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EUROPEAN COUNCIL, VENICE

12/13 JUNE 1980

ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

Brief by HM Treasury

OBJECTIVE

1. To emphasise that UK policies are part of agreed Community formula.

POINTS TO MAKE

2. (i) Activity in most economies beginning to slow down after recent unexpected resilience. Growth prospects this year are poor and little if any recovery is likely in 1981.

(ii) Upsurge in inflation may be reaching its peak, with wage settlements modest in many major countries.

(iii) Widespread acceptance that tight fiscal and monetary policies unavoidable. US interest rates have come off the boil but this might take a little longer elsewhere.

(iv) Better distribution of current account deficits than after 1973-74 oil shock. Helpful that countries which can finance deficits are doing so rather than trying to push them on to others less well off.

(v) But LDC's will have to reduce deficits to levels that can be financed. Increased recourse by them to the IMF seems necessary and desirable.

BACKGROUND (All information useable)

References

A: Com(80)300. The economic and social situation in the Community.

3. Recent price increases have underlined the disarray in the <u>oil markets.</u> Although stocks are high and demand and supply are broadly in balance, the price structure remains unstable and many major countries are in a weak supply position. The deflationary impact of oil price rises since 1978 is around 2 per cent of the OECD area's GDP, much the same as in 1973-74.

4. But although growth is likely to weaken substantially, the reversal should be less severe than in 1974-75. <u>GNP growth</u> in the OECD is expected to fall from almost 3½ per cent in 1979 to around ¾ per cent in 1980. The US recession could be quite deep, increasing the possibility that OECD growth will recover little, if at all, in 1981. Within the EC, growth held up surprisingly well last year - notably in Italy and Germany - and this year could average around 1¼-1½ per cent. This implies growth in Italy and the Netherlands over 2½ per cent lower in 1980 than in 1979 and in France and Germany between 1½ and 2 per cent lower. In Denmark, like the UK, output is expected to fall this year.

5. The average <u>inflation rate</u> in the major countries reached over 12½ per cent in March, but the upsurge that started in

mid-1978 might now have run its course. In general, only a small part of the upsurge has been home-grown. Wages have increased much less sharply in most countries than after the 1973-74 oil shock. Within the EC, experience in containing the increase in oil prices has varied widely. The average inflation rate is above that of the OECD as a whole and the gap between the best performers (Germany, Luxembourg) and the worst (Italy, UK) has grown. A number of EC countries have some form of indexation which makes the problem of containment especially severe. Italy is particularly vulnerable. A pay freeze is in force in the Netherlands.

6. Monetary policy has been the main weapon in the fight against inflation to which all countries have given priority. With money supply targets being maintained or tightened, interest rates reached record levels in most countries earlier this year as inflationary expectations worsened. Rates have fallen back dramatically in the US on the arrival of the recession and with clear evidence that money supply was growing well below target. An immediate or precipitate fall in European rates is unlikely. The European economies are slowing down later in the cycle than the US and money supply targets are not being as comfortably met.

7. Fiscal policy in many countries is becoming generally more restrictive as they seek to restrain or (in the US) eliminate budget deficits. Some of the smaller EC members, who have acute problems over the size or financing of their borrowing requirements, have suggested that policies are generally too tight. But advocacy of relaxation has won little support in the major countries. The Commission's view in its paper is that "there is ...no alternative to maintaining broadly restrictive budgetary and monetary policies".

8. The UK's commitments to lower government borrowing and the reduction of public spending are essential to squeeze out inflation and improve economic performance. The commitments have been widely endorsed internationally. To quote the Commission's paper, "A reduction of the budget deficit in proportion to GDP must indeed be a key medium-term objective for the Community as a whole..."

9. The OECD area is now expected to have a current account deficit of around $100 billion in 1980, of which about one-half could fall on Community countries. Deficits within the industrial countries should be better distributed than in the mid-1970's. Germany and Japan might share a deficit of around $40 billion and the US deficit could be quite small. It seems to be accepted that countries able to finance their deficits should do so rather than attempt to shuffle them off on to others. Recent moves by Germany and Japan to arrange capital inflows are welcome. However, some smaller EC countries, notably Denmark and Ireland, have especially severe current account problems and may have to tighten policy further.

10. The position of the LDC's is likely to deteriorate significantly. Even if they cut import growth sharply their combined deficit could rise to around $55 billion in 1980. No single initiative can solve their problems though, and they will need to reduce their deficits to what can be financed.

