causes of this slowdown were different from those the authorities sought: they key determinant was a widening in balance-of-payments deficits while, generally speaking, the rate of credit expansion was largely maintained (Table 16).

Table 16 depicts the trend in bank lending to the private sector, which, taking the average for the Community, rose by 14,7% in 1980, compared with 15,5% in 1979. There was thus little if any slackening in the rate of increase in lending despite the weakening of activity in real terms. Lending continued to expand briskly in Denmark, France, Italy and the United Kingdom. While the growth in bank lending remained within the credit control ceilings set in France, the Netherlands and Italy, the demand for credit, particularly in Italy, continued to exert strong pressure on interest rates. In the Federal Republic of Germany and in Belgium, the expansion in bank lending remained buoyant throughout the year, although a slight easing was discernible in Belgium. A shift in private-sector financing demand towards short-term bank borrowing may go some way towards explaining this sustained expansion in bank lending to the private sector. Given the ruling levels of interest rates, borrowers have preferred to borrow less at long term and more at short term. Moreover, this shift in demand facilitated the financing of budget deficits in a number of Member States.

In the light of the general increase in budget deficits, monetary financing by the authorities made a rather modest contribution to money creation. As compared with 1979, monetary financing in 1980 increased in Ireland, the Netherlands, Belgium and the United Kingdom but was reduced in the other Member States. The authorities benefited quite appreciably from the increased demand for government stock by the private sector and the banks. Thus, in Italy, private transactors purchased large quantities of short-term Treasury bills and in France the entire budget deficit was covered by placing long-term paper on the financial market. Sales of public debt instruments to the private sector were also substantial in the United Kingdom. Generally speaking, governments benefited from a fairly high level of liquidity in the private sector, coupled with reduced demand from firms for long-term financing. A policy of encouraging the taking-up of government stock through attractive yields was followed, particularly in Italy and France. In the Federal Republic of Germany and in

Table 16

Money supply and bank lending

December/December, percentage change

	Money supply				Credit to firms and households from monetary institutions		
	1979	1980	1981 forecasts		1979	1980 estimates	1981 forecasts
B (M2H)	6,0	3,0 [1]	5,0	**B**	14,0	10,0	8,1
DK (M2)	9,9	10,9	8,7	**DK** [4]	14,3	14,8	14,3
D (M3)	6,0	6,2 [1]	4,5	**D**	12,1	9,8	6,5
F (M2)	14,4	10,5 [1]	10,0	**F**	15,3	15,5	13,0
IRL (M3)	12,0	18,9 [1]	12,0	**IRL**	25,2	12,8	15,3
I (M2)	20,3	12,3 [1]	13,1	**I**	18,4	18,7	14,6
NL (M2)	7,6	5,8 [1]	6,5	**NL**	16,8	12,3	11,0
UK (Sterling M3)	12,7 [2]	19,5 [2]	10,2	**UK** [5]	20,4	22,7	18,3
Total [3]	11,2	10,1	8,2	**Total** [3]	15,5	14,7	11,6

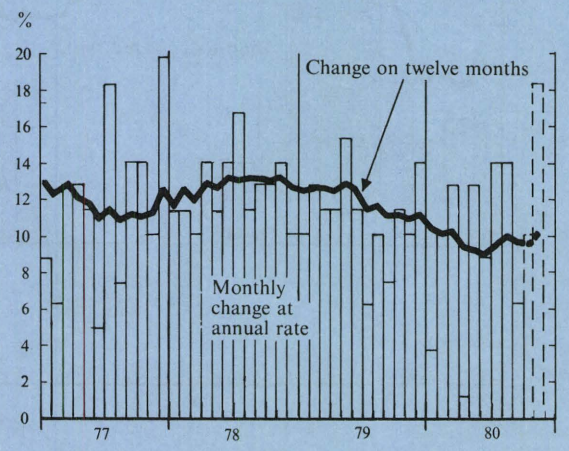
1 Estimate.
2 Money supply not adjusted for the effects of the abolition of the 'corset'. Figures adjusted for these effects would give an increase of +16,1% for sterling M3 in 1979 and 1980.
3 Weighted by 1978 GDP.
4 As % of the money supply at the end of the previous period.
5 Sterling loans to the private sector and to external residents during the financial year.

Source: Commission services.

Belgium, it did not always prove easy to place government stock in 1980, but the scale of sales of medium-term and long-term debt to the banks helped to contain monetary growth. Whereas in the Federal Republic of Germany, the proportion of the budget deficit financed out of monetary resources showed little if any change from 1979, this was not the case in Belgium, where very extensive recourse was had to bank financing in order to meet Treasury requirements.

The external contribution to the money supply served to curb money supply growth in all Member States except France, where substantial foreign capital inflows and borrowing abroad added to monetary expansion. In general, the deterioration in Member States' trade balances (with the exception, that is, of the United Kingdom) was not entirely offset by an improvement in the balances on services and private capital. Even so, in some Member States, such as the Federal Republic of Germany, Ireland and the United Kingdom, the negative contribution made by the balance of payments to money supply expansion was reduced in 1980. In the Federal Republic of Germany and Ireland this was in part a result of borrowing abroad. In the other Member States, the balance-of-payments contribution turned negative in 1980 (Italy) or exerted a greater negative impact than previously (the Netherlands, Belgium).

GRAPH 5: **Money supply (s.a.), EC 9 (1)**



1 Average of national money supplies weighted by 1978 GDP at current prices and exchange rates. Luxembourg is not included.

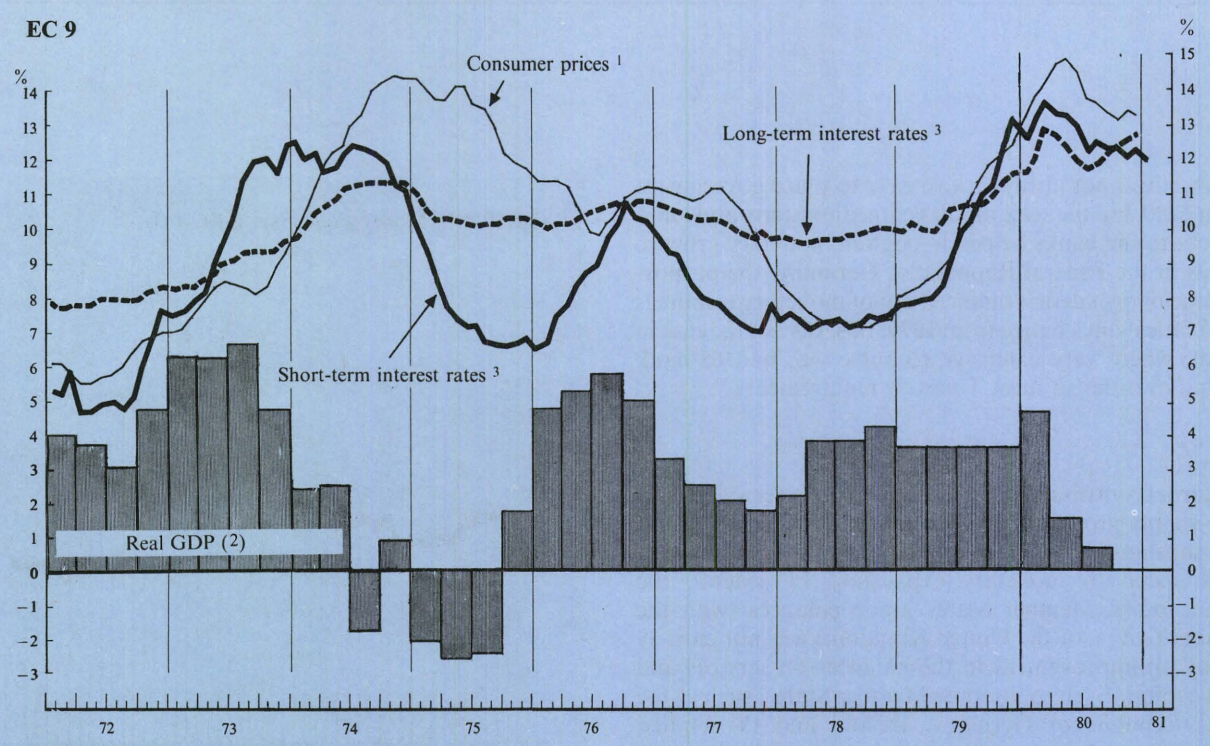
Sources: Eurostat and Commission services.

Taking the average for the Community as a whole, interest rates peaked in March 1980 (13,7% for short-term rates and 12,9% for long-term rates) before easing in the period up to July. Long-term rates then started to climb moderately once again, while short-term rates held steady at just over 12%.

In November, for the first time since September 1979, long-term rates were higher than short-term rates (Graph 6), but this normalization of the interest-rate structure occurred at high levels, higher in fact than those deemed desirable a year earlier. In December, short-term rates averaged 12,3% and long-term rates 12,7%.

Several factors prevented an orderly fall in the cost of money in the second half of 1980. In the first place, inflation-rate pressures turned out to be stronger than had been forecast. The second factor stemmed from external conditions, with the combination of a widening trade deficit in the Community and a return to a restrictive monetary policy in the United States at the end of the summer bringing the European currencies, and in particular the mark, under pressure and thereby preventing a reduction of interest rates in the Federal Republic of Germany. Although some other Member States (Denmark, France, the Netherlands) found themselves relatively well protected by the mark against exchange-rate fluctuations, they decided not to ease back interest rates beyond making, that is, a number of downward technical adjustments designed primarily to support the mark within the EMS; certain structural variables such as inflation or the budget deficit made it impossible for them to

GRAPH 6: **Relative movements of short and long-term interest rates, consumer prices and real GDP**



1 Consumer prices: change on 12 months.
2 GDP: change on same quarter of previous year average of volume indices for the major Member States weighted by 1975 GDP.
3 Interest rates: average, weighted by 1978 GDP, of representative money market rates (in principle, three-month interbank rates) for the short-term and of the yield on public sector obligations for the long term.
Source: Eurostat and Commission staff.

Table 17

Monetary targets and out-turns

	Key variable [1]	1980 Target %	1980 Out-turn %	1981 Target %
D	M2	5-8	4,9	4-7
F	M2	11	10,5 [5]	10
IRL	PSCE	13 [2]	11,5 [4]	
I	TDCE	17,5	17,3 [5]	
NL	DM2	8	7 [5]	
UK	Sterling M3	7-11 [3]	22 [4]	

1 PSCE: public sector credit expansion.
TDCE: total domestic credit expansion;
DM2: growth in domestic M2.
2 February 1980/February 1981.
3 Mid-February 1980/mid-April 1981, expressed at an annual rate.
4 Out-turn between February and December 1980, expressed at an annual rate.
5 Estimate.

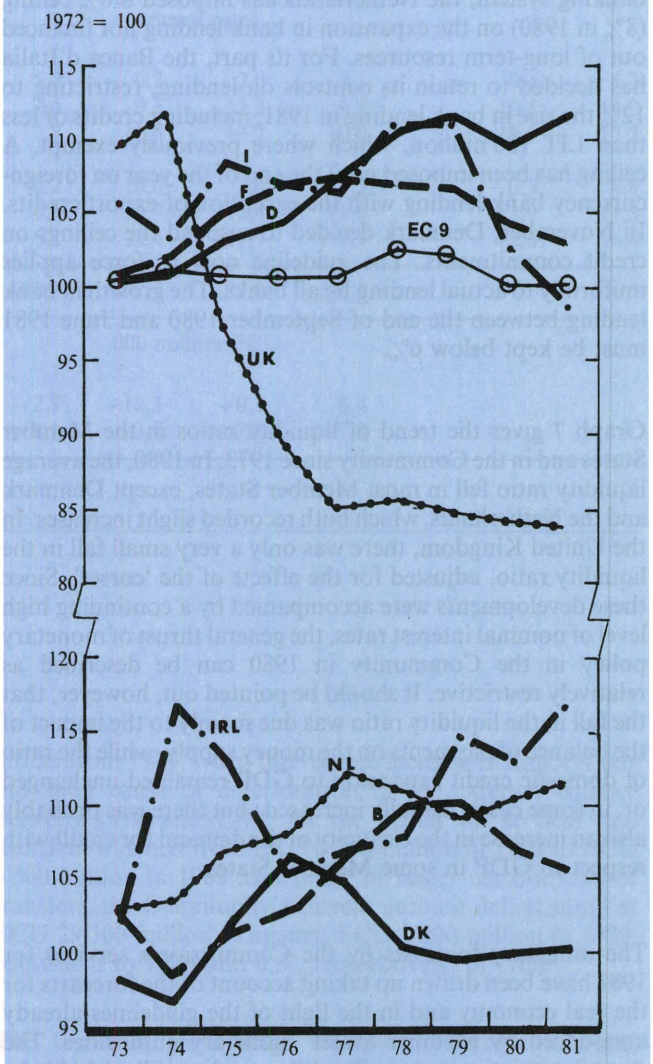
Source: Commission services.

contemplate bringing down short-term rates significantly. The United Kingdom found itself in a special situation in that, although sterling had risen steadily against the ECU throughout the year, it was only at the end of November that the United Kingdom authorities decided to cut the minimum lending rate from 16% to 14%, the steep rise in sterling M3 having prompted them to adopt a cautious approach to the lowering of interest rates. Lastly, the placing of large quantities of government stock gave a renewed twist to long-term yields in the Community in the second half of 1980.

Table 17 compares monetary out-turns with the targets set a year earlier. The Federal Republic of Germany achieved its target by keeping the expansion in central bank money to just under 5% between the fourth quarter of 1979 and the fourth quarter of 1980, i.e. the very bottom of the target range set for the year. In France, M2 is expected to expand at a rate just below or equal to the target of 11%, whereas in the Netherlands domestic money supply might grow less than the target of 8%. In Italy, total domestic credit expansion will probably be very close to the LIT 50 300 000 million forecast.

In the United Kingdom, the growth of sterling M3 showed a distinct acceleration after the summer and as a result was running at an annual rate of around 20% at the end of the year. The combination of a high public-sector borrowing requirement and strong private-sector demand for credit is the root cause of this development. However, the abolition in June of the supplementary special deposits scheme (the 'corset') also contributed, owing to the scale of the ensuing reintermediation within the UK banking system. In Ireland, a target of 13% was set for the expansion in domestic bank lending to the private sector between February 1980 and February 1981. Foreign currency lending by Irish banks to

GRAPH 7: **Trend of liquidity ratios**
Cumulative indices



1 Money supply for 1979 and 1980 adjusted for distortions resulting from the effects of the 'corset'.

Source: Eurostat and Commission services.

residents, previously disregarded when calculating the target, has been included in the calculation since October 1980. Although between February and November lending covered by this target rose at an annual rate of 11,5%, i.e. below the target set, its growth has accelerated sharply since August.

Two Member States have already published their monetary targets for 1981. The Federal Republic of Germany has announced that it will endeavour to keep within the 4-7% target range for the expansion in central bank money, and France has fixed a target of 10% for the increase in M2. Two other Member States have published their credit expansion ceilings for the year as a whole: in agreement with the banking system, the Netherlands has imposed a 6% ceiling (8% in 1980) on the expansion in bank lending not financed out of long-term resources. For its part, the Banca d'Italia has decided to retain its controls on lending, restricting to 12% the rise in bank lending in 1981, including credits of less than LIT 130 million, which where previously exempt. A ceiling has been imposed until the end of the year on foreign-currency bank lending with the exception of export credits. In November, Denmark decided to suspend the ceilings on credit commitments. The guideline now in force applies uniformly to actual lending by all banks. The growth in bank lending between the end of September 1980 and June 1981 must be kept below 6%.

Graph 7 gives the trend of liquidity ratios in the Member States and in the Community since 1973. In 1980, the average liquidity ratio fell in most Member States, except Denmark and the Netherlands, which both recorded slight increases. In the United Kingdom, there was only a very small fall in the liquidity ratio, adjusted for the effects of the 'corset'. Since these developments were accompanied by a continuing high level of nominal interest rates, the general thrust of monetary policy in the Community in 1980 can be described as relatively restrictive. It should be pointed out, however, that the fall in the liquidity ratio was due mainly to the impact of the balance of payments on the money supply, while the ratio of domestic credit expansion to GDP remained unchanged or, in some cases, actually increased; but there was probably also an increase in the elasticity of the demand for credit with respect to GDP in some Member States.

The monetary forecasts by the Commission's services for 1981 have been drawn up taking account of the forecasts for the real economy and in the light of the guidelines already announced by Member States' monetary authorities. The overall restrictive stance of monetary policy will probably be maintained in 1981. The slowdown in nominal GDP growth is expected to be accompanied by generally modest monetary expansion, and as a result the average liquidity ratio in the Community is likely to remain unchanged.

Foreign trade and balances of payments on current account

In 1980, world trade grew very little in volume terms and actually declined in the second half of the year. The Community's foreign trade did not escape the effects of this decline. Taking the average for the year, Community imports and exports of goods increased less than in 1979, but, as in 1979, the growth of imports in value terms was higher than that of exports (17,7% and 13,7% respectively). In volume terms, however, imports and exports both showed a 2% increase (see Table 18). The downturn in activity in real terms, and in particular a slowdown in stockbuilding, contributed to the slower volume growth of imports. Although imports continued to grow in volume terms during the first half of the year, if at a slower rate, they fell back in the second half. Exports followed the same profile, but the decline in volume during the second half of the year was less marked than that of imports.

Graph 8 shows the monthly movements in the trade balance (cif/fob). The period of rapid deterioration in 1979 gave way to relative stabilization in monthly deficits from early 1980 onwards, albeit at a very high level (around ECU 4 000 million on a cif/fob basis). There was a slight improvement during the final months of the year. This was mainly the result of movements in the trade balance in Denmark and the United Kingdom: in Denmark, the deficit began to shrink in the second quarter of 1980 as a result of a sharp increase in exports followed by a decline in imports; in the United Kingdom, the balance on goods was in surplus from May onwards mainly as a result of oil exports and the slowdown in imports. The trade balances of the other Member States tended on the whole to remain little changed: this was the case in France, whose monthly deficits were of the order of ECU 1 000 million (fob/fob), in the Federal Republic of Germany, where the trade balance remained in surplus though at a distinctly lower level than in 1979, and in Ireland, while Italy's deficit on trade in goods widened further during the second half of 1980.

Table 19 gives gives a breakdown of Community trade by area. The deterioration in the Community's trade balances with the United States and Japan is particularly pronounced, with the United States undoubtedly benefiting from a high level of competitiveness over the past few years and Japan from major gains in its competitiveness between 1978 and 1980.

The worsening of the trade balance with the United States involved all groups of products and was mainly due to the French and United Kingdom trade balances. As regards trade with Japan, the increase in Community imports was

Table 18

Trade balance and current account balance of the Community, 1976-81

(s.a.)

EC 9	1976	1977	1978	1979	1980	1981 forecast	1981 I	1981 II
				000 million ECU				
Exports (value fob)	287,2	324,6	352,7	413,9	470,7	517,5	497,4	537,7
Imports (value fob)	288,9	316,9	339,4	420,4	494,5	542,3	521,6	563,1
Trade balance (fob/fob)	−1,7	6,6	13,3	−6,5	−23,8	−24,8	−24,2	−25,4
Balance on services and transfers	−3,2	−4,4	0,1	−2,7	−5,5	−8,4	−8,6	−8,0
Current account balance	−4,9	2,2	13,4	−9,2	−29,3	−33,2	−32,8	−33,4
				% change over previous period, annual rates				
Exports:								
— volume	11,1	4,9	5,2	6,7	2,0	0,1	0,4	5,3
— price	9,9	7,7	2,5	9,3	11,5	9,9	10,5	11,3
— value	22,0	13,0	7,8	16,6	13,7	10,0	10,9	17,2
Imports:								
— volume	13,1	2,3	6,2	10,6	2,0	−1,2	−0,3	4,8
— price	12,5	7,9	0,0	10,7	15,4	11,0	12,9	11,3
— value	26,6	10,1	6,2	22,4	17,7	9,7	12,6	16,6
Terms of trade (1974 = 100) (goods) (total)	101,5	101,3	103,8	102,5	99,0	98,0		
				000 million ECU				
Components of EC trade balance changes [1]								
— volume	−3,8	7,4	−2,8	−12,3	−0,1	6,4		
— terms of trade	−5,2	−0,7	8,1	−3,5	−17,1	−7,8		

[1] These estimates are not exactly additive due to the presence of second order terms.
Source: Eurostat and Commission services: balance-of-payments definition.

not matched by any increase in Community exports. The Community's trade balance with the other OECD countries remained in surplus during the first half of 1980. During the same period, the deficit with the OPEC countries worsened and the net balance of trade with the other developing countries and the centrally-planned economies shifted into deficit.

All in all, last year's trade deficit amounted to ECU 23 800 million (fob/fob), as against ECU 6 500 million in 1979. A breakdown of the increase in the deficit as between the volume effect and the terms-of-trade effect shows that the increase was due almost entirely to the deterioration in the terms of trade, with the volume effect accounting for only ECU 100 million of the increase. It is in this respect that 1980 differs from 1979, when the volume increase in imports was the main cause of deterioration in the external balance between 1978 and 1979. As the deficit on services and transfers widened from ECU 2 700 million in 1979 to ECU 5 500 million in 1980 as a result of larger net outflows of transfers, the Community's current account deficit stood at ECU 29 300 million as against ECU 9 200 million in 1979, equivalent to 1,5% and 0,5%, respectively, of GDP.

The forecasts for foreign trade and current account, established by the services of the Commission on the basis of the prospects for world trade analysed above, look for a gradual recovery in the volume growth of exports during 1981. However, given the decline in the second half of 1980, export growth expressed as an annual average will probably

Table 19

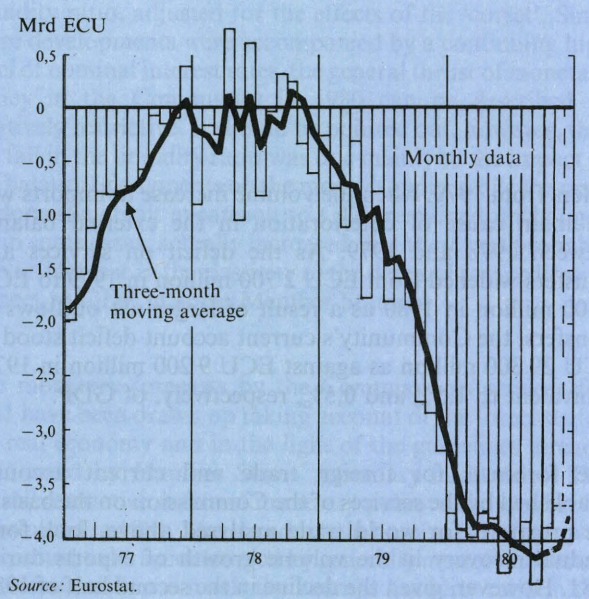
EC 9 trade balances (fob/cif) by area

(000 million ECU)

	1978	1979	1979 [1] I	1979 [1] II	1979 [1] III	1979 [1] IV	1980 [1] I	1980 [1] II	1980 [1] III
United States	−5,1	−9,3	−2,0	−1,6	−2,6	−2,8	−4,1	−5,1	−4,8
Canada	−0,8	−1,7	−0,3	−0,3	−0,4	−0,6	−0,6	−0,7	−0,8
Japan	−5,0	−5,2	−1,2	−1,2	−1,2	−1,5	−1,6	−1,9	−2,2
Other OECD countries	8,7	9,2	2,3	2,3	2,4	2,3	2,5	2,9	
Total OECD [2]	−0,2	−3,8	−0,2	0,1	−0,6	−1,6	−3,2	−3,3	
OPEC countries	−7,1	−20,3	−3,4	−4,4	−5,3	−7,0	−8,4	−8,4	−7,1
Other developing countries	2,5	1,7	1,0	0,7	0,5	0,0	−0,7	−0,5	
Centrally-planned economies	1,4	−0,5	0,4	0,3	−0,2	−0,8	−0,5	−0,7	−0,8
Other countries	1,5	1,6	0,4	0,4	0,4	0,5	0,5	0,5	0,5
Total	−2,5	−20,8	−2,2	−2,9	−5,3	−8,8	−11,6	−11,9	−12,3

1 Seasonally adjusted.
2 Including the difference between intra-Community imports and exports.
Source: Eurostat.

GRAPH 8: **Trade balance (s.a.) (imports cif, exports fob), EC 9 total**



Source: Eurostat.

be slight or non-existent in 1981. The reduction in stockbuilding could well continue in the first half of 1981; this is expected to influence the growth of imports, and the improvement in the net external balance in volume terms will probably continue. The terms of trade, by contrast, could well show a further deterioration, and the trade deficit is likely to remain more or less unchanged. The surplus on services might well show a slight increase, but this would not be sufficient to offset the worsening balance on transfers. The forecasts by the services of the Commission thus indicate that the current account deficit could grow from ECU 29 300 million in 1980 to ECU 33 200 million (1,5% of GDP) in 1981. However, the major shifts in exchange rates at the end of 1980 and the beginning of 1981 are a source of particular uncertainty as regards the outlook for world trade.

The rise in the Community's import prices stemming from the depreciation of the ECU against the dollar could well bring about a deterioration in the terms of trade and in the trade deficit in the early months of 1981. But since the recent trend of the dollar and the prospect of a fall in commodity prices in the months ahead could curb imports significantly (resulting in a rundown of raw material stocks), the Community's trade balance, after deteriorating initially, could show a significant improvement as the year progresses.

Exchange rates

Whereas in 1979 the ECU appreciated against the dollar and the yen, 1980 saw the dollar rate recover appreciably and that of the Japanese currency even more so. As early as the first quarter of 1980, the dollar strengthened against the European currencies, owing to a substantial rise in American interest rates. The rapid fall in interest rates in the second quarter caused the dollar to fall back slightly, although its upward movement resumed early in the second half of the year and accelerated spectacularly in the last months of 1980 and the first months of 1981. Beginning in November, the interest-rate differential again widened in favour of American markets and boosted the inflow of capital into the United States. In January, the average rate of the ECU in dollars regained its August 1978 value. In 1980 the yen made up almost all the ground lost in 1979: the ECU was worth on a monthly average 272,3 yen in December 1980—almost the same rate as in February 1979—whereas it had fallen between these two dates to 349 yen in February 1980.

The exchange-rate movements between Community currencies and the dollar had some impact on exchange-rate relationships within the EMS. The German mark, the European currency most exposed to capital movements linked to the dollar, gradually became established in the lower half of the bilateral fluctuation margin of ±2,25% and several times at the end of October reached its lower intervention point. Action to support the German currency was therefore taken mainly by the French authorities, whose currency had reached the upper intervention point of the bilateral margin of fluctuation against the mark. While the pressure on the German mark eased in the last two months of 1980, it again increased at the end of January and in February of this year once more necessitated intervention within the EMS. The German mark's position on foreign exchange markets is currently made more difficult by the fact that it is practically the only European currency actually to be used against the dollar under the bilateral swap arrangements between the Federal Reserve and certain Member States, with the result that the burden of adjustment is not truly spread among the other EMS currencies. The position of the currencies within the EMS changed compared with that of 1979. The French franc remained in the upper half of the fluctuation margin throughout the year and several times reached its upper intervention point, notably at the end of October and beginning of November 1980 and at the end of January and beginning of February 1981; since the summer of last year, it has been accompanied by the Dutch guilder. The Danish krone and the Irish pound fluctuated in the middle of the band, while the Belgian franc, which was weak throughout the year, remained close to its lower intervention point and had to be supported frequently. The Italian lira, which fluctuates within a margin of ±6%, began to weaken in June and remained approximately 4% below the French franc until the end of the year. While no currency exceeded its divergence threshold in 1980 (fixed at 75% of the maximum spread of divergence against the ECU), the relative position of the currencies in relation to this indicator was roughly similar to their bilateral exchange rate position: the French franc remained towards the top of the appreciation zone against the ECU, while the German mark and the Belgian franc saw their indicator remain around 50 to 70% in the depreciation zone against the ECU. This situation persisted in the first months of 1981, with the French franc reaching its divergence threshold on 28 January.

The pound sterling, which is not part of the exchange rate agreement, steadily appreciated last year against the other Community currencies. It appreciated by 17% against the ECU within one year. The United Kingdom currency has tended to follow the dollar rate, benefiting, like the United States currency, from capital inflows brought by high interest rates and from the United Kingdom's satisfactory external trade results.

Table 20 shows the extent to which the Community currencies and the other major currencies have fluctuated against the ECU. It can be seen that in 1980 the average coefficient of variation of the currencies involved in the exchange rate agreement was again lower than in the previous year, thus confirming the positive role played by the EMS in promoting exchange-rate stability. On the other hand, the degree of fluctuation of the other currencies against the ECU (notably the pound sterling, the dollar and the yen) was very high, while the Swiss franc was relatively stable.

Table 20

Variation of major currencies against the ECU [1]

	1976	1977	1978	1979	1980
BFR/LFR	38,5	6,2	11,4	8,4	9,0
DKR	33,8	32,4	7,7	32,7	4,5
DM	42,7	11,6	11,7	8,6	9,6
FF	30,1	9,6	18,0	7,4	6,1
IRL	63,5	11,3	23,8	7,7	9,2
LIT	55,5	21,1	24,8	9,8	17,9
HFL	39,0	5,7	11,3	9,0	4,4
Average EMS [2]	43,3	13,9	15,5	11,9	8,7
FS	43,5	45,5	53,9	10,5	13,0
UKL	63,2	11,3	23,8	32,2	44,7
USD	20,1	24,9	49,1	28,1	34,4
Yen	34,1	39,2	70,8	87,5	82,2

1 Coefficient of variation (standard deviation of end-of-month rates for each national currency against the ECU divided by the average rate for the year). Results multiplied by 1 000.
2 Unweighted mean.
Source: Commission services.

Table 21

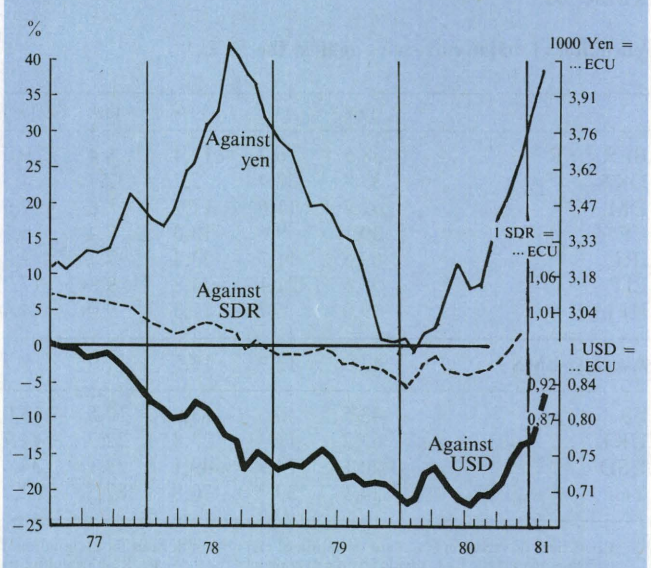
Movement of effective and real exchange rates

	Movement of effective exchange rates [1]				Movement of real exchange rates (competitiveness) [1 2]			
	1980				1980			
	quarters				quarters			
	I	II	III	IV	I	II	III	IV
BFR/LFR	120,5	120,6	120,8	116,9	89,9	88,6	87,4	84,2
DKR	105,4	103,9	104,4	100,7	104,4	103,2	103,2	99,8
DM	159,1	156,7	156,5	150,1	106,5	103,9	102,1	96,9
FF	99,8	99,2	99,5	96,3	102,1	102,9	104,4	101,9
IRL	73,4	72,5	72,7	68,2	93,7	92,8	92,9	87,7
LIT	54,4	53,1	52,4	50,6	105,8	104,7	104,2	101,4
HFL	128,6	127,5	128,4	125,4	99,4	97,4	97,8	95,0
UKL	70,8	72,2	73,9	77,5	115,0	118,4	122,4	127,6
USD	85,5	85,1	82,8	85,3	92,6	92,2	90,0	93,0
Yen	112,9	119,2	124,0	133,0	96,3	103,3	106,4	114,5

1 Rates based on export markets. 1972, first quarter = 100.
2 A rise in the index indicates an increase in relative prices and therefore a fall in competitiveness.
Source: Commission services.

GRAPH 9: **Value of USD, yen and SDR in ECU**

Change since 1/1972



Source: Eurostat.

Table 21 shows changes in effective and real exchange rates. In the fourth quarter of 1980 the effective exchange rates of the Community currencies declined fairly sharply, except for the pound sterling which continued its steady increase of the first three quarters. At the other extreme, the effective exchange rate of the Italian lira has fallen since the beginning of 1980; the German mark is in the same position, while the fall in the exchange rates of the other Community currencies did not get under way until the last three months of 1980. While the yen's effective exchange rate has appreciated markedly, that of the dollar has varied little. Real exchange rates (variation in relative prices adjusted for changes in effective exchange rates) showed a general downward trend in 1980, except in the United Kingdom where there was a sharp rise in the competitiveness index. However, the improvement in the price competitiveness of the European economies varied: between the first and last quarters of 1980, the improvement was sharp in the Federal Republic of Germany, appreciable in Ireland, Belgium, Denmark, the Netherlands and Italy, and slight in France. In the United Kingdom the loss of competitiveness amounted to 11% over the same period. In 1980 Japan saw an appreciable rise in its relative prices adjusted for exchange rate variations, reversing the steady downward trend of 1978 and 1979. The United States saw a slight gain during the first nine months of 1980, followed by a slight loss in the fourth quarter of the same year (see also the special article on unit labour costs in manufacturing industry).

Oil and energy

The slowdown in economic growth in the Community, a relatively mild winter at the beginning of the year, the reaction to the sharp rise in the real cost of energy (especially the real price of oil) and other efforts at energy-saving led to an estimated reduction in 1980 of 4% in the Community's gross inland consumption of primary energy (see Table 22). Gross inland consumption of crude oil and equivalents fell even more sharply last year, by 7,7% to 485 million tonnes (497 million tonnes in EC 10). Crude-oil production within the Community rose by 3 million tonnes, much less rapidly than in recent years. The weakness of domestic demand for oil together with much smaller additions to oil stocks than in 1979 resulted in a large reduction in net imports of crude oil and oil products, down 10,7% to 424 million tonnes for 1980 (EC 9). This fall in the volume of oil imports was much larger than had initially been expected, but because of the further substantial rise in the price of oil the Community's bill for net imports of crude oil nevertheless increased from some USD 70 000 million in 1979 to USD 103 000 million in 1980.

The share of oil in total energy consumption fell from 54% in 1979 to 52% in 1980. (Among the energy policy targets adopted by the Council on 13 May 1980 is a reduction in this share to 40% by 1990.) The share of imported oil in the Community's total energy requirements (including bunkers) also continued to decline last year, to reach about 44%, some 11 percentage points lower than five years earlier.

