

Macroeconomic Thought at the European Commission in the 1970s: The First Decade of the Annual Economic Reports *

IVO MAES

1. Introduction

The 1970s were a period of economic turmoil, marked by the breakdown of the Bretton Woods system, two oil price shocks, stagflation and important changes in economic theories and beliefs. The purpose of this paper is to analyse the shifts in macroeconomic thought in the 1970s at the European Commission, an institution which has become increasingly important in shaping policy formulation at the European level.¹

In the analysis of these shifts in macroeconomic thinking, special attention is given to elements which are specific for policy institutions. One of the purposes of this paper is to contribute to a better understanding of how economic thought changes at policy institutions, as compared to academic institutions.

The analysis will focus on the Annual Economic Reports, the main macroeconomic policy document of the Commission. These

□ National Bank of Belgium, Brussels, and University of Leuven, Leuven (Belgium).

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¹ The further evolution of macroeconomic thought at the European Commission, in the first half of the 1980s, is analysed in Maes (1998).

Annual Economic Reports consisted of two main parts: a description of the economic situation and policy recommendations. This implies that the economic theories and paradigms are less explicit and more hidden, compared to traditional academic economic texts. Consequently, a history of the Annual Economic Reports involves a greater degree of 'rational reconstruction'. This is even more so as the economic thought behind the Reports was more heterogeneous, as the Reports were a compromise between different persons and tendencies.

The paper opens with a description of the origins of the Reports in the process of European monetary integration. The next sections go deeper into the policy conception of the Reports and how this policy conception changed through time.

2. Background: from the golden Sixties and monetary integration plans to stagflation

At the beginning of the 1970s, economic thought among economic policy makers was still dominated by the experience of the 'golden Sixties': strong economic growth, stable prices and the success of Keynesian demand management. European economic integration also thrived in the 1960s, especially with the successful completion of the common market. The launching of the monetary union project, at the Hague Summit of 1969, reflected this atmosphere.

The Annual Economic Reports of the European Community were a by-product of this first attempt at monetary union in the Community in the early 1970s. The blueprint for the monetary union project can be found in the Werner Report (Council-Commission of the European Communities 1970), which contained a plan for the establishment of an economic and monetary union by 1980.

The Werner Report first discussed the essential characteristics of an economic and monetary union. It envisaged two poles of decision making: a centre of decision for economic policy and a Community system for the central banks.

TABLE 1

CHRONOLOGY

1969	December	Hague Summit: monetary union becomes an objective of the European Community
1970	October	Werner Report
1971	March	Council Decision on the strengthening of short-term economic policy coordination
	August	Nixon announces the suspension of the conversion of the dollar into gold
	December	Smithsonian agreement (new central rates and wider fluctuation margins)
1972	April	EEC narrows margins of fluctuation to 2.25% (EEC "snake" in Smithsonian "tunnel")
	June	UK and Ireland leave EEC snake
	October	January 1974 is set as date for the second stage of EMU
1973	January	The United Kingdom, Ireland and Denmark join the EC
	March	End of Bretton Woods System (floating of EEC currencies against USD)
	Autumn	First oil price shock
1974	January	French franc drops out of EEC snake
	February	Council Decision on the attainment of a high degree of convergence of the economic policies of the member states
	December	Bundesbank sets, for the first time, a money supply target (for 1975)
1975	July	French franc rejoins EEC snake
1976	March	French franc drops out of EEC snake
1978	June	G-7 Bonn Summit (Concerted action plan)
1979	March	Creation of the European Monetary System
	October	Second oil price shock

Thereafter, it specified the main elements of the stages towards monetary union: *a*) a reinforcement of procedures for consultation and policy coordination; *b*) a further liberalization of intra-Community capital movements and steps towards an integrated European capital market; *c*) a narrowing of exchange rate fluctuations between Community currencies.

Of fundamental importance in the Werner Report is the concept of "parallel progress" (cf. Tsoukalis 1977, p. 101). This notion formed a compromise between the monetarists (arguing that a nar-

rowing of exchange rate fluctuations would induce a convergence of economic policies and performances and so stimulate economic and political integration, mainly represented by France) and the 'economists' (emphasising the differences in economic performance of the different economies and the need for convergence and policy coordination as a prerequisite for monetary unification, led by Germany).

The first phase of economic and monetary union started on 1 January 1971. The Annual Economic Report had a pivotal role in the coordination of economic policy in the Community. It was installed by the "Council Decision of 22 March 1971 on the strengthening of the coordination of short-term economic policies of the Member States of the European Economic Community" (Conseil 1971).² The purpose of this directive was to strengthen and improve the coordination procedures in order to achieve a high degree of convergence of the economic policies pursued by the member states.

