II

(Acts whose publication is not obligatory)

COUNCIL

COUNCIL DECISION

of 19 December 1984

adopting the annual report on the economic situation in the Community

(85/105/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Decision 74/120/EEC of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community (1), as amended by Decision 75/787/EEC (2), and in particular Article 4 thereof,

Having regard to the proposal from the Commission,

Having regard to the consultation procedure of the European Parliament which was completed on 10 December 1984,

Having regard to the opinion of the Economic and Social Committee (3),

Having regard to the conclusions of the European Council at Dublin on 3 and 4 December 1984,

HAS ADOPTED THIS DECISION:

Article 1

The Council hereby adopts the annual report on the economic situation in the Community attached hereto.

Article 2

This Decision is addressed to the Member States.

Done at Brussels, 19 December 1984.

For the Council

The President

J. BRUTON

(1) OJ No L 63, 5. 3. 1974, p. 16.
(2) OJ No L 330, 24. 12. 1975, p. 52.
(3) OJ No C 25, 28. 1. 1985, p. 39.

ANNUAL ECONOMIC REPORT 1984/85

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ANNEX

PART I

THE COMMUNITY ECONOMY

1. Introduction: The dominant problem of unemployment

This annual economic report of 1984/85, has as its principal theme the need to achieve a substantial and durable growth of employment in the Community, and therefore one consistent with stabilization objectives.

In fact, important progress has been made in stabilization policies and monetary convergence. These gains have to be consolidated and in some countries the extent of progress is still insufficient. A recovery in economic activity has begun. On the other hand no significant progress has yet been made in increasing employment or reducing unemployment in the Community as a whole.

The Council feels that the conditions are now particularly appropriate for intensifying a collective effort to turn employment trends in a far more positive direction.

TABLE 1

Main economic aggregates 1961 to 1984, EC total, 1961 to 1985

	GDP, current prices (4)	GDP, real terms (4)	GDP deflator (4)	Private consumption deflator (4)	Compensation per employee (4)	Current account of balance of payments	General government net lending or borrowing	Money supply M 2/3 (5)	Unemployment (% of labour force)	Employment
	% change					% of GDP		% change	%	% change
1961 to 1970	9,1	4,7	4,3	3,8	8,9	0,4	−0,4	10,4	2,1	0,2
1971 to 1980	13,0	2,9	9,8	9,7	13,3	−0,1	−2,8	13,8	4,2	0,2
1981	8,7	−0,4	9,2	10,1	11,6	−0,6	−5,4	10,8	7,8	−1,6
1982	9,5	0,6	9,0	8,8	8,7	−0,5	−5,6	10,8	9,4	−1,3
1983	7,4	0,9	6,4	6,2	7,7	0,0	−5,4	10,0	10,6	−0,7
1984	(6,6)	1,5	(4,9)	5,6	6,0	−0,0	−4,7	7,8	10,9	−0,2
Last report (1)	6,9	2,2	4,7	5,1	6,0	−0,0	−5,3	8,0	11,0	−0,0
This report (2)	6,5	2,3	4,1	4,2	5,5	0,4	−4,8	7,2	11,5	0,0
1985 (3)										

(1) Of October 1983. Figures in brackets from the last annual report are revised as a result of change in statistical weighting methods.
(2) Estimates of the Commission services, October 1984.
(3) Forecast of the Commission services, October 1984, on the basis of present policies.
(4) EC average calculated with current GDP weights at purchasing power parities.
(5) End of year (annual growth rate).

Note: Percentage changes are given as annual rates.

2. Assessment of cyclical and structural trends in the Community economy

2.1 *Developments in 1984 and the outlook for 1985*

The Council expects for 1984 a growth rate of GDP of the order of 2,2 % and for 1985 of 2,3 %. By comparison, growth was only 0,6 % in 1982 and 0,9 % in 1983. After a mediocre performance during the years 1981 to 1983, during which GDP growth in the Community cumulatively totalled as little as 1 %, it is thus confirmed that the Community economy is engaged on a course of recovery; this is, however, only gradual and remains subject to uncertainty and is clearly insufficient to bring down unemployment significantly.

Trends in 1984. While the United States economy has been booming since the second quarter of 1983, the Community economy as a whole began to show signs of

stronger growth only in the last quarter of 1983. In early 1984 there were signs of a strengthening European recovery, but this was interrupted in the second quarter by the strike of metal-workers in the Federal Republic of Germany which temporarily caused serious losses of production. In the United Kingdom the strike in the coal-mining sector may also have dampened business optimism, although direct losses to output have been less.

The substantial drop in industrial production in the second quarter of 1984 (– 5,7 % at an annual rate) was thus primarily due to Germany, but with some fall also in the UK and in France.

TABLE 2

Output: % increases at seasonally adjusted annual rates

	1983		1984	
	Year	Q4	Q1	Q2
Gross domestic product				
— European Community	0,9	4,1	3,8	– 3,9
— United States	3,3	5,9	10,1	7,1
— Japan	2,9	3,1	7,6	6,7
Industrial production				
— European Community	2,0	6,6	3,1	– 5,7
— United States	7,8	9,9	11,7	8,3
— Japan	3,7	10,0	13,4	11,7

Under the influence of the industrial disputes mentioned, business surveys were also reporting in the middle of 1984 a weakening in the production expectations of enterprises. However, order-book levels were reported as continuing their gradual improvement in the EC as a whole.

After the metal-workers' strike was settled in Germany in late June there was an immediate recovery of business confidence there. In July industrial production recovered 14 percentage points to a level a little above that recorded at the beginning of the year. There is now evidence of overtime working in enterprises seeking to make up lost output. In the United Kingdom, on the other hand, the weakening of business confidence, associated with the miners' strike, has not been reversed.

In 1984 real domestic demand is estimated to increase slowly by 2,0 % compared to exports (6,4 %) and imports (5,9 %). GDP should increase by 2,2 %. In this context the increase in United States imports in 1983 and 1984 may be estimated to have contributed about 0,3 % to the growth of Community GDP in both years.

Among domestic demand items, both private and public consumption are likely to grow only very modestly in 1984 (1,2 % and 0,6 % respectively). However, capital formation has developed more strongly. The main growth has been in private industrial investment (as analyzed in more detail below), whereas public investment and residential construction remained rather weak.

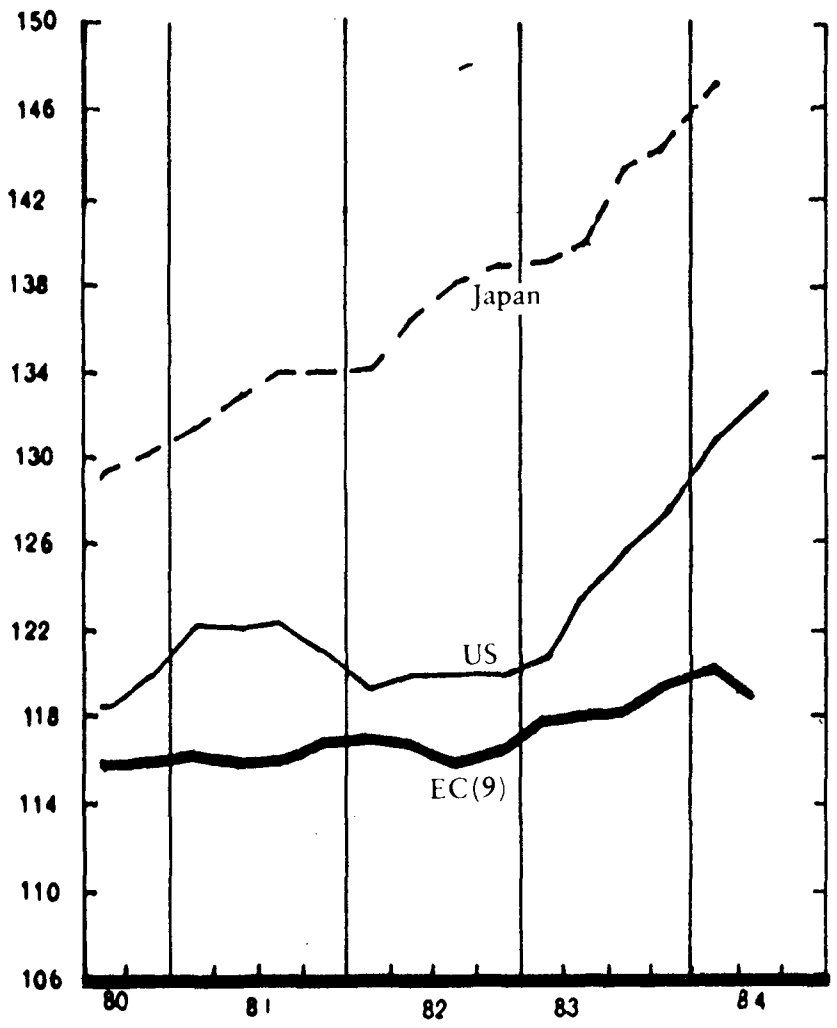
Inflation continued to slow down during the first three quarters of 1984, and for the year as a whole the rise in prices (GDP deflator) should average 4,7 % compared with 6,4 % in 1983. The rate was 10 % on average during the period 1972 to 1981. The Community's progress in disinflation is analyzed in more detail below. On the other hand, unemployment increased again in 1984 and, on average for the year, unemployment is likely to be 11 % of the labour force compared to 10,4 % in 1983 and 9,5 % in 1982; in 1981 the level was still only 6,1 %. The problem of unemployment is also analyzed in more depth later in this report.

GRAPHS 1 to 4

Comparative evolution of the EC, US and Japanese economies, 1980 to 1984

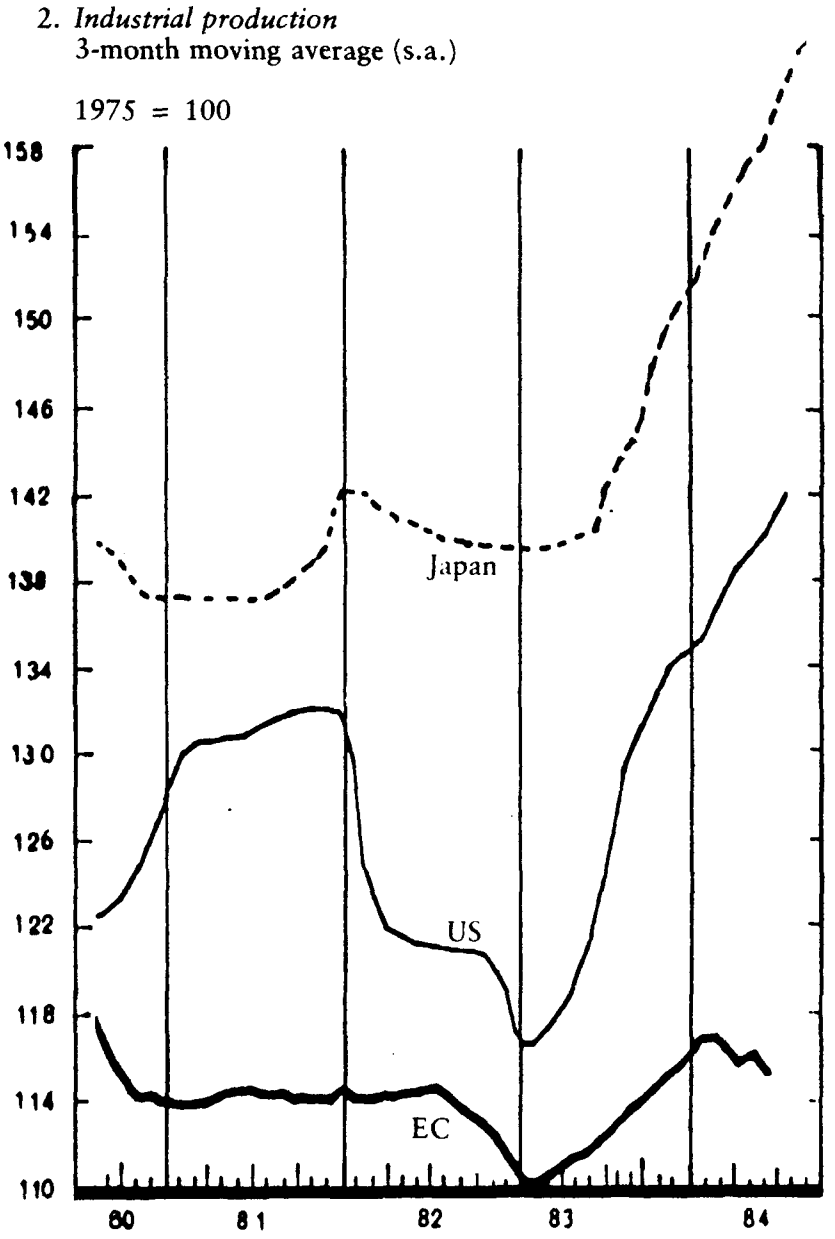
1. *Gross domestic product (s.a.)*

1975 = 100

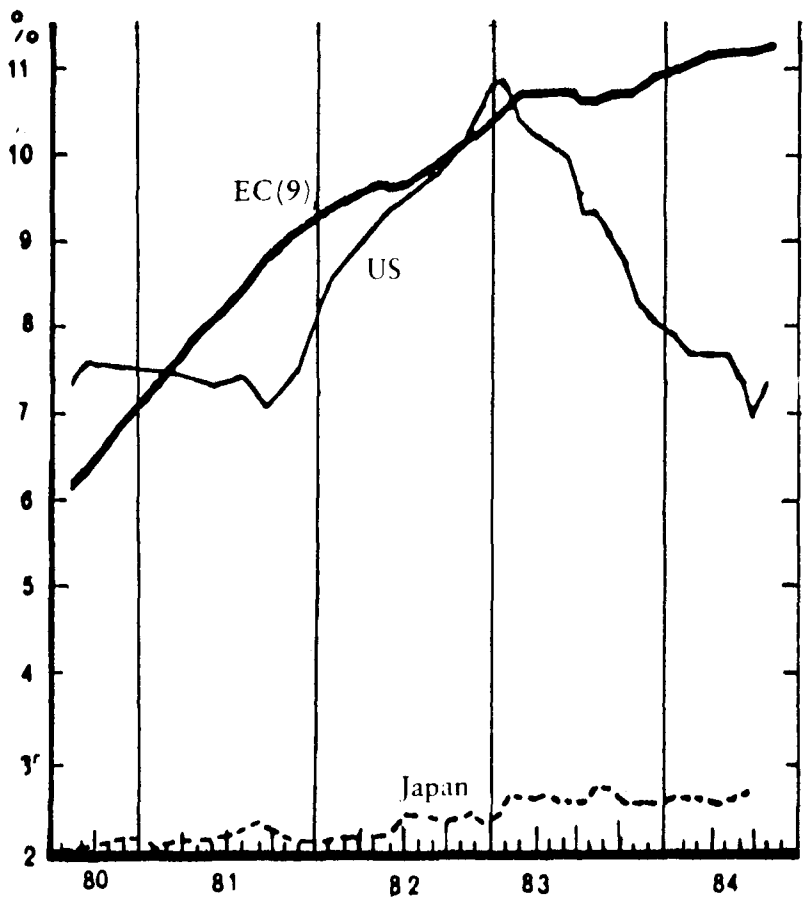


2. *Industrial production*
3-month moving average (s.a.)

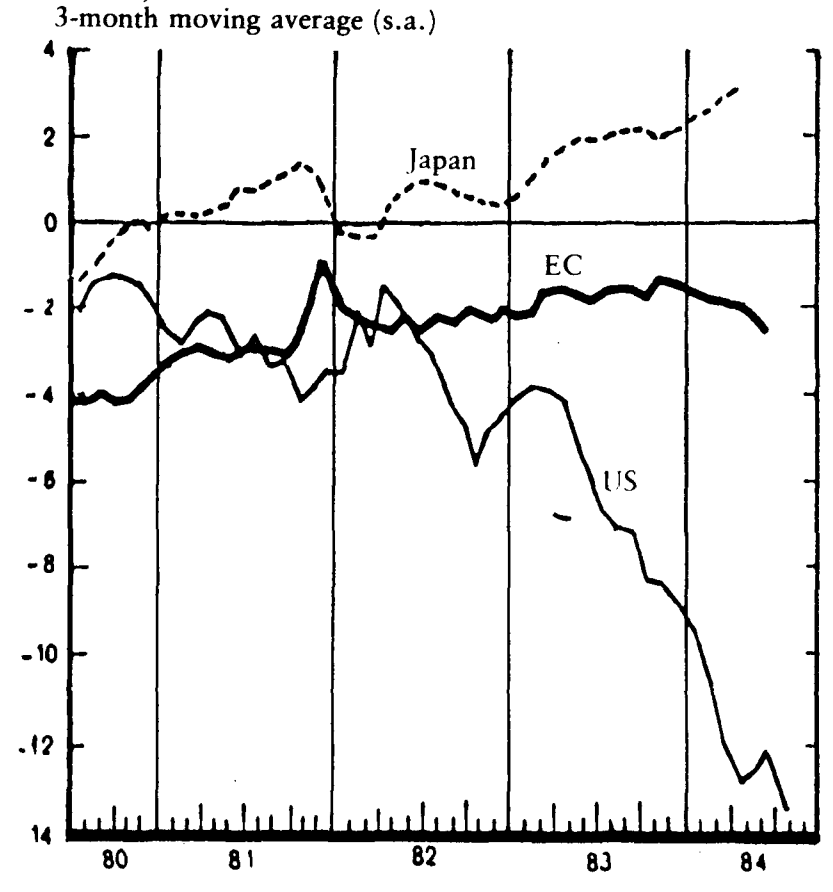
1975 = 100



3. *Unemployment rate*



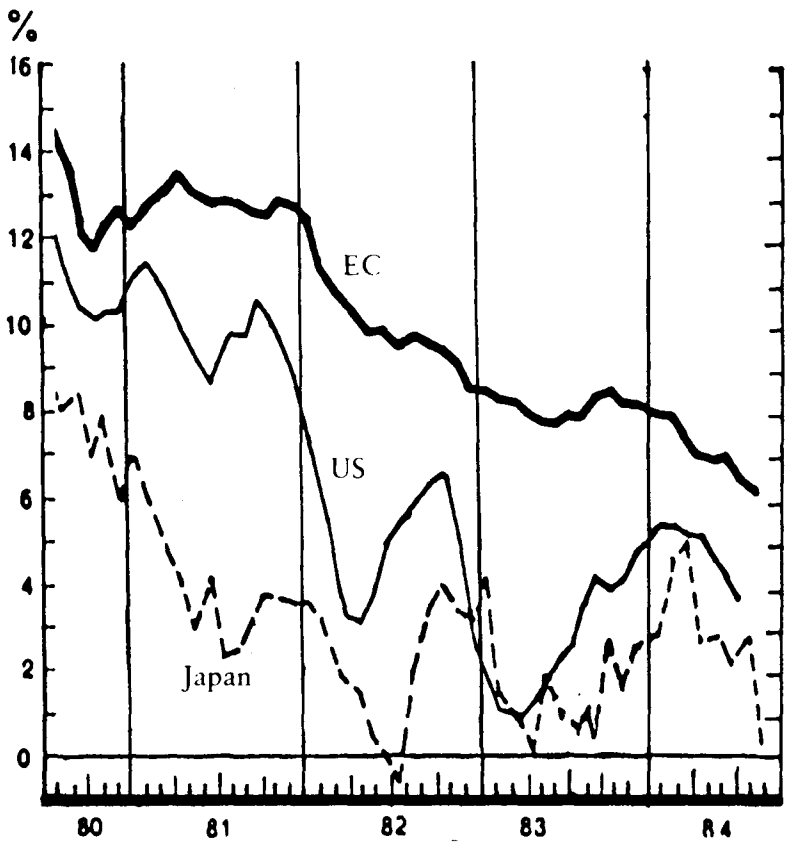
4. *Trade balance*
fob/cif, '000 million ECU
3-month moving average (s.a.)



