CHAPTER 4

The World Economy in 1975

THE 1974–75 RECESSION APPEARS TO DIFFER from previous recessions, not only in its breadth and depth but also in the length of time it is taking for recoveries to take hold. Although the fall in activity rates generally seems to have halted by the end of summer, in many countries recoveries seem slow and appear fragile. The quintupling of the price of oil over the past several years has been a major factor deepening the world recession and inhibiting economic recovery. First, it ensured the simultaneity of the recessions in many countries. Second, structural changes necessary to adjust to the increased cost of energy have compounded the uncertainties created by the inflationary wave of 1972–73.

Because of the historically very strong inflationary pressures that preceded the downturn and persisted well into the recession, authorities in many countries were cautious in the timing and degree to which they moved toward expansionary policies late in 1974 and in early 1975. Since mid-1975, however, the thrust of policy has become broadly expansionary in almost every industrial country and policy measures put in place have cumulated to impart a very considerable stimulus. As a result, individual economies now seem to be poised for a return to acceptable growth paths, particularly since private sector assets have increased and liquidity positions have improved considerably over the past year. Recoveries could therefore broaden out very quickly. Just as the downturn was deepened because activity fell at the same time in many countries, recovery paths may become considerably steeper than now appears likely because upturns in individual countries, led by the recovery in the United States, are beginning to reinforce each other.

THE CURRENT STATE OF THE CYCLE

By early 1975 the slowdown in economic activity that had started in late 1973 in a number of industrial countries had broadened into the most widespread recession since World War II. By May, industrial output in the Organization for Economic Cooperation and Development (OECD) area had fallen to a trough, 12 percent below the cyclical peak reached in November 1973. This drop in economic activity in the industrial countries necessarily had severe repercussions throughout the rest of the world. Consequently in 1975 the volume of world trade registered its first significant decline in three decades. At the low point in the first quarter of 1975 the flow of goods across national borders was 11 percent below its historical high, reached in the second quarter of 1974. With the broadening and deepening of the recession, the thrust of economic policy in most major industrial countries turned increasingly expansionary during the year.

The bottom of the recession appears to have been reached, at least for most industrial countries, sometime during the summer of 1975. The recovery first became apparent in the United States and Japan early in the year and is now in train in Germany and France. In the other major economies the downward trend seems to have been halted. But the underlying strength of a broad upturn in activity is contingent upon the restoration of confidence in the private sector.

DOMESTIC DEMAND

In the major foreign industrial countries the stabilization of economic activity around mid-1975 was largely the result of previous increases in government expenditures and the ending of the inventory adjustment. Earlier in 1975 inventory decumulation constituted a considerable drag on activity almost everywhere. By midyear reduced liquidation of inventories began to lend some support to industrial activity, and by the autumn industrial production was moving up, albeit slowly, in an increasing number of countries (Table 38).

TABLE 38.—*Changes in industrial production in selected industrial countries, 1974–75*

[Percent change; seasonally adjusted]

Country	Peak	Peak to December 1974	Peak to June 1975	From preceding month in 1975 to:				
				July	August	September	October	November
United States	Nov. 1973	—7.9	—12.9	1.0	1.8	1.8	0.4	0.5
Canada	Mar. 1974	—3.2	—5.8	—.3	—.3	—1.2	—.5	-------
Japan	Nov. 1973	—16.4	—16.9	2.2	—1.5	1.6	.6	—1.1
France	Aug. 1974	—11.6	—12.4	—2.7	0	—.9	2.8	0
Germany	May 1974	—8.0	—9.7	—2.0	2.0	2.0	1.0	1.9
Italy	Apr. 1974	—15.0	—13.9	1.8	—15.4	19.1	—.3	1.8
United Kingdom	Oct. 1973	—7.7	—10.7	.9	—1.8	1.7	1.2	.1

Source: National sources.

Final demand, however, has not turned up decisively. One relatively bright spot in the private demand situation is the positive response of residential construction activity to easier monetary policy and to direct fiscal measures. But the upturn in private consumption demand has remained hesitant, except in the United States, and so far has been unable to provide the consumption-led upswing hoped for in a number of countries. This reflects in part developments in the growth of disposable personal incomes. In real terms disposable incomes have grown only slowly, despite the lessening of price pressures and the adoption of various fiscal measures designed to support the growth of income. Incomes have been affected first and foremost by the large rise in unemployment, although income maintenance programs have tended to offset a significant part of earnings losses. In addition, increases in wage rates have slowed considerably, and wage drift has diminished because of the deteriorating employment situation and rising short-time work.

Perhaps equally important for the behavior of consumer markets was the rise in household saving rates to postwar highs during the year (Table 39). To some extent the increase in the propensity to save in many industrial countries was directly related to the recession. It reflected uncertainties about the employment outlook and the large fall in the demand for housing and durable goods. These purchases usually require large down payments which are often financed by drawing down savings and substantial borrowing which implies additional dissavings. But in large part, saving rates also increased because of the inflationary environment of the past several years. Real financial assets were eroded significantly during 1972–75; and the large price rises for goods and services purchased frequently, such as food and fuel, reduced discretionary spending power and led to an increase in precautionary savings. The desire to rebuild real asset positions and renewed uncertainties about price prospects help explain why saving rates, although declining somewhat, have remained remarkably high. (For a fuller discussion of saving behavior in the United States, see Chapters 1 and 2.)

TABLE 39.—*Personal or household saving rates in selected industrial countries, 1965–75*

[Percent; seasonally adjusted]

Country	1965–72 average	1970	1973	1974	1975		
					I	II	III
United States	6.7	7.4	8.0	7.5	7.2	9.9	7.9
Japan	19.1	20.3	22.5	24.3	24.0	23.5	24.3
Germany	13.0	14.0	14.1	14.8	16.5	17.0	15.0
United Kingdom	8.8	9.1	11.3	12.7	14.2	13.0	13.7

Note.—For the United States and the United Kingdom, the rate is personal saving as percent of personal disposable income. For other countries, the rate is household saving as percent of disposable income.

Source: National sources.

During the second half of 1975 retail sales were generally increasing and consumer surveys indicated a moderate improvement in the way private households were judging economic prospects. But unemployment continued to increase, or at any rate did not decline (Table 40). By late 1975 the number of unemployed in Western Europe reached postwar highs and on average was almost twice as large as in 1974. And unless certain income maintenance programs are extended, payments may begin to decline.

With the decline in demand, price pressures have been reduced. The moderation in the rate of price increases has in fact been dramatic in a number of countries, especially in comparison with the performance in 1974 (Table 41). But in most countries the progress on the price side appears to be slow-

TABLE 40.—*Unemployment rates, adjusted to U.S. concepts, in selected industrial countries, 1962–75*

[Percent[1]; seasonally adjusted]

Country	1962–72 average	1973	1974	1975 I	1975 II	1975 III	1975 IV
United States	4.7	4.9	5.6	8.1	8.7	8.6	8.5
Canada	5.1	5.6	5.4	7.0	7.3	7.2	7.1
Japan	1.3	1.3	1.4	1.7	1.8	1.9	[2] 2.2
France	2.1	2.9	3.1	3.9	4.2	4.4	[3] 4.6
Germany	.6	1.0	2.1	3.2	4.0	4.6	[3] 4.6
Italy	3.6	3.8	3.1	3.0	4.0	3.6	-------
Great Britain	3.1	2.9	2.9	3.5	4.3	5.6	5.7

[1] Unemployment as percent of the civilian labor force.
[2] October.
[3] October–November average.

Note.—The quarterly adjusted data for the European countries make use of annual adjustment factors and should be viewed as approximate indicators under U.S. concepts. These data should be viewed as approximate only because of the difficulty in adjusting very disparate concepts.

Source: Department of Labor, Bureau of Labor Statistics.

