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# From Crisis Management to Long-term Strategy

by Dr Hans-Eckart Scharrer, Hamburg \*

**In view of the multitude of factors which are at work it is evident that there is no one-way solution to the current problems of the EC. Rather a differentiated approach is required. In this context it is essential that the long-term economic and political goals of the Community are not "forgotten" over the need to find pragmatic answers to present-day difficulties.**

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**A**t the beginning of 1975 the European Community is facing serious economic problems:

In most countries rates of inflation are high and are likely to remain high (see Table 1).

At the same time, the economic slowdown experienced in the second half of 1974 has led into a recession with close to zero growth rates to be expected in many of the member countries (see Table 2). Unemployment and short-time work have markedly increased (see Table 3).

Some EC countries will continue to run large current account deficits which can only be financed by incurring additional foreign debts (see Table 4).

Existing structural disequilibria and rapid structural changes, adding to the strains caused by conjunctural forces, complicate the task of policy-makers to stabilize their economies.

The economic "crisis" comes on top of, and is partly due to, a deterioration of social and industrial relations and increased political instability in the member countries.

From a Community standpoint it seems particularly disadvantageous that the individual countries are hit quite unevenly by these developments (although this may also be considered a stabilising factor). Whereas in the 1960s the performances of the national economies with regard to prices and balances of payments did not deviate by much from the Community average, they have been diverging progressively in the last months.

If one looks at the nature and the causes of the current "crisis" it is evident that exogenous (e.g. oil price explosion) as well as endogenous (e.g. wage push) factors are at work, some of which are of a short-term nature (e.g. aggregate demand situation) whereas others are more fundamental

(e.g. structural disequilibria; industrial and social relations). Therefore, there is no one-way solution to the problems. Rather, a differentiated approach is required. In this context it is essential that the long-term economic and political goals of the Community are not "forgotten" over the need to find pragmatic answers to present-day difficulties.

## Recycling of Petrodollars

One major problem area to be systematically tackled by the Community is the recycling of petrodollars to deficit countries. The smooth financing of deficits is a prerequisite to the survival of stable international as well as European trade and currency relations in the medium term. There are a number of channels for the flow of OPEC funds to countries in need:

The international financial markets have shown a remarkable efficiency in recycling the oil money. In fact, of their total 1974 surplus of \$ 60 bn the OPEC countries have placed \$ 21 bn on the international money markets and another \$ 17 bn on the national markets of the USA and the UK. However, due to the heavy risks involved, banks have become more and more reluctant to perform the job of deficit financing. If this financial channel is to remain open in the future, and if defaults on outstanding loans are to be avoided, the Community and/or the respective member countries will have to give implicit or explicit guarantees to banks to meet at least part of the obligations in case of a major debtor's insolvency. In return, banks operating in the international markets seem increasingly prepared to subject themselves to certain rules and regulations. The elaboration of such rules should vigorously be pursued on Community level. Among the subjects to be dealt with one might think of the supply of (confidential) information on large bank loans to an EC "clearing

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**Table 1**  
**Consumer Prices**  
**— OECD Estimates and Forecasts —**  
 (percentage changes, annual rates)

	Average 1959/60 to 1971/72	1973	1974	1975
EC	3.8	8.0	12.5	12.5
France	4.3	7.1	13.75	13
Germany	3.0	7.0	7.5	7
Italy	4.1	10.8	19.25	20.25
United Kingdom	3.8	8.6	14.75	18
Belgium	3.2	7.0	12.5	11.5
Netherlands	4.7	9.0	10.5	10.5
Denmark	5.8	9.3	14.5	14.5
Ireland	5.1	11.5	17	15
USA	2.4	5.5	11.5	11
Japan	5.5	11.7	25	16

Source: OECD, Economic Outlook, No. 16, December 1974.

house", rules on the maximum size of loans to any one debtor relative to a bank's equity capital, rules on maximum currency positions, etc. As a first step, rules could be implemented on a voluntary basis; banks submitting to the information and surveillance system should be awarded a "quality mark".

□ Direct bilateral loans of OPEC countries have been a second major source of funds. In 1974 they totalled \$ 9 bn, \$ 6½ bn of which went to industrial countries. A regular exchange of information on the amounts and conditions of foreign indebtedness appears necessary in order to enable the Community to make correct assessments on the economic situation of member countries.