GRAPHS 5 to 8

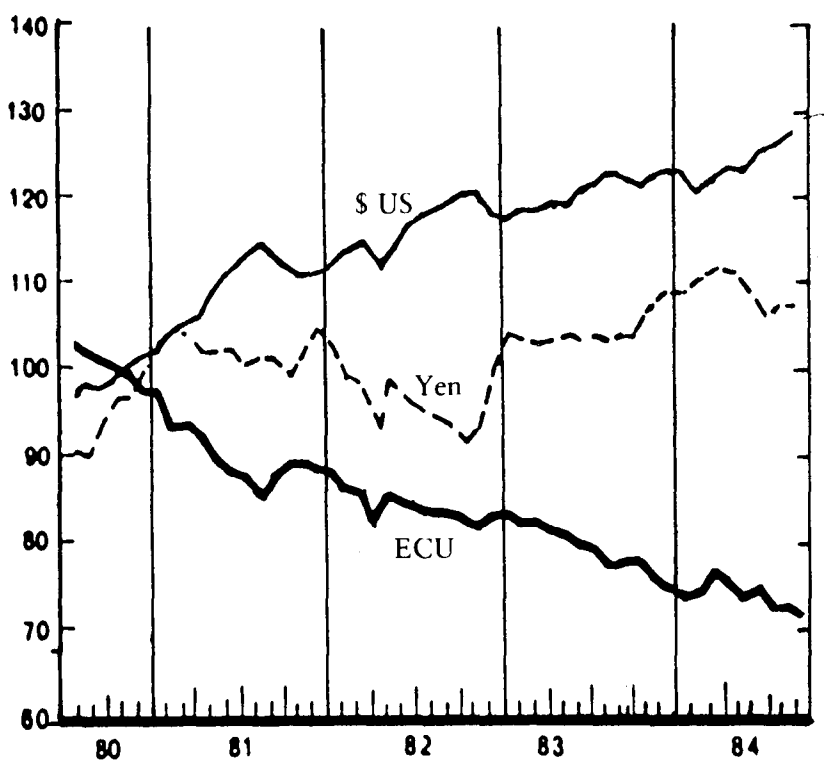
Comparative evolution of the EC, US and Japanese economies, 1980 to 1984

5. *Consumer prices*
6-month change, s.a., annual rates

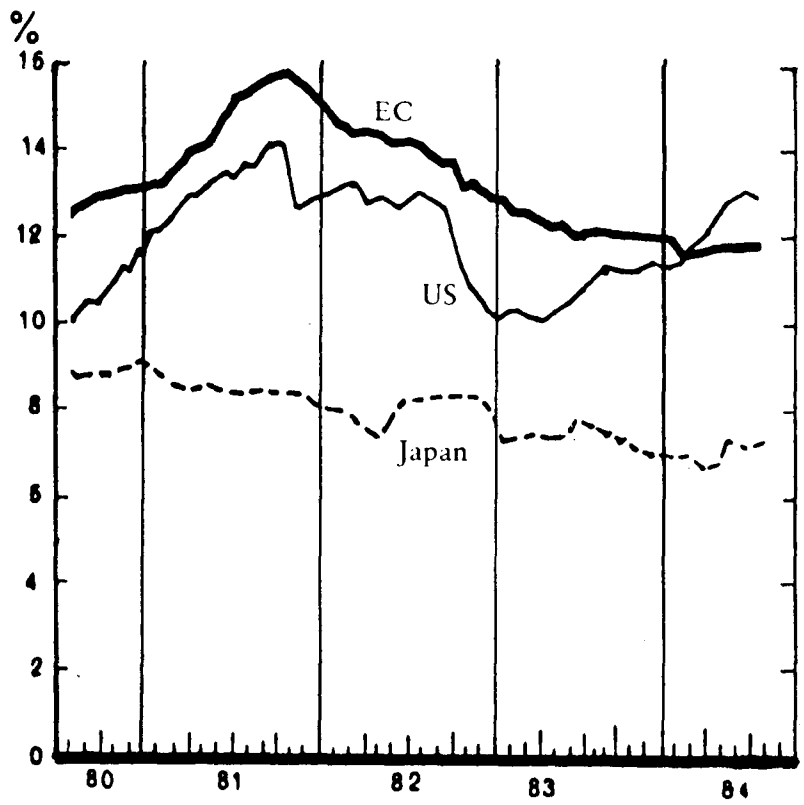


6. *Exchange rates*
Index of SDRs per currency unit

March 1979 = 100



7. *Long-term interest rates*



8. *Short-term interest rates*

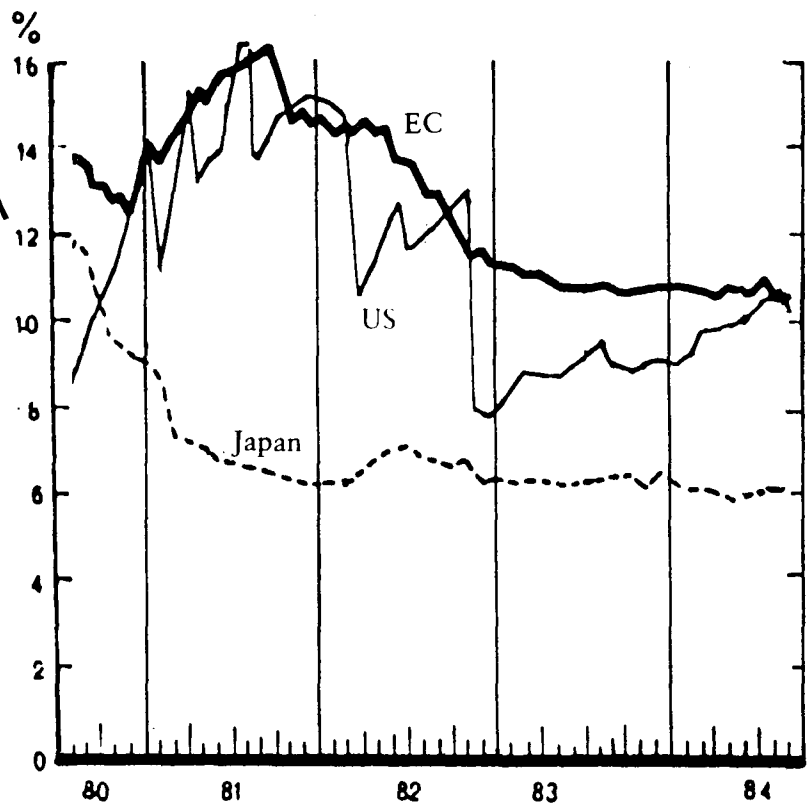


TABLE 3

Forecast increase in gross domestic product in 1984 and 1985, %

	1984			1985		
	Nominal GDP	GDP output volume	GDP price deflator	Nominal GDP	GDP output volume	GDP price deflator
Belgium	7,1	1,5	5,5	6,4	1,0	5,3
Denmark	9,5	3,8	5,5	7,6	2,9	4,5
Germany	4,4	2,4	1,9	4,7	2,5	2,1
Greece	20,9	2,2	18,3	20,0	2,0	17,7
France	9,0	1,4	7,5	7,7	1,7	5,9
Ireland	10,9	3,1	7,6	8,5	2,6	5,8
Italy	13,3	2,9	10,2	10,0	2,3	7,5
Luxembourg	9,0	2,0	6,8	8,2	1,9	6,2
Netherlands	4,6	2,0	2,5	2,8	1,8	1,0
United Kingdom	6,2	2,0	4,1	8,5	3,0	5,4
EC	6,9	2,2	4,7	6,5	2,3	4,1

Source: Commission services.

Prospects for 1985. The forecasts recently prepared (see Table 3) indicate for 1985 only a gradual change in the pattern and volume of growth. They may be summarized as follows: the GDP of the Community should grow by about 2,3 %, while further progress will be made in reducing inflation (to 4,1 %). Unemployment is likely to increase again at the level of the Community as a whole, reaching an annual average 11,5 % of the labour force.

These trends would result from the following developments:

— The growth of domestic demand would strengthen a little (1,8 %), largely due to private consumption and private investment, the increase in public consumption being limited to about 0,4 %. In most countries, budget deficits announced for 1985 will be lower than in 1984 and are likely to average 4,5 % of GDP, compared with 5,3 % in 1984.

— The growth rate of world trade is expected to be 5,2 % in 1985, which would be a positive result, but less than the remarkable 9,4 % now expected for 1984. The Community's external trade flows should grow slightly less strongly in 1985 (exports + 5,5 %; imports + 4,1 %). The contribution of the United States and Japan to the growth of world imports should still be substantially positive in 1985 (imports increasing 8,3 % in the first case and 6 % in the second) but nonetheless significantly below that recorded in 1984.

TABLE 4

World imports of goods, % increase in volume

	1981	1982	1983	1984	1985
European Community	- 2,9	2,4	2,3	6,5	4,4
United States	2,5	- 5,0	11,4	30,4	8,3
Japan	- 2,2	- 0,5	0,1	9,0	6,0
OPEC	27,4	5,5	- 8,2	- 3,0	2,5
Other developing countries	4,3	- 6,1	- 0,7	5,7	5,9
World	1,8	- 1,0	1,9	9,3	5,2

Source: Commission services.

— There is considerable uncertainty about the US economy in 1985, and especially about the exchange rate and interest rates. Forecasts of these financial variables are less robust than in the past, making it difficult to assess the speed and timepath of US growth next year. Given the present level of the dollar and the size of the US current account deficit, there is a greater possibility of a rapid turn-around in

exchange-rate trends. There must also be uncertainty about the reactions of the US monetary authorities if events indeed took such a course. The fact that US budgetary policy in 1985 depends at this stage on an unknown political factor adds to the uncertainty. The arbitrary element in the assumptions on which the forecasts for 1985 are based is thus inevitably larger than usual.

The path assumed for the US economy includes volume growth in 1985 of around 3 % on average for the year, against 7 % in 1984. This corresponds with a rate of 2 % between the fourth quarter of 1984 and the fourth quarter of 1985. This forecast is towards the bottom of the rather wide range given by various official forecasts. Interest rates would, in this forecast, remain at an average level close to that for 1984 mainly as a result of the persistence of a high Federal budget deficit and strong private-sector demand for credit. This should lead to a slight increase during the course of the year in the interest rate differential between Europe and the United States. For the exchange rate, the working assumption is that the dollar will depreciate with respect to its record level reached in the autumn of 1984, but will on average in 1985 remain slightly higher than its average level for 1984.

First indications of possible developments in 1986. The above discussion underlines the difficulty of sketching the likely movement of the economy in 1986. Nonetheless, it is already clear that much will be critically dependent on two factors:

— the first concerns the capacity of the European economies to sustain, and with sufficient speed, the present economic recovery without putting at risk stabilization and adjustment policies which are now well under way,

— the second concerns the international environment. To what extent could the effects of a progressive slowdown in the growth of the US economy be offset by appropriately timed developments in the European, Japanese and developing economies so as to prevent a new slowdown of world trade?

One simple illustration gives an idea of the potential impact of possible developments in the US. For example, a mechanical calculation suggests that a reduction of US imports to the tune of 1 % of US GDP (around $US 35 billion) would directly produce a fall of the order of $US 12 billion in Community exports. Taking account of induced dynamic effects, the overall result could be a contraction of around 0,3 % in Community GDP.

It is thus apparent that, more than ever, the prospects for 1985 and 1986 require particular attention to be paid to problems of coherence and coordination of economic policy at international level. This is particularly true of interactions between the economic policies pursued in the United States, Europe and Japan. In assessing this requirement, it should be borne in mind that in recent years, while monetary policy coordination within the Community has been strengthened such a coordination effort at international level has proved particularly difficult, except as regards the debt problem.

2.2 *Better convergence of economic performance in the Community*

Progress has been made in the battle against inflation in 1984, and a further favourable outturn is expected for 1985. Compared to the peak rate of inflation after the second oil shock, when consumer prices rose 11 % in 1980, the average Community rate has been reduced by more than half to an estimated 5 % in 1984 on the latest estimates. This performance has to be seen in the light of the effects of movements in the value of the dollar:

— immediately, the dollar's overvaluation implies that the process of disinflation in the Community is even more marked than it appears, probably to the extent of two percentage points,

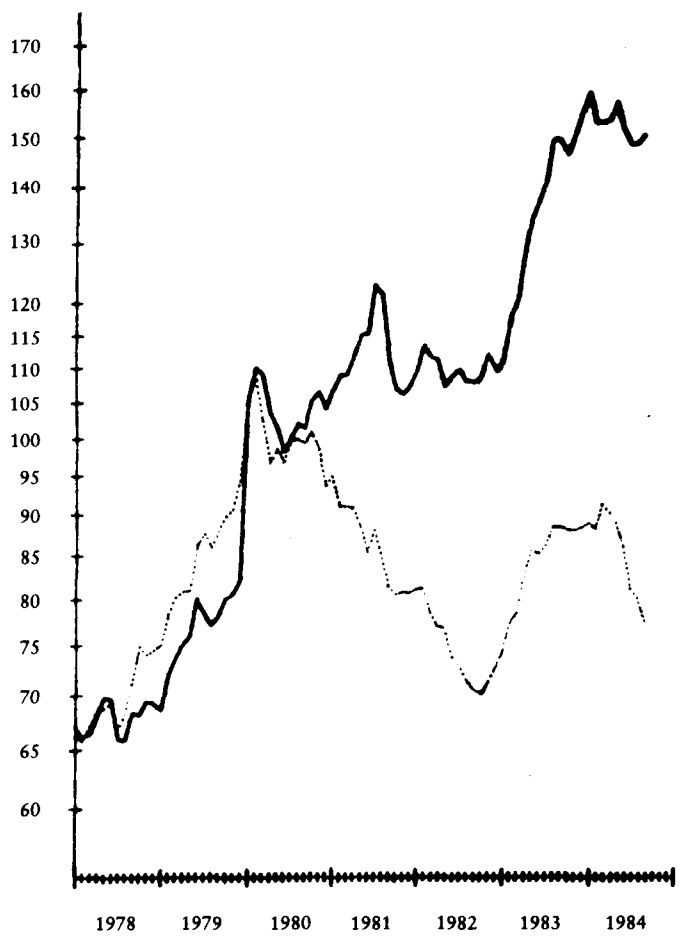
— this immediately ensuing effect is, however, reduced by developments which have, in part, been brought about by the high value of the dollar. Thus raw material prices have been weaker in dollar terms than would otherwise have been the case (see Table 5 for commodity prices expressed in dollar and ECU terms). In particular the price of petrol, expressed in dollars, fell repeatedly in 1982, 1983 and 1984, and OPEC's share in world supply has fallen from 65 % in 1973 to 45 % in 1984. This means that an increasing share of oil production is being marketed under competitive conditions. The dollar prices of non-oil primary products and basic materials, which fell in 1981 and 1982, were stable in 1983 but have risen again in 1984. However, the precise interaction between commodity prices and exchange rate movements is still a subject of considerable uncertainty.

GRAPH 9

Commodity prices

Non-oil commodity index
All items (1980 = 100)

..... $ US index
——— ECU index



Oil prices
(1980 = 100)

..... Spot price $ US
——— EC import price $ US
——— EC import price ECU

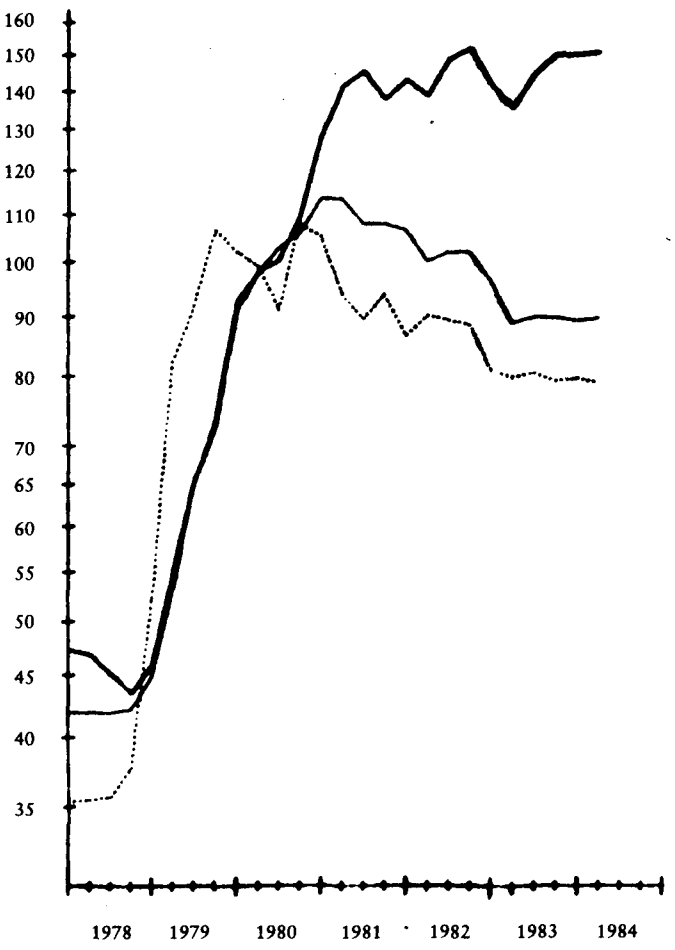


TABLE 5

World prices of primary products in $US and ECU

(% change)

	1980	1981	1982	1983	1984	1985
Oil price in dollars	73,1	10,3	- 4,3	-11,6	-4,7	0,0
in ECU	71,1	37,7	8,8	- 2,5	7,2	3,4
Other primary commodity prices						
in dollars	12,5	-10,1	-10,7	0,5	0,9	2,0
in ECU	10,8	12,2	1,6	10,9	13,2	5,5

Source: Commission services.

Within the Community, the limited overall improvement in price stabilization is associated with a more convergent country-by-country performance. This is shown (Table 6) by comparing the slowdown of prices between 1980 and 1984, a development which could continue into 1985. Five Member States (France, United Kingdom, Ireland, Italy and Greece) recorded inflation rates substantially above 10 % in 1980; four of these even recorded rates significantly above 15 %. In 1984, three of these countries (France, United Kingdom, Ireland) had brought their inflation down to below 10 %, the United Kingdom even achieving a rate of around 5 %, while Italy's inflation rate was just above 11 %. Over the same period, inflation was also decelerating in the other Member States: in 1980, the rate varied between 5,4 and 9,8 % in a group made up of the Federal Republic of Germany, the Netherlands, Belgium, Luxembourg and Denmark, while in 1984 it was within a range of 2,3 to 6,7 % for these countries. In other words, while the average inflation rate in the Community in 1980 was 11 % with a standard deviation of 5,9, in 1984 the average rate had fallen to around 5 %, with a standard deviation of 4,3. This increased convergence of inflation rates is associated in part with the functioning of the EMS, in that several countries (France, Italy, Denmark, Belgium) have linked their stabilization strategies to the pursuit of stable exchange rates. By contrast, the first oil price shock was followed by less convergent policies which led to several countries leaving the 'Snake' exchange rate system then in operation. The result was a shorter and shallower stabilization process than the one which is at present under way.

TABLE 6

Deceleration and convergence in inflation (private consumption deflator)

	1980	Estimate 1984	Deceleration 1980 to 1984	Forecast 1985
	% changes		% points	% changes
Germany	5,4	2,3	- 3,1	2,2
Netherlands	6,7	3,2	- 3,5	2,3
Belgium	7,0	6,4	- 1,5	5,5
Luxembourg	7,7	6,7	- 1,0	5,5
Denmark	9,8	6,0	- 3,8	4,3
France	13,1	7,6	- 5,5	5,7
United Kingdom	16,8	5,1	-11,7	5,6
Ireland	18,6	8,8	- 9,6	7,0
Italy	20,3	10,3	- 9,6	7,1
Greece	22,1	18,5	- 3,6	18,0
European Community	11,1	5,1	- 6,0	4,2
(Standard deviation)	(5,9)	(4,3)	—	(4,2)
United States	10,3	3,4	- 6,9	3,6

The past year has also seen better current account convergence within the Community. This improved convergence within the Community is another consequence of the policy choices which have brought down inflation.

The present phase of balance of payments adjustments began in 1982, at a time when the second oil price increase had been practically absorbed and even before the US deficit had begun to grow massively (see Table 7). At that time, Italy, France, Belgium, Greece, Denmark and Ireland all had excessive current account deficits. In most of these countries, corrective action took the form both of moderation of incomes and domestic demand and of moderate exchange rate adjustments within the EMS. By the beginning of 1984, all these countries except Greece had very much reduced or eliminated their current account deficits. The improvement in the current accounts averaged nearly 2 % of gross domestic product, with an adjustment of more than three times as much in Ireland.

At the same time, the United Kingdom's current account surplus declined by about 2 % of GDP. Finally, the German current account surplus continued to increase. In 1982 to 1984 this was mainly a result of the progressive build-up of a surplus with the United States (by an amount equivalent to 0,65 % of German GDP), while German trade with the rest of the Community moved favourably for the other Member States (Germany's current account with the rest of the Community deteriorating by 0,36 % of Germany's GDP).

The improvement in the Community's aggregate current balance, amounting to $US 13 billion between 1982 and 1984, can been seen (Table 7) in the context of an improvement of $US 27 billion in Japan's current balance over the same period, and one of $US 30 billion for the non-oil developing countries as a group. By contrast, the US balance of payments worsened by $US 83 billion between 1982 and 1984 (1). Though the Community countries have, through a recovery of their exports, benefited from trends in the US economy, the negative effects of the rise in US interest rates and the dollar's exchange rate place a question mark against the sustainability of the present pattern of current account imbalances as between the United States, the Community and Japan. Capital outflows to the United States are less worrying for Japan, with its abundant supply of savings, than for the Community. For the indebted developing countries, on the contrary, such flows are a much more serious problem. Too much asymmetry in economic trends among the principal groups of industrialized countries gives rise to a serious risk of instability.

(1) Assessment of the imbalances is complicated by the existence of a world-wide residual, unexplained deficit of around $US 100 billion.

TABLE 7

Balance of payments current account, % of GDP

	1982	1984	Change 1982 to 1984	
Netherlands	2,8	3,8	+ 1,0	
United Kingdom	2,8	0,2	- 2,6	- 0,8 (1)
Germany	0,6	0,6	+ 0,0	
Italy	- 1,6	- 0,4	+ 1,2	
France	- 3,0	- 1,2	+ 1,8	
Belgium	- 3,6	- 0,4	+ 3,2	
Greece	- 3,7	- 4,7	- 1,0	+ 1,5 (1)
Denmark	- 4,1	- 2,8	+ 1,3	
Ireland	- 8,3	- 4,4	+ 3,9	
European Community	- 0,5	0,0	+ 0,5	
United States	- 0,3	- 2,5	- 2,2	
Japan	0,7	3,0	+ 2,3	
In US dollars:				
European Community	- 14	- 1	+ 13	
United States	- 11	- 94	- 83	
Japan	7	34	+ 27	
OPEC	- 15	7	+ 22	
Other developing countries	- 64	- 34	+ 30	

(1) Weighted average change of the group of countries.

2.3 *Unemployment in Europe still rising, employment stagnates*

In the EC as a whole the growth of unemployment has slowed down during the last year, but not quite to the point of stopping. In the short-term it seems that the GDP growth rate would have to rise from just over 2 % to about 2,5 % for unemployment even to stabilize. Over the course of the last cycle, from the peak in 1978 to the present time, the total rate of unemployment has doubled from 5,4 to 11,1 %. The Commission's forecasts for 1985 indicate at best a stabilization or slight decline in a few countries (Denmark, Germany, United Kingdom), with some further rises elsewhere.

