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REVIEW OF FOREIGN DEVELOPMENTS

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Recent Economic Developments in Germany:
July-December 1966

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Recent Economic Developments in Western Europe, July-December 1966

Summary

Below-average[1/] rates of economic expansion, which became apparent in 1965, continued through 1966 for most European countries and are likely to persist at least through the first half of 1967. On a year-to-year comparison, the average rate of growth of real GNP for European countries fell from an exceptionally high 5.9 per cent in 1964 to 3.7 per cent in 1965 and an estimated 3.5 per cent for both 1966 and 1967. (See Table 1.) Because prices are expected to rise less in 1967 than in 1966, the slowdown in the growth of money GNP in 1967 as compared with 1966 will be somewhat greater than that in real GNP.

Three main factors have contributed to the recent slowdown in growth: resource limitations, particularly labor, as countries reached virtually full capacity utilization (Germany, the Netherlands, Sweden, Switzerland and the United Kingdom); for most countries, a downturn in the inventory cycle and, for some, a slowdown in private investment demand and residential construction as well, following earlier rapid expansion; and perhaps most significant, the general use of restrictive credit policies to reduce the growth in inflationary pressures.

1/ As measured against Europe's economic performance from 1958 to 1965, when the rate of growth of real GNP averaged 4.8 per cent.

Table 1. Selected European Countries: Growth Rates of GNP, 1958-67
(per cent change over preceding year, constant prices)

	Average 1958-65	1964	1965	1966 e/	1967 f/
OECD-Europe	4.8	5.9	3.7	3.5	3.5
EEC-Total	5.5	5.8	4.1	4.5	4.1
Belgium	4.7	6.6	3.3	3.5	3.5
France	5.1	5.9	3.4	5.0	5.5
Germany	5.7	6.6	4.6	3.5	a/ 2.2
Italy	5.8	2.7	3.4	5.3	5.5
Netherlands	5.5	8.8	5.4	5.0	4.0
United Kingdom	3.7	5.7	2.3	1.0	1.0
United States	4.6	5.3	5.9	5.5	4.0

a/ Estimate by six economic research institutes; Economic Ministry estimate: 3.2 per cent.
e/ Estimate.
f/ Forecast.
Source: EEC Commission La situation économique de la Communauté; national statistics.

During 1966, only in France and Italy did economic trends continue to be clearly expansionary. By contrast, almost everywhere else business activity slowed down perceptibly. Despite slower rates of growth, however, policies remained directed toward restraint of domestic demand, especially in the first half of the year. Between May and mid-July 1966, for example, six major European countries raised their official discount rates (the Netherlands, Germany, Belgium, Sweden, Switzerland and the United Kingdom); only in the case of Belgium could there be any doubt that domestic economic conditions provided the major motive for these actions. In most cases, the higher discount rates followed money market movements, rather than lead them. Only in Denmark, Sweden and the United Kingdom were fiscal actions used to support monetary restraint. Price and wage ceilings were also used in Belgium, the Netherlands and the United Kingdom.

By the third quarter, however, it became increasingly apparent that restrictive policies had succeeded in cooling off--to varying degrees--the German, Swiss and Dutch booms and a downturn in activity in Britain was in process. In addition, earlier signs of an upturn in Belgium never materialized and somewhat faster growth in Sweden disappeared. By year-end, therefore, economic policy debates turned on whether a switch from restrictive to expansionary policies might be in order for a number of European countries.

For 1967, policy formulation in virtually all countries will be against a background of a better balance between demand and supply than at any time in the past 18 months. For France and Italy, the only countries currently in a clear cyclical upswing, there is sufficient spare capacity to accommodate expanding demand upon their resources and in an increasing number of other countries growth of demand is beginning to fall below the growth of capacity. For these latter countries, two distinct schools of thinking about policy-making are emerging. One group, which emphasizes rising wage and price trends, proposes a cautious easing of credit and other restraints during the next few months. A second view, which stresses the danger of an actual reduction in the level of real demand from sluggish investment, continued high interest rates and tight money, is concerned to achieve a distinct easing of credit conditions in the near future.

Easing of demand factors. The weakening of private productive investment and residential construction demand have been major factors in the lessening of demand pressures. This easing was partly a spontaneous reaction to earlier large increases; in addition, financing difficulties were brought about by credit restraint policies and shrinking profit margins, aggravated particularly in Germany by heavy public authority demands on domestic money and capital markets. These policies had some effect on public consumption spending, but public investment expenditures continued to rise rapidly, particularly in the United Kingdom, Sweden and the Netherlands.

