CHRISTOPHER TUGENDHAT

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Prime Minister

CDP 26/xi

(4)

19 November 1984

Dear Prime Minister

I thought that you might be interested to see the attached speech on economic priorities for Western Europe which I delivered to a private conference in Brussels jointly organised by the US Missions to the European Communities, NATO and Belgium. It was attended by politicians, businessmen and diplomats from both sides of the Atlantic.

Yours ever

Christopher

The Prime Minister
The Rt Hon Margaret Thatcher, MP
10 Downing Street
GB - LONDON SW1

The Challenge of Change :-

**The Western Economies and the Atlantic Relationship**

PAPER BY MR CHRISTOPHER TUGENDHAT, VICE-PRESIDENT OF THE COMMISSION OF THE EUROPEAN COMMUNITIES, FOR THE US MISSIONS CONFERENCE, BRUSSELS, ON I6 NOVEMBER I984

Some thoughts on the European Economy

## I. Introduction

I have been asked to address myself to the state of the European economies, and to the pre-requisites for bringing about an improvement in their performance.

This theme is, of course, central to answering a question that lies at the heart of the business of this conference: are the Europeans sufficiently robust economically to maintain their expenditures on defence and, if possible, to increase them to levels more acceptable to the United States?

We all know that economic difficulties weaken the political consensus for defence expenditure.

High unemployment, in particular, erodes the fabric of our societies, and saps the will to defend ourselves. It makes more popular the illusion that détente and East-West negotiations can, if only they were more energetically pursued, substitute for strong defences, or make them less necessary. Indeed, we see this happening today within the Socialist parties of the two greatest European contributors to NATO: the United Kingdom and the Federal Republic of Germany.

Inflation erodes the value of those resources that the public has consented to allocate to defence. In addition, it makes it extremely difficult to undertake long term planning on defence and arms procurement, which is increasingly essential at a time of rapid growth in the sophistication and cost of weapons as well as of growing lead times for their development.

If only for these reasons, the management of the European economies is crucial to the maintenance of healthy defences in the Alliance. Other speakers will, no doubt, develop this point further. I shall now turn to the first part of my own themes: how sick have the European economies really become?

## II. How sick is the European Economy?

There can no longer be any doubt that the European countries of OECD are in a worse position, from a macroeconomic point of view, than the United

States and Japan. Growth of output continues to lag far behind that of North America and Japan. Most European countries have been far less successful than the two other regions in reducing inflation, though a group of low-inflation countries in Europe has emerged led by the Federal Republic of Germany, Switzerland and the Netherlands - with the United Kingdom as a prospective member. Above all, unemployment is considerably worse than it is in the US. The recent annual survey on unemployment of the OECD again confirms this finding. It points out that between 1973 and 1983 almost 18 million extra jobs were created in North America, compared with a 5 million increase in Japan and a loss of 1 1/2 million jobs in Europe.

This picture of European unemployment needs to be qualified in two ways.

First, there is much evidence to suggest that, over the last decade, new jobs in Europe have tended to consist of rather more productive activities than many of those created in the United States. This can be inferred, at the most general level, from the fact that a 23% growth in real national output in the US from 1975 to 1983 was supported by a 17% increase in total employment, whereas an 18% expansion of output in Europe was supported by a reduction of 0.8% in employment (Source: OECD Second Annual Survey on Employment).

But some of the most compelling evidence for this thesis comes from the services sector, which has provided such a large proportion of the gains in employment in the US. In the US the creation of jobs in the service sector reflects, to a far greater extent than it does in Europe, the tendency of employers to reduce their permanent staff and to cover holiday and demand peaks by contracting out to service agencies which employ part-timers. This trend is, in reality, a form of market-generated work-sharing, and therefore does not contribute as much to output and full time employment as the figures might at first suggest.

Thus, while the US was generating all those new jobs about which we hear, it was until recently actually losing its commanding lead over the rest of the world in both productivity and living standards. Since 1973, output per head in the whole US economy has grown by only 0.3% a year, against 2% in the European Community. Moreover, after a brief upward boost at the start of the economic recovery, growth in United States productivity slowed again in the last quarter to an annual rate of barely 1%. In short, what has happened since 1973 is that the US has chosen a path of high employment, at the cost of stagnant productivity and wages, while Europe has chosen greater growth in productivity and living standards (for those in work) at the expense, it would appear, of a rise in unemployment.

The second way in which the statistical trends in European unemployment need to be qualified is that there is sadly no reason to hope that unemployment will greatly decrease as economic recovery takes place. For example, the OECD report points out that some of the developments which have mitigated the problem of unemployment until now may be near maturity. Financial services, to take the sector on which so many hopes for new employment rest, may shed rather than create jobs as competition intensifies, as may distribution, while new employment in public services is limited by the squeeze on public expenditure to which most countries are subjecting themselves.

## III. The problems - and some remedies

My analysis of Europe's economic problems will focus primarily on their intra-European causes. There are two reasons for this, the first one economic and the other political:

- First, from a strictly economic point of view, I am profoundly convinced that the main causes of Europe's sluggish growth and insufficient competitiveness in some industrial sectors are domestic. The US budget deficit, and the sky-high interest rates to which it and the accompanying tight monetary stance have contributed, do, of course, seriously exacerbate Europe's economic problems; but they are not the fundamental causes of them. Why else are the South-East Asian countries and Japan going from strength to strength, even though they are as exposed as Europe is to the effects of current US policies? Above all, why has there been such a considerable increase in employment in the US and in the after-tax profits of so many American companies operating in the US itself?

