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**EEC**

## Uncertain Economic Situation

by Dr Bernhard Molitor, Brussels

The cyclical upsurge characterised by increasingly marked symptoms of overheating which has been evident in the Community ever since 1967 passed its climax in 1970. Several causes contributed to this fact: The brakes applied in the form of restrictive measures in all member States, though in many instances rather late and not sufficiently tightly, have begun to bite. The expansive impulses reaching the Community from the world economy have weakened notably, especially under the influence of the cooler atmosphere in the US economy. And spontaneous market forces, such as the normalisation of the—previously excessive—inventory-building for some of the most important basic materials in particular and the slowdown of what has been the longest ever investment boom in the Community, in turn helped to bring about a certain relaxation.

The overall growth of real GNP slowed down less in 1970 than had been expected in the autumn of 1969<sup>1</sup>. The increase amounted to close on 6 p.c. for the Community as a whole, after a 7 p.c. rise in 1969. Satisfactory though this result is, it must not be overlooked that it went side by side with a further deterioration of the economic equilibrium. While the expansion of demand was slowed and some industries consequently needed less labour and also slightly reduced capacity loads, this has not yet had an appreciable dampening effect on prices.

### Persistent Inflationary Tendencies

The inflationary tendencies which were very pronounced at the beginning of 1970 have persisted throughout the year and even grown in intensity in some countries. Prices therefore experienced their biggest uplift in any year since the Common Market was established. The price

index inferential in the Community's GNP may be assumed to have risen by about 6.5 p.c. and the private consumer price index by 4.5–5 p.c.

A distinct change has however occurred in regard to the causes of the inflationary tendencies. Relations with non-members in the sphere of goods production imparted relatively weak inflationary impulses to the Community. Its balance of trade (on a cif/fob basis) which showed a surplus of \$ 1.7 bn in 1968 and a deficit of no more than \$ 8 mn in 1969 has ended 1970 with a shortfall of about \$ 0.5 bn. The surplus on the current payments balance consequently contracted appreciably. Besides, the rise in the world market prices of important industrial raw materials which gave quite an uplift to prices in 1969 has been halted since the spring of 1970 and since given way to a downtrend.

On the other hand, there has been a distinct turn-round in the liquidity flow between the Community and non-member countries which has fed on the inflationary tendencies in Europe and greatly impaired the effectiveness of the restrictive money and credit policy of the central banks in particular.

A shift among the factors favouring a surge of prices however has occurred inside the Community as well as in the external economic sphere. The demand-supply relationship is now certainly of much less significance as a price-driving factor than it was at the beginning of 1970 although conditions in this respect differ from country to country and industry to industry. Generally, excess demand had been substantially reduced in the Community by early 1971.

<sup>1</sup> Cf. Bernhard Molitor, Konjunkturaussichten in der EWG für 1970 (Economic Prospects in the EEC for 1970), in: WIRTSCHAFTSDIENST, 50th year (1970), No. 3, p. 177 ff.

The previously existing stringency has in consequence eased in important merchandise markets but this has hardly been reflected by the wage-price trend in recent months. Earnings per employee have risen briskly in all member countries up to recent dates; and as the gains in productivity have slowed down noticeably at the same time, wage costs per unit have gone up substantially. On the basis of early estimates by the Commission's officials which are of course very provisional, earnings per employee in manufacturing industry may have risen over the whole of 1970 by between 10 and 22 p.c. in the individual countries; France is at the lower end of the scale and Italy at the top. Making allowance for output gains, the 1970 increase in the cost of labour per unit of output may for manufacturing industry be estimated for Italy at about 14 p.c., for Germany at about 12.5 p.c., for France at approximately 5 p.c. and for the Netherlands and Belgium at around 4.5 p.c.

The further economic development in 1971 will be determined chiefly by three factors: The economic development in the world, the after-effects of higher mass earnings in 1970, and the repercussions of future wage agreements on investment and consumption and the future course of economic policy.

### **Tendencies in World Business Trends**

As regards the business trends in the world during 1971, the United States and the United Kingdom, on one side, and Continental Europe, on the other, may be expected to move in opposite directions. While the two first-mentioned countries may count on a business recovery, economic growth in most countries of Continental Europe is likely to slow further. This may result in lessening the differential in real GNP growth rates after its further widening in 1970.

In the US economy the production curve appears to have moved beyond its lowest point. Following the strike in the automobile industry which affected many other trades, industry will make special efforts to recoup the production lost, and the tendencies towards a business recovery of which there was some evidence before the strike already may become more significant. Growth will be promoted by the large income increases, the relaxation of credit policy and the rise in public spending, especially on the part of the individual Federal States and local authorities, which involves a substantial public sector deficit. Since however private income-earners are still inclined to save on a fair scale and firms should on the strength of the latest investment enquiries

be expected to keep capital spending down, economic growth will presumably continue on a moderate scale in 1971<sup>2</sup>. Unemployment will consequently recede only slowly. Moreover, the economic growth will take place against a price background which will still be precarious even though it will probably be better than in 1970.