The contribution of each factor in final expenditure to growth during 1966 for selected European countries is summarized in Table 2. For the EEC countries, private consumption accounted for 40 per cent and gross exports for 36 per cent of the increase in final demand. The increase in export demand was accompanied by a

Table 2. Selected European Countries: Changes in the Supply and Use of Resources, 1964-1966
(in percentages of total increase in real resources)

	Supply of Resources			Use of Resources				
	GNP	Imports	Total Change	Private Consumption	Public Consumption	Gross Fixed Investment	Inventory Change	Exports
E.E.C.								
1964	74	26	100	35	4	24	7	30
1965	67	33	100	44	9	13	- 7	41
1966 e/	64	36	100	40	6	13	5	36
France								
1964	75	25	100	39	8	31	7	15
1965	85	15	100	50	6	29	-29	44
1966 e/	70	30	100	40	8	15	11	25
Germany								
1964	73	27	100	35	--	32	9	24
1965	58	42	100	46	12	21	2	19
1966 e/	69	31	100	48	4	-7	13	42
Italy								
1964	168	-68	100	74	25	-99	-29	129
1965	97	3	100	32	11	-44	- 1	104
1966 e/	60	40	100	39	7	9	7	38
U.K.								
1964	75	25	100	33	4	37	16	10
1965	91	9	100	42	20	25	-29	42
1966 e/	61	39	100	66	26	11	-28	25

e/ Estimate.
Source: E.E.C. General Statistical Bulletin; national statistics.

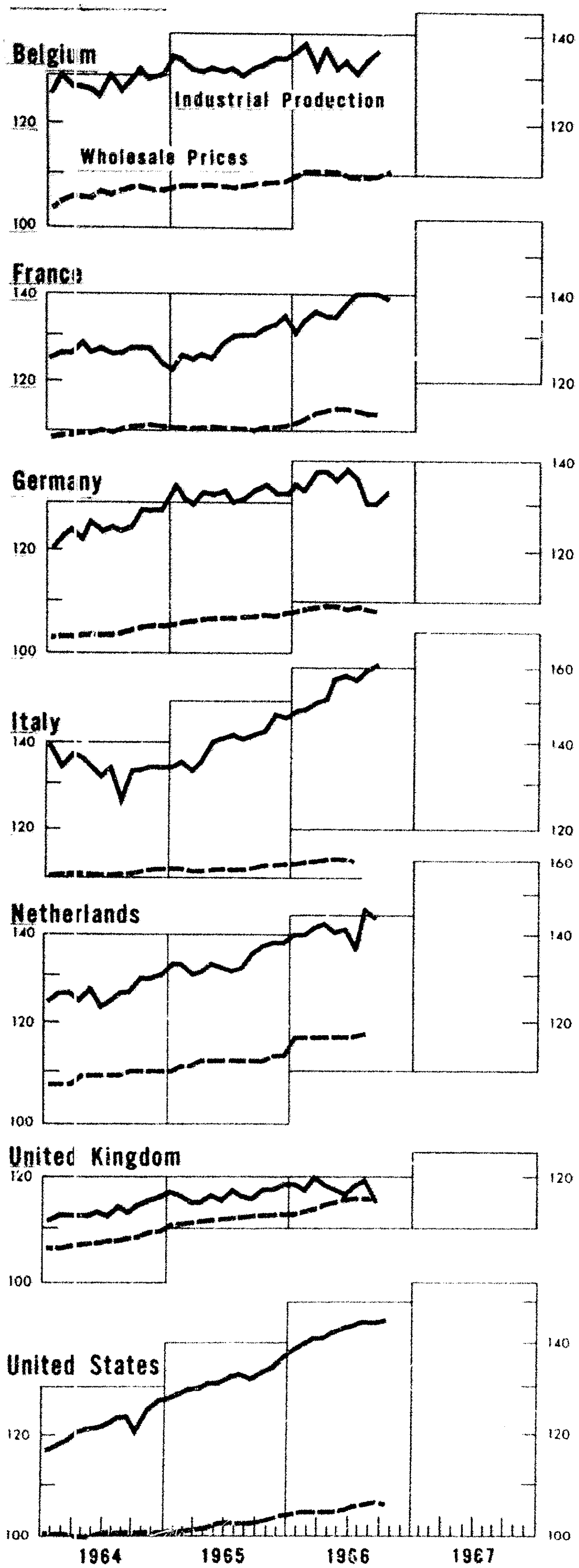
36 per cent import contribution to the rise in resources. Public consumption expenditures contributed only 6 per cent of the change during the year, but public investment undoubtedly was an important sustaining factor: the limited growth in the gross investment column is the sum of below-average private investment and above-average public spending. The contrast between the growth patterns of the EEC countries, either as a group or individually, and the United Kingdom is marked. For Britain, despite efforts to curtail imports, two-fifths of all additional resources came from imports and only one-fourth went into exports. The increase in net imports together with declines in inventories provided resources for expansion in private and public consumption; in 1965 private consumption and exports had been the most dynamic factors.

