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EUROPEAN COUNCIL, LUXEMBOURG
27/28 APRIL 1980

ECONOMIC SITUTATION IN THE COMMUNITY AND WORLDWIDE
Brief by HM Treasury

OBJECTIVE

1. To emphasise that UK policies are part of the agreed Community response to rising inflation. And to demonstrate the link between these policies and our attempts to cut our Budget contribution.

POINTS TO MAKE

2. (i) Despite surprising resilience of output in some countries, prospects for growth are poor. Those for inflation are poorer still.

(ii) Notable unanimity within Community about primacy of controlling inflation. But translating common approach into greater convergence of performance hindered 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 must include our EC Budget contribution.

(iv) LDC's very hard hit by the effects of oil price rises. Some may find it harder to borrow from the banks on good terms. Increased recourse to the IMF by poorer and middle income LDC's seems necessary and desirable.

BACKGROUND (All information useable)

References:

A: Commission paper on the Economic and Social Situation in the Community (COM (80) 145)

3. In real terms, oil price increases since 1978 are roughly as big as those in 1973-74. The oil markets remain in some disarray, but spot prices have fallen back a lot and stocks are now relatively high. Supply disruption cannot be ruled out, but, on the basis that the market stays broadly in balance, the latest Treasury World Economic Prospects exercise assumes an average offical price in 1980 of just under $30 a barrel.

4. Activity in the OECD area is expected to weaken substantially this year, though by rather less than once thought likely. GNP growth could average 1 to 1½ per cent compared with over 3 per cent in 1979. The recent US measures increase the possibility of the downturn stretching into 1981. Community growth held up quite well last year and should be higher this year than in the OECD as a whole, averaging more than 1½ per cent. But this implies growth in Germany and Italy around 2½ per cent lower in 1980 than in 1979, and in France around 1½ per cent lower. Output could fall in Denmark, where,like some other

smaller EC countries, policy may have to be tightened further in the face of growing current account deficits or problems over financing borrowing requirements.

5. The average <u>inflation rate</u> in the major economies has accelerated into double figures for the first time since 1975, and could be around 11½ per cent in 1980, compared with 9 per cent last year. The Community rate is expected to be some way above the OECD average, largely because of Italy and the UK. The differential between the lowest OECD inflation rate (Germany) and the highest (Italy) has widened significantly since early 1979, reflecting varying degrees of success in preventing higher oil prices feeding through into prices generally. A number of EC countries have some form of indexation which makes the problem of containment especially difficult. Italy is particularly vulnerable, and a pay freeze is in force in the Netherlands. In general, though, the chances of avoiding a wage - price spiral are better than in 1974-75.

6. <u>Monetary policy</u> 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 have surged as inflationary pressures and expectations have worsened. There may be further increases to come following the latest US measures. Some countries, Germany is one, are trying to avoid currency depreciation to reinforce their counter-inflation policies. <u>Fiscal policy</u> is also generally restrictive, and could become more so, as countries seek to rein in or (in the US) eliminate their budget deficits. There is little scope for any relaxation of policy and only France

and Italy of the major countries have taken measures explicity to offset some of the deflationary impact of higher oil prices.

7. The UK's commitments to lower Government borrowing and the reduction of real public expenditure are essential components of the policy to squeeze out inflation and improve economic performance. Our EC Budget contribution must be cut as part of this effort.

8. The OECD area is now expected to have a current account deficit of some $85 billion in 1980, of which about one-third could fall on Community countries. The OPEC surplus could exceed $115 billion in 1980 and is unlikely to fall back as rapidly as after the first oil shock. Deficits within the industrial countries should be distributed better than in 1974-75: Germany and Japan might share a deficit of around $30 billion and the US deficit could be quite small. Recent German moves to encourage capital inflows and seek balance of payments financing abroad are helpful. Some of the smaller EC countries, notably Denmark, are experiencing severe current account problems.

9. The position of the LDC's will greatly deteriorate. Even if they cut import growth sharply their combined deficit could rise substantially to around $50 billion in 1980. They will need to continue borrowing heavily but market conditions could be less favourable to them.

10. Concern has been expressed about the ability of the <u>international banking system</u> to recycle OPEC surpluses as smoothly as in the mid 1970's. It may be that the concern is exaggerated: the thesis of large scale difficulties in the banking system and the consequent need for major new initiatives or institutions remain uproven. The IMF, though, is currently reviewing the adequacy of its facilities and greater use of its funds seems inevitable. The LDC's should be encouraged to approach the Fund and agree adjustment programmes at an early stage.