11. Concern has been expressed about the ability of the international banking system to recycle OPEC surpluses as smoothly as in the mid-1970's. Market conditions could be less favourable to borrowers, but it remains to be proved that the

banking system will encounter serious difficulties. It is clear, though, that the IMF will have to play a larger role and its credit arrangements are currently being reviewed. The LDC's should be encouraged to approach the Fund and agree adjustment programmes at an early stage.

HM TREASURY
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COMMISSION OF THE EUROPEAN COMMUNITIES

COM(80) 300 final

Brussels, 29 May 1980

THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the European Council)

1. Results for 1979 and recent trends. Following a fairly buoyant expansion throughout 1979 the economic activity of the Community showed a more hesitant development in the first half of 1980. Industrial production stagnated between the fourth quarter of 1979 and the first quarter of 1980 and the rate of unemployment rose by three decimal points from January to April, after quasi-stability since the middle of 1978. The rate of increase of consumer prices has been very high in recent months in response to the direct and indirect effect of the oil price adjustments and rise of indirect taxes in some Member States. The inflation momentum is now of the same order of magnitude as in 1974/75. The upward movement of hourly earnings has on the other hand been more modest and the profit situation and cash flows of the enterprises have deteriorated less than after the previous oil price increase.

2. As a result mainly, but not only, of the deterioration of the terms of trade following the oil price increase, the trade balance of the Community has deteriorated considerably since 1978. The deficit on the current account of the balance of payments reached approximately 7 mrd. ECU (10 mrd. dollars) in the first quarter of 1980 against a small surplus in the first quarter of 1979. The current deficit was to some extent financed through a reduction of official reserves, related to interventions in favour of European currencies against the dollar in the period up to the beginning of April. As a consequence of the fall in exchange reserves and a restrictive stance of monetary policy in some Member States the growth in money supply (measured over 12 months) has slowed down from more than 12 % in early 1979 to around 11 % in recent months.

3. Due not least to a forceful monetary policy in the framework of the European Monetary System, exchange rate movements have shown a high degree of convergence over the past year. But underlying rates of inflation and real economic performances have not yet shown signs of yielding to the policy constraints and are showing divergent movements which may become sources of balance of payments disequilibria and exchange rate tensions in later phases.

4. Outlook for 1980 and 1981. Based on the main assumption of no major changes in the stance of budgetary and monetary policies, of a stabilization of the savings ratio of households after a fall in the second half of 1979 and early 1980 and of a sustained growth of export markets (imports to non-EC markets, weighted with their share in Community exports are forecast to increase by 5% in 1980 and expand well also in 1981) real gross domestic product of the Community is expected to rise by 1.5% in 1980 (or slightly more than the 1.2% forecast in February). This would be consistent with a slight decline in the second and third quarters of 1980 followed by a gradual pick-up in the following year. By the end of 1981 the rate of expansion could (at annual rate) be around 2.5%. Inventory adjustments are expected to exert a negative influence on activity, notably in the second half of 1980, and other domestic components may show only little buoyancy. Net exports of the Community may, on the other hand, increase strongly in volume terms and should therefore help to sustain activity somewhat in face of weak domestic demand in most of 1980. However, domestic consumption is forecast to strengthen again in 1981, on the assumption that inflation moderates.

5. With economic activity in the first quarter of 1980 more buoyant than expected, unemployment is now forecast to reach 6% on average for the year (against 6.4% in the February forecast); but a strong increase is likely in 1981. The rise in consumer prices in recent months has been faster than foreseen and may on average for 1980 reach 12.3%. The month-to-month increase would be detelerating as from mid-1980 and should - if the rise in wage costs is checked - get back into single figures in the course of 1981. The deficit on the current account of the balance of payments may, for 1980 on average, reach 24 000 million ECU (33 000 million dollars) but should decline somewhat in 1981.

6. The outlook as presented here may be said to constitute the most probable outcome on the assumptions stated above. The growth of activity and employment could however prove to be slower or even negative if households, enterprises or the government sector - in order to avoid a deterioration of their financial position - increase expenditure less than foreseen. There is also a risk that more divergent movements of prices and wages, and in policy reactions by governments to the strains of the economic situation, could lead to graver instability in both the real economy and monetary relations; and thence also to a lower overall level of activity.