Oil prices were increased by OPEC countries in several stages during 1980. The official price of 34° API Arabian Light, which now represents a minimum crude marker price, rose from USD 24 per barrel at the end of 1979 to USD 32 per barrel with effect from 1 November 1980. Further increases effective from January 1981 were decided at Bali last December by other OPEC countries who on average added about USD 2-3 to their prices per barrel.

With continuing weakness in economic activity in the Community during 1981 gross inland consumption of energy is again expected to fall. Further gradual progress in

Table 22

Oil-market developments in the Community, EC 9

	1975	1976	1977	1978	1979	1980 [1]	1981 [1]
			Million tonnes of oil equivalent				
Net oil imports (crude and refined)	482,6	517,8	481,1	472,1	474,2	423,5	403
Crude-oil production	11,2	21,0	47,2	62,1	87,2	90,0	95
Gross inland consumption of crude oil and equivalents [2]	478,3	508,6	496,6	512,7	525,2	485,0	472
Gross inland consumption of primary energy [2]	847,6	902,3	898,3	924,5	967,7	931,9	930
Share of oil in total inland energy consumption (%)	56,4	56,4	55,3	55,5	54,2	52,0	50,8
Dependence on imported oil [3] (%)	55,0	55,5	51,9	49,5	47,6	44,2	42,1
			US dollars				
Crude-oil imports, average price per barrel (fob)	10,3	11,4	12,6	12,8	19,5	31,3	(37)
Net crude-oil import bill (cif), 000 million	39,9	45,2	48,9	47,9	69,7	103,0	(116)
			Percentage change				
Net oil imports (crude and refined)	7,3	−7,1	−1,9	0,4	−10,7	−5	
Crude-oil production	87,5	124,8	31,6	40,4	3,2	6	
Gross inland consumption of crude oil and equivalents	6,3	−2,4	3,2	2,4	−7,7	−3	
Total inland consumption of primary energy	6,5	−0,4	2,9	4,9	−3,9	−0	
Crude-oil import price (fob)	11,1	10,5	1,3	52,3	60,5	18	
Net oil import bill	13,3	8,2	−2,0	45,5	47,8	13	

1 Estimates and forecasts.
2 Equal to production plus net imports less additions to stocks less marine bunkers, (energy supplied balance sheets).
3 Net oil imports as % of gross inland consumption of primary energy plus bunkers.
Source: Eurostat and Commission services.

substituting other sources of energy for oil is likely, and oil production in the North Sea should expand more strongly than in 1980. Demand by the Community for imported oil may therefore fall by about 5%, to about 403 million tonnes (415 million tonnes in EC 10). But, even on the assumption of only modest oil price increases during the remainder of 1981, the price rises that have already taken place mean that the Community's oil import bill in US dollars will again rise.

The recent rise in the US dollar against most Community currencies introduces a new element of uncertainty in the outlook for 1981: a mechanical conversion of dollar-denominated prices entails a very large rise in import prices measured in local currency. Even in early 1981 there were, however, signs that the rise in the US dollar was exerting a dampening impact upon world market prices, notably in the market for crude oil and base metals.

The economies of Member States

Belgium

Trends and prospects

Economic activity began to slacken in the spring of 1980 and continued to do so until the end of the year. Despite the very high level it reached in the period January to April, the index of industrial production for 1980 as a whole was not higher than the average outturn for 1979. As suggested by the business survey results, the slowdown should be less perceptible in the next few months and there could even be signs of a slight upturn in the second half of the year. All in all, *gross domestic product,* which increased by slightly over 1% in 1980, should fall by 0,7% in 1981.[1]

Any upturn during the year could only be due to some strengthening of export demand, contrasting with a decline in domestic demand. *Economic policy* will not be able to provide much support for the upturn, since the room for manoeuvre is now very limited in view of the public finance situation and the external deficit. The recently adopted recovery programme, the prime objective of which is to moderate incomes, will, in the immediate future, have a somewhat restrictive effect on demand. Against an international background of high interest rates, the Belgian authorities have been compelled to raise the yields offered on capital. This policy became all the more necessary because the budget deficit has forced the public authorities to borrow frequently on the financial market.

As a result of implementation of the recovery plan, *private consumption* is likely to remain static in real terms in 1981. The measures taken to limit social transfer payments and increase social security contributions with a view to correcting the social security situation will have a considerable impact on personal incomes. The interprofessional agreement, concluded in February between management and unions with the active participation of the government, will to some extent moderate the upward movement of wages in the private sector, as compared to the rise recorded in 1980. The law on moderation also provides for a reduction in certain other income categories (professional fees, remuneration for public office, public service salaries). All in all real personal disposable income must be expected to fall and the effect on consumption should be only offset by a reduction in the savings ratio.

General government consumption will increase, in nominal terms, at a faster rate than in 1980, reflecting a more frequent application of the mechanism for indexing civil servants' salaries and the increase in the number of pensioners. Expansion in volume terms should nevertheless remain very low, as it was in 1980, because of the economy measures taken.

Fixed corporate investment last year was well up on the 1979 figure. Towards the end of the year, however, the confirmation of less-favourable prospects, low company profitability and the high level of interest rates seemed to slow this trend down, a tendency which will probably became more marked in 1981, despite the considerable support of the restructuring programmes implemented in some industrial sectors, and the execution of important multiannual projects. The result could be a slight reduction in the volume of corporate investment for the year as a whole.

The effect of the government's support measures in the area of *residential construction* will probably be only limited. Activity in this sector should therefore remain depressed, under the impact of the moderation of incomes, the high cost of mortgage loans, the taxation impact of the reform of the land register and restrictions on rent increases especially since the property market is showing signs of saturation.

Public investment too is likely to fall back, since the implementation of new programmes has for two years been held back by budgetary difficulties.

Since April 1980, *exports* have definitely been on a declining trend; a limited upturn in 1981 is probable but not entirely certain. Belgian exports are likely to be out of step with the expansion of world trade, because of the high level of costs, and because their composition is ill-adapted to external demand. Compared with the action taken in certain neighbouring countries, wage costs have not been moderated sufficiently to enable Belgium to improve her market shares. *Imports,* after expanding vigorously at the beginning of 1980, have since turned down considerably. Given the persistent weakness of overall demand, the volume of imports should not go any higher this year. The rapid rise in import prices, which in 1980 led to a considerable deterioration in the terms of trade, could ease in 1981.

The slowdown in economic activity will be reflected, in 1981, by a further reduction in the number of *wage and salary earners,* particularly in industry. In the public sector, the numbers employed should remain stable overall. At the same time, the labour force will probably increase, as female participation rates go up and the effects of the early retirement measures disappear. The number of *registered unemployed,* which went up sharply in the second half of last year,[2] could continue to mount. The average unemployment rate for 1981 should be some 10,7% of the labour force. The jump in the number of unemployed men of normal working ability and in the number of young unemployed, reveals particularly the deterioration in the labour market.

In the absence of large increases in public utility charges or indirect taxes, the rise in *consumer prices* is likely to slow down during the year.

[1] See table.

[2] See graph.

Belgium: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [3]	1979 II	1980 I	1980 II	1981 [3] I	1981 [3] II	1979
	Annual data				Half-yearly data (s.a.)					BFR 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1975 prices									
Private consumption	3,9	4,6	2,0	0	3,8	1,8	0,6	:	:	1 966,9
Public consumption	4,3	2,5	0,2	0,6	0,5	0,1	0,3	:	:	566,3
Gross fixed capital formation	2,6	−0,7	2,9	−1,9	0,8	4,3	2,4	:	:	667,5
Change in stocks [1]	0,9	0,5	0,4	0,3	0,6	0,4	0,3	:	:	13,0
Domestic demand	3,6	3,4	1,6	−0,3	2,6	1,7	0,6	:	:	3 213,7
Exports of goods and services	5,9	5,8	2,6	−0,8	5,9	2,4	0,1	:	:	1 805,5
Imports of goods and services	6,1	7,6	3,3	−0,2	7,6	2,8	0,3	:	:	1 844,2
GDP at market prices	3,4	2,4	1,2	−0,7	1,6	1,4	0,5	:	:	3 175,0
	% change over preceding period at annual rates									
GDP at current prices	10,8	6,5	6,3	5,5	:	:	:	:	:	
Industrial production	2,7	4,5	1,5	−2,4	2,8	1,8	−0,4	−2,7	−3,7	
Unemployment rate [2]	4,9	8,6	9,3	10,7	8,8	9,0	10,2	10,5	10,9	
Compensation of employees	12,9	6,7	7,8	6,6	6,7	8,2	8,2	7,4	6,8	
M2	12,2	6,1	3,0	5,0	:	:	:	:	:	
GDP (implicit price index)	7,2	4,0	5,1	6,0	:	:	:	:	:	
Private consumption (implicit price index)	6,7	3,4	6,3	6,2	5,0	6,7	6,7	5,9	5,6	
Exports, goods (implicit price index)	6,2	9,9	11,0	8,5	12,7	11,0	9,4	8,4	7,8	
Imports, goods (implicit price index)	6,7	9,7	14,0	9,2	14,9	14,9	11,8	8,7	8,0	
Terms of trade	−0,4	0,2	−2,6	−0,6	−1,9	−3,4	−2,1	−0,3	−0,2	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,0	−6,2	−8,5	−9,2	:	:	:	:	:	
Current balance	0,4	−2,9	−5,6	−6,6	:	:	:	:	:	
Net lending (+) or net borrowing (−) of general government	−4,3	−7,1	−9,4	−9,7	:	:	:	:	:	

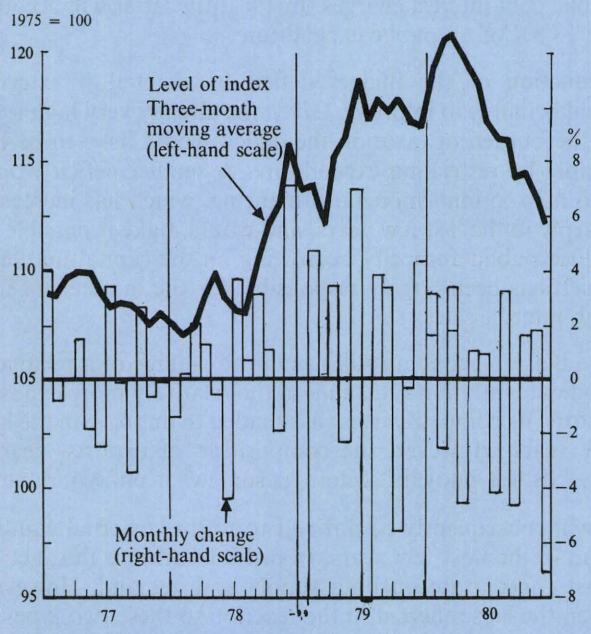
1 As % of GDP.
2 Unemployment as % of total labour force.
3 Forecasts.
Sources: Eurostat and Commission services.

According to present forecasts, the deterioration in the *balance of payments* on current account should be less pronounced than in 1980. The deficit should nevertheless be 6,6% of gross domestic product as against 5,6% in 1980 and should be one of the highest in the Community in absolute value. The heavier deficit will mainly be the result of the steady deterioration in the trade balance, one reason for which is the higher cost of energy products. It will also reflect the unfavourable movement of the balance of factor incomes, which is mainly due to the considerable increase in charges relating to the external debt largely contracted in the form of public sector borrowing in foreign currencies.

Problems of economic policy

The levels of the external deficit and the budget deficit, but above all the rapid rate at which these balances have deteriorated in the last few years, are today the most worrying aspects of Belgium's economic situation. The room for manoeuvre with regard to economic policy has been reduced considerably, and in particular, there are far fewer opportunities for improving growth and employment conditions. There is no doubt that an even more marked deterioration in the balance of payments on current account,

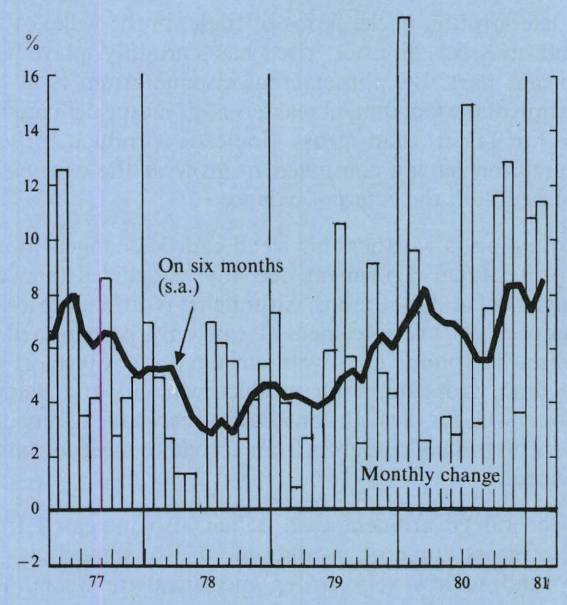
Belgium: Industrial production (s.a.)



Source: Eurostat.

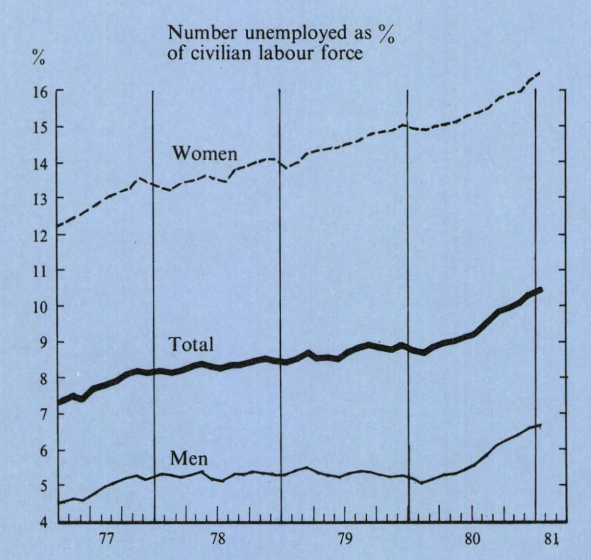
Belgium: Consumer prices

Change expressed as an annual rate



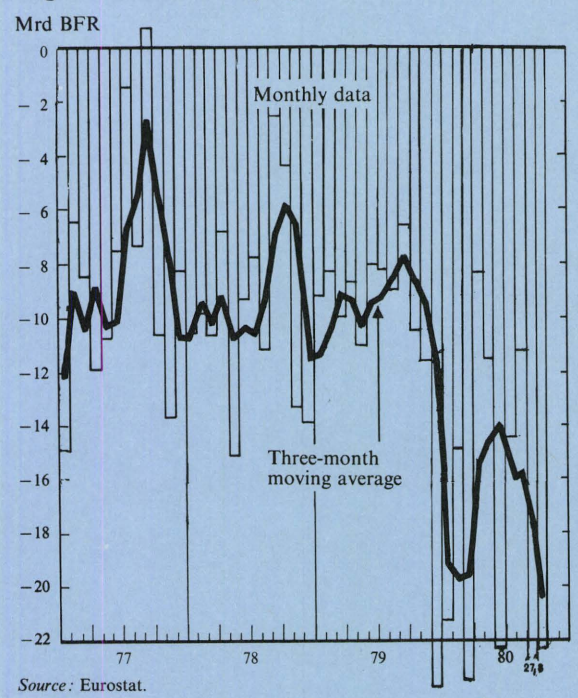
Source: Eurostat.

Belgium: Unemployment (s.a.)



Source: Eurostat.

Belgium: Trade balance (s.a.)



Source: Eurostat.

mainly as a result of heavier interest charges on foreign borrowings, would make rectification of the external situation very painful.

The deterioration in the terms of trade, in the wake of the second massive oil-price rise, has certainly played an important part. But the external disequilibrium is also a reflection of the fact that, in real terms, domestic demand has risen far faster than gross domestic product, private consumption having continued to grow at the expense of investment and the external balance.

The question is whether this trend can be changed by the interprofessional agreement recently concluded between management and the unions. Although it is difficult to assess the impact of this agreement it can only be expected to stabilize the volume of private consumption. Since, at the same time, gross domestic product will fall, the Belgian economy will, for the fifth consecutive year, have to rely on a net contribution of resources from abroad to meet consumption needs.

The general government cash deficit also increased from 8,5% of gross domestic product in 1979 to some 11,0% in 1980[1] and, unless very strong measures are taken, this proportion will be more or less maintained in 1981. The increase can be explained by both a smaller rise in tax receipts following the slowdown in economic activity, and a sharp increase in expenditure, notably in social transfer payments (unemployment benefits), aid to firms in difficulties, and public debt interest charges. In 1981, the latter will account for 13,8% of all public expenditure.

Reduction of the budget deficit is essential if external equilibrium is to improve. Given the already very high level of the burden of taxation the deficit would have to be cut mainly by restricting expenditure. A smaller deficit would also help to limit monetary financing, which has increased sharply in the last few years, and would make it possible to reduce public authority borrowing on the capital markets, which has been largely responsible for the maintenance of high interest rates.

The Belgian economy still has the advantage of a relatively moderate inflation rate, and, in the relatively more exposed sectors, its competitiveness has tended to improve in the last few years. However, the composition of exports, geared towards less-buoyant sectors, is somewhat unfavourable.

It will consequently be difficult to restore external equilibrium in the next few years. In order to achieve this, action must concentrate on both supply and demand. However, given the lags inherent in the reaction to these two types of action, together with the absolute necessity of preventing an even greater deterioration on current account suggests that the only effective short-run remedy is a severe restriction of the volume of consumption: this policy is also being pursued by other Community countries with particularly open economies.

[1] Including loans, advances and shareholding.

Denmark

Trends and prospects

The fairly high level of activity prevailing towards the end of 1979 started to decline in the early spring and resulted in a fall of *gross domestic product in 1980* of some 1%.[1] Gross domestic product in *1981* is likely to show little change on 1980, implying a further recession in the beginning of the year and a certain pick up in activity during the latter half of 1981.

The fall in economic activity during 1980 is largely the result of a more restrictive *economic policy* stance adopted since autumn 1979. Fiscal policy has been tightened affecting both private business and households. The deterioration in the terms of trade, resulting from the depreciation of the Danish Krone and from the new escalation of oil prices, which was passed on to the consumers by the measures concerning wage indexation and wage control was another deflationary factor affecting domestic demand.

Despite the tightening of direct and indirect taxation the government deficit increased compared with previous estimates, because of a fall in receipts, due to a slowdown in private consumption, and a rise in transfer payments associated with unemployment and the early retirement scheme.

The monetary authorities have pursued a restrictive policy with respect to domestic liquidity. Interest rates were maintained at a high level. However the fall in international interest rates towards mid-1980 allowed the Central Bank to lower the discount rate by 2%. The fall in the demand for credits facilitated furthermore an easing of the credit ceilings.

The present economic policy stance will be maintained in 1981. The raising of direct and indirect taxation and the envisaged slowdown in central and local government expenditure should result in a further decline of domestic demand. Monetary policy will remain restrictive. The need to maintain an adequate non-monetary financing of the government deficit and the present level of external interest rates limit the scope for a further easing of credit policy.

Domestic demand will remain weak during the coming months. The ceilings imposed upon general government expenditure, aimed at a gradual slowdown of its increase over a number of years, will contain *public consumption and investment* in 1981. Whereas public consumption might still grow at a moderate pace, public investment will continue to fall, although to a lesser extent than was the case during 1980.

In 1980, the decline in *private investment* has been somewhat more important than was the case in the public sector. Thus residential construction fell considerably and will continue to do so at least during the first half of 1981. The sluggishness in private gross disposable income and the high costs of borrowing, together with a general lack of consumer confidence, may explain the present setback within this sector. Rising energy prices and the impact of measures to improve heat insulation have on the other hand sustained some repair and renovation activity. Industrial construction slowed down last year, and this may continue, at least in the early part of 1981, as investment plans are adjusted downwards and idle production capacities increase. In agriculture, deteriorating profitability of previous investment due to the rise in costs of factor input is the main explanatory factor behind the fall in construction. Investment in equipment will remain depressed during most of the year. New orders for investment goods were fairly low towards the end of 1980 compared to the year before, and survey results actually confirm the fall at the beginning of 1981. However, it may be expected that a recovery in domestic and external demand in the latter half of 1981 as well as the impact of improved competitiveness, will give rise to some expansion in private investment.

Private consumption will continue to fall in volume terms in 1981 although at a slower pace than in 1980. Gross real disposable income will decline for the year on average, but might start to pick up during the year as a consequence of wage indexation and some wage drift, and thus sustain the recent tendency for private households to increase their savings.

The sluggishness of final demand and of economic activity resulted in a considerable fall in *stocks* in the course of last year. This trend is unlikely to continue in 1981 as the larger part of the downward adjustment has already taken place.

The improvement in the trade and services balance constituted the main expansionary element during 1980. Better competitiveness due to the measures taken since the end of 1979 and the levelling-off in domestic demand, which curbed imports of goods and services are the main explanatory factors for this improvement. *Export* volume continued to perform well in the first quarter of 1980 but started to fall off during the remaining part of the year and this trend could still prevail during most of 1981. The fall in foreign demand for investment goods and other manufactured products was to a large extent linked to the relatively unfavourable geographical structure of Danish industrial exports. The deterioration might however have been even more important if competitiveness had not improved, implying slight market gains. Stagnating exports of livestock products will reflect not so much general demand trends but rather stagnating or, in certain respects, even declining domestic production. The fall in *import* volume in

[1] See table.

Denmark: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [3]	1979 II	1980 I	1980 II	1981 [3] I	1981 [3] II	1979
	Annual data				Half-yearly data (s.a.)					DKR 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1970 prices									
Private consumption	2,5	3,0	−3,8	−2,0	2,0	−5,4	−6,3	−1,4	0,6	195,7
Public consumption	4,4	4,5	5,8	3,0	8,0	5,9	4,4	3,6	1,2	86,4
Gross fixed capital formation	1,0	−1,9	−14,9	−6,4	−7,1	−22,8	−11,5	−5,9	−1,0	75,8
Change in stocks [1]	0,6	0,6	0,2	−0,1	0,4	1,3	−0,9	−0,9	0,6	2,0
Domestic demand	2,5	2,6	−4,2	−1,8	0,6	−4,4	−8,8	−1,0	3,4	359,9
Exports of goods and services	4,9	9,8	5,5	1,3	9,8	12,6	−11,1	4,6	6,3	102,2
Imports of goods and services	3,9	6,4	−5,6	−3,7	7,7	−0,4	−29,7	4,2	7,7	114,0
GDP at market prices	2,8	3,5	−0,9	−0,1	1,0	−0,8	−2,2	−0,8	3,0	348,1
	% change over preceding period at annual rates									
GDP at current prices	12,5	10,8	7,5	8,2	11,2	5,5	8,0	7,1	10,5	
Industrial production	2,5	4,4	0,6	−1,4	10,5	1,2	−9,6	1,0	2,0	
Unemployment rate [2]	3,3	5,3	6,2	7,6	5,0	5,5	6,9	7,7	7,5	
Compensation of employees	12,6	11,0	9,0	8,7	12,4	8,2	7,5	8,2	10,9	
M2	11,0	9,9	10,9	8,7	:	:	:	:	:	
GDP (implicit price index)	9,4	7,1	8,5	8,3	10,0	6,5	10,3	8,1	7,5	
Private consumption (implicit price index)	9,4	9,5	11,0	9,0	16,2	9,2	9,4	8,8	9,0	
Exports, goods (implicit price index)	7,7	8,5	13,8	9,0	16,6	15,1	9,0	9,0	9,4	
Imports, goods (implicit price index)	9,1	14,0	22,3	13,3	26,1	27,7	9,4	13,4	16,2	
Terms of trade, goods	−1,3	−4,8	−7,0	−3,8	−7,5	−9,9	−0,4	−3,9	−5,9	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,5	−3,4	−1,8	−1,1	−4,2	−3,6	−0,1	−0,6	−1,6	
Current balance	−2,8	−4,6	−4,1	−3,6	−5,2	−5,8	−2,3	−3,1	−4,2	
Net borrowing of general government	−0,9	3,1	4,6	5,7	:	:	:	:	:	

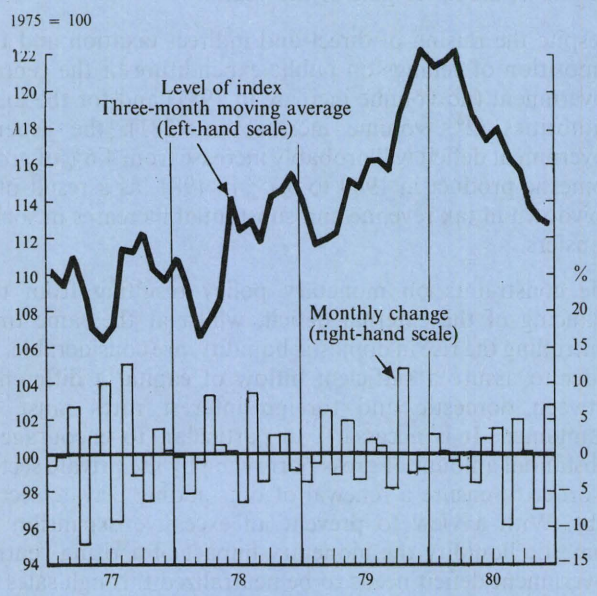
1 As % of GDP.
2 Unemployment as % of total labour force.
3 Forecasts.
Source: Commission and national services.

1980 was in particular linked to a slowdown of activity in manufacturing industry and construction and affected investment goods as well as intermediary products used in these sectors. Furthermore the volume indices for imported fuel continued to fall from the second half of 1979, reflecting both a slowdown in activity and the continued efforts to increase efficiency in using fuel and power. An increase in domestic demand could bring about some rise in imports in 1981, particularly in the latter half of the year.

Although an increasing number of persons have chosen to retire early from the labour force, the participation rate continued to rise due to a growing number of women looking for jobs. The considerable rise in the rate of unemployment, which may attain some 7,5% of total labour force on average in 1981 (SOEC definitions), will continue during the first half of the year, but could be reversed in the latter part of 1981. Persons under the age of 25 now account for one-third of those unemployed. Compared to 1980 employment in the private sector, especially in manufacturing industry and construction, will be considerably lower and public employment somewhat higher.

Domestic *prices* may rise at a moderate pace during most of 1981. Although the price freeze adopted in December 1979 expires at the end of February this year, the impact on actual prices should be fairly limited. Planned increases in public charges could however be carried through and a certain adjustment of rents may be envisaged.

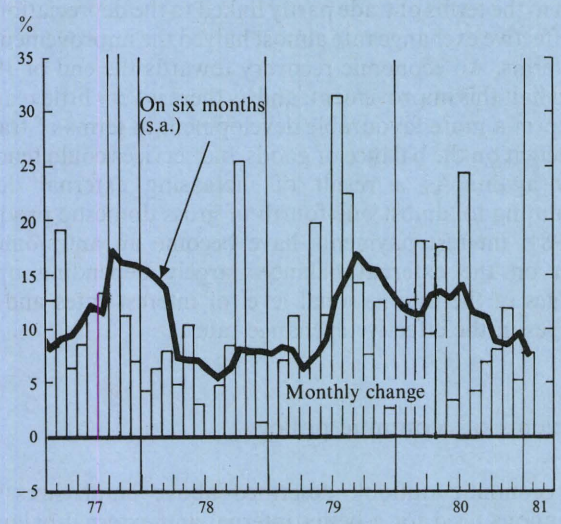
Denmark: Industrial production (s.a.)



Source: Eurostat.

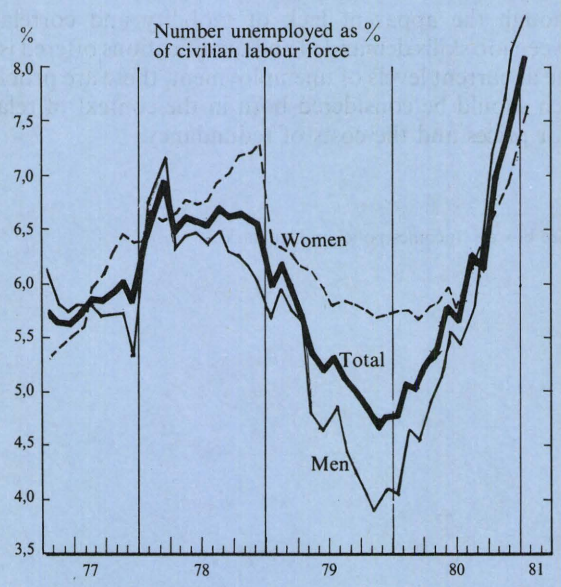
Denmark: Consumer prices

Change expressed as an annual rate



Source: Eurostat.

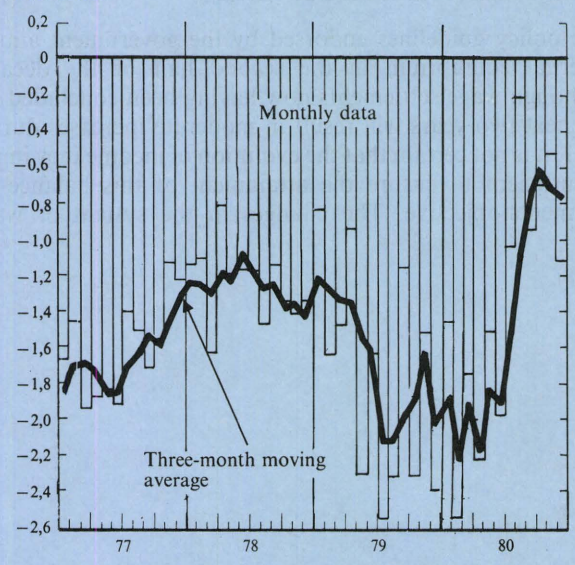
Denmark: Unemployment (s.a.)



Source: Eurostat.

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

Mrd DKR



[1] Ships and aircraft excluded.
Source: Danmarks Statistik.

The improvement of the *balance of payments* towards the end of 1980 should not conceal the underlying disequilibria. Despite considerable gains in volume terms on the trade and services balance which took place during 1980 and which may continue during the greater part of 1981, the deterioration in the terms of trade partly linked to the depreciation of the effective exchange rate almost halved the improvement in real terms. An economic recovery towards the end of 1981 could halt this improvement, and as there is very little reason to expect a more favourable development in terms of trade, the deficit on the balance of goods and services could tend to grow again. As a result of increasing external debt, amounting to almost one-fourth of gross domestic product in 1981, interest payments have become an autonomous drain on the external balance, largely depending upon changes in the international level of interest rates and on changes in the effective exchange rate.

Problems of economic policy

The economic outlook described above emphasizes the continuous need for a better internal and external balance. The measures adopted at the end of 1979 and during 1980, aiming at improved competitiveness and reduced domestic demand, brought about a marked fall in the external deficit throughout the year. The improvement is however not yet consolidated, as it stems mainly from a fall in imports due to a decline in final domestic demand, which could be reversed later on. A further deterioration in the terms of trade and the increasing cost of servicing the external debt are risks of which due account should be taken.

The policy guidelines endorsed by the government aim at external equilibrium in the second half of the decade. Although wage settlements now having been concluded for the next two years will result in moderate increases during 1981, it is not certain that the evolution of income they imply is sufficient to ensure the attainment of this balance-of-payments-objective. The changes in the system of wage indexation [1] have reduced the impact stemming from higher energy prices, but some wage drift may cushion the fall in real income in the latter part of the year.

Despite the raising of direct and indirect taxation and the imposition of ceilings on public expenditure of the central government (no volume increase in 1981) and for the local authorities (2% volume increase in 1981), the general government deficit will probably increase from 4,6% of gross domestic product in 1980 to 5,7% in 1981, as a result of a slowdown in tax revenue and substantial increases in social transfers.

The constraints on monetary policy resulting from the financing of the external deficit, whilst at the same time controlling the rise in domestic liquidity, are considerable. In order to assure a sufficient inflow of capital a difference between domestic and foreign interest rates must be maintained. It is necessary, in particular, to encourage a substantial amount of gross borrowing by the private sector in order to ensure a renewal of outstanding private sector debt. With a view to prevent an excessive expansion of domestic liquidity the monetary impact of a rising central government deficit needs to be neutralized through sales of government securities.

Given the fairly bleak outlook for 1981 and in view of the constraints imposed on economic policy stance, the employment problem will remain severe. The shedding of labour in the private sector is only to some extent compensated for by a rise of employment in the public sector. Selective measures have been evisaged in the government employment schemes to encourage structural adaptation on the labour market. Although the apparent lack of mobility and correlation between job skills demanded and qualifications offered is less acute at current levels of unemployment, these are problems which should be considered both in the context of relative factor prices and the costs of redundancy.

[1] See box on 'Incomes policy in Denmark'.

Incomes policy in Denmark

1. During the 1960s and at the beginning of the 1970s, incomes policy in Denmark was only considered as having a modest role in supporting budgetary and monetary policies. However, the growing external deficit and rising unemployment brought about new interest in a feasible incomes policy as an alternative to the traditional approaches. The measures taken to moderate income developments so as to achieve a better economic balance have been conceived so far on an *ad hoc* basis intended to put a brake on domestically-generated increases in factor costs, to sustain competitiveness in exporting and import substituting sectors and to restrict the autonomous tendency towards a growth in consumption.

2. National wage agreements are negotiated biennially between the social partners in the private and the public sectors. Matters of particular interest to the different trade unions are negotiated separately, whereas questions concerning the labour market in general are negotiated between the main partners at a central level. An official arbitrator can be asked by the social partners to assist during the negotiations and may eventually put forward a draft proposal, which is intended to avoid a conflict of interests rather than to constitute a policy. Apart from conditions concerning holidays, working hours, etc. the agreements stipulate general changes in basic rates, the application of wage indexation and other modifications in pay to different sectors or categories. The agreements implemented in March 1981 were, however, negotiated separately in almost all cases. The fairly successful outcome may be explained by the need felt by the social partners to reassert their autonomy as regards the government, by the decentralized procedures allowing characteristics in each sector to be taken into account and by the government's firm commitment on the permissible rise in wage incomes.

3. From 1975 until 1981, the government has intervened by law due to a failure to obtain agreement, and has to a varying degree acted on the different wage components.

