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The Economic Situation in Western Europe

The first few months of 1982 witnessed continuance of the marked lull in economic activity in Western Europe. Although some countries repeatedly experienced short-term ups and downs in production, there were no definite signs of an end to the stagnating trend which has dogged Western Europe since autumn 1980. Even the reflationary measures pursued by France have only managed to temporarily stimulate demand.

Western Europe's already low level of capacity utilisation has thus dropped even further and the unemployment situation has deteriorated. Labour policy measures taken in a number of countries have at best helped slow down, yet not prevent, the increase in unemployment. At the last count the unemployment rate had reached an average of almost 9½ %.

Attempts to curb inflation have led to first signs of success in some Western European countries; the upward trend in wages and prices has begun to slow down. Compared to the previous year the rise in prices for private consumption, which at the turn of the year still averaged 11 %, appears to have fallen in April below the 10 % mark for the first time since mid-1979. The reduced price of crude oil and crude oil products was the main reason behind this development, more important than the easing-off of the internal upward drift in prices and wages. Even in the case of other imported raw materials, the effects of the renewed devaluation of European currencies against the dollar were largely offset by falling world market prices.

Pull of Dollar Interest Rates Continuing

Declining interest rates in the USA last autumn had favoured first steps toward a relaxation of monetary restrictions and a slight reduction of interest rates in Western Europe. However, the first few months of 1982 have again come up against the retardant effects of events in the USA. Many of Western Europe's central banks apparently regarded this to be a temporary setback and tried to make sure that domestic financial

markets were affected as little as possible. In doing so, they were even willing to accept renewed devaluation against the dollar. Contrary to the USA, therefore, no new interest rate increases were recorded in most Western European countries at the start of this year, with the downward trend still continuing. This was particularly strong in countries boasting improved current accounts, some showing substantial surpluses, for example, the Federal Republic of Germany, the Netherlands, Switzerland and Great Britain. Only in those countries in which the external position was under strain, such as France and Belgium, were interest rates raised again in an attempt to ease pressure on the exchange rates of those countries' currencies.

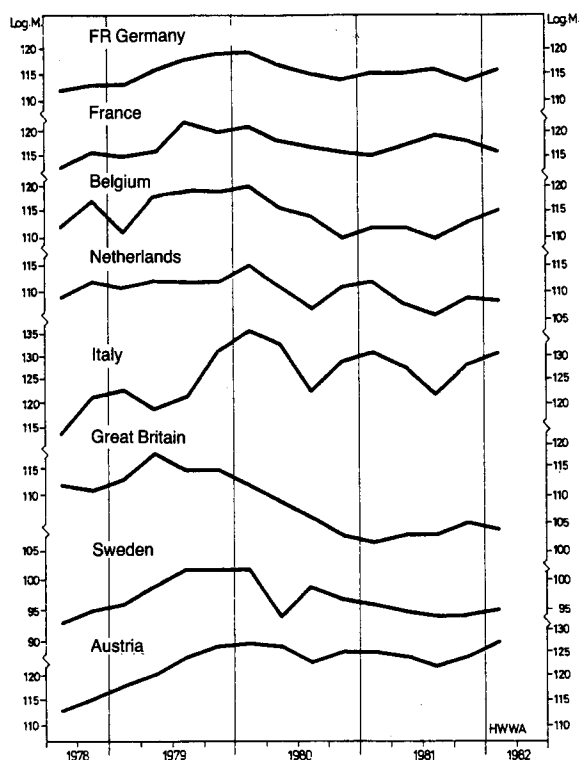
Whereas monetary policies have revealed signs of a more relaxed approach since last autumn, fiscal policy has generally stuck to its consolidating course, although selective measures were taken to secure and create jobs and to encourage investments. Despite falling levels of utilisation of productive potential, most countries are striving to reduce government deficits. This is not likely to be successful in a number of cases, the more so since general economic development and the possibilities regarding tax revenues and those expenditures sensitive to cyclical influences, which underlie the respective budgets, would seem to have been viewed with excessive optimism. Effects of growing deficits on price and exchange rate expectations have forced the French government to repeatedly back down from its reflationary fiscal policy aimed at stimulating demand.