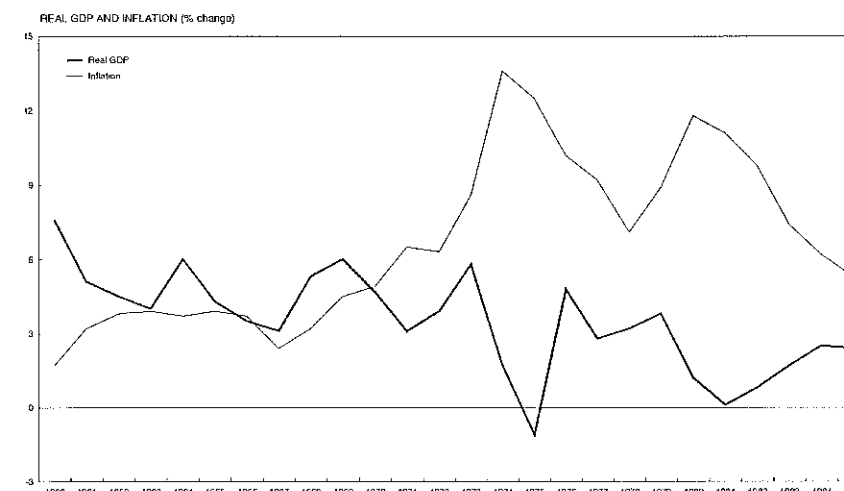
However, Europe's first attempt at monetary union was not very successful. The breakdown of the Bretton Woods System in the early 1970s and the first oil shock of 1973 made for an unfavourable international environment. More fundamentally, divergencies about policy priorities between the European countries, especially France and Germany (cf. Wegner 1985), came to the surface and led to wide differences in inflation rates and exchange rate turmoil in Europe.

The breakdown of the Bretton Woods System implied further that economic policies, especially monetary policy, did not have to be geared any more in function of the exchange rate against the dollar. This implied that policy makers had to find a new nominal anchor for their policies.

European monetary integration languished further in the mid-1970s, when discussions about the place of the United Kingdom dominated the European scene. Only at the end of the 1970s, with Roy Jenkins' speech in Florence and the initiative of Helmut Schmidt and Valéry Giscard d'Estaing, came monetary integration again to the forefront (cf. Ludlow 1982). However, the European Monetary System, started in March 1979, was a rather modest creation, when compared with the ambitions of the Werner plan.

² Later, there were certain changes. Most important was the Council Decision of 18th February 1974 on the attainment of a high degree of convergence of the economic policies of the member states of the European Economic Community.

GRAPH 1

EVOLUTION OF THE EUROPEAN ECONOMY¹

¹ 1960-1980: EC9, 1981-1984: EC10.

Source: Commission of the EC.

In the 1970s, the European Community's economic performance deteriorated markedly: economic growth slowed down and inflation shoot up, leading to 'stagflation'. This gave raise to important discussions among economic policy makers, both at the world annual economic summits, which were initiated in 1975 (Dobson 1991, p. 13), as at the European level. It would lead to the 1978 "concerted action", whereby Germany agreed to boost its economy with a budgetary package of 1% of GDP. So, the "golden Sixties", with its strong economic growth performance, associated with Keynesian demand management policies (cf. Hall 1989), remained an implicit reference frame against which many policy makers also approached the economic problems of the 1970s. The failure of the concerted action led to serious reflections and discussions among policy makers.

3. The elaboration of the Report

The drafting of the Annual Economic Report at the European Commission went through several phases. The first draft was essenti-

ally prepared in Directorate-General II, Economic and Financial Affairs, which can be considered as the economic research department of the European Commission.³

In order to better understand the philosophy behind the Reports, it is appropriate to consider the economic thought at the Commission. Originally, with the Community of the Six, the economic ideas at the Commission were to a large extent marked by French ideas of indicative planning and German ideas centered around the social market economy (cf. Wegner 1989, p. 285).

TABLE 2
THE COMMISSION OF THE EUROPEAN COMMUNITY

	President	Member responsible for DG II
1958	W. Hallstein (D)	R. Marjolin (F)
1968	J. Rey (B)	R. Barre (F)
1970	F.-M. Malfati (I)	R. Barre (F)
1973	F.-X. Ortoli (F)	W. Haferkamp (D)
1977	R. Jenkins (UK)	F.-X. Ortoli (F)
1981	G. Thorn (L)	F.-X. Ortoli (F)

French ideas were considered to be dominating at the Commission (cf. Mortensen 1990, p. 18). It is remarkable that, from the origin of the Commission until now, the commissioner responsible for DG II has always been French, with the exception of the periods that the French held the presidency (Ortoli and Delors).

Robert Marjolin, the first commissioner from 1957 to 1967, had been the principal assistant to Monnet at the French Planning Office, famous for its five-year plans (cf. Marjolin 1986). The French planning office, while it was part of the French 'Colbertiste' tradition, was also a spearhead of Keynesianism in France, with the national accounts at its heart (cf. Rosanvallon 1987, p. 40).⁴ At the heart of French planning was the idea that planning made it possible to avoid

³ For an overview of the functioning of the Commission and the development of its economic ideas, cf. Maes (1996).

⁴ In the 1960s (indicative) planning was very popular in several European countries. An example is also the Netherlands, where Tinbergen was the first director of the planning office.

chance (cf. Massé 1965). The issuing of guidelines for next year's budget, during the second quarter of the preceding year, which were moreover situated in a medium term perspective, certainly bore the imprint of the French planning tradition.

Among the German (social market) economists two tendencies can be distinguished: one more emphasising the market and "Ordnungspolitik" (policy of safeguarding the economic order, i.e. sound monetary and budgetary policy, competition policy, ...), while the other, more linked to the trade unions, emphasised the social dialogue.