TABLE 41.—*Changes in consumer prices in selected industrial countries, 1962–75*

[Percent change; annual rate]

Country	1962–72 annual average	1974	1975 I	1975 II	1975 III	1975 Oct	1975 Nov
United States	3.3	12.2	6.3	7.3	7.7	7.3	7.3
Canada	3.3	12.5	7.2	11.8	10.9	11.0	10.9
Japan	5.7	21.5	7.3	15.0	7.2	19.2	−6.7
France	4.4	15.2	11.3	9.8	9.3	9.2	7.7
Germany	3.1	5.9	7.9	8.7	1.5	3.5	3.5
Italy	4.3	25.0	10.3	12.9	7.5	13.1	13.7
United Kingdom	4.9	19.2	27.8	48.0	10.3	17.0	14.3

Note.—Change from 1962–72 is based on annual data. Changes for 1974 and the quarters of 1975 are based on data for end of month in period. The monthly changes are simple annual rates (monthly change times 12). Quarterly changes are compounded annual rates.

Source: National sources.

ing, and inflation rates remain unacceptably high. Higher food and energy prices and some increases in the prices of manufactured goods are putting pressures on price levels well before the productivity gains that normally accompany recoveries have had their full downward effect.

With the lessening of price pressures, new wage contracts have also moderated in some countries. But, because less progress has been made in containing inflation elsewhere, a number of countries—for example, Canada, the United Kingdom, Belgium, Finland, and some other smaller countries—have instituted some type of incomes policy.

The evolution of consumption demand and interest rate movements may be crucial to the eventual support the recovery can derive from a resumption of investment spending. Capacity utilization is at very low levels over a wide range of industries in many countries. Consequently, private investment intention surveys have, until recently, shown continuous downward revisions of projected expenditures. Latest surveys indicate that the erosion of business confidence may have come to a halt, but strong support to activity should not be expected from the side of private investment expenditures over the next several quarters.

EXTERNAL DEMAND

At the same time that private consumption expenditures failed to impart the upward impetus to economic activity hoped for earlier in 1975, external demand fell. Countries experiencing a fall in internal demand in earlier periods generally derived support to the level of economic activity from foreign trade. But trade during the 1974–75 recession failed to conform to this pattern because the cyclical downturn was simultaneous across countries. Trade volumes fell significantly for the first time in postwar history, mainly because of a drop in demand among industrial countries for each other's products.

Imports of major industrial countries began to decline in the autumn of 1974, reflecting both weak final demand and inventory decumulation. The latter may have been particularly important because of the generally high import content of inventories in many countries. In value terms the fall in imports amounted to almost 7 percent between the second half of 1974 and the first half of 1975, and in volume terms imports fell by 11 percent. Exports of industrial countries also fell during the first 8 months of 1975, but less than imports (Table 42). Exports to OPEC and to Communist countries have continued to grow, and shipments to lesser developed countries which are not members of OPEC (non-oil LDCs) have been reduced relatively little. The fact that a large number of non-oil LDCs have been able to maintain their import levels in the face of falling demand in industrial countries and rising oil prices largely reflects their much above average export earnings in the 2-year period to mid-1974. In addition, industrial countries, seeking to bolster their export activity as domestic demand shrank, increased their extension of trade credits. Because of the cyclical fall in imports and the somewhat better-sustained level of exports, there have been significant shifts out of deficit in the trade balances of the industrial countries. These shifts are mirrored by larger deficits of non-oil LDCs and shrinking surpluses of OPEC.

With the recession bottoming out around midyear, import demand in the large industrial countries stabilized during the summer months, and trade among industrial countries appears to have resumed its growth in the second half of 1975. But increases in world trade are likely to be constrained to some extent by a deceleration in the growth of import demand of OPEC and by a possible slowdown in shipments to non-oil LDCs.

Although the slide in the exports from LDCs to the larger industrial countries seems to have been halted in recent months, the fall in commodity prices from their cyclical peaks has yet to be reflected fully in earnings figures. There is usually a considerable lag between a change in spot prices and a change in unit values of trade because a fair amount of trade moves under long-run contracts and contract rates take some time to adjust to new spot prices. Lags also occur between the time orders are placed and prices agreed upon and the time of actual shipments; hence trade values at any given time

TABLE 42.—*Merchandise trade in selected industrial countries, 1973–75*

[Billions of U.S. dollars[1]; seasonally adjusted annual rates]

Country and trade item	1973	1974	1974 III	1974 IV	1975 I	1975 II	1975 III	1975 Oct–Nov average
United States:								
Exports	71.4	98.3	100.1	106.4	108.8	102.8	106.9	110.9
Imports	70.4	103.6	109.4	111.9	101.4	89.3	98.8	101.8
Balance	1.0	−5.3	−9.3	−5.5	7.3	13.5	8.1	9.2
Six other industrial countries:								
Exports	217.0	291.1	304.2	308.2	317.0	310.3	296.9	299.7
Imports	207.9	294.7	309.7	307.7	300.8	290.1	291.3	303.4
Balance	9.2	−3.8	−5.6	.5	16.4	20.1	5.5	−3.8
Canada:								
Exports	25.4	33.1	34.5	34.3	32.2	32.0	31.9	33.5
Imports	22.7	31.5	33.6	34.3	34.0	32.7	32.9	34.6
Balance	2.7	1.6	.9	−.1	−1.8	−.7	−1.0	−1.1
Japan:								
Exports	36.3	54.5	56.9	60.1	58.6	54.8	51.9	53.4
Imports	32.6	53.0	54.0	54.3	51.1	46.9	49.1	51.3
Balance	3.7	1.4	2.9	5.8	7.5	7.9	2.8	2.1
France:								
Exports	36.7	46.6	48.7	49.6	54.7	54.5	52.4	51.0
Imports	35.2	50.0	53.1	52.0	53.0	50.0	50.4	54.2
Balance	1.4	−3.4	−4.4	−2.3	1.8	4.5	2.0	−3.2
Germany:								
Exports	67.6	89.6	91.2	93.1	93.8	93.5	85.9	[2]84.7
Imports	55.0	69.9	73.1	73.6	74.5	76.5	73.2	73.8
Balance	12.7	19.7	18.1	19.5	19.4	17.0	12.7	10.9
Italy:								
Exports	22.2	30.1	33.1	32.3	34.3	34.0	35.3	35.5
Imports	27.9	40.9	44.8	41.4	36.5	36.2	38.0	41.8
Balance	−5.7	−10.9	−11.8	−9.1	−2.2	−2.2	−2.7	−6.3
United Kingdom:								
Exports	28.8	37.2	39.8	38.8	43.4	41.5	39.5	41.6
Imports	34.4	49.4	51.1	52.1	51.7	47.8	47.7	47.7
Balance	−5.6	−12.2	−11.3	−13.3	−8.3	−6.4	−8.3	−6.2

[1] Data converted to dollars on the basis of average exchange rates as published in the Federal Reserve Bulletin.

[2] October only.

Note.—Merchandise trade data for the United States, Canada, Japan, and the United Kingdom are on a balance of payments basis; others are on a customs basis. Imports for the United States are f.a.s. (free alongside ship) values; for Germany and Italy, c.i.f. (cost, insurance, and freight) values; for other countries, f.o.b. (free on board) values. Exports for the United States are f.a.s. values and for all other countries f.o.b. values.

Detail may not add to totals because of rounding.

Sources: Department of Commerce (Bureau of Economic Analysis), Board of Governors of the Federal Reserve System and Council of Economic Advisers.

reflect prices of some earlier period. A second factor likely to inhibit the growth of import demand of non-oil LDCs is that debt burdens are mounting as a consequence of growing trade deficits. Thus, external financing difficulties may force curtailment of order activity in some of these countries. To a certain extent some smaller OECD countries, which were able to maintain demand levels well into 1974 and early 1975, are beginning to experience similar problems. External financing problems may be increased by the recent rise in OPEC's export price of oil as it works its way through the individual economies.