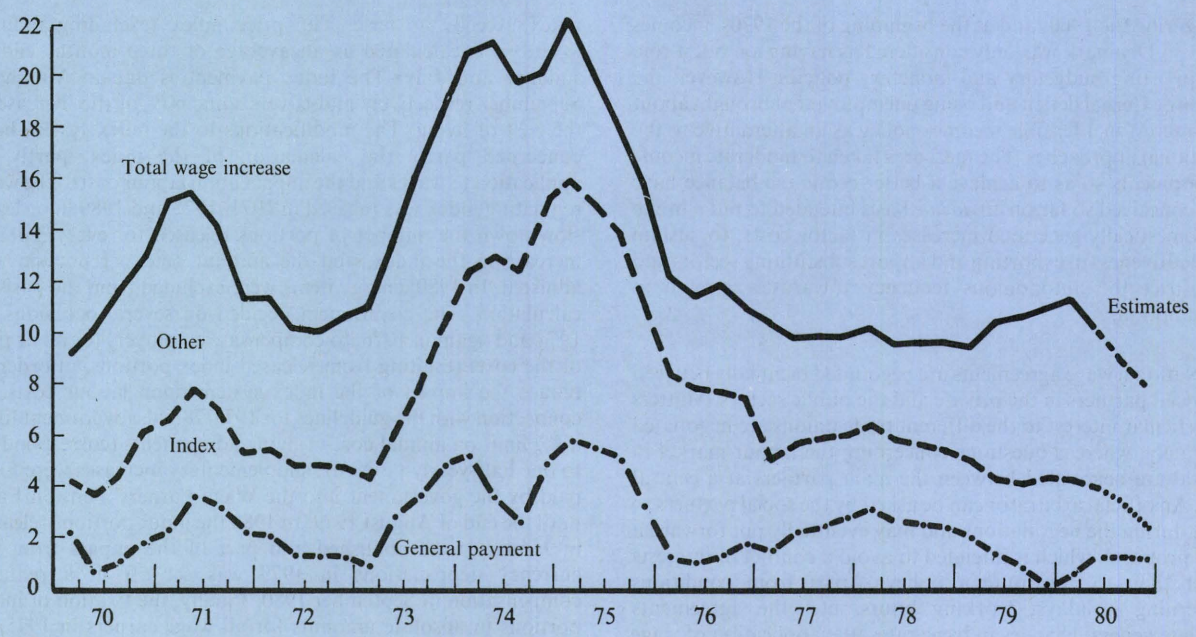
In general the government has confined itself to setting forth qualitative recommendations when referring to real wage increases. Prior to the wage negotiations for 1977/78 however, the government framed its policy in the form of quantitative guidelines suggesting a total nominal increase of 6% p.a. of which 2% represented a real increase. In the pluriannual programme endorsed by the government in December 1979 'guidelines' in terms of real disposable income were presented. The government invited the social partners to agree upon moderate settlements in order to improve competitiveness, implying that excessive nominal increases in average income would be counterbalanced by fiscal measures neutralizing any apparent gains.

Steps have been taken in order to reduce the impact on wages resulting from the index system. The cost of living adjustments may take place automatically twice a year. A fixed amount is released for every 3 points by which the wage-regulating price index exceeds its base. The price index (excluding indirect taxation) is calculated as an average of three months ending January and July. The index payment is due in March or September respectively and covers some 60% of the increase in the cost of living. The modifications to the index system have concerned partly the calculation of the index, partly its application to wages and the impact upon labour costs. The wage regulating index was rebased in 1971, 1975 and 1980 in order to slow down the number of portions released for every 3 points increase in the index, and the amount paid per portion was adjusted. In 1980, energy items were excluded from the basis of calculation. The government decided on several occasions, in 1974 and again in 1976, to compensate employers for all or part of the costs resulting from released index portions, in order to reduce the impact of the index system upon labour costs. In connection with the guidelines for 1977/78, the government fixed a 4% limit on annual cost-of-living adjustments (corresponding to one half-yearly portion); supplementary increases were to be paid by the government into the Wage Earners' Pension Fund until the end of August 1979. In 1980 the index portions released in January were abolished and part of the impact from the currency depreciations in 1979 was set off in a reduced compensation in September 1980. Finally, the fixation of index portions in absolute amounts for all wage earners in 1975, as against percentage compensation previously granted to certain categories, gave an egalitarian trait to the wage system, in particular as between the public and the private sector.

The residual part of the wage increases (settlements by sector and by plant, wage drift) is far more difficult to control as it represents a complex of different factors at play between sectors and among different categories of wage earners (depending to a large extent on different conditions of demand for and supply of labour and of labour productivity, and on changes in the level of transfers and taxes). In order to avoid wage drift, the authorities have, on some occasions, adopted a temporary freeze on prices and wages or applied specific rules of price calculation supervised by the Monopolies Control Authority. The controls intended to exclude from the price calculations wage increases not provided for in the settlements and to maintain the levels of profits, fees, dividends, etc.

4. Danish experience shows that the latter part of wage increases has had a determining impact in recent years (see graph.). Specific negotiated supplements to certain low-income categories may have added to wage drift. The more or less explicit linking between wages in different sectors (e.g. wage drift guarantees) has furthermore spread the benefits that may be economically justified in one part of the labour market to other parts. Finally tax push elements may have played a role and been carried forward into nominal wages. The temporary price freezes and controls applied, in particular with respect to domestic non-competitive sectors—the last one expired end-February 1981—have frequently been used to act as a brake on wage drift, without any conclusive effects however.

Denmark: Development in wage components (% increase compared to same quarter previous year)



Source: Danish Employers' Confederation: *Statistics of hourly wages.*

Federal Republic of Germany

Trends and prospects

Following a particularly sharp downturn in the second quarter of 1980, economic activity continued to fall in the remainder of the year. Because of the high level reached in the first quarter, average *real GDP for 1980* was still 2% higher than in 1979,[1] but by the fourth quarter, its level had fallen to some 1% below the average for the year.

In the opening months of 1981, activity has remained weak but the downswing is expected to bottom out by mid-year. If the international environment improves as assumed, the second half of the year should mark the beginning of a cyclical upswing. The recovery will probably be relatively slow, in part because of the continuing limited room for manœuvre in economic policy. All in all, because of the low starting level, the forces of recovery are unlikely to be strong enough for average economic growth to be positive between 1980 and 1981. Indeed, *real GDP* is likely to be 0,5 to 1% down on the out-turn for 1980.

Room for manœuvre in *economic policy* was considerably reduced in the past year both by external developments and by constraints arising from the domestic economy, particularly in the area of public finance. Budgetary policy fell a long way short of success in carrying out the Financial Planning Council's recommendation that the general government deficit (excluding social security) in 1980 be brought below that of the previous year, mainly because of a failure to curb the expansion of expenditure in line with plans. In spite of the marked economic slowdown during the year, receipts were barely lower than forecast. Overall, the public budgets continued to provide a marked expansionary stimulus, as they had done the year before.

The Bundesbank tightened the restrictive stance of its monetary and credit policy adopted in 1979, reducing the target range for the expansion of central bank money from 6-9% in 1979 to 5-8% in 1980. In order to forestall a surge in domestic prices following the oil-price rises, and taking account of the behaviour of the exchange rate of the German mark, the Bundesbank reduced the growth of central bank money to the lower limit of the target band. Because of heavy outflows of foreign exchange in the wake of the rising current account deficit and the movement into deficit of private capital movements, the Bundesbank gave the banking system considerable liquidity assistance on several occasions, but nevertheless raised its key rates in stages. As the economic slowdown intensified, monetary and credit policy was increasingly prone to conflicting objectives, being caught between moves to keep the mark exchange rate within the limits of fluctuation *vis-à-vis* the other EMS currencies and efforts to keep the rise in interest rates within bounds, with a view to limiting as much as possible its effects on the already weak domestic economic activity.

Although short-term pressures may at times become more marked, the authorities intend to maintain their policy approach towards the medium-term improvement of the general economic environment. As a result of the tax reliefs effective since the beginning of the year and the raising of certain social benefits, combined with cyclically-induced shortfalls in tax receipts, the general government borrowing requirement will again rise sharply. This deterioration of the budgetary position is accepted but there are no plans for further measures to support demand, over and above the stimuli resulting from automatic stabilizers.

In 1981 as in 1980, monetary and credit policy will be caught in the conflict between domestic and external requirements. Considering the dangers of a resurgence of inflation and the persistent current account deficit, the Bundesbank reduced by 1% (to 4-7%) its target range for the growth of central bank money stock from the final quarter of 1980 to that of 1981. Within this band, the Bundesbank has allowed sufficient margin so as not to obstruct somewhat stronger economic growth if this proves possible. All in all, however, there is not much scope in the short term for supporting a revival of economic activity.

In the first half of the year domestic demand is likely to fall further, but will gradually improve as the year goes on. Efforts to hold down public expenditure are clearly reflected in the Federal Government budget for 1981. The Financial Planning Council has also recommended that the regional and local authorities should join in these efforts. Consequently, after a vigorous increase in the past year, *public consumption* will not climb much further in real terms. Following the slump in demand connected with a sharp drop in orders, *building investment* is likely to decline sharply in the current year, the austerity measures probably having a noticeable effect on public building orders. It is true that because the fund allocation periods for 1981 have been extended, some residual effects are still to be expected from the future investment programme ('Programm für Zukunftsinvestitionen'), but public building investment in 1981 will nonetheless fall appreciably in real terms. In private residential construction however, new orders and in particular mortgage loan commitments point to some improvement in demand. Building output will probably not be effected, however, until the second half of the year. Since output will initially drop even further, the average for the year is expected to be well down in real terms compared to 1980. Commercial and industrial building investment might turn out to be somewhat more resilient, but will probably also fall short of the previous year's level after the consistently brisk expansion in recent years.

[1] See table.

FR of Germany: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [4]	1979 II	1980 I	1980 II	1981 [4] I	1981 [4] II	1979
	Annual data				Half-yearly data (s.a.)					DM 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1970 prices									
Private consumption	3,6	3,2	1,7	0,7	−0,8	3,9	−0,2	0,5	1,9	766,3
Public consumption	2,9	2,9	2,8	0,5	1,1	4,8	0,7	0,4	0,4	277,9
Gross fixed capital formation	2,9	8,7	4,1	−2,8	14,5	2,3	−1,7	−3,8	−1,8	318,1
Change in stocks [1]	1,0	2,3	1,7	0,7	2,9	1,9	1,4	0,5	0,9	29,6
Domestic demand	3,3	6,1	1,8	−1,2	5,8	1,6	−1,4	−2,6	1,7	1 391,8
Exports of goods and services	6,2	5,1	5,4	0,6	5,4	12,4	−7,2	2,0	6,0	357,4
Imports of goods and services	7,1	11,0	5,0	−1,2	10,4	7,7	−5,2	−2,3	5,1	349,1
GDP at market prices	3,2	4,6	2,0	−0,7	4,5	2,9	−2,1	−1,4	2,0	1 400,2
	% change over preceding period at annual rates									
GDP at current prices	8,9	8,6	7,1	3,7	9,0	7,7	4,1	2,4	5,8	
Industrial production [2]	2,8	5,3	1,0	−1,5	6,0	2,0	−7,0	−1,0	1,6	
Unemployment rate [3]	2,8	3,3	3,3	4,3	3,2	3,2	3,5	4,4	4,3	
Compensation of employees	9,6	7,3	7,7	3,3	9,6	6,2	9,0	1,3	1,9	
M3	10,3	8,9	5,2	4,5	5,0	5,6	4,9	4,0	5,0	
GDP (implicit price index)	5,5	3,8	5,0	4,4	4,3	4,7	6,3	3,9	3,7	
Private consumption (implicit price index)	5,2	3,9	5,4	4,5	6,1	4,8	5,8	4,2	3,8	
Exports, goods (implicit price index)	4,2	3,8	6,0	5,5	6,1	6,8	4,4	5,7	6,0	
Imports, goods (implicit price index)	4,1	7,9	10,8	6,0	18,8	11,0	3,8	7,0	6,1	
Terms of trade	0,1	−3,8	−4,3	−0,5	−10,7	−3,8	0,6	−1,2	−0,1	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	3,0	1,4	0,4	0,8	0,7	0,5	0,3	0,7	0,8	
Current balance	0,9	−0,7	−1,7	−1,6	−1,3	−1,6	−1,7	−1,6	−1,5	
Net borrowing of general government	−2,1	−3,0	−3,5	−3,8	−3,5	−2,8	−4,0	−3,8	−3,7	

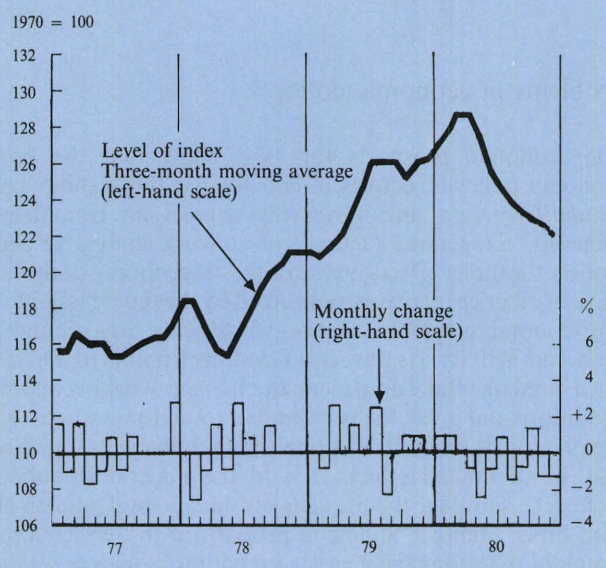
1 As % of GDP.
2 Excluding construction.
3 Unemployment as % of total labour force.
4 Forecasts.
Sources: Eurostat; Commission and national services.

Last autumn's business surveys already pointed to a considerable slowdown in corporate *investment in plant and machinery* for 1981. Because of the deterioration in growth prospects for the current year, persistent pressure on profits and continuing relatively high interest rates, it is now assumed that investment plans will be revised downwards more sharply, but without causing a real cyclical downturn in investment.

In 1981 *private consumption* is likely to be supported mainly by the programme of tax reliefs which came into force at the beginning of the year. Nonetheless, an expansion in real terms can only be expected if efforts to reduce inflation are successful, since the rise in disposable income is seen to slow down. The savings ratio is expected to remain at a relatively high level because of the unfavourable employment situation.

Stockbuilding could still be a dampening force in the coming months, but this will gradually change to give way to a more expansionary trend.

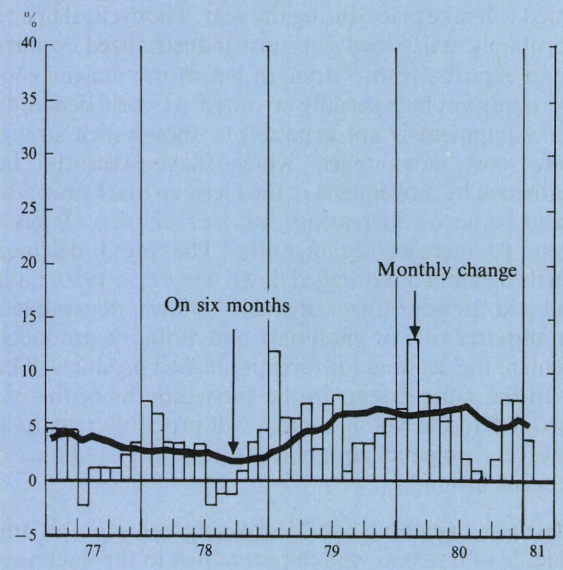
Federal Republic of Germany: Industrial production (s.a.)



Source: Deutsche Bundesbank.

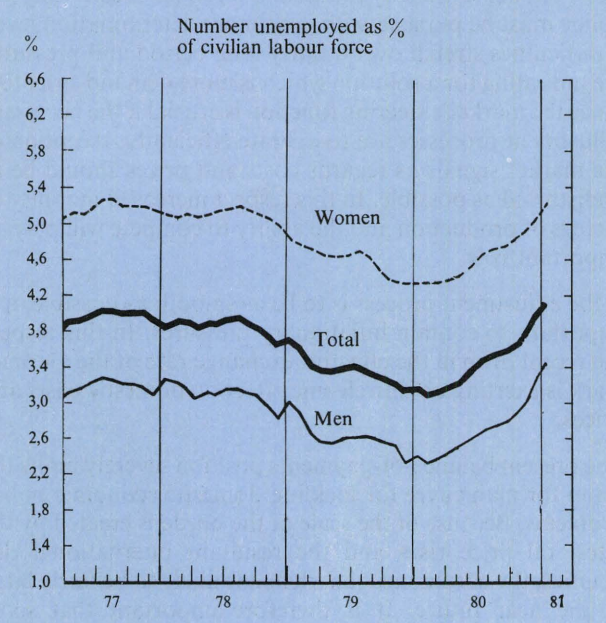
Federal Republic of Germany: Consumer prices (s.a.)

Change expressed as an annual rate



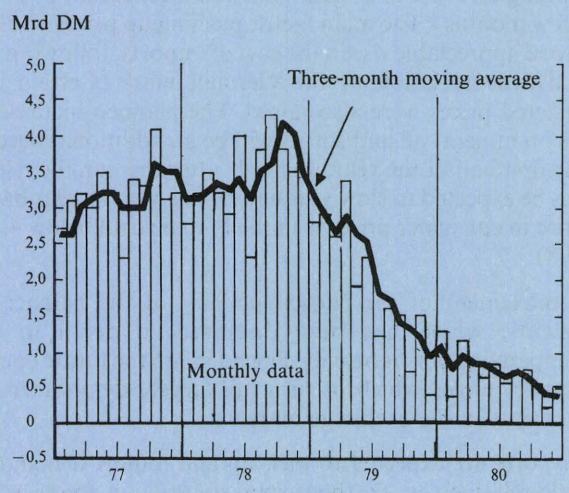
Source: Eurostat.

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



Source: Eurostat.

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



Source: Deutsche Bundesbank.

The expected recovery in world trade and the consequent acceleration in German *exports of goods,* sustained by a favourable competitive position, are likely to provide the main impetus for the revival of economic activity which it is assumed will take place during the year. The cyclical upswing will probably start slowly in most industrialized countries. German exports, whose strength lies in investment goods, will certainly not be especially favoured, as world demand for capital equipment is not expected to show much strength. Despite cost advantages which have recently been strengthened by movements in the German mark, and which are seen to go on increasing this year, market shares are unlikely to increase significantly. The rapid decline of domestic demand has dragged down *imports* in 1980. Falling output and the adjustment of stocks to lower demand led to lower imports of raw materials and primary products in particular; the demand for foreign finished products did not react to the same extent. In the early months of this year, import demand in volume terms will probably remain at a low level and only pick up again as output rises and the stock cycle turns around.

Employment, which was still increasing considerably up to the middle of last year, will in part adjust to the slackness of economic activity and may fall in the months ahead. It can be assumed, however, that as in other downward phases, firms will attempt to hold on to their staff, and will firstly go over to increased short-time working, thus limiting the fall in employment. Nevertheless unemployment will increase appreciably and the level as a percentage of the labour force is expected to climb from the 1980 average of 3,3% to 4,3% in 1981, partly as a result of the increase in the labour force.

The upward movement of *prices,* which had abated at the beginning of 1980, has again gathered momentum over the last few months.[1] The main factor pushing up prices was the renewed appreciable rise in the cost of imports, following the effective depreciation of the German mark. Certain administered prices were also raised. The planned increase in taxes on mineral oil and spirits will be an additional burden in the first half of the year, and only after this can the rise in prices be expected to slow gradually. On a year to year basis, the rise in consumer prices is unlikely to be held below 4,5% in 1981.

The movement of the *current account* of the balance of payments, which has been discussed in detail in the accompanying box, is heavily dependent on the future course of import prices which in turn are largely determined by movements in the exchange markets.

As exports are expected to pick up and import demand to remain relatively weak, the surplus on trade in goods could increase considerably despite a further deterioration in the terms of trade. On the other hand it must be expected that the deficit on services and transfers will again rise, so that overall the 1981 current account deficit is unlikely to be markedly lower than in 1980.

Problems of economic policy

The economic prospects for 1981 show that the basic economic policy objectives, as laid down in the 'stability law' *(Stabilitätsgesetz)* are in varying degrees far from being achieved. Exogenous factors are at work in this respect, namely the direct effects on the domestic economy of the last wave of oil price increases, reinforced by the repercussions on the external economy of the world-wide weakening of economic activity. As this recent evolution points to the need for a fundamental adjustment to changed world economic conditions and given the very limited room for manœuvre in the present situation, traditional short-term cyclical policies may be of limited effect. It is in the Federal Republic's interest to shoulder the burdens of fundamental adjustment with other Member States, in proportion to her economic strength, so as to make it easier for countries in even weaker positions to solve their problems and to prevent any upsurge of unilateral protective measures.

In the Federal Republic of Germany, the experiences of the first oil crisis resulted in economic policy being more firmly directed toward the medium-term improvement of supply conditions and the promotion of structural change. The latest setback caused by the second oil shock means that this policy must be pursued with even more determination, even if difficulties stretch over a fairly long period and pressures are mounting for a solution which is more demand-oriented. Since the market's steering function is crucial if the necessary adjustment processes are to operate efficiently, reception of the market signals as regards costs and prices should be as undistorted as possible. In this respect increased mobility of factors of production and the ability to compete will play an important role.

If the adjustment process is to be as smooth as possible, it is important to contain inflationary pressures. In this respect the recent drop in the effective exchange rate of the German mark is exerting an unwelcome effect on domestic costs and prices.

The present balance-of-payments position severely limits the room for manœuvre for tackling domestic economic policy problems. Because of the scale of the burdens created by the latest oil price rises and the resultant international difficulties, the current account deficit is likely to be fairly large in the near future. It is therefore important that some improvement is seen to be underway and that the market succeeds in financing the current deficit by corresponding imports of capital. This would ease the external economic

[1] See graph.

constraints on monetary policy and enable it to be more closely geared to domestic economic requirements. In this respect, the Bundesbank's target range for the expansion of central bank money stock gives sufficient flexibility for dealing with developments if and when they arise.

Budgetary policy is presently directed toward the medium-term reduction of the large public deficits. The essential point here is to change the structure of expenditure and reduce the rate at which it is rising. The Federal Government draft budget for 1981 points in this direction and regional and local authorities too should comply with the recommendation of the Financial Planning Council and control current expenditure more strictly.

The task of mastering the structural adjustment process at a time of keener international competition and revolutionary high-risk technological change, lies primarily with the economy itself. Economic policy can only give assistance. What matters is that all sectors concerned with economic policy work together as closely as possible and that the necessary adjustments are not held up by group interests. The investment needed to convert productive capacity can only be forthcoming if the introduction of new technologies is not obstructed, if the greater risks are also balanced by greater opportunities and if the necessary mobility of the factors of production is accepted. Such a conversion process can also be expected to produce substantial positive employment effects which could undoubtedly outweigh the losses in the declining sectors. Labour market policy can use its range of instruments to help improve professional mobility, to promote retraining and training programmes in respect of new production techniques and processes, and to facilitate the reabsorption of specially disadvantaged groups.

The energy situation has important macroeconomic implications. As long as energy requirements are met to such a large extent by foreign resources, they constitute a genuine constraint on the balance of payments and on the future growth potential of the economy. It is important that decisions on these matters are taken and uncertainties removed. At the same time continuing attention should be given to measures which save energy and stimulate its more rational use, so as to bring about a new structure of consumption, particularly as regards reduced dependence on oil.

External disequilibrium in the Federal Republic of Germany

The external position of the Federal Republic of Germany showed a further appreciable deterioration in 1980. The shortfall on current account, which in 1979 moved into deficit (−DM10 100 million) for the first time since 1965, grew to approximately DM28 200 million.[1] Given the relatively high surplus achieved in 1978 (+DM17 500 million), the negative swing since the last oil-price rise, i.e. between 1978 and 1980, was some DM45 700 million. About DM28 500 million of this swing was due to the higher oil bill, although the volume of oil imports fell considerably. Thus, although an overwhelming part of the deterioration is attributable to the oil-price rise, other areas of the current account, mainly tourism and unrequited transfers, also contributed to the widening of the external deficit.

Of the main components of the current account balance, the balance of trade showed a particular deterioration, due largely to the higher oil bill. Indeed, the surplus on non-oil trade in goods hardly changed over the last few years. The geographical composition of the trade balance, since 1978, has however shown quite marked changes. OPEC's share in the supply of oil to the Federal Republic of Germany fell considerably between 1978 and 1980, while that of other oil producers, in particular the United Kingdom, followed at some distance by Norway, the Soviet Union and the Netherlands increased, the last named mainly supplying reprocessed mineral oil products or products in transit. The trade balance with the European oil-supplying countries (including the Soviet Union), deteriorated by some DM10 000 million between 1978 and 1980, although the deterioration would have been higher but for the rapid expansion of exports to these countries. This contrasts sharply with the trend in German exports to OPEC, which fell by 20% in 1979 and which despite a considerable recovery in 1980, are not yet back to the 1978 level. A substantial proportion of the fall is explained by the sharp decline in exports to Iran, but other OPEC countries, in particular Saudi Arabia, expanded their purchases from the Federal Republic of Germany only gradually. In addition to the oil-price-induced burdens, the trade balance with the North American continent deteriorated appreciably, but rising surpluses with European neighbours, especially Italy, France and Switzerland, more than offset this movement. Overall, the higher oil bill broadly matches the deterioration in the trade balance. The remainder of the deterioration in the current account between 1978 and 1980 (approximately DM17 000 million) is largely due to the sharp increase in the deficits on services and transfers. The important factors here were in particular the persistent buoyancy of tourist travel, which in 1980 showed a deficit of approximately DM25 000 million (DM19 000 million in 1978) and the sharp rise in the deficit on unrequited transfers.

In 1979, the current account deficit was almost entirely financed by corresponding imports of capital: net private capital movements produced a surplus of some DM11 200 million. However, this process ran into considerable difficulties last year. Although in 1980 the public sector, in particular the Federal Government, borrowed abroad for the first time on a fairly large scale, raising more than DM21 000 million mainly in long-term funds chiefly from the OPEC countries and the USA, the Bundesbank used about DM28 000 million of its exchange reserves. There was a decisive move into deficit on overall private capital movements (−DM15 600 million) contrasting sharply with the surplus recorded in 1979.

Companies and private individuals borrowed some DM8 500 million net abroad in short-term funds in 1980, mainly financial loans, but this was more than matched by long-term net capital exports (−DM14 400 million). In addition the credit institutions invested a further DM9 700 million net abroad in short-term markets. The swing into deficit of private long-term capital movements was attributable to the fact that the taking-up of long-term foreign loans fell sharply while portfolio investments showed a substantial net outward movement. Moreover, in line with the trend evident since 1975, German direct investment abroad was again much higher than foreign direct investment in the Federal Republic of Germany.

The main factor behind the marked deterioration in the balance of private capital movements from 1979 to 1980 is undoubtedly the level of interest rates abroad which were, in general, considerably above the German rates. For example at the end of 1980, rates for short-term dollar investment stood at 20% compared with the corresponding DM rates of 10%. Other factors, including political developments, both domestically and internationally, may also have affected capital flows and market sentiments on future exchange-rate movements.

The above developments have put the German mark's exchange rate under considerable pressure. Within the EMS the mark moved for quite some time along its lower intervention point and at times required support under the EMS arrangements. Heavy intervention was also needed to check the mark's fall against the dollar. By the end of 1980, the mark had lost some 10% of its value against the dollar compared with the level of a year earlier. The exchange rate against sterling and the Japanese yen fell back by approximately 20% over the same period, while the German mark lost just under 1% in value against the weighted average of the currencies participating in the EMS. The effective exchange rate of the German mark against 23 important trading partners was down by roughly 3,5%. At the beginning of 1981 the strengthening of the dollar accelerated and brought the depreciation over a twelve-month period temporarily to over 20%. This induced the Bundesbank on 19 February to take special measures with a view to raising short-term interest rates and limiting further capital exports.

The weakness of the German mark cannot be explained by any major change in the overall competitive position of the Federal Republic of Germany, as this has been improving recently against most countries given the lower rate of increase in prices

[1] See table.

and costs compared with those of its major trading partners. It can therefore be assumed that the underlying external position is likely to improve, once the adverse effects on the trade balance resulting from the fall in the mark's exchange rate (J-curve) have worked through. In addition, when account is taken of the level of foreign reserves built up in periods of surplus and of the relatively low foreign indebtedness of the German economy, it is clear that the Federal Republic is able to spread the necessary adjustment over a longer period. As a result domestic short-term needs can be better accommodated and at the same time the Federal Republic could contribute to a smoother solution of the difficult international balance-of-payments problems. Extensive use of the Bundesbank's foreign exchange reserves can, however, only be justified if the breathing space it procures is used to chart a course for the gradual closing of the external gap. Nevertheless, the higher oil bill, a further net increase in the use of foreign services, growing international commitments and substantial net capital exports, together represent excessive strains on the German economy in the longer term, even though it is still distinguished by its industrial strength and efficiency. Nor does there appear to be any prospect that the Federal Republic of Germany will in the near future again benefit from the favourable circumstances which followed the first oil-price shock in 1973/74, and be able to reduce considerably the current account deficit solely by expanding exports more rapidly. In addition, a drastic devaluation of the mark or the introduction of exchange controls with regard to individual balance of payments positions in heavy deficit should be ruled out. Under these circumstances, the Federal Republic will be running a substantial balance of payments current account deficit for some time to come. This points to the need to finance the deficit at least partly by correspondingly high net capital inflows and by stimulating a restructuring of the use of domestic resources away from consumption and in favour of capital expenditure, innovation and energy saving. Such structural changes should be favoured by moderation in wage settlements, which are in turn conducive to investment, and a successful outcome to the present price stabilization policy. This would help to set the conditions for a gradual improvement in the current account of the balance of payments and restore confidence in the exchange markets. Such a development would permit the Bundesbank to rely less heavily on interest rates as an instrument of balance-of-payments policy.

FR of Germany: balance of payments

(DM 000 million)

	1972	1973	1974	1975	1976	1977	1978	1979	1980
Trade balance (fob/cif)	+20,3	+33,0	+50,8	+37,3	+34,5	+38,4	+41,2	+22,4	+9,1
Mineral oil imports, net (cif)	−9,5	−13,5	−29,2	−26,7	−32,6	−31,8	−29,3	−44,3	−57,8
Trade balance (fob/cif) excluding mineral oil	+29,8	+46,5	+80,0	+64,0	+67,1	+70,2	+70,5	+66,7	+66,9
Trade balance (fob/fob) [1]	+26,7	+40,6	+57,4	+43,3	+42,0	+46,0	+51,2	+32,5	+20,1
Services [2]	−10,1	−12,7	−14,8	−15,5	−14,2	−18,3	−16,1	−21,8	−24,1
Unrequited transfers	−14,0	−15,6	−16,1	−17,9	−18,1	−17,9	−17,6	−20,8	−24,2
Current account	+2,6	+14,3	+26,5	+9,9	+9,7	+9,8	+17,5	−10,1	−28,2
Long-term capital movements (exports −)									
private	+17,0	+15,2	−5,4	−19,4	−3,9	−11,3	+0,6	+12,0	−14,4
public	−1,5	−2,2	−0,9	+1,2	+2,4	−1,6	−3,3	−1,5	+19,3
Short-term capital movements (exports −)									
private	−4,0	+0,1	−19,0	+4,2	+1,0	+12,7	+7,2	−0,8	−1,2
public	+0,5	+0,3	−0	+0,7	−0,5	−0,5	+1,3	−0,4	+1,9
Total capital movements	+12,0	+13,2	−25,3	−13,3	−0,9	−0,8	+5,8	+9,3	+5,6
Residual items	+1,1	+0,9	−3,2	+1,1	+0	+1,4	−3,5	−4,1	−5,3
Change in the Bundesbank's external position	+15,2	+16,1	−9,1	+3,3	+1,3	+2,6	+12,2	−7,3	−25,7
of which: change in valuation of reserves	−0,5	−10,3	−7,2	+5,5	−7,5	−7,9	−7,6	−2,3	+2,2

1 Including supplementary trade items.
2 Including the freight and insurance costs included in the cif value of imports.

Source: Deutsche Bundesbank.

Greece

Trends and prospects

Economic activity stopped declining towards the middle of 1980 and picked up slightly in the second half of the year. Overall, *gross domestic product* in 1980 increased by 1,4% compared with 1979, thanks to an exceptionally strong contribution from agriculture. The upturn should be maintained in 1981 and growth should continue at a moderate rate, leading to a further increase of over 2% in gross domestic product. [1]

The marked slowdown in activity prior to this upturn had been caused by the combined effect of a sharp acceleration in price rises—itself reflecting the higher cost of energy and imported raw materials, the abolition of certain agricultural subsidies and the sharp depreciation in the exchange rate early in 1980—and of a restrictive *economic policy*. The 1980 budget attempted to curb the increase in the deficit by containing the rise in current expenditure and by sharply reducing the volume of capital expenditure, while the growth of lending to the private sector was kept well below the increase in gross domestic product in value terms. In addition, the sharp rise during the year in interest rates on savings deposits helped to consolidate liquid savings to some extent. However, this restrictive stance is likely to be eased in 1981: budgetary policy will be much less rigorous in the field of current expenditure and above all in that of capital expenditure, and will lead to an increased deficit in relation to gross domestic product in value terms. Private sector lending is likely to keep broadly in line with this aggregate. Under these conditions, increased recourse to external credit will be necessary to compensate for the planned reduction, as a proportion of gross domestic product, in the expansion of domestic credit. Finally, incomes policy should exercise both a moderating influence on consumer expenditure and influence the distribution of value added in favour of investment by firms. thanks in particular to the measures which have been taken to limit wage and salary adjustments.

The growth expected in 1981 should result both from the spread and strengthening of the upturn in domestic demand first noted towards the end of 1980, and from a continuing growth in exports. However, it is likely to entail some increase in imports, so that the real trade balance, which had improved appreciably in 1980, will again tend to worsen somewhat.

Fixed investment, which was hit rather heavily by the recession (especially building investment), is likely to prove the most buoyant component of domestic demand in 1981. This upturn will be due above all, it would seem, to the shift in economic policy, which is mainly designed to stimulate such a recovery in order to meet the major requirements arising from the need to adapt the economy to the changed external situation. The appreciable increase in capital expenditure by general government and public enterprises, the relaxation of credit policy, particularly for the benefit of building and construction, and incomes policy, all reflect the desire to promote this component of demand, which is expected to lead the recovery.

The upturn in consumption, on the other hand, is likely to prove limited. The easing of budgetary constraints will cause *public consumption* to accelerate somewhat, but *private consumption* is expected to increase only slowly. Despite the elimination of fiscal drag, the overall growth of incomes expected in 1981 should lead to only a slight increase in purchasing power, and the rise in deposit interest rates is expected to cause savings to stabilize at the relatively high level reached at the end of 1980. However, the continuing high rate of inflation is a factor of uncertainty and the pattern of development now forecast for nominal incomes, prices and savings may well be disrupted.

It is highly likely that the real external trade balance will tend to worsen again in 1981 following the recovery in 1980. Firstly, it would not seem possible for *exports* to increase more quickly than in 1980. Yet, even if the previous rate of export growth is simply maintained, this would mean, given the much weaker growth of world demand expected in 1981, an appreciable gain in market share which, however, is justifiable given present price competitivity and the new prospects opened up for agricultural exports by accession to the Community. Secondly, the upturn in domestic demand, and particularly of investment demand, which involves a high proportion of imports, and the first steps made, following accession, towards dismantling protection, should lead to an appreciable increase in *imports,* whose elasticity with respect to gross domestic product should thus return to the medium-term average.

In view of the prospects outlined above, the *employment* trend should be relatively favourable. The numbers in service employment, in both the public and private sectors, should continue to increase steadily, while the growth in the industrial workforce should accelerate again after being temporarily checked by the recession. Nevertheless, apparent unemployment is likely to increase somewhat, although it will remain at a very low level.