Further Decrease in Capacity Utilisation

The economic downswing Western Europe is going through has dragged on now for more than two years. Just as unusual as its duration is the course it has taken: following a deep recession in summer 1980, production in Western Europe stagnated right up until the present day. Both the general level of real GNP and the level of industrial production, excluding the construction sector,

Industrial Production¹ in Selected Countries

(quarterly averages, seasonally adjusted, 1975=100)

¹ Excl. construction.

Sources: OECD and national statistics.

recorded in the first quarter of 1982 were apparently not significantly higher than one-and-a-half years ago. This stagnating trend marks the development of almost all Western European economies, ignoring short-term deviations.

As production capacities are – despite the depressed investment level – still growing while the level of production remains the same, there is inevitably a decrease in the utilisation of capacities. The extent to which this occurs is difficult to assess, since the effects of slack investments on the path of productive potential taken cannot be directly measured. Apart from this, in times of structural friction, such as that created by the energy price explosion, the extent to which the uneconomical nature of products and production techniques leads to a reduction in economically utilisable plant stock remains an unknown quantity.

There has also been a remarkable development in the level of industrial production as vouched for by a longer-term comparison. In Western Europe it was only about 5 % higher during the first quarter of 1982 than in early summer 1974, i. e. before the recession set in as a result

of the first oil price explosion. This means that the rise in industrial production over the past eight years has been no greater than the long-term annual average before this period, for example between 1960 and 1973. Even though an economic peak and a trough are compared there is still a clear break in trend.

Unemployment Still Rising

The substantial slowdown in the increase in production since the mid-70s has led to a noticeable decrease in the number of persons employed. After an initial drop in Western Europe between mid-1974 and early 1976 of more than 2 % this level remained virtually unchanged for four years. The present recession then led to a renewed decline, which again reached more than 2 % by the end of 1981.

The deterioration of the employment situation was the prominent feature of labour market development. Unemployment, measured in terms of the number of gainfully employable persons, averaged 2½ % in Western Europe during the first half of 1974. It then sharply increased to a level of 4½ % by spring 1976. With the stabilisation of employment during the subsequent period the increase in the unemployment rate slowed down again. At the start of 1980 it exceeded the 5½ % mark. Its upward movement accelerated again as an accompanying feature of the overall economic recession, the latest unemployment rate averaging 9½ %.

Up to now the only country in which the increase in unemployment has markedly slowed down is Great Britain. Here, the tough recession came to a standstill last year. Changes in the speed of increase recorded by other countries are hardly significant if allowing for the weaknesses of seasonal adjustment techniques. In a few cases there were temporary signs of supportive effects for employment induced by measures of labour market policy. However, a lasting improvement is not likely to occur, since the financing of such efforts via tax increases and/or raising government deficits itself militates against an improvement of the overall economic framework.

Price Rise Slowing Down

The most important prerequisite for overcoming stagnation in Western Europe still remains success in the fight against inflation. Three years after the about-turn in economic policy onto a stabilisation course, intended to prevent any escalation of distributional conflicts ensuing from the high oil prices, a number of Western European economies are showing signs of a

deceleration of price increases; this applies particularly to the Federal Republic of Germany, Great Britain, Switzerland and Italy. The average rate of price increases for private consumption in Western Europe, which figured at just over 11 % in 1981, has probably now dropped to just under 10 %.

The declining tendency was often even more apparent at the producer and wholesale levels. This mainly reflected the falling prices on the international raw materials, in particular crude oil, markets. The HWWA Index of World Market Prices of Raw Materials, computed on a dollar basis, was 5 % lower at the end of May than at the turn of the year. This reduction more or less compensated for the effects of a renewed devaluation of Western European currencies against the US dollar during the first few months of this year.

The inflation differential between individual Western European countries still has not narrowed to any great extent. The lowest inflation rates were recorded in the Federal Republic of Germany, Switzerland, Austria and the Netherlands, all registering an increase in consumer prices of between 5 and 6½ % compared to the previous year. France and Italy topped the list with inflation rates of 14 and 16 % respectively. World market influences have so far probably played a large part in slowing down upward price movements. Even though such movements are determined to a certain extent by the weak economic situation in Western Europe, a lasting success in the fight against inflation can only be said to have been achieved in Western Europe when inflationary expectations recede on a broader basis and this is reflected in the development of the internally determined goods and factor prices, especially in wages. The latter also registered decelerating tendencies in some countries, for example, the Federal Republic of Germany, Great Britain, Italy, Sweden and Switzerland. However, this very often did not apply to the real wages levels; the rate of increase for hourly income in many cases still exceeded the inflation rates. In the Netherlands and Denmark, countries in which income policy measures had previously gone a long way towards cutting back wage increases, there was a renewed acceleration.