There was also a quite important interaction between the Commission and the OECD (formerly OEEC): Marjolin had been the first secretary-general of the OEEC, from 1948 to 1955, and several other EC officials had worked at the OECD. Moreover, many officials, both of the Commission and the member states, would assist at OECD meetings. The OECD was very important for the transmission of Anglo-saxon economic ideas, especially before the accession of the United Kingdom in 1973.

TABLE 3

A SIMPLIFIED ORGANIGRAM OF DIRECTORATE-GENERAL II
(ECONOMIC AND FINANCIAL AFFAIRS)¹

Director-general	U. Mosca
Economic advisors	M. Wegner, P. Buffet, C.F. Cavanagh, M. Fratianni, A.E. Smith
Directorate A "Economy of the Member States and Business Cycles"	M. Emerson
Directorate B "Economic Structures and Development"	J.C. Morel
Directorate C "Monetary Matters I"	F. Boyer de la Giroday
Directorate D "Monetary Matters II"
Directorate E "Budgetary Matters"	P. van den Bempt

¹ Situation as of January 1979. With the reform of March 1980 the monetary directorates would be merged, the budgetary directorate would be suppressed and a new directorate, "Macro-economic Research and Policy", with M. Emerson as director, would be created.

The director-general of DG II has typically been an Italian. In 1979 Tommaso Padoa-Schioppa became director-general. He was not only a good administrator but also a brilliant economist. People de-

scribe him as combining a German rigor with Italian imagination and a profound economic culture, including mainstream Anglo-saxon economics. He was then quite young (around 40), dynamic and rather ambitious.⁵ One of his main aims, at DG II, was to reinforce the 'analytical level' of the directorate general.

During Padoa-Schioppa's director-generalship, there was a profound reorganisation of DG II. Before this reform the directorates were "Economy of the Member States and Business Cycles" (the A Directorate), "Economic Structures and Development" (B), "Monetary Matters I and II" (C and D) and "Budgetary Matters" (E). The Annual Economic Report was mainly written in Directorate A "Economy of the Member States and Business Cycles", while the other directorates would supply contributions from their areas.

In March 1980 DG II was restructured. The main change was the creation of a new directorate called "Macro-economic Research and Policy", with Michael Emerson as a director, and the abolition of the budgetary directorate. The creation of the new macro directorate, which became responsible for the annual report, reflected a double aim. The 'methodological' purpose was to pursue more academic-oriented research, as clearly reflected in the inclusion of the word "Research" in the name of the new directorate. Another indication was the creation of an econometric division in this new directorate.⁶ The other purpose was to focus on macroeconomic policy for the European economy as a whole, instead of national economies. This reflected the idea that the Commission could have more influence on economic policies in the member states if it could highlight the Community dimension of a certain national policy stance. This was mainly done in a newly created division, called "Concerted Action". Another motivation of the reform, of a completely different nature, was that DG II economists were tired of writing 'tedious' national chapters and were looking for something intellectually more exciting. The abolition of the budgetary directorate reflected also a change in

⁵ Padoa-Schioppa had been for many years at the research department of the Banca d'Italia, one of the top policy-oriented research institutes in Europe, with strong connections with leading American and British universities (cf. Porta 1996, p. 180). Padoa-Schioppa had been a student and, later, a visiting scholar at the Massachusetts Institute of Technology. He was close to Franco Modigliani: they published articles together (e.g. Modigliani and Padoa-Schioppa 1978) and he contributed to Modigliani's *Festschrift* (Padoa-Schioppa 1987).

⁶ This is also an indication of the tendency of internationalisation and americanisation of economics in the post-1945 period (cf. Coats 1996 or Backhouse 1996).

the strategy of monetary integration at the Commission. It can be considered as the definitive burial of the Werner concept of economic and monetary union, with two centres of decision making: one for monetary policy and one for budgetary policy. With the creation of the European Monetary System, in March 1979, the emphasis was clearly on the monetary side. Michael Emerson, who had been in the Jenkins cabinet, had been involved in this.

An important role in the conception of the Reports was also played by the cabinets, especially the cabinet of the member of the Commission responsible for DG II.⁷ They determined to a large extent the general orientation of the Reports. Sometimes, they have requested quite substantial revisions of a Report.

Before its acceptance by the Commission, the Report was also submitted to the Economic Policy Committee (EPC),⁸ composed of senior officials of the member states (ministries and central banks) and the Commission. In general, the discussions in the EPC did not lead to important changes in the Report.

4. The structure of the Annual Economic Report

The Annual Economic Report consisted of two parts. The first presented an overview of the actual economic situation, the economic policy problems encountered, the implementation of economic policy and the outlook for the next year. The structure of this first part was designed to deal with the actual economic situation and the policy problems encountered. So, in 1973, there was a special section on the implementation of the Council Resolutions on the Actions against inflation (CEC 1973, p. 9). In 1975 the first section was devoted to the very deep recession of that year (CEC 1975a, p. 2).

The second part of the Report contained the guidelines for economic policy for the next year. The first section comprised general guidelines discussing the policy objectives and priorities for the

⁷ Every member of the Commission is assisted by a small group of personal collaborators, known as "the cabinet" (from its French name).