Some progress should also be made towards reducing the rate of *price increases.* With import prices decelerating and the pressure of consumer demand likely to remain slight, the rate of consumer price inflation should slacken a little during the year. In addition, the next stage of the progressive alignment of agricultural prices with those in the rest of the

[1] See table.

Greece: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [4]	1979 II	1980 I	1980 II	1981 [4] I	1981 [4] II	1979
	Annual data				Half-yearly data (s.a.)					DR 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1970 prices									
Private consumption	5,3	3,0	−0,5	1,5	:	:	:	:	:	962,6
Public consumption	6,9	6,0	3,4	5,3	:	:	:	:	:	233,5
Gross fixed capital formation	3,7	8,0	−6,0	3,4	:	:	:	:	:	366,1
Change in stocks [1]	2,6	1,2	2,0	2,0	:	:	:	:	:	44,1
Domestic demand	5,0	4,0	−0,3	2,5	:	:	:	:	:	1 606,3
Exports of goods and services	10,8	6,4	2,9	3,0	:	:	:	:	:	174,1
Imports of goods and services	7,7	6,5	−5,0	3,5	:	:	:	:	:	349,5
GDP at market prices	5,1	3,8	1,4	2,4	:	:	:	:	:	1 430,9
	% change over preceding period at annual rates									
GDP at current prices	18,9	22,5	24,2	24,3	:	:	:	:	—	
Industrial production	7,6	6,0	0,5	3,0	−0,9	1,1	0,7	3,8	3,9	
Unemployment rate [2]	2,3	1,9	2,0	2,1	:	:	:	:	—	
Compensation of employees	19,0	26,2	24,0	23,5	:	:	:	:	—	
M2	22,5	18,6	25,5	20,5	:	:	:	:	—	
GDP (implicit price index)	13,1	18,0	22,5	21,4	:	:	:	:	—	
Private consumption (implicit price index)	12,4	17,7	24,5	21,5	18,8	30,8	19,5	24,1	18,0	
Exports, goods (implicit price index)	12,0	12,6	31,1	23,5	:	:	:	:	—	
Imports, goods (implicit price index)	14,7	19,2	33,2	22,0	:	:	:	:	—	
Terms of trade	−2,4	−5,5	−1,6	1,2	:	:	:	:	—	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	:	−12,7	−12,2	−12,5	:	:	:	:	—	
Current balance [3]	:	−2,8	−2,6	−2,9	:	:	:	:	—	
Net borrowing of general government	:	:	:	:	:	:	:	:	—	

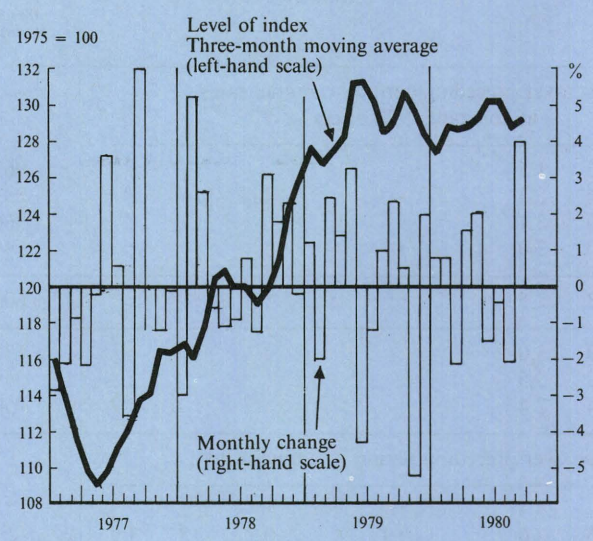
1 As % of GDP.
2 Unemployment as % of total labour force.
3 National Accounts concept.
4 Forecasts.
Sources: Eurostat; Commission and national services.

Community should, in fact, have a smaller impact than in 1980. The rate of inflation, at an annual rate, could thus come from the 25,5% of the last quarter of 1980 to 19,5% in the last quarter of 1981.

Finally, the *balance of payments* deficit on current account, expressed as a percentage of GDP, could well increase from 2,6% in 1980 to 2,9% in 1981. [1] The deterioration is the likely result of a significant worsening of the trade balance, although much of this should be offset by a further appreciable improvement in the balance on invisibles, in particular from transport, tourism and factor incomes. The increase in the trade deficit should, however, be practically limited to the protracted effects of earlier factors, as the additional deterioration in the volume movements should be minimal and the terms of trade, helped by the appreciable competitive edge enjoyed by most types of product, should remain broadly unchanged.

1 In national accounting terms, national concept.

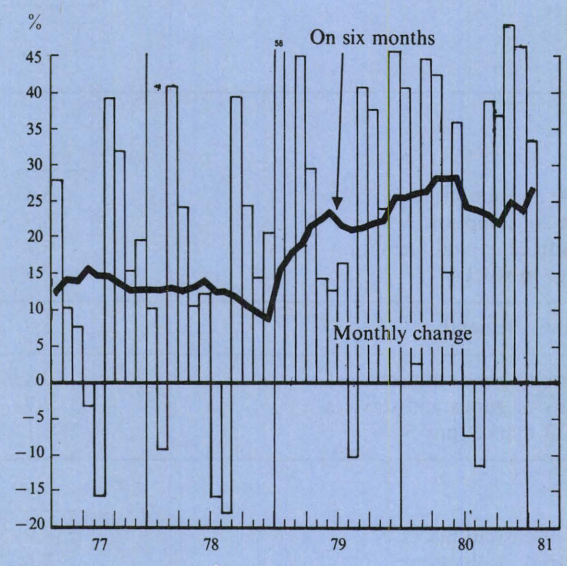
Greece: Industrial production (s.a.)



Source: Eurostat.

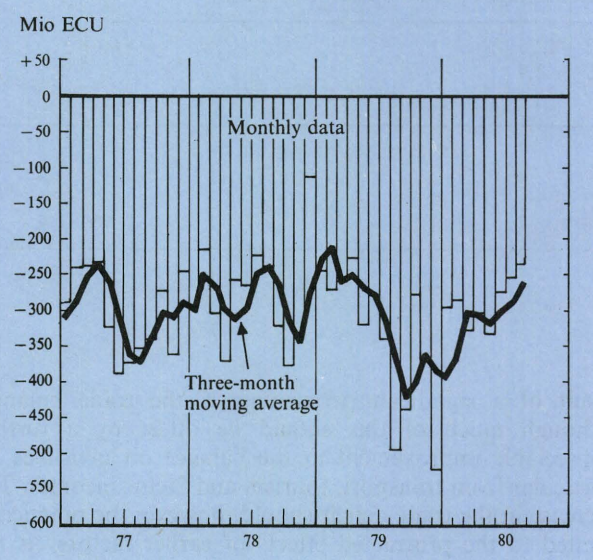
Greece: Consumer prices

Change expressed at an annual rate



Source: Eurostat.

Greece: Trade balance (s.a.)



Sources: National services and Eurostat.

Problems of economic policy

The Greek economy, having been affected by the recession much earlier than the economies of most industrialized countries, was in a better position than other economies to absorb the negative impact on its trade balance of the higher oil bill. Its early recovery may have the opposite effect in 1981, despite the opportunities for extending market shares offered by the economy's present high degree of competitiveness. In the short term, therefore, the external constraint makes it necessary for economic policy to limit the expansion of domestic demand. This constraint will only be eased gradually as world demand picks up, so paving the way for a progressively faster rate of growth sufficient to ensure full employment and permit the structural transformation necessary to adapt the economy to its new external context, and in particular to the changes resulting from the country's progressive integration into the Community.

This situation presents two main problems. The first is to make sufficient room for investment under a policy designed to restrict total domestic demand, since structural adaptation requires an immediate acceleration in investment. The second is to control inflation as quickly as possible, since the economy's competitiveness, though quite sufficient in the immediate future, may shortly be jeopardized by a rate of

inflation which continues to be markedly higher than that of the main industrialized countries.

The present policy is designed to achieve these objectives simultaneously. It is relying on incomes policy to bring about the desired moderation both in the growth of nominal wages and salaries, and in the growth of private consumption. It is also using various budgetary measures and a relaxation of domestic credit restrictions to give the necessary boost to investment. However, this policy seems likely to be more successful in stimulating investment than in controlling incomes and inflation. Thus the authorities, if they wish to fulfil their stated aim of avoiding a downward drift in the exchange rate and the likely resulting inflationary spiral, may well need to give a more restrictive stance to certain parts of their present policy.

France

Trends and prospects

Economic activity moved into a downward path in the second quarter of 1980 and, after a temporary interruption in the third quarter, the decline continued in the fourth. Even so, as a result of the growth already achieved at the end of 1979 and the expansion recorded in early 1980, *gross domestic product* in real terms in 1980 was still 1,8% higher than in 1979, [1] although in the final quarter it was some 0,6% below the average for the year.

After steadying in the early months of 1981 economic activity will probably tend to pick up slowly throughout the rest of the year. As a result of this slight improvement, real gross domestic product is likely to show an increase of, at best, 0,5% between 1980 and 1981, although this would imply growth of 1% in the course of the year.

The present cyclical slowdown can be traced back to a number of external causes and in particular to the substantial increase in the cost of imported energy at the beginning of 1980. In addition large increases in public service charges were introduced at the beginning of the year, additional to the general increases in the burden of taxation resulting from previous decisions taken by central and local government. Secondly, public debt policy, in line with the objective of reducing inflation, favoured the placing of large amounts of long-term debt with the public. This helped to reduce the liquidity ratio of the economy without, however, causing any significant increase in real interest rates and without the credit limits having any real restrictive effect on the demand for liquidity by firms.

The stance of *economic policy* is not expected to undergo any fundamental change in 1981, even though, unlike in 1980, the effects of public finance policy will this year tend to have a beneficial impact on households' purchasing power. Factors contributing to this result include the stabilization of the tax burden, the cancellation with effect from February of the surcharge on social security contributions introduced in August 1979, the granting of financial assistance to farmers to compensate for the decline in their real incomes in 1980 and additional financial assistance for families. Consequently, the above measures will substantially raise the general government borrowing requirement. However, the 1981 budget has placed strict limits on general government current and capital expenditure. The objective of monetary policy will continue to be the reduction of the rate of inflation, which implies not only a strong exchange rate but also a reduction in the liquidity ratio of the economy; in these circumstances, monetary policy could have a slightly restrictive impact on demand. Lastly, the authorities will endeavour to influence the trend of wages and salaries with the aim of stabilizing their real value. All in all, the economic policy adopted for 1981 is not therefore expected to provide any stimulus to demand. Indeed, the upturn in demand is expected to come from spontaneous factors, which may, however, be of internal rather than external origin since there seems to be no prospect of the anticipated revival in domestic demand being accompanied by any appreciable recovery in exports.

Consumption is likely to be the major, and probably the initial, factor in any revival in aggregate demand. *Public consumption,* will continue to expand, albeit at a distinctly slower rate; *private consumption* will probably pick up again in the early months of 1981 and subsequently remain on a slightly upward path. This forecast does not assume any further fall in the savings ratio, which, on the contrary, may well remain at the level which it had regained during 1980. It is based, in essence, on likely improvement in the respective trends of prices and incomes. For the major part of 1980, the acceleration in the rate of consumer price increases meant that incomes were not adjusted quickly enough to keep pace, particularly in the early months of the year, and it was only because of a pronounced fall in the savings ratio that the level of consumption was maintained until the third quarter. The converse is likely to happen in 1981, when transfer incomes are expected to show a real increase, taking the average for the year, while the deceleration in prices will probably tend to be sharper than that in incomes generally, during the year. It thus seems highly probable that private consumption will pick up even though the exact scale of the recovery is impossible to predict because of the continuing uncertainties regarding the trend of savings and that of prices. The forecasts adopted, point to a real annual increase of 1,3%, mid-way between those resulting from a more pessimistic assumption as regards savings or a more optimistic assumption as regards prices.

Fixed investment, on the other hand, is likely to have an adverse effect on the trend in demand, taking the average for the year. *Public investment* alone will continue to rise a little, with the increase for local government slightly exceeding the continuing contraction at central government level. *Business investment,* however, which has been declining since the second quarter of 1980, will probably maintain its downward movement in the early months of 1981 before turning towards the end of the year, producing an overall decline compared to 1980. The effects of the worsening financial position of firms and of the gloomier economic outlook, which led to the reversal in trend in 1980, are likely to be felt for some time to come and will give way only very gradually to a healthier economic and financial climate. The impact of planned long-term investment—in particular that by public enterprises—and the new forms of fiscal stimulus introduced in the 1981 budget should, however, be sufficient to prevent

[1] See table.

France: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [4]	1979 II	1980 I	1980 II	1981 [4] I	1981 [4] II	1979
	Annual data				Half-yearly data (s.a.)					FF 000 Mio at current prices
	% change over preceding period at annual rates									
Private consumption	4,5	3,2	1,9	1,3	2,4	1,8	1,8	1,2	1,2	1 515
Public consumption	3,3	2,5	2,6	1,5	2,6	2,6	2,4	1,2	1,2	361,4
Gross fixed capital formation	2,7	2,5	2,2	−0,6	8,7	0,4	−0,2	−1,8	1,2	517,4
Change in stocks [1]	1,5	1,6	1,7	1,1	2,1	2,0	1,5	1,0	1,2	39,7
Domestic demand	3,8	3,9	2,2	0,3	5,5	1,4	0,6	−0,2	1,5	2 433,5
Exports of goods and services	8,7	7,3	2,8	0,2	9,7	0,6	0,6	−0,2	0,6	503,2
Imports of goods and services	8,5	10,9	4,5	−0,4	13,1	3,0	−0,4	−1,0	0,8	506,1
GDP at market prices	3,9	3,2	1,8	0,5	4,9	0,8	0,8	−0,2	1,4	2 430,6
	% change over preceding period at annual rates									
GDP at current prices	13,4	13,9	14,0	11,8	17,9	13,0	12,6	11,3	12,7	
Industrial production	3,4	3,9	−1,0	0,0	6,7	−3,3	−4,6	1,1	4,9	
Unemployment rate [2]	3,3	5,9	6,3	7,3	6,0	6,2	6,4	7,1	7,5	
Compensation of employees	11,8	13,1	14,9	12,1	16,0	14,7	14,2	11,5	11,4	
M2	15,5	14,4	10,5[3]	10,0	12,6	12,4	9,2	10,2	9,8	
GDP (implicit price index)	9,2	10,3	11,9	11,3	12,4	11,1	11,7	11,5	11,1	
Private consumption (implicit price index)	9,0	10,5	13,5	11,8	12,8	14,3	12,8	12,2	11,4	
Exports, goods (implicit price index)	7,9	9,9	12,2	11,5	12,0	12,4	12,0	11,7	11,3	
Imports, goods (implicit price index)	8,6	10,6	19,3	14,0	18,0	20,0	18,6	15,0	13,0	
Terms of trade	−0,6	−0,6	−5,5	−2,0	−1,2	−6,5	−4,5	−2,0	0,0	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−1,3	−1,1	−3,1	−3,4	−2,5	−2,8	−3,4	−3,6	−3,4	
Current balance	−0,4	0,2	−1,3	−1,7	0,0	−1,0	−1,6	−1,9	−1,7	
Net borrowing of general government	−0,1	−0,8	−0,6	−1,8	−0,7	−0,4	−0,8	−1,6	−2,0	

1 As % of GDP.
2 Unemployment as % of total labour force.
3 Provisional estimates.
4 Forecasts.

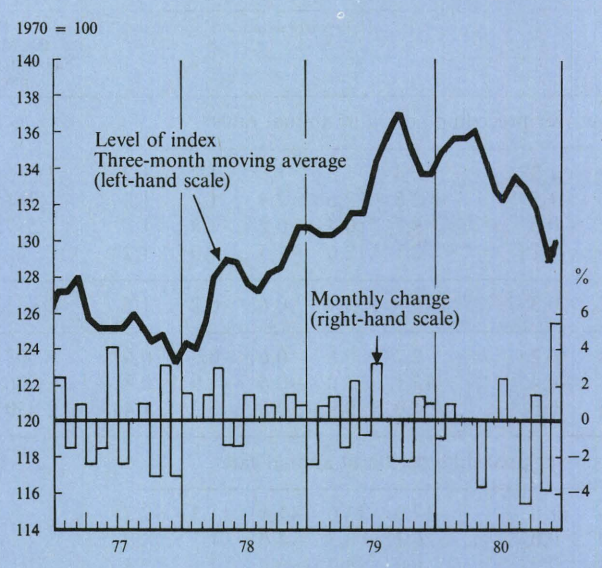
Sources: Eurostat; Commission and national services.

any significant fall in investment. *Investment by households,* however, will probably continue to fall significantly under the impact of the rise in production and financing costs in the construction industry.

A great deal of uncertainty surrounds *stockbuilding*. The tendency for firms to adopt a very cautious line over stocks, which did much to accentuate the decline in demand in the second half of 1980, will probably continue, at least until the third quarter of 1981, when a recovery is expected to get under way. In any event, the contribution of stockbuilding to the annual growth in the volume of demand, which had been virtually neutral in 1980, is likely to be distinctly negative in 1981.

In addition, economic activity is unlikely to receive any significant stimulus from movements in the real trade balance. In the second half of 1980, *imports* showed only a very moderate decline in response to the weakening of demand, and this would seem to provide confirmation of an unfavourable trend of import penetration, notably for consumer durables and for plant and machinery. Since a reversal in this trend is rather unlikely in the short term, any further decline in imports in the first half of 1981 is expected to be minimal and will probably be followed by an upturn in the second half of the year as domestic demand picks up. Taking the year as a whole, imports are expected therefore to show an insignificant decline overall compared with 1980. *Exports* showed little vigour in 1980, reflecting both the

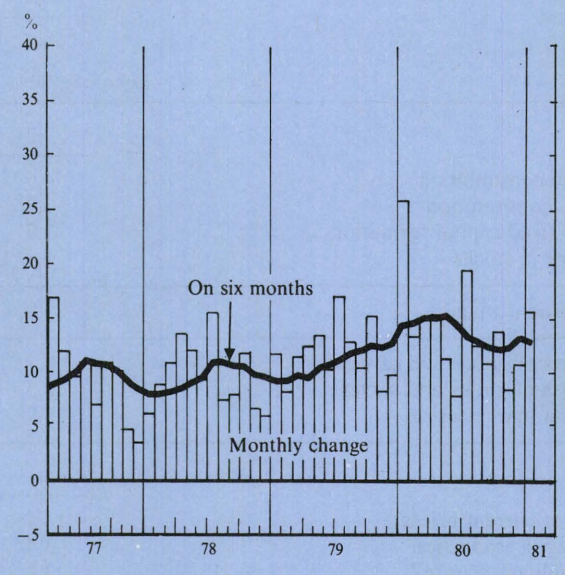
France: Industrial production (s.a.)



Source: INSEE.

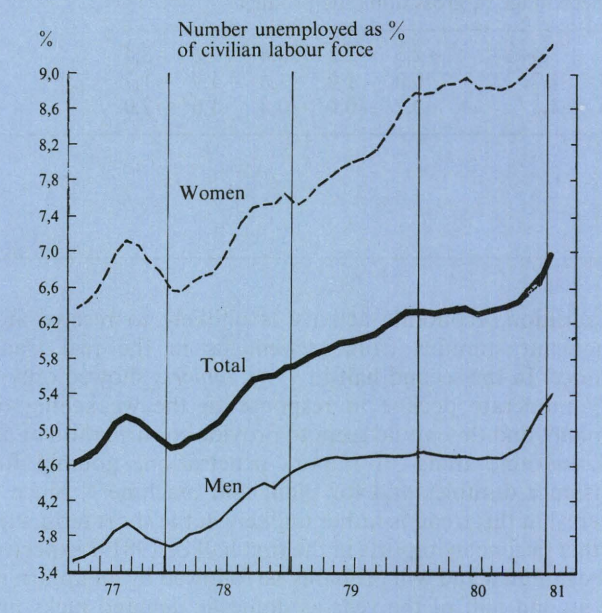
France: Consumer prices

Change expressed at an annual rate



Source: INSEE.

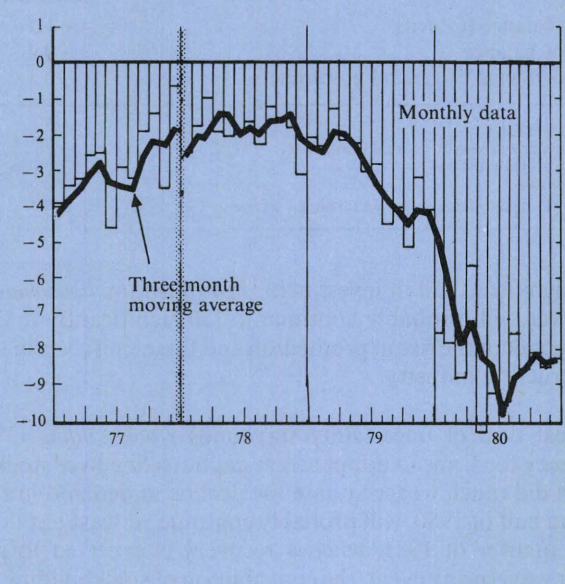
France: Unemployment (s.a.)



Source: Eurostat.

France: Trade balance (s.a.)

Mrd FF



Source: INSEE.

slowdown in world demand and a contraction in market shares. A short-term reversal of this trend can hardly be expected, in spite of the improvement in sales by certain key sectors such as agriculture and the food industry, and heavy machinery. For 1981 as a whole, exports are therefore to show little or no increase over 1980, with this virtually unchanged situation masking, however, an initial downturn followed by a slow improvement.

The outlook for activity in 1981 points to an *employment* trend that will bring, at best, a general levelling-off or, more probably, a slight fall in the number of persons employed. The continuing decline in employment in industry will doubtless not be fully offset by the slower expansion of employment in the services sector due primarily to the decision to allow no increase in the number of civil servants. In these circumstances, unemployment will probably rise more rapidly (average annual rate of 7,3% in 1981, compared with 6,3% in 1980).

Price inflation, on the other hand, will probably show a more satisfactory trend. The tendency for prices to climb less rapidly, discernible in the closing months of 1980 and momentarily disrupted by exogenous factors in the early months of 1981, will probably be resumed and may actually strengthen subsequently. [1] As the pressures built up under past price freezes disappear the effects of the fall in the prices of imported raw materials other than oil, and the weaker pressure of demand will probably serve to bring down the annual rate of consumer price increases from around 11% in the first quarter of 1981 to around 8% in the last quarter of the year. This probability is, however, subject to a fair degree of uncertainty stemming from exogenous factors and from the behaviour of economic agents.

Lastly, there would seem to be no way of averting a further deterioration in the *balance of payments on current account* in 1981. The deficit in 1980 was kept to 1,3% of GDP [2] as a result of the substantial improvement in the balance on invisibles, which compensated in part the large increase in the trade deficit. A further, but smaller, improvement in the balance on invisibles will occur in 1981, but the trade deficit will probably continue to increase markedly under the impact of the further deterioration in the terms of trade attributable in large measure to the higher prices of imports invoiced in dollars. The current account deficit could therefore reach 1,7% of GDP in 1981, a figure which presupposes that the major part of the effects of the deterioration in the terms of trade will appear in the first few months, to be followed by an improving trend during the remainder of the year.

[1] See graph.
[2] As defined in the ESA.

Problems of economic policy

The outlook for 1981 is relatively satisfactory in that, unlike the situation in many other industrialized countries, it rules out the possibility of a recession. Nonetheless, whether it will become a reality depends in part on an international environment still subject to considerable uncertainty. But above all, no appreciable short-run improvement in the overall response of the economy to the external challenge can be discerned in these circumstances as witnessed by the very small contributions that the real trade balance is expected to make to the recovery in growth.

The major problem confronting the economy would indeed seem to be that of competitiveness, a factor which will determine its capacity for future growth and, to a large degree, any eventual improvement in employment prospects. It involves not only the difficulty of increasing shares of export markets but also, and perhaps more important, the domestic market's vulnerability to imports. The problem stems both from the unfavourable trend of real costs and from the fact that the structure of production has not sufficiently adapted to changes in the composition of aggregate demand.

The containment of cost inflation is all the more urgent in that stability will, from now on, have to be preserved against the backdrop of an external environment in which rises in the prices of traded goods and services will probably slow down significantly. Budgetary and monetary stringency is a necessary but not sufficient condition for the required price deceleration. In addition, the authorities could well make greater efforts to impress more vividly on economic agents the prejudice, both individual and collective, caused by inflationary chain reactions and expectations, and influence their behaviour in such a way as to break the pattern. Exhortation could be backed up by even longer-term measures aimed at reforming certain economic and financial structures that help to underpin this inflationary pattern of behaviour. It would appear to be inconceivable that the principles underlying current price policy should be abandoned. On the contrary, this policy could lead to further measures aimed at increasing somewhat the role of market forces in price determination. [3]

As regards the reorganization of the structure of production, the policy of allowing free play, for the most part, to market forces and of confining government intervention to national enterprises and to certain specific sectors has been largely successful, notably with regard to energy saving, the switch to alternative sources of energy, the development of high-

[3] See box appended 'Lifting of price controls in France'.

technology industries and the rundown of obsolete production capacities. On the contrary, however, certain measures favouring traditional industries have tended to delay inevitable conversion operations. On the other hand, the results obtained are more clearly manifest in the highly-concentrated sectors of industry than elsewhere. Thus, it would appear necessary now to strengthen the industrial fabric at the level of smaller firms. Since these are flexible in structure and creative in outlook, they have an eminent capacity for adapting to market developments that has not yet been fully exploited and which could be better used if certain administrative constraints were relaxed and if access to credit was made easier. Among other initiatives, the size of the appropriations in the 1981 budget for assisting this category of firms is an indication of the extent to which the authorities are now preoccupied by this problem.

Basically, the employment situation can be improved only if economic structures are strengthened and the economy becomes more competitive. But employment policy as such can be an useful adjunct. In this connection, the important measures taken to promote vocational retraining and to help young people to find jobs could be expanded with a view to matching initial training more exactly to labour market requirements and to introducing more flexible working hours. There is absolutely no doubt that the gains from such measures in terms of employment and productivity will justify the efforts made.

Lifting of price controls in France

After more than thirty years of controls that have at times resulted in prices being frozen, not to mention compulsory reductions, the lifting of controls first on prices in industry and then on the prices of certain services can be seen as a major turning-point in the direction of economic policy in the post-war period.[1] This complete break with the past is all the more conspicious in that it comes only shortly after the worst bout of inflation in France since the end of the war (with consumer prices rising by 51% between 1973 and 1977), this period itself having been followed by a further upsurge in the prices of certain imports and by a broad-based escalation of inflation rates in most industrialized countries.

The application of price controls during the lengthy period of economic growth up to 1973 was a fundamental and constant feature of economic policy. Generally speaking, budgetary policy and monetary policy were regarded as instruments that did not readily lend themselves to the task of restoring overall economic equilibrium. It was, in any case, acknowledged that little was known about their effectiveness over a period of time and that, in the short term, their effects on the trend of demand might create difficulties for firms and might lead to higher unemployment. For this reason, the authorities responsible for economic policy maintained in force the texts empowering them to exert control over price movements on the grounds that this provided them with an unrivalled instrument for curbing price rises.

This power can be traced back to the Order of 30 June 1945 ('Charte des prix'), which applies to all goods and services, except those expressly excluded by the Order itself or by subsequent provisions. It manifested itself in a very wide variety of forms including price freezes, tax measures, 'controlled' and 'supervised' freedom to determine prices, contracts for stabilizing prices, 'programme contracts', contracts for combating price rises, and controlled annual price programmes. Generally speaking, the implementing provisions, which differed widely, enabled the arrangements to be tailored to the situation in individual branches of activity (to take account of their productivity performances) and, in some cases, even to a particular firm's individual products. Lastly, the degree of compulsion for firms varied considerably over the years. Attempts to remove price controls were, however, always short-lived for fear of triggering a fresh acceleration in price rises.

The authorities responsible for economic policy deployed a number of arguments based on the observation that the French economy had special features that distinguished it from the economies in which the freedom to determine prices seemed to produce excellent results. These special features fall into two categories. Firstly, it will be seen that one feature of the French economy is a very broad degree of indexation and that action on prices was a very effective way of using indexation to bring all nominal movements under control (particularly since firms tended to anticipate cost increases). Secondly, the laws of the market function imperfectly: more than half of expenditure on consumption goes on services in which there is probably no genuine competition, and public service charges are, in any event, fixed in the light of different criteria. And so, at best, competition probably operates only in respect of prices of industrial products, which are, to a variable but significant degree, themselves made up of prices that are broadly sheltered from competition.

The present arrangements—under which industrial prices are free from any controls whatsoever, the prices of services have been extensively and progressively deregulated and public service charges are meant to reflect actual costs—have, for the most part, been instituted since 1978. It took several years for the realization to dawn that the period of rapid inflation since 1974 had brought out more clearly the negative aspects of price controls, particularly in the wake of the significant changes in price structure that have occurred. In addition to being ineffective, price controls have, because of the element of rigidity they introduce into price formation, been found to have had numerous perverse effects on production and distribution: development of new products involving artificial innovations (to justify higher prices): discontinuation of unprofitable product lines (the prices of products that have been on the market a long time have become unrealistic as a result of not being adjusted sufficiently); compensation for inadequate profits on the domestic market sought through export prices; penalization of all firms and branches of activity unable to resort to the contrived practices mentioned above (semi-manufactures or traditional products); lastly, firms that are large enough are tempted to invest abroad or, above all, to import goods (since, in the latter case, only mark-ups on the domestic market are subject to controls). It was for all these reasons that the French authorities decided to extend and entrench the various decisions to abolish price controls, the first of which date back to 1972.

It is extremely difficult to ascertain just how the trend of retail prices may have been affected by the lifting of controls. This is because the period prior to deregulation was marked by a number of decisions (price freeze during the last quarter of 1976 and adjustments in VAT rates in 1977) the effects of which hamper comparisons, as do the sharp increases in import prices registered since then, and in particular during the early months of 1980.

The statistical data set out below, which are taken from a study that was published recently in the French-language review *Economie et statistiques* (No 125), at least show that price deregulation has not engendered any surge in prices and that the latest increase in oil prices has, if anything, been absorbed more smoothly by the French economy than the previous increase.

[1] Controls on the prices of industrial products were lifted on 15 August 1978, with the exception of two categories of goods, namely petroleum products, the importation and distribution of which have been governed by special legislation since 1928, and such pharmaceuticals as qualify for reimbursement under the social security system.

1. Comparison of consumer prices over time (change through period)

	1978	1979	Increase between 1978 and 1979	First half of 1980
Composite index for France's main trading partners	6,3	10,6	4,3	6,3
France	9,7	11,8	2,1	7,1

2. Comparative increase over three typical periods

	September 1973 to March 1975	December 1976 to June 1978	November 1978 to May 1980
All industrial products	23,5	12,7	20,1

3. Comparative increase in the prices of industrial products

	1979				1979	1980	
	I	II	III	IV		I	II
Raw materials	12,8	6,9	3,3	9,8	36,9	14,6	−18,7
Wholesale prices (exclusive of tax)	6,2	2,5	2,7	1,3	13,2	2,9	0,0
Wholesale prices of semi-manufactures	6,0	2,3	3,0	2,0	13,9	2,5	0,6
Retail prices	2,3	2,7	2,8	3,6	11,8	4,2	2,9

Source: INSEE.

The remaining controls on the prices of services are expected to be lifted in the coming months, marking the end of a long period of 'repressed inflation'. The future trend of costs and prices will then, irreversibly, have to be managed solely with the help of the macroeconomic instruments of budgetary and monetary policy.

Nonetheless, the role played in cost and price formation by unjustified profit situations resulting from the absence of genuine competition in certain branches of activity will not have to be overlooked. In such cases, the authorities will doubtless endeavour to improve the working of the laws of the market.

Ireland

Trends and prospects

The slowdown in economic activity which began in the second half of 1979 continued into 1980, despite a certain buoyancy of consumption in the first half of the year, a significant rate of growth of exports and a downward adjustment in imports. The major factor behind the low growth was a substantial fall in investment particularly in the first half of the year and a poor second half performance by the other components of demand. In volume terms, the increase in *gross domestic product for 1980* as a whole is estimated at 0,8%. [1]

For the first half of 1981 the upturn of certain indicators, towards the end of 1980, such as cement sales and imports of equipment and raw materials, points to a certain recovery of growth and this will be further stimulated by public sector investment and by the slowing down in the rate of destocking. For the year as a whole these factors should boost the growth rate of *gross domestic product* to almost 2%.

The more moderate trend in economic activity since the second half of 1979 has resulted from external factors superimposed on a cyclical downturn in the Irish economy from the substantial growth rates of the previous two years, when expansionary *economic policy* supported the recovery from the first oil-price shock. Over the past few years the execution of budgetary policy has not been as restrictive as originally intended. The general government deficit, as a percentage of GDP, for the three year period 1978-80, has been around the same high level as in 1975. The budgetary measures so far announced for 1981 promise a major change in the stance of budgetary policy. Monetary policy has restrained the growth of credit to the private sector, whilst permitting firms to borrow abroad for most of the year. In view of the gap in domestic and foreign interest rates, foreign currency borrowing has been expanding, a factor, in addition to public sector overseas borrowing, behind the rise in official external reserves in 1980 (+ IRL 371 million). Effectively therefore, monetary policy was geared towards financing rather than correcting the external deficit for most of the year. However, the termination with effect from October 1980 of the exemption from the 1980-81 credit guideline on foreign currency lending to residents has tightened up credit policy.

Guidelines have been announced for the credit policy year to February 1982. It is likely that they will neutralize, as far as possible, any supplementary expansionary pressures which might arise from the execution of the budget, by maintaining upward pressure on interest rates.

[1] See table.

The outlook for *domestic demand* as suggested is somewhat more favourable than the evolution in 1980. Judging from the budget, *government consumption* will be curbed in 1981 but *investment* is likely to recover during the course of the year as the recently published Investment Plan is implemented. The diversity in trend noted in 1980, with significant increases in public investment counterbalanced by a large fall in private sector investment, is likely to continue in 1981, although the downward trend in private investment may well come to an end. For the second year running, overall private capital formation is likely to be sluggish despite the continued high level of investment associated with the establishment of new industrial undertakings in Ireland. However the modest profitability of the company sector, and high interest rates are likely to dampen new investment projects. Investment in construction, where some turnround was observed towards the end of 1980, could be more sustained than in equipment.