Declining Domestic Demand

Compared to the cyclical patterns followed by Western Europe's economies over the past thirty years, a stagnation in demand and production of such duration can certainly be regarded as an unusual phenomenon. Either expansive or contractive forces predominated in a "normal" situation. The latest development is all the

more remarkable in that it results from the continuation of mutually opposing influences: on the one hand, a decline in domestic demand in Western Europe and, on the other, an increase in exports to the rest of the world.

Recently, there have probably been changes in the constellation of driving forces in the economy. There are signs that the external demand pull has died down following an increased deterioration in the balance of payments situation of the oil-exporting countries and the persisting recession in the USA. This is likely to induce a levelling-off in the expansion of Western European exports to the rest of the world. However, the extent of this development cannot yet be quantified. Nor can the extent of the possible levelling-off of the decrease in inner European demand, which would probably have to be initially supported by a less contractive stockbuilding behaviour. Regular economic surveys in EC industries already showed that during the course of the second half of 1981 the percentage of firms which regarded their stocks of finished products as being too high was on the wane. However, this trend did not continue beyond the turn of the year.

Little Change in Private Consumption

The development in the most important consumptive area, private consumption, has been characterised in Western Europe by stagnation. In real terms there was already hardly any change last year. France managed to achieve a noticeable expansion due to efforts towards stimulating demand. However, this is the exception and most Western European economies witnessed a stagnation or indeed a decrease in consumption, the latter being the case in the Federal Republic of

Table 1
Consumption and Investment
(in real terms, year-on-year change in %)

Country	Private Consumption			Fixed Investment		
	1980	1981	1982 ^a	1980	1981	1982 ^a
FR Germany	1.7	-1.1	-0.5	3.6	-3.3	-5.0
France	1.7	2.3	2.0	2.4	-1.8	0
Great Britain	0.0	0.0	0.0	-1.1	-7.6	1.0
Italy	4.3	0.2	0.0	9.4	-0.2	-5.0
Others ¹	0.5	-0.7	-0.5	1.2	-5.0	-2.4
Western Europe, total ²	1.4	0.0	0.1	2.7	-3.6	-2.5
Western Europe excl. FR Germany	1.3	0.3	0.3	2.4	-3.8	-1.5

^a Forecast, national data rounded to the nearest half percentage point.

¹ Austria, Belgium, Denmark, Finland, Ireland, Netherlands, Norway, Spain, Sweden, Switzerland.

² 1979 weights and exchange rates.

Sources: National statistics, own estimates. FR Germany: Joint Assessment by the Association of German Economic Research Institutes.

Germany, Belgium, the Netherlands, Denmark and Sweden.

A similar situation is shaping up for 1982. Yet again private consumption in France, encouraged by government measures, is still increasing substantially, whereas in other countries it is unlikely to exceed the 1981 level. The increase in disposable incomes will level off in most cases. This results primarily from the dampening effects of the continuing deterioration of the employment situation; these effects are only partially compensated by the increase of transfer payments. In addition, many countries have experienced a slowing down of wage increases. On the other hand, consumers' real purchasing power is very often improved by a deceleration of the rise of prices. The drop in interest rates expected during the course of this year will also serve to stimulate the propensity to consume.

Sagging Investments

The most powerful contractive influences in Western Europe still come from investments in fixed assets. Persistently high real interest rates were the result of a monetary policy which under the pull of the strong dollar

was often pursued, for reasons of exchange rate policy, more restrictively than would have been necessary for the domestic economy. This factor, together with the depressed business profits and profit expectations, has dampened the propensity to invest. True, a slump as in 1974/75 has been prevented this time by the urgent need to structurally adjust products and production technologies, in particular to greater energy costs in connection with the fact that this time the distributional conflicts in the wake of the income lost by the Western European economies to the oil-producers were not quite as serious. However, due to the long duration of the present phase of stagnation, business losses may nevertheless be expected to have reached levels similar to those recorded during the mid-70s.