TABLE 8

Unemployment rates, %

	Belgium	Denmark	Germany	Greece	France	Ireland	Italy	Luxembourg	Netherlands	United Kingdom	European Community (10)
Total, %											
1978	8,1	7,1	3,8	—	5,2	8,4	7,1	0,7	5,4	5,3	5,5
1984	14,4	10,0	8,5	8,4	10,7	16,5	12,5	1,7	14,8	11,6	11,0
1985	14,8	9,9	8,5	8,8	12,6	16,5	12,9	1,8	14,8	11,7	11,5
Young people, %											
1979	14,0	14,7	4,5	—	17,5	18,4	26,2	6,7	11,5	10,5	13,5
1983	30,0	27,9	13,3	—	21,7	—	35,7	—	31,0	25,9	24,5
Long-term unemployed (over one year), % of total unemployed											
1979	38,1	6,8 (1)	22,2	—	19,4	34,6 (1)	35,0	—	28,9	30,4	28,4
1983	49,9	5,6	29,9	—	24,4	40,9	40,2	—	49,4	41,5	38,8

(1) 1980.

The rising unemployment rate has particularly affected those seeking to enter the labour force: young people as they finish their education and women who are seeking to join or rejoin the labour force. For young people below 25 years, the rates of unemployment by country have risen to a range between 13 % in Germany to as high as 36 % in Italy.

In addition the extent of long-term unemployment (over one year) has increased substantially both in absolute terms and as a share of total unemployment. In 1983 over a third of unemployed persons had been out of work for more than a year.

The Community's performance contrasts with that of the United States where unemployment was cut from 10 to 7 % in the 18 months to July 1984 and may in 1985 return quite close to the 1978 level. This is in sharp contrast to previous history. The unemployment rate in the Community exceeded that of the United States for the first time in 1981 and has remained well above it over the last two years. Japanese figures are not comparable, but overt unemployment there has been kept at a low level (under 3 %).

Since 1973 the employment record of the US, Japan and a number of other OECD countries has been markedly better than that of the Community where total employment has been more or less stagnant over the last two decades. Differences in growth performance do not adequately explain these divergent employment trends. The EC and the US have shared a similar long-run growth rate during the last two decades of about 3 %, but the employment record was quite different. The US and Japan have had more similar employment records, but Japan's growth rate over the last two decades was over twice as high.

TABLE 9

Unemployment rate, %

	European Community	United States
1978	5,5	6,0
1979	5,5	5,8
1980	6,1	7,1
1981	7,8	7,6
1982	9,4	9,7
1983	10,6	9,6
1984	11,0	7,5
1985	11,5	7,1

Comparisons of total numbers in employment, however, should be set alongside other comparisons which reflect changes in the population of working age and changes in the proportion of the population of working age who wish to work. Table 10 shows the extent to which the rate of increase in the population of working age was higher in the United States and Japan than in the Community. It shows also that in the case of the United States there was a rapid increase in the participation rate.

TABLE 10

Employment and labour force growth

		European Community	United States	Japan
		millions of persons		
Employment growth change 1960 to 1982		3,4	33,7	12,0
Employment growth 1982 to 1984		- 0,8	4,4	1,6
Population of working age 1960 to 1982		22,3	45,9	20,3
		percentage		
Employed working age population ratio	1960	65,8	60,9	74,5
	1982	59,4	64,7	70,6
Participation rate (1)	1960	67,3	66,8	75,8
	1982	65,1	72,7	72,3

(1) Labour force as a percentage of population of working age.

During the present cyclical upswing, taking Commission estimates and forecasts for 1983 to 1985, most countries are expected to suffer losses of employment over the three year period. Positive employment growth is expected only in Italy (+ 0,3 % per annum), United Kingdom (+ 0,6 %) and Denmark (+ 1,0 %).

TABLE 11

Employment growth in the long and short-run, annual % change

	Belgium	Denmark	Germany	Greece	France	Ireland	Italy	Luxembourg	Netherlands	United Kingdom	European Community (10)
1960 to 1982	0,2	0,7	- 0,1	- 0,1	0,4	0,4	0,0	0,8	0,4	- 0,1	0,1
1982 to 1985	- 0,5	1,0	- 0,7	- 0,3	- 1,2	- 0,5	0,3	- 0,5	- 0,8	0,6	- 0,3

The fast demographic expansion of the population of working age experienced so far during the 1980's will start coming to an end in the course of 1985. Since 1980 there has been an annual average growth in the population aged from 15 to 64 of nearly 1 %. From 1986 this will reduce to a low or nil growth rate. Any easing of pressure on the labour market, however, may be at least partly offset by a renewed increase in the labour force participation rate, which has been falling in recent years, no doubt partly because people have been discouraged from trying to obtain employment.

TABLE 12

Demographic growth of population of working age (15 to 64), (EC 10), %

1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
0,8	1,1	0,8	0,9	0,9	0,5	0,2	0,2	0,2	0,1	0,0

Source: Commission and national sources.

Trends in the sectoral composition of employment show similar patterns in most EC countries. Agriculture continues to shed employment, although more slowly than in the past. Industry as a whole has suffered job losses of 1,3 million over the four most recent years for which data are available. Services have expanded employment by 3,3 million over the same period. Within the broad total for industry, only the energy and construction branches have maintained a constant employment level. Manufacturing has seen a decline. Within the service sector, employment increases have been notable in the public sector, a trend which cannot be sustained under present budgetary constraints.

TABLE 13

Employment by economic activity, EC(9), millions of persons

	1977	Change (1)	1981
Agriculture, fishing	7,3	− 0,9	6,4
Industry	40,2	− 1,3	38,9
— energy, water	2,0	—	2,0
— extractive, chemicals	4,9	− 0,3	4,6
— metal manufacturing, engineering	12,4	− 0,4	12,0
— other manufacturing	12,6	− 0,8	11,8
— construction, civil engineering	8,3	+ 0,1	8,4
Services	51,7	+ 3,3	55,0
— distribution	17,1	+ 0,4	17,5
— transport, communications	6,1	—	6,1
— financial, insurance	5,4	+ 0,8	6,2
— public administration	7,0	+ 1,2	8,2
— other services	16,0	+ 0,9	16,9
Total employment	99,7	+ 1,3	101,0

(1) From 1977 to 1981.

Source: Eurostat, Labour Force Sample Surveys.

Note: Total employment includes an item not distributed by sector.

The long-run and cyclical relationships between output and employment vary somewhat between the economies of the Community, the United States and Japan, with Japan showing the lowest rate of employment growth per unit of output growth (i.e. the most rapid improvement in labour productivity), the US the highest and the Community in between. Comparisons of employment performance need to be made cautiously and take into account both the volume of employment (number of jobs multiplied by average hours of work) and the quality of that employment. Long-run employment trends within an economy are influenced of course by the growth rate of output, and also to a considerable extent by the choice of technology, the capital/labour mix (and therefore the relative costs of capital and labour) and hours of work. Policy can also have an influence as can be seen when we consider the effect of taxes and subsidies on factor costs.

In the short run, employers in the Community tend to be slower to take on labour on permanent contract when demand increases and especially so in periods of low profitability. Equally, employers are generally rather reluctant to shed labour if they foresee only temporary demand reductions. This contrasts both with a much higher short-run propensity to hire and fire employees in the US and with the Japanese system where employment in many enterprises involves a long-term commitment by both employers and employees, with fluctuations in the demand for labour being taken up in the secondary, unregulated labour market. For the past decade in the US economy the short-run elasticity of employment with respect to GDP growth has been about 0,75 whereas for the EC the comparable figure is only 0,4.

2.4 *Capacity utilization, the capital-labour mix and relative factor prices*

Recent investment trends in the European Community contain encouraging features, but also give rise to questions.

An encouraging feature is the widespread intention on the part of industrialists in the EC to increase their investment significantly in 1984 compared to 1983. The data in Table 14, obtained from Community business surveys are expressed in nominal, national currency terms. In real terms the EC aggregate figure is estimated to move from – 2 % in 1983 to + 7 % in 1984. This latter increase is the strongest for many years although admittedly from a low level, and is, in particular stronger than the modest investment recovery reported in the last cyclical upturn of 1978/79. Total investment is expected to grow by about 4 % in 1984, as in the 1979 upswing, but private industrial investment is stronger now, and public and residential investment weaker.

TABLE 14

Investment intentions of industrialists, % change in value in relation to preceding year

	Belgium	Denmark	Germany	Greece	France	Ireland	Italy	Luxembourg	Netherlands	United Kingdom	European Community (10)
1983	– 2	19	1	– 36	5	– 1	3	20	5	3	3
1984	15	60	5	23	20	13	11	– 20	29	16	13

Source: EC investments surveys.

The explanation of this upturn in industrial investment appears to lie in a combination of four main factors: the ageing of the capital stock in the Community in recent years leading to technological needs for replacement, improved profit expectations, the easing of liquidity constraints on enterprises and an increase in capacity utilization in many branches of industry. Increases in the gross operating surplus of enterprises are expected to occur in the range of 10 to 14 % in nominal terms in 1984 for the four larger EC economies, which represent a moderate improvement from a low base. Capacity utilization in industry, according to survey data, increased from 76,5 % in the second quarter of 1983 to 81 % in the third quarter of 1984 (1). This compares with high points at recent cyclical peaks of 84 % in 1979 and 86,5 % in 1973. The 1973 figure, in particular, reflected a situation of overheating of the economy.

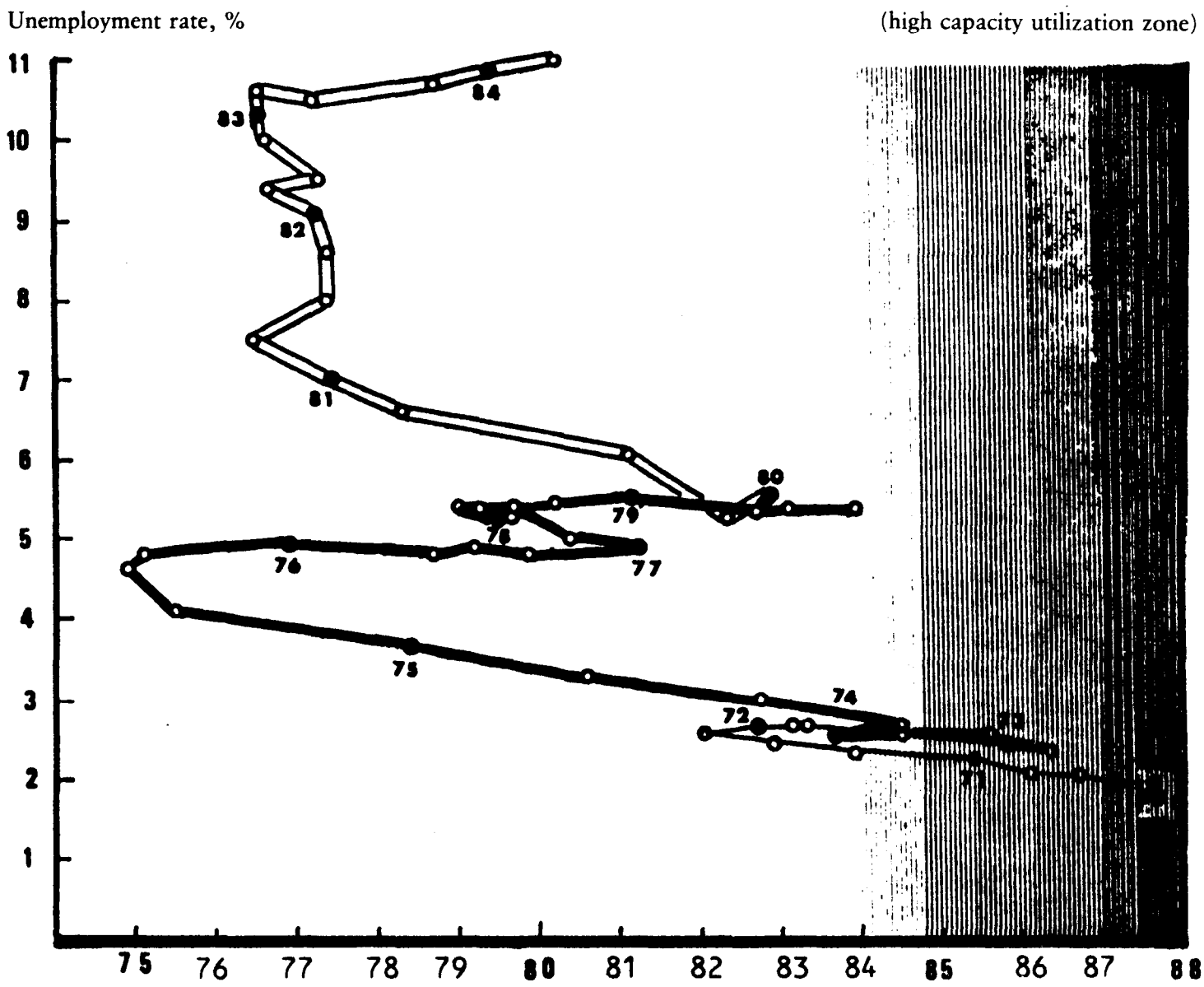
The question raised by these trends resides in the fact that while the recovery remains only a modest one, the rate of capacity utilization in industry has substantially increased and has thus moved towards the current potential level of production without any reduction in unemployment (see graph 10). While private investment has been more quickly responsive to changing demand and profit conditions than some analysts expected, this has so far only slightly raised the very modest trend growth in productive potential of the past decade (1 to 1,5 %). The amount of spare capacity which can be put into profitable production at a given time may vary as a function of factor prices and conditions of work organization. At present, however, this margin appears to be small. (This issue is further discussed in section 3.1.1 below.)

(1) Adjusted for the effects of the strike in Germany.

GRAPH 10

Rates of unemployment and capacity utilization in industry in the EC, 1970 to 1984

——— period prior to the 1973 oil shock
▬▬▬ 1973 to 1979 business cycle, following the first oil shock
═══ 1979 to 1984 business cycle, following the second oil shock



Capacity utilization in industry (1), %

Note: Quarterly observations are shown, with the years ('84') marked against the first quarter.

(1) *Source:* EC business surveys.

As regards other types of investment, residential building remains subdued, and is expected to grow about 2% in 1984 and 1985 after a fall in 1983. High real interest rates, especially when combined with market rigidities such as rent controls, hit residential construction particularly hard. Surveys of order-books and employment expectations among construction enterprises show this sector to remain very depressed.

The gross capital formation of the public sector has also been subdued. Its growth rate in volume terms is estimated to develop as follows for the EC as a whole: 1983 +0,3%, 1984 +1,1%, 1985 +1,1%.

Alongside the stagnation of employment there has been a considerable increase in the capital stock per employed person in the Community; this contrasts with the United States where increases in investment and employment have moved in step. In Japan, however, the rate of increase in the capital stock per employed person has been closer to that in the Community than to the United States. The contrasting trends in the Community and the United States trends have been evident for over two decades. For the period 1973 to 1983 the capital stock per employee increased 3 % per annum in the EC while, according to some estimates, the figures in the United States was close to zero.

Enquiry into the possible causes of this divergence reveals that there was a marked difference, according to some evidence, in the development in real labour costs relative to the rate of return on capital – an increase of 4 % in the Community and near stability in the United States. Japan, like the Community, experienced an unfavourable divergence between the development of real labour costs and that of the rate of return on capital. The impact on investment decisions of the rate of return on existing as well as new capital stock, as compared with that of the cost of new capital, is a complex process. Moreover, there is a considerable margin of statistical error surrounding figures on the capital stock. The fact remains nevertheless that there is evidence of significant capital deepening in Europe (data exists for manufacturing industry, the total economy and business survey results (1)).

Up to 1981 the rate of growth of output per person employed in the Community was faster than in the United States, and a significant part of this increase was brought about by an increase in the capital stock per employed person. The relationship between the recovery of growth of output and that of employment has thus been much less strong in the Community than in the United States. The tendency towards capital deepening in the EC has persisted through the 1981 to 1982 recession. As shown below, the ratio of GDP growth to investment in the Community over the last decade was little more than half that for the United States; but the contrasts are in some degree exaggerated because of the recent differences in the EC and US cyclical situations. Moreover, account should be taken of investment scrapping. An improvement in the efficiency of investment in terms of generating output and employment must be one crucial objective for policies designed to create sufficient output growth to cope with the unemployment situation in the Community.

(1) For detailed studies see *European Economy,* No 20, July 1984.

TABLE 15

Growth of output in relation to the share of investment in GDP, EC and US

	1960 to 1973	1974 to 1984
European Community (10)		
Gross fixed investment as % of GDP	22,8	20,2
Rate of growth of GDP	4,8	1,7
Efficiency of investment (1)	0,21	0,08
United States		
Gross fixed investment as % of GDP	19,4	16,4
Rate of growth of GDP	4,0	2,3
Efficiency of investment (1)	0,21	0,14

(1) Rate of growth of the volume of GDP divided by gross fixed investment as % of GDP.

3. Towards more growth and employment in the European economy

3.1 *Objectives and principles for collective action*

3.1.1 Growth and inflation

The Community aspires to better economic performance, and there is an effective consensus that the multiple objectives of higher growth and employment and low inflation have to be pursued together, with a particular attention being paid to employment creation.

Over the past two decades the respective percentage rates of growth of output and of inflation have evolved from 4,5: 4,5 in the sixties, to 2:11 in the 10 years 1973 to 1982, and to 2:5 at the present time. Thus a beginning has been made in a long struggle to improve again the fundamental growth/inflation relation.

How ambitious should the Community be for the improvement of its economic performance? Knowledge of the precise parameters of policy action is too uncertain to permit a formal setting of price and output targets. However, orders of magnitude should be discussed.

It may be useful to subdivide the issue in the following terms:

— what is the present margin of spare capacity, and rate of growth of productive potential? (2)

— how could the growth of productive potential be raised, and in this event, would demand increase to match supply possibilities?

(2) 'Productive potential', or 'potential output' represents the level of output that could be produced with the existing stock of capital at prevailing labour costs, without accelerating inflation.

As regards present spare capacity, the only direct information concerns industry, which accounts for only a third of total output. In that sector capacity utilization was reported in the third quarter of 1984 to be 81 %, compared to a range between 84 and 86 % for recent cyclical peaks. The speed at which spare capacity has been taken up over the past year suggests that high capacity levels would soon be reached in a number of sectors unless the process of expansion of potential output, involving both the creation of new capital stock and the productive use of existing stock, is stepped up promptly. The latest business surveys show a rapid decline in the net majority of industrialists expecting capacity to be more than sufficient in the months ahead.

As regards the recent annual growth of potential output, various indicators suggest that this has reduced to a slow rate of around 1 to 1,5 % in the Community in the course of the past decade (1).

Taken together these facts imply, that the growth rate of potential output would soon need to be increased if higher actual growth rates were to be envisaged. Improved profitability, and especially improved profitability expectations, would be an important factor in encouraging new investment; achieving this improvement is therefore one of the principal tasks taken up under the more detailed policy discussion below.

Increases in demand, actual or expected, have also been an essential factor in triggering investment recoveries and demand must therefore grow if the economy is to achieve an effective expansion of potential output. A successful strategy has to rely on a combination of growth forces originating principally in the private sector from the improvement particularly of supply conditions and also of demand expectations, and a consistent framework of macroeconomic policy. General demand deficiency would represent a serious threat to the sustainability of the existing recovery. Monetary, fiscal and budgetary policies should therefore be managed accordingly, so as to avoid the recovery process failing due to a general demand deficiency.

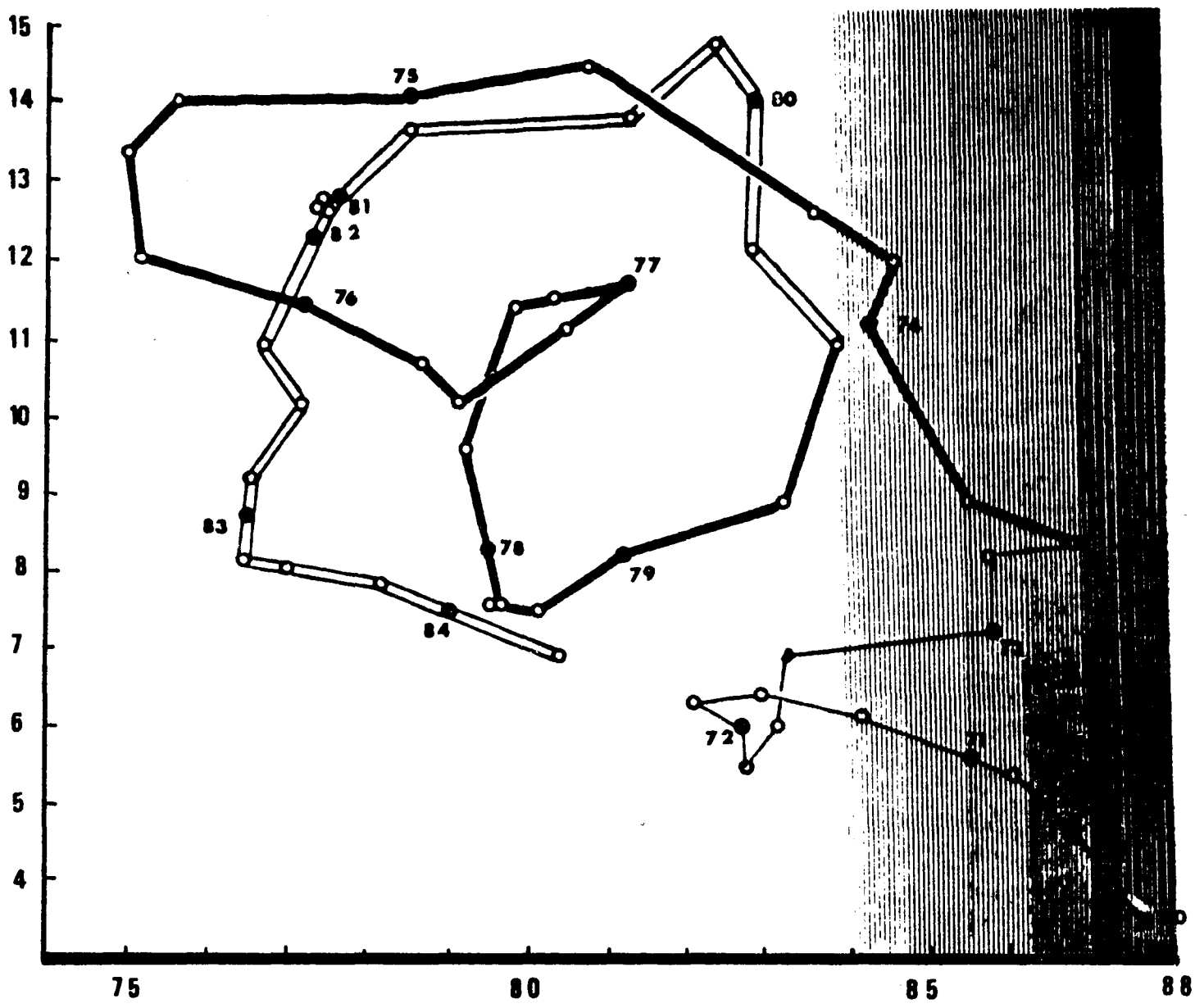
As regards the inflationary risks of higher growth objectives, there is no immutable law fixing a trade-off between stability and growth. The trade-off has deteriorated in the past in Europe. Graph 11 portrays the evolution of the relationship between consumer price inflation and capacity utilization in the years since 1970. Successive peaks in capacity utilization – in 1970, 1973 and 1979 – were associated with increasing rates of inflation – 4 %, 8 % and 10 % respectively. Thus the trade off between capacity utilization and inflation was apparently worsening. Following each of these peaks in capacity utilization, the rate of inflation further accelerated and reached levels even higher than 14 %, in particular because of the impact of the two oil price shocks. It was only after severe recessions that the average rate of consumer price inflation was cut back down to about the 7 % recorded in 1978 and now in 1984.