□ The EC itself may perform banking functions by partially or fully guaranteeing international loans

**Table 2**  
**Growth of Real GNP**  
**— OECD Estimates and Forecasts —**  
 (percentage changes)

	Average 1959/60 to 1971/72	From previous year		
		1973	1974	1975
EC	4.9	5.5	2.5	2
France	5.8	6.0	4.75	3
Germany	4.9	5.3	1	2.5
Italy	5.5	6.0	4.75	- 0.25
United Kingdom	3.1	5.3	- 0.5	1.75
Belgium	4.9	6.1	4.5	3
Netherlands	5.2	4.2	2.5	2.5
Denmark	4.8	3.5	1.5	1
Ireland	4.0	6.8	2.5	1.5
USA	4.1	5.9	- 1.75	- 2
Japan	11.0	10.2	- 3.25	2

Source: OECD, Economic Outlook, No. 16, December 1974.

raised by individual member states (Eurocredits as well as bilateral official loans) and/or by raising loans in its own name and forwarding the money to members. A first test, a \$ 3 bn EC loan, is still in the planning stage. The problem with this kind of activity is that the credit risk is shifted from the Arab investors to the Community. In order to minimize these risks, Community loans should be made subject to stringent conditions with respect to internal and balance-of-payments policies of recipients. The terms of the medium-term standby credit extended to Italy on December 19, 1974, may serve as an example for future agreements. (Italy agreed *inter alia* to keep the rate of monetary expansion and the size of the budget deficit within precisely defined, narrow limits.) However, the pledge of a recipient country should be paralleled by pledges of the other EC members to support its stabilisation policy by adequate measures (rather than to render this policy more difficult).

**Table 3**  
**Unemployment Rates**  
 (in percent)

	1973	1974	Latest monthly rate
EC	n. a.	n. a.	n. a.
France	2.1	2.7	3.3 Q IV
Germany	1.2	2.6	4.2 Dec.
Italy	3.5	2.9	3.1 Oct.
United Kingdom	2.7	2.7	2.8 Nov.
Belgium	3.7	4.1	5.4 Dec.
Netherlands	2.7	3.3	4.4 Dec.
Denmark	2.5	5.1	9.2 Nov.
Ireland	7.2	7.9	9.7 Dec.
USA	4.9	5.6	6.7 Nov.
Japan	1.3	1.4	1.3 Nov.

Sources: International Labour Office; OECD.

Whereas the Community should on the whole take a moderate approach to the raising of petrodollars, the opportunity should be used to test different models of monetary units and to develop an attractive "European" alternative to the SDRs as a store of value. At the same time the institutional framework in the EC monetary sector should be thoroughly studied. There is now an opportunity of giving the European Fund of Monetary Cooperation substantial functions, also in the field of domestic monetary policy.

□ The oil countries have started to acquire participations in business enterprises in industrial countries, including EC countries. Whereas in principle such investments should be welcomed as they tend to strengthen the interest of the OPEC countries in the economic well-being of the West, there may be instances where such trans-

**Table 4**  
**Current Balances and Increases**  
**in Net Expenditure on Oil**  
**— OECD Estimates and Forecasts —**  
 (\$ billion)

	1973		1974		1975	
	Total current balance	Total current balance	Increase (-) in net oil expenditure from 1973	Total current balance	Increase (-) in net oil expenditure from 1973	Total current balance
EC	0.8	-15.8	n. a.	-12.75	n. a.	
France	-0.75	-7.5	-6.25	-6.25	-6.25	
Germany	4.5	9	-6.25	6	-8.25	
Italy	-2.5	-8.25	-5	-5.75	-6	
Un. Kingdom	-3	-9	-5.25	-6.5	-7	
Belgium	1.5	0.25	-1.25	0	-2	
Netherlands	1.75	1.5	-0.5	1.5	-1.5	
Denmark	-0.5	-1.2	n. a.	-1.15	n. a.	
Ireland	-0.2	-0.6	n. a.	-0.6	n. a.	
USA	0.5	-3.25	-14.75	-7.5	-19	
Japan	-0.25	-4.75	-12	0	-15.5	

Source: OECD, Economic Outlook, No. 16, December 1974.

actions are considered dangerous. It would be expedient for the Community to devise a common strategy with respect to equity acquisitions. Moreover, the Apel-proposal on the foundation of an international investment bank opens up alternatives to direct participations in enterprises. This idea might be studied with a view to implementing it on a Community scale.