In Great Britain the slight revival of economic growth observed in recent months is likely to continue at a moderate pace. It will be chiefly carried forward by consumer spending, investment in housing and an upward trend of exports, whereas capital expenditure by the enterprises will, to judge from investment enquiries, remain low.

In most Continental countries outside the Community economic growth is likely to slow down. For one thing, the restrictive measures were tightened in most of these countries in the autumn of 1970 because of the strong uplift of prices; for another, these countries will probably receive less strong impulses from economic progress in the Community.

Bearing the prospects for economic development in other industrial countries in mind and assuming a slowdown in the upward movement of imports into developing countries, the authorities of the Commission nevertheless expect world trade<sup>3</sup> in 1971 to expand by about 10 value p.c., compared with about 13 p.c. in 1970. In view of the particular structure of the Community's exports their growth rate in 1971 is however likely to lag behind that of world commerce. The decisive factor is that deliveries to Continental EFTA countries will probably show a relatively small increase only.

### **Growth of Production Slowing Down**

There is a great danger of the internal economic climate in the EEC being marked this year by a relatively swift increase in nominal demand whilst real growth abates at the same time. In 1970 capacity bottlenecks were still mainly responsible for the slowing-down of economic growth, though there was unmistakable evidence of differences between individual member countries and industries. In 1971 demand elements may play a bigger role. This may at a first glance seem paradoxical because total nominal demand

<sup>2</sup> The recently announced improvements in treatment of depreciation for tax purposes are likely to be reflected only by a gradual recovery of the entrepreneurs' propensity to invest.

<sup>3</sup> Including EEC imports from non-member countries and member countries but excluding the imports by State trading countries. The data for 1970 have been estimated on the basis of actual figures for the first nine months.

is still expected to expand comparatively quickly. But it follows from the complex situation in which the economies of most Community countries find themselves. The falling-off of excess demand, reflected more especially by a slowdown of order intakes, drawing-down of order books and shortening of delivery times, has—so far at least—failed to dampen the upsurge of wages in any way. Enterprises in almost all member countries are exposed to pronounced pressure on profits which bears most heavily on industries in which, either because fewer orders are coming in and capacity loads decline—as happened in the steel industry—or on account of persistent labour conflicts—as in Italy—productivity is on the wane or improving only slowly. Industry tries to offset this pressure by raising prices, which in turn leads to more wage increases, either because of gliding wage scales as have long been practice in Italy, Belgium and Luxembourg and are now adopted more and more often in wage agreements in France and the Netherlands or on account of the fresh wage demands which they provoke<sup>4</sup>.

### Consumption Boom Continuing

The year 1971 will be dominated by a boom in consumption. The rise in mass earnings due to the strong uplift of nominal wages and the improvement of social services foreshadowed in all member States will again result in rapidly increasing private consumer outlays. It is to be hoped though that the uptrend of wage rates will gradually abate. Besides, the slowing increase in employment and the anticipated shortening of effective working time per employee will have an impact on the rise of total wage payments in 1971. Moreover, the additions to gross earnings will be absorbed in part by progressive taxes. This applies to Germany in particular where a surcharge is levied on income tax until mid-1971, and also to the Netherlands where the Govern-

ment at the beginning of 1971 raised income tax by 3 p.c. In France, on the other hand, tax progression is to some extent offset by tax relief for earnings which totals Fr. 3.2 bn. It is particularly difficult at present to forecast savings trends because of the juxtaposition of diverging tendencies in this field: If incomes rise sharply, there is a general disposition to save a larger proportion, but there is also an inclination to seek protection against the consequences of inflation by acquiring assets in kind and, on the other hand, a propensity to augment savings when jobs do not look quite as safe as they did before the upturn reached its cyclical zenith.

Current public spending is, to go by the budget plans of member States, likely to impart further strong impulses to the economy, especially through higher wages and salaries. Less strong impulses will, on the other hand, be derived from investment activity. Drawings on accumulated stocks however may be expected to proceed at a slower pace, especially in the case of steel; dealers and users are more likely to replenish than reduce their stocks because of the possibility of a strike in the US steel industry this summer and increased drawings on European steel supplies in this event.