HM TREASURY

10 April 1980

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REF A.

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(80) 145 final

Brussels, 20 March 1980

THE ECONOMIC AND SOCIAL SITUATION IN THE COMMUNITY

(Communication from the Commission to the European Council
Brussels, 31 March - 1 April 1980)

COM(80) 145 final

CONFIDENTIAL

1. The following assessment of economic trends and policy was discussed and broadly agreed by the Council of Finance Ministers on 17th March 1980.

Results for 1979. In spite of the new oil shock, the performance of the Community economy in 1979 was in several respects favourable.

2. Gross domestic product (GDP) is now estimated to have grown 3.3% in the Community as a whole. Capacity utilisation in industry increased significantly. Employment grew by 0.9%, the most positive result since 1973. The level of unemployment stabilized in the course of 1979.

3. Money supply growth decelerated notably, from 12.7% in 1978 to 10.6% in 1979, with a large degree of fulfillment of national quantitative objectives. Some progress was also made in efforts to reduce public sector deficits.

4. Intra-Community exchange-rate relations were more stable than in any year since 1972. The average change in the exchange-rates of Member States vis-à-vis the ECU in the year 1979 as a whole was 1.9%, compared to 5.2% in the average of the six preceding years.

5. As regards external exchange-rate relations, the ECU appreciated in 1979 against both the US dollar and the Yen, especially the latter whose value against the ECU declined 30% in the course of 1979, which is matter for preoccupation.

6. The oil price rise in 1979 (of nearly 50% in dollar terms, yearly average) was in part responsible for the deterioration in price performance. After the lowest rise in 1978 in seven years (6.9%), consumer prices rose on average in the Community in 1979 by 9%, with a 12.4% rise in the second half of the year (at an annual rate). All major components of the consumer price index accelerated. There was a renewed tendency for inflation rates to diverge. The standard deviation of consumer price rises nearly doubled over the same period. The greater exchange-rate stability was not, therefore, underpinned by a better convergence of inflation.

7. For 1979 the Community pledged to limit oil consumption to 500 million tons, 5% less than the original forecast and 2 1/2% less than the 1978 outturn. However, this target was not achieved. Gross inland consumption in 1979 is estimated to have reached 523 million tons, 4.6% above the target.

8. Outlook for 1980. The beginning of the new year saw further major oil price rises which may mean an average increase for 1980 of some 60% (in dollar terms). This has been taken into account in revised economic forecasts prepared by the Commission services, which now suggest 1.2% growth for the year as a whole.

9. While the oil price rises are a major set-back, the impact on the business cycle is far from clear. The latest recorded output figures still show a firmly rising trend. Leading indicators (notably business surveys) suggest a turning-point for the Community as a whole, but the range between Member States is wide.

10. The prospects for employment have worsened with unemployment expected to increase from an average 5.6% in 1979 to 6.4% in 1980 for the Community as a whole.

11. The outlook for inflation is worse. The forecast for 1980 has been revised upwards 2 points to 11.3% for the Community as a whole and a further divergence of performance between Member States is expected.

12. The balance of payments current accounts have also suffered from the oil price rise, with the Community's total deficit for 1980 now revised upwards from 4 to 14 billion ECU. The financing of these deficits should not pose major problems for the four larger Member States: Germany in particular is expected to account for half of the Community total. However, some of the smaller Member States are now facing overriding balance of payments constraints.

13. Policy for the period ahead. In December of last year the Council agreed, in adopting its Annual Report, that priority had to be given in 1980 to alleviating the inflation and energy constraints, and to proceeding with other more widespread improvements in economic structures in many Member States.

14. The economic situation has since evolved (as outlined above). But the changes amount, on the other hand, to higher inflation, unemployment, a still more acute energy constraint, and worse balance of payments situations; and, on the other hand, stronger recent trends in real output and greater uncertainty in this respect for 1980 and the trends that may lead into 1981.

15. In this situation the Commission judges that it is not appropriate to change the basic stance of macroeconomic policy in the Community. Certain objectives of economic and social policy have to be implemented with even greater urgency and force. This concerns notably:

16. Energy Policy (in all Member States and at the Community level). Efforts to produce alternative supplies and economise in consumption have to be increased.