- Second, the US decision-making process is extremely difficult to influence from overseas. Thus, to the extent that US monetary and fiscal policies are responsible for high interest rates and do therefore damage the European economy, we should not see diplomatic pressure on the US Administration and Congress to bring down interest rates, important though that is, as a reliable way of improving our own economic prospects. Moreover the difficulty of influencing the US budget deficit is compounded by the fact that there is a continual growth in the structural component of it - that is to say, the component that currently comprises growing entitlement expenditures, the proposed erosion of the tax base through indexation of tax brackets and allowances, and continued projected growth in military spending. All these costs to the budget are supported and perpetuated by massive vested interests - whose susceptibility to influence by Europeans or Japanese is negligible if not non-existent.

I should now like to turn to what I see as the principal domestic causes of Europe's economic problems. I must emphasize that there are no easy answers, no single slogan such as wage flexibility, public investment or shorter working hours, depending on one's political standpoint, that encapsulates the magic formula for bringing about growth and employment. A broad mix of policies and policy instruments is required. These fall, I believe, into five broad categories.

(a) **Inflexibilities of the labour market.**

As you see, I place these at the top of my list. They encompass a number of crucial issues:

- **Insufficient geographical mobility of labour.**

This has long been seen in, for example, the United Kingdom, where loyalty to the local community has historically been very great and where whole communities were for decades or even centuries formed around particular industries, such as coal in Wales and textiles in Lancashire. Even in Germany, where the physical and psychological destruction of communities by the Second World War ensured that mobility was peculiarly great, it is now substantially declining.

Government has a major role to play in providing inducements to industrial mobility. There are at least four priorities here: the first is to encourage a more fluid housing market with a large rented sector, in order to reduce the transaction cost of moving. The second is to make company pension schemes more easily transferable if a worker moves from one employer to another, an area where the Federal Republic, for example, has made much progress. The third is to provide grants to unemployed individuals to go to interviews for jobs in other parts of the country and to move to those parts should they secure jobs - an area where the Germans and the British, amongst others, have taken important initiatives. The fourth is to ensure that those who move from one region to another are in a position to obtain proper education for their children by making the curricula of schools compatible, the availability of places reasonably assured and their final examinations recognised as equal tests of ability.

Although for the time being these are objectives which must be sought within the Member States of the Community, I hope that they will, in time, also be attained between Member States so that free movement of persons within the Community as a whole could at last become a reality.

- **Excessively high wages**

This is, I believe, a problem common to almost all countries of the European Community. There has been a steady growth in real wages - in contrast to the US where wages have maintained a far more realistic relationship to output and productivity. High technology will not make the question of wages in the economy as a whole less relevant, as so many commentators suggest. For we must not overlook the fact that many if not most of the jobs of the future will be in labour-intensive service industries which deploy little or no sophisticated technology. In such industries, wages will continue to account for a large proportion of input costs.

The current fixation of many trades unions in Europe on the reduction of working time is, therefore, totally self-defeating, unless reductions in working time are accompanied by corresponding cuts in pay or increases in productivity. Although this obvious truth has not been fully acknowledged by most unions, some of them have implicitly recognised it by accepting shorter working hours as a partial substitute for wage increases. I believe that if cuts in working hours are accompanied by improvements in efficiency, they could help in the short term to curb the increase in unemployment, until it once again becomes possible to relax the tight monetary and fiscal policies which are currently needed to contain inflation.

## - The power of corporatism in modern society

Corporatism is of course part and parcel of modern industrial societies. It helps to make possible the crucial economies of scale required to generate employment and to remain competitive. It contributes to the orderly articulation and reconciliation of innumerable conflicting interests. And it is an inevitable concommittant of the organization of labour into trade unions. Yet, for someone like me who believes profoundly that the key to economic growth lies in the maximum freedom of enterprise from restraints, a major obstacle to growth must be the capacity of such organizations to pursue their special interests to the detriment of society as a whole - and, I would contend, ultimately of their own members as well. Mancur Olson, in his important book 'The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities', has brilliantly analysed the way in which this happens. He suggests, I believe rightly, that these interest groups flourish in societies in proportion to the length of uninterrupted stability in the latter - one reason for the deep-seatedness of the so-called 'British disease'. They frequently hamper efficient production and technological innovation, largely by slowing down decision-making and by impairing the nation's capacity for adaptation and change; they distort distribution and increase the complexity of regulation; and they tend to evade political control.

I conclude from this analysis that a condition for conquering the present 'stagflation' - a word as ugly as the phenomenon it describes - is to place restrictions on the irresponsible use of power by special interest groups. With respect to industrial corporations, many such rules already exist in the form of controls on mergers, cartels and the abuse of dominant market positions. Strict rules of competition exist both at the level of nation states, such as the Federal German Cartel office, and at the level of the European Community - which has very considerable powers in this area. Moreover the trend towards deregulation which is catching on in Europe, and particularly in Britain and the Federal Republic, will contribute in a major way to the promotion of competition and thereby to limiting the power of individual corporations or interest groups. This is an utterly healthy trend, which I wholeheartedly welcome.

Action must also be taken, by employers and employees together, to ensure that workers do not automatically price themselves out of jobs. I have two particular points in mind here.

The first is that we should re-examine what was, in some countries, once thought to be the god-given right of workers to automatic increases in wages. This is already happening in several Community Member States, notably Italy, Belgium, France and Denmark, in all of which a de-indexation of wages has been agreed. I hope it will last.

The second point is a peculiarly British one. It is the need to curb in the United Kingdom the ability of Union leaders to use their formidable powers in irresponsible ways. I welcome the measures which the Thatcher government has so far taken in this respect. Under the Trade Union Act of 1984, workers will have to be given a secret vote on whether or not to strike if their Unions are to retain their legal immunity. And since 1 November of this year any closed shop that fails to gain the support of the overwhelming majority of its members in a secret ballot will cease to have any legal standing. These measures will defend the rights and jobs of individual workers. They will limit only the opportunity for their union leaders to pursue courses of action, such as Arthur Scargill has followed with such tenacity during the current Miners' strike, which will ultimately put at risk thousands of jobs as well as the incomes of those lucky enough to remain employed.