(1) This range is seen, for example, in the average growth rate for the last five years, and the average growth rate in the course of the last two business cycles (more precisely, between points in these cycles when industrial capacity utilization was the same).

GRAPH 11

Inflation (1) and capacity utilization (2) in the EC 1970 to 1984

period prior to the 1973 oil shock
1973 to 1979 business cycle, following the first oil shock
1979 to 1984 business cycle, following the second oil shock



Notes: Years on the graph (e.g. 79) are placed against observations for the first quarter of the year.
The shaded area represents high effective levels of capacity utilization.

(1) Consumer price rises, percentage change on corresponding quarter of previous year.
(2) Capacity utilization in industry, quarterly observations.
Source: EC business surveys.

The starting point now for the period ahead is the same, at least as regards capacity utilization and inflation, as that which obtained in the middle of 1978. Then, as now, a preceding period of slow economic recovery had increased capacity utilization in industry to around 80 %.

From mid-1978, rising capacity utilization coincided with accelerating inflation. The question now is thus:

(i) whether further increases in capacity utilization can be achieved without reversing the gradual deceleration of inflation, and

(ii) whether increases in potential output can be made sufficiently rapid to enable capacity utilization then to be held constant at, say, around the 83 to 84 % level in the presence of an adequate trend rate of growth, and with little or no loss in terms of price stabilization objectives.

External factors are largely favourable to a good or better price performance in the next year or two. The oil market seems likely to be weak for some time and energy prices do not appear to present a particular risk for inflation in a foreseeable future. The dollar's exchange rate, while proving stronger for longer than many analysts expected, is hardly likely to appreciate again *vis-à-vis* the ECU as it has done over the last three years, and is much more likely to depreciate over a medium-term period ahead. In these respects, the period ahead is likely to be more favourable than 1979 and 1980.

If internal factors are also to be favourable, it would be necessary, as already indicated, for profitable capacity to be increased. Wage moderation and other microeconomic supply side measures would be important in increasing profitable capacity and in keeping downward pressure on prices. In addition, in order to avoid repeating the experience of 1978 when money supply was allowed to grow excessively fast, – 14 % for the EC as a whole and 11 % in Germany, monetary policy would have to keep clearly to medium-term stability and growth objectives.

In conclusion a rate of growth above the present short-term trend of 2 to 2,5 % would be necessary to improve substantially the employment situation in conditions of continued technical progress. Some Member States, for example Germany, already consider 2,5 % to be a feasible rate of growth for potential output in the medium-run. An intensified improvement of the supply-side of the economy in all Member States might well, combined with steadily rising demand expectations, make a slightly higher potential growth rate of 3 % feasible for the Community as a whole, a striking but not unattainable improvement over the recent trend. In addition, there exists some scope for above-trend growth to take up a certain margin of present unused or less than efficiently used capacity. When combined with measures to increase the trend growth of potential output, an actual growth rate of 3,5 to 4 % might conceivably become possible for a period. The margin of purely cyclical slack appears to be quite small in the Community economy and it would seem unwise to assume more than a small contribution from a cyclical catch-up of say 1 % per year for two years. Intensified measures to improve the capacity of existing capital stock, for example involving the reorganization of production and working time, could enlarge the contribution of cyclical catch-up and allow for an even more ambitious target in the short term.

An ambitious improvement over current economic performance is surely a common objective, albeit only qualitatively, of all Member States. To improve economic performance to the extent suggested would however imply a very strong and rapid reinforcement of the best features of recent policy movements in the Community. To describe such movements more precisely is the subject of the remainder of this report, which is summarized in 16 points.

TABLE 16

Growth and inflation

	Annual average % increases			
	1961 to 1970	1971 to 1980	1981 to 1983	1984 to 1985 (1)
GDP				
— Volume	4,3	2,9	0,4	2,2
— Price deflator	4,7	9,8	8,0	4,4
— Nominal	9,1	13,0	8,4	6,7

(1) Forecasts on present polices.

Point 1: The Community should aim collectively at creating the conditions that would permit significantly higher actual and potential growth rates and low or lower inflation rates. A potential growth rate of 2,5 to 3 % should be achieved, and, for a temporary period of cyclical catch-up, a somewhat higher actual growth rate of 3,5 to 4 % but only on condition that potential output were simultaneously improved. To succeed along these lines necessarily means a powerful set of actions to improve supply conditions in all markets – goods, services, labour and capital – or else the faster demand and output growth would soon encounter capacity or inflation constraints.

3.1.2 Employment and investment

With current high levels of unemployment, it is necessary not only to seek higher growth rates, but also ensure that each point of growth yields more in the way of employment. As pointed out above (in section 2.4), there is no simple or fixed relationship between the growth of output and that of employment; nor is there any reason to believe that the low propensity to create employment which has been witnessed in recent years cannot be improved.

The volume of employment hardly grew even during the fast growth in the 1960s and has declined slightly in the last decade. Meanwhile, the stock of capital per employed person has grown steadily, rising at an average annual rate of 2,5 % over the last 10 years. An important factor in encouraging this capital deepening has undoubtedly

been the persistent rise in real labour costs in relation to the rate of return on capital. An important part of this movement can be attributed to increases in non-wage labour costs, while the cost of capital was kept low at times with low real interest rates and fiscal distortions. Such a tendency has probably helped to push Community economies into productive activities of a strongly labour-saving kind and needs to be reversed.

Avoiding a capital-deepening and labour-saving bias in the structural development of the economy does not mean reducing investment and retarding technical progress as is sometimes incorrectly supposed. The investment and technological performance of the United States and Japanese economies, which do not appear to have labour-saving biases, amply illustrate this important point.

•

In the Community, an apparent improvement in labour productivity of 2% per annum during the past decade seems to have been associated, according to available estimates, with a declining trend in capital productivity. Total factor productivity growth appears therefore to have been only 1,5% per annum. Labour costs rose substantially (2% per annum) while the rate of return on capital was declining about as fast (– 2% per annum). Labour costs relative to the rate of return on capital thus increased at an estimated rate of about 4% per annum cumulatively for 10 years.

Estimation of the elasticity of substitution between factors is notoriously difficult and estimates of long-run elasticity vary considerably. The extent to which changes in relative prices of capital and labour will have an impact on employment is therefore difficult to predict accurately. Nevertheless, the existing trend in factor proportions will have to be changed if a substantial growth of employment is to be achieved without requiring an unrealistically high rate of growth, and at least stability of real labour costs together with a significant recovery in the rate of return on capital should be an attainable objective. Adjustment of the tax and subsidy structure to encourage a more efficient allocation of resources would be an element in the basket of measures to achieve this end. The actual impact on employment would, however, depend on the whole range of supply and demand side policies recommended in this report.

Point 2: The Community needs to aim to change the composition of its economic growth more in favour of employment, correcting its past strong bias towards capital deepening. With an appropriate evolution of relative factor costs, and with a more favourable pattern for economic growth, it should be possible to achieve a substantial annual growth of employment. Correcting the past capital-labour bias does not mean neglecting technical progress, nor reducing the total investment effort. On the contrary it implies using capital more productively.

The next sections describe, in a necessarily summary fashion, a comprehensive set of macroeconomic and microeconomic policies that should be sufficient to get the Community's economy performing satisfactorily. Most of the policies are basically of medium-term character, but where conjunctural policy is relevant this is indicated.

3.2 *The financial policy framework*

3.2.1 A pause in the growth of public expenditure

Until very recently public expenditure had been growing as a share of GDP practically without interruption since the beginning of the post-war period. In 1958, when the EEC was founded, the ratio was 32,5% of GDP for the EC as a whole. In 1983 the ratio reached its historical peak of 47,8% of GDP, followed by a decline to an estimated 47,3% in 1984. Preliminary information suggests that this decline will continue in 1985 at a somewhat faster rate, to 46,4% of GDP. While the volume of public expenditure will be increasing slightly in both years, this smaller share in GDP taken by public expenditure may mark an important change in structural trend for the European economy. Several countries (Germany, United Kingdom, Denmark, Netherlands) have established firm multi-annual programmes for consolidating this trend, and this practice merits adoption by other Member States.

There are surely many unsatisfied and well-founded demands for better social services: health care for example. However, it appears now to be widely recognized that taxation, social security levies and social transfer payments in the Community have in the aggregate grown too fast ahead of the capacity of the economy, thus weakening the growth potential of the economy itself. Therefore a reversal of past trends in the growth of public expenditure should now be a major feature of the medium-term recovery of the European economy. These new trends should lead to reductions in

tax burdens, should help re-establish work incentives and reduce inflationary pressures (the latter may be aggravated by tax-push wage inflation or by monetization of budget deficits).

The elimination or reduction of operating subsidies for uneconomic enterprises is proceeding with unequal speed and firmness in different sectors and countries. The efficiency and economy with which programmes of social benefits are administered clearly leaves substantial room for progress in some countries.

In the multi-annual public expenditure programmes of Germany and the United Kingdom very similar objectives have been set for the period 1984 to 1988. In Germany the share of public expenditure in GDP is to decline from 47 to 43 %, in the United Kingdom from 44,5 to 40,5 %. In most other EC countries, the present level of public expenditure is substantially higher than in the two countries mentioned (57 % for Italy, and nearly 60 % or more for the Benelux, Denmark, and Ireland). There is still scope for greater efficiency in public expenditure programmes in these countries, in spite of recent efforts to economize. The EC as a whole could therefore envisage progress in achieving structural change in public expenditure's share in the economy, no less ambitious (at least in the rate of reduction of public expenditure's GDP share) than is seen in the objectives already set by the countries which have medium-term strategies.

These global objectives for public expenditure imply even more severe restraint on many categories of current public expenditure, since priority should be given to the expansion of public expenditure programmes that contribute efficiently to restoring the productive potential of the economy. The latter implies investments in human and physical capital: in retraining programmes and in the formation of skills that are in increasing demand, and economic infrastructure investments, vital for economic development. In the search for budgetary economies, cuts in public investment have in many countries been severe. As a result the construction industry is at present at a depressed level of activity in most Member States, especially Germany. Public investment proposals must be judged on the economic rate of return they offer. Projects offering high and relatively sure rates of return should be undertaken in the present weak economic climate, wherever the budget deficit is not in paramount need of reduction. Given the time lags involved in public investment projects, preparatory work for well-conceived programmes of expanded public works should now be set in hand.

TABLE 17

Public expenditure's share of GDP, past trends and a possible objective for 1987

	1970	1984	1987
Current public expenditure	32,6	47,3	43,3
Investment and capital transfers	5,1	4,0	5,0
Total public expenditure	37,7	51,3	48,3

In setting out some simple, illustrative figures for future public expenditure trends in Table 17, two important qualifications should be borne in mind. Firstly, while all Member States should envisage a declining GDP share for public expenditure, some countries whose budgetary consolidation is well advanced may be able to afford some modest public expenditure growth in volume terms. Secondly, the distinction between current and capital expenditure is only a very simple criterion of priorities. It is to be interpreted as favouring public expenditure that supports the growth of the economy's productive potential. This will include several types of current expenditure, just as public investments offering poor economic and social returns should be rejected.

Point 3: The recent check to the rise of public expenditure should be maintained for a medium-term period in the Community as a whole, with as a possible objective, a reduction of 1 % point in GDP share per year. However, opportunities for public investment (and, more generally, expenditure favouring economic development) giving high rates of return in relation to the rate of interest should be exploited. Programmes of public investment should be strengthened especially in countries whose public finances have been adequately consolidated and where the construction sector is underutilized.

3.2.2 Lightening taxation to promote enterprise and employment

Important new trends are being established in the EC for the lightening of tax burdens, increasing incentives to expand production and for encouraging the creation of new enterprises and employment. The confirmation and deepening of these trends is of the highest importance for a strategy aimed at a more dynamic economy.

Rising tax burdens in Europe have driven an increasing wedge between the cost of labour to employers and the

post-tax income of employees. Rising social security charges on top of wages tend to reduce employment creation by enterprises. Rising tax burdens on wage incomes (income tax and social security contributions of employees) increase the pressure in wage negotiations for higher pre-tax salaries, and this tends to intensify cost inflation. Taken together, these trends may be measured by the ratio of net wage income to total labour costs inclusive of social security. For the four large EC countries together, this ratio steadily declined from 59 % in 1971 to 51 % in 1981 and to an estimated 46 % in 1984. By comparison, in the United States, the ratio has been substantially higher. While the US ratio also feel from 69 % in 1971 to 59 % in 1981, it is estimated that under the impact of recent tax cuts there, the ratio recovered to 66 % by 1983, which is a sharp reversal of the previous trend. These figures provide suggestive evidence of how the rising weight of the public sector and taxation can dampen economic performance and employment, and vice versa.

Several countries have been embarking upon programmes of tax cuts and reforms.

The last United Kingdom budget (for 1984/85) saw cuts in corporation tax announced for four successive years, elimination of a social security surcharge and many detailed initiatives to help small or new enterprises.

In its 1985 budget, the French Government is to cut taxes on enterprises, a social security surcharge and income tax by an amount equivalent to 1 % of GDP, and a continuation of such moves for subsequent years is also intended. The Dutch budget for 1985 makes tax-cuts amounting to one-third of 1 % of GDP, mainly reducing the social security contributions of employers.

The German Government has announced DM 20 billion (1 % of GDP) of income tax cuts and increases in child allowances to be made over three years, not starting, however, until 1986. The present intention of the Government is to implement the first part of its fiscal package (mainly family allowances) on 1 January 1986, and the second part (lowering of the progressive income tax scales) on 1 January 1988. While no compensating tax increases are envisaged, the tax programme is not fully determined; federal net borrowing is projected to decline to 1 % of GDP in 1988. In the case of the United Kingdom, in addition to the tax reforms and reductions already mentioned, the medium-term financial strategy provides for a margin of fiscal adjustments (potential tax cuts or expenditure increases) consistent with the reduction of the public sector borrowing requirement to 1,75 % of GDP, cumulating to £ 13,5 billion (3 % of GDP) in the last year projected (1988/89).

Where there is a budget deficit constraint, Member States may nevertheless envisage changes in tax structure favourable to employment. For example, this would mean in practice lowering payroll or social security taxes on employment and raising taxes on consumption. Increases in value added tax or excises on energy or other products entail a risk of aggravating inflation. This problem has to be recognized and countered. Thus in principle indirect tax increases should not be taken into account in wage negotiations for compensation, a principle already discussed and accepted in some countries. Moreover, in an economy suffering from underemployment it makes sense to switch the tax structure to give a greater incentive to employ labour, possibly by diminishing certain subsidies to investment where such schemes are seen to have led to excessive capital deepening or to the maintenance of inefficient industries. It may also make sense in certain circumstances to tax more heavily another factor of production, such as energy, so as to encourage the rational use of energy and improve the European economy's terms of trade.

Apart from the objective of reducing direct tax burdens in the aggregate, the way in which social security contributions are levied should also be reviewed for possibly unfavourable effects on employment. For example, contributions which are based in part or wholly on a fixed money sum contribute an element of rigidity to labour costs and of discrimination of the tax system against lower income employment. Contributions that set minimum contributions or ceilings *per capita* employed should be reconsidered with a view to replacing such features by simple linear percentage levies, preferably lower ones. Part-time employment is discouraged in many countries by high minimum social contributions. A Community Directive for proportionality of contributions has yet to be fully implemented.

From 1970 to 1984 changes in tax structure in the EC were generally quite contrary to the direction now recognized as beneficial for the priority expansion of enterprise and employment. The indirect tax burden did not change, but the large increase of seven percentage points of GDP in the total tax burden fell entirely

on income and profits taxes and social security contributions. These trends should now be reversed. In the three years 1985 to 1987 the Community might, for example, envisage that the total tax burden be reduced in the EC by an amount of the order of three percentage points of GDP, with a larger, perhaps four percentage point cut in taxes on income and employment, and a rise in taxes on consumption (of perhaps one percentage point).

In conclusion, reductions in the tax burden on employment and enterprise, and elimination of tax distortions over the medium-term should now be a leading component of a strategy to strengthen European economic recovery. A start has been made with actual tax-cuts in 1984 or 1985 in some countries. The way has been thoroughly prepared through the consolidation of budget deficits in other countries. It is, however, now urgent to make permanent, sustainable improvements in the profitability and employment propensity of the enterprise sector through a widespread programme of structural tax reductions in the Community. To what degree such tax-cuts should be financed by expenditure cuts, changes in tax structure or deficits will vary from country to country, and policy for the budget balance is discussed below. All countries, however, should now proceed either with tax-cuts, where the financial room for such measures has been secured, or with expenditure-cutting programmes that will enable future tax-cuts to be made. This implies, of course, the need for thorough medium-term programming of public finance in order to define precisely the means by which a substantial lightening of the tax burden can be obtained.

TABLE 18

Changes in tax structure from 1970 to 1984, and a possible objective for 1987, % shares of GDP

	1970	1984	1987
Indirect taxes	13,9	13,8	15,0
Direct taxes	10,3	13,1	11,5
Social security contributions	11,0	15,5	13,0
Total	35,3	42,4	39,5

Point 4: Tax burdens on enterprise and employment should now be set on a substantially declining trend for a medium-term period, offset where there is a serious budget deficit problem, by expenditure cuts or by some increases in indirect taxation. As a quantitative point of reference, the total tax burden might be reduced by one percentage point of GDP per year from 1985 to 1987. Such tax-cutting action should constitute a major, permanent improvement in supply conditions in the European economy.

3.2.3 Budget balance and the public debt

In defining the best budget balance strategy, it is necessary to recognize major differences between country situations, and, for all countries, the critical importance of other features of the policy-mix. Such differences can determine not only the magnitude but also the sign of the impact of changes in the budget balance on activity and inflation.

To take one extreme position, where the budget deficit is contributing to an increase in the public debt burden as a share of GDP at a rate of 5 % or more per annum, and where the public debt burden is approaching 100 % of GDP, the only sound course of action is to reserve these trends as decisively and quickly as possible. If not, the prospect would be one of accelerating monetization of the public debt or real interest rates so high as to cripple economic development. Several EC countries are presently seeking to avoid precisely this set of problems: Belgium, Ireland and Italy for example. In the case of Greece the very large budget deficit is not yet being corrected fast enough. In these situations a well designed and coordinated stabilization policy – embracing budgetary and monetary policies and the cooperation of the social partners over incomes – should not be feared for its 'restrictive' effects. If a stabilization policy is made sufficiently efficient and credible, immediate benefits will begin to flow, in particular through a drop in the long-run rate of interest and a renewal of business confidence. An actual example of a rapid transformation of this kind is seen in Denmark, whose public finances were on a rather unsustainable course until policy changes were made two years ago. There, a rigorous set of public expenditure and income restraints, announced for a multi-annual period, led quickly to a very large drop in interest rates and, currently, the fastest expansion of private investment and employment in the Community. By contrast, delay in correcting unsustainable public debt levels leads with certainty to recession or higher inflation or both.

At the other extreme are situations in which the real public debt burden is declining, and where the budget deficit and rate of inflation are low. For example, on present plans, the general government borrowing requirement in Germany is expected to fall from 1,8 % of GDP in 1984 to 0,8 % in 1985 (resulting in 1985 from 4,8 % revenue growth and 2,7 % current expenditure growth in nominal terms). The advantage in such

situations of avoiding penal interest rates at or above those prevailing in world markets is important. Indeed, in the cases of Germany, the United Kingdom and the Netherlands (1) the long-term rate of interest is now significantly below that paid by the United States Treasury on dollar-denominated debt. Nonetheless, in open capital markets it is difficult for the rate of interest for individual borrowers to be decoupled completely from world capital market conditions. Further benefits to the economy from declining budget deficits – through the channel of lower interest rates – may now be rather limited in amplitude. While higher budget deficits do place upward pressure on interest rates, it is worth noting from the current United States experience that changes in the profitability of the private sector may be more than sufficient to warrant business expansion and investment notwithstanding high interest rates. This emphasizes the case for concentrating on tax reductions that strongly benefit profitability and the propensity to employ (although this argument in no way implies replicating the excessive budget deficits of the United States).

