CDP 26/6

PM/84/101

PRIME MINISTER

European Community

1. Mr Lubbers has told our Ambassador in The Hague that he would like to speak to you on the telephone before Fontainebleau. If you can find time to speak to him tomorrow morning before he sees President Mitterrand this would be very useful. Any pressure which steers President Mitterrand towards proposing a solution acceptable to us would be advantageous. I recommend that you should stress the following points to Mr Lubbers:

Needs

Play our part

(i) the Community needs a fair and defensible settlement of the budget issue at Fontainebleau, which will put this problem out of the way and allow the Community to concentrate on its long-term objectives. The United Kingdom will play its part in arriving at a budget solution. We have also made a contribution to the debate on the Community's future development with the recent paper "Europe - The Future" (of which Mr Lubbers has a copy).

(ii) On the budget imbalance and the United Kingdom refund we must not go back on the position reached in the last European Council and the Foreign Affairs Council of 27 March. The United Kingdom is ready to reach a settlement on the basis of the system as proposed by the

/Presidency

Presidency at the last European Council: one ad hoc year (1984) at 1,000 mecu and the system thereafter (if there is a settlement the new owned resources will be available to apply to the 1985 refund): and a fair compromise between 1,000 and 1,250 mecu on 1983 figures.

(iii) We would be prepared to settle only on the figure to be inserted in the Presidency text, if this would facilitate an agreement. Equally, if others wish, we would be ready to settle the threshold and rate of compensation above the threshold: this would, of course, have to be consistent with a fair compromise between 1,000 and 1,250 mecu.

GEOFFREY HOWE

Foreign and Commonwealth Office
19 June 1984

0900Z

CONFIDENTIAL

DISTRIBUTION SELECTORS
FILE COPY

GRS 220
CONFIDENTIAL [FRAME ECONOMIC
FM THE HAGUE 191000Z JUN 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 220 OF 19 JUNE 1984
INFO IMMEDIATE UKREP BRUSSELS
INFO PRIORITY PARIS BONN BRUSSELS AND LUXEMBOURG
INFO SAVING OTHER EC POSTS

Lubbers not available 6-8 p.m. this evening. Best time 7:30/7:45 a.m. tomorrow.

MG

EC: BUDGETARY IMBALANCES

1. LUBBERS AND VAN DEN BROEK LEAVE TOMORROW MORNING FOR A MEETING WITH MITTERRAND IN PARIS AT THE LATTER'S INVITATION.

2. AT DINNER LAST NIGHT, LUBBERS SAID THAT IT WAS A PITY HE COULD NOT MEET THE PRIME MINISTER BEFORE FONTAINEBLEAU, BUT HE AGREED THAT A TELEPHONE CONVERSATION WOULD BE USEFUL. HE REFERRED FAVOURABLY TO MRS THATCHER'S TELEPHONE CALL JUST BEFORE THE INF DECISION; HE PARTICULARLY APPRECIATED HER OPENING REFERENCE TO THE COMMEMORATION OF 'D' DAY. HE SUGGESTED THAT IF MRS THATCHER WISHED TO SAY SOMETHING BEFORE HIS MEETING WITH MITTERRAND, SHE COULD CALL TODAY OR EVEN EARLY TOMORROW MORNING (I HAVE TOLD LUBBERS' OFFICE THAT THIS WILL HARDLY BE POSSIBLE BECAUSE OF THE FOREIGN AFFAIRS COUNCIL). IF NOT, HE WOULD CONSIDER CALLING HER AFTER HIS MEETING WITH MITTERRAND.

3. IN THE LIGHT OF THIS CONVERSATION, I THINK LUBBERS WOULD BE RECEPTIVE TO A TELEPHONE CALL FROM THE PRIME MINISTER. HE IS BUOYANT AFTER HIS SUCCESSFUL HANDLING OF THE INF ISSUE. I TOLD HIM I BELIEVED THAT HE WOULD NOW CAP THIS ACHIEVEMENT BY ANOTHER SUCCESSFUL AND POSITIVE CONTRIBUTION TO A SOLUTION AT FONTAINEBLEAU. HE WILL CERTAINLY BE GIVING EC PROBLEMS HIS FULL ATTENTION NOW THAT INF IS OUT OF THE WAY FOR THE TIME BEING.