Any increase in *private consumption* is likely to be modest given the projected behaviour of prices and incomes. Although the pay terms of the National Understanding provide for an approximately 12% rise in wage and salary incomes in 1981, average earnings are expected to be markedly higher, at over 15%, due to structural movements (loss of jobs in lower-paid industries and strong growth in more specialized sectors) and an increase in overtime payments as production begins to recover. Income in agriculture is expected to grow by 5% as cattle prices rise due to a scarcity in supply, after a fall of over 10% in 1980. The other major positive factor on disposable incomes is likely to be the fall in the growth rate of personal taxation implied by the full-year effect of the 1980 tax measures, with taxes on personal incomes projected to rise by only 17% as against the 36% figure recorded on 1980. Overall, disposable income could rise by some 15%, slightly lower than inflation. However a downward trend in the savings ratio is projected, due to the continued fall in real agricultural incomes, thus leading to a marginal increase in the volume of private consumption.

Destocking, which contributed massively to the poor growth performance last year, could continue in 1981 but at a very much decreased rate so that the contribution of the change in *stocks* will be markedly positive.

Export performance in 1980 appears to have been quite dynamic, taking account of the fall in export markets. However this was due mainly to the strong growth in cattle and beef exports, with industrial exports experiencing some slide in performance during the year. Forecasts for 1981 assume a reversal in this pattern although this may not occur before the middle of the year. A continued gain in market share in expected due to the impact of new firms on Irish output and exports and the fact that these firms are less affected by cyclical trends than the existing and, on average, more traditional industries. The latter could be particularly

Ireland: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [6]	1979 II	1980 I	1980 II	1981 [6] I	1981 [6] II	1979
	Annual data				Half-yearly data (s.a.)					Million IRL at current prices
	% change over preceding period at annual rates – at constant 1975 prices									
Private consumption	3,5	3,6	−1,0	0,3	−2,0	2,6	−7,0	3,6	1,4	4 550
Public consumption	5,7	3,5	2,0	−1,5	2,0	1,0	4,0	−2,9	−4,0	1 450
Gross fixed capital formation	5,4	15,6	−10,0	6,8	10,0	−15,9	−9,7	8,0	16,2	2 330
Change in stocks [1]	1,2	0,9	−2,7	−1,3	−0,5	−3,4	−1,8	−1,8	−0,8	75
Domestic demand	4,3	7,0	−6,0	2,9	−3,0	−8,0	−3,2	3,6	6,2	8 405
Exports of goods and services	7,0	6,7	5,4	1,6	15,1	4,2	−1,1	2,5	2,4	3 943
Imports of goods and services	6,9	14,7	−6,7	3,3	4,8	−12,2	−6,0	5,9	7,9	5 113
GDP at market prices	3,9	1,9	0,8	1,8	0,9	2,1	−0,1	1,5	2,8	7 235
	% change over preceding period at annual rates									
GDP at current prices	17,8	15,4	15,8	16,2	7,4	21,8	10,8	18,1	12,9	
Industrial production [2]	5,1	6,1	−1,0	4,0	3,3	2,1	−10,9	8,8	10,9	
Unemployment rate [3]	7,1	6,0	6,0	7,4	:	:	:	:	:	
Compensation of employees	19,2	20,0	22,4	15,1	:	:	:	:	:	
M3	18,3	29,6	14,2	19,8	17,9	7,6	23,1	:	:	
GDP (implicit price index)	13,4	13,2	14,8	14,1	6,4	19,2	10,9	16,4	9,8	
Private consumption (implicit price index)	12,9	12,2	18,2	16,0	15,0	19,9	18,3	16,9	11,8	
Exports, goods (implicit price index)	14,0	9,2	10,0	14,2	7,2	12,4	8,5	16,6	15,1	
Imports, goods (implicit price index)	14,6	13,4	19,7	16,0	21,2	21,1	16,3	17,4	12,6	
Terms of trade	−0,4	−3,3	−7,1	−1,3	−10,3	−6,0	−6,0	−0,5	2,0	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−12,4	−18,4	−15,4	−17,6	−19,3	−15,3	−15,6	−17,0	−18,2	
Current balance	−4,6	−10,1	−8,3	−11,4	:	:	:	:	:	
Net borrowing of general government [5]	10,2[4]	11,9	13,5	11,7[5]	:	:	:	:	:	

1 As % of GDP.
2 Transportable goods industries.
3 Unemployment as % of total labour force, mid-April.
4 1973-79.
5 The net borrowing of general government amounts to 13,8% of GDP in 1981 if no account is taken of IRL 200 million private-sector participation in public investment, an item which according to standard definitions is not deductible.
6 Forecasts.

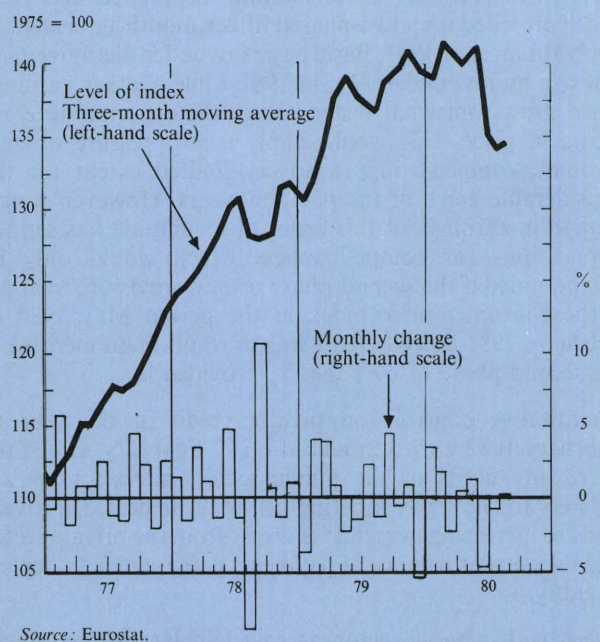
Sources: Eurostat; Commission and national services.

hit by sluggish demand in the UK, a market which still accounts for one-third of Irish industrial exports. Agricultural export volumes are forecast to decline by as much as 10% due to the limited availability of suitable cattle. *Imports,* after the substantial volume fall registered in 1980, will pick up again through the year as destocking levels off and investment turns around. Nevertheless import elasticities for 1981 with respect to final demand may be somewhat lower than previously experienced due to the contribution of agricultural stockbuilding to the change in demand, which has little effect on imports. This factor operated in 1980 to prevent an even more dramatic fall in imports.

The outlook for the recovery in activity in 1981 will not be reflected in any great improvement in the *employment* situation due to the consistent drop of numbers in agricultural employment. In addition the continued rapid growth in the labour force (at approximately 1% per annum) means that unemployment, broadly defined, may continue rising in the early part of the year.

Consumer *prices,* after slowing down through 1980, are projected to rise again significantly due to changes in excise duties. By autumn, given a greater stability of the exchange rate, the absence of new external price shocks and no further

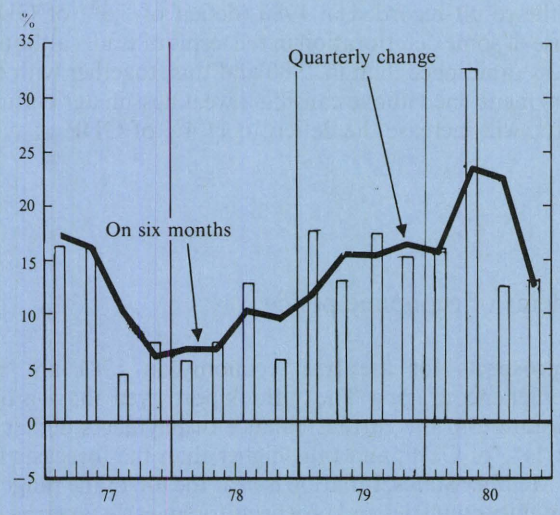
Ireland: Industrial production (s.a.)



Source: Eurostat.

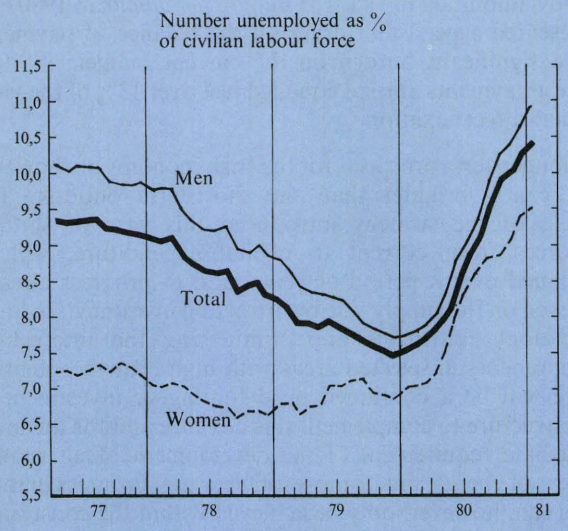
Ireland: Consumer prices

Change expressed as an annual rate



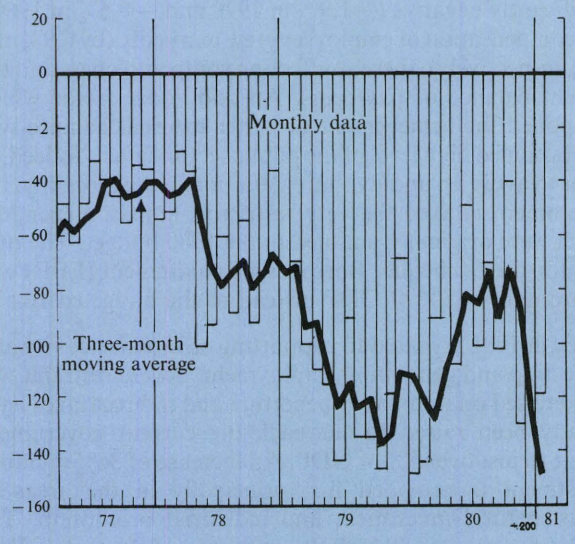
Source: Eurostat.

Ireland: Unemployment (s.a.)



Source: Eurostat.

Ireland: Trade balance (s.a.)



Source: Eurostat.

build up in wage demands, inflationary pressures may abate. For the year as a whole the rise in the consumer price deflator is projected to fall to 16%.

The *current balance of payments* will be substantially weaker than the result recorded in 1980 (deficit of 8,3% of GDP) because of some deterioration in the terms of trade, although at a less rapid pace than in 1980 and this, together with the factors mentioned above causing a weakness in agricultural exports, will increase the deficit to 11,4% of GDP.

Problems of economic policy

The prospects for the Irish economy in 1981 are not altogether encouraging. The outlook portrayed above is of a deterioration in the current balance of payments deficit to about 11% of GDP, and thus higher than the forecasts for other Member States. Inflation is near the top of the range of Community countries and prospects for an early tapering off in the rise in consumer prices are uncertain. Although comparing relatively favourably to rates experienced elsewhere, growth for the third year running is likely to be low by Irish standards and insufficient to bring about an improvement in the current unemployment situation.

The main cause of the present slow growth is the stagnation in world trade. However, to some extent the weak performance can also be attributed to domestic causes. Thus in 1979 and 1980, although growth was sluggish and the effect of the terms of trade on real domestic income significantly negative (−1,9% in 1979 and −3,5% in 1980), real compensation of employees grew markedly (by 6,9% and 3,4% respectively), thereby affecting competitiveness and the current balance of payments. An additional factor which postponed the achievement of better external balance was the continued high level of the public sector deficit. Indeed, in order to avoid an unduly sharp deflation in the economy, the government relaxed the very restrictive limits on spending which were originally outlined in the 1980 budget. The outturn for the Exchequer Borrowing Requirement (EBR) was accordingly 14,5% of GDP instead of the budgeted 10,5%.

Policy in 1981 is geared to supporting economic activity and protecting and generating employment. Severe restraint will be exercised on non-pay expenditure and indirect taxes have already been raised to cut back the current government deficit to just over 5% of GDP. An increase of 36% in public investment is provided for, principally in the areas of infrastructural investment and industrial promotion. The EBR emerges at IRL 1 496 million (15,4% of GDP). Participation by the private sector in public investment may, however, reduce this figure by up to IRL 200 million.

Pay development in 1981 will be determined by the terms of the second National Understanding negotiated last year, which provided for a two-phased fifteen month agreement to apply for most of 1981. Basic pay rates under this agreement will rise by just under 12% in 1981 while average earnings could grow somewhat faster. Given the expected developments in prices this would imply some pressure on real incomes, compensating to a very limited extent for the considerable gains of the past few years. However even a growth in earnings of this order of magnitude has serious implications for competitiveness which would only be compounded if the second-phase review provision, to apply if the consumer price index in the period May 1980 to February 1981 exceeds 10%, was to result in an increase in the second phase of over the 7% provided for.

Quantitative controls on private credit in the year to February 1982 were announced on 27 February. Given the borrowing needs of the public sector, interest rates are unlikely to show any tapering off as the expected recovery leads to increasing demand for credit from the private sector and the current balance of payments deficit tends to deplete liquidity.

The growth in public sector external debt, if continued, could increasingly be felt as a constraint on economic management. Public sector indebtedness abroad has more than quadrupled in the past decade to reach a level of IRL 3 000 million (35% of GDP) at the end of 1980. Although Ireland entered the external financial market later than many other countries, interest charges on government debts held abroad already amounted to IRL 155 million *per annum* in 1980 and represented a persistent drain on the balance of payments and a significant burden on the current budget; in 1980 interest payments abroad equalled just over 13% of the yield of total direct taxation.

The longer-term prospects for the Irish economy are however significantly brighter than the short-term outlook. The success of the strategy introduced this year of shifting resources from current to capital expenditure, will, if continued over a period of years, add to progress already achieved on the supply side by attracting investment in high-technology industries and stimulating the interest of entrepreneurs in selected areas with high growth potential. There will be a continued need for higher investment in infrastructure to complement this advance and for the more immediate requirement of the development of alternative sources of energy and its more efficient use. Progress in these areas can, however, only be achieved within the constraints presently posed by the need to reduce imbalances on the external and budgetary accounts.

Italy

Trends and prospects

The decline in economic activity which was first discernible in the spring of 1980 gathered a great deal of momentum in the summer but came to a halt in the autumn, giving way to a slight recovery. Because of the very high level of activity during the early months of the year, the volume of *gross domestic product* probably grew by nearly 4% between 1979 and 1980, [1] but its level in the last quarter was slightly below the average for the year.

Activity seems to have registered a further, albeit moderate, downturn in the first quarter of 1981, when it probably bottomed out. Indeed, a recovery is expected to get under way in the second quarter and to gather strength considerably in the second half of the year. Because of the initial low level of activity, the volume of gross domestic product is likely to show a drop of nearly 1% between 1980 and 1981, although its level in the last quarter should be more than 1,5% above the average for the year.

The present slowdown in the economy is due mainly to cyclical factors of external and internal origin but also to *economic policy,* which, in response to the acceleration in price rises and the widening of the external deficit in the wake of the second oil-price shock, was given a more restrictive bias during the course of 1980. Firstly, tax measures boosted the spontaneous growth in revenue by stepping up the campaign against tax evasion, streamlining the collection of certain direct taxes and increasing indirect taxes on two occasions, in July and in December. Secondly, on the credit policy front, the penalties intended to persuade banks to observe the credit expansion ceilings were stiffened in March with the ceilings themselves being tightened up in July although the effects of the tighter limits were largely offset by the possibility left open to firms to obtain finances from abroad. Finally, the tendency for the private sector to consolidate its savings has continued and has even accelerated due particularly to the growing gap between the effective yield from public securities and that from deposits.

These policies should be maintained in 1981, with no reflationary measures being planned to hasten or accelerate the recovery. In point of fact, monetary policy in 1981 is geared to bringing about a further significant reduction in the liquidity ratio of the economy by compressing further the total amount of credit expansion measured as a proportion of gross domestic product and by pursuing efforts to encourage the consolidation of savings. In this context, the monetary authorities established, on 31 January 1981, especially strict limits for domestic credit for the current year, and fixed the ceiling for external credit used to finance imports at the level reached on 31 December 1980. Thus, despite the expected deterioration in the financial situation of the public sector—as a result, essentially, of automatic budgetary mechanisms—the recovery of the economy will not receive any stimulus from the current stance of economic policy. The recovery should occur spontaneously, due to the combined impact of a slow recovery in domestic demand and the improvement in the real trade balance.

The outlook for the trend of domestic demand involves aspects that can be predicted with certainty and others that are more open to doubt. *Public consumption* will continue to show a steady, albeit moderate increase, and it is expected that, in early 1981, *investment* in building and construction will return to the growth path from which it was deflected in the second half of 1980. This forecast is based on the persistence of relatively sustained demand for private housing, on the exceptional reconstruction requirements of the disaster-struck areas in the Mezzogiorno, on the more rapid growth of public investment and on measures to promote the construction of subsidized housing. This set of factors is not expected, however, to offset the anticipated decline in business investment in plant and machinery and in transport, where the downward trend which emerged in the second half of 1980 in response to the gloomier economic outlook, the fall in the rate of capacity utilization, the contraction in profits and the high level of interest rates, will probably continue throughout most of 1981. This trend should, however, be attenuated by the budgetary measures in favour of investment by public enterprises and by firms in which the government has a holding and it could well be reversed towards the end of the year if the recovery in the other components of demand is confirmed and if the financial situation of firms begins to improve.

It would appear that the recovery in *private consumption* which is expected to get under way in the second quarter of 1981 and to take a somewhat firmer hold in the second half of the year, is likely to be less vigorous to the extent that the decline in the second half of 1980 may prove to have been very moderate. Indeed, the contraction in disposable income and the increase in the savings ratio which caused that decline have been fairly slight and much less marked that the opposite trends recorded in the first half of the year. If the reversal in trend anticipated for 1981 is to take place, not only would real personal disposable income have to start growing again as at the beginning of 1981 (its growth having been interrupted during the final months of 1980) but the increase in personal savings would have to be rapidly halted. Both assumptions depend on the rate of deceleration in price rises from the end of 1980 onwards and, as a result, are subject to uncertainty. In this respect, it is a moot point, whether the lull in demand discernible since mid-1980 has been protracted enough and pronounced enough for the anticipated change in trend to take place at the beginning of

[1] See table.

Italy: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981	1979 II	1980 I	1980 II	1981 I	1981 II	1979
	Annual data				Half-yearly data (s.a.)					LIT 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1970 prices									
Private consumption	3,4	5,1	4,5	−0,5	5,5	6,7	−0,8	−1,4	1,6	170 067
Public consumption	3,3	2,7	2,1	2,0	2,8	1,8	1,8	2,2	2,0	42 395
Gross fixed capital formation	0,4	4,5	8,3	−1,2	13,4	12,8	−0,4	−1,0	1,8	50 289
Change in stocks [1]	1,5	1,9	3,5	1,4	2,5	4,7	2,4	1,1	1,8	7 945
Domestic demand	2,9	5,8	6,5	−2,3	9,2	11,9	−5,7	−3,4	3,0	270 696
Exports of goods and services	8,1	8,9	−4,7	3,0	3,8	−8,2	−5,3	6,1	5,7	68 579
Imports of goods and services	6,7	14,0	6,4	−4,1	18,8	9,0	−8,8	−5,5	4,2	70 407
GDP at market prices	3,3	5,0	3,8	−0,8	5,9	7,3	−4,9	−0,8	3,4	268 868
	% change over preceding period at annual rates									
GDP at current prices	16,7	21,3	25,4	16,8	:	:	:	:	:	
Industrial production	3,4	6,4	4,9	−5,7	8,0	14,1	−14,1	−4,0	0,4	
Unemployment rate [2]	5,7	7,7	7,6	8,0	7,6	7,6	7,6	7,9	8,1	
Compensation of employees	19,4	17,8	23,6	19,4	25,5	24,0	21,0	19,2	18,7	
M2	20,3	20,3	12,3	13,1	:	:	:	:	:	
GDP (implicit price index)	13,3	15,5	20,8	17,7	15,5	25,5	16,7	17,9	18,7	
Private consumption (implicit price index)	13,0	14,9	21,2	18,7	17,1	24,4	19,1	20,1	16,0	
Exports, goods (implicit price index)	15,0	17,6	19,5	15,5	18,0	22,3	16,0	18,1	10,4	
Imports, goods (implicit price index)	17,0	18,4	26,0	19,1	27,8	27,7	22,8	22,1	10,4	
Terms of trade	−1,7	−0,7	−5,2	−3,0	0,2	−0,9	0,6	−1,1	1,3	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,3	−2,0	−5,9	−4,9	:	:	:	:	:	
Current balance	0,5	1,6	−2,5	−1,4	−0,1	−2,3	−2,7	−1,4	−1,5	
Net borrowing of general government	−7,3	−9,4	−7,8	−8,4	:	:	:	:	:	

[1] As % of GDP.
[2] Unemployment as % of total active labour force
Source: ISTAT.
Sources: Eurostat; Commission and national services.

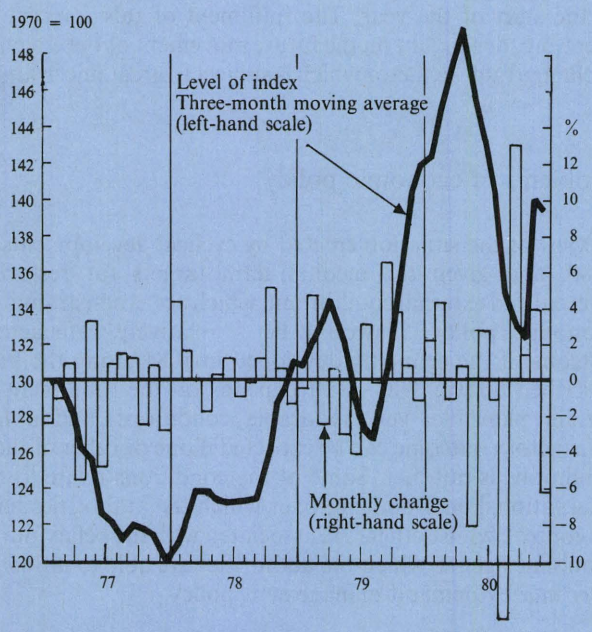
1981. Nevertheless, the above assumptions are still plausible and, for the rest, their effect would be merely to push demand in the second half of 1981 back up to the level at which it stood in the first half of 1980, with the result that, taking the year as a whole, the volume of private consumption would be slightly down on 1980.

Stockbuilding, which was a major factor in the decline in demand in the second half of 1980 particularly as it had, at the outset, risen to an abnormal level in response to inflationary expectations, is likely to contract further during the first two quarters of 1981 before expanding once again in the third quarter as final demand recovers and reverting to a normal level in the fourth quarter.

However, the main stimulus to activity, at least during the first half of 1981, will probably come from the underlying improvement in the real trade balance. This tendency, which was first discernible in the fourth quarter of 1980 [1] under the combined effect of a substantial fall in imports and a slight recovery in exports, should become much more distinct in 1981. *Imports,* which, for reasons partly to do with speculative behaviour, reached an exceptionally high level during the first few months of 1980, subsequently fell sharply in response to the downturn in demand. The probability is that imports will virtually mark time during the first quarter

[1] See graph.

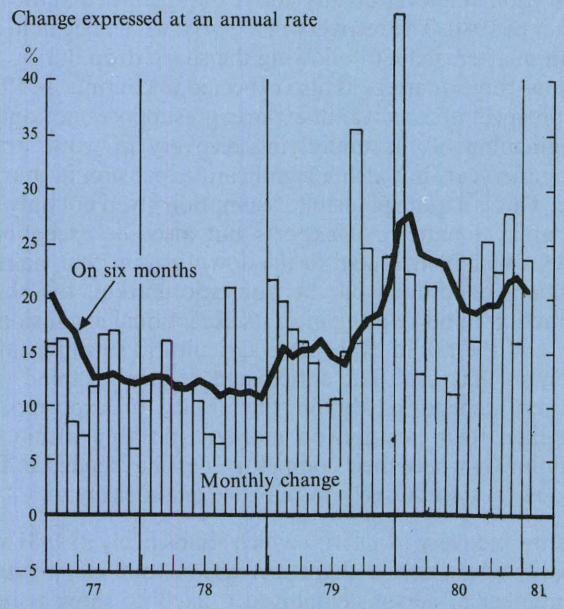
Italy: Industrial production (s.a.)



Source: ISTAT/ISCO.

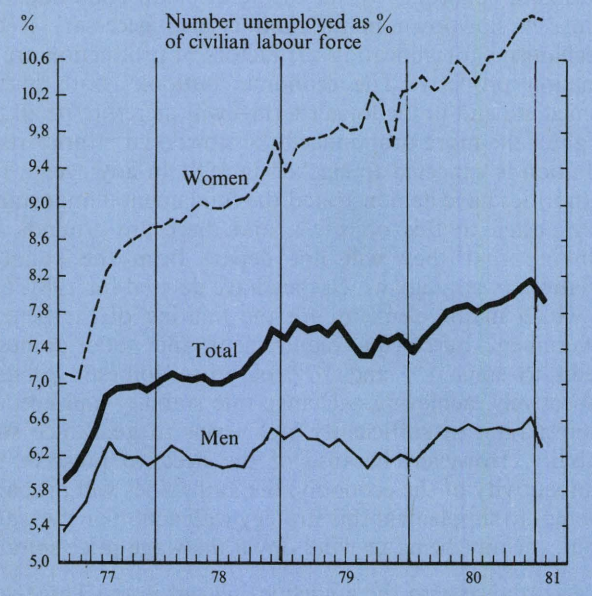
Italy: Consumer prices

Change expressed at an annual rate



Source: ISTAT.

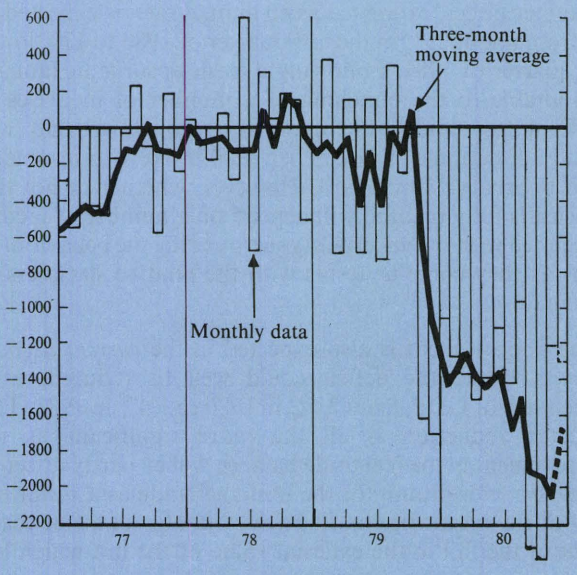
Italy: Unemployment (s.a.)



Source: Eurostat.

Italy: Trade balance (s.a.)

Mrd LIT



Source: ISCO.

of 1981 and will pick up again only in the second quarter, though this forecast implies a stable degree of import penetration at a level slightly above that recorded in the last quarter of 1980. The recovery in *exports,* which began in the fourth quarter of 1980 following the sharp drop during the previous three quarters, is also expected to continue in 1981. The prospect of a revival in exports presupposes not only a strengthening of the underlying recovery in world trade during the year, but also a significant expansion in market share. This is a quite plausible assumption given not only the geographical pattern of exports but also the exceptional factors which contributed to the downturn in 1980, namely the boom conditions on the domestic market, the sharp contraction in oil refining after its exceptional expansion in 1979, and the fall in exportable agricultural surpluses after some poor harvests. The anticipated reversal in trend will, however, depend partly on the ability of exporters to strengthen their position on markets (notably within the Community) where their competitiveness has tended to flag and does not seem likely to improve again easily.

The slow recovery in activity which seems likely in 1981 will probably allow only a slight increase in total *employment.* The number of persons employed is likely to show a slight decline, in fact, in industry and to grow at an appreciably slower rate in the marketable services sector. Under the circumstances, unemployment, which started to climb again slowly in the second half of 1980, [1] is expected to continue to rise in 1981, to reach a rate of around 8% by the end of the year.

In contrast, there will probably be a deceleration in *price rises,* helped by the slackness of domestic demand and by the slower rise in import prices. Thus, the rate of increase in consumer prices, expressed as an annual rate, is expected to fall from about 23% in the last quarter of 1980 to 17% in the last quarter of 1981. Following a fresh upsurge in January attributable to the bunching of a number of increases in public sector prices, the underlying slowdown that was already discernible in December 1980 is likely to resume as from February-March 1981. However, whether or not this forecast is fully realized will depend on a number of factors associated with the uncertainty surrounding the behaviour of firms as they come to terms with the relative slackness of demand.

Some improvement is also expected in the *current account balance,* where the deficit could well be reduced, as a percentage of GDP, from 2,5% in 1980 to 1,4% in 1981. This expected reduction is all the more significant as the improvement in the real trade balance will be partly offset by a further deterioration of the terms of trade as a result not only of the recent rise in oil prices, but also of a full year's effect of the fall in the external value of the lira which has occurred since the spring of 1980. The present forecast assumes, however, that no further deterioration in the terms of trade will occur beyond that which has already taken place at the start of the year. The fulfilment of this forecast is, therefore, dependant on the future movement of the effective exchange rate—a factor which is subject to great uncertainty.

Problems of economic policy

In view of the situation created by cyclical developments in 1980, and given the medium-term targets for restoring internal and external equilibrium, which act as constraints on economic policy, it would be a relatively satisfactory outcome if the economy developed in 1981 along the lines described above. This result depends on the fulfillment of certain plausible, yet favourable conditions, and a less satisfactory outcome can be expected if one or other of these conditions is not met. Some of the conditions relate to the international environment, over which the authorities have no control, whilst others are associated with the behaviour of economic agents, which the authorities are able to influence *inter alia* by demand management policy.

The crucial problem here is to bring inflation under control. In the short term, a slowdown in inflation will be the determining factor both in the continuing competitiveness of the economy and in the revival of domestic demand. This is because it will help directly to stabilize the savings ratio after the rise stemming from the reconstitution of real balances, and it should have an indirect effect via a lowering of interest rates and, consequently, an easing of credit conditions for firms. A slowdown in inflation is also necessary if the mechanisms for allocating the factors of production are to function properly. The economic outlook—both in the immediate and in the longer term—will therefore be all the brighter the more pronounced the slowdown in price rises. Inflation is expected to slacken in 1981 in any event. The authorities have demonstrated the fundamental importance they attach to this objective, and there are grounds for thinking that they will not depart from the counter-inflationary strategy which they have devised for 1981, and of which major elements are the limiting of the general government borrowing requirement and total domestic credit to some 8% and 16% of gross domestic product respectively, achieving exchange-rate stability and keeping interest rates at sufficiently high levels to guarantee such stability. However, because of the need to preserve the competitivity of the economy, the authorities will probably attempt to supplement this strategy with action on the wages front, the aim being to wind down the wage-price spiral.

In accordance with the guidelines set out in the Three-year Plan, action by the authorities should also develop in another direction, that of adapting the structures of the economy to the new conditions governing economic growth. The Plan

[1] See graph.

proposes a reduction in the dependence of the economy on external supplies for the sectors of fuel and food, an improvement in the allocation of resources in those sectors suffering a crisis, the use of the resulting room for manœuvre to raise the level of socially-useful services (housing, public health, transport), and the expansion of output and employment by encouraging, in particular, the strengthening of the industrial base in the South, the restructuring of industry around new technologies and the modernization of the distributive system. In many cases, detailed programmes have been drawn up and some have been given the legislative bases necessary for their implementation. However, the implementation of these programmes may be delayed by administrative or political difficulties, as has often happened in the past. The authorities will have to make an effort, determined at times—and in particular in the energy sector (see appended box on Italy's energy plan)—to overcome these difficulties, and will have to earmark large-scale resources to ensure that the necessary finance is available. Increased stringency in the management of current expenditure will, in these circumstances, be necessary if, as is foreseen in the Plan, these requirements—together with those related to the reconstruction work required in the regions affected by the earthquake of November 1980—are not to lead to a further increase in the tax burden. Nevertheless, the authorities plan to cover a significant proportion of the expenditure involved by increased public sector borrowing abroad.

Italy's energy plan

Primary energy consumption in Italy totalled 144 million toe in 1979, with the degree of dependence on energy imports amounting to about 83%. Electricity generation from hydraulic power was only 10 million toe and that from nuclear power 0,6 million toe. With coal and natural gas contributing some 34 million toe, oil accounted for the largest share (68%) of consumption in 1979.

In 1980, Italian imports of energy products came to more than LIT 22 500 000 million. This figure, which was 25% up on the previous year, amounted to 26% of the value of total imports for the year. In addition, the deficit on trade in energy products (LIT 18 500 000 million) was virtually identical to the overall trade deficit (LIT 18 700 000 million).

This situation has prompted the Italian authorities, in the context of the medium-term plan for 1981-83, to concentrate on drawing up an energy plan.

1. The objectives for 1990

Under the energy plan, the main objectives for 1990 are as follows:

(a) a vigorous policy to promote energy saving and a more rational use of resources in all sectors of consumption, the aim being to limit energy demand to 200 million toe;

(b) reducing dependence on oil from 68% in 1979 to some 50% of total energy requirements (100 million tonnes of crude oil imports) through the development of alternative and competing sources of energy;

(c) maximum utilization of national energy sources;

(d) reducing supply risks through diversification of sources and of supplying countries and through the build-up of appropriate reserves.

The promotion of energy savings (some 20 million toe/year by 1990) is seen as the basic objective of the Italian plan: it presupposes that measures aimed at curbing the growth of energy consumption, while at the same time allowing 3%—3,5% annual growth in gross domestic product between now and 1990, will be completely successful.

2. Energy saving

(a) Civilian and residential uses

The introduction of 'heating service' contracts under which professionals in the trade would manage heating systems is seen as a key component of the policy encouraging energy conservation in the home.

In new buildings, application of the standards which already exist (Law 373/76) will result in savings of the order of 0,2 million toe/year. However, the introduction of new building and material manufacturing techniques should make it possible to achieve more substantial results.

Lastly, energy savings that can be achieved in the home and in the services sector through the proper use of electrical household appliances that are better designed from the viewpoint of energy consumption are put at some 1,8 million toe/year.

(b) Industry

Industry has, in recent years, managed already to hold down somewhat the increase in its energy consumption; further savings can be achieved only if existing incentives (Laws 675 and 655) are improved. The aim of other, more general provisions is to set up energy-conservation agencies and in particular to establish an 'energy diagnosis' service for small and medium-sized industrial firms. The plan also features a programme for the training of experts and technicians in energy management, the carrying out of demonstration projects, the dissemination of the results obtained, and the introduction of financial incentives for investments designed to save energy.

(c) Transport

Savings can be achieved here only if there is an improvement in the energy efficiency of vehicles and in transport structures. The reductions in consumption which seem possible by 1990 will come from the rationalization of transport and a reduction in specific vehicle consumption. Provision is made for incentives to encourage the development of prototype vehicles with low energy consumption and their subsequent manufacture and to improve the energy efficiency of existing means of transport. Measures to promote district heating are also planned. All in all, the plan provides for financial incentives amounting to LIT 9 000 000 million up to 1990, including LIT 2 800 000 million for the period 1981-83.