The oil-exporting countries are expected to continue to increase their import demand, though not as rapidly as in 1974 and 1975. Growth rates will naturally tend to be lower because imports are expanding from a much higher base than in 1973–74. More significantly, physical as well as emerging financial constraints in the high-import-absorbing countries, such as Indonesia and Iran, are limiting growth in import demand. Recent data show that a significant reduction in the rate of growth of export flows to the oil-exporting countries as a group is in progress.

THE ROLE OF EXTERNAL DEMAND IN THE RECOVERY

Although little impetus to world recovery can be expected from changes in the import demand of nonindustrial countries, the current resumption of growth of domestic demand in the industrial countries could lend considerable support to world demand. Just as world trade during the recession fell by more than might be expected from its past relationship to changes in overall demand, trade may recover faster than one would normally expect as demand in industrial countries begins to turn up.

A major factor in the resumption of growth in trading volumes is the swing in the inventory cycle. As noted above, inventories in many countries have a relatively high import content, hence trade flows are particularly sensitive to inventory changes. In addition, the past recession has been one in which expenditures for services have held up relatively well, while those for goods fell disproportionately. As final demand begins to turn around, this pattern is likely to be reversed and demand for goods will grow faster than that for services. This will result in a stimulus to world trade over and above what could be expected from the observed changes in total demand.

Although recovery paths as currently projected do not indicate a steep upturn, the effect on world trade of the growth in demand that actually is occurring should not be underestimated. The U.S. economy is moving from a fall in real GNP of about 5 percent between the first half of 1974 and the first half of 1975, to a rise of perhaps 7 percent or so from the first half of 1975 to the first half of 1976. Such a shift alone would have a considerable effect in expanding the volume of world trade. In addition, recovery in the United States is being accompanied by similar, although perhaps somewhat smaller, shifts in the growth rates of other major industrial economies. The swing in activity rates over the comparable period for the six largest foreign economies is from a fall of 2 percent to a projected rise of almost 4 percent, with the largest swing occurring in Germany. Changes in demand of this sort produce significant effects on world trade at any time. But because of the simultaneity of the upturns, these effects are likely to be substantially magnified.

Hopes for recovery of domestic economic activity in most of the smaller countries, and in a number of larger ones as well, have centered upon export-led growth. Because of the depth and the length of the recession, the authorities in some of these countries have been urging others, particularly the United States, to adopt more expansionary policies that would produce greater external stimulus and thereby help put their economies back on a satisfactory growth path. Our analysis indicates, however, that further expansionary action in the United States—within reasonable bounds—would do little to accelerate world recovery.

The evidence suggests that an additional 1 percentage point of growth of the U.S. economy—over and above what is currently expected for 1976—may produce an additional increase in the volume of world trade of no more than 0.2 percent in that year. By 1977, partly because of multiplier effects, the extra 1 percentage point of growth in U.S. demand could be expected to induce an expansion in world trade of 0.5 percent. The effect that such a change in the growth of world trade would have on economic activity in the major industrial countries is very small indeed and clearly cannot be decisive to the path of world recovery. For example, the effect on German gross domestic product (GDP) would be virtually negligible: less than 0.1 percent in 1976 and a bit over 0.1 percent by 1977. Effects on other European countries would be of similar magnitude. Although the impact on Canada and Japan would be somewhat greater, it would by no means be of overwhelming significance. Canadian GDP in 1977 might be 0.4 percent higher than it would otherwise have been, and Japanese GDP might be increased by 0.2 percent.*

As noted above, external demand began to revive in the second half of 1975 as the expansionary measures taken in many countries over the past several quarters began to work through the several economies. A resumption in the growth of export demand, such as is in progress now, in addition to its direct effect on activity, can further quicken the pace of world recovery by its effect on business confidence and on the general economic climate. But a slightly faster growth in world trade than is now foreseen cannot make the crucial difference in the turnaround in economic activity in the industrial countries. The main impetus must clearly come from internal demand. And the path of internal demand over the next several quarters depends primarily upon the response of the private sector to the domestic policy measures taken last year.

GOVERNMENT POLICIES

Governments in most of the industrial countries responded to the deepening recession early in 1975 and the continued weakness of final demand through the summer by adopting successive measures designed to bring their economies back to more normal rates of growth. Earlier in the year, with inflation rates still high, expansionary measures, except in Germany, tended mainly to reverse earlier restrictive policies and involved, for example, the easing of credit and public expenditure ceilings. But since midyear the thrust of policy has become broadly expansionary almost everywhere except in Great Britain and Canada, where, however, policies had not been

*These calculations derive from special simulations produced by the LINK model by Professor Lawrence R. Klein of the University of Pennsylvania. The LINK results are in broad agreement with those derived from other econometric models and with simpler calculations based solely on the relative importance of exports to the United States for each of the economies in question.

notably restrictive earlier and where inflation rates continued high relative to 1974 levels.

Discount rates have been cut, monetary aggregates have been growing significantly faster than in 1974, and expansionary fiscal measures were adopted in most major countries. Thus the fiscal and monetary stimuli built into the various economies have been considerable. The fiscal packages announced at the end of the summer, excluding multiplier effects, amount to roughly 3½ percent of GNP in Italy, and 2¼ percent, 1½ percent, and ½ percent of GNP in France, Japan, and Germany, respectively. Although some of these measures will not come into effect until later this year, they are in addition to steps taken during the first half of 1975, and as such they cumulate to considerably more than the impacts cited above. The large budget deficits foreseen in most countries are to some extent cyclically determined; but even on an estimated high-employment basis the shift in fiscal deficits of some countries, and therefore in discretionary policy, appears to be substantial. Monetary conditions have eased almost everywhere; and interest rates, notably short-term rates, have come down significantly.

THE GENERAL OUTLOOK

With the policy measures now in place, the strength of confidence may be the crucial element in determining the pace and breadth of the current recovery. Over the past 12 months liquidity positions in the private sector have improved significantly. Corporations' debt maturities have been lengthened, and consumer debt outstanding is at low levels in relation to disposable incomes. On the whole it appears that private sector demand is mainly inhibited by uncertainty. With growing confidence, recovery paths may well become steep, particularly because expansionary actions have been taken simultaneously in many countries—as they had in 1971–72. In contrast to 1972, however, purchasing power in oil-importing countries continues to be siphoned off by the higher foreign price for oil. Furthermore, capacity utilization is currently at considerably lower overall levels; hence bottlenecks are not likely to develop at an early stage of the recovery.

As the recovery proceeds, however, particularly as it starts from low primary-stage inventory levels in many countries, pressure on some industrial sectors could become severe well before the upswing becomes broad-based and before overall capacity utilization reaches more normal levels. For example, in the United States overall capacity utilization in the manufacturing sector, at its cyclical peak in the third quarter of 1973, was 83.3 percent as measured by the Federal Reserve index; but at the same time capacity utilization for firms processing raw materials had approached post-Korean war highs. It may also be that general measures of spare physical capacity do not serve well in periods following relatively long and deep recessions. During such recessions effective capacity, rather than being added to, as is generally assumed in calculations of potential capacity, may grow only slightly or may even be consumed. Actually usable capacity, therefore, tends to be less—and in some cases considerably less—than calculated.

Furthermore, the current upswing comes at a time when the world economy has begun to adjust to the higher relative price of energy. This adjustment implies an increasing obsolescence of high-energy-using equipment where alternative production methods are being devised. Thus, although this structural shift adds to demand for new equipment, it may reduce currently usable capacity in some sectors. Finally, the large increases in exports to OPEC, which have given considerable support to activity during the recession, are largely concentrated in goods incorporating precisely those industrial materials that tended to be in short supply early in the 1972–73 upswing.