FCO PLEASE PASS SAVING COPIES

(REPEATED AS REQUESTED)

MANSFIELD

FRAME ECONOMIC
ECD(I)

CONFIDENTIAL

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(84)351 final

Brussels, 18 June 1984

THE ECONOMIC AND SOCIAL

SITUATION IN THE COMMUNITY

(Communication from the Commission to
the European Council of 25-26 June 1984)

THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the European Council of 25-26 June 1984)

CONTENTS

INTRODUCTION

The economic situation has changed little since last March when the European Council last met. The most recent indicators have confirmed or accentuated the three main features of the Community economy in mid-1984:

- the economic recovery is a little stronger than was expected at the end of 1983; it is accompanied by a reduction in the main disequilibria (inflation, budget deficits, external accounts) and by a growing convergence in Member States' performances;

- however, the recovery is not strong enough to bring any general improvement in the employment situation in the immediate future;

- continuation of the recovery depends partly on the external environment, i.e. on developments in a number of areas which affect the growth of the world economy: interest rates, exchange rates and international indebtedness.

I. THE ECONOMIC SITUATION IN 1984 AND 1985

A. The growth rate of international trade is expected to accelerate further taking 1984 as a whole and to remain strong in 1985. It is forecast to be nearly 7% in volume terms in 1984 and more than 4% in 1985, notably under the impact of growth in the OECD countries, which is expected to reach 4.5% in volume terms in 1984 and around 2.5% in 1985. Overall, taking the three years 1983, 1984 and 1985, real growth in the OECD countries as a group should average around 3% per year as compared with 0.2% in 1982.

World trade could thus expand at a significantly faster rate.
This prospect depends essentially on the growth profile of the industrialized countries, which in turn depends to a large extent on:

- growth in the American economy being maintained at a satisfactory level;

- interest rates and exchange rates moving in such a way that they do not choke off the recovery, particularly the recovery in investment, and do not show sudden changes that would affect the return to a climate of greater confidence;

- an improvement in the developing countries' terms of trade.

8. If these conditions are met, the recovery should be able to continue in the Community in 1984 and be maintained in 1985, though at a lower rate because of the slowdown in the growth of international trade. The Community economy is expected to grow at a rate of about 2.2% in 1984 and 2% in 1985 under the impact of the growth of world trade and the recovery in some Member States (Federal Republic of Germany: 3% in 1984 and 2.5% in 1985; United Kingdom: 2.7% in 1984 and 2.1% in 1985): this trend is likely to spread to a greater or lesser extent to the other Community countries.

However, two comments must be made on this prospect of a continuing recovery in the Community:

- firstly, appreciable though it may be following the recession which began in 1979, growth is likely to remain modest compared with past performance (from 1969 to 1976, the growth rate of Community GDP averaged 3.6% a year and, from 1971 to 1980, it was still 2.9%). This slowdown coincides with a decline in the potential rate of growth[†]: estimates indicate that while the Community's potential growth rate was still in the 3.7% to 4% range between 1970 and 1974, it fell to around 2.9% in the period 1977-80;

[†] This is the growth rate that is theoretically possible in a given period, representing the maximum rate of utilization of factors of production.

- the second comment concerns the self-sustaining nature of the recovery and the role of investment. Whereas the recovery in 1983 was largely generated by the external sector, productive investment should play a greater role in fuelling the growth process in 1984 and 1985. In 1983, investment volume had already stopped declining throughout the Community and was showing appreciable increases in the United Kingdom (4.7%) and in the Federal Republic of Germany (2.9%). In 1984, it should grow by some 3.4% in the Community as a whole and by 3.8% in 1985.

C. The inflation rate is expected to continue to fall in 1984 and 1985, to 5% this year and 4.3% next year, or half the average annual inflation rate in the period 1971-80. As in 1984, this trend will probably be accompanied by a narrowing of differentials between EMS countries, with inflation rates ranging between 2.9% and 10% in 1984 and, according to certain hypotheses based on the determined continuation of policies aimed at restoring the key equilibria, between 2% and 6.5% in 1985.

D. The main adjustments in internal and external disequilibria (incomes, public deficits and external accounts) which were initiated in 1983 are expected to continue in 1984-85. In these areas, there should also be a reduction in divergences within the Community, though to a lesser extent than in the case of inflation.

E. If the prospective trend for 1984-85 is relatively encouraging with regard to inflation and, to a lesser extent, growth, it is very unsatisfactory with regard to employment. Despite the recovery, the unemployment rate could continue to rise to reach an annual average of 11.4% in 1985, as against 10.4% in 1983.

This is linked to the fact that growth in 1984-85 is likely to be lower than the average rates observed during longer periods in the past, while, even if there is little change in the total employed population, the labour force will continue to increase.