⁸ Established in 1974 and comprising the former Short-term Economic Policy Committee (1960), the Budgetary and the Medium-term Economic Policy Committee (1964).

TABLE 4

TYPICAL STRUCTURE OF THE ANNUAL ECONOMIC REPORT

Introduction
I. Actual situation and perspectives
A. Actual situation
1. The international context
2. The economic situation in the Community
B. The economic policies implemented
C. The outlook for the next year
II. The guidelines for economic policy
A. General guidelines
B. The guidelines for member states
III. Conclusions

Community, possible conflicts, and general guidelines for the coordination of economic policy. In the 1970s the policy conception was rather Keynesian and the discussion was, to a large extent, focused on the issue of whether policy should combat slow economic growth or high inflation. In the next Section the policy guidelines were elaborated on a country-by-country basis. The Report contained orientations how individual member states could use the different instruments (fiscal policy, monetary policy, incomes policy) in order to reach internal and external equilibrium.

Starting in 1978, the Commission's Annual Economic Report was published in *European Economy*, a new publication of the Directorate-General for Economic and Financial Affairs. From that date on, the Report was also supplemented by an Annual Economic Review, which presented a more detailed study of the economic situation in the Community. The review was organized around the major areas of macro-economic analysis, discussing economic cycles, the balance of payments, prices and costs, monetary and exchange-rate policies, budgetary policies and employment. Another innovation of the 1978 Report was the presentation of forecasts for the main macro-

economic aggregates for the coming years.⁹ These changes were linked to the appointment for a new director of the A Directorate, namely Michael Emerson. He wanted to strengthen the analytical content of the Report and to focus more on the European Community as a whole, and not on the different countries. With the Review, which was a publication of DG II and not of the Commission, the economists of DG II had more freedom to elaborate their ideas. The tendency to focus on the macro-economy of the European Community would be confirmed in 1980 with the creation of the new Directorate "Macroeconomic Research and Policy".

5. A Keynesian policy conception in the first Reports

According to the Council Decision on the strengthening of the coordination of short-term economic policies, the Annual Report had an important role to play in the coordination of budgetary policies in the European Community (cf. *infra*). The main elements of this Council Decision were:

- the Council will hold three meetings yearly to examine the economic situation, on the basis of documentation and proposals of the Commission (article 1);
- during the second examination (during the second quarter), the Council will lay down appropriate guidelines for the main elements of the preliminary economic budgets (article 3);
- the third examination is in autumn. The Council will then, acting on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt an Annual Report on the economic situation in the Community and shall establish the guidelines to be followed by each member state in its economic policy for the following year¹⁰ (article 4);

⁹ In some earlier Reports forecasts and estimates for certain macro-economic aggregates, especially real GDP growth, were sometimes mentioned in the text.

¹⁰ As in this paper, as a general rule, the Commission proposal of the Annual Economic Report is used, reference will be made to the Annual Economic Reports as documents of the Commission of the European Communities (CEC).

– as soon as this Annual Report has been adopted by the Council, governments shall bring it to the attention of their national parliaments so that it can be taken into account during the debate on the budget (article 5).

In the Council Decision, the main instrument mentioned was budgetary policy. The Decision specified that quantitative guidelines for the draft public budgets for the following year should be fixed before they were finally adopted (article 3). They should include the evolution of government expenditures, taxes and the budget deficit (or surplus) and its financing.

This emphasis on budgetary policy was in line with the Keynesian economic orthodoxy of the time. Very influential in policy circles was the Heller Report, which defined the role of fiscal policy as “not to balance the budget of the public sector, but to balance the economy as a whole” (OECD 1968, p. 15). Monetary factors were not considered to be of great importance. Leijonhufvud (1968, p. 13) described this period, especially the mid-1940s and extending into the 1950s and 1960s, as the Keynesian Revolution’s “Anti-Monetary Terror” (see also Maes 1986).

In this context, with the focus on economic policy, Coddington’s view, that the distinctive trait of Keynesianism is an “utilitarian view” of the public finances, seems the most appropriate. A prerequisite for taking such a utilitarian perspective of the public finances is that there must be a systematic, reliable connection between fiscal policy and effective demand in the economy, so typical for hydraulic Keynesianism (cf. Coddington 1983). According to the OECD (1968, p. 14): “fiscal policy has become the most important instrument for managing the level and composition of demand”. In line with these developments, Raymond Barre created a Directorate for “Budgetary Matters” at the Commission at the end of the 1960s.

Fiscal policy can, however, only determine nominal demand. In order that fiscal policy can influence the level of real activity a stable and reliable relationship between prices and output is necessary. This was found in the Phillips curve, showing a negative relationship between changes in prices and unemployment (cf. Phillips 1958).

According to the (simplified) Keynesian framework, which permeated the Annual Economic Reports of the Commission in the 1970s, the main task of the policy makers was to determine the pre-

ferred trade-off between unemployment and inflation. Demand management, especially budgetary policy, would then be used to reach the preferred trade-off.

The first Reports were also characterised by a business cycle perspective. Economic policy was explicitly described as “conjunctural policy” (e.g. CEC 1973, p. 9). One of the main aims of macroeconomic policy was to stabilise the business cycle. This was in line with the general development of Keynesian economics, which, after the elaboration of the principle of effective demand, had turned to the analysis of business cycles (cf. Hansen 1951 or Hicks 1950).