Other countries in the Community are in an intermediate position between the categories so far mentioned. France is an example of a country which has a moderately-sized budget deficit and debt level but which does not easily mobilize adequate domestic savings. In such a case, the deficit should not at present be increased, but a more buoyant European economy would more easily permit a reduction of tax burdens within a given constraint for the budget balance.

Point 5: A budget strategy for stronger, stable growth in the Community should contain differentiated trends as between countries. Deficits should be reduced in some countries, but in other countries, where structural deficits have largely been eliminated, a stance of conjunctural neutrality would be appropriate for the time being rather than restriction. Such budget balance policies should be able to accommodate the substantial tax-cutting action already mentioned. Special efforts are required in several countries to eliminate deficits on current budgetary transactions rapidly.

3.2.4 Monetary objectives and the European Monetary System

Monetary policy in the last year has been managed successfully in the Community in several respects. A gradual deceleration of the rate of growth of money supply has been associated with a deceleration in the average rate of inflation, and the dispersion of money supply and inflation rates has also been reduced.

Interest rates in the EC have on the whole declined or stabilized in the course of the last 12 months, notwithstanding substantial and at times sharp rises in US dollar rates. Long-term rates in the EC on average are currently at 11,5 %, compared with 13 % in the United States, whereas, historically, the EC average rate was always substantially higher than that of the US. This degree of decoupling from US interest rates admittedly went together with a depreciation of the ECU, but this has not prevented the continued deceleration of inflation in the Community. Indeed, the inflation differential between the EC on average and the United States is narrowing (see graph 5).

This experience of monetary relations between the EMS and the dollar in the recent period, and in particular the substantial decoupling of interest rates, points to a number of conclusions. The unity of the EMS block of currencies substantially diluted the extent of the price increases that would have been imported if single currencies has been depreciating alone. The clarity of the commitment of Member States to the EMS appears to have made it easier for all countries to follow the distancing of German mark interest rates from those of the dollar. Thus the correlation between movements of EMS currencies' interest rates with those of the German mark became greater than their correlation with the dollar interest rates in the period during which the EMS has functioned since 1979. This was not the case in the preceding years from 1973 to 1979 for either the French franc for the lira. The weakness of world commodity prices in dollars also reduced the inflationary risk inherent in the depreciation of the ECU against the dollar. Finally, as regards real demand, the ECU's depreciation against the dollar has contributed to the strong demand for exports from the EC. Thus the policy of substantial decoupling comprised two elements that were helpful to the recovery in Europe – interest rates and exchange rates lower than would otherwise have been the case.

Exchange rate relations within the EMS have been kept stable and quiet. Convergence of monetary policies in the EMS gained substance and credibility. There has been no realignment of EMS parities since 21 March 1983. However, there have been some striking alignments in the setting of quantitative monetary objectives. For example, the Bank of France's objective for 1984 of 5,5 to 6,5 % money supply growth now overlaps with that of the Bundesbank, whose central bank money growth target is 4 to 6 %.

For 1985, these tendencies should be continued. In countries with low inflation rates, money supply targets

(1) The Netherlands' economy is in the unusual situation of having a rapidly rising public debt but a large excess of domestic savings as manifested in a rising balance of payments surplus, currently of 3,5 % of GDP.

should favour some further increase in the real growth rate of gross domestic product. In countries in which the inflation rate is still unduly high, the crucial task is to coordinate monetary and budgetary policies and the evolution of incomes along consistent stabilization paths. In this way the credibility of the strategy is maximized, and its real economic costs minimized.

Work is currently in progress on a number of possible measures to improve the mechanisms and functioning of the European Monetary System. Such work should be considered to be part of the Community's overall economic strategy. In September 1984, a revision of the ECU basket was made, following the first five-yearly re-examination of its composition. On this occasion, the Drachma was incorporated into the ECU.

Point 6: In 1983 and 1984, the combination of monetary and economic policy in Europe has been able in substantial degree to decouple interest rates from upward trends in the US, while achieving at the same time improved convergence on monetary stability. The European Monetary System has contributed positively to these achievements. These trends should be further pursued. Increasing room for real monetary expansion and GDP growth should be compatible with a steady monetary policy in countries with low and still declining inflation rates. The mechanisms and functioning of the European Monetary System should be further strengthened as an element of the overall economic strategy of the Community.

3.3 *Conditions for expansion and competitiveness of the enterprise sector*

3.3.1 The internal market for goods, services and capital

The process of market integration in the Community appears to have slowed down. In 1958 exports of the present 10 Member States to their actual or future Community partners accounted for 7 % of the Community's total GDP. By 1974 this ratio had nearly doubled, reaching 12%. Since then this ratio has essentially stabilized, reaching only 12,5% of GDP in 1982, despite the strong growth of trade between the new Member States and the original six. These trends almost certainly reflect the depressed general economic environment, a multiplication of defensive national reactions to the problems of structural change in many branches of industry, and failure to expose new sectors to thoroughly open conditions of competition and more generally to exploit fully the potential of the European dimension in responding to the third industrial revolution now under way.

Awareness of the gravity of these trends for the Community's economic potential has increased. Since 1981, with the support of the European Council, new programmes of action to improve the internal market have been proposed by the Commission. The Council has begun to meet in a new formation dealing specifically with the internal market. Quite a number of decisions have been taken by the Council, for example in the area of technical standards and information procedures.

However, more progress must be made to match the scale and urgency of the issues at stake. The economic purposes of extending the internal market are several: to provide a new spur to growth and efficient investment, to give enterprises in Europe a continental-size home market as have their main competitors and so strengthen their position in world competition, accelerate the introduction of new technologies and, finally, to exert continuing downward pressure on costs and prices and so dampen inflation and increase the standard of living.

Taking advantage of the new political impulse mentioned and the growing support of industry, the Commission presented in June 1984 an important programme aiming at a decisive move to improve the internal market before the end of 1985. These extensive proposals include, for example, a reduction and simplification of customs formalities, a new flexible approach to the harmonization of technical standards and tax legislation, the opening up to fuller competition of important transport and financial service sectors, extension of the list of liberalized professions, and subjecting of new branches of the equipment industry to open public procurement. There are also proposals to make the corporate legal environment in the Community more favourable to the formation of groups of enterprises undertaking projects of Community interest.

Community competition policy needs to be vigorously implemented both as regards State aids and private enterprises. As regards State aids in particular, the Commission counts on Member States for support to ensure that Community competition policy achieves its full potential benefits.

Finally, the Commission has issued in September 1984 a detailed communication on proposals for the citizens' Europe, thus responding specifically to the guidelines set by the European Council at its meeting in June 1984 at Fontainebleau.

Point 7: The Community should now make rapid progress in opening up an effectively competitive market

for all goods, services and professions. This corresponds to the urgent need for a new impulse in the European economy promoting efficiency and growth. The Commission has outlined priorities in its consolidation programme for the internal market in June 1984. Most of the proposals under this programme are before the Council and their acceptance requires for the Community institutions neither budgetary funds nor special legislative powers for new policies. These new actions to open the internal market should be supported by a vigorous implementation of the Community competition policy.

3.3.2 Technology and innovation

Technological innovation is one of the main determinants, both on the supply side as well as the demand side, of long-term structural change – economic growth or decline. The Community is now having to respond to the challenge of an emerging inferiority, by comparison with the United States and Japan, in industrial capacity in new and fast-growing technologies. While in some branches (such as aerospace) Community technology is at the highest level, in several other areas the Community has, over a long period, fallen far behind the world leaders. The deteriorating world trade performance of the Community in such fields as computers, micro-electronics and equipment is now generally recognized. The Community at present imports about 80 % of its consumption of integrated circuits. It imports an estimated $US 20 billion worth per year in computer and related software from the United States. The Community has begun to implement the ESPRIT programme in information technology, and several national programmes of research and development expenditure are being built up. The Commission is also proposing new R & D initiatives in basic technologies and bio-technologies. The fact that Europe has strengths in basic scientific research seems well established. Weaknesses in the full chain of activities from pure research to commercial exploitation are the subject of intense discussion between industrialists, the financial sector, the educational system and government throughout the Community.

For the Community to succeed in regaining a powerful and leading role in the major new industrial technologies, a number of instruments of policy have to be adopted both at national and Community levels.

The education system has to be adapted to producing the appropriate number and quality of technical and managerial skills, as well as more generally to encouraging adaptability to change.

In addition, the tax system and capital market institutions have to provide a financial environment favourable to innovation and risk-taking investment.

Technical standards (norms, testing procedures, certification) need to be set at a level valid for Europe, in a manner also giving full access to world market norms, as is now being done for information technology.

For public procurement the relevant agencies in Member States need to collaborate with a view to opening up national markets and ensuring consistency in the specification of their future requirements for equipment. This is beginning to be done in the telecommunications sector, but compatibility across networks requires a high degree of harmonization of technical specifications.

The conditions for open trade in fast growing goods and services branches employing new technologies (e.g. data networks) now warrants urgent attention. Where the markets for specific goods and services are not effectively opened, information systems (e.g. inventories of technical standards in Member States) need to be established.

Competition policy at the Community level needs to be directed in a manner that favours collaborative research and development efforts of European enterprises so that these can be efficient at the world level. To this end, the Commission will propose before the end of 1984 an appropriate Regulation to clarify the rules of competition in this respect. The Community's commercial policy for trade in high technology products has also to be managed in a manner favourable to the emergence of an industrial capacity that is fully competitive on world markets.

For the Community's own research expenditure, the Commission has proposed in its framework programme to increase the share of Community funds devoted to improving industrial competitiveness (from 17 % of the total R & D budget in 1982 to 28 % for the period 1984 to 1987).

Point 8: The Community's increasing efforts to catch up or maintain leadership in the major new industrial technologies require a widespread mobilization of resources by schools, universities, enterprises and government. The numerous national and Community policy instruments that are relevant – education, research, taxation, technical standardization, competition, public procurement and commercial policies – need to be directed systematically towards this end.

3.3.3 Promoting dynamism in the enterprise sector

It is increasingly recognized that part of the problem of slow growth in the European economy originates in an environment of regulatory and administrative controls that is unduly burdensome or inefficient. By way of complement to moves to improve the opening up of the internal European market and the flexibility of labour markets, it is desirable that throughout the Community economy there be a reconsideration of the existing mass of regulatory practices with a view to favouring the creation of enterprises and the expansion of employment. Various initiatives in individual countries, and debates over the usefulness of existing measures, indicate there is considerable scope for progress, even if this subject matter is bound to be inherently detailed and difficult to summarize.

An example of the speeding up and easing of statutory formalities for the creation of new enterprises has been seen recently in France, with a one month maximum administrative delay now introduced. Doubtless several Community countries could consider improving the speed of administration of regulatory controls and the reduction of the number of different authorizations required for new investment. Delays in administrative controls are particularly damaging in branches where technological innovation is fast-changing.

Restrictions on entry into many service activities, and technical restrictions on hours worked or on the qualifications of employees often appear to be unnecessarily rigid. The United Kingdom has recently taken steps to increase competition in service professions which have been unduly restricted (financial and legal services, some medical services). There is also a major extension of competition in the financial sector, for example the stock market and housing finance. In Germany there is a major debate on whether the closing of all shops by 6.30 p.m. is still entirely justified, and if so at what cost to the considerable possibilities for expansion of employment, including part-time employment in the distribution sector. The technical qualifications required of persons estabilishing new enterprises in Germany appear to be sometimes unduly restrictive. Also in Germany, there is planned a reduction in the burden of regulations concerning the construction sector. In Denmark various public sector activities are being opened to private suppliers.

In most Member States, consideration is being given as to how monopolies and rigidities in the State enterprise sector could be adapted to assure a more flexible and efficient expansion of these enterprises. The United Kingdom has sought to achieve this by embarking upon a large programme of privatization and deregulation, involving telecommunications, air and road transport, the petroleum sector, and several manufacturing industries. Germany is also preparing privatization and deregulation programmes, the Netherlands a deregulation programme.

Several countries have prepared tax changes to favour the start-up of new, small enterprises (France, United Kingdom, Germany). Tax changes have also been made in some cases to favour employee participation in the equity of the enterprise in subscribing to share issues or through share-option schemes.

Point 9: To reinforce the improvement in business confidence Member States should undertake comprehensive reviews of the mass of regulatory requirements placed upon the enterprise sector, especially for the creation of new enterprises, and wherever possible remove unnecessary rigidities and speed up administrative procedures.

3.3.4 European infrastructure for transport and communications

To develop its full potential the European economy needs excellent intercommunications between its national transport networks, especially road and rail, and also for telecommunications. At the present time, while some of the network interfaces are quite adequate (for example some of the motorways links), there are important weaknesses in several areas. These are, for transport networks in several categories:

(i) the cross-channel links, and related access;

(ii) the trans-alpine crossings which are often a source of serious congestion;

(iii) high-speed rail links, for which the technology for major advances is now available and proven, but unused between countries.

These improvements in the physical infrastructure should be associated with a widespread easing or elimination of administrative delays at frontiers (as discussed above).

The Community's financial instruments for investments in transport infrastructure are currently based on a Regulation, with limited scope, for support of projects of Community interest through budgetary grants. To this may be added grants from the Regional Fund and loan finance from the European Investment Bank and the New Community Instrument. A proposal for a Community guarantee of transport projects has also been made. The

Council has recently invited the Commission to propose a medium-term perspective for Community action in the field of transport infrastructure. The Commission will soon be submitting a communication to this end.

For action in the short-run the Council and Commission have established a consensus on the list of transport projects to be financed under the appropriations of the 1983 and 1984 budgets. These mainly involve road projects leading to or across major frontier crossings, and railway investments that concern principal European axes of traffic.

Looking ahead, there is a potential list of major infrastructure investments that correspond to the needs of a faster-expanding European economy and the structure of intra-European trade flows. These opportunities have also been highlighted in a number of reports prepared by independent or private initiatives. Indeed the scope for private investment in major transport infrastructure initiatives appears to be considerable, and this could help prevent public sector financial constraints from limiting the expansion of investment in projects offering a high long-run rate of return.

Similarly, the Community should envisage the development of integrated high-capacity telecommunication networks which take advantage of the available digital and optical technologies.

Point 10: The Commission is currently preparing a medium-term programme of European transport and telecommunications infrastructure projects. Such a programme should permit a stronger flow of trade between Member States, and, together with the market opening measures already indicated, stimulate the development of these flows. Existing Community instruments should be adapted so as to facilitate the funding of projects of Community interest and encourage the participation of private capital in them.

3.4 *Conditions for the expansion of employment*

3.4.1 Labour costs and remuneration

Since 1982, the rise in both nominal and real labour costs has significantly decelerated. In 1984, it is estimated that nominal compensation per employee will increase by 6 % in the EC on average, compared to an annual average of 13 % in the period 1973 to 1981. Real wages per employee are expected to rise on average by 0,5 % in 1984, compared to 2,3 % on average during 1973 to 1981. Real unit labour costs are presently declining slightly in most Member States. Moreover in several countries conventions on wage/price indexation have been adapted. These trends will help stabilization and employment prospects. More generally and in view of the changes in labour costs during the last decade, further progress is essential so that the competitive situation of European firms can be improved and their productive potential reinforced.

In the long-run an inappropriate development of total labour costs directly affects the employment level in two ways. On the one hand, disproportionate increases in the cost of employment leads to a deterioration of the cost structure of firms and feeds inflationary pressures. On the other hand, increases in the relative costs of labour tend to accelerate the substitution of capital for labour. Although there is a general agreement on the consequences of such labour cost developments, the policy prescriptions which can be drawn should be conceived with much care for the following reasons.

Firstly, it is difficult to assess precisely the separate effects on employment of the real cost of labour and of fluctuations in the aggregate level of demand. Nevertheless, many indications point to the fact that a substantial part of the increase in unemployment in the EC during recent years can be associated with labour cost developments and insufficient market flexibility.

Secondly, there is the important question whether downward real wage adjustment would bring about transitional problems of demand weakness in the absence of demand policy reactions. This potential problem has to be handled by macroeconomic policies that aim to keep the economy on a steady growth path, for example money supply and public expenditure targets fixed in nominal terms. If a problem of deflation arises, the automatic stabilizers, both from monetary and budgetary policies should be allowed to play their full role. Evidence is also accumulating to the effect that the responsiveness of investment to improvements in profit expectations are quicker and stronger than some analysts had earlier suggested. Employment expansion will also help consumer demand, and here the speed of positive employment effects depends on the flexibility of the labour market (see following sections).

The third issue is that of designing policy proposals to obtain an appropriate real wage adjustment. Given the present condition of the European economy, the objective

for labour costs should, qualitatively, have three features:

(i) nominal wage settlements, consistent with programmed targets for lower inflation and monetary policy objectives, especially where further reductions in inflation are required;

(ii) average real wage settlements ensuring that at the beginning of a period of renewed growth, there is a sufficient acceleration of enterprise profitability;

(iii) a more differentiated pattern of wage cost levels reflecting the different levels of present profitability of enterprises and of degrees of imbalance in different areas of the labour market.

Of course there will have to be major differences between countries in appropriate wage trends and the means of achieving this.

As regards quantiative trends, Germany, for example, already experiences low nominal pay increases and there is probably some scope there for modest real wage increases, albeit still permitting a further improvement in average profitability. Several other Community countries, however, have serious problems of cost inflation and of excessive real wage levels to overcome.

At the Community level, an appropriate objective would be for real labour costs to remain stable or even decline, so that the cost structure of firms is more conducive to employment creation. Such a trend could, for example, be met by a strict moderation in real wage settlements, accompanied by reductions in social security levies and taxes on employment and reductions also in the regulatory cost of employment. In this way there would be a balance of effort by employees, employers and government. A trend growth of labour incomes could be resumed as soon as an adequate structural change in the economy had got under way.

The greater differentiation of wage costs by enterprise or segments of the labour market raises of course difficult issues of fairness. In the present context the issue is one of fairness between the employed and the unemployed, as well as one of relative income levels among the employed. To adjust wage differentials, there will need to be changes in conventions; and in some cases the law will need to be changed. One idea would be to convert a significant share of total remuneration into a flexible component related to the performance and profitability of the enterprise. Such a component is as high as 30 % of total remuneration in Japanese enterprises, and this element of flexibility in real labour costs has helped maintain a stable and positive growth of employment there in changing economic conditions. However, where the starting situation is one of insufficient profitability due attention would need to be given to not granting excessive increases in total remuneration while normal profitability levels are being restored.

Point 11: An appropriate trend for per capita *real wages for the Community as a whole would be one of strict moderation consistent with the objective of achieving a pause in the growth or even a reduction in total real labour costs so that the cost structure of firms becomes more conducive to employment creation. By country, industry, enterprise and skill there should be more differentiated trends in order to return to a high employment level together with the highest feasible average wage. In some countries in particular some modest real wage increases may be warranted, but elsewhere strict discipline must be respected. Conversion of a significant fraction of pay into a profit- or performance-related element would help give a much needed increase in real wage flexibility in the Community. Combined with reductions in employment taxes and the costs associated with undue labour market regulation (see points 4 and 13), strict wage moderation would – in conditions of stronger output and demand growth – lead to a structural change in relative factor rewards highly favourable to employment.*

3.4.2 Promoting adaptability in the labour market

Conditions of employment in the Community are the subject of both legislation and collective agreement. Such regulations and conventions typically concern conditions of recruitment and dismissal, the duration of employment contracts, conditions of part-time work, levels of professional training provisions and qualifications, wage relativities and minimum wage provisions. They were generally introduced in periods of high growth and full employment when there was considerable labour mobility. Some of these regulations have proved to be ill-adapted to new circumstances and may, in some cases, have reinforced the rigidities which have hindered employment creation, especially in a period of low growth. Evidence of rigidities of this kind is seen in the weak short- and long-run employment propensity of the economy for each point of output and demand growth; in

econometric studies of capital and labour demand in the production process; and in much informal evidence of how enterprises in Europe tend to react to increases in demand. For example, on the latter point, it is widely reported that enterprises at present delay recruiting additional labour when product demand increases, in order to be sure that they do not increase their long-run labour costs when the product demand may prove only short-term.

While many mechanisms, particularly those enforced by legislation, may have contributed to rigidity, there are indications that collective negotiations are increasingly taking into account the need for flexibility and adaptability, especially in relation to the internal work organization of enterprises and to working time practices.

Against this background the Economic Policy Committee of the EC has examined the present situation in Member States and this work will be continued by the Commission. It is considering the scope for revisions or reforms of regulations and conventions that could, whilst not undermining the objectives of social policy, help achieve a higher employment propensity in the economy.

Efforts by governments, however, to dismantle or reduce existing regulations or to limit their coverage have demonstrated the practical difficulties of achieving such changes without injuring those who are already the least well protected in the labour market and of avoiding a deterioration in the industrial relations climate in which negotiations on flexibility take place. While taking account of this, such efforts nevertheless need to be pursued, because there are a number of ways in which some labour market regulations have proved to be inefficiently drafted, with the result that they tend to discourage recruitment in difficult labour market conditions.