Thus, despite a less sharp increase and indeed a stabilization of unemployment in the Federal Republic of Germany and the United Kingdom in 1984-85, the overall trend of unemployment in the Community is very worrying.

*

* *

The outlook for 1984-85 is thus for further consolidation of the recovery in the Community. The Community economy is expected to return gradually to a more satisfactory growth rate as the stabilization and adjustment policies currently being pursued produce results. However, though this outlook may be moderately satisfactory, it remains subject to considerable internal and external uncertainties.

II. Problems facing the European economies and economic policy priorities

The uncertainties as to the durability of the economic recovery and as to the chances of beginning to reverse the trend of employment are closely bound up with the structural weaknesses of the European economies. Significant progress has no doubt been made in achieving stabilization and adjustment in recent years; however, such progress, which would certainly be facilitated by a sustained recovery, must be maintained if there is to be strong enough growth, over a sufficiently long period, to obtain a more favourable trend in employment.

A. Experience and a comparison between the different regions show that there is a link between job creation (and, hence, a fall in the unemployment rate) and the strength of competitive structures.

A comparison between European and American performances on job creation is equally enlightening. The facts revealed are well known, and the Commission has already presented them to the European Council: from 1973 to 1983, total employment fell in the Community from 106 million to 104 million, whereas it increased in the United States from 85 million to more than 100 million. During the same period, the ratio of labour costs to return on capital increased by 2.4% a year in the Community but decreased by 0.4% in the United States, while capital endowment per person employed increased by 3% a year in the Community, but by only 0.3% in the United States. Admittedly, during this period average annual real growth was 1.6% in the Community, whereas it was 2% in the United States. However, the profitability of companies has begun to improve, in some cases very appreciably, in certain Community countries during the last two years, reflecting the adjustment process that is under way. Even so, the figures cited above (which should be interpreted in the light of demographic trends) illustrate just how much the capacity to achieve growth that can create lasting employment depends on an appropriate trend in production costs, particularly the relative costs of labour and capital.

B. The adjustment and stabilization efforts being undertaken must therefore be continued and, at the same time, helped by lower inflation, the conditions must be created for sustained stronger growth. Close consistency must consequently be ensured between short-term economic policies and policies to adjust production structures.

This means that economic policies must be geared to two objectives: consolidating the slowdown in inflation, or where appropriate obtaining a sharper deceleration and increasing the flexibility and dynamism of the economies of Member-States.

1. Short-term economic policies must continue to be aimed at restoring the key equilibria and pursuing the fight against inflation:

- monetary policies must continue to ensure that the trend of the monetary aggregates is such as to prevent the re-emergence of inflationary expectations, while at the same time seeking to establish the conditions for getting interest rates down to as low a level as possible;

- budgetary policies must pursue a threefold objective: reducing the deficits which in several Member States are still claiming an excessive proportion of savings and are keeping interest rates high; stabilizing, then reducing the share of public expenditure; and restructuring public budgets in such a way as to restore their role in supporting and underpinning growth by modifying taxation and by strengthening in particular measures to promote investment, research and training. Efforts in this area are of overriding importance in cases where the trend of deficits is handicapping the fight against inflation and threatening the recovery;

- the growth of incomes must be consistent with the need to keep the economies competitive and flexible.

2. The second objective of economic policies must be to strengthen structures and introduce greater flexibility into the economies, both being necessary if employment is to recover:

- even though investment is picking up again in the Community, it must not be forgotten that the Community's economy is emerging from a long period - beginning in 1975 - during which the investment share in the Community declined steadily; this coincided with the premature obsolescence of much of the capital stock as a result of changes in relative prices (oil shocks) and technology. Hence the need for improved investment performance over an extended period if ground is to be made up in the adaptation and modernization of productive structures and if the potential growth rate of the European economies is to be gradually raised.

The Member-States must therefore press ahead with the measures taken to alter legislation, taxation and regulations so that they favour productive activity. This objective will have to be attained through a set of measures which in isolation are often unspectacular but whose combined effect can make a significant contribution to the restoration of more stable and lasting growth. This means essentially changing taxation and easing the regulatory framework, promoting competition and securing better use of productive structures.