Although the current outlook carries a number of downside risks, the above discussion points to the existence of very real upside risks. A significantly faster recovery than now projected could lead to a repetition of the inflationary pattern of 1972–73. This outcome would not necessarily imply a return to double-digit inflation. Perhaps only one-half of the acceleration in inflation rates in the industrial countries, from an annual rate of 5¾ percent in 1970 to over 14 percent by the end of 1974, can be attributed to cyclical factors. Exogenous shocks, such as the increase in the import price of oil and shortfalls in grain harvests, may have accounted for the rest. But significant upward pressure on price levels, even if inflation rates remain below the two-digit level, may revive inflationary expectations. Such a development, because of its possible effect on saving rates, could carry the seeds of renewed curtailment in the growth of private demand.

For the short run, the major policy task in the industrial countries seems to center on the lessening of uncertainties in the private sector. Some policy makers have suggested that this can best be achieved by a steady policy stance supportive of the recovery. Uncertainties about future policy action, both in demand management and in social policy, should not be added to the uncertainties already created by the oil crisis and by the inflationary experience of the past several years.

INTERNATIONAL ECONOMIC COOPERATION

The experience of 1972–73 has shown that simultaneous measures to reflate national economies, without due regard to the amount of spending power that is being built up collectively, can lead to worldwide inflation. Similarly, the simultaneous deflationary policies of 1973–74 led to cumulative recessions. Thus in formulating national demand management policies explicit account needs to be taken of changes in world demand, in order to avoid the misreading of the changes in demand forces that occurred in 1972–73 and in 1974–75. If domestic policy objectives are to be achieved efficiently in an interdependent world, economic changes and policy goals in other countries must be given explicit consideration, precisely because they affect the path of any national economy, even the largest.

Faced with the great economic difficulties of 1974–75 and the threat that these might be intensified by divisive action, governments have striven to strengthen the mechanisms of international cooperation and understanding. These efforts are exemplified by the Economic Summit at Rambouillet in November 1975, a meeting of heads of government of six major industrial countries, and by the beginning in December 1975 of the Conference on International Economic Cooperation (CIEC), which involves a dialogue between industrial countries, oil producers, and non-oil LDCs. Some progress has also been made in matters involving trade and international monetary arrangements. The commitment to pursue internationally compatible policies and to avoid beggar-thy-neighbor policies may become increasingly important in months to come, since unemployment levels are likely to remain high in the early stages of the recovery and some sectors of the economy will tend to lag considerably behind a general upturn in activity. The political pressures on governments to take a narrowly nationalistic view of these problems may therefore intensify.

TRADE POLICIES

Pressures for protectionist actions, which resulted from the worldwide recession and were latent throughout much of 1975, intensified in a number of countries toward the end of the year. Recognizing that beggar-thy-neighbor policies can only serve to make everybody ultimately poorer, the governments of the OECD countries except Portugal renewed in May 1975 the pledge they had made a year earlier to refrain from taking measures specifically aimed at improving their individual trade positions. As a result, international trading arrangements were not seriously breached during the course of 1975, and there have been few significant departures from the pledge. On the import side a number of smaller OECD countries, Portugal, Finland, Iceland, New Zealand, and Yugoslavia, have instituted import deposit or licensing schemes. (An import deposit scheme in effect in Italy was lifted in March 1975.) Among the larger countries only Australia, which had earlier cut some tariffs, imposed tariff increases or quotas on a relatively wide range of goods. Political pressure to institute protectionist measures was particularly evident in Great Britain, where the government in December imposed restrictive import measures on a limited number of products. On the export side, a number of governments, among them the French, Italian, and British, have instituted or expanded fiscal and monetary measures specifically designed to encourage exports.

Against this background, the heads of government of six major industrial countries at the Economic Summit reaffirmed their commitment to the principles of the OECD trade pledge and agreed that the time schedule of the Multilateral Trade Negotiations (MTN) now under way in Geneva should be accelerated. The MTN aim at achieving substantial tariff cuts or elimination of tariffs in some areas, a significant expansion in agricultural trade, and a reduction in nontariff barriers by the end of 1977. This constitutes an ambitious program, yet a necessary one in the current economic and political setting.

Progress in 1975 has mainly been toward laying the basis for actual negotiations in 1976 and 1977. The preparatory work for the MTN proved to be more time consuming, compared to that in preceding trade negotiations because of the larger number of participants and because for the first time a wide range of nontariff barriers are being included. Unlike preceding negotiations, the MTN have been marked by a concentrated effort within the United States to reach a broad domestic consensus on what they are to achieve.

Progress in Geneva has been made on a draft code for the regulation of product standards and the treatment of tropical products. It is expected that broad agreement will be reached in 1976 on the major elements of a tariff-negotiating plan and on the procedure for achieving a meaningful liberalization of quantitative restrictions. It is further hoped that substantial progress can be made this year on procedures for dealing with questions of subsidies, government procurement, and safeguards against injurious import penetration so that substantive negotiations can begin. The United States also continues to work toward developing improved procedures and agreed principles on assured access to supply.

The admittedly difficult area in which little movement can be discerned is agriculture. The problems in the agricultural area are well known and of long standing. First, they concern the great comparative advantage that the United States and some other primary producers have over producers in the European Community (EC). Second, there are different approaches toward maintenance of farm incomes, with the United States moving away from price stabilization and production controls and the EC firmly committed to price supports. Because of the deep-seated problems in this area, it was particularly important that the heads of government at the Economic Summit specifically emphasized their commitment to achieve a significant expansion of trade also in agriculture.

INTERNATIONAL MONETARY DEVELOPMENTS

Discussions initiated in the International Monetary Fund (IMF) in 1972 about the structure of a reformed international monetary system were quickly overtaken by events in early 1973. Growing pressures on price levels and volatile short-term capital flows led to the adoption of de facto generalized floating in March 1973. Toward the end of 1973 the quadrupling of the export price of OPEC oil brought about a fundamental change in the international payments structure. Oil-importing countries as a group began to be faced with large current account deficits vis-a-vis the oil exporters, at least for a number of years until import demand in oil-exporting countries can rise to match export revenues and until importing countries develop alternative sources of energy and succeed in economizing on energy use. Consequently, financial markets and official international monetary arrangements had to adapt to rapidly changing payment patterns, including an enormous increase in capital flows connected with the financing of the so-called "oil deficits." Moreover there were wide disparities in inflation rates among countries. In these circumstances the flexibility of the exchange rate regime that had emerged after the breakdown of the parity system became increasingly important in facilitating trade and payment flows in 1974 and 1975. Of course the monetary, fiscal, and other policies that individual authorities adopt to stabilize their economies and to adapt to the higher oil import bill—whether by increasing net exports, borrowing from official or private sources, or drawing on reserve assets—constitutes "managing" their exchange rate in the wider sense of the term. It is of continuing importance that this "management" of exchange rates not lead to competitive devaluations or other self-defeating and disruptive policies, but be accomplished in an internationally cooperative manner.

The financing of the large external deficits of oil importers over the past 2 years has been accomplished considerably more smoothly than had been anticipated earlier. Financial markets turned out to be very adaptable, and the more flexible exchange rate system helped to avoid the market disruptions so often experienced during past periods of strain. Furthermore, deficits were somewhat smaller than was earlier foreseen because of a faster rise of import demand in oil-exporting countries and a reduction in the demand for oil imports resulting from resistance to high oil prices, conservation efforts, and the recession. Finally, expansion of international liquidity through increased use of IMF credit, including the creation of the Oil Facility in the IMF and increases in official lending, helped ease more serious financing strains. Traditional concepts of measurement of total international liquidity, such as those published by the Bank for International Settlements (BIS), however, have dubious applicability in today's international monetary system. Some of the currency reserve assets—for example, those accumulated by oil-exporting countries—tend to be "inactive" assets because they represent the intended accumulation of foreign investment and differ in important respects from earlier foreign currency accumulations by monetary authorities. And large-scale official borrowing in foreign financial markets has demonstrated the ability of countries to create liquidity through debt operations. The fact that not only the Eurocurrency markets but also national money markets, such as the U.S. market, are open to foreign borrowers and lenders is very important in this respect and has helped smooth the financing of external deficits.