3. The main sources of energy

Requirements in 1990 (200 million toe) are expected to be met as follows:

Domestic production (35 million toe)

— Nuclear power	10	million toe
Hydrocarbons	9,2	million toe
of which: — natural gas	6,7	million toe
— oil	2,5	million toe
— Coal	2	million toe
— New energy sources	2	million toe
Hydroelectric and geothermal power	11,6	million toe

Imports (165 million toe) (total dependence = 72,5%):

— Coal	34	million toe
Natural gas	30	million toe
Oil (to make up total requirements)	101	million toe

(a) Coal

Under the plan, the proportion of consumption accounted for by coal is to rise from 8% in 1979 to 18% in 1990. The increase in coal consumption will mainly involve power stations but will also apply, to a lesser degree, in industry.

Since domestic production in 1990 is put at some 4 million tonnes, it will be necessary in that year to import 55 million tonnes of coal.

(b) Natural gas

With the construction of the Algeria-Italy gas pipeline, which will be completed in 1985 and will then enable 12 000 million m^3 of gas to be imported annually, the amount of natural gas available each year will rise to 35 000 million m^3 in 1985. By 1990, additional imports of 10 000 m^3 a year will be necessary to reach the target of 45 000 million m^3 a year.

Annual natural gas consumption is thus expected to increase from the present level of 22,9 million toe to 37 million toe by 1990, i.e. to 18% of energy consumption.

(c) Nuclear energy

Despite successive delays, nuclear energy is expected to account for 10 million toe by 1990, as against 0,6 million toe at present, and this means the construction of at least four additional stages each of 1 000 MW in addition to the Montalto di Castro power-station. A number of initiatives must therefore be taken by the public authorities, particularly with regard to:

— plant safety,

— selection of sites and location of power-stations,

— a standard power-station plan.

Investment in the nuclear sector in the period 1981-90 is expected to total LIT 12 750 000 million, more than LIT 9 000 000 million of which will be used solely for the construction of nuclear power-stations, the remainder being divided between research and development activities and the various phases of the fuel cycle.

(d) Oil

The two main objectives under this heading are:

(1) to ensure continuous and regular supplies while minimizing costs;

(2) to bring about a gradual change in the structure of supplies so as to make them less oil-dependent and more flexible.

In quantitative terms, this will involve imports of crude oil and of petroleum products amounting to about 100 million tonnes in 1990; however, before then, and more particularly towards 1985, the 100 million tonnes mark will be passed since substitute sources of energy will not yet have been sufficiently developed. Investment for the period 1981-90 is expected to amount to LIT 17 150 000 million.

(e) Renewable sources

The Italian plan provides for increasing use of renewable sources (solar energy, wind energy, hydroelectric power, geothermal power, biomass and other alternative fuels) more as part of the rational use of energy and not so much for the contribution they can make to electricity generation, which will remain slight.

It is mainly in the fields of geothermal and hydroelectric power that the relevant investment might be expected to assume significant proportions.

Luxembourg

Trends and prospects

The slowdown in *economic activity* from the second quarter of 1980 was sharply accentuated by the general slackening of export demand, and in particular by the crisis in the steel industry. For the year as a whole, the index of industrial production was 3,3% down with steel production alone showing a 4,1% fall. However, real gross domestic product was still some 0,5% up, mainly as a result of a moderate growth in the services sector.

Because of the persistently depressive effects of export demand in particular, the outturn for industrial production, as an average for 1981, should be very much lower than the year before. The upturn expected later in the year should prove fairly modest. All in all, real *gross domestic product* in 1981 could be some 1% down on 1980.

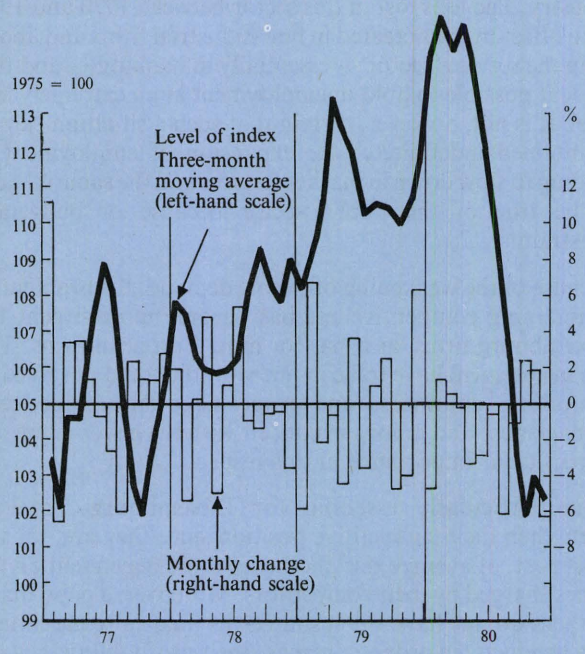
The growth of *private consumption* should again fall back because, as in 1980, *per capita* wages in the corporate sector will increase more slowly. Presumably the moderation of wage costs envisaged in several competing countries will encourage management and unions to agree to limit the rise in real wages, in order to preserve the country's competitive position. The savings ratio, already up last year, could go

Luxembourg: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [3]	1979 II	1980 I	1980 II	1981 [3] I	1981 [3] II	1979
	Annual data				Half-yearly data (s.a.)					LFR 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1975 prices									
Private consumption	4,3	3,6	1,8	1,2	2,8	1,6	1,2	:	:	71,2
Public consumption	3,3	3,5	2,1	1,4	3,8	1,7	1,1	:	:	18,8
Gross fixed capital formation	3,7	2,9	2,7	0,6	4,1	2,8	1,4	:	:	31,7
Change in stocks [1]	1,2	−1,7	:	:	:	:	:	:	:	−1,7
Domestic demand	3,9	0,5	4,9	−0,1	2,0	6,7	4,3	:	:	119,9
Exports of goods and services	3,2	9,1	−1,4	0,3	3,8	−3,2	−3,0	:	:	102,6
Imports of goods and services	4,7	5,2	3,5	1,4	4,5	3,6	2,3	:	:	101,4
GDP at market prices	2,7	3,6	0,4	−1,0	1,7	0,3	−0,6	:	:	121,1
	% change over preceding period at annual rates									
GDP at current prices	9,9	10,9	4,9	5,7	:	:	:	:	:	
Industrial production	0,4	3,3	−2,5	−6,0	−0,2	−2,6	−4,6	:	:	
Unemployment rate [2]	0,3	0,7	0,7	0,8	0,7	0,7	0,7	:	:	
Compensation of employees	13,5	10,0	10,0	8,2	9,7	10,4	9,5	:	:	
M2	:	:	:	:	:	:	:	:	:	
GDP (implicit price index)	7,0	7,0	4,4	6,7	:	:	:	:	:	
Private consumption (implicit price index)	6,3	5,8	6,3	6,3	6,6	6,2	6,2	:	:	
Exports, goods (implicit price index)	6,9	10,1	4,0	7,5	6,5	2,7	4,3	:	:	
Imports, goods (implicit price index)	7,7	8,4	8,5	9,0	8,9	8,3	8,6	:	:	
Terms of trade	−0,5	0,6	−3,4	−1,3	−2,2	−5,2	−4,0	:	:	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,4	−8,1	−15,7	−18,4	:	:	:	:	:	
Current balance	18,5	28,7	20,9	18,0	:	:	:	:	:	
Net lending (+) or net borrowing (−) of general government	2,5	0,1	−0,9	−2,1	:	:	:	:	:	

1 As % of GDP.
2 Unemployment as % of total labour force.
3 Forecasts.
Sources: Eurostat and Commission services.

Luxembourg: Industrial production (s.a.)



Source: Eurostat.

higher in 1981, since the less-favourable short-term prospects should encourage households to be cautious.

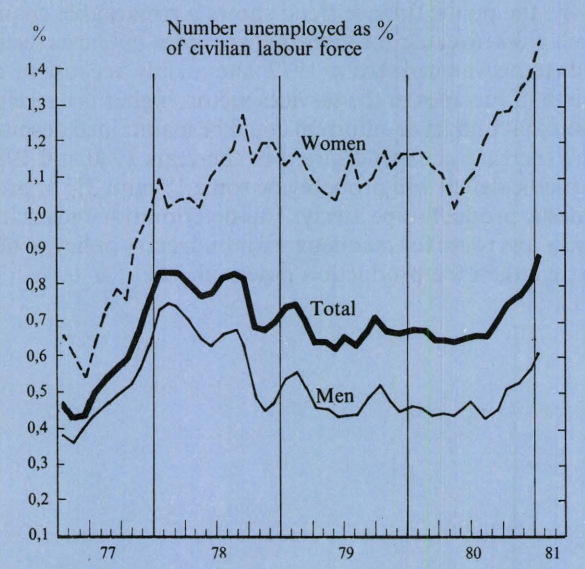
General government consumption in nominal terms advanced fairly vigorously in 1980. Although public sector recruitment is being held down, this trend is likely to continue in 1981, reflecting a 2% pay increase effective from 1 January, and more frequent triggering of the indexation mechanism.

Public investment, fairly buoyant in 1980, will be slightly less so this year.

Activity in *residential construction* began to slow down appreciably in the second half of last year, and will probably continue to do so in 1981. Developments in this sector could be affected by the moderate growth of incomes foreseen as well as the high level of interest rates and the greater profitability of other placements.

The expansion of *corporate investment* proved weaker than forecast in 1980, mainly because of delays in executing investment programmes in the steel industry and in new firms. In 1981, the propensity to invest is likely to be affected by lower capacity utilization rates and less-favourable short-term expectations. The volume of corporate investment is likely to stop growing, especially since the steel industry has revised its original programme downward.

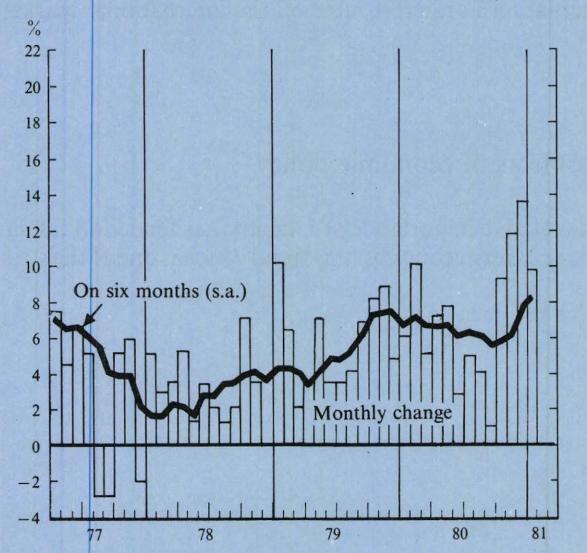
Luxembourg: Unemployment (s.a.)



Source: Eurostat.

Luxembourg: Consumer prices

Change expressed as an annual rate



Source: Eurostat.

As a result of the sharp drop in steel sales abroad, *exports* declined last year and on the whole there seems little chance of improvement in 1981. *Imports* went on expanding vigorously in 1980. The signs of deceleration which became evident towards the end of the year will grow stronger in 1981, because of the weakness of private consumption and investment. The very appreciable deterioration in the terms of trade, caused in 1980 by the combined effects of higher prices for energy products and lower prices for steel products, will continue in 1981 but at a more moderate rate.

The prospects for *employment* are not very favourable. The numbers employed in industry will fall, and reduced recruitment must be expected in the services and general government sectors. The unemployment rate will nevertheless still be very low in comparison with that of the other Member States (1 % as against an average of 7,3 % for the Community as a whole).

Despite the fairly strong upsurge in consumer *prices,* stimulated in particular, at the beginning of 1981, by a rapid increase in import prices in the preceding months, the average rise for the year could well be comparable with the 1980 rates, i.e. 6,3%.

The *balance of payments* on current account should close with a substantial surplus as it did last year, corresponding to 18% of gross domestic product. Nevertheless, this out-turn conceals a growing deterioration in the trade balance, which, seriously burdened by an ever-higher oil bill, is likely to move from a LFR 1 300 million surplus in 1979 to a LFR 10 600 million deficit in 1981. The development of the net balance of factor incomes, which depend mainly on the banks' activities in Luxembourg, remains uncertain due to the wide fluctuation in interest rates on the international markets.

Problems of economic policy

The relative importance of industry has tended to fall in the Luxembourg economy: this trend which is one of the striking aspects of economic developments in recent years, has definitely strengthened as a result of the crisis in the steel industry. The jobs lost in this sector between 1970 and 1980 were offset by jobs created in new industrial firms and above all in the services sector — essentially in banking — and this made it possible to hold unemployment at an extremely low level. It is not, however, certain that such a situation can be maintained indefinitely: the expansion of employment is tending to slow down in market services and the same is likely to be true of the public sector because of budgetary constraints.

Because of the weakening of export demand, the problem of maintaining competitiveness has become more urgent for Luxembourg firms, as it has for most European firms. The rise in costs will have to be in line with the trend observed in competing countries, and wage negotiations between management and unions in concert with the government are of particular importance in this respect.

It is particularly essential for Luxembourg firms to strengthen their competitive position since they are, for the most part, of average size and hence more dependent on the prices charged by their competitors. Moreover, a good many of them do not have the resources to finance research into new products; in order to increase their profitability they are therefore compelled either to confine themselves to improving traditional products, or to buying patents and licences.

Added to this problem is that of the diversification of Luxembourg industrial production, which must be actively pursued if the above-mentioned tendency for unemployment to increase is not to continue.

Lastly, the public finance trend shows a remarkable change which gives no cause for immediate concern but nevertheless needs to be watched. Up to 1979, and mainly because of the growth of incomes in the services sector, higher tax receipts meant that budget equilibrium could be maintained despite a sharp increase in expenditure. For the years 1980 and 1981, the public deficit will probably be some 1% and 2% of gross domestic product respectively. This deterioration means that there is less room for manoeuvre for budgetary policy to help to strengthen the production potential.

Netherlands

Trends and prospects

The relatively favourable economic picture at the beginning of *1980* was replaced, in the second half of the year, by an appreciable slowdown in activity. As a result, for the year as a whole, the growth of real *gross domestic product* is very small and unemployment has increased significantly.[1]

Although these developments are largely attributable to the downturn in export demand caused by the deterioration in world economic activity, they also reflect the weakness of domestic demand. Real incomes have been eroded by measures to limit the rise in wages, and by heavier taxation and social security charges, and this has had the effect of reducing consumer demand. In addition, the swollen public sector deficit has imposed a restrictive stance on budgetary policy, though this did not stop general government net borrowing in 1980 from going well above the previous year's amount. Lastly, the objective of monetary policy has been to limit domestic liquidity creation. Interest rates, largely determined by the international market, stayed fairly high, another factor being the public sector's heavy calls on the capital market.

For *1981, a* reduction of approximately 0,5% in *real gross domestic product* was assumed. This figure implies a certain upturn during 1981 to follow the sharp fall in the second half of 1980. The upturn would, however, be only limited in scale. In fact, external economic activity can only be expected to produce limited stimuli. As in 1980, restraining effects could also come from *economic policy,* which is centred on restructuring the Netherlands economy in the medium term. In order to hold down wage costs and improve company profitability, the automatic working of the indexation mechanisms was partially interrupted for the first half of 1981. The impact of this measure was only partly offset by income tax cuts, which mainly benefited the lowest paid. The curbing of the structural growth of public expenditure forms part of the same policy.

Of the aggregates of demand, only *general government consumption* will show some increase in real terms, whereas the volume of *public investment* will fall. Particularly important here is the difficult financial situation of the local authorities, which are responsible for the bulk of this investment.

The fall will be much sharper for *private investment*. It will be particularly perceptible in residential construction, partly because of pessimism concerning income expectations, and the high level of interest rates. A notable result of these factors has been the accumulation of a considerable stock of unsold dwellings in the non-subsidized sector. Similarly, a distinct fall in corporate investment must be expected, both in industrial and commercial buildings and in plant and machinery. Despite the slower rise of costs which is bound to result from wage restraint, the investment climate is still very depressed. The sales outlook still remains generally poor, while the financing problems posed by the high level of interest rates are also important. In addition, structural difficulties are hampering financing by means of risk capital.

As in 1980, the volume of *private consumption* must be expected to decline, despite some fall in the savings ratio. Not only will consumer durables be affected, but a distinct fall in tourism is also feared. The *per capita wage and salary* bill is forecast to rise by only 5,5% in the private sector; because of the exceptional measures restricting expenditure, the rise in civil servants' salaries should be only 0,5%. Consequently, and given a foreseeable increase of over 6% in the price of private consumption, real disposable income as a whole will be reduced further.

After last year's downturn, *exports* could pick up in the course of 1981 as world economic activity improves. On average for the year, however, the volume of sales is still forecast to fall slightly, since the bulk of exports go to other Community countries, and are heavily dependent on economic activity in those countries, particularly in the Federal Republic of Germany and in Belgium. A large proportion of exported products have a high energy content and are greatly affected by the rise in energy prices. However, since the increase in wage costs is below the average of the other countries, the Netherlands will be able to improve its competitive position slightly in 1981. Nevertheless, the level of export prices is still relatively high compared with the other Community countries.

In 1981, the weakness of economic activity will have the effect of accentuating the reduction in the volume of *imports*. Because of the rise in the price of natural gas, the deterioration in the terms of trade will remain limited, so that the trade balance deficit, and hence the current account deficit could be smaller than those recorded in 1980.

Towards the end of last year, the number of *unemployed* had already gone above an unprecedented 300 000, but the number will edge up even further, given the unfavourable economic outlook for 1981; on average for the year, it could be as high as some 350 000, or 7% of the labour force. This increase is also expected to affect the male labour force considerably. Young people will be particularly hard hit: already in 1980, no less than 40% of the unemployed were under twenty-five years of age. The slump in employment in industry and construction is only marginally offset by an increase in market and non-market services. On the supply side, the natural increase in the labour force will continue.

[1] See table.

Netherlands: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [3]	1979 II	1980 I	1980 II	1981 [3] I	1981 [3] II	1979
	Annual data				Half-yearly data (s.a.)					HFL 000 Mio at current prices
	% change over preceding period at annual rates – at constant 1975 prices									
Private consumption	3,9	2,2	−0,5	−1,0	4,5	−1,5	−3,3	−3,6	6,8	173,8
Public consumption	3,1	2,9	1,2	0,8	1,7	0,8	0,6	0,9	1,0	56,4
Gross fixed capital formation	1,7	0	−1,4	−5,6	43,2	−13,0	−11,7	−6,0	2,4	64,8
Change in stocks [1]	1,3	0,5	0,3	0,2	−0,1	0,8	−0,1	1,7	−1,2	1,2
Domestic demand	3,1	1,3	−0,5	−1,7	8,2	−1,9	−6,1	−0,4	0,3	296,2
Exports of goods and services	6,5	8,0	0,7	−0,4	1,4	6,1	−9,9	0,0	9,1	151,0
Imports of goods and services	5,6	6,2	−0,6	−2,4	3,5	2,5	−10,4	−1,9	5,6	148,2
GDP at market prices	3,5	2,2	0,2	−0,6	7,0	0,0	−5,9	0,6	1,6	299,0
	% change over preceding period at annual rates									
GDP at current prices	11,4	6,2	5,9	4,5	12,2	6,8	−2,2	7,2	5,5	
Industrial production	3,8	2,8	−1,0	−1,3	1,8	2,6	−10,6	1,5	3,4	
Unemployment rate [2]	3,1	4,2	5,0	6,8	4,2	4,4	5,5	6,8	6,8	
Compensation of employees	12,1	7,1	5,5	3,0	7,1	5,8	3,1	2,1	4,9	
M2	11,5	7,1	5,8	7,6	:	:	:	:	:	
GDP (implicit price index)	7,7	3,9	5,6	5,2	4,9	6,8	3,9	6,6	3,8	
Private consumption (implicit price index)	7,4	4,3	6,5	6,3	4,3	9,0	3,9	7,7	5,8	
Exports, goods (implicit price index)	5,9	8,6	13,5	10,0	16,7	19,0	0,7	13,4	12,8	
Imports, goods (implicit price index)	7,1	11,1	14,5	10,5	19,4	19,5	1,3	14,5	12,1	
Terms of trade	−1,0	−2,3	−0,9	−0,5	−2,3	−0,4	−0,6	−1,0	0,6	
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,2	−2,7	−2,8	−2,2	:	:	:	:	:	
Current balance	1,3	−1,4	−1,5	−0,9	:	:	:	:	:	
Net lending (+) or net borrowing (−) of general government	−0,5	−2,0	−2,8	−3,2	:	:	:	:	:	

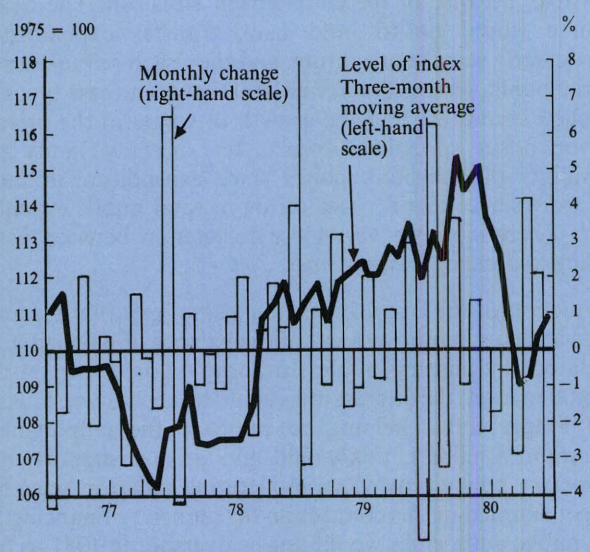
1 As % of GDP.
2 Unemployment as % of total labour force.
3 Forecasts.
Sources: Eurostat and Commission services.

The average 6,5% rise in *consumer prices* recorded in 1980 is lower than the rate forecast at the beginning of that year. Part of this relative success is certainly due to the slower rise in wage costs achieved by the pay policy. Another factor was the movement of import prices, which rose less sharply than estimated. In 1981, the inflation rate could fall again, mainly owing to a less-rapid increase in import costs.

Problems of economic policy

The Netherlands economy is faced with substantial structural problems seriously affecting employment, further aggravated by the cyclical slowdown in economic activity. Since it must be presumed that, in the next few years, the increase in employment will be very limited in the public

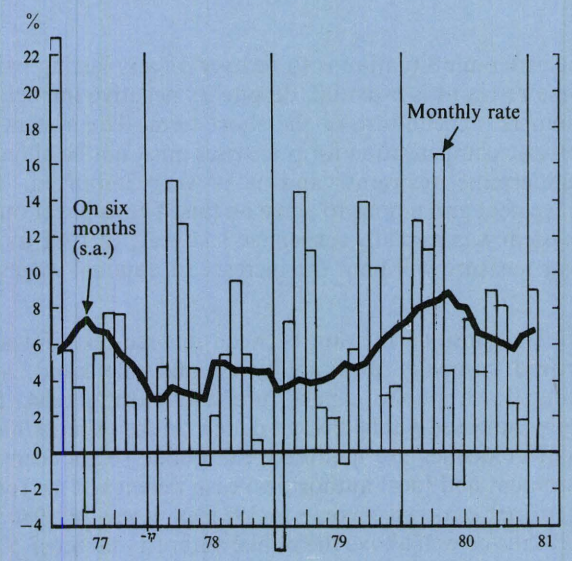
Netherlands: Industrial production (s.a.)



Source: Eurostat.

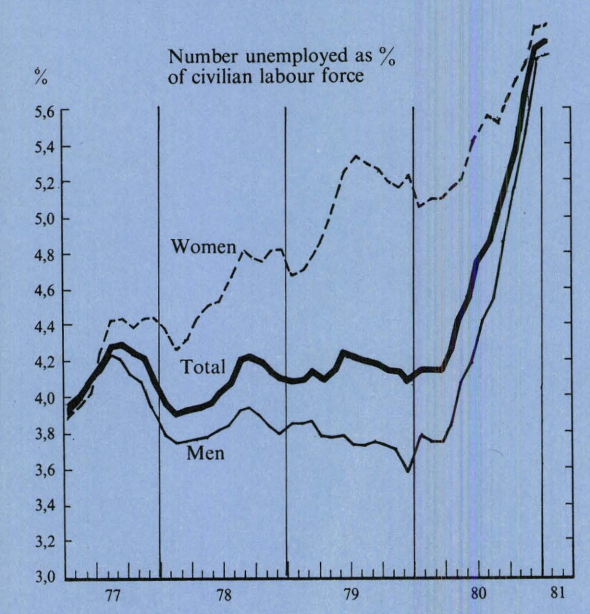
Netherlands: Consumer prices

Change expressed as annual rate



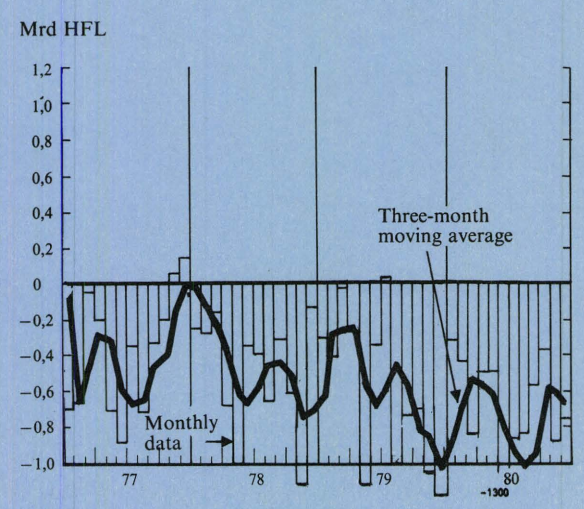
Source: Eurostat.

Netherlands: Unemployment (s.a.)



Source: Eurostat.

Netherlands: Trade balance (s.a.)



Source: Eurostat.

sector, the private sector will have to make the main contribution toward remedying the situation. An improvement in company profitability and, in general, in the corporate business climate is of prime importance in this respect.

If the economic situation is to recover on any lasting basis, income restraint is essential, despite its negative impact on consumers' expenditure in the short term. The system of automatic compensation for price rises must not be allowed to undermine restraint, and it is very important for management and unions to agree on this. The application of the system was partially suspended last year. In 1981 too, a similar measure will limit the increase in nominal wages.

There is a close correlation between income restraint and improved company profitability on the one hand, and holding down public expenditure and cutting back the sharply-increased public budget deficit on the other. Unless present guidelines are modified, the public sector (central government and local authorities) cash deficit will be some 7,5% of net national income in 1981 as it was in 1980; it would thus be well above the public authority target (5,5%). The difference is largely attributable to unfavourable cyclical developments and their automatic impact on public receipts and expenditure. In view of the worsening budgetary situation and the poor prospects for growth over the next few years, new measures seem essential. Since the tax burden is already very heavy, further savings will be necessary in 1981. In making these savings, public authority purchases of goods and public investment ought to be preserved as far as possible, because of the employment situation. The better course would be to hold back transfer expenditure, particularly social expenditure, and the rise in remuneration in the public sector. The formal link between these types of public expenditure and the growth of wages in the private sector poses special problems. It especially limits the flexibility of budgetary policy since expenditure in these categories accounts for two-thirds of total public expenditure. There is thus a very close correlation between fiscal policy and changes in incomes.

Reduction of the budget deficit is also of great importance for a structural improvement of the balance of payments. In addition, by limiting public authority's borrowing on the capital market, the interest rates could be kept down, thus, in the longer term, helping to improve the employment situation. Similarly, this would give greater support to a monetary policy centred on moderating inflation since the target adopted in this connection for monetary financing by the public authorities would not be overshot in 1981 as has often been the case in recent years, with the result that the authorities have created excessive liquidity.

United Kingdom

Trends and prospects

For 1980 as a whole *gross domestic product* (GDP), as measured from the expenditure side, fell by 2%.[1] The major part of this fall was concentrated in the second half of the year, when GDP is estimated to have contracted at an annual rate of over 5%. In particular there was a sharp fall in stocks as well as a marked decline in gross domestic fixed capital formation.

This fall in output is reflected in the employment and unemployment figures. Between December 1979 and December 1980 unemployment (seasonally adjusted and excluding school leavers) rose by 850 000, an increase in the unemployment rate from 5,4 to 8,8%.

There was also a sharp fall in the rate of inflation in 1980. In the six months to December retail prices increased by less than 8% (at an annual rate) whilst the December year-on-year change was 15%.

On the external side the balance of trade registered a massive surplus of UKL 1 900 million in the second half of the year, following a deficit of UKL 900 million in the first half, a development which owes much to the steep fall in import volume, itself associated with large-scale destocking. In addition, the UK benefited from a significant improvement in the terms of trade, reflecting the UK's oil production. At the same time the surplus on invisibles in 1980 reached UKL 1 200 million.

The present outlook is that *gross domestic product* in 1981 will fall by a further 2%. In particular the sharp contraction in output, which occurred in the second half of 1980, is expected to be followed by a further fall in activity in the first half of 1981, and a slight recovery is foreseen for the second. The pattern of demand, however, changes significantly over this period. In the second half of 1980 the fall in domestic demand, including the effects of destocking, was offset, but only to a limited extent, by an improvement in the external position. Through 1981 the fall in domestic demand (including stocks) is now forecast to moderate. On the other hand a significant deterioration in the external position is expected as exports decline, and import volumes increase. A sustained decline in wage and price inflation is foreseen.

The combined fall in output through 1980 and 1981 of over 4%, together with the easing of inflationary pressures, are in part due to the response of both internal and external demand to a particular *economic policy stance* together with some significant structural changes in the UK economy.

In mid-1979 the present government effected a marked switch from direct to indirect taxation, whilst at the same time raising interest rates, with a view to controlling the expansion of the money supply, so as to reduce the rate of inflation in the longer term. This policy, combined with expanding UK domestic oil production at a time of increases in world oil prices, led to a significant strengthening of the sterling exchange rate. However, as wages continued to rise rapidly, particularly in the public sector, whilst price inflation decelerated markedly (helped by the unexpected strength of sterling in the exchange markets), the company sector experienced an exceptional financial squeeze, which led to a fall in stocks and fixed investment.

During the first half of 1981 real personal disposable incomes are expected to stagnate or even to decline somewhat, as the rate of growth of earnings is expected to fall below the rate of inflation, and this suggests there may well be a further but small decline in *private consumption*. In the second half of the year real incomes are expected to recover slightly, and assuming no marked change in the savings ratio, this should permit a modest expansion of consumer demand.

In line with the authorities announced intentions *general government consumption* is expected to decline slightly in 1981, less rapidly however than *general government fixed investment* which is foreseen to remain on the declining trend established since the mid-1970s. *Private sector fixed capital formation* is forecast to fall further in 1981 although the outlook is that, in the second half of the year, falling interest rates may give a modest stimulus to private sector house-building activity.

Some improvement in the financial position of the company sector in the latter part of 1981, resulting from previous adjustments to investment plans, and stock and employment levels, together with the easing of inflationary pressures, is expected to bring the *destocking cycle* to an end, by the end of the year.

For 1981 as a whole a decline in the volume of *non-oil exports* of at least 4% is foreseen, reflecting the effects of the UK's loss of export price competitiveness due to the strong exchange rate; the volume of *non-oil imports* is expected to rise, partly as a result of the movement in stocks and private consumption. Although a modest improvement in the terms of trade is expected to occur between 1980 and 1981 this will largely be the result of an assumed increase in the real price of oil, and no significant change in the terms of trade for non-oil goods is foreseen. Consequently the outlook is for a deficit on non-oil trade in 1981 following the surplus of UKL 900 million in 1980. The volume of *crude oil exports* is expected to rise markedly (by more than 25%) and the volume of *crude oil imports* to fall (by more than 15%). These favourable volume movements combined with the terms of trade improvement, point to a substantial surplus in trade in crude oil in 1981, leading to an overall surplus on the balance of trade equivalent to 0,2% of GDP.

[1] See table.

United Kingdom: Supply and uses of goods and services together with main economic indicators

	1970-79	1979	1980	1981 [5]	1979 II	1980 I	1980 II	1981 [5] I	1981 [5] II	1979
	Annual data				Half-yearly data (s.a.)					Million UKL at current prices
	% change over preceding period at annual rates – at constant 1975 prices									
Private consumption	2,3	4,7	0,2	−1,1	−2,2	3,4	−3,7	−1,5	2,2	115 543
Public consumption	2,5	2,0	0,7	−0,7	1,8	1,5	−2,0	−0,3	−0,3	38 316
Gross fixed capital formation	0,6	−1,4	−2,5	−5,3	8,2	−4,3	−8,8	−5,4	−1,5	33 646
Change in stocks [1]	0,8	1,4	−1,5	−0,6	1,1	−0,7	−2,4	−1,3	0	2 760
Domestic demand	2,1	3,6	−3,0	−0,9	−0,6	−2,0	−7,4	0,3	3,6	190 265
Exports of goods and services	4,5	2,7	0,8	−2,4	9,5	1,3	−8,1	−0,5	−0,1	54 676
Imports of goods and services	4,2	11,0	−2,9	1,5	8,5	−1,9	−14,9	8,0	7,1	54 501
GDP at market prices	2,2	1,3	−2,0	−2,0	−0,5	−1,1	−5,2	−2,1	1,4	190 440
	% change over preceding period at annual rates									
GDP at current prices	15,7	16,1	16,6	10,0	22,3	15,1	14,7	7,8	9,7	:
Industrial production [2]	0,7	0,1	−8,9	−3,8	−1,9	−10,4	−12,8	−2,1	2,6	:
Unemployment rate [3]	4,0	5,3	6,8	9,8	5,2	6,0	7,6	9,4	10,1	:
Compensation of employees	15,1	16,7	18,1	8,2	20,6	18,0	14,7	4,9	8,5	:
Sterling M3[4]	14,1	12,4	20,0	10,0	:	:	:	:	:	:
GDP (implicit price index)	12,6	14,6	19,0	12,3	22,8	16,5	20,9	10,1	8,2	:
Private consumption (implicit price index)	12,2	12,2	16,1	11,0	19,6	15,5	14,1	11,5	7,0	
Exports, goods (implicit price index)	13,9	12,0	14,0	11,5	15,1	18,7	4,9	13,5	14,0	:
Imports, goods (implicit price index)	14,9	7,9	10,5	9,2	7,5	20,9	−5,3	14,3	14,7	:
Terms of trade	−0,9	3,8	3,2	2,1	7,1	−1,8	10,8	−0,7	−0,6	:
	As a percentage of gross domestic product									
Trade balance (fob/cif)	−2,1	−1,8	0,5	0,2	−1,3	−0,8	1,7	0,9	0,1	:
Current balance	−0,9	−0,9	1,0	0,3	−0,5	−0,2	2,1	0,9	−0,4	:
Net borrowing of general government [4]	−2,6	−5,0	−5,3	−4,3	:	:	:	:	:	:

1 As % of GDP.
2 Manufacturing industry.
3 Unemployment as % of total labour force.
4 Financial years.
5 Forecasts.

Sources: Eurostat; Commission and national services.