Lastly, the outlook on unemployment confirms the importance of the role which must be played by active employment policies. Measures to reduce and reorganize working time may help to improve the employment situation provided that they respect the constraint of competitiveness, that they enable the productive system to be used more flexibly and more efficiently, that they assist structural change and that they do not create bottlenecks in labour supply. An unequivocal stand by the Community could give employers and unions valuable guidance here. The Member States must also reinforce their specific measures to increase youth employment and alleviate the problem of long-term unemployment. Lastly, the return to higher growth is closely linked to labour market flexibility, and it is important that changes be made in this area, notably in respect of the operation or forward planning of labour markets, and that vocational training policies be given a higher priority.

C. The Community can contribute to the success of these policies in three ways:

- the effects of internal economic cohesion, monetary stability and collective discipline in economic policies represent a valuable achievement and have a very direct bearing on the existence of the Community as a homogeneous and open entity: in this respect the role of the EMS is fundamental and its consolidation should be a primary objective;

- exploitation of the advantages of a large integrated economic entity such as the Community can more than ever help the European economies to adjust and to achieve a lasting return to competitiveness. In this respect, the completion of a single, continental-size market by a range of radical measures in fields such as the movement of goods and services, technical barriers and standards, taxation and company law, may make a direct contribution to the restoration of higher growth;
- lastly, the Community countries, largely united in the pursuit of the required modernization of productive activities through faster technological development, should take more systematic advantage of the added effectiveness offered by common measures in the field of technology, whether these be closer coordination in the use of government procurement, the mutual recognition of standards in high-technology industries, pre-competitive research, or training.

III. EXTERNAL UNCERTAINTIES

Several uncertainties originating from outside the Community could affect the economic recovery. These include, of course, the implications for Europe of a possible reduction in Gulf oil supplies. The two main factors of uncertainty, however, are the international monetary situation and the problem of developing countries' indebtedness.

A. The international monetary situation is marked by the increase in real interest rates and continued existence of exchange rate relationships which do not sufficiently reflect economic fundamentals.

From 1981 onwards, real short- and long-term interest rates in the United States were hovering around 6%. After easing slightly in 1983, they have risen again since early 1984. It is true that in Europe interest rates have not risen to the same extent, and full use has been made of any scope for decoupling them in practice from United States interest rates, to assist the recovery in Europe. Yet, in the wider world context, higher interest rates could affect the economic recovery in three main ways: they increase the developing countries' burden of indebtedness; they raise the threshold above which investment becomes profitable, and therefore jeopardize its growth; and, pushing up both prices and the cost of servicing the public debt, they make it more difficult to pursue stabilization policies.

The recovery could also be undermined by the movement of exchange rates, coupled with heavy current account deficits in some countries.

These two problems - the movement of exchange rates and the level of interest rates - stem partly from the mix of United States monetary and fiscal policies. There is no doubt that this policy has brought about rapid stabilization, and then a strong recovery, of the United States economy, and hence of world trade (in 1983 the volume of United States imports increased by 12%). It is also true that at 4.4% of GDP in 1983, the United States public sector deficit is much smaller than the general government deficit recorded in a group of Community countries where efforts to establish a healthier public finance situation must be continued as a matter of priority. The United States public sector deficit is, however, appreciably larger than the deficits in the Federal Republic of Germany, France and the United Kingdom. Moreover, it must be set against the structurally very low savings ratio in the United States (5.8% of personal disposable income in 1983) and against the fact that, combined with high interest rates and a heavy current account deficit, it is bound to have something of a crowding-out effect in the other economies.

On both questions (interest rates and exchange rates), the Community must push forward with the efforts made since the Versailles summit to secure, through proper supervisory machinery, greater coherence of economic policies and to lay the foundations for organized monetary cooperation between the principal monetary entities. The work started in 1982 is continuing within the Group of Ten. As the Commission has advocated, the Community should adopt common positions and should be able to make concrete proposals at the appropriate time on the main subjects under examination.

8. The second problem is that of international indebtedness. This is being dealt with in a variety of forums, and was notably discussed at the last economic summit in London. The Community must participate in the overall strategy into which the specific solutions most appropriate to each particular situation can be fitted.

This strategy covers the following main questions:

- first, an improvement in the financial position of the developing countries depends in large measure on a better international environment as regards interest rates, exchange rates and the opening up of markets; the conclusions reached in work done elsewhere on these subjects will therefore have a direct impact on indebtedness problems;

- second, if the most heavily indebted countries are to achieve a healthier financial position, economic recovery must continue in the industrialized countries and the developing countries' terms of trade must be improved;

- third, the Community should - also in the context of the forthcoming international meetings and in particular the IMF meeting in September - join in the various specific initiatives in the international financial field which were outlined at the recent London summit and which closely correspond to its earlier policy thinking.

*

* *