The first phase of economic policy making is a diagnosis of the economic situation. So, the first part of the Report was dedicated to an analysis of the economic situation. In the Reports of 1972, 1973 and 1974, with prices more and more increasing, inflation was identified as the main economic problem to be tackled.

To combat inflation, different measures were proposed. However, one of the main messages of the Reports was that cutting inflation was not just a technical problem, but that a social consensus was necessary: “Inflation will not be controlled by technical measures without a collective effort to search for a greater economic and social coherence” (CEC 1972, p. 8).¹¹

On the technical side different policy options were proposed:

- regulation of demand (fine-tuning), by budgetary and monetary policy, so that bottlenecks can be avoided (CEC 1972, p. 8);
- the strengthening of productive capacities. The objective here was to “remedy regional disequilibria” (CEC 1972, p. 6);¹²
- a direct price policy. While admitting that this does not tackle the fundamental causes of inflation, direct action is considered useful (CEC 1973, p. 12).¹³

¹¹ See also CEC (1972, p. 32), where also a just repartition of efforts and sacrifices is demanded, or CEC (1973, p. 24), where the necessity of the active cooperation of all groups is emphasised.

¹² Regional policy became more prominent with the Paris summit of 1972, where it was decided to create the European Regional Development Fund. So it is not surprising to find references to regional matters in Community policy documents at this time.

¹³ Also contributions of the Common Agricultural Policy in the actions against inflation are mentioned (CEC 1973, p. 12).

One of the fundamental tasks of the Annual Economic Reports was also to contribute to a better coordination of economic policy among the member states. The steering of the economy had then to be differentiated according to the economic situation in the member states. One of the fundamental aims here was a greater convergence, in order to contribute to monetary integration in the Community.

In the first Reports no precise quantitative targets for economic policy were specified: the main problem was put in focus and proposals for policy were formulated. Guidelines for individual countries were adjusted according to the concrete situation of each country.

In 1973, W. Haferkamp, a German trade unionist, became the commissioner responsible for DG II. His main objective was to introduce, at the European level, the 'social dialogue', which had worked so well in Germany. It led to the June 1976 "Tripartite Conference on Employment and Stability in the Community", with the participation of the governments of the member states, representatives of unions and employers' organizations and the Commission. The 1976 Report presented more concrete medium-term targets, reminiscent of the golden Sixties, which were formulated at this conference (CEC 1976, p. 9):

- the simultaneous restoration of full employment and stability as a matter of priority;
- an annual rate of real growth of the domestic product of the Community averaging around 5% in the period from 1976 to 1980;
- full employment by 1980;
- the gradual reduction in all member states of the annual rate of inflation to between 4% and 5% by 1980.

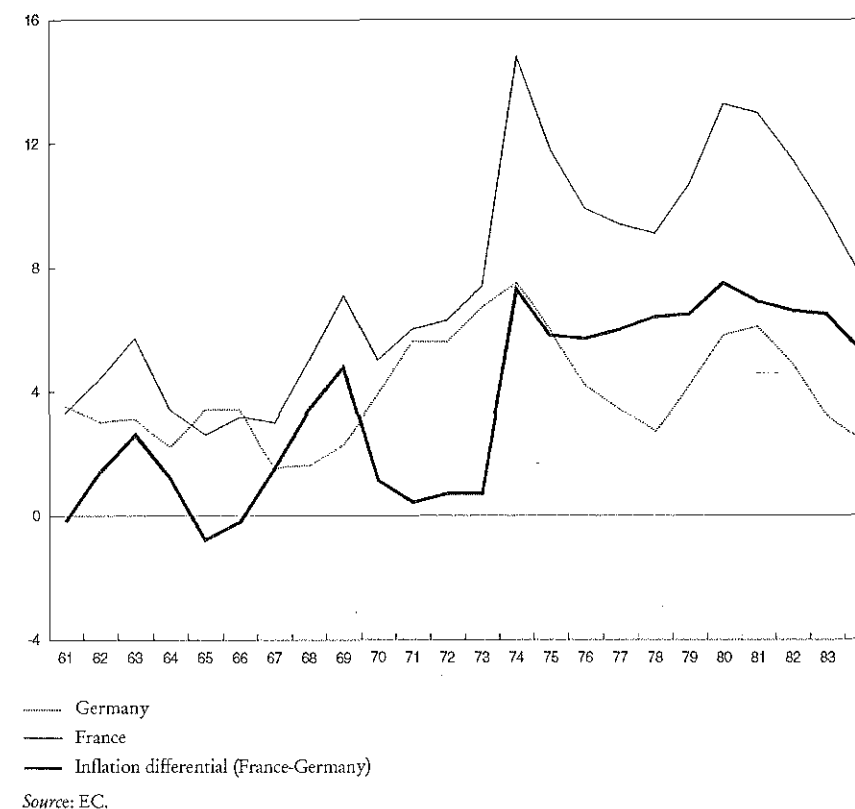
The Commission was also very well aware that member states could experience a conflict between the need to reduce inflation and the balance of payments deficit, and the objectives of economic recovery and employment. A differentiation of policy among countries was therefore necessary:

"The overall approach to the Community economy in 1977 must be to ensure that no obstacle is put in the way of the expansion in domestic demand, in those Member States where there are no ex-

ternal economic constraints and where a further slowdown in price increases is likely [...]. In those Member States faced with high underlying rates of inflation, sizeable trade deficits, and the threat of a vicious circle of monetary depreciation and rising prices, economic policy must be used to impose some constraints on consumer demand and to make the most of the stimuli provided by export demand" (CEC 1976, p. 10).