Easing of strains on capacity. Industrial output. The slower expansion of demand produced a slowdown in the growth of industrial output. (See Chart 1, p. 7.) The combined seasonally-adjusted production index for the European OECD countries rose at an annual rate of about 6 per cent in the last quarter of 1965 and the first quarter of 1966; by 2.5 per cent in the second quarter; and was probably unchanged in the third quarter. Industrial output continued to rise vigorously only in France, Italy and to a lesser extent in the Netherlands; it rose only slightly, if at all, in Austria, Belgium, Sweden and Switzerland and actually turned down in the United Kingdom

WAGES, PRICES AND OUTPUT Selected Industrial Countries

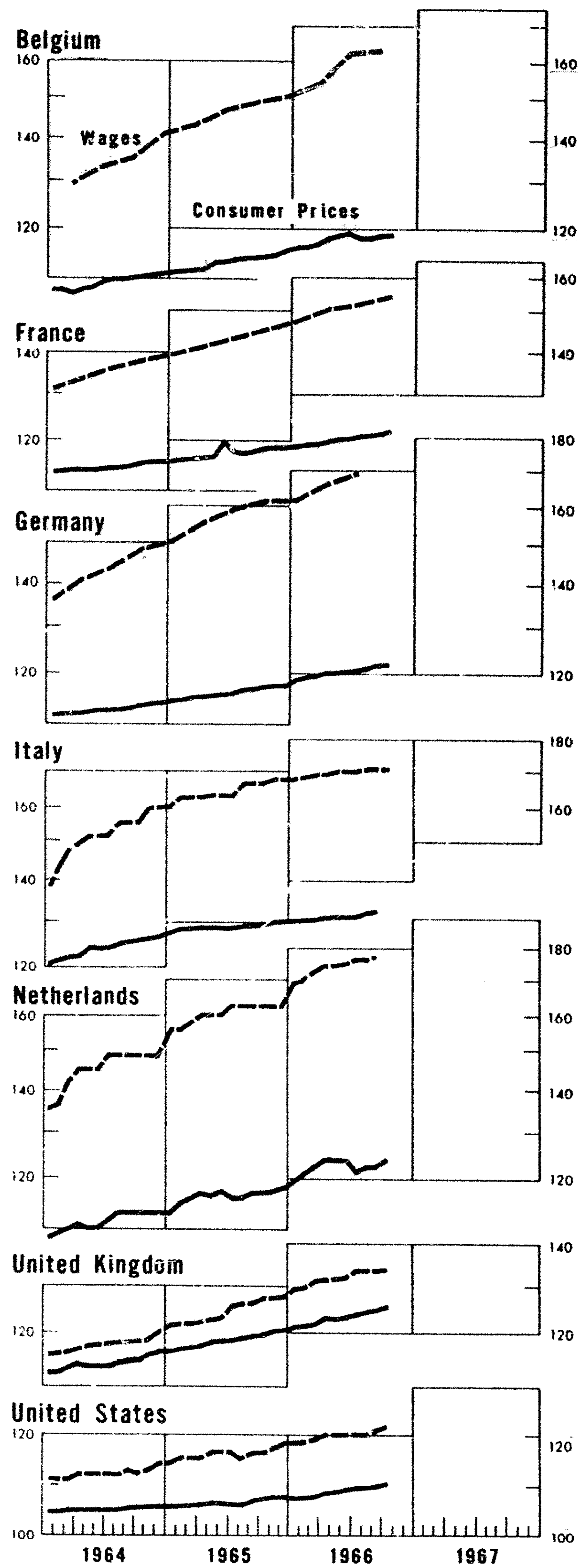
Industrial Production (s.a.) and Wholesale Prices [1]

1960=100, Semi - log



Wages [2] and Consumer Prices [3]

1960=100, Semi - log



1. Manufactured goods
2. Hourly earnings in manufacturing -- France, Italy & Netherlands: hourly rate
3. Nonfood -- Belgium : total

and Germany. For almost all countries, the mining industries were depressed and metal products, textiles, clothing and footwear output weakened. On the other hand, output of chemicals continued to expand rapidly.