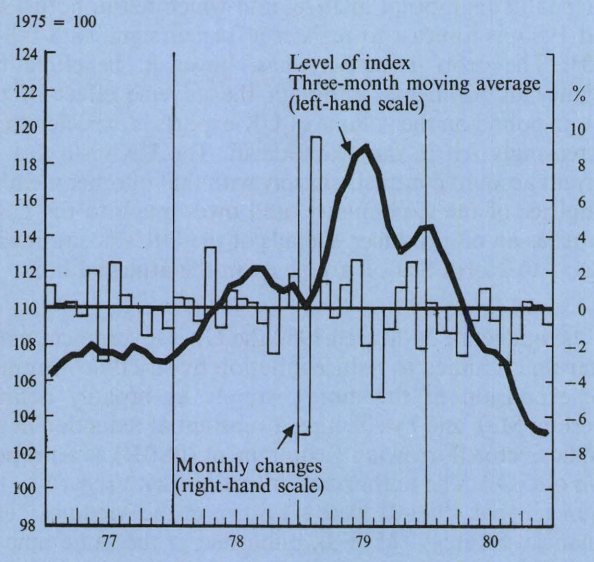
Taking the developments in domestic and external demand together, a fall of about 2% in GDP (at an annual rate) is forecast for the first half of 1981, followed by a modest recovery in the second.

On the output side the fall in *manufacturing production* is expected to continue in the first half of 1981, but at a much slower rate than in 1980. Furthermore the end of the destocking cycle is expected to provide the stimulus for a small recovery in manufacturing output in the second half of the year. However, for the year as a whole the fall in manufacturing production is still expected to be 4%, bringing the decline over two years to 12,5%.

Despite the modest upturn in activity foreseen for the second half of the year, *unemployment* is expected to increase throughout 1981 reaching a level of perhaps 2,75 million (including school leavers) by the end of the year. However, it appears that, after allowing for school leavers, the rise in unemployment so far has been broadly equal to the fall in employment and this suggests that the available labour force has not been affected by any significant change in overall activity rates.

The assessment of the likely trends in inflation has been based on the assumptions that the value of sterling will remain at the level established at the end of 1980, and that

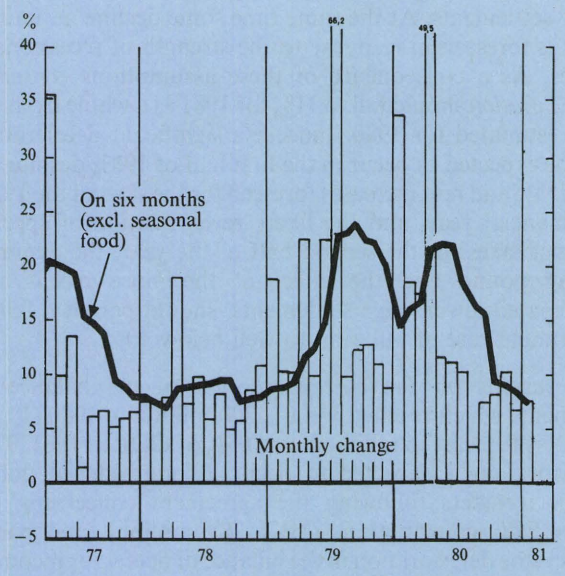
United Kingdom: Industrial production (All industries other than construction) (s.a.)



Source: CSO.

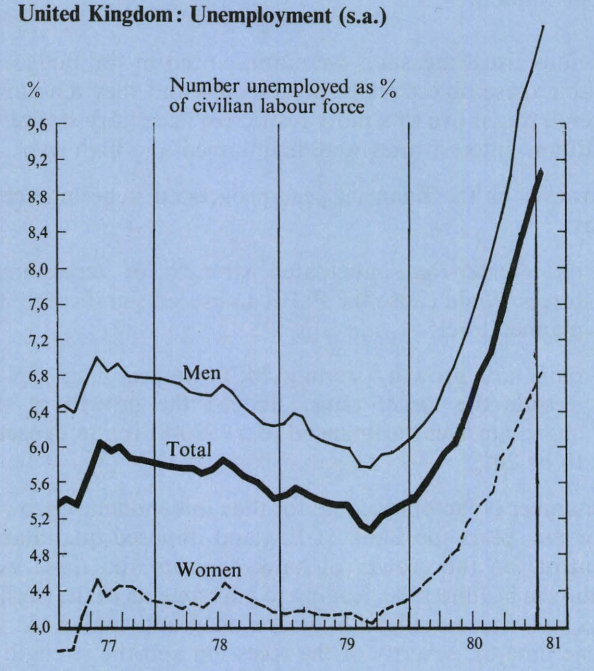
United Kingdom: Consumer prices

Change expressed at an annual rate



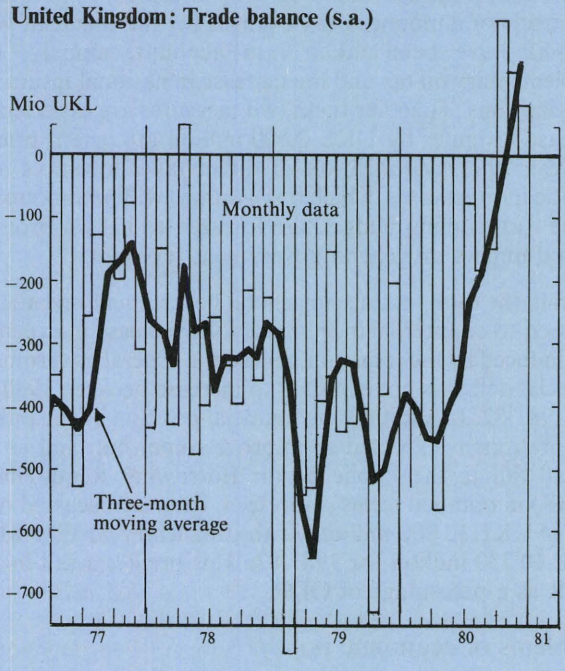
Source: Department of Employment.

United Kingdom: Unemployment (s.a.)



Source: Eurostat.

United Kingdom: Trade balance (s.a.)



Source: Eurostat.

over the 1980-81 pay round (the twelve months to July 1981) the rate of increase of average earnings will fall to 11%, from the 19% recorded for the previous pay round, an outlook which seems to be justified by the most recent information on wage settlements. At the same time some decline in interest rates is foreseen in response to the strength of recessionary forces. As a consequence of these assumptions *consumer price inflation* should fall to 11% for 1981 as a whole from the 16% estimated for 1980. Indeed, a significant deceleration can be expected to occur in the first half of 1981, despite the large rate and rent increases foreseen for the start of the 1981-82 financial year, and the likely revalorization of specific indirect taxes. In the second half of the year, the assumed strong pound and the effect of the more recent and anticipated lower wage settlements, should permit a fall in the annual rate of inflation to well below 10%.

The surplus on the *current account* of the balance of payments which reached UKL 2 200 million in 1980 (1% of GDP) is forecast to fall to about 0,3% of GDP in 1981. This deterioration is expected to occur despite reduced public sector transfers following the agreement concerning the UK's EEC contributions (UKL 700 million), and partly reflects the deterioration in the balance of net factor incomes, resulting from payments of profits and dividends abroad associated with the North Sea oil development programme.

In assessing future trends in *borrowing by the public sector* it has been assumed that the UK authorities will be successful in keeping general government expenditure, at current prices, within the cash limits already indicated. In addition, the effects of announced tax changes for the financial year 1981-82 have been taken into account, namely, the supplementary oil tax and the increase in national insurance contributions. Together these two measures are expected to increase revenues by UKL 2 000 million at current prices. However the revalorization of direct tax allowances and specific indirect taxes, which it is assumed will be announced in the forthcoming budget, are foreseen to have a broadly neutral impact on general government revenues.

Overall, the total increase in general government revenues is foreseen to counterbalance broadly the increase in expenditure induced by the recession, and so the general government financial deficit is not expected to increase between 1980-81 and 1981-82. In addition the financial position of the public corporations is expected to improve somewhat, and so an overall fall in the Public Sector Borrowing Requirement (PSBR) in nominal terms is foreseen, from a forecasted outturn of UKL 12 000 million for the financial year 1980-81 to UKL 10 750 million for 1981-82. This implies a fall in the PSBR as a percentage of GDP.

Problems of economic policy

The UK authorities have enjoyed considerable success in reducing the underlying rate of price inflation, to which the strength of sterling has made a significant contribution. This achievement was however accompanied by a marked fall in output and employment, particularly in manufacturing industry. Moreover, the volume of fixed investment, which reached its high point in 1978, and which fell in both 1979 and 1980, is forecast to register a further significant fall in 1981. The drop in activity has, however, benefited the balance of payments, although the adverse effect of the strong pound on the volume of UK exports is expected to be increasingly felt in the years ahead. The UK's surplus on current account contrasts sharply with that of other member countries of the Community, and owes much to the UK's status as an oil producer. Details of the UK's position with regard to North Sea oil are given in the attached box.

In the budget of 26 March 1980 the UK Government made clear that it aimed to reduce inflation by strictly controlling the expansion of the money supply as broadly defined (sterling M3), and by effecting a substantial reduction in the Public Sector Borrowing Requirement (PSBR) as a proportion of GDP. The authorities' intentions with regard to the financial year 1980-81 were set down in the Medium Term Financial Strategy (MTFS), published at the same time as the budget, which set out target ranges for the growth of sterling M3 for the years 1980-81 and 1983-84, together with an illustrative profile for the PSBR, as a percentage of GDP. For the fourteen months to April 1981, the announced target range for sterling M3 was 7-11%, at an annual rate, and the associated PSBR for the financial year 1980-81, at UKL 8 500 million.

Various fiscal measures were announced in the budget to enable these objectives to be achieved and they amounted overall to a move to a more restrictive budgetary stance. In addition, interest rates were maintained at a high level.

However as the financial year progressed it became clear that:

— the greater-than-anticipated strength of recessionary forces would cause the PSBR to exceed significantly the planned level;

— monetary growth (sterling M3), was moving rapidly outside the target range; indeed the growth of this aggregate over the financial year 1980-81 is now expected to be 20%.

A number of factors account for the rapid monetary growth. For two years the Bank of England imposed quantitative controls on the growth of bank deposits and these were removed in June 1980, leading to adjustments to the sterling M3 statistics, significantly greater than anticipated. At the same time the severity of the recession and the strength of sterling, by intensifying the financial squeeze on the company sector, helped to sustain bank lending, despite the very high levels of interest rates.

Conscious of the financial difficulties of the company sector and of the need to assure financial markets that the MTFS was not being abandoned, the Government announced a set of measures on 24 November 1980. In particular:

— anticipating that monetary growth was about to slow down, the Minimum Lending Rate (MLR) was reduced from 16 to 14%;

— increases in national insurance contributions and taxes on North Sea oil revenues were announced for the financial year 1981-82. The revenue measures coupled with various adjustments on the expenditure side point to a fall in the PSBR in 1981-82.

Fiscal and monetary policy for the financial Year 1981-82 will be laid down in the budget to be presented to Parliament on 10 March, and the recent departure from the scenario set out in the MTFS must be a major consideration of the authorities when formulating policy objectives and deciding upon the appropriate measures.

The PSBR for 1980-81 is now expected to be some 5,5% of GDP and on the basis of present policies (but not counting the proposed introduction of a new tax on North Sea oil and gas production, which has yet to be approved by Parliament), the PSBR for 1981-82 is forecast by the Commission services to be some 5% of GDP, so probably implying a modest tightening of fiscal policy.

The central element of the MTFS is the set of growth ranges for sterling M3 with the suggestion that, for the financial year 1981-82 the target range should be 6-10%. Given the rapid monetary expansion and the higher than expected PSBR in 1980-81, the authorities may take the view that fiscal policy should be tightened. In particular the MTFS sets down an illustrative value for the PSBR in 1981-82 equivalent to 3% of GDP, and if the authorities wish to steer the PSBR towards this figure then a substantial fiscal adjustment must be made, by increasing taxes markedly, by reducing public expenditure, or by both. Such a move could amplify recessionary forces in the short term. However it could well provide room for a substantial fall in interest rates.

In considering any fiscal adjustment, the Government's room for manoeuvre is bound to be limited. Substantial cuts in public expenditure in 1981-82 would be difficult to achieve, especially given the low level to which public sector investment has already sunk. On the other hand increases in personal taxation would not contribute to the Government's objective of reducing the burden of taxation in order to improve incentives to effort and enterprise. Nonetheless this would appear to be the main avenue of adjustment open to the authorities, since there is little scope for raising the level of taxation on companies, except possibly in the financial or North Sea sectors.[1]

[1] The manuscript of this chapter, like the rest of the publication, was completed by 3 March 1981. However, at the proof stage information has become available about the budget, which the Chancellor of the Exchequer presented to Parliament on 10 March 1981. The budget measures, which reaffirm the authorities' commitment to the MTFS, provide for a substantial increase in the burden of direct and indirect taxation on persons, higher taxes on oil and gas production and a special tax on banking deposits. Public expenditure, in volume terms, is planned to remain broadly unchanged between the financial years 1980-81 and 1981-82. Taken together these measures are expected to reduce the PSBR from UKL13 500 million (6% of GDP) in 1980-81 to UKL10 500 million (4,25% of GDP in 1981-82). In addition, it was announced that the target range for sterling M3 would be 6-10% at an annual rate in the fourteen months to April 1982. Minimum lending rate was reduced from 14% to 12%.

North Sea oil and the British economy

Three aspects of North Sea oil production are of particular interest:

— its contribution to the balance of payments;

— the increase in government revenues due to the taxation of North Sea production activities;

— associated changes in industrial structure.

Each of these points will be considered in turn. It should be stressed that this brief treatment of certain questions relating to North Sea oil does not attempt to assess the overall impact of North Sea oil on the UK economy. This would be a very ambitious undertaking and can only be based upon detailed assumptions about how the economy would have developed in the absence of North Sea oil. In any case, given that the North Sea oil production and development programme has now been underway for almost a decade, it may well be impossible to establish an agreed alternative scenario.

The balance of payments

The North Sea oil and gas [1] development and production programme affects both the current account and the capital account of the balance of payments. The contribution of the current account may be considered under four headings:

(i) Reduction in net imports of crude oil, due both to increased crude oil exports, and reduced crude oil imports. It is estimated that about 49% of the total volume of North Sea oil production was exported in 1980. This was also a year when total production of crude oil was over 90% of total consumption and so crude oil imports amounted to some 52% of total consumption.

(ii) Import of goods associated with the North Sea programme, for example production platforms.

(iii) Net import of services for the programme, in particular hire of equipment, diving and labour costs.

(iv) Interest, profits and dividends remitted abroad; mainly the net earnings of foreign companies on their North Sea investments.

Table 1 sets out official figures for these current account items for the period 1973 to 1979 together with estimates for 1980 and 1981; the total of the individual items is given in the line 'Oil balance of payments on current account'. For purposes of comparison, figures for the oil balance of payments on current account as a percentage of GDP, are also presented, together with the most appropriate figures for France and the Federal Republic of Germany—namely crude oil imports as a percentage of GDP. The following points should be noted:

— the total debit items associated with North Sea exploration and development are considerable;

— these debit items have been increasing in recent years, largely because of the build-up of payments of interest profits and dividends as North Sea oil production has come on stream;

— such payments are foreseen to increase significantly in 1981 partly offsetting the contribution to the current account from the increased oil output expected. Indeed the oil balance of payments on current account is forecast to remain negative in 1981 (−UKL 400 million) even though the UK will be more than self-sufficient in oil. The expectation is that this debit item will become even greater in the early to mid-1980s, so reducing the contribution to the balance of payments of increased crude oil output for some time to come.

The item concerning the imports of goods for North Sea development and production has its counterpart in inward capital movements. Official estimates of these movements for the years 1973 to 1979 are also given in Table 1 under the heading 'Related capital account flows'. Up to 1980 (for which year the figure is estimated) these inward capital movements are likely to have been considerable. This state of affairs is expected to change. Indeed from 1981 onwards net outward repayments of capital loans, facilitated by the build-up of oil production, are expected to offset new inward capital movements. As a consequence the total oil balance of payments on current account plus related capital transactions is foreseen to remain slightly negative in 1981.

Increase in government revenues

The increase in North Sea oil and gas production will also benefit central government revenues, since the value of the output of these activities, and the associated profits, are subject to four types of taxation:

— royalties on seaward activities;

— the special petroleum revenue tax;

— corporation tax on the profits of companies engaged in North Sea oil and gas production and development;

— the more recent supplementary tax on oil and gas production announced by the Government on 24 November 1980, and applicable to the 1981-82 financial year.

As production builds up so these revenues will increase rapidly. Revenue figures for the financial year 1979-80 are set out in Table 2 together with estimates for 1980-81 and 1981-82. They show that by 1981-82 taxation from North Sea activities should yield UKL 6 000 million, 6,0% of total general government revenues from taxation and social security contributions. In 1979-80 North Sea revenues at UKL 2 300 million accounted for just over 3% of general government revenues.

[1] The impact of North Sea gas production on the balance of payments is very small and will not be considered. Indeed, North Sea gas production has largely replaced the previous shore-based gas manufacturing industry which used coal and oil.

Table 1

Net balance-of-payments transactions on oil and related items

(UKL 000 million)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Net exports of crude oil (deficit −)	−0,9	−3,4	−3,1	−3,9	−2,8	−2,0	−0,8	0,1	2,3
Other current account entries associated with the North Sea programme (deficit −)									
— imports of goods fob	−0,1	−0,1	−0,3	−0,5	−0,5	−0,2	−0,2	−0,2	−0,2
— net imports of services	−0,1	−0,2	−0,5	−0,6	−0,7	−0,5	−0,5	−0,5	−0,5
— interest profits and dividends		:	:	:	:	−0,6	−0,7	−1,3	−2,6
Oil balance of payments on current account (deficit −)	−1,1	−3,7	−3,9	−5,0	−4,6	−3,4	−2,8	−2,1	−0,4
Related capital account flows (surplus +)	0,1	0,2	0,9	1,1	1,5	0,8	0,7	0,5	:
Total (deficit −)	−1,0	−3,5	−3,0	−3,9	−3,1	−2,6	−2,1	−1,6	−0,4
Memorandum items:									
United Kingdom: Oil balance of payments on current account as % of GDP	1,4	4,5	3,7	4,0	3,2	2,1	1,5	0,9	0,2
France: Crude oil imports (cif) as % of GDP	1,4	3,8	2,9	3,3	3,1	2,5	3,0	4,0	:
FR of Germany: Crude oil imports (cif) as % of GDP	1,0	2,3	1,9	2,1	2,0	1,6	2,1	3,0	:

Sources: UK balance of payments: HMSO; Overseas Trade Statistics; International Financial Statistics IMF; 1980 and 1981: Estimates of Commission departments.

Table 2

Central government revenues from North Sea oil and gas production

(UKL 000 million; Financial years)

	1979-80	1980-81	1981-82
Royalties on seaward activities	0,7	1,2	1,6
Petroleum revenue tax	1,4	2,5	2,9
Corporation tax	0,2	0,5	0,5
Supplementary oil tax	:	:	1,0
Total	2,3	4,2	6,0

Sources: Financial Statistics, HMSO; *Economic Progress Report July 1980,* H.M. Treasury; Estimates of Commission services.

North Sea oil production and changes in industrial structure

The argument has been put forward that the expansion of North Sea oil production is likely to be accompanied by structural changes elsewhere in the British economy, in particular by a decline in the output of manufacturing industry. This argument may be outlined as follows:

As a result of increasing North Sea oil production, the balance of payments on current account should, *ceteris paribus,* show a tendency to move into surplus. However, in order that the balance of payments, overall, should, over a longer period, be in equilibrium, there must be a tendency for other components of the balance of payments to move so as to offset the effects of the increased oil production.

A strengthening of the exchange rate, partly reflecting exchange market sentiment about the present and future benefits of oil production, is seen as one of the ways in which such a structural change is brought about. Thus, as the exchange rate rises, so the volume of exports of tradeable goods (largely manufactures) declines and the volume of imports of tradeable goods rises. This leads to a deterioration in the balance of trade in non-oil goods,

and to an associated contraction in the output of manufacturing industry. The recent sharp decline in manufacturing output in the United Kingdom is seen as evidence that this particular structural change is underway.

However, it should be stressed that such a development is by no means inevitable: there are other ways in which the economy can adjust to increased North Sea oil output in the shorter term. Thus

— Increased capital outflows (the purchase of foreign, financial and physical, assets) could well increase to offset the impact of the oil. However, the extent to which this occurs depends upon a number of factors over which the UK has little or no control—the rate and pattern of expansion of the world economy, movements in interest rates in other financial centres, etc.

  The invisibles account could well take part of the adjustment, in particular a move towards a smaller surplus on services may occur in the years ahead.

— The argument that increased oil output leads, through a strong exchange rate, to a lower level of manufacturing production is dependent upon the authorities assuming a particular fiscal and monetary policy stance. Should conditions emerge that permit a less restrictive fiscal and monetary policy, which could well be associated with a weaker exchange rate, then manufacturing output could possibly be maintained at a more satisfactory level.

Unit labour costs in manufacturing industry

Between 1970 and 1980, unit labour costs in manufacturing industry in the Community, expressed in dollars, went up by 35% (or at an annual rate of 3,0%) by reference to a weighted average of the other industrialized countries. Expressed in ECU, unit labour costs in the Community went up 2,4% more than the average for the competing countries (in national currencies), the difference between the two measures of relative labour costs being explained by an appreciation of the effective exchange rate for the Community averaging 0,6% a year (Table 1).

All the Member States with the exception of Denmark averaged for the period (1970-80) an increase in their relative costs in dollars. In the case of Ireland, Italy and the United Kingdom an effective exchange-rate depreciation did not entirely offset the rise in relative-labour costs. For the Federal Republic of Germany, Belgium and the Netherlands, the currency's effective appreciation was greater than the fall in relative labour costs. Denmark and France averaged only a slight change over the period both in the effective exchange rate and in relative labour costs (see graph).

Among non-member countries, a real appreciation (position to the right of the diagonal in graph) was recorded for Switzerland, Japan, the Scandinavian countries and Spain while Australia and, in particular, the United States experienced a real depreciation. The latter country is in fact the only one in the group of industrialized countries to have combined an effective exchange-rate depreciation with a fall in relative labour costs (in national currencies).

Table 1

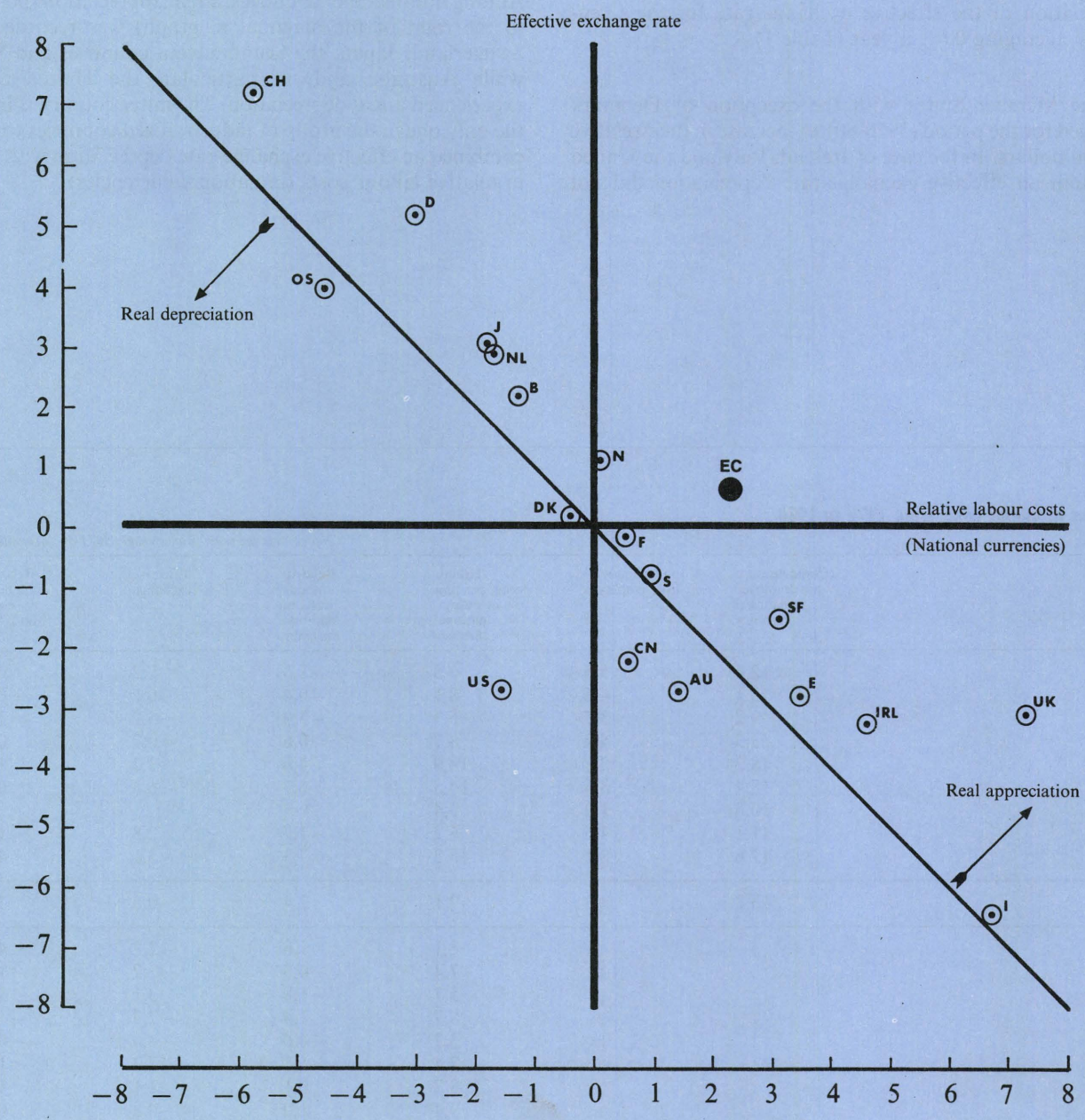
Changes in labour costs from 1970 to 1980

Change over previous year average, 1971-80 (at annual rate)

	Compensation per employee in national currency	Productivity (per employee	Labour cost per unit of output, national currency	Relative labour costs in national currency	Effective exchange rate	Relative labour costs in USD
B	12,4	5,6	6,5	−1,3	2,2	0,8
DK	13,1	4,6	8,1	−0,4	0,2	−0,2
D	9,2	3,7	5,3	−3,0	5,2	2,0
F	13,3	4,2	8,7	0,6	−0,2	0,4
IRL	18,2	2,8	14,9	4,6	−3,2	1,2
I	18,4	3,4	14,5	6,7	−6,5	0,2
L	10,8	1,9	9,4	:	:	:
NL	11,1	4,6	6,2	−1,7	2,8	1,0
UK	17,6	2,1	15,2	7,3	−3,1	4,0
EC 9	13,2	3,8	9,1	2,4	0,6	3,0
US	:	:	6,1	−1,6	−2,7	−4,2
CN	:	:	7,4	0,5	−2,2	−1,7
J	:	:	5,7	−1,8	3,1	1,3
AU	:	:	8,7	1,4	−2,7	−1,3
OS	:	:	3,2	−4,6	4,0	−0,8
CH	:	:	2,4	−5,3	7,2	1,5
N	:	:	8,7	0,1	1,1	1,1
S	:	:	9,4	1,0	−0,8	0,2
SF	:	:	11,9	3,1	−1,5	1,5
E	:	:	11,8	3,5	−2,8	0,6

Source: Eurostat, estimates by Commission services.

GRAPH: **Labour costs and effective exchange rate (% change 1970-80, annual rate)**



Source: Commission services.

The main feature of the decade was the relatively large fluctuations in relative labour costs for the Community (in national currencies). Since exchange-rate fluctuations did not always follow the same curve as relative labour costs, the result was a fairly irregular movement of dollar labour costs with sharp falls in 1974 and 1976.

The year-to-year changes in the different Member States often show peculiarities and differences linked to the short-term fluctuations in exchange rates. In the United Kingdom, in particular, relative labour costs in dollars tended to fall up to 1977 (because of sterling's effective depreciation). Since 1977 sterling's increasing strength, combined with a steady, and, in 1980 even accelerated rise, in wage costs in national currency, has led to an unprecedented increase in relative wage costs in dollars.

It will be noted that the Federal Republic of Germany and the Benelux countries in 1980 (and Belgium even in 1979) improved their relative labour-cost positions appreciably, the fall in relative labour costs not having been offset in that year by an appreciation in the weighted exchange rate.

For the Community as a whole, relative labour costs in national currencies could, in 1981, show a slight fall (Table 2).

On the basis of the market exchange rates at the beginning of February one could expect a sharp effective depreciation for most of the Community currencies on average for 1981 and therefore a marked improvement in the relative dollar labour-costs position with the United Kingdom again proving the exception to the rule. Given the great volatility of exchange rates in the last few months, however, the outlook for dollar labour costs seems particularly uncertain.

Table 2

Price and cost indicators, EC 9

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	11,6	2,9	8,5	3,1	3,9	0,8	7,4	6,5	3,2	0,3
1972	11,6	5,5	5,8	4,1	5,3	1,1	6,6	6,2	2,3	1,9
1973	15,7	6,3	8,8	3,8	5,6	1,7	7,5	8,1	8,1	−3,4
1974	17,2	2,8	14,0	−2,2	−4,7	−2,6	11,1	12,7	23,6	−9,6
1975	17,8	1,1	19,1	3,2	5,7	2,4	13,5	12,5	7,5	3,2
1976	15,3	9,5	5,4	2,1	−6,5	−8,4	9,7	10,2	9,6	−2,1
1977	10,4	2,8	7,4	2,7	3,6	0,9	9,6	9,8	8,1	−0,2
1978	8,3	2,7	5,4	0,9	3,9	3,0	8,5	7,3	3,7	3,1
1979	11,0	4,6	6,2	2,4	8,4	5,8	9,5	9,4	9,0	−1,0
1980	13,8	2,1	11,5	4,4	6,4	2,0	12,1	11,6	15,4	−3,3
1971-1980	13,2	3,8	9,1	2,4	3,0	0,6	9,5	9,4	8,9	−1,1
1981 [3]	10,7	2,1	8,4	−0,1	:	:	10,4	9,9	10,9	−0,9

1 Unit labour costs in national currency by reference to the weighted average for the 10 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 10 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 3

Price and cost indicators, Belgium

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	12,9	4,2	8,4	1,2	1,3	0,1	5,4	5,2	0,9	−1,4
1972	15,1	9,2	5,4	1,3	4,8	3,5	6,3	5,5	1,0	1,3
1973	12,7	9,4	3,0	−3,6	−1,6	2,1	6,9	5,9	8,0	0,7
1974	20,4	2,4	17,6	3,9	5,7	1,8	12,3	12,5	25,5	−2,7
1975	14,6	−1,4	16,2	−0,3	1,3	1,6	12,5	12,4	4,1	−1,0
1976	17,9	13,0	4,3	−0,6	1,6	2,2	7,5	8,0	6,1	−0,9
1977	9,5	4,0	5,3	−1,2	4,8	6,1	7,3	7,0	2,3	0,3
1978	8,1	5,8	2,3	−2,7	0,9	3,7	4,2	4,2	0,2	−0,2
1979	6,5	7,1	−0,6	−5,6	−4,2	1,5	4,0	3,5	9,9	0,1
1980	7,5	3,3	4,1	−5,0	−5,4	−0,4	5,1	6,2	11,0	−2,7
1971-1980	12,4	5,6	6,5	−1,3	0,8	2,2	7,1	7,0	6,7	−0,7
1981 [3]	6,6	3,0	3,5	−4,1	:	:	6,1	6,0	8,5	−0,1

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 4

Price and cost indicators, Denmark

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	14,6	6,2	7,9	0,6	−0,3	−0,9	7,9	7,3	3,0	−7,9
1972	8,2	5,0	3,0	−1,2	−1,4	−0,2	9,0	8,3	6,2	1,9
1973	14,6	2,7	12,0	5,5	12,1	6,3	10,2	10,2	11,2	6,1
1974	22,9	5,5	16,5	1,3	2,0	0,7	12,9	14,4	17,6	0,8
1975	15,9	7,1	8,2	−8,9	−5,7	3,4	12,6	10,0	6,9	−10,5
1976	7,6	7,5	0,1	−6,0	−3,8	2,3	9,2	9,4	7,1	1,1
1977	15,4	3,3	11,7	4,1	3,8	−0,3	9,0	10,8	6,1	−2,2
1978	8,7	3,1	5,4	−0,7	−0,3	0,4	9,2	9,4	3,5	0,7
1979	13,7	3,7	9,6	4,2	3,4	−0,8	7,3	9,6	7,7	0,7
1980	10,1	1,9	8,0	−2,3	−10,2	−8,1	8,5	11,0	14,0	−6,5
1971-1980	13,1	4,6	8,1	−0,4	−0,2	0,2	9,6	10,0	8,2	−1,6
1981 [3]	11,4	1,5	9,8	1,0	:	:	8,9	9,5	9,0	−2,2

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 5

Price and cost indicators, Federal Republic of Germany

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	10,6	2,1	8,4	1,5	4,9	3,4	7,6	6,0	3,1	2,6
1972	10,2	4,7	5,3	1,8	4,6	2,7	5,5	5,6	2,2	1,9
1973	13,5	5,7	7,3	0,9	11,9	10,9	6,0	7,5	4,6	−5,0
1974	12,2	4,1	7,8	−6,9	−1,1	6,3	6,7	7,1	15,7	−5,1
1975	8,2	0,7	7,4	−10,6	−8,9	1,9	6,4	5,9	4,7	5,3
1976	10,3	9,2	1,0	−4,4	1,3	5,9	3,4	4,4	3,0	−2,6
1977	7,5	3,8	3,6	−3,5	4,7	8,5	3,8	3,9	1,0	0,1
1978	6,3	1,8	4,4	−0,8	5,9	6,8	3,9	2,6	0,6	4,0
1979	6,5	4,3	2,1	−3,5	1,5	5,2	4,0	4,0	3,9	−3,2
1980	7,1	1,2	5,9	−3,8	−3,4	0,4	5,0	5,4	6,0	−4,4
1971-1980	9,2	3,7	5,3	−3,0	2,0	5,2	5,2	5,2	4,4	−0,6
1981 [3]	4,6	2,4	2,2	−7,0	:	:	4,4	4,5	5,5	−0,4

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 6

Price and cost indicators, France

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	11,8	4,7	6,8	−0,7	−2,9	−2,2	5,8	5,5	4,4	1,0
1972	9,8	5,0	4,5	0,7	3,4	2,7	6,2	5,9	0,9	2,2
1973	12,5	4,4	7,7	1,0	4,7	3,7	7,8	6,8	6,2	0,7
1974	14,3	2,3	11,7	−2,5	−8,7	−6,3	11,1	13,2	23,6	−13,5
1975	24,0	1,7	21,9	3,9	14,0	9,7	13,4	11,4	3,9	4,6
1976	17,9	8,6	8,6	4,1	0,3	−3,7	10,1	9,9	8,7	−1,6
1977	12,3	4,0	8,0	1,1	−3,6	−4,7	8,9	9,2	9,2	−2,4
1978	5,3	4,0	1,3	−4,6	−5,7	−1,1	9,8	8,8	5,4	3,9
1979	12,4	5,1	7,0	1,7	2,3	0,6	10,4	10,5	10,0	−0,6
1980	14,2	2,7	11,1	1,6	1,9	0,3	11,9	13,5	12,2	−6,0
1971-1980	13,3	4,2	8,7	0,6	0,4	−0,2	9,5	9,4	8,3	−1,2
1981 [3]	12,2	1,8	10,2	1,9	:	:	11,3	11,8	11,5	−2,2