There are indeed numerous examples of regulations which have turned out to be drafted inefficiently or in ways that unreasonably deter employment. Of course not all examples apply to all countries, but the following illustrate the kinds of problems that exist: employers' rules that prevent employers from choosing employees whom they recruit from lists prepared by employment agencies, rules that are too rigid in setting the number or type of apprenticeship to be taken on, rules preventing employment for fixed-term contracts, rules imposing very heavy conditions for lay-offs, rules restricting part-time work or imposing disproportionate costs on such employment, rules for exercising in an inefficient way society's responsibility for employing handicapped persons, rules for minimum wages for various categories of workers which often discriminate in effect against young people seeking first employment.

At the same time, the overall content and balance of labour market regulation needs to reflect other changes in the labour market – notably the increased participation of women in employment on an equal basis, changes in the structure of working time and the impact of new technologies on production systems.

All this implies a more fundamental re-examination of labour market regulations in order to ensure both greater equality of access to employment and greater efficiency in the use of labour within the enterprise. Such a re-examination is a highly complex and time-consuming process, but it needs to be pursued with all the urgency and priority that the unemployment problem deserves.

Consideration should also be given to ways of making a quicker and substantial impact on the employment situation. There are examples of measures – already proposed in some countries, but only at the discussion stage in others – in which the existing regulations with respect to recruitment and dismissals are temporarily suspended for new employment to be created for a given period. Suspension may be selective in order to encourage the recruitment of categories of workers particularly hard-hit by unemployment, for example, young people. In this way any employment effects are immediate and are achieved without prejudice to the long-term reform of the basic legislation, or the acquired rights of existing employees. At the same time, effects can be monitored and lessons drawn for more permanent changes.

Point 12: A systematic reappraisal of labour market regulations and conventions should be urgently pursued with a view to removing obstacles to the short- and long-run employment propensity of the economy. This is undoubtedly a complex and delicate task which is bound to take time. Meanwhile consideration should be given to suspending onerous conditions of recruitment without prejudice to more permanent changes or to the acquired rights of existing employees. Such a move should be associated with efforts to boost recruitment among groups particularly hard-hit by unemployment.

3.4.3 The reduction and re-organization of working time

The reduction in average working time is a long-term trend reflecting changing social preferences for paid work

versus leisure time as incomes rise. Since 1960 the normal working week for industrial workers has decreased by some eight to 10 hours in most Community countries while the number of days of paid holidays have doubled. This trend is continuing, as illustrated by the German metal-workers' agreement to reduce their average working week from 40 hours to 38,5 hours from April 1985. It is worth noting in this context that a substantial part of the recent increase in employment in the US has been in jobs below average hours.

These long-term working time trends have had no systematic relationship with the level of employment of unemployment attained in the economy. In addition there is no doubt that the present search for more varied and individualized forms of working time organization correspond to important welfare objectives, especially for family life where both parents wish to work.

A number of collective agreements have been concluded recently, frequently at industrial branch level or in the framework of inter-professional agreements, in which the reduction and re-organization of average working time is linked to job savings or additional recruitment. There is a need to give political support to changes in working time which contribute positively to employment. In this context, the Commission submitted a proposal to the Council for a recommendation on the reduction and re-organization of working time which, following extensive discussions in the Council, has received wide support.

The relationship between changes in working time, employment and unemployment is complex. Employment is an economic variable that depends on labour costs and product demand and reductions in individual working time are far from leading automatically to increased job opportunities. Indeed, they must not increase unit production costs if competitiveness is to be maintained and a negative impact on employment thus avoided. The Commission's proposed recommendation underlines that an effective reduction in working time should be combined with its re-organization and the introduction of greater flexibility so that production time can be maintained or even lengthened and profitability improved. Some recent negotiations have shown how suitable arrangements can be found which meet these conditions, often involving more rotational patterns of work.

Point 13: The reduction and re-organization of working patterns is a continuing feature of social progress. Under certain conditions a reinforcement of this trend could bring substantial positive employment effects. This requires the strict avoidance of cost increases, especially through more flexible working time arrangements, and the safeguarding of fundamental social rights.

3.4.4 Direct action to improve the labour market

The problems of large-scale unemployment among young people and increasing long-term unemployment for many others requires intensified efforts to minimize the social as well as economic costs incurred. Such action best takes the form of training or retraining in order to create vocational skills in line with growing economic needs. In addition, activity of social value should be found wherever possible for people who otherwise become alienated from normal participation in society and the economy.

In June 1983 the Council adopted a resolution favouring a 'social guarantee' for young people, i.e. that all young people leaving school should be guaranteed vocational training if not employment and a further resolution was adopted in January 1984 on the promotion of employment for young people. Many initiatives have been taken in support of these resolutions. They include extension of vocational training schemes in Denmark, Germany and the United Kingdom, extension of the school leaving age in Belgium, and contractual arrangements between the government and employers to increase the number of young people taken on for mixed programmes of work experience and vocational training (France, Italy).

Point 14: Strong support is required for action to implement schemes providing young people, from a minimum age, with vocational training or employment to build up the availability of technical skills suitable for modern economic development and to promote local employment initiatives particularly to bring socially useful activity to disadvantaged groups.

4. Europe in the world economy

4.1 *European policy reactions to world economic disturbances*

The world economic environment has over the last decade become much more unstable and unpredictable. For an economic region as large as the European Community the task for policy-makers is a double one: to anticipate as well as possible what new disturbances in the world economy may arise, and work towards cooperative international actions to avoid disturbances that would be damaging.

In the period ahead a correction of the presently unsustainable growth rate and balance of payments deficit of the United States is the most likely source of change in world trade and financial conditions. It is to be hoped that the necessary adjustments will be managed smoothly. However, there could conceivably be an awkward sequence of events in the short-run. For example, delay in a budgetary correction could lead to a further rise in interest rates and a continued high exchange rate, causing a cyclical slow-down even before the budget deficit was corrected. A delayed budgetary correction could then lead to a more severe cyclical stop. The world economy could again experience for a while both rising interest rates and a slow-down in world trade.

Furthermore, if there were a precipitous change in market expectations of the dollar's exchange rate the United States would face the prospect of a considerable inflationary impulse. While this would not be different from the actual experience in Europe in the last three years, a policy reaction to extinguish this inflationary shock could also cause a renewed recession. On the European side there is also the risk that a sharp weakening of the dollar could be a potential source of instability in intra-European exchange rate relations.

The international interest is to minimize the risks of damaging instability in the world business cycle and monetary relations. To this end, the Summit countries as a group should be prepared to consider a balanced set of adjustments to budgetary and monetary policies. The counterpart to a necessary balance of payments correction of the United States should be carefully distributed between Japan and Europe to lessen present imbalances (Japanese surplus) and prevent a large new imbalance in Europe. In the aggregate, a continued substantial expansion of world trade would need to be assured. Growth in world imports is expected on present forecasts to slow from 9,5 % in 1984 to 5,5 % in 1985. Europe and Japan should be prepared to support the buoyancy of world trade with adequate domestic growth in a phase of sharp slow-down in the United States.

On the particular problem of high world interest rates, it would be appropriate if the United States contributed to reducing its budget deficit by reducing the tax-deductibility of the interest payments of households. This would put a double downward pressure on interest rates.

Point 15: Europe and Japan should seek to assure that their own economic recoveries prove self-sustainable as and when the United States moves, presumably in 1985, to reduce its balance of payments and budget deficits, possibly with a cooperative set of policy adjustments on all sides and a more positive management of exchange rate relations between the three parties.

4.2 *Improving the world financial and trade system*

A second potential source of instability in the world economy lies in the debt situation, in particular in the large Latin American countries. For the Latin American sub-continent, present debt service burdens are on average of the order of 50 % of export earnings, whereas this ratio is only half as high or less for the developing countries of Africa, the Middle-East and Asia.

Some broad principles are emerging for a balance of responsibilities in the present difficult period of transition. The industrialized countries have responsibility for maintaining a substantial growth of world trade, for conserving or improving the openness of markets for imports from developing countries, and for sustaining their development aid effort. As regards the indebted countries, it is evident that their individual situations are highly differentiated, and depend in the first place on each country's own policies. Where countries are successful in organizing adequate adjustment programmes in cooperation with the International Monetary Fund, but where their debt rescheduling needs remain a long-term problem, possibilities should be opened for multi-annual rescheduling and a lowering of the interest rate margin on the part of the commercial banks. In this way a double help – stability over time, and lower costs – can be extended. Mexico is a first example in this respect.

As regards the world trade system, it is of the highest importance to reverse the recent trend of increase in protectionism. There are now possibilities for the Community and its trading partners to achieve this. As a token of its commitment to trade liberalization, the Community has agreed in principle to advance (to 1 January 1985) its GATT tariff reductions originally planned for 1986, but the United States needs to fulfil its commitment too in this respect, which is not yet assured. The Community is prepared to work constructively towards a new GATT round of liberalization measures. It also favours an intensification of work at the international level on the role that agreed rules for trade in services might play in this context. Discussion on the arrangements to succeed the present Multi-Fibre Agreement, which expires in 1986, will also open opportunities for liberalization of trade in textiles and clothing.

As regards the international monetary system, the Community is contributing to the work of the Group of Ten. The Group's mandate from the Williamsburg and London Summits of 1983 and 1984 has been to consider the possibility of proposals to improve the functioning of the system. A variety of proposals from official and independent sources has been made for a more systematic management and surveillance of exchange rate relations. The example of the European Monetary System shows that exchange rate stability is a feasible objective when participating countries are sufficiently committed to the necessary degree of policy convergence and to common mechanisms of currency intervention. This model is of course not appropriate for wide international generalization, although it could usefully be further built on within Europe.

Proposals have been made for softer 'target zones' for the major international exchange rates involving the dollar, the yen and the European Monetary System. There could be potential for less-formalized improvements in the system of multilateral surveillance within existing international forums. Such surveillance, at present only weakly operative under the aegis of the International Monetary Fund, could be strengthened. The characteristic of this surveillance activity would be:

(a) its multilaterial nature;

(b) its coverage of all the large industrialized economies;

(c) the attention given to the mix of monetary and budgetary policies; and

(d) the particular importance of the exchange rate as a criterion of the international coherence of the macroeconomic policies of the major economies.

Point 16: Easing of the debt situation of developing countries could follow from the cooperative management of individual country cases and general support from the industrialized countries in terms of world trade growth and openness and sustained development aid. With support from all the major trading regions, the recent increase in protectionism could be reversed in the period ahead through a number of trade liberalizing programmes now in preparation. The Community is supporting these initiatives. The Community should also continue to work towards improvement of the international monetary system through the procedures set in motion by the Williamsburg and London Summits.

5. Summary and conclusions

While some economic trends in the Community are now positive, no success has yet been achieved in improving the employment situation. A gradual recovery of production is under way. There is an improvement of price stabilization on average and as regard convergence among Member States. Balance of payments current account imbalances are being substantially corrected within the Community. But the unemployment problem remains in its entirety and the stagnation of job creation in the Community reflects structural faults in the economy that need thoroughgoing correction. The main focus of this report is therefore the dominant problem of unemployment.

With a view to achieving further substantial improvement in the Community's economic performance, especially for increasing employment, this report recommends guidelines grouped under 16 points, which are summerized as follows:

The macroeconomic financial policy framework

1. general objectives of a progressive increase in the actual and potential growth rate, combined with low or declining inflation;

2. a more balanced pattern of growth in its mix of capital and labour, correcting past trends which have been biased against employment growth;

3. a pause in the growth of current public expenditure, and a decline for several years in its share of GDP, but greater investment in the improvement or renewal of economic infrastructure;

4. an urgent and substantial reduction in tax burdens, especially on employment and enterprise;

5. a more convergent pattern of budget balances as between countries, with a faster correction of mounting public debt burdens where these are highest but a pause in the reduction of deficits where these have been brought soundly under control to permit reduced tax burdens;

6. an introduction of monetary policies consistent with increasing growth and low or declining inflation, and supporting convergence and stability within the European Monetary System;

For expansion and competitivity of the enterprise sector

7. rapid progress in opening up the internal Community market for goods, services, capital and the professions, and assuring easy movement across frontiers;

8. reviews of regulatory policies affecting the business sector, with a view to facilitating the creation of new enterprises and the speeding up of administrative procedures;

9. a widespread mobilization of national and Community policies to catch up or maintain leadership in advanced industrial technologies;

10. a medium-term programme for improving transport infrastructure at the European level;

For the expansion of employment

11. strict moderation in the development of real wages, consistent with the objective of achieving a pause in the growth or even a reduction in total real labour costs, which with lower taxes and lighter burdens of employment regulation, would mean a cost structure of firms that would be more conducive to employment expansion;

12. re-examination of labour market regulations and conventions to increase the short- and long-run propensity of the economy to create jobs;

13. greater flexibility in working time to help achieve a better matching of labour supply and demand;

14. implementation of the Council resolution to provide all school-leavers with vocational training or employment, and further local employment initiatives to bring useful activity to disadvantaged groups;

For a more stable international economy

15. preparedness to develop cooperative action with the United States and Japan to secure a smooth correction of the major imbalances among the industrialized countries, and to sustain an adequate overall growth in world trade in the period ahead when the United States' contribution will have to be less;

16. support for measures to strengthen the international monetary and trade system, and to manage the debt problem successfully.

These guidelines are of course in many cases not original. The essential point is rather to accelerate and intensify the implementation of this set of policy guidelines. They have to be considered as a package. It is not possible, for example, for elements of policy on labour costs or microeconomic policies to be taken without an adequate macroeconomic demand policy, nor vice versa. Within each country, it is necessary for all elements of macroeconomic and structural policies to advance in a mutually reinforcing direction. Across the European Community, it is similarly necessary for the actions of the Member States and of the Community itself to join together in forming a combined drive for a fundamentally improved economic performance.

PART II

ECONOMIC POLICY IN THE MEMBER STATES

Economic activity has recovered in *Belgium* in 1984 as exports have expanded strongly; this development, combined with the low rate of expansion of imports owing to the stabilization of domestic demand, has led to an appreciable improvement in the trade balance. Gross domestic product has grown by at least 1,5 % in real terms, and the rate of increase of unemployment has shown a marked decline. Consumer price inflation has also slowed down, to about 6,5 % in annual average terms, but it is now higher than the Community average in contrast to development in previous years.

In 1985, gross domestic product growth may be expected to slow down to about 1 %, as internal demand slackens slightly and exports probably lose momentum. Business investment will continue to develop rapidly, but public investment will probably decline once again. Private consumption may also decline in real terms, owing in particular to measures under the austerity programme adopted in March 1984 and especially the 2 % levy on wage and non-wage income. The trade balance will show a substantial surplus; this should be the case for the balance of payments on current account for the first time since 1976, despite the rapidly growing burden of foreign-currency public debt. The rate of consumer price increase is likely to decline to about 5,5 % in annual average terms. There could be a further slight increase in the number of unemployed.

The authorities margin for manoeuvre to deal with the grave problem of employment is seriously limited by the need to continue applying vigorous measures to restore a healthy public finance situation. Persistent large deficits, generating a very heavy burden of interest, are aggravating the debt-servicing problem year by year; consequently, a substantial reduction in the deficit in the near future is essential if the situation is not to become intolerable. The authorities aim to reduce the central government borrowing requirement from 12,5 % of GNP in 1983 to 7 % by 1987. The introduction of a package of measures in the spring of 1984 was an important step towards achieving this aim. The measures in the programme to redress the public finances, applicable in 1984 to 1986, will lead to a reduction in households' disposable income, since they include provision for levies on wage and non-wage income, and substantial savings in operating expenditure and in transfer payments to households. Nevertheless, the intrinsic dynamics of expenditure and the low rate of expansion of revenue will tend to hamper however the effects of the programme on the central government deficit for 1985. Significant progress towards the objectives set for 1987 therefore depends on severely limiting the public deficit in 1985: the central government cash deficit must not be allowed to exceed 10 % of GDP; measures to prevent this ceiling being exceeded should be introduced if necessary.

Although the development of incomes, especially wages and salaries, made an effective contribution to improving Belgium's competitive position in 1982 and 1983, the reintroduction of proportional indexation and increases in certain social security contributions fuelled the acceleration of labour costs in industry in 1984. The rise in productivity has more than compensated for this increased cost burden. It is nevertheless necessary to ensure that the rise in aggregate costs does not exceed certain limits in 1985. In this respect, the government envisages extending by two years the application of the law which aims at protecting competitiveness by imposing as a norm for labour costs a rate of increase parallel to that recorded by Belgium's main trading partners. The retention of competitivity is an essential condition for achieving a trade surplus in coming years that will cover interest payments and the gradual redemption of foreign currency public debt.

Continued wage restraint is also required to consolidate the recovery of private investment, which is gaining momentum thanks to buoyant external demand and to the improvement in profitability and in enterprises' financial structures.

On the basis of the predicted rate of growth of economic activity in 1985, employment is unlikely to improve next year. However, the accumulated effects of the 1983 agreements on the reduction of working hours with compensatory recruitment, which have been extended to the end of 1986, and the extension of a part-time working programme, should check the expansion of registered unemployment. The government's proposed measures to increase flexibility on the labour market, in particular the recruitment of supplementary work-teams, and more flexible rules on severance pay and dismissal, should facilitate growth in job availability. Care should be taken that all these measures do not however raise firms overall production costs, as this would damage their still fragile competitive position.

BELGIUM

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	8,5	4,8	3,5	3,2	7,8	0,6	– 1,3	8,6	2,2	0,6
1971 to 1980	10,5	3,3	7,0	7,0	12,0	– 0,2	– 5,0	10,3	5,8	0,3
1981	4,2	– 1,2	5,4	8,6	7,7	– 4,5	– 12,8	5,8	10,3 (11,2)	– 2,1
1982	8,3	1,1	7,1	7,6	7,9	– 3,4	– 11,1	5,7	12,1 (13,1)	– 1,3
1983	6,2	0,4	5,9	6,8	7,1	– 0,9	– 12,2	8,8	13,4 (14,4)	– 1,6
1984 (1)	7,1	1,5	5,5	6,4	6,7	– 0,4	– 11,5	9,7	13,4 (14,4)	0,2
1985 (2)	6,4	1,0	5,3	5,5	6,2	0,5	– 10,5	8,8	13,8 (14,8)	– 0,3

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.
(4) Eurostat definition in brackets.

In *Denmark,* the economic recovery, which started in 1983, became significant in 1984: industrial exports rose, due mainly to the improved international economic environment; domestic activity was underpinned by higher private consumption and residential construction, and by a pick-up in private business investment. Gross domestic product may have grown by almost 4 % in 1984 after 2,5 % in the previous year. The improvement in the current balance of payments in 1983 did not continue in 1984 as a result of a substantial increase of imports of consumer durables and machinery and following a further rise in net transfer abroad. As a result of restrictive fiscal and incomes policies, the rise in domestic costs slowed down considerably. The public finance situation improved as a consequence of the economic recovery, but also following higher social contributions, increased public service charges and various expenditure cuts. The net central government borrowing requirement fell from 10,5 % of the gross domestic product in 1983 to about 7,5 % in 1984.

The outlook for 1985 points to a further improvement in activity and the gross domestic product could grow by another 3 %. Foreign demand and increased market shares should enable exports to continue their vigorous development and the improved business situation has helped to boost investment intentions.

While public consumption of goods and services is expected to remain broadly unchanged, private consumption will continue to grow, mainly as a result of higher employment. The unemployment rate will nevertheless remain at 10 %, on account of the growing labour force. Despite higher net transfers abroad, there should be a further small improvement in the current balance of payments as alternative national sources of energy are increasingly being substituted for imported energy and as the terms of trade improve. The deficit on current account might thus fall from almost 3 % of the gross domestic product in 1984 to some 2 % in 1985. Depending upon the outcome of wage bargaining at the beginning of 1985, the increase in consumer prices should continue to slow down to an annual average of 4 to 4,5 %.

The authorities intend to maintain the economic policy stance adopted since 1982 which seeks to reduce inflation, to control the public finances and to restore competitiveness and thus to improve the overall performance of the economy in the medium term. Nevertheless, some adjustments to this policy may be necessary if it would appear that domestic demand increases too rapidly, so as not to call into question 'the projected improvement of the current balance of payments and the expected deceleration of inflation'.

According to the draft budget for 1985, the ceiling on central government expenditure in real terms will be maintained at its present level, a similar guideline being recommended to local government. As a consequence of various fiscal measures, government revenue may, on the other hand, grow faster than the improvement in economic activity alone would imply. Net central government borrowing will continue to decline and might reduce to 6,5 % of the gross domestic product despite the rapidly growing interest payments on the public debt, which alone involve greater expenditure than the budget deficit.

Monetary policy should contribute to keep domestic demand within acceptable limits and in particular restrain the increase in money supply, which was very rapid in 1983. After the restructuring of portfolios which took place in that year, the rate of increase of monetary growth should now be held closer to that of nominal gross domestic product. In order to curb bank lending in excess of the official targets the central bank modified the banks' monthly borrowing limits to the effect that banks whose lending has grown particularly strongly will have their borrowing facility at the central bank reduced.

The authorities would like two yearly wage agreements next year to imply wage increases 2 % lower than the average of competing countries. The temporary suspension of wage indexation, prolonged until March 1987, helps to slow down the rise in costs provided compensatory wage drift can be avoided. In this respect, a pick-up in economic activity represents a risk, which could have an adverse influence on inflation expectations. In order to encourage non-inflationary growth, it is more important than ever to improve labour market flexibility, to reduce prevailing rigidities in wage formation and working time and to redress the mismatch between jobs available and the skills of persons seeking work. The reforms envisaged with regard to the unemployment compensation system (splitting the compensation between a fixed portion covered by the system, and an optional portion covered by supplementary insurance), more flexible retirement arrangements and the reduction of high marginal taxation of personal incomes are in keeping with these efforts.

With a view to improving the efficiency of resource allocation and thus raising growth potential, the government launched a programme that should, together with planned public investment, facilitate the coordination and strengthening of private and public activities in such major areas as education and research, technological innovation, infrastructure and communications. Funds have been made available from the budget, and various reforms have been envisaged, among other things, to encourage risk capital investment and to adjust vocational training to the needs of new technology.