Last year real fixed investments in Western Europe were about 4 % down on the previous year. With the exception of oil-producer Norway, all Western European industrialised countries recorded a decline. This development is apparently continuing this year. The pessimism regarding production expectations in the capital goods industries and in particular in the mechanical engineering sector has, according to surveys carried out by the EC, receded at a slower pace than in the case of other industries. For the whole of 1982, therefore, a further reduction in fixed investments to the tune of 2 to 3 % is to be expected; France, Great Britain, Norway and Switzerland will be the only countries to probably record a virtual stagnation. Generally, however, there is a large risk of an even more unfavourable development. Remarkable is, above all, the fact that the most recent national economic forecasts in Western Europe tend to assume a change in trend already for this year. This is probably due to too optimistic expectations regarding a speedy improvement of the general economic framework and in particular regarding a greater drop in interest rates. Under these circumstances it would hardly be surprising if there were no significant stimulation of investment activity in Western Europe before the year is out.

Exports Levelling Off

Last year's dwindling inner European demand coinciding with a surging external demand was largely the result of the oil price explosion. This was not only felt directly, via the associated redistribution of income in favour of the oil-exporting countries, but also indirectly via the monetary restriction subsequently sparked off in Western Europe. Other factors were – at least up until last autumn – the effects of the cyclical differential between Western Europe and the USA and the drastic improvement of the competitive position of European

Table 2
Foreign Trade Development¹ in Major Countries
(Year-on-year change in %)²

	Exports		Imports	
	1981	1982 ^a	1981	1982 ^a
Foreign Trade, in real terms				
Austria	5.0	6.0	-4.0	3.0
Belgium	-0.5	4.0	-5.0	0.0
Denmark	5.0	1.5	-4.0	3.0
Finland	3.0	1.5	-6.0	-1.0
France	4.5	3.0	-2.0	6.5
FR Germany	6.5	7.0	-3.5	2.5
Great Britain	-1.0	6.5	-2.5	9.0
Italy	6.0	6.0	-5.5	3.5
Netherlands	0.5	2.0	-7.0	2.5
Norway	-0.5	-2.0	-0.5	7.0
Switzerland	3.0	0.5	-2.0	0.5
Total ³	3.0	5.0	-4.0	4.0
Foreign Trade Prices ⁴ , total				
in domestic currency	11.0	8.5	16.0	8.0
in US \$ ⁵	-11.0	1.5	-7.5	1.0
Terms of Trade, total	(-4.0)	(0.5)		

¹ Special trade.

² Rounded to the nearest half percentage point.

³ Weights and exchange rates of the respective years.

⁴ Averages.

⁵ 1982 exchange rates according to national forecasts.

^a Forecast.

Sources: Data and forecasts from national institutes as of early April.

producers compared to their North American rivals, brought about by the devaluation of European currencies against the dollar.

The exact significance of these factors for the real flow of goods in trade with the rest of the world cannot be established, since the regional breakdown is only measured in nominal terms. It is, however, worth noting that in 1981 exports between the various Western European economies measured on a dollar basis fell by 12 %, the average export values again measured in dollar terms dropping by 10 %. Supplies to countries outside Europe rose by about 3 %, those to OPEC countries by as much as 13 %. However, since last autumn exports to these regions seem to have tailed off.

The differentiation was less marked with respect to the development of nominal imports: in 1981 there was an overall decrease in dollar terms of 11 %. In real terms, however, there were again considerable differences. The volume of imports, for example, fell by about 4 %, crude oil imports alone decreasing by about 12 %, particularly oil imported from countries outside of Europe. The current year has witnessed a continuation of this trend.

The development of real trade flows was therefore marked by an improving trend in Western European economies. Furthermore, since mid-1981 the terms of trade have not deteriorated for Western Europe. In fact, there have been slight improvements. This has meant that the reduction of the aggregate trade deficit of the Western European economies has made further progress. Projected on an annual basis, the deficit for the first quarter of 1982 is probably only about half as great as in 1980, a year in which the peak level of \$ 107 billion (imports cif/exports fob) was reached.