GRAPH 2

INFLATION IN GERMANY AND FRANCE IN THE 1960s AND 1970s



However, as compared with the ambitions of the Council Decision on the strengthening of the coordination, the influence of the Annual Economic Reports on the economic policies of the member states has been very limited. Countries gave priority to their own na-

tional economic objectives. This was especially clear after the 1973 oil crisis. This crisis was interpreted as mainly an inflationary shock in Germany, which then followed more restrictive policies, and as a deflationary shock in France, pursuing more expansionary policies. This led to an upsurge in the inflation differential between the two countries and obliged the French franc to leave the snake. The situation was aptly summarised in the Marjolin Report: "[...] if there has been any movement it has been backward" (CEC 1975b, p. 1).

In their work for the Delors Committee, Baer and Padoa-Schioppa (1989) argued that "insufficient constraints on national policies" was one of the main intrinsic weaknesses of the Werner Report:

"These guidelines had the character of recommendations and there was no provision to ensure their observance. Such an approach could work only as long as there was a sufficiently strong policy consensus and willingness to cooperate. However, once that consensus began to weaken, more binding constraints on national policy would have become necessary» (Baer and Padoa-Schioppa 1989, p. 57).

6. Changes in the conception of monetary policy

The 'Monetarist counter-revolution' questioned the Keynesian framework. One can distinguish three stages in the academic controversies. In the first stage discussions centered around the determination of nominal demand, monetarists emphasizing the money supply, and not budgetary policy, as the main determinant of effective demand (cf. Friedman 1956). In a second stage the attention shifted towards the functioning of the labour market with the monetarists attacking the Phillips curve (cf. Friedman 1968). In the third phase the formation of expectations became the focal point, when the monetarists advanced the "rational expectations hypothesis", implying that a change in policy can alter the behaviour of the economic agents (cf. Lucas 1976).

In Europe, the Konstanz seminars played an important role in the spread of monetarism, also in the transmission of monetarist ideas to policy makers. The first one was organised by Karl Brunner in Ju-

ne 1970. Among the participants were: H. Schlesinger of the Bundesbank,¹⁴ R. Masera of the Banca d'Italia and M. Fratianni, an economic advisor at DG II in the second half of the 1970s¹⁵ (cf. Neumann 1972, p. 30).

In the early 1970s the conception of monetary policy in the Annual Economic Reports of the Commission was rather open-ended. Sometimes even the name "credit policy" was used (CEC 1972, p. 7). Monetary policy concerned interest rates, the money supply and credit measures, but a coherent view was absent.

Gradually, however, a new policy conception emerged, quite close to the concept of the German Bundesbank, wherein monetary policy is geared principally against inflation and inflationary expectations. While, after the breakdown of the Bretton Woods system, smaller countries continued with exchange rate pegs, bigger countries started using the money supply as an intermediate target of monetary policy.¹⁶ The Bundesbank set its first money supply target in December 1974, for the year 1975. The 1976 Report proposed the prior notification by the member states of their money supply targets. It also proposed that the member states should use common criteria for the expansion of the money supply in 1977: "[A] real rate of growth [...] that would allow a more satisfactory utilization of capacity; a rate of price increase that would allow the rate of inflation to be gradually reduced to [...] 4% to 5% by 1980" (CEC 1976, p. 10).

So the Commission moved towards a framework in which monetary factors played a more important role. However, the Commission could be critical of the policy pursued in Germany. So the 1978 Report contained a quite specific recommendation for the money supply target of the German central bank: "In the area of monetary policy, it would be desirable for the Bundesbank to bear in mind the need to support policy for growth and stability when fixing its monetary objective for 1979" (CEC 1978a, p. 14).

¹⁴ Schlesinger became a regular participant at the Konstanz seminar.

¹⁵ Since the 1970s, DG II would employ a few 'economic advisors', academics or senior officials from the member states, e.g. M. Fratianni, A. Steinherr, F. Papadia, who would report directly to the Director General. It would be another channel through which new ideas, from academia or the member states, would be introduced in the Commission.

¹⁶ For an analysis of the policy dilemma which the Bundesbank faced at the end of the Bretton Woods system, cf. Emminger (1977).

7. From concerted action to supply-side economics

The synthetical and compromise nature of policy documents came clearly to the foreground in the 1977 Report, which combined quite monetarist prescriptions for monetary policy with a very Keynesian approach towards budgetary policy. The Report added also to the pressures on German policy makers to follow a more expansionary policy.