7. Policy issues for the period ahead. Against this background, there is, in the view of the Commission no alternative to maintaining broadly restrictive budgetary and monetary policies. Only through a marked and sustained deceleration of inflation will it be possible to strengthen confidence of households and enterprises and increase the propensity to invest. Without relaxing the overall policy stance, governments should contribute to this process through measures to facilitate necessary changes following the energy price rise, to economise energy and stimulate investment in general and assist the adaptation of the labour force to the changing pattern of supply and demand. Efforts to limit the growth of other public expenditure categories must be pursued. A reduction of the budget deficit in proportion to GDP must indeed be a key medium-term objective for the Community as a whole - and the restoration of better financial balance should remain an immediate preoccupation in Member States where budget and/or balance of payments deficits are creating particular problems: Belgium, Denmark, Ireland and Italy.

8. While pursuing policies geared to medium-term objectives, governments should, however, over the next 12-18 months, be careful to avoid creating conditions conducive to a cumulative collapse of demand due to excessive expenditure cuts aimed at keeping budget deficits on predetermined levels. As a consequence of a slow growth of tax receipts some increase in budget deficits is likely in the period up to mid-1981 and, on average in the Community, governments should accept this in some moderate degree.

9. With appropriate recycling of OPEC surpluses, including active efforts, on the part of governments to step up long-term borrowing from the OPEC countries directly or via the international capital market, the present orientation of monetary policy could be maintained and domestic monetary financing kept under control. While it would not be practicable to seek to negotiate among oil-importing countries a scheme for distribution of the current account deficits it is highly desirable to arrive at a certain consensus on the approach to the financial problems involved so as to avoid disruptively competitive or divergent policy responses.

11. Given that on one hand total employment is likely to decline in 1981 and that the labour force may see a further increase, the Community will over the coming year be faced with increasing employment problems, notably for young people entering into the labour força; also the employment opportunities for the steadily rising part of the female population which is aiming at an active participation in economic and social life will be severely limited. Moreover, in a context of slow overall growth the difficulties encountered by some low-growth branches of the Community's industry may be seriously aggravated. In this context Member States should prepare themselves to step up efforts to improve employment opportunities in particular for young people.

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(Vericupp)

Table : The Community economy 1978-80

	1978	1979	1980	1978	1979	1980
	GDP volume, % change			private consumption deflator, % change		
DK	1,0	3,5	- 0,8	9,4	9,6	11,5
D	3,2	4,4	2,5	2,5	4,1	5,5
F	3,8	3,2	2,2	8,1	10,5	13,2
IRL	6,0	3,2	0,9	7,9	13,2	19,5
I	2,6	5,0	3,5	12,7	14,9	19,6
NL	2,4	2,2	0,7	4,2	4,7	6,5
B	2,4	2,5	1,4	4,4	4,5	7,0
L	4,3	2,7	1,9	3,5	4,5	6,7
UK	3,1	0,6	- 2,6	8,6	12,0	20,3
EC	3,1	3,3	1,5	7,1	9,0	12,3

	unemployment rate, % civilian working population			balance of payments current account, mrd ECU		
DK	6,6	5,3	5,7	- 1,2	- 2,2	- 2,1
D	3,9	3,4	3,3	7,4	- 3,5	- 10,5
F	5,3	5,9	6,3	1,5	1,1	- 3,4
IRL	8,8	7,9	8,2	- 0,2	- 1,1	- 1,2
I Italy	7,1	7,6	8,2	4,9	3,8	- 1,4
NL	4,1	4,3	4,5	- 0,7	- 1,5	- 0,6
B	8,4	8,6	9,0	- 1,1	- 2,6	- 4,0
L	0,8	0,7	0,8	0,3	0,6	0,6
UK	5,7	5,4	6,5	0,6	- 3,8	- 1,0
EC	5,5	5,6	6,0	11,7	- 9,1	- 23,7

	public finance : general government deficit, % of GDP				money supply, % change		
DK	- 0,9	- 1,0	- 1,5	(M2)	6,7	9,9	6,0
D	- 2,8	- 2,9	- 2,8	(M3)	11,0	6,0	6,0
F	- 2,3	- 0,8	- 1,5	(M2)	12,2	14,3	12,5
IRL	- 10,5	- 12,5	- 11,4	(M3)	28,7	19,0	12,6
I	- 10,6	- 9,4	- 10,2	(M2)	22,8	20,4	19,2
NL	- 2,2	- 3,3	- 2,8	(M2)	4,2	6,9	8,4
B	- 6,0	- 6,8	- 7,9	(M2M)	9,5	6,0	7,0
L	3,3	1,3	0,4		:	:	:
UK	- 4,2	- 2,9	- 2,4	M3	13,3	11,7	9,6 (1)
EC	- 4,0	- 3,5	- 3,8		12,7	11,0	10,1

(1) Financial year, mid-April to mid-April.

Source : Commission services, based on information available up to 27th May 1980.