- **Better training and re-training of labour**

No industrial economy can keep its head above the waters of international competition unless it has effective means for training and re-training workers - and managers. The need for training is going to be more important than ever as a result of the information revolution which we are now experiencing. In the computer industry, for example, fundamental job changes requiring re-training probably occur every 18-36 months. Moreover, jobs in information services - which account for over 70% of the 19 million new jobs created in the US since 1970 - are often highly specialised. We can be sure that they will not absorb factory workers as smoothly as factory jobs absorbed agricultural workers 100 years ago.

Training is an area in which the state has a legitimate and necessary role to play: individual companies - particularly when profit margins are narrow, as they are at the present time of low growth and increasingly severe international competition - are often reluctant to invest the necessary resources in training workers, particularly young ones looking for their first jobs. Since skill needs are difficult to forecast with precision, it makes sense to aim for modes of training that are broadly-based and flexible. These are just the modes that government schemes should be in a good position to promote. Indeed, I believe that a greater proportion of state assistance to the unemployed should be provided in the form of entitlement to re-training and adjustment schemes, rather than being provided so largely in the form of straight cash transfers. In general, governmental policies should not only seek to relieve the hardships of the unemployed by way of income support, but also be designed to facilitate their return to employment as soon as jobs are available by means of retraining, job placement, geographic mobility aids, viable job creation schemes and the like.

Improved facilities for the training of workers must, however, go hand-in-hand with the development of early warning systems at the level of companies and plants, which can provide a flow of information about the planned introduction of new technologies.

(b) <u>Taxation systems insufficiently oriented towards encouraging profits</u>

Here we may have something to learn from the experience of the US, and particularly from the tax reform begun in 1981 which seems to have contributed in a major way to the remarkable increase in the profitability of investment in the US over the past two years or so. Progress has been made in Europe too. For example, the German Government has announced DM 20 billion in cuts of income tax to be made over three years from 1986. The French Government in its 1985 budget is to cut taxes by an amount of 1% of GDP. The Dutch budget for 1985 makes tax cuts amounting to 1/3 to 1% of GDP. And the British Government unveiled major tax reforms last April in which the emphasis has been switched from indiscriminate subsidies to lower tax rates for businesses of all kinds, thereby providing more scope for flexible investment decisions. It is perhaps in part a reflection of this that both fixed investment, particularly in manufacturing, and exports have grown rapidly in the United Kingdom over the past year.

(c) **Sharing by workers in corporate profits and decision-making**

There is hardly a human being whose motivation and sense of responsibility are not increased by feeling a master of his own destiny.

There are several different ways of achieving this. Germany and the Netherlands have done it by worker participation. One of the best of the other methods is to find ways of allowing employees to become co-owners, together with outside investors, of the new technologies acquired by their firms and to share directly in the benefits from them. This does not mean that enterprises need to be cooperatives or union-owned. Instead, pay-cheques might include a portion in cash and a portion in the common stock issued to purchase labour-saving devices. Such schemes would provide incentives to each and every worker which cannot be achieved to anything like the same degree by the legislation appearing all over Western Europe to increase employee representation on boards of directors. The reasons are straightforward: first, the overwhelming majority of workers cannot, by definition, be representatives on the board, and therefore cannot feel directly involved in the process of decision-making. Second, that process is often so complicated in the modern industrial firm that it is usually very difficult for the worker to guage what precise role he, or his representative, has had in it. We Europeans should not, therefore, see the participation of workers in decision-making as anything more than a modest contribution to the task of seeking greater motivation in the labour force.

Fortunately the problem of motivation will be helped by the likely trend towards the creation of small firms in the future, particularly in the sector of information services. In this sector, workers will increasingly have the opportunity to become entrepreneurial partners, rather than resentful employees.

(d) The European Common Market

The assault on unemployment requires not merely a more flexible labour market and a more motivated work-force, but better functioning of markets for goods and capital.

Let me give an example:

Frontier formalities represent a disgraceful anachronism. They are very expensive and swallow up between 5 and 10% of the pre-tax value of the goods concerned. The time lost merely in waiting and hold-ups amounts to about £500 million per year. In their internal markets which provide the basis on which their export trade is built, American and Japanese companies suffer no comparable disadvantage.

What we need in Europe is to create a situation in which managements can consider the Community as a single market in which they can take decisions on the basis of economic efficiency rather than having constantly to try to maximise the benefits and minimise the disadvantages arising from the continued existence of separate national markets. If Europe really became a single market in which manufacturers and those who provide services could sell their wares freely from Scotland to Sicily and from Brest to Bavaria, the consumer through the market place could determine which would prosper and which would not.

The Community's Institutions have a two-fold task in order to bring this situation about. On the one hand they must work to ensure that the legal and taxation systems of the Member States are sufficiently transparent, non-discriminatory and compatible with each other to ensure that the competition is fair and the adaptation possible. On the other, they must work to eliminate the bias in favour of national suppliers that still exists in the field of public procurement and to introduce common standards throughout the Community.

Persuading governments of the need to make the myriad specific changes that will be required and even more, persuading them to carry those changes into effect will be a massive task. It will also be politically difficult, not to say thankless, since in every country any domestic special interest that feels threatened will try to rouse government and public opinion against what is being attempted. Progress will not be made in the sort of dramatic leaps and bounds that attract favourable publicity but through the undramatic pursuit of what will often appear to be boring and rather minor issues. In my view, timetables with deadlines and specific objectives backed by the authority of the European Council have an essential role to play in bringing about such progress.

To plead for the creation of a genuine common market does <u>not</u> require one automatically to attach great importance to the encouragement of cooperative ventures between European companies of different nationality.