DENMARK

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 H [3]	Unemployment in labour force [4]	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	11,2	4,9	6,0	5,2	10,5	– 2,2	1,3	10,2	1,1	1,1
1971 to 1980	12,2	2,4	9,6	10,0	11,6	– 2,9	0,9	11,3	3,8	0,7
1981	9,6	– 0,9	10,5	11,8	10,0	– 3,1	– 7,0	9,6	9,2 (8,9)	– 1,4
1982	14,2	3,4	10,5	10,4	11,6	– 4,1	– 9,3	11,7	9,9 (9,5)	0,5
1983	10,3	2,5	7,6	6,7	7,0	– 2,1	– 7,6	24,7	10,5 (10,2)	0,5
1984 [1]	9,5	3,8	5,5	6,0	5,5	– 2,8	– 5,5	11,0	10,2 (10,0)	1,3
1985 [2]	7,6	2,9	4,5	4,3	4,6	– 2,2	– 3,7	8,0	9,8 (9,9)	1,4

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year. Until 1979: M2.
(4) Eurostat definition in brackets.

Economic development in the *Federal Republic of Germany* in 1984 was depressed by an industrial dispute: prolonged strikes and lock-outs in the metal working industry, which affected in particular automobile production, led to an abrupt interruption of growth in the second quarter (– 6 % of gross domestic product, annualized rate). The disruption to economic growth was however only temporary and output losses should largely be made good in the second half of the year. For the year as a whole the gross domestic product will grow by about 2,5 %, strongly supported by exports and gross fixed investment, which has benefited from improved profits. In contrast, private consumption has expanded relatively slowly.

The outlook for 1985 points to an upward movement of the economy at a similar pace. Investment in equipment will continue to rise quite strongly but total investment growth will be restrained by weakness in the construction sector. Exports will also contribute strongly to growth. An overall growth rate of some 2,5 % in real terms of the gross domestic product can be expected.

Economic policy has been successful with respect to its major objectives. As measured by the cost-of-living index, inflation should, as in 1984, be below 2,5 % and the surplus on current balance of payments should be of the order of 1 % of gross domestic product. Further progress will be made towards consolidation of the public finances and the structural deficit should practically disappear. The quantitative framework of monetary policy is likely to give sufficient support in 1985 to economic growth, while allowing some decline in domestic interest rates.

The economic situation is clouded however by the persistent imbalance on the labour market. The wave of redundancies came to an end in the first half of 1984, but no marked reduction in unemployment can be expected during 1985.

The improvement in general economic conditions in Germany in recent years has halted the rapid increase in unemployment since the beginning of 1980 and led to a reduction in the large amount of short-time working, but it has not yet brought about a rise in employment. Above all, relative factor prices, despite considerable progress with regard to wage adjustment, are still not yet compatible with a balanced labour market. The rise in real wage costs in the past led on the one hand to greater substitution of capital for labour, but at the same time to a weakening of companies' profitability and of their ability to invest and to innovate. Company profits have recently shown marked renewed growth but they are still well below the average of the 1970s.

Wage policy could make a decisive contribution to raising the level of employment, if settlements continue at a lower rate than the growth of productivity. This would do much to help improve the investment climate and would attract workers into labour-intensive sectors. In order to encourage this development, the labour market should operate more efficiently; in particular labour mobility should be promoted. Larger wage differentials, based on productivity performance and on relative positions of sectors and regions could make a decisive contribution thereto. Wage restraint in the public sector could also contribute towards this end.

The government can already point to some notable policy successes. In autumn 1984 a record number of new apprenticeships entered into by school-leavers was recorded: this was achieved without official intervention. Measures have been taken in the areas of professional training and retraining, regulations for part-time work have been adjusted and further legislative provisions to improve the working of the labour market are being prepared. Better housing market conditions should contribute to greater geographic mobility of the labour force.

An attempt has been made in two sectors to improve employment prospects by shortening the working week. Although the final compromise agreement largely corresponds to the demands for cost-neutrality, the additional compensation for those workers whose working week is below the agreed average of 38,5 hours raises problems. This will most likely apply to lower-skilled workers, whose labour will become more expensive and who will thus run the greatest risk of falling victim to rationalization.

There is also a danger that the necessary improvement in company profits could be set back by the shortening of work-hours coupled with wage compensation. The introduction of shorter hours should therefore be agreed in such a way that it does not endanger profitability but contributes instead to increased flexibility of the labour market.

A situation in which wages increase less than overall productivity, while purchasing power is reduced as a result of shorter working-time combined with continued budgetary restraint and reduction of the role of the State, is not without risk, particulary at a time when slower growth of world trade is expected. Faster growth and higher profits also require a satisfactory development of demand.

Fiscal policy therefore, while continuing to underpin effectively the desired supply-side improvement, should be flexible enough to compensate for any demand

shortfalls which accompany supply supporting measures. On the basis of a growth rate of 2,5 % the Central Government deficit (Bund and Länder) is forecast at some DM 40 000 million. Should the growth rate be substantially lower in the course of the year, budgetary policy should react flexibly, for example, by allowing the automatic stabilizers to work. Given the room for manoeuvre built up during the period of successful consolidation policy, the Government might also consider at least partly bringing forward the tax reform package planned for 1988. In any case, such a fiscal stance should be accompanied by further restructuring of public expenditure away from consumption and towards productive and environment protecting investment. This will further strengthen the private sector with consequent beneficial effects for capital accumulation and growth.

FEDERAL REPUBLIC OF GERMANY

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	8,4	4,7	3,5	2,9	8,6	0,7	0,5	10,4	0,8	0,2
1971 to 1980	8,2	2,9	5,2	5,2	8,6	0,6	−2,2	9,8	2,8	−0,1
1981	4,2	0,2	4,0	5,6	5,3	−1,0	−3,9	5,0	4,7	−0,7
1982	3,7	−1,0	4,8	5,3	4,4	0,5	−3,5	7,1	6,8	−1,8
1983	4,2	1,0	3,2	2,9	3,7	0,7	−2,7	5,3	8,4	−1,7
1984 (1)	4,4	2,4	1,9	2,3	3,4	0,6	−1,7	5,2	8,5	−0,4
1985 (2)	4,7	2,5	2,1	2,2	2,9	1,1	−0,8	5,0	8,5	0,0

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.

1984 was a year of recovery of economic activity in *Greece,* as consumption picked up and the real balance on foreign trade continued to develop favourably. As agricultural output also expanded strongly, the real rate of growth of gross domestic product was well over 2 %. Productive investment, however, did not recover as expected, and the reduction in the inflation rate, achieved at the cost of stricter measures, was only marginal. The balance of payments deficit on current account remained large, at 4,7 % of gross domestic product (1).

Economic growth is thus being hampered by the pronounced imbalances still facing the economy. Inflation, by perpetuating instability and necessitating the maintenance of controls, creates a situation that is hardly conducive to the adjustment of production structures essential to the gradual relaxation of the external constraint. Although the economy has benefited since early 1983 from the depreciation of the real exchange rate, the favourable effects did not suffice to reduce the trade deficit; at the same time, the overall surplus on invisible transactions has not improved, despite the marked recovery in tourism, partly because of the rapid increase in the burden of interest on external public debt. The room for growth in the near future is consequently limited. As growth in 1984 was underpinned by exceptional factors that are unlikely to recur, a further slight slowdown may be expected in 1985 although the growth rate should not fall far short of 2 %. In view of the continued strength of inflationary pressures, there is little hope of a spontaneous decline in the rate of price increase to less than about 18 %.

The return to strong growth, which would both check the expansion of unemployment and speed up productivity gains, will thus depend on loosening the external constraint, and this means a more rapid adjustment of production structures and a substantially higher rate of investment of a type to ensure such adjustment. It will therefore be important for economic policy in 1985 to step up considerably the efforts already undertaken in this direction, and to aim at achieving a recovery in private investment, in particular by facilitating a healthier financial situation among enterprises.

This policy will have to be part of a general disinflation drive that will be effective only if it is geared to removing

(1) According to national accounting conventions.

the fundamental causes of rising prices rather than to controlling the symptoms through administrative measures that cannot effect a genuine cure, and may, in fact, lead to discrimination and distortion. It is therefore essential to place a determined check on the dynamics of cost increases and to reduce the public deficit; the effects combine to bring about a rate of monetary creation that is incompatible with the prospect of a return, even very gradual, to stability.

Consequently, a restrictive wages policy must be restored in 1985, for example, by adopting a normative rate for pay increases corresponding to a programmed rate of inflation. As to budgetary policy, it should aim at limiting net central government borrowing to 9 % of gross domestic product, i.e. more than one point lower than the expected 1984 outturn. As the cost of interest may be expected to increase substantially, and as the budget will be called upon to make a further major contribution to investment, this aim for the deficit will require very strict management of operating expenditure on services, and appropriate adjustments to public service charges to reduce the requirement for subsidies. It will also imply a significant reinforcement of the tax pressure, which should however come for the main part from more efficient measures to combat tax evasion. Indeed, the expected outcome of measures taken in this area already could even make it possible to reduce the burden of personal income tax, which weighs most heavily on wage and salary earners, as a counterpart to restraining the rise in remuneration.

Monetary policy should support the disinflation drive by continuing to raise real interest rates (which recently returned to positive figures), thus encouraging the trend of savings towards a less liquid structure.

As these various approaches tend to speed up the return to domestic balance, they should, together with the help of supply-side measure mapped out in the Plan, enable the economy to make good progress towards structural adaptation. It will need to persevere on this path well beyond 1985 to return gradually to a growth rate commensurate with the need to halt and later reverse the upward trend of unemployment.

GREECE

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	11,0	7,6	3,1	2,5	9,8	-3,1	—	17,6	—	-0,7
1971 to 1980	19,1	4,7	13,8	13,6	18,3	-2,7	—	23,8	—	0,6
1981	18,9	-0,3	19,3	23,4	21,8	-0,2	-12,1	34,3	4,1	4,8
1982	24,4	-0,1	24,6	20,5	26,8	-3,9	- 9,7	29,1	5,8	-1,0
1983	20,1	0,3	19,8	19,0	21,3	-4,5	- 9,2	20,3	7,9	0,5
1984 (1)	20,9	2,2	18,3	18,5	21,2	-4,7	-10,0	24,2	8,4	0,3
1985 (2)	20,0	2,0	17,7	18,0	19,4	-4,9	-10,1	24,1	8,8	0,3

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.

The continued application of restrictive policies in *France* in 1984 has severely limited the expansion of domestic demand. At the same time, it has significantly changed the structure of demand to the benefit of the enterprise sector, whose investment upswing has gathered momentum, while the recovery of consumption has been weak and residential construction has continued to decline. The rate of price inflation continued to fall although the reduction was not sufficiently pronounced to prevent some deterioration in competitiveness. Altogether the 1984 growth rate should amount to some 1,5 %, while the rate of price increase in the course of the year will

probably be down to a little over 6,5 %; the balance of payments deficit on current account will probably be of the order of 0,5 % of the gross domestic product.

The progress made so far towards restoring balance does not appear sufficient to justify any relaxation of the strict policy. This policy of strict discipline comprising in the main of imposing constraints on prices, incomes and the money supply so as to ensure disinflation in the economy and external adjustment, and to restore the financial position of enterprises, will have to, therefore, be maintained in 1985. As there is a good chance that a fairly favourable international environment will continue to support France's efforts, the main objectives may well be achieved by the end of the year, namely to close the gap between inflation in France and the average inflation rate for the industrialized countries, to restore the balance of payments on current account to surplus, and to bring the level of corporate saving back up to that obtaining before the first oil shock. At the same time, domestic demand should have a slightly wider margin for expansion, mainly to the benefit of business investment. Altogether, the growth rate in 1985 might reach 1,7 %.

Whether these favourable prospects materialize, confirming the restoration of basic balance, will depend on how far economic policy can manage to keep labour costs and the public deficit low enough to ensure that inflation control does not require a further increase in real interest rates, which would adversely affect the recovery of investment demand.

Consequently, it is necessary in the first place for wages policy to maintain the disinflationary stance involving *de facto* disindexation that was successfully pursued in 1984. The rise in *per capita* earnings in the course of 1985 should be no greater, on average, than the programmed price rise of 4,5 % in the course of the year. This rate should serve as a benchmark for all pay agreements in the public and private sectors: it will be largely up to the two sides of industry to ensure that this limit is respected in the framework of customary negotiation procedures. The relaxation of tax pressure provided for in the 1985 budget should make the two sides of industry more willing to accept the necessary discipline.

Furthermore, it is equally essential for public finance policy to concentrate on keeping the general government borrowing requirement in 1985 to a figure no larger than 3 % of gross domestic product, in the interests of financial balance. This aim will be all the more difficult to achieve now that the decision has been made to start on a process of reducing the burden of compulsory levies, which had been steadily increasing since the early 1970s. The 1985 draft budget therefore provides for the suppression of the exceptional 1 % levy on incomes, collected for the social security funds, and major reductions in personal income tax and the business tax. Despite significant progress towards restoring balanced social security accounts, such major concessions will imply a much more vigorous effort to reduce expenditure on all items that are not determined by automatic mechanisms. This will mean tighter control of operating expenditure, investment and transfers to enterprises, and involve stricter rules on the ranking of priorities in the light, in particular, of the requirements of industrial renovation, the promotion of research and the support of employment. Furthermore, social benefits must not be allowed to outstrip the programmed price increases and the rate of expansion of real expenditure on the health service will have to be reduced once more.

If the necessary rigour is applied to wages and budgets, monetary policy should be able to make an active contribution to disinflation by further reducing the rate of domestic credit expansion and the liquidity ratio of the economy, without exercising too restrictive an effect on the external financing of enterprises. This monetary policy stance will, however, mean that any reduction in interest rates should be approached with great caution, and accurately tuned to the requirements of both domestic and external equilibrium.

Finally, action on the above lines should ensure that control over the domestic factors of inflation is strong enough to allow some relaxation of price controls and complete freedom for industrial prices to be restored.

But there are other reasons for a continued action of strict policies, beyond the requirements of restoring external balance and subsequently reducing the external debt. It is essential to ensure that the economy makes up as rapidly as possible the ground it has lost by delaying adjustment to rapid change in its growth factors, and to arrest and subsequently reverse the declining tendency of employment, largely due to this lack of adjustment. Net job creation cannot return to positive figures without faster regeneration of production structures involving both redeployment towards new forward-looking activities, and the indispensable technological renewal to

ensure the survival of traditional sectors. As the restrictive policies tend by all possible means to release the resources required for the major investment to ensure such regeneration, it is an indispensable step towards establishing the structural conditions for a return to lasting growth at a more sustained rate, leading to net job creation.

The outlook for employment will hardly begin to improve, however, until 1986. The declining tendency of employment that has been observed since the early 1980s will probably continue in 1985, because the inevitable restructuring of certain industrial sectors is still leading to labour-shedding on a large scale. The present stage is characterized by the predominance of efforts to streamline production processes rather than to create new capacity. This trend is especially pronounced in large industrial undertakings, which are leading the investment recovery now under way, since the pressures of international competition are forcing them to undertake radical adjustment. Investment support policy will have to ensure that this recovery spreads rapidly to smaller firms, which probably have a much greater potential for job creation.

Unemployment, therefore, will no doubt continue to increase for some time to come. But cost considerations are bound to prevent any significant reinforcement of the social measures already in force to keep unemployment in check; in particular, further measures to achieve a general reduction in working hours do not seem feasible. For the same reasons, it would be unadvisable to postpone necessary labour-shedding. Indeed, if social policy is to have a good chance of making an effective contribution to combating unemployment, the best approach lies in increasing the flexibility of the labour market and in adapting vocational training apportunities, one of the priorities of the Ninth Plan.

FRANCE

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 R (3) (4)	Unemployment in labour force (5)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,2	5,6	4,4	4,3	9,4	0,2	0,4	12,7	0,9	0,6
1971 to 1980	13,4	3,6	9,5	9,5	13,8	−0,4	−0,1	14,8	3,8	0,4
1981	12,1	0,2	11,9	12,9	14,5	−1,4	−1,8	11,4	7,8	−0,7
1982	14,8	1,8	12,8	10,9	14,5	−2,9	−2,7	10,8	8,7 (8,8)	−0,8
1983	10,8	0,7	10,0	9,3	10,8	−1,5	−3,3	11,2	8,4 (9,0)	−0,6
1984 (1)	9,0	1,4	7,5	7,6	8,8	−1,2	−3,4	7,0	10,0 (10,7)	−1,5
1985 (2)	7,7	1,7	5,9	5,7	7,0	−0,7	−3,6	6,5	11,6 (12,4)	−1,4

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.
(4) Up to 1980: M 2.
(5) Eurostat definition in brackets.

In *Ireland,* the economy began to emerge from recession in 1984. While domestic demand stabilized, a vigorous export performance provided the main stimulus to the recovery in output. The authorities can take considerable encouragement from the continued progress made in redressing the major imbalances in the economy. The deficit on the current account of the balance of payments, which had exceeded 14 % of GDP in 1981, has now fallen to 4,4 %. Inflationary pressures have eased significantly and the annual rate should be below 8 % at year-end, a reflection of favourable external factors but also of more wage restraint. The budgetary targets for

1984 seem well on the way being met. Overall, growth of GDP in 1984 is expected to exceed 3 %. Unemployment, however, is still on a rising trend.

In 1985 the pace of recovery will remain modest as growing consumer and investor confidence is partly offset by the dampening effects of high levels of nominal interest rates and taxation. The public authorities will, however, not be in a position to supply any major stimulus to overall demand as the large accumulation of public debt (implying interest payments of over 11 % of gross domestic product and the continuing high level of the General government deficit (about 11 % of gross domestic product in 1984) leave little alternative to pursuing firmly the fiscal adjustment policy.

The appropriate pace of this adjustment is a central question. The desireability of reducing quickly the Exchequer deficit must be balanced against the need to have a credible adjustment schedule, given the large magnitude of the deficits, as well as to allow the economy to absorb the short-run costs, in terms of output and employment. In this respect the recently published medium-term economic plan strikes a cord of realism in its assessment of the nature and scale of the budgetary problem. Nevertheless, in aiming to contain the current budget deficit to 5 % of gross national product by 1987, the plan is significantly less ambitious in its medium-term budgetary stance than earlier official policy and could thus lead to a loss of impetus in maintaining a steadily improving trend in fiscal correction. For instance, developments in government consumption and interest payments over the period may be less favourable than anticipated. In 1985, moreover, the level of the current budget deficit envisaged in the plan, about 7 % of GDP, is broadly unchanged compared with the expected outturn for 1984.

Given the large increases in the level and scope of taxation that have taken place in recent years, the burden of adjustment should be placed essentially on expenditure cuts. With debt interest payments continuing to rise sharply, and demographic factors and high unemployment exerting strong upward pressure on social expenditure (education, health, social welfare), a fundamental restructuring of the entire range of current expenditure is now required. The authorities intend to strengthen their existing policy of curbing the public service pay bill by limiting pay increases and by restricting recruitment and promotion, but, until the recent partial abolition of consumer subsidies, have seemed reluctant to establish priorities among other expenditure programmes, so that less essential schemes can be scaled down methodically within a medium-term framework. It is only in this way that the Exchequer can meet real social needs while redirecting expenditure as much as possible towards productive purposes, within the constraint of its limited resources, and, at the same time, continuing to move towards fiscal balance. In this respect, it must be remembered that the present level of social spending, although partly cyclically determined, also reflects substantial discretionary increases in the past decade in the real value of benefits.

The authorities should aim to cut current expenditure in 1985 by at least as much as envisaged in the medium-term economic plan. Such reductions in expenditure are unlikely to lead to lower Exchequer borrowing because they will be largely offset next year by the impact of increases in interest and dollar exchange rates on debt-related expenditure. However, it would be appropriate to reduce overall public sector borrowing in 1985 by some 1,5 % of gross domestic product. The fact that work is winding down on some major public capital projects, implying a considerable reduction in borrowing by the State-sponsored bodies concerned, should assist substantially in achieving this objective. In addition, as the new investment assessment criteria applied by the Exchequer should ensure better value for money, the authorities should be able to put greater emphasis on certain projects in the productive infrastructure area, taking account of their immediate and longer term implications for output and employment.

While international monetary conditions might not leave much room for lower Irish interest rates, the expected fall in the rate of inflation and the forecast improvement in the balance-of-payments position will exert a favorable influence in the medium term. In the short term these may be offset however, by the Exchequers' continuing large financing requirement in so far as there continues to be a need to maximize sales of Government paper to the non-bank public.

A major problem in Ireland is that the industrial sector is still small in size despite the long-established policies to promote industrialization; the buoyancy of industrial exports has largely originated from new, mainly foreign owned, high-tech' firms. Given the high import content of many of these exports and the current substantial level of repatriations, sustained growth in manufacturing output will not be proportionately reflected in domestic value added, unless industrial policy ensures the development of a larger manufacturing base. This implies a more

selective use of grants and tax-expenditure incentives not only to encourage foreign companies to reinvest profits and site key production processes in Ireland, but also to upgrade the potential of domestically owned firms in the traded goods sector to perform more effectively in terms of exporting, competing with imports and developing supply linkages with foreign owned firms. This emphasis is reflected in policy initiatives announced by the Government in a white paper on industrial policy published in July 1984.

Growth prospects in the Irish economy remain crucially dependent on the state of its international competitveness. Sustained wage moderation is required therefore both in order to match the modest rise in unit labour costs in the main trading partners and to restore the severely depressed levels of profits in domestically owned Irish industry. In addition, it is possible that a bias has developed towards excessive capital deepening at the expense of labour caused by an insufficiently selective use of investment incentives in the past but also by the fact that the competitive position of individual firms and sectors has not been adequately taken into account in negotiating pay increases and improved working conditions. Judicious use of marginal wage subsidies, such as through the employment incentive scheme, can play a useful corrective role in the short run; in the longer run, however, net employment can only be created on a larger scale through enhancing the competitiveness of labour.