Order backlog trends. In Germany and the Netherlands, where supply limitations had been particularly important, deliveries began to outpace the inflow of new orders and orderbooks were shortened. However, their order backlogs had been growing since late 1964--perhaps for 20 months--and these backlogs should provide an important stabilizing factor over the next several months. In addition, shorter delivery periods are giving these countries a strong competitive edge, both for home and for export sales, particularly over countries, like the United States, where demand pressures have reduced the ability to deliver promptly.

Labor market developments. The slowdown in the rate of output growth has brought about a slight easing of labor market strains in most European countries. As demand pressures have eased distinctly, labor hoarding has stopped and labor mobility has increased. Over the past few months, unemployment has risen slightly almost everywhere, and job vacancies have been reduced. This trend has been most apparent in the United Kingdom where unemployment has risen from 1.2 per cent of the labor force at the beginning of the year to close to 2 per cent (seasonally adjusted) in October and job vacancies are less than the number of unemployed for the first time since 1964. Continental countries have not experienced such a strong shift in labor market conditions. The number of job vacancies still remains a multiple of the number of unemployed (3 to 1 for Germany), but the ratio is much reduced. Even in France and Italy, where demand is expanding steadily, additions to output are being achieved with comparatively small gains in employment. As a result, for Europe as a whole, manpower shortages have become less acute, but in the longer run, they still remain a major limiting factor to output.

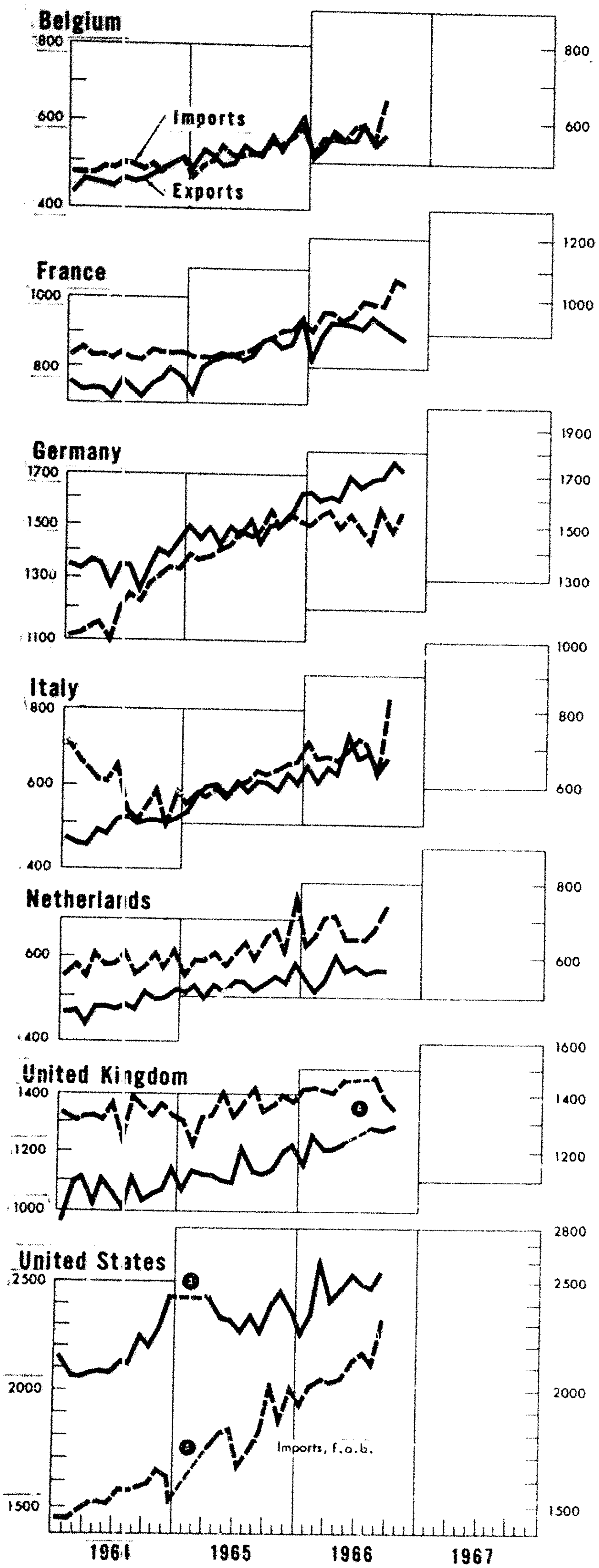
Because of a lesser tendency to hoard labor, slower growth of output has not been accompanied by the usual fall in productivity. In fact, productivity has been rising in most countries, except in the United Kingdom. At the same time, reduced over-time work and somewhat smaller wage settlements have slowed down the rise in unit labor costs; in France and Italy, these costs have actually fallen. (See Chart p. 7.)

