Iran problems

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EUROPEAN COUNCIL, DUBLIN
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ECONOMIC SITUATION IN THE COMMUNITY AND WORLDWIDE
Brief by H M Treasury

OBJECTIVE

1. To seek an agreed view of the problems facing us, stressing that HMG's policies are part of a co-ordinated response to rising Community inflation.

POINTS TO MAKE

2. (i) Prospects for growth, inflation and unemployment sombre. Most recent oil price developments imply some further deterioration.

(ii) Notable unanimity within Community about need to control inflation. But ability to translate this common approadh into greater convergence of performance ill-served by perverse transfers of resources between members.

(iii) Efforts to squeeze out inflation in the UK and restore the basis for growth require lower public expenditure. And that includes our EEC budget contribution.

(iv) US moving into recession. But, apart from the UK, growth in the Community and elsewhere should continue, if at a lower level.

(v) Community's reaction to G77 proposals for global negotiations under North - South dialogue should be constructive but cautious. We must insist on certain conditions.

BACKGROUND (All information useable: brief details on recent developments in members states are a Annex A)

3. A summary of the latest Treasury World Economic Prospects forecast is attached. It was based on an expected increase in oil prices of 40 per cent in 1979 and a further 20 per cent next year. But the <u>oil markets</u> are once again in disarray; prices are leapfrogging and the OPEC price ceiling set in June has been breached.

4. <u>GNP growth</u> in the OECD area is expected to weaken substantially: from 4 per cent in 1978 to 2¾ per cent this year and 1 per cent in 1980. The need to contain inflation prevents most countries from stimulating demand to offset the impending US recession, which could be quite severe by post-war standards. Community growth is expected to be rather higher than in the OECD as a whole, falling from around 3 per cent this year to around 2 per cent in 1980. Relatively strong recent growth in Germany is likely to slow down as inflation bites into real incomes; growth in France and Italy has become sluggish after buoyancy earlier in the year.

5. The upturn in inflation, which pre-dated the increase in oil prices, continues to gather pace. In the main industrial countries, inflation could average nearly 10 per cent in 1980, compared with 7 per cent in 1978. The year-on-year Community inflation rate is now running at over 11 per cent, one-third higher than at the end of last year. The differential between the lowest OECD inflation rate (Germany) and the highest (Italy) could widen markedly next year, reflecting varying degrees of success in preventing higher oil prices feeding through into the general price level. A number of EEC countries have some form of wage indexation. This exacerbates the problem of containment; Italy is especially vulnerable. In general, though, there is better hope of avoiding a wage explosion than in 1974-75; wage pressure has so far been moderate in the US, Germany and Japan.

6. In 1974, there were divergent responses to the oil price increase. The large disparities in inflation and current balances which ensued contributed to currency instability. This year, policy reactions have been more uniform. Most governments are choosing to tighten policy to contain the inflationary impact of higher oil prices.

7. The UK's commitments to lower Government borrowing and the stabilsation of public expenditure are essential components of the policy of squeezing out inflation and improving economic performance. Our EEC Budget contribution must be cut as part of these commitments.

8. Recent monetary measures in the US and the UK show the determination of both governments to tackle inflation. Elsewhere, interest rates have been increasing in all the main industrial countries and many of the smaller ones. Rates do not seem to have increased further than is justified by inflationary expectations. It is known, though, that the German government was unhappy about the Bundesbank's action in increasing rates last month.

9. The OECD area is now expected to have a current account deficit of over $30 billion in 1979 and 1980. The improved pattern of current balances is likely to prevail. Japan could still be in deficit next year, and the US could be close to balance. Despite sizeable deficits in Belgium, the Netherlands and Denmark, the Community had a record combined surplus last year. But a small deficit is expected for this year and next. The surpluses of Germany, France and Italy are shrinking any may disappear.

10. The position of the LDC's will deteriorate sharply. Debt rescheduling or other rescue operations are likely to increase. But there is no serious threat to the private banking system and the international institutions have ample funds if countries would overcome their reluctance to turn to them.

11. The UN General Assembly is expected to accept proposals of the G77 for a new round of global negotiations to be launched next year under the North - South dialogue. The round would

extend to "major issues in the fields of raw materials, energy, trade, development, money and finance. We have argued that there should be no duplication with existing N/S discussions; that specific issues should be delegated to appropriate international bodies; and that there should be no artificial negotiating linkage between separate issues. There could be pressure from other member states to adopt a softer line. We should resist this. The West should continue to be cautious about these negotiations. In present circumstances we have little to give on points of concern to the LDC's. We favour informal discussions with the oil producing countries: but any discussion of energy linked to wider N/S issues would be at best sterile and at worst dangerous.

H M TREASURY

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