If companies wish to engage in such cooperation they should certainly be able to do so. Artificial barriers and political constraints should be removed. On occasion, if the objectives are sufficiently clearly defined and limited to sufficiently specific operations and if the management structures are appropriately constructed, they have a useful role to play. But in my view, if a real European common market can be constructed, the future will lie with companies with clearly defined command centres and domestic markets in one Community country extending their activities into others, either by means of direct sales across frontiers or through the take-over or creation of subsidiaries, and generally by a mixture of all these methods.

There will of course always be those who argue that the pursuit of similar lines of research and development within several different firms is wasteful. They will say the same about the production of basically similar and competing products within a single politico-economic unit such as the Community. But I am sure they are wrong. In general the more competitive a domestic market - and in this sense we should regard the Community as a single market - the more competitive on international markets the companies concerned are likely to be. Per contra, when large units are created by government action and given preferential positions in their home markets, they are unlikely to be competitive internationally. Thus, a dirigiste Community industrial policy would, I fear, be more likely to reflect the political bargaining process between the Member States, with work being allocated on political grounds or grounds of so-called fairness between nations, than hard industrial reality. One has only to look at the history of the Common Agricultural Policy over the years to appreciate some of the dangers.

(e) **Coordination of macro-economic policies**

I have deliberately left the need for more closely coordinated macro-economic policies to last. As you might expect of a Vice-President of the European Commission, I attach great importance to this. I believe that the more coordination can be achieved the better.

But I am also a realist. I share the view of one of my distinguished predecessors as Vice-President of the European Commission, Raymond Barre, that "the fundamental necessity is for the national will in every country to maintain conditions required for balanced growth and international competitiveness". He is right in saying that the convergence of economic policies among industralized economies "ultimately depends on the political will of each government, and on the pressure of events, more than on international mechanisms for the coordination of policies" (Source: 'Unemployment and Growth in the Western Economies', Andrew J Pierre, Editor, Council on Foreign Relations, New York, 1984).

I believe M Barre is right for two reasons: one is economic, namely that the real obstacles to increased growth and employment lie in the rigidities to which I have referred. The second is political, namely that at the present stage of development of the Community we are simply not in a position to enforce coordination of economic policies. Coordination still depends primarily on the political will of each government and on the pressure of the money markets on it, far more than on negotiated mechanisms or on meetings of the Council of Ministers.

Nonetheless, the so-called 'divergence indicator' of the

European Monetary System has made a significant contribution to bringing about a closer coordination of economic policies in Europe. I recognise that this is difficult to demonstrate; but on the basis of my own observation, I believe that the adoption of agreed target zones for exchange rates has not only done much to stabilise parities within Europe, but has also been an instrument for the convergence of economic policies and performances, without which the European economy would be in still worse shape and protectionism would have made greater advances in all our Member States.

There are, I believe, two modest ways in which the European Monetary System now needs to be strengthened.

The first is to confer upon the European Currency Unit the status of a fully convertible foreign currency in each Member State of the Community. The ECU has now emerged as a significant currency for private investors. It is no longer merely an accounting unit for the big banks, or funny money in which governments can denominate their accounts. The volume of ECU deposits and credits has increased six-fold in two years. Moreover, so far this year the ECU has been the third major currency to be issued in the Eurobond markets, after the US Dollar and the Deutsche Mark. And just a few weeks ago an ECU denominated bond for the EEC institutions was floated on the New York Financial Market. In most Member States, including the UK, the private individual can open an account in ECUs at his local bank. All this is giving rise to an independent interest rate structure for the ECU.

Yet the reaction of some Community governments to the ECU, particularly the German Government, has sadly been very much less positive than the attitude taken by most private banks and investors. The German Government continues to refuse even to grant the ECU the status of a foreign currency or to permit it to be used by German residents. I do not accept the argument that the ECU is in effect an indexation clause and I urge the German authorities to find ways of overcoming their objections.

Unless and until they do, the ECU will inevitably labour under a serious handicap because the German financial system will not be playing its full part. This, in turn, will considerably impede the development of the EMS as a whole.

My second point on strengthening the EMS concerns the United Kingdom.

One cannot mention the benefits of the EMS and its great potential as a pillar of the International Monetary System, without urging Britain to become a full member by joining the exchange rate mechanism. As I have often said before, the absence of Sterling from the exchange rate arrangements denies British industry the chance of a more stable Pound in the Community, to which it now sends 43% of its exports, and weakens Britain's influence in the overall management of the System.

It is also unsettling for other European currencies that the Pound is in the ECU - whose stability it upsets as a result of its wide fluctuations - while Britain fails to participate in the intervention mechanisms which are designed both to avoid these fluctuations and to enable Europe to deal on a more equal basis with the United States and Japan.

Finally, it is very difficult to see how the EMS can be fully developed in the absence of what is after all one of Europe's major currencies.

## IV. Conclusions

What are the prospects for Europe of successfully applying the policies I have advocated? Difficult and dangerous though it is to predict the behaviour of states, I am optimistic, and for two basic reasons.

First, the Europeans are scared. No visitor to our shores can fail to notice the state of near panic about Europe's lag in high technology and her poor performance on unemployment compared with the US and Japan. Nor can anyone fail to notice the great sensitivity to inflation which has developed in recent years. It is as if we have all suddenly been saddled with the historical experience of inflation that has for long made Germans so prudent in their monetary and fiscal policies.

Second, the power of foreign exchange markets - which I believe can no longer be effectively resisted by exchange controls - will ensure that we remain scared. This is bound to exert a strong and continuing influence on governments. As France has already discovered, it makes it virtually impossible for any European economy to go for growth regardless of the policies of its neighbours.