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 7

Price and cost indicators, Ireland

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	16,2	3,8	12,0	4,6	4,3	−0,3	10,5	9,4	7,8	1,8
1972	17,7	5,8	11,3	7,2	4,8	−2,2	13,4	9,6	13,3	6,3
1973	18,7	5,9	12,1	5,5	−1,8	−6,9	15,3	11,6	21,3	5,6
1974	18,1	−0,4	18,5	1,3	−1,4	−2,7	6,0	15,8	24,0	−15,2
1975	20,9	−7,0	29,9	7,4	1,7	−5,3	22,3	22,3	18,3	−1,6
1976	22,2	10,6	10,5	3,3	−7,3	−10,2	20,2	18,7	23,6	3,7
1977	13,9	3,1	10,4	2,6	−0,6	−3,1	12,4	12,7	14,9	−1,8
1978	12,0	4,5	7,2	−0,2	1,1	1,3	10,1	7,2	6,7	1,8
1979	18,7	5,0	13,1	4,9	5,3	0,4	13,0	12,2	9,0	−3,5
1980	24,1	−1,8	26,5	10,0	7,0	−2,7	14,8	18,2	10,0	−8,1
1971-1980	18,2	2,8	14,9	4,6	1,2	−3,2	13,7	13,7	14,7	−1,1
1981 [3]	13,8	6,9	6,5	−3,1	:	:	14,1	16,0	14,2	−1,5

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 8

Price and cost indicators, Italy

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	10,9	−1,0	11,9	5,0	3,5	−1,4	7,2	5,5	4,4	−1,0
1972	11,1	4,9	5,9	2,3	1,4	−0,9	6,3	6,4	2,0	−1,3
1973	22,5	8,5	12,9	6,4	−4,0	−9,8	11,6	12,4	16,9	−8,5
1974	23,2	3,7	18,7	4,4	−5,6	−9,6	18,5	20,9	39,6	−13,1
1975	22,3	−9,4	34,9	16,9	12,2	−4,0	17,5	17,6	10,6	4,7
1976	24,0	12,4	10,4	6,0	−12,4	−17,4	18,0	18,1	22,6	−2,9
1977	19,9	2,0	17,5	11,3	2,7	−7,7	19,1	18,2	18,7	1,9
1978	14,3	2,8	11,2	6,2	0,1	−5,8	14,1	12,8	6,7	3,1
1979	18,1	6,9	10,5	5,4	2,0	−3,2	15,2	14,9	12,2	−1,0
1980	19,1	5,0	13,5	4,0	0,2	−3,7	20,8	21,2	19,5	−5,2
1971-1980	18,4	3,4	14,5	6,7	0,2	−6,5	14,7	14,7	14,9	−2,3
1981 [3]	16,1	−2,9	19,6	11,7	:	:	17,7	18,7	15,5	−3,0

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 9

Price and cost indicators, Luxembourg

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private con-sumption deflator	Exports price (goods) deflator	Terms of trade
1971	7,0	−3,6	11,0	:	:	:	−1,3	4,7	−5,0	−7,9
1972	9,3	3,4	5,7	:	:	:	5,6	5,2	2,2	1,9
1973	9,3	7,3	1,8	:	:	:	10,8	5,0	17,6	6,1
1974	25,9	2,0	23,5	:	:	:	16,4	9,9	24,2	0,8
1975	8,2	−18,0	32,0	:	:	:	−1,0	10,2	−2,9	−10,5
1976	11,5	7,6	3,6	:	:	:	13,0	9,5	7,0	1,1
1977	9,1	3,3	5,6	:	:	:	1,5	5,8	−0,1	−2,2
1978	10,8	10,8	0,0	:	:	:	4,4	3,5	4,6	0,7
1979	8,1	5,8	2,1	:	:	:	7,0	5,8	10,0	0,7
1980	8,5	0,1	8,4	:	:	:	4,4	6,3	4,0	−4,1
1971-1980	10,8	1,9	9,4	:	:	:	5,9	6,6	5,8	−1,3
1981 [3]	7,5	−4,4	12,5	:	:	:	6,7	6,3	7,5	−1,4

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 10

Price and cost indicators, Netherlands

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private con-sumption deflator	Exports price (goods) deflator	Terms of trade
1971	12,4	3,9	8,2	0,8	1,8	1,0	8,5	8,5	2,3	−1,4
1972	13,5	6,0	7,1	2,9	4,6	1,7	9,4	8,9	0,7	1,9
1973	17,2	9,2	7,3	0,6	4,4	3,9	8,4	9,1	6,4	−0,5
1974	15,6	4,3	10,9	−2,4	3,1	5,6	9,3	10,0	28,4	−5,4
1975	12,2	−2,4	15,0	−1,5	1,0	2,5	11,2	10,7	4,7	0,8
1976	12,1	12,0	0,1	−4,7	−2,0	2,8	8,9	8,8	6,3	0,2
1977	8,2	3,4	4,6	−2,0	3,7	5,8	6,3	5,9	3,1	0,5
1978	6,9	3,6	3,2	−2,1	0,9	3,1	5,1	4,2	−2,0	0,8
1979	6,9	4,0	2,7	−2,4	−0,8	1,7	3,9	4,3	8,5	−2,6
1980	6,4	2,9	3,4	−5,9	−5,9	0,1	5,6	6,5	13,5	−0,8
1971-1980	11,1	4,6	6,2	−1,7	1,0	2,8	7,7	7,7	6,9	−0,7
1981 [3]	5,6	4,1	1,5	−6,0	:	:	5,2	6,3	10,0	−0,5

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Table 11

Price and cost indicators, United Kingdom

(% change over preceding year)

	Labour costs in industry					General indicators				
	Compensation per employee national currency	Productivity (output per employee)	Labour costs per unit of output national currency	Relative labour costs national currency [1]	Relative labour costs in USD [2]	Effective exchange rate	GDP deflator	Private consumption deflator	Exports price (goods) deflator	Terms of trade
1971	12,4	3,3	8,8	2,2	1,7	−0,5	9,3	8,6	4,8	0,8
1972	11,2	6,0	4,9	1,2	−2,6	−3,8	8,3	6,6	4,6	1,6
1973	14,0	7,0	6,6	−0,1	−10,7	−10,6	7,1	8,6	11,5	−8,8
1974	22,5	0	22,6	6,8	3,1	−3,5	15,1	17,4	28,1	−12,1
1975	33,1	−0,6	33,9	16,5	7,6	−7,6	26,8	23,5	22,8	5,8
1976	19,7	6,8	12,1	7,4	−8,5	−14,8	14,3	15,5	18,6	−1,7
1977	10,7	0,2	10,5	4,2	−0,8	−4,8	13,9	15,1	16,9	1,1
1978	14,5	1,7	12,6	7,7	8,8	1,1	10,7	8,9	7,7	4,1
1979	15,2	1,2	13,8	8,9	15,9	6,4	14,6	12,5	12,0	3,6
1980	24,0	−4,2	29,5	20,0	32,0	10,0	19,0	16,1	14,0	3,1
1971-1980	17,6	2,1	15,2	7,3	4,0	−3,1	13,8	13,2	13,9	−0,3
1981 [3]	16,7	2,6	13,8	5,5	:	:	12,3	11,0	11,5	2,1

1 Unit labour costs in national currency by reference to the weighted average for the 17 main competing countries.
2 Unit labour costs in dollars by reference to the weighted average for the 17 main competing countries.
3 Provisional forecasts.

Source: Eurostat, estimates and forecasts by Commission services.

Methodological note on unit wage costs

The labour cost per unit of output is defined as the ratio of compensation of employees at current prices to value added at constant prices for industrial products (base 1975 = 100). The basic data for the Community countries are the EUROSTAT data up to 1978 and Commission department estimates for the period 1979-81. Two special cases: Denmark and Ireland have value added series at factor cost and not at market prices, and furthermore their figures for compensation of employees are estimated from 1976.

Since there are no data in the same nomenclature for the non-EC countries, gross domestic product per branch were used, as published by OECD from 1970 to 1978. The series were completed to 1981 on the basis of Commission estimates based on OECD data.

In order to calculate relative costs, non-EC countries had to be taken into account so that the study covers 18 OECD countries whose foreign trade is more than 1% of total world trade: EC [1] plus USA, Canada (CN), Japan (J), Austria (OS), Australia (AU), Switzerland (CH), Norway (N), Sweden (S), Spain (E) and Finland (SF). Labour costs per unit of output are then weighted by an effective exchange-rate matrix, the weights being those used by Commission services in competitiveness index calculations. The weighting coefficients take account not only of bilateral trade but also of the intensity of competition in third markets and in the domestic market of each country. The exchange rate used is that of the number of dollars per unit of national currency. This first calculation gives a 'competitors' labour cost'. The ratio of the labour cost per unit of output calculated on the basis of national currency data to this 'competitors' cost' gives the 'relative cost'.

The same calculation can be made but without including the exchange rate, giving a 'relative cost in national currency'. Thus, three series are used as a basis for the study.

— The labour cost per unit of output:

$$ULC = \frac{RSN}{VA_{75}}$$

— The relative labour cost in national currency:

$$ULCR_i = \frac{ULC_i}{\text{antilog} \sum_{j=1}^{18} W_{ij} \text{ Log } ULC_j}$$

— The relative labour cost in USD:

$$ULCR\ USD_i = \frac{ULC\ USD_i}{\text{antilog} \sum_{j=1}^{18} W_{ij} \text{ Log } ULC\ USD_j} =$$

$$ULCR_i \times \frac{TCH_i}{\text{antilog} \sum_{j=1}^{17} W_{ij} \text{ Log } TCH_j}$$

RSN = Compensation of employees (wages + total social security charges) in national currency,

VA_{75} = Industrial products value added in 1975 prices,

TCH_i = Exchange rate of the currency of country i against the USD,

$ULC\ USD_i$ = $ULC_i \times TCH_i$ = labour cost per unit of output in USD

W_{ij} = Weighting for country i

$$\frac{TCH_i}{\text{antilog} \sum_{j=1}^{17} W_{ij} \text{ Log } TCH_j} = \text{effective exchange rate}$$

All the data have been calculated on the basis of the cost in national currencies expressed as a index (base 1970 = 100) for each country.

Caution is required in interpreting gross data, particularly over the period 1979-81. The use of a weighting matrix based on the structure of international trade from 1974 biases the end-of-period results, especially in the case of the United Kingdom and Ireland, the geographical distribution of whose trade has changed since their entry into the Community. Fresh calculations will be carried out subsequently with a matrix of moving weights.

The data relating to the effective exchange rate for the Community are calculated for the ECU by reference to a weighted average of the ten competing countries, the Community being considered as one market. Relative labour costs for the Community were calculated using the same matrix of weighting coefficients.

[1] Belgium and Luxembourg aggregated in the calculations of relative data.

The Community's borrowing and lending operations: recent developments affecting certain instruments

Contents

List of tables

Abbreviations

ECSC	European Coal and Steel Community
EIB	European Investment Bank
EMS	European Monetary System
Euratom	European Atomic Energy Community
NCI	New Community Instrument
ECU	European Currency Unit
	1 ECU = USD 1,18325 on 2.3.1981

The Community's borrowing and lending operations: recent developments affecting certain instruments

In recent months the Community has taken three initiatives concerning its borrowing and lending instruments. [1] *As a result of the external payments imbalance caused by the two oil crises, the Community was prompted to consider the role it ought to play in recycling oil-producing countries' surpluses: this led to the adoption of a regulation amending the Community loan mechanism which had been set up in 1975 to give Member States balance-of-payment support. At the same time, the Commission, learning from eighteen months' operational experience of the New Community Instrument, which was created in 1978 to promote investment in the Community, proposed that it be made permanent; Commission proposals on this point are under examination by the European Parliament and the Council. Lastly, following the earthquake which struck the south of Italy, the Community took exceptional measures to help reconstruct the areas affected. This article describes the content and purport of these initiatives.* [2]

1. Adjustment of the Community loan mechanism for balance-of-payments purposes

The agreement reached in the Council, [3] on 16 February 1981, on the adjustment of the Community loan mechanism, is the outcome of a comprehensive examination of issues raised by the recycling of oil surpluses which the Commission began in mid-1980 in close collaboration with the Monetary Committee.

1.1. It was for several reasons essential to retain this mechanism within the Community's panoply of borrowing and lending instruments.

The mechanism in its original form had been established in 1975 [4] to help member countries in balance-of-payments difficulties caused by the first oil crisis. As a result of new massive increases in petroleum prices, payments imbalances increased considerably at the end of 1979 and they will probably be long-lasting. For 1980, the current payments deficit for the Community as a whole is put at USD 41 000 million, as against USD 11 300 million in 1974 immediately after the first oil price rise. It will probably be around USD 44 000 million in 1981. Furthermore, unlike in 1974 when the Federal Republic of Germany and the Benelux countries maintained current account surpluses, all member countries except the United Kingdom are now running deficits.

International financial markets will continue to handle a large proportion of recycling operations. In 1980 international bond issues and Eurocurrency bank loans totalled close on USD 120 000 million, i.e. three times the annual volume of operations in 1975. However, markets alone cannot ensure the right combination of financing external deficits and adjustment to the new terms of trade. Closer cooperation between States and international organizations must supplement, guide and strengthen the capital markets so as to preserve the stability of the international financial system. Here the Community has a specific role to play, especially as far as its members are concerned.

The Community loan mechanism fills a need not met by the Community's other borrowing and lending instruments. Its objective, balance-of-payments support for Member States coupled with economic policy conditions, distinguishes it from the structural instruments intended to finance investment projects; because of the origin of the funds borrowed, third countries, financial institutions or capital markets, it does not commit member countries' foreign exchange reserves directly, unlike medium-term financial assistance. [5]

The original 1975 instrument limited borrowing operations under this mechanism to USD 3 000 million in principal and interest. Two series of operations were carried out: [6]

— the first, authorized by Council Decision of 15 March 1976, for USD 1 100 million and DM 500 million for the

1 An earlier issue of *European Economy* reviewed the Community's financial instruments as a whole. See 'Borrowing and lending instruments in the context of the Community's financial instruments', *European Economy* No 6, July 1980. Overall statistical data tracing the development of the different borrowing and lending instruments over the period 1970-80 are given in Tables 1 and 2.

2 This article was prepared on the basis of contribution by J.P. Baché from the Directorate-General 'Economic and Financial Affairs'.

3 At the time of going to press, the Council had not yet formally adopted the regulation adjusting the Community loan mechanism, pending finalization of the text in the various Community languages.

4 Council Regulations (EEC) Nos 397/75 and 398/75 of 17 February 1975 (OJ L 46/1 of 20 February 1975).

5 Medium-term financial assistance is one form of the mutual assistance provided for in Article 108 of the EEC Treaty. It is granted by the Council to a Member State in difficulties or seriously threatened with difficulties as regards its balance of payments. This mechanism was introduced in 1971 and in December 1978 its lending capacity was increased to adapt it to the needs of the EMS. Each Member State is required to grant credits up to a commitment ceiling. The ceiling's total was raised to 14 100 million ECU. The borrowing country must enter into undertakings in respect of economic and monetary policy.

6 For the characteristics of the various loans, see Table 3.

Table 1

Borrowing operations of the European Communities

(million ECU)

Year	ECSC	EIB [1]	Euratom [2]	EEC [3]	NCI	Total
1970	60	169	—	—	—	229
1971	102	413	1	—	—	519
1972	230	462	—	—	—	692
1973	263	608	—	—	—	871
1974	528	826	—	—	—	1 354
1975	731	814	—	—	—	1 545
1976	956	732	—	1 249	—	2 937
1977	729	1 030	99	571	—	2 429
1978	981	1 863	72	—	—	2 916
1979	837	2 437	153	—	178	3 605
1980	1 004	2 384	181	—	304	3 873

1 Excluding third-party contributions totalling EUA 319 million in the period 1972-79 to EIB financing operations.
2 The figures given for the period prior to 1977 correspond to drawings on the credit lines negotiated and concluded with the Eximbank (United States).
3 For balance-of-payments financing.
Source: Commission departments and EIB.

benefit of Italy (10/13ths) and Ireland (3/13ths); the dollar operations included a floating-rate bank loan which was later consolidated by three fixed-rate loans;

— the second, authorized by Council Decision of 17 May 1977, was for USD 500 million for the benefit of Italy; this loan replaced the United Kingdom share of the short-term monetary support granted by the Community central banks to Italy in June 1973 and which the United Kingdom, in balance-of-payments difficulties, was unable to consolidate into medium-term financial assistance in December 1974 as the other Member States had done.

These borrowing operations, including interest, total more than the equivalent of USD 2 600 million. The margin available for new borrowings under the original ceiling was therefore virtually exhausted.

1.2. The recent adjustments to the mechanism do not change

Table 2

Outstanding borrowing of the European Communities (at the end of each year)

(million ECU)

Year	ECSC	EIB	Euratom [1]	EEC [2]	NCI	Total [1]
1970	741	1 020	:	—	—	1 761
1971	802	1 423	:	—	—	2 225
1972	963	1 784	:	—	—	2 747
1973	1 172	2 287	:	—	—	3 459
1974	1 617	3 124	:	—	—	4 741
1975	2 393	3 926	17	—	—	6 336
1976	3 477	4 732	14	1 161	—	9 384
1977	3 956	5 421	110	1 500	—	10 986
1978	4 416	6 715	182	1 361	—	12 674
1979	4 713	8 541	333	965	178	14 730
1980	5 300 [3]	10 598	502	1 016	402	17 898

1 Excluding Euratom figures for the period prior to 1975.
2 For balance-of-payments financing.
3 Estimate.
Source: Commission departments and EIB.

Table 3

Characteristics of the Community loans raised for the purpose of giving balance-of-payments support

Operations carried out under the 1975 Regulation*

	Capital amount [3] (million)		Rate (%)	Duration	Type of loan	Beneficiaries (million)		
							Italy	Ireland
1976-1	USD	300	$8^1/_4$	1976-82	Public placement on the Euromarket	USD	230,5	69,5
1976-2	DM	500	$7^1/_4$	1976-83	Public placement on the Euromarket	DM	384,5	115,5
1976-3	USD	300	variable LIBOR[4] + 1%	1976-81	Syndicated loan	USD	230,5	69,5
1976-4	USD	500	$7^1/_2$	1976-79	Public placement on the Euromarket	USD	385,2	114,8
1976-5[1]	USD	100	$7^3/_4$	1976-81	Public placement on the US market	USD	76,9	23,1
1977-1[1]	USD	25	$7^5/_8$	1977-80	Private placement with Dutch banks on the Euromarket	USD	76,8	23,2
		45	$7^5/_8$	1977-81				
		30	$7^5/_8$	1977-82				
1977-2	USD	200	$7^1/_2$	1977-82	Public placement on the Euromarket	USD	500	:
		300	$7^3/_4$	1977-84				
1977-3[1]	USD	100	$7^5/_8$	1977-82	Public placement on the US market	USD	76,8	23,2
TOTAL [2]	USD	1 600				USD	1 346,2	253,8
	DM	500				DM	384,5	115,5

* Regulation EEC No 397/75 of 17 February 1975.
1 Loans to consolidate the floating-rate loan, 1976-3.
2 Without taking into account the floating-rate loan, 1976-3, consolidated in 1976 and 1977.
3 Interest over the life of the loans amounts to USD 649 421 million and DM 253 750 million.
4 London Interbank Offered Rate: actual rate on Euro-currencies market in London.

Source: Commission departments.

its general design. The principle is still that the Community uses its credit worthiness to borrow funds and lend them to a Member State in balance-of-payments difficulties related to an increase in prices of petroleum products. The Community is not involved in transforming maturities, in exchange risks, or in managing funds and so bears no risk, except that of insolvency of the Member State. The mechanism can be used alone or together with other Community or non-Community instruments designed to give balance-of-payments support.

The purpose of the changes is to enable the mechanism to be used promptly, rapidly and flexibly, without changing the respective decision-making and supervisory powers of the various Community institutions.

It had to be possible to use the mechanism sufficiently early to avoid the balance-of-payments crisis becoming acute. To this end, the Regulation makes it possible to adopt economic policy conditions attaching to the loan according to the gravity of the situation in the borrowing Member State. Under the new instrument, the borrowing Member State has to take the initiative in drawing up an adjustment programme which is then presented to the Council in support of the loan application and which the Member State undertakes to apply. When seeking a loan the Member State can therefore choose the means and objectives it intends to set itself in order to redress its external position, and this may encourage it to seek Community financing without waiting for a manifest state of crisis. Having seen this programme and after examining the Member State's situation, the Council will lay down the economic policy conditions attaching to the loan. If the Council considers that the situation requires it, the conditions can go further than the programme drawn up by the Member State, including, for example, quantified targets.

The Member State benefiting from a loan is subject to a monitoring procedure similar to the original instrument. This supervision enables the Council to adjust the economic policy conditions according to the situation.

Under the 1975 mechanism, two successive Council Decisions were needed, each involving consultation with the Monetary Committee: the first authorized the Commission

to negotiate the loan, and the second authorized the borrowing and lending operation. The new instrument proposes, if feasible, to reduce the process to a single referral to the Council. The Council's decision covers the question of whether to grant the loan to a Member State, the economic policy conditions attaching to the loan and the financial arrangements involved. Since the Commission is empowered to carry out the corresponding borrowing operations, the Council no longer has to be brought in to authorize negotiation of the loans and to set their conditions. The Monetary Committee remains closely associated with each phase in the operation of the mechanism.

The new mechanism explicitly provides for greater flexibility in the choice of financial borrowing and lending techniques so that greater advantage can be taken of prevailing market conditions and to allow the loans to be more closely adapted to the needs of the borrowing Member State.

Thus, when seeking a loan, the Member State can request the inclusion of an early repayment clause. This option aims to correct an unsatisfactory feature of the 1975 instrument: in October 1977 Italy asked to repay loans before maturity; the Community was unable to accede to this request since it had no way of making early repayment of the funds it had itself borrowed.

The minimum average period of five years for which funds are borrowed is dropped and provision is made for the loan to be drawn down in instalments.

Lastly, it was considered unnecessary to renew the mechanism under which Member States provide guarantees. Experience has shown that the entry in the Community budget of the liability contracted was a sufficient guarantee for lenders. The guarantee system for borrowed funds is thus aligned on the system for the Community's other borrowing and lending instruments.

Under the renewed mechanism, and this is one of the most important changes, a far larger volume of funds can be raised. The ceiling for borrowing operations has been increased to ECU 6 000 million to maintain the Community's share in the recycling process at a constant level. The Community also needed sufficient power of intervention to produce a positive psychological effect on foreign exchange markets. The ceiling excludes interest and the margin available under the ceiling is reconstituted as and when repayments are made.

2. Renewal of the New Community Instrument (NCI)

This mechanism was created by Council Decision in October 1978 [1] empowering the Commission to contract loans to finance investment projects which serve the priority Community objectives in the energy, industry and infrastructure sectors. The instrument was first brought into operation on an experimental basis. Loans were therefore limited to ECU 1 000 million in principal, and activated by tranches by the Council which lays down the guidelines for the eligibility of projects.

In May 1979, the Council authorized a first tranche of borrowings for an amount of ECU 500 million to be used for investment projects in the infrastructure and energy sectors. [2] In July 1980 it authorized a second ECU 500 million tranche to be used according to the same criteria [3] and in November of the same year [4] accepted that, among certain infrastructure projects, housing and advance factories should be financed as part of overall projects directed toward the development of priority regions in the Community.

Authorization of the second tranche exhausted the initial endowment of this instrument. Learning from this experimental period the Commission proposed in October 1980 [5] to make the instrument permanent and to modify it in certain ways.

2.1. Operational experience of the NCI is brief but encouraging.

Despite delays in authorizing the second tranche, loans signed from the creation of the NCI in October 1978 to the end of 1980, total ECU 475 million spread over 20 projects.

An examination of loans signed [6] shows the main guidelines chosen by the Community in the use of the mechanism.

— All NCI loans were granted as part of cofinancing operations for projects already covered by the European Investment Bank (EIB) out of its own resources. The NCI financed an average of 13% of the total cost of projects. This is a net additional contribution by the Community to the financing of these projects, since in setting the level of the corresponding loans in its own name the EIB applied the same criteria as for projects not benefiting from NCI loans (the Bank's contribution represented on average some 40% of the cost of the projects that were cofinanced).

— The loans were concentrated on a small number of projects in countries and sectors whose growth and development represent priority Community objectives. With 47% of the funds granted and 9 projects covered, Italy has received the largest share. A total of 27% went to 7 projects in Ireland, a large share in view of the size of the

[1] Council Decision 78/870EEC of 16 October 1978.

[2] Council Decision 79/486/EEC of 14 May 1979.

[3] Council Decision 80/739/EEC of 22 July 1980.

[4] Council Decision 80/11/3/EEC of 25 November 1980.

[5] Proposal for a Council Decision, COM (80) 670 final of 30 October 1980.

[6] See Tables 4 and 5.

Table 4

New Community Instrument: Breakdown of loans signed (from 16 October 1978 to 31 December 1980)

Country and sector	Projects financed		NCI loans			
	Number	Cost (million ECU)	Amount (million ECU)	of which carrying interest-rate subsidies (million ECU)	% breakdown by beneficiary country and sector	% of cost of projects
Italy	9	1867	222,8	173,0	46,9	11,9
Energy	5	1078	120,9	120,9	25,4	11,2
Infrastructure	4	789	101,9	52,1	21,5	12,9
United Kingdom	2	785	105,3	—	22,2	13,4
Energy	1	669	79,4	—	16,7	11,9
Infrastructure	1	116	25,9	—	5,5	22,3
Ireland	7	699	128,4	79,0	27,0	18,4
Energy	3	199	39,1	14,4	8,2	19,6
Infrastructure	4	500	89,3	64,6	18,8	17,9
Denmark	2	234	18,1	—	3,9	7,7
Energy	2	234	18,1	—	3,9	7,7
Infrastructure	—	—	—	—	—	—
TOTAL	20	3585	474,6	252	100	13,2
Energy	11	2180	257,5	135,3	54,3	11,8
Infrastructure	9	1405	217,1	116,7	45,7	15,5

Source: Commission departments.

country. In the United Kingdom, only 2 projects have been financed by NCI loans but the share of funds involved is relatively large (22%). Very recently, two NCI loans were made to finance projects in Denmark. From the sectoral point of view, the largest share of the loans—54% of the total—has gone to investment in energy. Infrastructure accounted for the other operations, but no loans have yet gone to industry, although it is included in the basic Decision.

Since Italy and Ireland have been designated as less-prosperous member countries effectively and fully participating in the European Monetary System, they are able to benefit from a 3% interest-rate subsidy on certain loans made out of the EIB's own resources or out of NCI resources. The aid is to be concentrated on infrastructure projects and programmes. Investment in industry is excluded so as to avoid any distorting of competition. The loans on which interest-rate subsidies are payable are limited to five tranches of ECU 1 000 million per year; the present value of the subsidies is written into the budget in the form of five annual appropriations of ECU 200 million each. Almost 78% of NCI loans to Italy and 62% of NCI loans to Ireland have carried this advantage. Of the ECU 400 million in interest-rate subsidies which the Community granted in the two years 1979 and 1980 in respect of the measures accompanying the EMS, ECU 52 million, or 13%, were allocated to the NCI, the rest benefiting EIB loans. In net present value the subsidy represents on average 20% of the capital amount of the loan concerned.

As laid down in the basic Decision, the NCI loans have been granted under a mandate given to the European Investment Bank. In accordance with this mandate, the Bank carries out transactions on behalf of, for and at the risk of the Community. Loan applications are addressed to the Bank either directly or through the Commission or a Member State. After a Commission decision on the eligibility of each project, the Bank examines these applications, decides whether and on what terms to grant the loans and administers them in accordance with the procedures laid down in its Statute and its usual criteria. The division of tasks enables the Commission to exercise fully its responsibilities in the policy guidance of this new instrument.

2.2. The Commission, in the light of the experience acquired, proposed in October 1980 that the loans be continued and expanded and given greater operational flexibility.

The proposal contains two significant changes to the initial Decision:

— there is no longer any overall ceiling on the loans which

Table 5

List of projects financed by the New Community Instrument (from 16 October 1978 to 31 December 1980)

Country	Sector	Project	Amount of loan (million ECU)	EMS interest-rate subsidy
Italy	Energy	Alto Gesso hydroelectric power-station (ENEL)	34,9	×
		Geothermal power-stations (ENEL)	10,5	×
		System for monitoring the production and transmission of electricity (ENEL)	17,1	×
		Algeria-Italy gas pipeline, Sicily and Calabria section (ENI)	41,7	×
		AGIP Hydrocarbons	16,7	×
	Infrastructure	Aqueduct, Pertusillo III (Cassa)	39,6	×
		Industrial estate, Syracuse IV (Cassa)	12,5	×
		SIP Apulia	12,5	
		Friuli II motorway	37,3	
United Kingdom	Energy	Dinorwic hydroelectric power-station (CEGB)	79,4	
	Infrastructure	Lothian Water	25,9	
Ireland	Energy	Aghada power-station (ESB)	24,7	
		Peat production (BORD NA MONA I)	5,5	×
		Peat briquettes (BORD NA MONA II)	8,9	×
	Infrastructure	Dublin Water	24,7	
		Irish Telephones	17,9	×
		Irish Roads	19,4	×
		Irish Telephones VII	27,3	×
Denmark	Energy	Coal-burning power-stations Anaes III	8,9	
		Combined heat/electric Randers stations	9,2	

Source: Commission departments.

the Commission is empowered to raise. The action of the mechanism would thus be given the continuity required by the very objectives which it sets itself; to assist, by an additional contribution to investment promotion in the Community, the greater convergence of economic performances and the support of priority sectors;

— the system of borrowing in tranches is changed to allow simultaneous tranches in addition to successive tranches. The retention, in more flexible form, of the tranche system flows from the need to concentrate NCI contributions on the priority sectors of the Community's structural policies.

Lastly, although this involves no change to the basic text, the Commission and the European Investment Bank are working on a more flexible financial administration of the instrument. The former practice designed to avoid risk was for the amount of the borrowings contracted to correspond exactly, for each project or set of projects, to the amount of the loans signed. Thus loan contracts were concluded before the funds were borrowed so that the borrower could be given no assurance as to the exact terms of the loan he would receive. The two institutions aim to enable funds raised to be temporarily invested before being used to finance projects.

3. Aid for reconstructing regions affected by the Italian earthquake

In December 1980 shortly after the earthquake in the south of Italy, the European Council meeting invited the Council to decide without delay, and acting on a proposal from the Commission, on exceptional aid measures designed to contribute to the reconstruction programme in the stricken areas. The Commission immediately presented a proposal for a Decision, adopted by the Council on 20 January 1981,[1] which provided for the Community to assist Italy in two ways.

[1] Council Decision 81/19/EEC of 20 January 1981.

3.1. By way of sole exception, and by extension of the original provisions of the NCI, the Commission is empowered to contract loans for the purpose of financing the reconstruction of the means of production and the economic and social infrastructure in the region of the Italian earthquake. All in all, these loans may not exceed ECU 1 000 million in principal and any loans granted for the same purposes by the EIB out of its own resources will be deducted from this ceiling. The choice of the NCI in its original version was necessary for two reasons:

— since Parliament and the Council had not completed their examination of the proposed adjustments, use of the renewed NCI mechanism would have delayed a decision while the Italian authorities needed rapid and definite information on the financing they were to receive from the Community in order to establish their reconstruction programme;

— the creation of an *ad hoc* mechanism would have unnecessarily increased the means by which the Community borrows on the markets; by contrast, the NCI offered a well-tried framework for the management of loans and for joint action by the Commission and the EIB.

3.2. The Commission is to grant an interest-rate subsidy charged to the general budget of the Community of the NCI and EIB loans granted. The subsidy is fixed at 3% per annum for a maximum period of 12 years. Unlike those granted under the EMS, these subsidies will not be the subject of an initial budget appropriation for their net present value, but will be spread over successive budget years as and when they are actually paid.

Conclusions

Of the means of action available to the Community, borrowing and lending are among those best able to combine rapid action adapted to each situation, with the pursuit of medium and long-term structural objectives. It is in the interests of the Community as a whole for this machinery to be kept in a fit state to respond to all new demands. The initiatives which have just been described are in line with this desire. Despite the diversity of the situations motivating them and the special features of each mechanism, the initiatives stem from a similar approach and reaffirm three general principles guiding the Community's action in this respect.

The borrowing and lending instruments are based on the community of interests of the Member States. In these borrowing and lending operations, the Community's role is not merely that of a passive intermediary acting on the beneficiary's behalf. As a loan-issuing body, it commits itself directly *vis-à-vis* the persons providing the capital. Through interest-rate subsidies on certain of its loans, the Community assumes part of the costs. In return for the advantageous financing terms which the Community can offer by committing its credit worthiness and its finances, its loans are granted subject to economic policy conditions or to conditions which dictate the eligibility of the projects on the basis of the Community's objectives.

Loans from the Community accompany other measures. The purpose is to supplement not take the place of existing means of finance, by making additional funds available in defined areas by adding greater variety and by exerting the maximum follow-through effect.

For these reasons, the loan instruments must be bound by specific rules setting the objectives, the amount of funds to be raised and the conditions for allocating loans so that the mechanisms can be set in motion rapidly (but not automatically) following established procedures. The Community's room for manoeuvre must be sufficient for it to be able to assess, case by case, the advisability of financial intervention and to determine the procedures involved.

List of contents of European Economy Nos 1-7

1. November 1978	— *Annual Economic Report 1978-79* — *Annual Economic Review 1978-79*
2. March 1979	— *European Monetary System* Texts of the European Council of 4 and 5 December 1978 — *Short-term economic trends and prospects*
3. July 1979	— *Short-term economic trends and prospects* — *The European Monetary System* Commentary Documents
4. November 1979	— *Annual Economic Report 1979-80* — *Annual Economic Review 1979-80*
5. March 1980	— *Short-term economic trends and prospects* — *Adaptation of working time*
6. July 1980	— *Short-term economic trends and prospects* — *Borrowing and lending instruments looked at in the context of the Community's financial instruments*
7. November 1980	— *Annual Economic Report 1980-81* — *Annual Economic Review 1980-81*
Special issue 1979	— *Changes in industrial structure in the European economies since the oil crisis 1973-78* — *Europe — its capacity to change in question!*