The financial surpluses of OPEC in the first instance were largely invested in very short-term assets. But during 1975 considerable diversification of OPEC investments took place. The share of investible funds flowing into bank deposits and short-term assets was much reduced—from about one-half to perhaps one-quarter—and purchases of corporate bonds, equities, and long-term government securities rose. For the reasons discussed above, the total amount of OPEC new investible funds declined sharply in 1975.

The shrinkage in OPEC surpluses in 1975 was reflected in a large reduction in the current account deficits of the industrial countries (Tables 43 and 44). The decreased financing needs of industrial countries in 1975, however, were partly offset by an increase in import surpluses of LDCs that stemmed largely from the recession. (The financing problems of LDCs are discussed below.) Because of the smaller total external financing needs and the realization that the international financial system had been able to intermediate successfully between the large increases in the supply and demand for loanable funds, developments in international money markets in 1975 more closely reflected differential economic conditions than they had during the turbulent year of 1974. Because most other economies have lagged the United States in the cycle, interest rate relationships have shifted during the year (Charts 3 and 4). Early in 1975 short-term rates in the United States declined sharply relative to rates in other money-market centers. But from mid-June to September, most interest rate differentials swung the other way. Some of the resulting interest rate incentive was reversed again later in the year, but by then rate-induced capital flows to the United States were also being strengthened by the relatively better economic news here than abroad, and by the continuing high U.S. trade surplus.

TABLE 43.—*Current account balances for OECD, OPEC, and other countries, 1973–76*

[Billions of U.S. dollars]

Group of countries	1973	1974	1975 [1]	1976 [2]
OECD	2½	—36¼	—6	—17½
OPEC	3½	56	40	43
Non-oil developing countries	—2½	—17½	—27	—21¼
Other countries [3]	—4	—10	—14½	—13½
Discrepancy	—½	—7¾	—7½	—9¼

[1] Estimates.
[2] Projection.
[3] Sino-Soviet area, South Africa, Israel, Cyprus, Malta, and Yugoslavia.

Sources: Organization for Economic Cooperation and Development, Department of the Treasury and national sources.

TABLE 44.—*Current account balances for OECD countries, 1974-75*

[Billions of U.S. dollars; seasonally adjusted]

Country	1974		1975	
	First half	Second half	First half	Second half [1]
OECD: Total	—19.2	—17.0	—0.1	—6
United States	—1.8	—1.6	5.8	6¾
Canada	—.1	—1.5	—2.5	—2½
Japan	—4.1	—.9	.9	—1¾
France	—3.7	—2.3	.7	—1
Germany	5.2	4.4	3.5	1
Italy	—4.5	—3.3	.3	0
United Kingdom	—4.2	—4.4	—2.0	—2½
Other OECD	—6.0	—7.4	—6.8	—6

[1] Estimate.

Sources: Organization for Economic Cooperation and Development and national sources.

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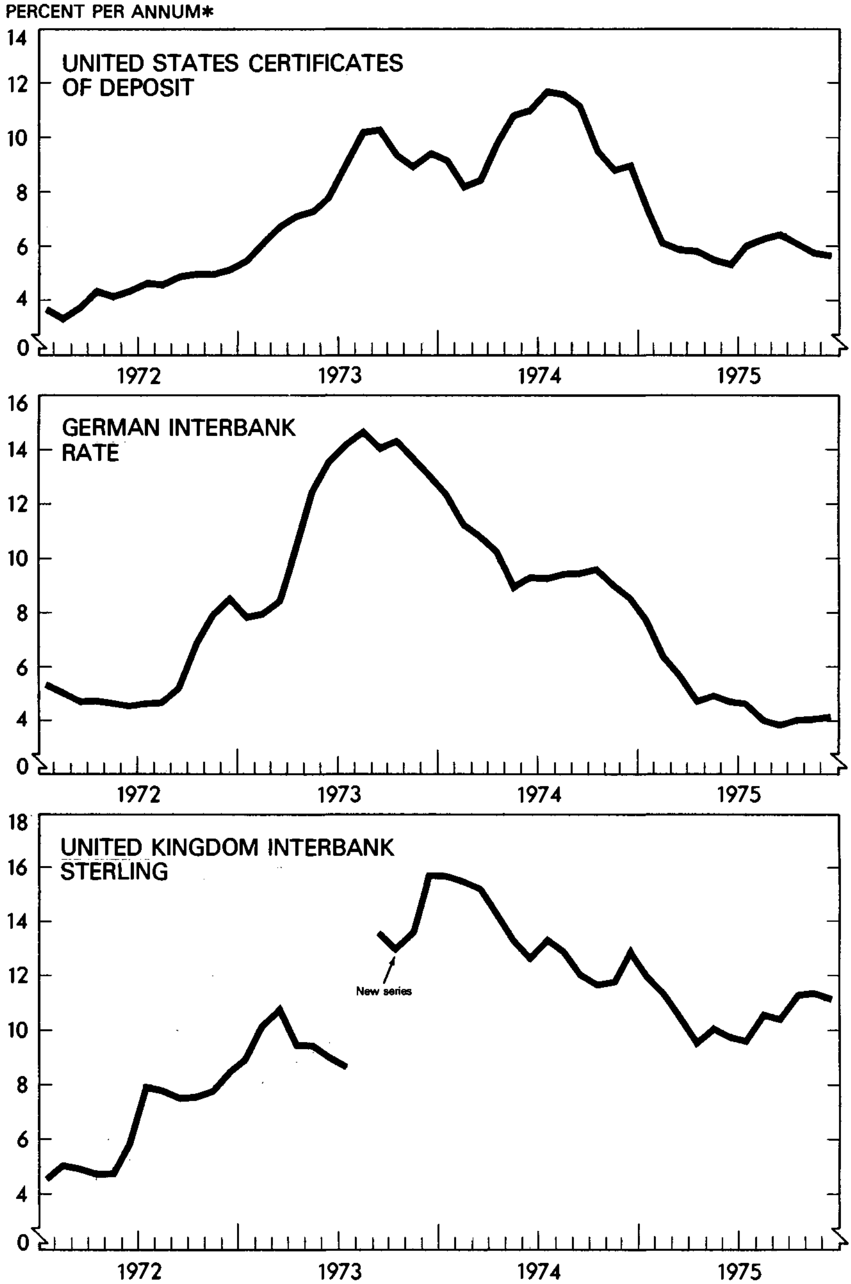
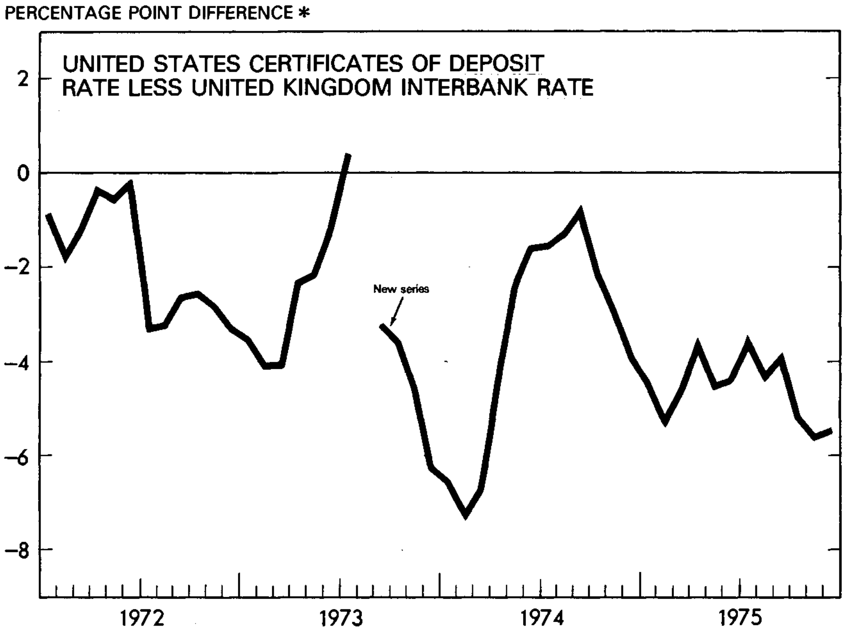
Chart 3