Third, Europe is increasingly conscious of being on its own in the world. This is where attitudes in the spheres of security and economics interact. At the same time as Europe has come to recognise its economic lag in relation to Japan and the United States, it has also become acutely aware (indeed, to an exaggerated degree) of its lack of influence in the sphere of East-West relations and in relation to both Superpowers. The cancellation of Mr Honecker's visit to the Federal Republic of Germany only underlines this stark reality.

The crucial question is, of course : will this powerful sense of impotence galvanize Europe into making the sacrifices and efforts needed for it to gain greater command over its destiny. In the sphere of security, this question remains open. In the realm of economics, I am increasingly convinced that it will.

Foreign and Commonwealth Office

London SW1A 2AH

14 December 1984

Already seen by PM
CDP 14/12

Dear Charles,

Speech by Mr Tugendhat

At the Dublin European Council, the Prime Minister commended the Commission's Annual Economic Report as much more realistic than its predecessors. The Foreign Secretary believes that the Prime Minister may also be interested to see the enclosed speech which Mr Tugendhat delivered at a conference organised by the US missions in Brussels on 16 November.

Like the Annual Economic Report, Mr Tugendhat's analysis differs significantly from traditional Commission attitudes, both in presentation and in substance. We will want to do all we can to encourage such moves towards greater realism on the Commission's part.

I am sending copies of this letter to the Private Secretaries of other members of OD(E). We have also sent a copy for Sebastian Birch to pass to Lord Cockfield.

Yours ever,

Colin Budd

(C R Budd)
Private Secretary

C D Powell Esq
10 Downing Street

The Challenge of Change :

**The Western Economies and the Atlantic Relationship**

PAPER BY MR CHRISTOPHER TUGENDHAT, VICE-PRESIDENT OF THE COMMISSION OF THE EUROPEAN COMMUNITIES, FOR THE US MISSIONS CONFERENCE, BRUSSELS, ON 16 NOVEMBER 1984

## Some thoughts on the European Economy

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We all know that economic difficulties weaken the political consensus for defence expenditure.

High unemployment, in particular, erodes the fabric of our societies, and saps the will to defend ourselves. It makes more popular the illusion that détente and East-West negotiations can, if only they were more energetically pursued, substitute for strong defences, or make them less necessary. Indeed, we see this happening today within the Socialist parties of the two greatest European contributors to NATO: the United Kingdom and the Federal Republic of Germany.

Inflation erodes the value of those resources that the public has consented to allocate to defence. In addition, it makes it extremely difficult to undertake long term planning on defence and arms procurement, which is increasingly essential at a time of rapid growth in the sophistication and cost of weapons as well as of growing lead times for their development.

If only for these reasons, the management of the European economies is crucial to the maintenance of healthy defences in the Alliance. Other speakers will, no doubt, develop this point further. I shall now turn to the first part of my own themes: how sick have the European economies really become?

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States and Japan. Growth of output continues to lag far behind that of North America and Japan. Most European countries have been far less successful than the two other regions in reducing inflation, though a group of low-inflation countries in Europe has emerged led by the Federal Republic of Germany, Switzerland and the Netherlands - with the United Kingdom as a prospective member. Above all, unemployment is considerably worse than it is in the US. The recent annual survey on unemployment of the OECD again confirms this finding. It points out that between 1973 and 1983 almost 18 million extra jobs were created in North America, compared with a 5 million increase in Japan and a loss of 1 1/2 million jobs in Europe.

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But some of the most compelling evidence for this thesis comes from the services sector, which has provided such a large proportion of the gains in employment in the US. In the US the creation of jobs in the service sector reflects, to a far greater extent than it does in Europe, the tendency of employers to reduce their permanent staff and to cover holiday and demand peaks by contracting out to service agencies which employ part-timers. This trend is, in reality, a form of market-generated work-sharing, and therefore does not contribute as much to output and full time employment as the figures might at first suggest.

Thus, while the US was generating all those new jobs about which we hear, it was until recently actually losing its commanding lead over the rest of the world in both productivity and living standards. Since 1973, output per head in the whole US economy has grown by only 0.3% a year, against 2% in the European Community. Moreover, after a brief upward boost at the start of the economic recovery, growth in United States productivity slowed again in the last quarter to an annual rate of barely 1%. In short, what has happened since 1973 is that the US has chosen a path of high employment, at the cost of stagnant productivity and wages, while Europe has chosen greater growth in productivity and living standards (for those in work) at the expense, it would appear, of a rise in unemployment.

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My analysis of Europe's economic problems will focus primarily on their intra-European causes. There are two reasons for this, the first one economic and the other political:

- First, from a strictly economic point of view, I am profoundly convinced that the main causes of Europe's sluggish growth and insufficient competitiveness in some industrial sectors are domestic. The US budget deficit, and the sky-high interest rates to which it and the accompanying tight monetary stance have contributed, do, of course, seriously exacerbate Europe's economic problems; but they are not the fundamental causes of them. Why else are the South-East Asian countries and Japan going from strength to strength, even though they are as exposed as Europe is to the effects of current US policies? Above all, why has there been such a considerable increase in employment in the US and in the after-tax profits of so many American companies operating in the US itself?

- Second, the US decision-making process is extremely difficult to influence from overseas. Thus, to the extent that US monetary and fiscal policies are responsible for high interest rates and do therefore damage the European economy, we should not see diplomatic pressure on the US Administration and Congress to bring down interest rates, important though that is, as a reliable way of improving our own economic prospects. Moreover the difficulty of influencing the US budget deficit is compounded by the fact that there is a continual growth in the structural component of it - that is to say, the component that currently comprises growing entitlement expenditures, the proposed erosion of the tax base through indexation of tax brackets and allowances, and continued projected growth in military spending. All these costs to the budget are supported and perpetuated by massive vested interests - whose susceptibility to influence by Europeans or Japanese is negligible if not non-existent.