Price rises moderating. These developments, combined with the keen competitive situation prevailing in most markets, are producing a moderation in the rate of price increases. In addition, imports have been adding substantially to domestic resources, and thus are helping to restrain price rises. (See Chart p. 10.) As a result, wholesale prices of manufactured

FOREIGN TRADE Selected Industrial Countries

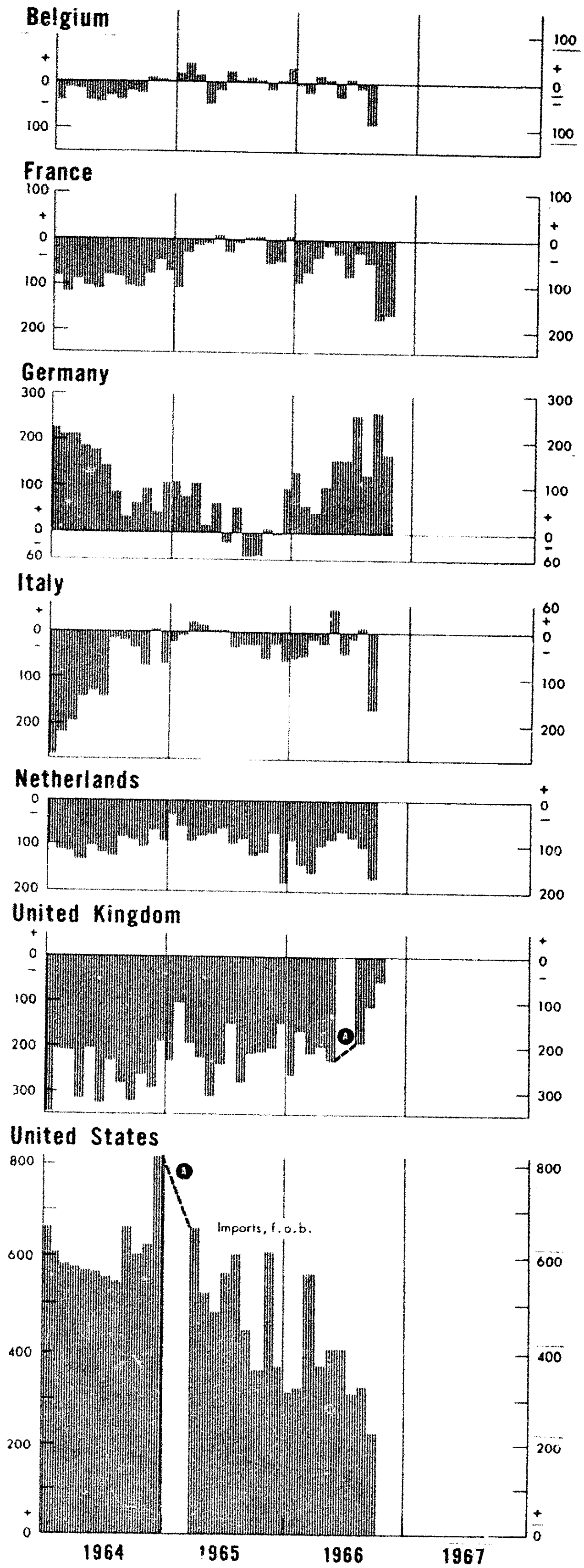
Exports f.o.b. & Imports c.i.f.

s.a. $ Million, Semi-log



Trade Balances Exports, f.o.b. - Imports, c.i.f.

s.a. $ Million



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goods have stabilized in almost all countries, largely because of market developments; only in the United Kingdom, the Netherlands and Belgium were government price measures important.