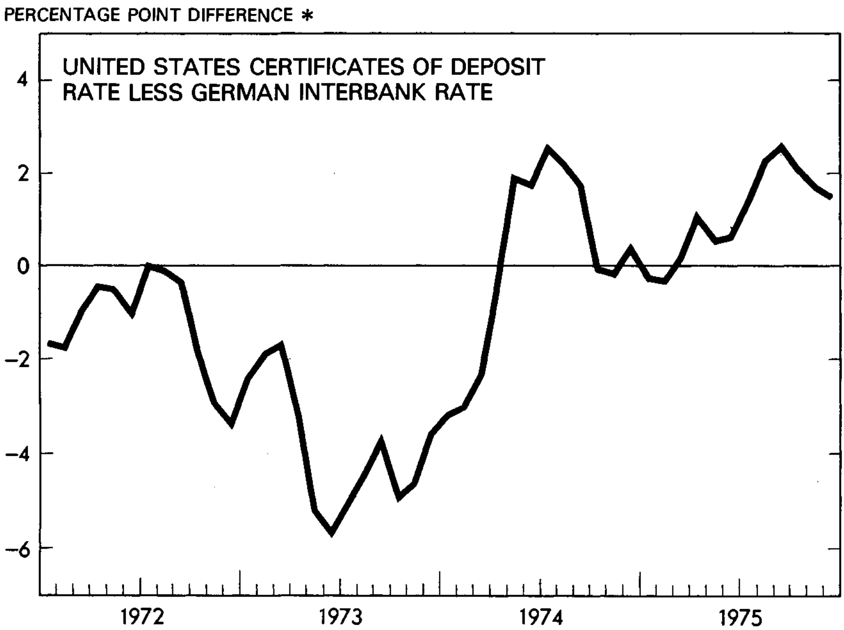
Interest Rates



* 3-MONTH RATES.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

Interest Rate Differentials





* DIFFERENCE IN 3-MONTH RATES.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

Private capital transactions in the U.S. balance of payments registered sizable outflows in the first half of the year. U.S. banks increased their foreign assets by about $7½ billion, reflecting in part relatively low interest rates in the United States, and in part heavy loan demand of some foreign countries, largely LDCs. The volume of new foreign bonds issued in the United States reached record rates, reflecting to some extent extraordinary financing requirements of international agencies. But these outflows were partly offset by rising foreign purchases of U.S. corporate stocks, including sizable purchases by oil-producing countries. In the third quarter, as U.S. interest rates rose relative to rates abroad, there was some reduction in banks' acquisition of foreign assets, and the net flow of private capital was inward. The final quarter brought a resumption of net outflows through banks, as well as a sizable net outflow through transactions in securities, as placements of foreign bonds in the U.S. market, including a large issue by the International Bank for Reconstruction and Development (IBRD) more than matched a continued high volume of foreign purchases of U.S. corporate stocks. For the year as a whole net private capital outflows were probably somewhat above the net outflow of over $10 billion reported for 1974.

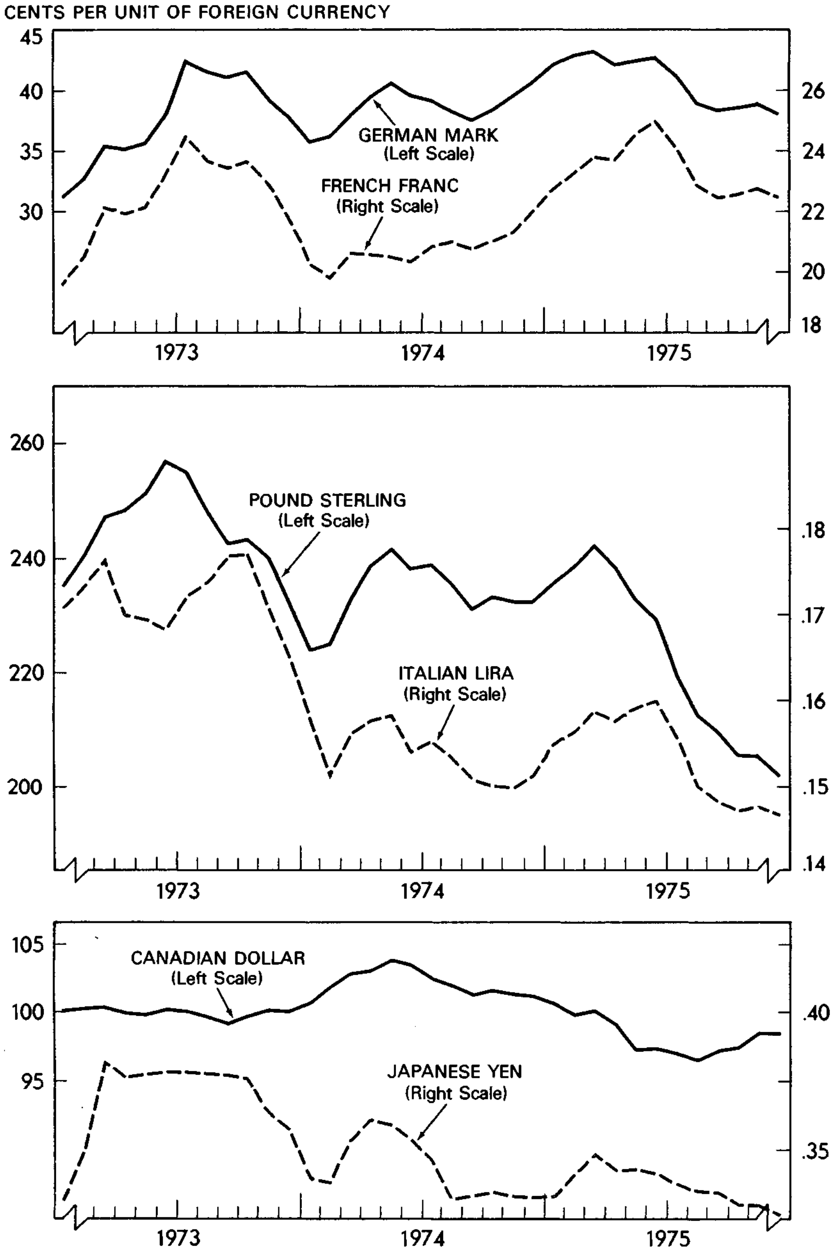
Reflecting these changes in capital flows and the large surplus on trade account, noted above, the exchange value of the dollar, in terms of a trade-weighted average of major foreign currencies, first depreciated by about 4½ percent between the end of December 1974 and the end of February 1975 and then appreciated by about 12 percent from March through September 1975. During the fourth quarter of 1975 the dollar rate changed very little, drifting down by about one-half of 1 percent.