17. Employment Policy. Policies to counter the worsening of the employment situation should be strengthened. Such policies should aim to facilitate the adaptation of economic and social structures by complementary measures in the labour market, training and certain forms of work-sharing.

18. Budgetary Policy. In many Member States severe public finance policies have to be pursued as an unconditional necessity, so as to reduce the strain of deficits on the non-inflationary financing of the economy, and to improve resource allocation in favour of productive investment (this applies notably to Denmark, Ireland, Italy, the Netherlands, Belgium and the United Kingdom). In these cases there is little or no room, for the time being, for counter-cyclical flexibility in budget policy.

19. Monetary Policy. The maintenance or reassertion of firm control over the monetary aggregates in the recent conditions of rising inflation has naturally led to higher nominal interest rates. However, for the Community as a whole this has only just enabled real short-term rates to become positive again at the end of 1979, while long-term rates remain on average slightly negative. In general, a significant easing of interest rates can only be expected when inflation trends are seen to be improving, which is not yet the case. However, the trend in interest rates should be carefully controlled so as to avoid an unduly severe impact on economic activity.

20. Incomes. The oil price levy on household incomes has been further, inescapably increased. While governments may alleviate the impact on the poorest and hardest-hit parts of the population, there can be no alternative for the population as a whole to accepting the loss of real income to oil producers so long as oil consumption habits are not changed.

21. Balance of payments. Member States in basically sound economic situations (for example Germany) should accept for the time being deficits on current account. Some Member States in the most exposed situation (for example Denmark and Ireland) have urgently to reduce their deficits, especially through budget policy and income adjustments (the recent Irish budget is an example).

22. Financing problems could arise for non-oil producing developing countries. The Community should be prepared to support international efforts to assure sound and adequate financial recycling facilities.

Table : The Community economy 1978-80

	1978	1979	1980		1978	1979	1980
	GDP volume, % change				private consumption deflator,% change		
DK	0.9	3.1	- 0.3		9.4	9.5	12.5
D	3.2	4.4	2.1		2.6	4.1	5.0
F	3.3	3.4	2.1		8.8	10.5	12.1
IRL	6.1	3.2	1.4		7.9	13.2	15.5
I	2.6	4.9	2.0		12.7	15.0	17.1
NL	2.4	2.3	1.0		4.4	4.7	6.8
B	2.6	3.0	1.9		4.5	4.5	6.9
L	4.5	2.7	1.8		3.5	4.5	6.5
UK	3.3	0.2	- 2.5		8.4	13.2	18.9
EC	3.0	3.3	1.2		6.9	9.0	11.3
	unemployment rate, % civilian working population				balance of payments current account, billion ECU		
DK	6.6	5.3	7.0		- 1.2	- 2.1	- 2.3
D	3.9	3.4	3.5		7.4	- 2.7	- 6.9
F	5.3	6.1	6.9		2.9	1.7	- 0.1
IRL	8.7	7.9	7.8		- 0.3	- 1.1	- 1.3
I	7.1	7.6	8.5		4.9	4.6	1.2
NL	4.2	4.3	4.5		- 0.7	- 0.7	- 0.9
B	8.3	8.7	9.2		- 1.2	- 1.6	- 2.2
L	0.7	0.7	0.9		0.4	0.4	0.4
UK	5.7	5.3	6.8		1.0	- 3.8	- 2.3
EC	5.5	5.6	6.4		13.4	- 5.1	-14.2
	public finance : general government deficit, % of GDP				money supply, % change		
DK	- 0.9	- 1.3	- 1.2	(M2)	6.7	9.9	9.0
D	- 2.8	- 3.0	- 2.6	(M3)	11.0	6.0	6.0
F	- 2.3	- 1.4	- 1.8	(M2)	12.2	13.5	12.0
IRL	-10.5	-13.2	-11.2	(M3)	28.7	19.0	13.0
I	-10.6	-10.5	-11.5	(M2)	22.8	20.0	20.0
NL	- 2.2	- 3.0	- 2.7	(M2)	4.2	6.0	8.0
B	- 6.0	- 6.8	- 7.5	(M2H)	9.5	6.5	6.5
L	3.3	2.7	1.2		:	:	:
UK	- 4,2	- 3.5	- 3.4	£M3	13.3	11.7	11.5
EC	- 4.0	- 3.9	- 4.0		12.7	10.7	10.4

Source: Commission services, based on information available up to 27th February 1980.
Data for Ireland do not take into account the budget announced on 28th February.