□ Loan agreements among EC countries of the kind concluded between Italy and Germany in 1974 are another means of enabling deficit countries to refrain from measures harmful to international trade. However, in future they should be handled on Community level rather than on a bilateral basis. It is in the interest of both the recipient countries and the Community that the money be spent within the framework of effective stabilisation programmes to be worked out with the Community bodies.

□ The EC should also use its weight for securing continuation and improvement of existing, and for establishing new, recycling mechanisms on an international scale. Among new possibilities to be elaborated the IMF's windfall profits on its gold assets might be used for providing special assistance to the poorest countries. In addition to this, special allocations of SDRs to the IDA or directly to the most hit LDCs might be considered.

On the whole, a multifold approach to financing the deficits, making use of the full spectrum of methods available, seems appropriate. There is an imminent danger that the current problems give rise to an undue expansion of official liquidity

schemes and thus to a repetition of the errors of the Bretton-Woods era. Yet the main problems, the overcoming of which will in the end also determine the success of financial efforts, are the current account balances themselves and the speed of inflation.

### Stabilising the Economies

As to the development of the current account balances the main clue is of course with the OPEC countries: As long as they stick to the high oil prices on the one hand, and don't increase their internal absorption considerably, on the other, oil consuming countries will have to live with large current account deficits. Under the assumption that over the next few years the total deficit of consumer countries will be around \$ 40 bn the Community goal cannot be to reduce its own deficit of \$ 16 bn by much. It represents a fair share in total world deficit. The task is rather to work towards a more equitable distribution of national balances within this overall framework, which means that the variances among individual deficits and surpluses should be reduced.

The problems of external (balance of payments) and internal (anti-inflation policy, stabilisation of employment) harmonisation are to some degree overlapping. Thus, the expansionary policies in Germany and the Benelux countries leading to an increased absorption are consistent with both internal and external goals. On the other hand, Italy, the UK, France and Denmark, while also stimulating their economies should continue (or start) fighting inflation. A tight monetary policy limiting the growth of the monetary base would appear appropriate to both groups of countries. Indeed, as the German Council of Economic Experts has recently stated: "Problems which cannot be solved by monetary policy being in conformity with the goal of price stability, will not be solved by a permissive monetary policy either, at least not permanently and at tolerable costs."<sup>1</sup> The annual rate of expansion of money supply a central bank is willing to permit should be announced in advance so that trade unions, enterprises and the Government are fully aware of the monetary constraints for their future operations<sup>2</sup>. Within the limits so determined fiscal policy should be used to influence the level of aggregate demand which under present circumstances

<sup>1</sup> Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 1974 (Council of Experts on Economic Development, Annual Report 1974), Bonn 25. Nov. 1974, figs. 30\* and 292.

<sup>2</sup> The success of such a policy is inter alia dependent upon the expectations of trade unions, enterprises and the public sector with regard to the determination — and (political) ability — of the central bank to stick to its targets even under conditions of rising unemployment.

would mean that it ought to follow a moderately expansionary course.

Monetary and fiscal policy should be accompanied by (active or passive) exchange rate adjustments, reducing international competitiveness of the first group of countries (revaluation) and improving competitiveness of the second (devaluation).

To indicate some main lines of future economic policies in the EC means at the same time pointing to their limits. Thus, there is the danger that under the present social and political conditions a restrictive monetary policy will lead to stagflation or even slumpflation in the inflation-prone deficit countries without improving their external balances sufficiently. On the other hand a forced expansionary policy in the surplus countries may quickly have the effect of giving a new impetus to inflation. In addition to the cyclical problems all countries are subject to an unprecedented process of structural change which is bringing about some structural unemployment.

In a situation which is characterized by scarcity rather than by the affluency experienced so far, formulation of a coherent Community policy is rendered much more difficult. On the other hand it appears to be more urgent, too.

### Long-term Strategies

Efforts exceeding the current oil-crisis management should be made within the Community already today to procure a strong basis for a long-term economic and monetary policy. These efforts should realistically proceed on the assumption that it will not be possible in the foreseeable future to achieve the aim of an economic and monetary union, at least not in the way devised by the Council of Ministers. It should further be recognized that the traditional strategy of monetary integration which is generally — though not quite correctly — termed the “Werner” strategy, has proved to be largely inefficient. What matters now is to seek for other, less bold methods which, starting from present economic and political realities, strengthen the economic coherence of the Community and simultaneously open the way for future further-reaching steps of integration.