The swing in the exchange value of some individual currencies against the dollar was of course greater than is reflected in the weighted average value. In particular, movements of the European currencies against the dollar were very wide. For example, against the European currencies linked in the "snake" arrangement, the dollar depreciated by about 6 percent from the end of December 1974 to its low early in March 1975, rose by 17½ percent to its September high, and depreciated again by 2½ percent to year-end (Chart 5).

Even though governments on the whole allowed market forces to move exchange rates rather widely, there appears to have been a considerable amount of intervention by foreign banks, particularly during the second half of the year. Gross intervention by the Federal Reserve, however, has been very limited. In order to avoid disorderly conditions and to lessen the danger of unwanted and self-defeating actions which might lead to competitive currency depreciations or other international policy conflicts, national governments recognized the need to intensify international consultation on these matters. As part of the broader international monetary negotiations, the United States and France reached an understanding at the time of the Economic Summit regarding a shared position on amendments to the Arti-

Chart 5

Foreign Exchange Rates



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

cles of Agreement of the IMF dealing with the exchange rate regime. This facilitated agreement by the Interim Committee of the IMF in January 1976 on the entire package of amendments to the IMF's Articles of Agreement which had been pending since agreement on certain parts was reached at the time of the Interim Committee meeting in August 1975. The main elements of this package, in addition to amendment of the Article dealing with exchange rates, are a 33.6 percent increase in the Fund's resources to SDR 39 billion as decided in the Sixth Quota Review; the phasing out of gold with regard to Fund transactions and other gold arrangements; and the establishment of a Trust Fund for the benefit of the poorer members of the IMF.

Agreement on the outstanding IMF issues does much to help assure the adequacy of international financing arrangements in the face of the continuing large payment surpluses of the oil-exporting countries. As economic recoveries broaden, current account positions of the oil-importing countries as a group will move into greater deficit. This shift may put financing strains on some countries and might lead to policies that could arrest the recoveries or be mutually damaging in other ways. It is therefore important to ensure that safeguards are in place to prevent unavoidable financial difficulties from being compounded by internationally inappropriate policies. Therefore the cooperative international spirit underlying the agreements reached at the meetings in January 1976 is particularly significant.

EXCHANGE RATE ARRANGEMENTS

The agreement on amended exchange rate provisions of the IMF Articles, first worked out between the United States and France and subsequently accepted by the Interim Committee of the IMF, recognizes that the underlying economic and financial situation determines the degree of exchange rate stability that is possible. Participating members agree to endeavor to direct their economic and financial policies toward the achievement of orderly economic growth with reasonable price stability, to recognize that orderly underlying economic and financial conditions are prerequisites to stability, to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage, and to follow exchange policies compatible with these undertakings.

When formally approved by 60 percent of the member countries representing 80 percent of the votes, these general provisions will be incorporated in amended Articles of Agreement of the IMF. The agreement allows countries to choose among exchange arrangements, including: (1) The maintenance by a member of a value for its currency in terms of the Special Drawing Right or another denominator other than gold; or (2) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members; or (3) other exchange arrangements of a member's choice.

The revised Articles would authorize the Fund, upon approval by an 85 percent majority vote, to establish a system of exchange arrangements based on stable but adjustable par values when international economic conditions are appropriate. In effect such a system could not be established without the approval of the United States, which under the proposed new quotas will have approximately 20 percent of the voting strength. As far as the United States is concerned, for the foreseeable future it is thought unlikely that conditions will be appropriate for the establishment of a par value system or the setting of target rates and zones or bands within which movements in the rate of the dollar would be contained. Policies aim at achieving stable economic conditions. However, progress toward narrowing disparities among inflation rates in different countries is slow, nor can one be sure that progress once made will be lasting. Exogenous shocks to which the various economies continue to be subject also argue for a considerable degree of flexibility in the monetary system. Central bank intervention will be limited to that necessary to counter disorderly conditions or erratic fluctuations. Each country will be the judge of what constitutes an erratic fluctuation in its exchange rate.

To facilitate the achievement of internationally cooperative behavior in exchange markets, the French and the U.S. authorities have suggested an intensification of the consultative arrangements among governments and central banks of major countries. Central bank officials will exchange daily information on the foreign exchange market and their intervention activities. Finance ministry and central bank officials will at frequent intervals review exchange rate movements and intervention activities, and discuss both the underlying economic and financial conditions and the impact of policies on these conditions. Under these arrangements there may be somewhat more frequent intervention than in the past. But the main point is that decisions on intervention in exchange markets will be based on better information, and that a growing understanding may also develop which recognizes that managing the exchange rate rather than the economy may only serve to introduce disequilibria and lead to misallocation of resources.

GOLD ARRANGEMENTS

The agreement reached on gold consists of four major elements:

1. Gold no longer will be a medium of settlement in IMF transactions.
2. One-sixth of the gold holdings of the IMF will be restituted to members, that is distributed to members in proportion to their quotas.
3. One-sixth of the gold holdings of the IMF will be sold at auction over a period of 4 years to finance a Trust Fund for the benefit of the poorer members of the IMF.
4. An agreement that will be reviewed after a 2-year period has been concluded by the 10 largest industrial countries. It bars any action to peg the price of gold and provides that the total stock of gold held by

the Fund and the monetary authorities of the participating countries will not be increased. Other countries may also adhere to this agreement.

The agreements on gold reflect general acceptance of the agreed upon objective to reduce the role of gold in the international monetary system. In addition, with the scheduled sale of some of the IMF's gold holdings for the purpose of financing the Trust Fund, gold may be expected to begin—gradually—to move out of the monetary system into private hands.

Some observers have argued that these new agreements may lead to a revaluation of official gold holdings at market-related prices or encourage more frequent use of gold as a medium for settlement among central banks. It is further argued that this, combined with the distribution of IMF gold to members, will have the effect of making more gold available to major countries, thus giving them greater liquidity, and perhaps adding to world inflationary pressures and reducing the likelihood that additional allocations of SDRs would be approved.

However, central banks have had the ability for some time to sell their gold holdings in the market as well as to value such holdings at market-related prices. Only one foreign central bank has actually written up its gold reserves, and there is no indication that others intend to do so. Moreover there also is no reason to expect the agreements to result in significant transactions in gold among monetary authorities. Indeed, by abolishing the official price for gold in the IMF, by strengthening the prospect of future sales of officially held gold into the market, and by establishing transitional provisions against pegging of the price, these agreements should in fact discourage widespread revaluations of official gold holdings and increase the risks associated with transactions among monetary authorities.

With the phasing of gold out of international official transactions, the danger that some authorities might seek to stabilize the price of gold is much diminished. In addition, authorities attempting to peg the price of gold, despite agreement among major countries not to do so, would find that such an effort could be exorbitantly expensive in terms of foreign currency assets needed for such operations. The cost would be higher, the smaller the number of participants.

Finally, the increases in world credit during the past several years have made it unlikely that new SDRs will be issued in the near future. Therefore, the restitution provision has been welcomed by some of the lesser developed countries which will receive 28 percent (their quota share) of the amounts to be distributed. In addition, the gold arrangements make possible the establishment of the Trust Fund, which is of crucial importance to the poorest developing countries, particularly now that the Oil Facility in the IMF is being terminated. Moreover a large number of LDCs will not make any nominal contribution to the Trust Fund, but will have that part of the profits on the gold sales by the IMF that represents their quota share in the Trust Fund distributed to them directly. Thus of the 25 million ounces of gold to be sold by the IMF, the profits on perhaps 6–7 million will go directly to LDCs, and those on 18–19 million will be used for the Trust Fund.

INTERNATIONAL FINANCIAL RESOURCES

In some sense a very important aspect of the completion of the arduous negotiations on exchange rate and gold arrangements is that the agreement on quota increases can now go forward. Such an increase in the general resources of the IMF is particularly important at this time because of the possible increase in external financing strains which some countries may face in the years ahead.