The longer the unstable balance lasts between contractive and expansive economic forces in Western

Europe, the more urgent the question becomes when and in which direction overall demand and production will finally begin to move. Among the indications of such beginning changes there are again mutually opposing forces to be found. On the one hand, a deterioration in the situation in important overseas markets; on the other, a trend towards an improved economic framework in many Western European countries. Any forecast of economic development must take both of these – partially interlinked – factors into consideration.

Prospects: Still Waiting for an Improvement

The growing balance of payments difficulties of the oil-exporting countries, resulting to a large extent from the continuing adjustment of industrialised countries to the oil price explosion, would point towards a slackening-off of external impulses. Another retardant influence on Western European exports at present is caused by the recession in North America. The stimulation of demand expected in the USA during the second half of this year is likely to lead to improved sales chances in this area, the more so as the competitiveness of European producers, especially in comparison to their rivals in the dollar area, continues to be good. Even allowing for a decrease in supplies to major oil-exporting countries, a slight increase in exports to markets outside Europe can be expected during the further course of this year.

A further marked decline in inner European demand as witnessed at the start of the year, however, would not under such circumstances be able to be compensated for. However, there are various reasons which support the belief that this trend is running out. One reason, a cyclical element, is the advanced stage of stock reduction; hopes are yet again justified in Western Europe that final demand will gradually become more and more effective for production. If optimistic economic

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expectations were to enhance the propensity to keep stocks, this impulse would be strengthened.

The slight improvement in the Western European economic framework since autumn last year is likely to support such a tendency. The slowing down of upward price and wage movements in a number of countries indicates that the distributional conflicts are dying down, a development favoured by the slight increase in the terms of trade. This has subdued inflationary expectations and supported a further reduction of interest rates despite the ups and downs of US interest rates. Greater progress is to be expected with regard to fighting inflation, since the effects of stabilisation policies, which most countries have been pursuing for three years, are not likely to be counteracted any more by depreciation effects against the dollar. It is assumed that a budgetary compromise will be pushed through in the USA, which will encourage declining interest rates there, effects spreading to Europe. Countries continuing efforts to combat the depreciation pressures exerted on their currencies by resorting to monetary measures will be left little scope for lowering interest rates. In the case of depreciation, on the other hand, which, considering the need for rectification would appear inevitable in some cases, a lasting success can only be achieved via a consistent stabilisation policy.

Considering the still high level of real interest rates and the delays with which any improvement of the economic framework takes place, a marked stimulation of demand by investors and consumers in Western Europe is not likely to occur during the remaining months of 1982. The declining trend in fixed investments will level off. Private consumption can be expected to continue stagnating. Stimuli to production are expected only from the stock-cyclical impulses. The expected slight increase during the course of the year means that the annual average real GNP in most Western European countries will, if at all, only be marginally up on 1981. At the same time, there are signs of a decline in the inflation rate for private consumption, from 11 % in 1981 to about 9½ % in 1982, levels varying considerably from one country to the next.

Even if production in Western Europe picks up during the second half of the year, unemployment is likely to further increase in most Western European countries. On average, 10 % of gainfully employable persons will probably soon be out of work. How explosive this issue will become depends on whether the general improvement of the economic trend expected for the second half of this year proves to be the start of a gradual recovery or just a transitional stock-cyclical reaction.

The World Economy in the Summer of 1982

During the first half of 1982 the development of the world economy was persistently weak. The recession in the USA dragged on, and stagnation remained a dominant feature in other industrialised countries. There was a further general drop in capacity utilisation. At the last count, the USA and Western Europe registered an unemployment rate exceeding the 9 % mark. On the other hand, however, a number of major national economies were able to boast progress in curbing inflation. Apparently there was also a further decrease in the aggregate current account deficit of the industrialised countries. The reduction in both the

quantity and price of oil imports played an important part in this respect.

The long duration of the downswing, which began with a world-wide recession in early summer 1980, is a definite sign of the fact that the international economy is not just passing through one of the usual phases of cyclical weakness. We are dealing with a more fundamental crisis of stabilisation and adjustment. Basic misdevelopments had already appeared on the scene by the end of the sixties, as indicated by accelerating inflation in the industrialised countries. The oil price shocks of the seventies aggravated the