I should now like to turn to what I see as the principal domestic causes of Europe's economic problems. I must emphasize that there are no easy answers, no single slogan such as wage flexibility, public investment or shorter working hours, depending on one's political standpoint, that encapsulates the magic formula for bringing about growth and employment. A broad mix of policies and policy instruments is required. These fall, I believe, into five broad categories.

(a) Inflexibilities of the labour market.

As you see, I place these at the top of my list. They encompass a number of crucial issues:

- Insufficient geographical mobility of labour.

This has long been seen in, for example, the United Kingdom, where loyalty to the local community has historically been very great and where whole communities were for decades or even centuries formed around particular industries, such as coal in Wales and textiles in Lancashire. Even in Germany, where the physical and psychological destruction of communities by the Second World War ensured that mobility was peculiarly great, it is now substantially declining.

Government has a major role to play in providing inducements to industrial mobility. There are at least four priorities here: the first is to encourage a more fluid housing market with a large rented sector, in order to reduce the transaction cost of moving. The second is to make company pension schemes more easily transferable if a worker moves from one employer to another, an area where the Federal Republic, for example, has made much progress. The third is to provide grants to unemployed individuals to go to interviews for jobs in other parts of the country and to move to those parts should they secure jobs - an area where the Germans and the British, amongst others, have taken important initiatives. The fourth is to ensure that those who move from one region to another are in a position to obtain proper education for their children by making the curricula of schools compatible, the availability of places reasonably assured and their final examinations recognised as equal tests of ability.

Although for the time being these are objectives which must be sought within the Member States of the Community, I hope that they will, in time, also be attained between Member States so that free movement of persons within the Community as a whole could at last become a reality.

- Excessively high wages

This is, I believe, a problem common to almost all countries of the European Community. There has been a steady growth in real wages - in contrast to the US where wages have maintained a far more realistic relationship to output and productivity. High technology will not make the question of wages in the economy as a whole less relevant, as so many commentators suggest. For we must not overlook the fact that many if not most of the jobs of the future will be in labour-intensive service industries which deploy little or no sophisticated technology. In such industries, wages will continue to account for a large proportion of input costs.

The current fixation of many trades unions in Europe on the reduction of working time is, therefore, totally self-defeating, unless reductions in working time are accompanied by corresponding cuts in pay or increases in productivity. Although this obvious truth has not been fully acknowledged by most unions, some of them have implicitly recognised it by accepting shorter working hours as a partial substitute for wage increases. I believe that if cuts in working hours are accompanied by improvements in efficiency, they could help in the short term to curb the increase in unemployment, until it once again becomes possible to relax the tight monetary and fiscal policies which are currently needed to contain inflation.

- **The power of corporatism in modern society**

Corporatism is of course part and parcel of modern industrial societies. It helps to make possible the crucial economies of scale required to generate employment and to remain competitive. It contributes to the orderly articulation and reconciliation of innumerable conflicting interests. And it is an inevitable concommittant of the organization of labour into trade unions. Yet, for someone like me who believes profoundly that the key to economic growth lies in the maximum freedom of enterprise from restraints, a major obstacle to growth must be the capacity of such organizations to pursue their special interests to the detriment of society as a whole - and, I would contend, ultimately of their own members as well. Mancur Olson, in his important book 'The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities', has brilliantly analysed the way in which this happens. He suggests, I believe rightly, that these interest groups flourish in societies in proportion to the length of uninterrupted stability in the latter - one reason for the deep-seatedness of the so-called 'British disease'. They frequently hamper efficient production and technological innovation, largely by slowing down decision-making and by impairing the nation's capacity for adaptation and change; they distort distribution and increase the complexity of regulation; and they tend to evade political control.

I conclude from this analysis that a condition for conquering the present 'stagflation' - a word as ugly as the phenomenon it describes - is to place restrictions on the irresponsible use of power by special interest groups. With respect to industrial corporations, many such rules already exist in the form of controls on mergers, cartels and the abuse of dominant market positions. Strict rules of competition exist both at the level of nation states, such as the Federal German Cartel office, and at the level of the European Community - which has very considerable powers in this area. Moreover the trend towards deregulation which is catching on in Europe, and particularly in Britain and the Federal Republic, will contribute in a major way to the promotion of competition and thereby to limiting the power of individual corporations or interest groups. This is an utterly healthy trend, which I wholeheartedly welcome.

Action must also be taken, by employers and employees together, to ensure that workers do not automatically price themselves out of jobs. I have two particular points in mind here.

The first is that we should re-examine what was, in some countries, once thought to be the god-given right of workers to automatic increases in wages. This is already happening in several Community Member States, notably Italy, Belgium, France and Denmark, in all of which a de-indexation of wages has been agreed. I hope it will last.

The second point is a peculiarly British one. It is the need to curb in the United Kingdom the ability of Union leaders to use their formidable powers in irresponsible ways. I welcome the measures which the Thatcher government has so far taken in this respect. Under the Trade Union Act of 1984, workers will have to be given a secret vote on whether or not to strike if their Unions are to retain their legal immunity. And since 1 November of this year any closed shop that fails to gain the support of the overwhelming majority of its members in a secret ballot will cease to have any legal standing. These measures will defend the rights and jobs of individual workers. They will limit only the opportunity for their union leaders to pursue courses of action, such as Arthur Scargill has followed with such tenacity during the current Miners' strike, which will ultimately put at risk thousands of jobs as well as the incomes of those lucky enough to remain employed.

- **Better training and re-training of labour**

No industrial economy can keep its head above the waters of international competition unless it has effective means for training and re-training workers - and managers. The need for training is going to be more important than ever as a result of the information revolution which we are now experiencing. In the computer industry, for example, fundamental job changes requiring re-training probably occur every 18-36 months. Moreover, jobs in information services - which account for over 70% of the 19 million new jobs created in the US since 1970 - are often highly specialised. We can be sure that they will not absorb factory workers as smoothly as factory jobs absorbed agricultural workers 100 years ago.