For the period necessary to ratify the scheduled quota increases, it was agreed that general access to the IMF's resources be temporarily liberalized by permitting a 45 percent increase in drawings in all credit tranches. This decision increases the general availability of IMF credit, but to the extent that it applies to the first credit tranches, it makes available a larger amount of resources that can be drawn upon freely without any, or at any rate with only a few, conditions attached. To that extent it will be necessary to guard against a possible inflationay impact. The temporary liberalization of access to IMF credit exceeds the scheduled quota increase and, thereby, should help smooth the continuing financial repercussions of the recession in the immediate future. By the time the permanent increase in IMF resources is in place, this exceptional bridging support should no longer be necessary.

For the industrial countries the IMF resources will be supplemented by the agreement reached last spring to establish a mutual Financial Support Fund among members of the OECD. This fund is designed to backstop traditional sources of financing and is to come into use only when financing is not available at reasonable rates through other channels. Drawings upon the Support Fund will be conditional upon the pursuit of appropriate domestic and international economic policies and upon progress toward increased conservation and production of energy. Thus, the Fund effectively constitutes an effort by industrialized oil consumers to insure against too great a bilateral financial dependence upon oil producers and to guard against protectionist or divisive measures designed to improve external payments positions at the expense of others. To the extent that it prevents member countries from taking restrictive payments measures, and more generally by contributing to an improved world economic outlook, the Fund would also be of help to nonmember countries.

For the poorer among the LDCs, the establishment of the Trust Fund in the IMF is of great importance, as noted above. Of potential help to a broader spectrum of LDCs is the decision to liberalize significantly the IMF's compensatory financing facility. Under this facility the IMF provides balance of payments support in amounts additional to normal IMF credit available to member countries who are experiencing a shortfall in export earnings for reasons beyond their control. The IMF's buffer stock facility, which assists countries in balance of payments need that have made contributions to international buffer stocks, is also being modestly liberalized.

THE CURRENT FINANCIAL POSITION OF THE NON-OIL LDCs

The difficulties experienced by LDCs in adjusting to the higher price of oil have been compounded by the depth of the recession that the oil price increases themselves helped to produce. So far, the financing of the large payments deficits which the non-oil LDCs have been incurring since 1973 has been managed with considerably less strain than was feared. Consequently actual expenditures requiring foreign currencies have been curtailed considerably less than was expected. The combined deficit on goods and services of the non-oil LDCs in 1975 is estimated at approximately $35 billion. Total financing requirements, however, would be in the $40– to $45–billion range, since scheduled debt amortization must be added. These requirements were partly met by official aid flows and financing available through the IMF's Oil Facility. Through mid-1975 most LDCs were able to finance the remainder with little recourse to their first-line resources. Reserves, which had grown by very large amounts during the 1972–73 commodity inflation, and conditional IMF resources were not drawn on to any considerable extent. In addition to official aid flows, the main financing came from bank lending and trade credits, an indication that a large number of these countries have maintained their credit worthiness in the view of private lenders. Many LDCs seem to have preferred bank borrowing because a rundown of their reserves or IMF resources might have eroded their credit standing.

In 1976 the overall position of the non-oil LDCs could improve somewhat (Table 43). The recession caused the external balances of the industrial countries to move from large deficits toward surplus in 1975, and the counterpart of these changes was to be found in deteriorating payments positions of the developing countries. In 1976 this pattern should be partially reversed as the recovery proceeds. The earnings of non-oil LDCs may therefore begin to rise once more and could well rise faster than imports. The non-oil LDCs as a group have lagged behind the industrial countries in the cycle; and many began to take deflationary, or import-reducing, measures only sometime during 1975. Thus imports in 1976 may show little, if any, growth. Accordingly, financing requirements for the year may be in the $30- to $33-billion range on a goods and services basis, and in the $35- to $40–billion range when debt amortization is taken into account.

Private market sources still appear to be willing to increase their lending to a number of these countries. Although their debt burden has grown considerably in nominal terms since 1973, inflation has reduced their real debt position. Consequently debt burdens, in real terms, may not be too far from their level of 1972 or thereabouts.

The fact that financial disaster or drastic cutbacks in development plans and economic growth have so far been avoided in the larger number of non-oil LDCs does not mean that their situation can be viewed with equanimity. Some countries' financial positions are indeed precarious. Considerable amounts of official aid will be necessary, particularly since their problems are likely to be compounded over time. But such aid should be conditional upon the adoption of appropriate policies that will allow existing growth potential to come fully into play. For the remaining countries the outlook is more encouraging, partly because of their natural endowment, partly because of efficient domestic management, and other reasons. For these countries, the increase in official financial resources currently being put in place, in addition to their access to private financing, may well suffice. The need is clear, however, to assure that these financing facilities are promptly accessible.

The Extended Fund Facility of the IMF is already in place. This facility provides considerably more liberal financing possibilities in connection with programs aiming at major structural changes than the regular IMF resources do, both in terms of amounts and in terms of maturities of loans available. In addition, the Trust Fund will become operational early this year, as will the liberalization of the IMF's compensatory financing and buffer stock facilities discussed above. These facilities and the enlarged access to regular resources of the IMF represent important safeguards against financing problems that may arise in 1976.

EARNINGS STABILIZATION AND COMMODITY ARRANGEMENTS

In part because of the financial problems created by the higher oil prices and the waning of the commodity boom of 1972–73, developing countries have forcefully attempted to focus the world's attention on their longer-run problems. LDC demands stem mainly from a desire to maintain or increase the purchasing power of their export earnings and to receive increased aid flows from richer countries. In certain matters, the interests of LDCs and industrial countries clearly coincide. The large fluctuations in prices for primary products disrupt LDCs' development plans and compound inflationary problems in the industrial countries. In addition, greater earnings stability in the commodity area would help the investment climate and thereby contribute to adequacy of supply. In recognition of these facts the liberalization of the compensatory financing and the buffer stock facilities in the IMF, noted above, have been agreed upon.

As part of its approach to commodity problems, the United States has expressed willingness to discuss commodity agreements case by case. U.S. objectives are to arrive at agreements which reduce excessive price swings without raising commodity prices above their long-term market trends and without significantly weakening the functioning of market forces. In line with these objectives, the U.S. view is that production controls and export restrictions should be avoided, because they create supply rigidities and longer-run market distortions and because they result in misallocation of resources and excessive costs to consumers.

The current approach to earnings stabilization problems relies on financing arrangements through the IMF which help smooth shortfalls in export earnings and on joint producer-consumer efforts to contain cyclical price fluctuations through buffer stock arrangements. Past attempts at using buffer stocks generally have foundered upon the inadequate size of such stocks, the high costs of holding inventory, and breakdowns in agreements among members on operating the stocks. Some of these drawbacks were due in part to the fact that the direct cost was carried by producers. The current approach, which brings producers and consumers together, perhaps carries a better promise for success than past buffer stock programs, in terms of both setting more realistic stock disposal rules and attempting to provide sufficient safeguards to protect consumers from a situation where average prices over the cycle are significantly higher than competitive market prices would have been.

The general and specific problems relating to commodity issues are being discussed in various international forums. One of the major issues that continues to be pressed by the LDCs is some provision to link their export prices to changes in prices for manufactured goods. These "indexation" proposals need to be opposed on various grounds. First, efficient use of economic resources depends upon the smooth functioning of the price mechanism. If relative prices were frozen, misallocation of resources would inevitably result. Second, because such arrangements tend to result in selling prices that are higher than market forces would bring about, they impart an inflationary bias to the international economic system. Therefore, earnings stabilization schemes can better be implemented through the more market-oriented ways discussed above, and any transfer of resources to the poorer countries can better be accomplished through official aid channels.