The 1977 Report noted a disappointing growth performance. It attributed this to the necessary restrictive monetary and budgetary policy in the countries with a deficit on the balance of payments and the absence of a more expansionary policy in the 'strong currency' countries. Especially Germany was mentioned, where "public-sector deficits have been scaled down at a rate which can be regarded as very fast, given current needs" (CEC 1977, p. 3). The Report argued for a "normative growth scenario" (*ibidem*, p. 5). This, very Keynesian, idea was that the European economy required a demand injection of about 1% of GDP. The policy mix which the Report proposed emphasized a more expansionary budgetary policy, while monetary policy should be geared towards money growth and price targets, while wage claims should be properly related to productivity gains. Also certain structural measures were deemed necessary.

The 1978 Report conveyed a very different atmosphere. It saluted the improved economic perspectives for 1979, partly due to the "concerted action", after the European summit in Bremen and the G-7 summit in Bonn in July (CEC 1978a, p. 11). It was, possibly, the first and last action of coordinated Keynesian demand expansion.

However, the euphoria did not last very long. The second oil shock, with its stagflationary effects, dominated the 1979 Annual Economic Report. A strategy in two successive phases was proposed to confront this shock:

"The first and immediate need, given that the oil price rise be fully communicated to the consumer, is to prevent a secondary increase in the rate of inflation. Thus should be created a certain room for manoeuvre for a second phase of policy. Control over monetary aggregates should be kept steadily to present strict policies, but it may become possible and desirable, as inflation expectations are abated, to move in the course of 1980 to more supportive budget-

ary policy, if also investment and consumption were weaker than expected" (CEC 1979a, p. 11).

The 1980 Report (CEC 1980a) marked a break in comparison with the preceding studies. Most important was certainly the shift in economic policy orientation, away from active demand management policies and towards a more medium-term orientation, emphasizing structural, supply-side oriented, policies. There was also an increase in the analytical level of the Report, reflecting the aims of Padoa-Schioppa and Emerson and the restructuring of DG II.

The new policy orientation was clearly set out in the Introduction of the Report: "While, in the past economic policy was often perceived as a problem of demand management, in a world based on the assumption of unlimited supply of energy and raw materials, the importance and critical value of supply constraints and structural adjustment problems are now evident" (CEC 1980a, p. 9).

The break with the past, and the medium-term orientation of economic policy, was further illustrated and elaborated: "The *concerted response* to the present general economic situation should be based on the right strategic mix of demand and supply policies and notably the right balance in their application to short and medium-term problems. Short-term adjustments should be more moderate than at times in the last decade, and a heavier weight has to be given to reducing medium-term inflationary expectations and improving supply conditions in the economy. This in turn means a steadier management of monetary aggregates, exchange rates and budget balances than in earlier economic cycles, and giving a strong twist to the numerous policy variables within the overall structure of public expenditure, taxation and regulation in order to strengthen economic potential" (CEC 1980a, p. 13).

Behind the new policy orientation was a new view of the functioning of the economy, stressing the limits of demand management. This new view was in first instance based on an analysis of the failure of the concerted action of the Bonn summit. This failure was at the origin of an important discussion on the efficiency and possibilities of economic policy, especially budgetary policy.¹⁷

¹⁷ This was not only a topic of discussion at the Commission, but also at other (international) institutions, especially the OECD.

The authors of the Report were also strongly influenced by two debates which were going on in the academic world. The first one concerned the Lucas critique and rational expectations. Commission economists became very much aware that economic agents were not responding in a mechanical or Pavlovian way to changes in economic policy. Policy makers had to take into account that markets would anticipate policy measures. This further undermined the belief in the possibility of fine-tuning the economy and led to a greater emphasis on medium-term policies. The other influence reflected the McKinnon argument that monetary policy could only influence the nominal growth rate of GDP. Moreover, monetary policy was, in the long run, not independent of budgetary policy, via the financing of public deficits. The only way then to improve the trade-off between inflation and growth was to take measures on the supply side of the economy.

A reflection of these debates can be found in the last chapter of the Review (Perspectives and policy options), which offered a thorough analysis of the limits of demand management policy. Two elements were emphasized: the external constraint and time lags.

The situation of the balance of payments, as also pointed out in McKinnon (1976), limits the possibilities of an expansionary policy response to combat the recession. This is so also when the recession has its origin in a restrictive fiscal and monetary policy stance in non-EC countries, or a loss of market shares of the Community (cf. CEC 1980b, p. 135).

Other problems were related to the time profile of fiscal policy measures. It is only possible to have a clear view on the evolution of the economy with a time lag of some months or sometimes even quarters. Moreover, the preparation and implementation of measures takes time, leading to a risk of a pro-cyclical policy: "As perfect forecasts are impossible, will a discretionary budgetary policy only have an impact when the economy is out of the recession, and will so tend to reinforce rather than smooth the business cycle" (CEC 1980b, p. 136).