Training is an area in which the state has a legitimate and necessary role to play: individual companies - particularly when profit margins are narrow, as they are at the present time of low growth and increasingly severe international competition - are often reluctant to invest the necessary resources in training workers, particularly young ones looking for their first jobs. Since skill needs are difficult to forecast with precision, it makes sense to aim for modes of training that are broadly-based and flexible. These are just the modes that government schemes should be in a good position to promote. Indeed, I believe that a greater proportion of state assistance to the unemployed should be provided in the form of entitlement to re-training and adjustment schemes, rather than being provided so largely in the form of straight cash transfers. In general, governmental policies should not only seek to relieve the hardships of the unemployed by way of income support, but also be designed to facilitate their return to employment as soon as jobs are available by means of retraining, job placement, geographic mobility aids, viable job creation schemes and the like.

Improved facilities for the training of workers must, however, go hand-in-hand with the development of early warning systems at the level of companies and plants, which can provide a flow of information about the planned introduction of new technologies.

(b) <u>**Taxation systems insufficiently oriented towards encouraging profits**</u>

Here we may have something to learn from the experience of the US, and particularly from the tax reform begun in 1981 which seems to have contributed in a major way to the remarkable increase in the profitability of investment in the US over the past two years or so. Progress has been made in Europe too. For example, the German Government has announced DM 20 billion in cuts of income tax to be made over three years from 1986. The French Government in its 1985 budget is to cut taxes by an amount of 1% of GDP. The Dutch budget for 1985 makes tax cuts amounting to 1/3 to 1% of GDP. And the British Government unveiled major tax reforms last April in which the emphasis has been switched from indiscriminate subsidies to lower tax rates for businesses of all kinds, thereby providing more scope for flexible investment decisions. It is perhaps in part a reflection of this that both fixed investment, particularly in manufacturing, and exports have grown rapidly in the United Kingdom over the past year.

(c) Sharing by workers in corporate profits and decision-making

There is hardly a human being whose motivation and sense of responsibility are not increased by feeling a master of his own destiny.

There are several different ways of achieving this. Germany and the Netherlands have done it by worker participation. One of the best of the other methods is to find ways of allowing employees to become co-owners, together with outside investors, of the new technologies acquired by their firms and to share directly in the benefits from them. This does not mean that enterprises need to be cooperatives or union-owned. Instead, pay-cheques might include a portion in cash and a portion in the common stock issued to purchase labour-saving devices. Such schemes would provide incentives to each and every worker which cannot be achieved to anything like the same degree by the legislation appearing all over Western Europe to increase employee representation on boards of directors. The reasons are straightforward: first, the overwhelming majority of workers cannot, by definition, be representatives on the board, and therefore cannot feel directly involved in the process of decision-making. Second, that process is often so complicated in the modern industrial firm that it is usually very difficult for the worker to guage what precise role he, or his representative, has had in it. We Europeans should not, therefore, see the participation of workers in decision-making as anything more than a modest contribution to the task of seeking greater motivation in the labour force.

Fortunately the problem of motivation will be helped by the likely trend towards the creation of small firms in the future, particularly in the sector of information services. In this sector, workers will increasingly have the opportunity to become entrepreneurial partners, rather than resentful employees.

(d) The European Common Market

The assault on unemployment requires not merely a more flexible labour market and a more motivated work-force, but better functioning of markets for goods and capital.

Let me give an example:

Frontier formalities represent a disgraceful anachronism. They are very expensive and swallow up between 5 and 10% of the pre-tax value of the goods concerned. The time lost merely in waiting and hold-ups amounts to about £500 million per year. In their internal markets which provide the basis on which their export trade is built, American and Japanese companies suffer no comparable disadvantage.

What we need in Europe is to create a situation in which managements can consider the Community as a single market in which they can take decisions on the basis of economic efficiency rather than having constantly to try to maximise the benefits and minimise the disadvantages arising from the continued existence of separate national markets. If Europe really became a single market in which manufacturers and those who provide services could sell their wares freely from Scotland to Sicily and from Brest to Bavaria, the consumer through the market place could determine which would prosper and which would not.

The Community's Institutions have a two-fold task in order to bring this situation about. On the one hand they must work to ensure that the legal and taxation systems of the Member States are sufficiently transparent, non-discriminatory and compatible with each other to ensure that the competition is fair and the adaptation possible. On the other, they must work to eliminate the bias in favour of national suppliers that still exists in the field of public procurement and to introduce common standards throughout the Community.

Persuading governments of the need to make the myriad specific changes that will be required and even more, persuading them to carry those changes into effect will be a massive task. It will also be politically difficult, not to say thankless, since in every country any domestic special interest that feels threatened will try to rouse government and public opinion against what is being attempted. Progress will not be made in the sort of dramatic leaps and bounds that attract favourable publicity but through the undramatic pursuit of what will often appear to be boring and rather minor issues. In my view, timetables with deadlines and specific objectives backed by the authority of the European Council have an essential role to play in bringing about such progress.

To plead for the creation of a genuine common market does not require one automatically to attach great importance to the encouragement of cooperative ventures between European companies of different nationality.

If companies wish to engage in such cooperation they should certainly be able to do so. Artificial barriers and political constraints should be removed. On occasion, if the objectives are sufficiently clearly defined and limited to sufficiently specific operations and if the management structures are appropriately constructed, they have a useful role to play. But in my view, if a real European common market can be constructed, the future will lie with companies with clearly defined command centres and domestic markets in one Community country extending their activities into others, either by means of direct sales across frontiers or through the take-over or creation of subsidiaries, and generally by a mixture of all these methods.