### Propensity to Invest Declining

Enterprises are likely to show less inclination to effect additional investments, chiefly because of the pressure on profit margins; France, where the firms' profit experience in the past two years was relatively favourable, is an exception. It also appears that in a number of industries plant capacities have, in the course of the big investment boom in preceding years, been enlarged so much, chiefly for technical reasons and partly also, perhaps, owing to errors in demand projecting, that for the time being they are likely to prove adequate. It is not impossible that the expected slowdown of foreign demand and the debate about growing protectionism on the other side of the Atlantic will dampen the predilection for additional investment in Europe.

<sup>4</sup> Cf. Bernhard Molitor, *Economic Prospects in the EEC for 1970*, *Ibid.*, p. 177 ff.

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## Demand for and Supply of Goods and Services

	1968 1	1969 1		1970 2+4		1971 3+4
	bn units of account 5 at current prices	Per cent change from preceding year				
		volume	value	volume	value	volume
Gross fixed investment	88.9	+ 9.7	+14.5	+ 8.5	+18.5	+ 4
Public consumption	54.2	+ 3.9	+10.3	+ 3	+11.5	+ 4
Private consumption	228.9	+ 6.9	+10.1	+ 6.5	+10.5	+ 6.5
Gross social product	384.2	+ 7.1	+11.2	+ 5.5	+12	+ 4.5
External contribution (bn units of account) 5	+ 7.1	.	+ 5.3	.	+ 4.1	+ 3

1 Statistical Office of the European Communities, Economic Accounts 1959-1969, 1970 issue. 2 Estimates by the Commission Services. 3 Advance estimates by the Commission Services. 4 Aggregation of the figures for the individual member countries of the Community based on the official currency parities in 1970. 5 1 unit of account = 0.888671 grammes of fine gold = 1 US\$ at the official rate of exchange.

Source: Commission of the European Communities, first quarterly report, 1971: "On the economic situation of the Community".

On the strength of the EEC industry investment project census in the autumn of 1970 the enterprises in the Community can be expected to increase their investment expenditure further in 1971. But outlays will grow at a distinctly slower pace. The expansion will be largest in France where an increase of about 14 p.c., after 29 p.c. in 1970, can be anticipated. In the FRG, where investment spending showed a growth of about 22 p.c. in 1970, a 5 p.c. rise only can be forecast. Belgium, where industrial investment expenditure mounted almost by half in 1970, a small rise only is expected in 1971. No complete figures are as yet available for Italy and Luxembourg but an increase is likely in the first of these two countries. Generally it may be said that too much should not be made of the slowdown of investment activity because it follows on a sharp rise of the investment ratio in most member countries over recent years<sup>5</sup>.

Progress in housebuilding may be slight because of the persistently marked shortage of manpower and the exceptionally big lift in construction costs, although in some countries—e.g. Italy and the Netherlands—measures stimulating housing have been taken.

The public sector may fulfill a moderating function in regard to investment if this should prove necessary in the further course of the year. To judge from the budget plans, public capital outlays may be expected at present to grow at a faster pace, but the volume expansion will be strictly limited by the sharp rise in the cost of building services. Apart from that, the moderating function should depend on the general economic situation which will still be precarious in the

first half of the year, especially because of the surge of prices and costs. Only in France has so far a decision been taken to speed the rhythm of investment expenditure projected in the 1971 budget compared with 1970.

The officials of the European Communities Commission at present forecast for 1971 a 4.5 p.c. rise at constant prices in the Community's GNP. This figure implies a real GNP increase of over 3 p.c. in the FRG, nearly 5.5 p.c. in France, under 5 p.c. in Italy and over 4 p.c. in the Netherlands and Belgium; the growth rate in Luxembourg, estimated at about 2 p.c., will be below average.

These growth rates however conceal substantial differences in the economic development of the various member States. The cyclical disproportion of demand and supply is at present most marked in the Netherlands where there is special reason to fear another wage-price push in the second half-year. In France where the economic development pursued a fairly calm course last year a very rapid rise of private consumer spending has been noticeable for some time now, which will render further advances towards the consolidation of the internal equilibrium more difficult. A special position is occupied by Italy where the severe labour conflicts and their repercussions have resulted in substantial production losses during the past two years. The chances for future growth depend decisively on a normalisation of the relations between the social partners; the potential demand could eventually allow larger output increases than are suggested by the rate mentioned above. Mention should finally be made in this context of the particular problems facing Belgium where after the introduction of the added value tax system on January 1, 1971, and the expiry of the price control introduced earlier by the Government the principal issue now is how to avoid undesirable price reactions.

<sup>5</sup> The share of the investments by the enterprises' sector (excluding housebuilding) in the GNP reached a record level in the Community in 1970. In the Federal Republic of Germany, France, the Netherlands and Belgium it was the highest on record since the Common Market was established.