In the monetary field this would mean, above all, the elaboration of generally acceptable rules for the management of flexible exchange rates; efforts to instal and defend a common system with fixed exchange rates should be postponed for the time being. Hence, the question must not be: How can we manage to maintain the “Mini-Snake” and have it gradually developed again into a beautiful big animal with many currencies? But: How can

we devise a body of rules which, in recognition of the different exchange-rate systems practised within the EC and in consideration of the divergent structures and priorities of the member states, allow for largely unimpeded goods and factor movements (with limited exchange-rate fluctuations around the trend)? Initial outlines of such rules have been prepared by the Committee of Twenty in their consultations concerning the reform of the international monetary system. On the basis of this preliminary work the member states could devise and test standards of conduct for their mutual monetary relations which provide for stronger ties than are enforceable on the international level.

An essential prerequisite to a stabilisation of monetary intra-Community relations and, in the last analysis, also to a free movement of goods and factors, is a better harmonisation of the economic development of the member states. The traditional method of consultations has proved little effective to achieve such harmonisation, since the Council and the committees have virtually always avoided controversial discussions on the economic policy of individual countries. It should be examined whether better results may be achieved by having the national demand policies bound to certain rules and, above all, by making provisions for a steadying of these policies.

Regarding the binding to rules it has been proposed<sup>3</sup> that the member states observe jointly agreed indicators in their economic policy; if certain predetermined “warning marks” are exceeded, this would substantiate the presumption that the policy must be changed. This presumption could be invalidated in a consultation procedure. An advantage of this model is that greater pressure is exercised on the member states to pursue a “Community-minded” economic policy than under the traditional non-committal procedure. The binding to rules naturally does not solve the problem of — sometimes only apparent — target conflicts (price-level stability vs. full employment) and it does not remove the dependence of governments on the national voters’ will either. Frequent changes in the direction of economic policy are likewise not necessarily avoided thereby.

Since such changes of policy often have a destabilizing effect on both the national and European economic developments, a steadying of economic policy should also be aimed at. This means that economic interventions should be guided by long-term criteria, in particular by the growth rate of

<sup>3</sup> Cf. Institut für Europäische Politik, Gutachten zur Übergangsphase der Wirtschafts- und Währungsunion, Bonn, 15. November 1973 (English summary available at the Institute).

the overall economic production potential. This suggests itself in particular for the money policy. There is much in favour of the argument that a continuous expansion of the money supply at an annual rate of 5–8 p.c. will check inflation effectively without necessarily causing a decline in employment. Rather than fixing a uniform rate of money expansion for all member countries individual rates could be agreed on, which take account of the divergent national "propensities to inflation". In addition to this, a steadying of fiscal policy should also be aimed at long-term, in observance of the same criteria; it would appear, however, that this objective cannot yet be reached on EC level.

Another field of activity of utmost importance for the restoration and protection of (relative) price stability and long-term growth is competition policy. In addition to the traditional approach further liberalisation of trade with third countries, and notably with LDCs, should be aimed at in the forthcoming round of GATT negotiations. Moreover, new impulses should be given to the rather sluggish process of abolishing non-tariff barriers to trade among member countries. Increased competition both among member countries and from abroad will set an effective brake to excessive price and wage demands on national markets and it will stimulate productivity in the long run.

On the other hand, more competition will accelerate the process of structural change the Community is currently undergoing. Social and regional policies provide some safety nets for the regions and individuals hit by this process, a net which might be further strengthened by the provision of a "basic" unemployment insurance on an EC scale. However, with the Community funds having reached very sizeable amounts the EC can no longer afford the luxury of spreading the money around as before. In fact, "charity should be given to the honest poor, not to those who inflate fastest or produce unattractive goods."<sup>4</sup> The means should therefore be used for programme financing rather than as budgetary contributions (the latter method has only recently be applied to the new Regional Fund) and they should be incorporated into a coherent growth strategy.

Preliminary work on the formulation of a new strategy and "schedule" for economic and monetary integration with realistic interim targets instead of pleasing-to-hear promises should soon be commenced. The "oil price crisis" is no longer a credible alibi for the lack of political initiative.

<sup>4</sup> Peter M. Oppenheimer in his review article on Magnifico, European Integration. In: Journal of Common Market Studies, Vol. XII (1974), No. 3, p. 352.

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