Difficulties with forecasting were also a problem for the Commission itself. So were the forecasts of the Commission Services for 1980, made in the 1979 Report, rather off the mark. Real GDP grew with 0.1% in 1980 compared with a forecast of 0.6%. Inflation amounted to 11.8%, against a forecast of 9%, and the balance of

TABLE 5

MAIN MACROECONOMIC DATA

	Real GDP		Inflation		Current account balance of payments		Government deficit		
	Forecast	Estimation Realisation	Forecast	Estimation Realisation	Forecast	Estimation Realisation	Forecast	Estimation Realisation	
EC9	1970	4.7			4.9				0.1
	1971	3.1			6.5				-0.6
	1972	3.9			6.3				-1.6
	1973	6.0			8.6				-1.1
	1974	2.7			13.6				-2.0
	1975	-2.4		12.4	12.5				-5.2
	1976	4.8	9.6	10.3	10.2		0.1		-3.7
	1977	2.5		9.5	9.2				-3.0
	1978	2.6	8.3	6.9	7.1		0.5		-3.7
	1979	3.1	7.0	8.9	8.9		-0.2	-4.1	-3.5
	1980	1.3	9.0	12.0	11.8		-0.3	-3.9	-3.6
EC10	1981	0.6	9.7	11.6	11.1		-1.2	-3.9	-5.3
	1982	2.0	11.2	10.5	9.8		-0.9	-4.2	-5.2
	1983	1.1	6.6	6.3	7.4		-0.4	-4.9	-5.0
	1984	1.5	5.6	5.1	6.2		0.0	-4.7	-5.0
	1985	2.3	4.2				0.4	-4.8	-4.6
Average ^a		2.7	8.4	9.0	9.1		-0.4	-4.4	-4.6

^a Average of the years for which forecasts (made the preceding year) and estimations (made during the current year) are available.

payments deficit of the EC increased to 1.1%, whereas a deficit of 0.3% was foreseen.

Given the limits of a policy of fine-tuning, a medium-term orientation of budgetary and monetary policy was more appropriate. Also, as the possibilities of macroeconomic policy were limited, the emphasis had to be on a more microeconomic-oriented policy, with measures to improve the functioning of the different markets. Something which was in line with supply-side economics, which was gaining ground at that time (cf. Feldstein 1986).

One can also discern a more quantitative analysis of several issues: for example the detailed analysis of the influence of the two oil shocks on the terms of trade of the Community (CEC 1980b, p. 38), the use of measures of capacity utilization in manufacturing in the analysis of the business cycle (CEC 1980b, p. 45) and the introduction of government budget balances at constant activity (CEC 1980b, p. 70). Compared to the 1979 Report, the number of pages of the 1980 Report increased from 13 to 24 and those of the Review from 80 to 108.

As for the reasons for these shifts in the Report, it is clear that the failure of the coordinated action of the Bonn summit had a traumatic effect on the Commission. It contributed to a re-examination of the limits and possibilities of economic policy.

In the 1981 Report (CEC 1981a) and Review (CEC 1981b) the supply-side approach to economic policy continued, even if the tone was less explicit than in 1980. Typical of this change in tone was the absence of an Introduction to the Report, where in 1980 so clearly the new approach was set out. However, the analysis of the supply side of the economy was elaborated with a new chapter in the Review: "Some structural properties of subsidies, investment incentives and energy taxation".

The Report also emphasized the interrelationship between budgetary and monetary policy, developing a 'crowding-out' analysis. This further illustrated the difficulties of using budgetary policy for fine-tuning the economy: "The first particularity of the outlook for 1982 is the acute interrelationship between budget and monetary policy. The sensitivity of interest rates to budget-policy variables is almost certainly much stronger now than at any time in the past. A budget policy allowing the deficit to rise is likely now to be relatively heavily offset in its stimulative effects on economic activity by increa-

sing interest rates; conversely budget-policy action to reduce deficits is likely to be considerably offset in its contractionary effects by falling interest rates" (CEC 1981a, p. 12).

8. Conclusion

During the 1970s the economic paradigms behind the Annual Economic Reports of the European Commission changed quite dramatically. The changes reflected both the evolution of 'academic' economics and factors which were more specific for policy institutions and for the European Commission itself.

One can observe an initial dominance of Keynesian economics, followed by a rise of monetarism and supply-side economics. However, the Commission Reports, quite typical for an international policy institution, always presented a more synthetic view, combining elements of the different strands of thought, while the timing of the changes was related to concrete experiences in the policy world. From a methodological point of view, more sophisticated and econometric methods of analysis were increasingly used. Specific for the Commission is moreover the shift towards the analysis of the European economy as a whole, contrasting with the earlier focus on the national economies.

These shifts in paradigms were naturally complex processes. Policy formulation at the European Commission was certainly influenced by the general shift in paradigms, both the more ideological shifts from Keynesianism towards monetarism and supply-side economics, as the more methodological shift towards more quantitative methods of analysis. The Commission stimulated these kind of interactions with the outside world, for instance through the presence of academic economic advisors and advisory councils. However, certain elements of the Reports are quite specific for the economic policy world and the Commission in particular. So is the greater emphasis on the European economy as a whole a reflection of both the greater degree of European integration and the aim of the Commission to push forward the integration process. The closeness to policy also plays a role in the timing of certain shifts in paradigms. So gained monetarism in importance with the breakdown of the Bretton Woods system, when

a new anchor for monetary policy was needed. The medium-term orientation of policy, with more emphasis on the supply side and structural adjustment, came to the forefront after the failure of the, very Keynesian, Concerted Action Plan of 1978. Changes in top personnel positions were also important, like the nomination of Padoa-Schioppa as director-general in 1979, who stimulated the use of more analytical methods of economic research.

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