By contrast, consumer prices are continuing to rise. But most of the recent increases are caused by the upward trend of the cost of private services and by administrative price increases (such as higher prices for utilities) designed to balance the budgets of government enterprises or increases in excise taxes designed to curtail consumer spending. While the trend for prices of consumer goods still remains upward, the rate of increase has diminished noticeably, except in Italy. (See Chart p. 7.)

Foreign trade expanding. In contrast with slower domestic growth trends, external trade of European OECD countries has remained buoyant. (See Chart p. 10.) Exports of these countries have grown somewhat faster than imports in 1966. This trend is expected to continue into 1967 and in particular an improvement in their balance of trade with non-European countries is expected.

Trade performances of individual countries have been widely divergent. On the import side, demands from Germany, the United Kingdom and some smaller European countries (Switzerland and some Scandinavian countries) slowed down and the dynamic impulses for world trade expansion have been emanating from France, Italy, Japan, the United States and some less-industrialized countries. On the export side, sales by the Netherlands and France (for whom Germany and some of the EFTA-countries are major customers) have been affected by slowing demand in these markets; Germany, by contrast, has profited by the upsurge in demand in EEC and overseas markets, and Italian exports have been particularly strong to non-European markets. European countries in general (except perhaps for the Netherlands) continue to have sufficient capacity to take advantage of export opportunities. However, imports have provided a rising share of available resources in France, Italy and the Netherlands.

As a result, trade balances of France, Italy and the Netherlands have deteriorated recently. Within Europe, however, this deterioration is being more than offset by a large improvement in the German trade balance and some improvement in that of the United Kingdom; the combined trade balances of other European countries have shown little change.

For the EEC countries as a group, changes in trade balances and continued inflows on invisible account are expected to produce a current-account surplus in 1966 of about $3.2 billion and, on current trends, a similar surplus is expected for 1967, according to official EEC Commission estimates. As the United Kingdom moves towards better payments balance and the combined deficit of some smaller European countries is expected to be reduced, Western Europe may well show a current balance surplus approaching $4 billion in 1967.

Prospects and government policies. Official estimates, either by national authorities or international organizations, put economic growth in 1967 as compared with 1966 for all European countries combined at about 3.5 per cent, the same rate expected for 1966 over 1965. This would imply some quickening of the rate of growth during the course of 1967 from levels prevailing at the end of 1966.

In France and Italy, expansion is expected to continue to gather momentum, but without creating significant renewed inflationary pressures. In Germany and the Netherlands, the weakening of demand is not likely to produce more than a slowdown in the rate of growth, to a rate somewhat below the rate of growth in capacity. With private investment declining, stabilizing factors in both countries include a continued growth in export sales and in mass incomes, which should maintain consumer spending. Labor markets continue to be relatively tight; any dimunition in the overall demand for labor is likely to lead to a greater reduction in foreign labor than in employment of domestic labor. In addition, the strong pent-up government investment demand, held back by restrictive policies particularly in the monetary field during 1966, may also help to sustain final demand.

So long as price stability remains the major policy objective of European officials, a general relaxation of credit restraint may be delayed. Even though monetary policy is affecting private investment to an undesirable extent, both countries find it difficult to make greater use of fiscal policy, particularly at a time of internal political difficulties.

However, the setting in which credit policy decisions will be made in 1967 in practically all European countries is quite different from conditions prevailing a year earlier. In most countries, inflationary pressures are appreciably less and the burdens of restrictive demand management, which monetary authorities had to assume during 1966, were already being lightened late in the year. In Germany and the Netherlands, the authorities have already allowed market factors to bring down interest rates somewhat. The United Kingdom, alone among those European countries where rates peaked in July-August 1966, is actively attempting to slow the downward market tendencies in interest rates. For the two countries where demand is expanding, only France has encouraged any firming of domestic money rates thus far. Because financial markets now seem to be in much better balance in several major European countries, the prevailing trend in interest rates at the beginning of 1967 is downward in contrast with the sharp upward trend evident in early 1966.