There will of course always be those who argue that the pursuit of similar lines of research and development within several different firms is wasteful. They will say the same about the production of basically similar and competing products within a single politico-economic unit such as the Community. But I am sure they are wrong. In general the more competitive a domestic market - and in this sense we should regard the Community as a single market - the more competitive on international markets the companies concerned are likely to be. Per contra, when large units are created by government action and given preferential positions in their home markets, they are unlikely to be competitive internationally. Thus, a dirigiste Community industrial policy would, I fear, be more likely to reflect the political bargaining process between the Member States, with work being allocated on political grounds or grounds of so-called fairness between nations, than hard industrial reality. One has only to look at the history of the Common Agricultural Policy over the years to appreciate some of the dangers.

(e) Coordination of macro-economic policies

I have deliberately left the need for more closely coordinated macro-economic policies to last. As you might expect of a Vice-President of the European Commission, I attach great importance to this. I believe that the more coordination can be achieved the better.

But I am also a realist. I share the view of one of my distinguished predecessors as Vice-President of the European Commission, Raymond Barre, that "the fundamental necessity is for the national will in every country to maintain conditions required for balanced growth and international competitiveness". He is right in saying that the convergence of economic policies among industralized economies "ultimately depends on the political will of each government, and on the pressure of events, more than on international mechanisms for the coordination of policies" (Source: 'Unemployment and Growth in the Western Economies', Andrew J Pierre, Editor, Council on Foreign Relations, New York, 1984).

I believe M Barre is right for two reasons: one is economic, namely that the real obstacles to increased growth and employment lie in the rigidities to which I have referred. The second is political, namely that at the present stage of development of the Community we are simply not in a position to enforce coordination of economic policies. Coordination still depends primarily on the political will of each government and on the pressure of the money markets on it, far more than on negotiated mechanisms or on meetings of the Council of Ministers.

Nonetheless, the so-called 'divergence indicator' of the

European Monetary System has made a significant contribution to bringing about a closer coordination of economic policies in Europe. I recognise that this is difficult to demonstrate; but on the basis of my own observation, I believe that the adoption of agreed target zones for exchange rates has not only done much to stabilise parities within Europe, but has also been an instrument for the convergence of economic policies and performances, without which the European economy would be in still worse shape and protectionism would have made greater advances in all our Member States.

There are, I believe, two modest ways in which the European Monetary System now needs to be strengthened.

The first is to confer upon the European Currency Unit the status of a fully convertible foreign currency in each Member State of the Community. The ECU has now emerged as a significant currency for private investors. It is no longer merely an accounting unit for the big banks, or funny money in which governments can denominate their accounts. The volume of ECU deposits and credits has increased six-fold in two years. Moreover, so far this year the ECU has been the third major currency to be issued in the Eurobond markets, after the US Dollar and the Deutsche Mark. And just a few weeks ago an ECU denominated bond for the EEC institutions was floated on the New York Financial Market. In most Member States, including the UK, the private individual can open an account in ECUs at his local bank. All this is giving rise to an independent interest rate structure for the ECU.

Yet the reaction of some Community governments to the ECU, particularly the German Government, has sadly been very much less positive than the attitude taken by most private banks and investors. The German Government continues to refuse even to grant the ECU the status of a foreign currency or to permit it to be used by German residents. I do not accept the argument that the ECU is in effect an indexation clause and I urge the German authorities to find ways of overcoming their objections.

Unless and until they do, the ECU will inevitably labour under a serious handicap because the German financial system will not be playing its full part. This, in turn, will considerably impede the development of the EMS as a whole.

My second point on strengthening the EMS concerns the United Kingdom.

One cannot mention the benefits of the EMS and its great potential as a pillar of the International Monetary System, without urging Britain to become a full member by joining the exchange rate mechanism. As I have often said before, the absence of Sterling from the exchange rate arrangements denies British industry the chance of a more stable Pound in the Community, to which it now sends 43% of its exports, and weakens Britain's influence in the overall management of the System.

It is also unsettling for other European currencies that the Pound is in the ECU - whose stability it upsets as a result of its wide fluctuations - while Britain fails to participate in the intervention mechanisms which are designed both to avoid these fluctuations and to enable Europe to deal on a more equal basis with the United States and Japan.

Finally, it is very difficult to see how the EMS can be fully developed in the absence of what is after all one of Europe's major currencies.

## IV. Conclusions

What are the prospects for Europe of successfully applying the policies I have advocated? Difficult and dangerous though it is to predict the behaviour of states, I am optimistic, and for two basic reasons.

First, the Europeans are scared. No visitor to our shores can fail to notice the state of near panic about Europe's lag in high technology and her poor performance on unemployment compared with the US and Japan. Nor can anyone fail to notice the great sensitivity to inflation which has developed in recent years. It is as if we have all suddenly been saddled with the historical experience of inflation that has for long made Germans so prudent in their monetary and fiscal policies.

Second, the power of foreign exchange markets - which I believe can no longer be effectively resisted by exchange controls - will ensure that we remain scared. This is bound to exert a strong and continuing influence on governments. As France has already discovered, it makes it virtually impossible for any European economy to go for growth regardless of the policies of its neighbours.

Third, Europe is increasingly conscious of being on its own in the world. This is where attitudes in the spheres of security and economics interact. At the same time as Europe has come to recognise its economic lag in relation to Japan and the United States, it has also become acutely aware (indeed, to an exaggerated degree) of its lack of influence in the sphere of East-West relations and in relation to both Superpowers. The cancellation of Mr Honecker's visit to the Federal Republic of Germany only underlines this stark reality.

The crucial question is, of course : will this powerful sense of impotence galvanize Europe into making the sacrifices and efforts needed for it to gain greater command over its destiny. In the sphere of security, this question remains open. In the realm of economics, I am increasingly convinced that it will.