IRELAND

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	9,9	4,2	5,5	4,6	9,9	- 2,3	- 2,7	10,4	4,5	0,0
1971 to 1980	19,5	4,6	14,2	13,8	18,0	- 4,6	- 8,1	18,5	7,4	1,0
1981	20,5	2,9	17,1	19,5	19,9	-14,4	-16,5	17,4	10,3	-0,6
1982	18,0	1,9	15,8	16,1	14,2	-10,1	-14,2	13,0	12,3	-0,2
1983	11,1	0,6	10,4	9,7	10,4	- 5,9	-12,3	5,6	14,8 (15,0)	-1,9
1984 (1)	10,9	3,1	7,6	8,8	10,6	- 4,4	-10,8	13,2	16,3 (16,5)	-0,5
1985 (2)	8,5	2,6	5,8	7,0	5,9	- 3,3	-10,9	11	16,3 (16,5)	1,1

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.
(4) Eurostat definition in brackets.

In 1984, the *Italian* economy remained on the growth path it had been following since the second half of 1983. The recovery was entirely export-led in the early stages, but the exceptionally rapid expansion of exports lost some of its momentum later on, while domestic demand was strengthening appreciably during 1984, accompanied by rising imports. The real external balance continued to make a positive contribution to growth, which should increase to close to 3 %. There was a further decline in the rate of price increases, which should average around 10 % for 1984, i.e. more than four points below the 1983 rate, with the rate over 12 months down to around 9 % by the end of the year. The balance of payments on current account, on the other hand, which was back in balance in 1983, will probably revert to deficit in 1984 as a result of a deterioration in the terms of trade and of the increasing burden of interest on the external debt.

The policy pursued, and the improvement in the international environment, enabled the economy to return to a path of sustained growth, so far compatible with further progress towards disinflation, and characterized by a clear improvement in business investment, which is an essential condition for its solidity. Nevertheless, the outlook for lasting growth at a comparable rate is not guaranteed. Without determined

action to ensure that both public finances and wage costs develop in a way compatible with the 7 % target for price increases in 1985, the disinflation process is likely to be interrupted and further monetary restrictions would have to be introduced to guard against the resultant threat of a deterioration in the already fragile equilibrium of the balance of payments on current account. Only if such a policy, which corresponds to the Government's intentions, can be successfully and comprehensively applied, will the inflation differential in relation to the Community average continue to narrow, and the process of restoring a more solidly-based balance-of-payments equilibrium on current account get under way again. These developments would, however, lead to a slow-down in activity, and probably imply a growth rate of some 2,5 % in 1985.

The authorities should take advantage of the fundamental improvement in the economic climate to get the process of reducing the public deficit under way, in line with the Government's multiannual programme for transforming the present current deficit of 7,4 % of gross domestic product into a small surplus by 1988. Determined action to reduce tax evasion should play an important part in reducing the public sector deficit. The contraction of the deficit should have a restraining effect on consumption demand while appreciably relaxing the pressures on the financial system. It will attenuate the crowding out effects of very high real interest rates, which the restrictive monetary policy in force since 1981 cannot avoid. In this context, it would be appropriate, to limit the Treasury's borrowing requirement in 1985 to Lit 96 000 billion (1), a figure close to the expected outturn for 1984, but equivalent to about 14,4 % of the forecast gross domestic product instead of 15,8 % in 1984.

This target, which was included in the Finance Act presented to Parliament on 30 September and still under discussion, implies a correction of Lit 24 000 billion in relation to the underlying deficit (2). It will have to be reconciled with the Government's other commitment to stabilize the tax burden and real expenditure in the medium term. On the revenue side, the approach will involve returning to the 1983 level of the tax burden by introducing temporary measures to raise an extra Lit 16 000 billion, in particular by carrying over into 1985 the amnesty on unauthorized building, and by a number of changes in value added tax rates and collection arrangements that aim principally at reducing tax evasion. On the expenditure side, a major and determined adjustment of the underlying trend for 1985 and beyond will be necessary. It can be achieved in a variety of ways notably by seeking greater efficiency in the civil service, putting a check on the development of earnings, making a continued effort to streamline the pensions system, increasing user charges for certain public services, especially the national health service, and applying stricter conditions for Government financing. The draft Finance Act for 1985 contains a package of proposals to this effect, but further measures will probably be required at a later stage.

As to wages policy, new measures will be required to ensure that the disinflation of earnings continues, in the first instance, by limiting the upsurge in the rate of pay rises that can be expected to result from the application, at the beginning of 1985, of the Agreement of 22 January 1983. A new acceleration of wage inflation would be all the more likely as the rise in prices will tend to gather momentum from 1 January following the reorganization of value added tax, the effect of which would normally be reflected in the indexation mechanism. This is one more reason why the forthcoming negotiations should deal with all aspects of wage-fixing arrangements and lead not only to temporary measures for 1985, but also to permanent changes and in particular to a fundamental revision of the 'scala mobile' system.

If the aims of both fiscal policy and wages policy are met, the role of monetary policy would essentially consist in sustaining further disinflation by setting a target for the expansion of money supply (M2) no higher than the nominal gross domestic product growth rate while avoiding further increases in real interest rates.

The various components of economic policy would thus combine to preserve as far as possible the recovery of business investment, essential to an improvement in the steadily deteriorating employment situation. The modest investment drive of the past few years was mainly geared to more rapid modernization of production processes; it has led so far, at least in industry, and especially among larger firms, to net labour-shedding on a large scale. However, modernization was absolutely essential to protect competitiveness: it prevented the obsolescence of capacity that would eventually have damaged employment even more. Consequently, it is important to pursue the investment drive, especially in the large public sector corporations, where restructuring has lagged. The

(1) Not including the settlement of debts owed by local health service departments to the banking system.
(2) Estimate made by the services of the Commission.

most critical phase in the adjustment process is probably nearly over; with the help of the recovery of growth, capital widening can now be expected to account for a larger share of the growing volume of total investment.

Basically, the development and modernization of production capacities should be a natural concomitant of the improvement in firms' financial situations, itself associated with the benefits to be expected from productivity gains and cost disinflation. This improvement will also enable firms to reinforce their efforts of research and innovation; but all these spontaneous developments will still need to be underpinned by an appropriate industrial policy. The general stance of this policy is at present being reviewed; it might be appropriate in this context to put emphasis on the development of public sector demand for advanced technology products rather than on tax or financial incentives. Specific intervention is still required, of course, in the South.

A return to more satisfactory employment trends also depends on whether vocational training policy and employment policy concentrate on improving labour market conditions, in particular by adjusting vocational training so as to provide the skills required by the economy, and by continuing efforts to increase labour market flexibility.

ITALY

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,5	5,7	4,5	3,8	10,7	1,8	− 2,3	13,3	5,2	− 0,4
1971 to 1980	18,3	3,1	14,7	14,6	18,4	− 0,2	− 8,0	19,5	6,0	0,5
1981	17,4	− 0,2	17,6	19,0	22,0	− 2,3	− 11,7	16,0	8,8	0,5
1982	17,1	− 0,3	17,5	16,7	17,1	− 1,6	− 12,7	17,2	8,7 (10,5)	− 0,2
1983	13,7	− 1,2	15,0	15,1	15,9	0,1	− 11,8	13,2	9,7 (11,8)	0,2
1984 (1)	13,3	2,9	10,2	10,3	12,3	− 0,4	− 13,6	12,0	10,2 (12,5)	0,5
1985 (2)	10,0	2,3	7,7	7,1	7,9	0,0	− 12,2	10,8	10,5 (11,9)	0,2

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.
(4) Eurostat definition in brackets.

Economic activity recovered in *Luxembourg* in 1984, especially in the steel sector, leading to a gross domestic product growth rate of about 2 %. External demand developed appreciably while domestic demand declined as a result of a slowdown in private consumption, public investment and residential building, although business investment improved slightly. Consumer prices continued to rise at a fairly rapid rate until autumn.

The rate of growth of the gross domestic product could stabilize at about 2 % in 1985, due to the firmness of exports and to the expected expansion in private consumption following an improvement in households' disposable incomes. Business investment, especially in the steel sector, should expand considerably and residential construction will be stimulated by measures promoting subsidized housing. The rate of increase in consumer prices should be lower.

Restructuring in the steel industry, supported in 1983 and 1984 by State aid on a significant scale, will have to continue for some years but the potential for economic

growth will depend to a large extent on the success of efforts to achieve industrial diversification, which the authorities are anxious to intensify.

The reintroduction of automatic pay indexation on 1 January 1985, will require increased vigilance concerning production costs in order to prevent a deterioration in Luxembourg's competitive position. The Government has reserved itself the right to intervene temporarily in wage fixing. The gap between the rate of inflation in Luxembourg and that in neighbouring countries should cause the authorities to seek suitable means to control rising prices, for example by stimulating competition at the level of retail distribution.

Even though the social impact of restructuring in the steel industry has been successfully cushioned by measures to provide jobs for steel workers threatened with dismissal, the arrangements applied should be carefully reconsidered to prevent their cost from becoming too high, and to avoid labour market rigidities. The new anti-unemployment measures proposed in the Government's programme (including traineeships and part-time working) seek to solve, by means of temporary measures, the problems of frictional or structural unemployment likely to be caused by the rather unfavourable outlook for employment in the tertiary sector.

Cautious fiscal policy management is still essential to ensure that adequate means are available for the industrial conversion and employment policies. The public finance situation could improve substantially in 1985 thanks to supplementary revenue generated by the law on restructuring the steel industry and to the major reduction in State aids to steel. Without allowing for any further measures that might be taken, the central government budget should show a surplus equivalent to at least 1,5 % of the gross domestic product.

LUXEMBOURG

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	7,6	3,6	3,8	2,5	6,7	7,4	1,9	—	0,1	0,6
1971 to 1980	9,6	3,1	6,3	6,7	10,5	21,5	2,2	—	0,3	1,3
1981	5,2	−0,3	5,5	7,7	8,3	30,9	−2,3	—	1,0	0,0
1982	8,4	−0,9	9,4	10,0	6,6	40,2	−1,4	—	1,2	0,1
1983	6,0	−1,4	7,6	8,4	6,6	39,0	0,0	—	1,6	−0,4
1984 (1)	9,0	2,0	6,8	6,7	6,8	39,1	0,1	—	1,7	−0,8
1985 (2)	8,2	1,9	6,2	5,5	7,5	37,5	0,9	—	1,8	−0,4

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.

Economic activity in the *Netherlands* gathered considerable momentum in 1984, with real gross domestic product expanding by about 2 %, thanks to the buoyant development of external demand, even though domestic demand remained weak owing to the very slow rate of pay increase and to a restrictive budgetary policy. The number of unemployed expanded once again, although at a much slower rate than in previous years, reaching an average for the year of 16 % of the labour force. Inflation remained moderate at about 3 %. Buoyant exports and lack of domestic demand further boosted the balance-of-payments current account surplus to almost 4 % of the gross domestic product.

Expansion will continue in 1985 probably at a similar rate to that recorded in 1984, without however having any appreciable effects on the employment situation. The reinforcement of the Netherlands' competitive position over the past few years should help to sustain exports despite the slowdown in world trade. This will encourage private investment, especially in export-oriented sectors, as will the recent improvement in business profitability. On the other hand household consumption is unlikely to expand appreciably, since wage restraints and the limits placed on social transfer payments will be more or less compensated for by the reduction in employees social contributions and income tax. A further reduction in the

inflation rate is possible in 1985, since major productivity gains resulting from the rationalization drive in a large number of firms combined with the low rate of increase expected in private sector remuneration may even lead to a decline in unit labour costs in absolute terms.

The main aim of economic policy has been, for the past few years, to correct the structural imbalances that emerged during the 1970s. Policy has been geared in particular to reinforcing competitiveness and profitability through wage restraint and a reduction in the public finance deficit, so as to lessen the burden of costs faced by the private sector. The initial impact of this policy was to impede growth and employment, which have developed less favourably than in the rest of the Community; however, positive effects are beginning to become apparent.

The budget deficit and the resulting debt burden have grown so large (with the burden of taxes and charges now the heaviest in the Community) that a policy of severe expenditure cuts is inevitable. For the first time for many years, a slight reduction will be achieved in the current financial year in net central government borrowing requirements thanks to successive austerity programmes and to an increase in revenue generated by the economic recovery. Further progress should be possible in 1985 towards the government's aim of reducing the net general government financing requirement of 7,5 % of net national income by 1986. The central government budget for 1984 provides for savings amounting Fl 10 500 million, mainly on social transfers and civil service pay. A further package of measures in the 1985 central government budget should lead to savings of Fl 9 500 million. Although the improvement in the economic environment will slow down the expansion of expenditure on unemployment benefits and improve the yield of taxes to some extent, the increase in the burden of interest payments and the foreseeable decline in the rate of growth of revenue from natural gas are not factors conducive to a sizable reduction in the public deficit.

Thus the aim of reducing the net public financing requirement of central government to slightly less than 10 % of net national income in 1985 is ambitious but indispensable.

Such a reduction would hold the budget deficit steady in absolute terms, a very desirable result from the monetary point of view, after the rapid expansion of monetary aggregates in 1982 and 1983; this would help to consolidate the encouraging results achieved on the inflation front and to check the rise in nominal and real interest rates.

There should also be further restraint in the development of wages and salaries in 1985. While it is to be hoped such a restraint would not be so severe as to affect markedly household consumption, there is very little room for an increase in real pay if it is intended to reorganize working hours without increasing production costs, and to improve business profitability, the decline of which was until recently seriously damaging the propensity to invest.

The decision to reduce employers' social security contributions is also part of the drive to improve employment prospects, which could benefit further from wider pay differentials between branches, to bring rates more closely into line with relative selling prices. Another direct measure under consideration by the government to increase employment is worth noting: it is planned, in agreement with both sides of industry, to develop the apprenticeship system in the private sector and to create extra part-time jobs in the public sector, with a view to reducing youth unemployment, which at present affects more than 25 % of the labour force in the under-25 age group.

NETHERLANDS

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force (4)	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	10,6	5,2	5,2	4,1	10,6	0,0	−0,9	9,1	0,9	1,2
1971 to 1980	10,8	2,9	7,7	7,7	10,7	1,3	−1,5	10,8	3,4	0,2
1981	4,8	−0,7	5,5	6,5	3,5	2,1	−5,2	5,3	9,4 (8,8)	−1,5
1982	4,2	−1,7	6,0	5,4	5,6	2,8	−6,9	7,6	12,6 (11,7)	−2,5
1983	2,5	0,6	1,9	2,9	3,6	2,8	−6,1	10,4	15,6 (14,0)	−2,1
1984 (1)	4,6	2,0	2,5	3,2	0,4	3,8	−5,6	7,0	15,9 (14,8)	−0,2
1985 (2)	2,8	1,8	1,0	2,3	−0,2	4,4	−6,0	6,0	15,9 (14,8	0,1

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.
(4) Eurostat definition in brackets.

In the *United Kingdom,* the economy has continued to expand in 1984 but at a rather slower rate (about 2 %) than that officially forecast at the time of the budget in March. Of the components of demand, fixed investment and exports have shown strong growth, while consumer spending has slowed and there has been some destocking. The rate of inflation (about 5 % per annum) and the level of unemployment (11 to 12 %) have both shown little variation during the last 12 months. Had it not been for the miners' strike (still unresolved at the time of writing), output growth would certainly have been stronger, if one takes account both of the observed loss of coal output and of the indirect effects on other sectors.

With respect to the outlook for 1985, economic conditions in general and the announced policy stance are consistent with continued modest growth. Assuming that the dispute in the coal-mining industry is resolved soon, and that output of coal and related sectors recovers quickly to the levels prior to the strike, gross domestic product growth of about 3 % should be possible. Fixed investment is again expected to be the fastest-growing element of domestic demand, and there should be some rebuilding of stocks. Inflationary pressure could be somewhat stronger as a result of smaller productivity gains than in recent years and of increases in import prices. There is however a danger that this relatively stable outlook could be upset by factors largely outside the authorities' control, such as the continuation of the miners' strike, leading to a shortfall of energy supply, or instability in the world oil market.

Public sector borrowing in the first half of the current financial year almost equalled the target for the public sector borrowing requirement (PSBR) for 1984/85 as a whole (£ 7 200 million) indicated in the medium term financial strategy (MTFS). In the interim statement, presented to Parliament in November, a revised estimate of the PSBR for 1984/85 of £ 8 500 million was announced. The target for 1985/86, of £ 7 000 million as indicated in the MTFS, is appropriate for the expected economic conditions, and should allow for some further reduction of direct taxation or partly for some increase in public investment, to the extent that infrastructure projects available with a positive rate of return and the objective of reducing public expenditure as a proportion of the gross domestic product are not jeopardized.

If, however, the economy expands at a slower rate than expected (for instance, because of the unresolved miners' dispute or less buoyant world trade), there may be upward pressure on the PSBR targets. If such pressure results from short-term or exceptional factors, or from a cyclical shortage of demand, it may be appropriate to allow higher levels of public borrowing.

Monetary conditions and prospects are largely satisfactory. The rates of growth of sterling M3, the broad monetary aggregate, and M0, the narrow aggregate, have recently both been within their target ranges (6 to 10 % and 4 to 8 % per annum respectively). The sharp rise in interest rates which occurred in July was mainly a response to international developments and to particular uncertainties affecting sterling, relating to the prospects for oil prices and the miners' and dock disputes, rather than to underlying domestic monetary conditions. Higher interest rates put upward pressure, in the short term, on the inflation rate, and may brake consumers' expenditure and discourage some investment. The renewed fall in the banks' base rates in August was therefore welcome, and any further opportunity to lower rates should be taken.

There has been an encouraging rise in employment over the last year, which has been concentrated in particular on female part-time employment. As the sustained recovery in economic activity has, however, also drawn more people into the labour force, the level of unemployment has not fallen and a high and increasing proportion is remaining unemployed for long periods. Thus, about 40 % of those at present unemployed have been without a job for more than a year.

The growth of the labour force, together with the improved productivity performance, suggests that the potential growth rate of the non-North-Sea economy over the next few years may be rather higher than the average rate observed since the mid-1970s. But to exploit this potential fully, and assuming that conditions of both domestic and foreign demand are appropriate, the currently unused labour resources need to be gradually brought back into employment. Wage restraint would be beneficial to the economy, in order to bring further downward pressure on inflation and to improve competitiveness, particularly bearing in mind that several important trading partners have now entered a period of virtual price stability. Furthermore, wages in certain uncompetitive sectors require relative downward adjustment, allowing appropriate differentials to develop.

There are, however, other persistent non-wage rigidities impeding market forces with respect to labour. There is evidence that some traditional rigidities in the United Kingdom, such as restrictive work practices or resistance to technical progress, may have diminished in recent years but further efforts could be made to improve training possibilities and to remove obstacles to labour mobility.

As mentioned above, fixed investment has recently become one of the main contributors to gross domestic product growth in the United Kingdom. Since 1982 it has been growing in real terms by about 5 % per annum or more, and in 1984 is expected to reach a record level, more than 8 % above the average of the 1970s. The recent better investment performance was largely due to improved conditions and prospects for profitability, while public sector investment has been decreasing. Company profits indeed rose by about 40 % between 1981 and 1983, and have further increased this year, and continuation of a dynamic trend is essential to ensure growth of the private sector, on which overall output and employment prospects are dependent.

In the past, capital investment in the United Kingdom has often been found to be relatively unproductive and the company taxation system, incorporating high first-year capital allowances, may have contributed to this by permitting relatively inefficient projects to be undertaken. It probably also favoured the use of capital at the expense of labour. The budget measures to reform company taxation should help to correct this bias. It does however appear that many large companies are still reluctant to adjust and extend their capital stock in a way which requires an increase in the labour force, and indeed much investment, particularly in manufacturing industry, involves the introduction of labour-saving techniques. The willingness of companies to undertake projects that are more labour-intensive is clearly linked to both the overall level of direct and indirect wage costs and to the issue of non-wage rigidities in the labour market referred to earlier. In this respect, a more optimistic note can be struck on the basis of the sharp rise in recent years in the numbers of new firms being founded (the surplus of business starts over failures amounted to 47 000 in 1983, three times as high as in 1980) and of evidence that small businesses have now become an important factor in employment creation.

UNITED KINGDOM

Main economic aggregates 1961 to 1985

	GDP current prices	GDP real terms	GDP deflator	Private consumption deflator	Compensation per employee	Current transactions account	General government net lending or borrowing	Money supply M 2 (3)	Unemployment in labour force	Employment
	% change					% GDP		% change	%	% change
1961 to 1970	7,1	2,8	4,2	3,9	7,1	0,2	-0,7	5,9	1,9	0,2
1971 to 1980	16,0	1,8	14,0	13,3	15,9	-0,1	-3,2	14,5	4,2	0,2
1981	10,2	-1,3	11,6	11,1	13,2	2,9	-3,1	14,6	9,3	-4,2
1982	9,6	2,3	7,2	8,3	8,4	1,9	-2,3	10,6	10,6	-1,6
1983	8,6	3,3	5,1	5,1	8,3	1,0	-3,4	10,3	11,5	-0,4
1984 (1)	6,2	2,0	4,1	5,1	5,8	0,2	-3,0	8,5	11,6	1,1
1985 (2)	8,5	3,0	5,4	5,6	8,5	0,2	-2,4	7,0	11,7	1,0

(1) Estimates of the Commission services, October 1984.
(2) Forecast of the Commission services, October 1984 on the basis of present policies.
(3) End of year.