CHAPTER 3

The World Economy—a Hesitant Recovery

THE WORLD ECONOMY in 1977 continued to feel the aftershocks of the 1972–75 period: output remained well below productive potential while unemployment reached new peaks in many countries, inflation continued at high levels, and unusually large imbalances in current accounts persisted. These are problems that are likely to continue to command the attention of policy makers in the coming year. Economic growth in the United States was stronger than that in industrial countries abroad. This difference in growth rates and strongly rising oil imports contributed to the emergence of an unprecedented U.S. deficit on current account transactions. Concern over the U.S. deficit was a major factor leading to a substantial depreciation of the dollar against many foreign currencies, which was especially rapid toward the end of the year.

This chapter focuses on the causes of the hesitant recovery of the world economy from the 1974–75 recession, and on the challenge to the conduct of national economic policies that it represents. Developments in the world economy over the past 5 years are assessed. Then a closer look is taken at developments in 1977—concentrating on the largest foreign industrial countries, which along with the United States set the pace for the world economy as a whole. Finally, the major continuing problems in the world economy that grew out of the disturbances in the first half of the 1970s are assessed, and the Administration's approach to these problems is set forth. Thus the discussion is not a complete catalog of world economic problems or of U.S. international economic policies. One important omission is the long-standing challenge to raise incomes in the poorer countries. U.S. programs specifically directed toward this goal are not examined. Nevertheless, solutions to the problems that are examined—hesitant world recovery, imbalanced international payments, volatile commodity prices, and slow growth of world trade—are crucial to the success of development programs.

ORIGINS OF THE CURRENT WORLD ECONOMIC DISORDER

Although individual countries have from time to time faced conditions similar to today's, the combination of prolonged inflation along with unemployment in many countries and large current account imbalances is a new experience. A first step toward developing policies to deal with the

present constellation of problems is to study how they arose and to sort out what has changed in the world economy and what has not.

The period from the late 1940s to the late 1960s counts as one of the most successful periods of modern world economic history. Successive steps were taken to liberalize world trade. Real incomes in Western Europe grew at an average rate of 4.6 percent between 1955 and 1970. The economy of Japan grew an average of 9.5 percent per year as that economy joined the front ranks of the industrial economies. Major economic gains were also made in many developing countries, and growth in this group averaged 5.1 percent per year. Problems with inflation and with international payments tended to be isolated in individual countries and were tractable. Consumer price increases in the group of developed countries making up the Organization for Economic Cooperation and Development (OECD) were brought under increasingly better control and averaged only 2.6 percent per year from 1961 to 1966.

During the late 1960s problems began to appear. Inflationary tendencies gradually developed as labor and product markets tightened in some countries and wage pressures increased even in economies that appeared to have some slack. The mild recessions that occurred in various countries seemed less able to eliminate the inflationary momentum that had built up in the preceding expansions. In addition, the mechanisms of the Bretton Woods system of par value exchange rates were increasingly unsuited to deal with the imbalances that arose in countries' payments positions. Although these developments posed serious puzzles for policy makers in the late 1960s and early 1970s, the problems seemed manageable. In retrospect, they were dwarfed by later events.

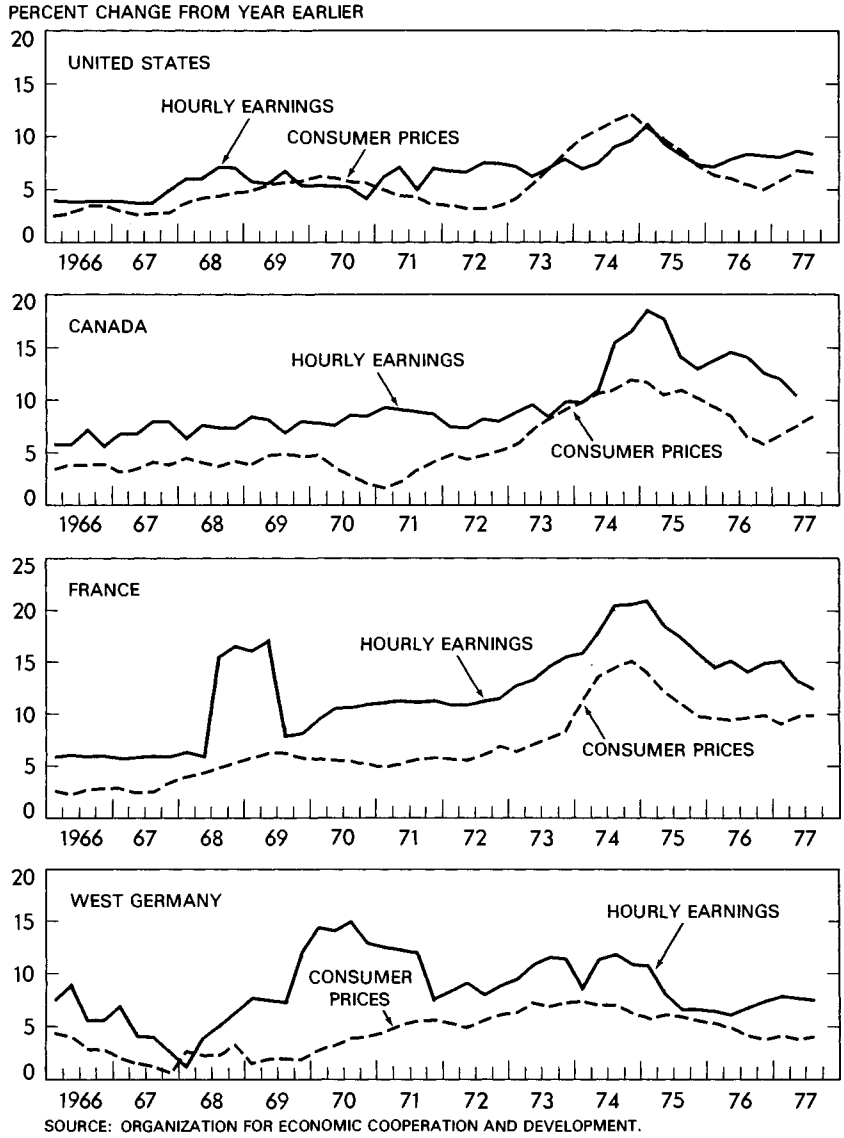
INFLATION

The slow upward drift of inflation rates in the late 1960s quickened after 1971, carrying inflation in most industrial countries above 10 percent per year in 1974 and more than twice that high in some countries. Although inflation rates have since receded, they remain well above those previously experienced, and further declines are now coming only slowly in most countries (Chart 6).

The upward movement of inflation rates was the consequence of a series of events that culminated with the oil embargo and oil price increases of late 1973. Economic policies in virtually all industrial countries were oriented toward expansion in 1972. As a result, growth was strong virtually everywhere that year and the next year. Although aggregate capacity utilization and unemployment data indicate that demand had been pushed beyond potential output in only a few national economies, the nearly simultaneous expansions outran available supplies of many raw materials and strained worldwide capacity in a number of basic industries. Industrial commodity prices climbed rapidly. The nonfood component of *The Economist* index of

Chart 6

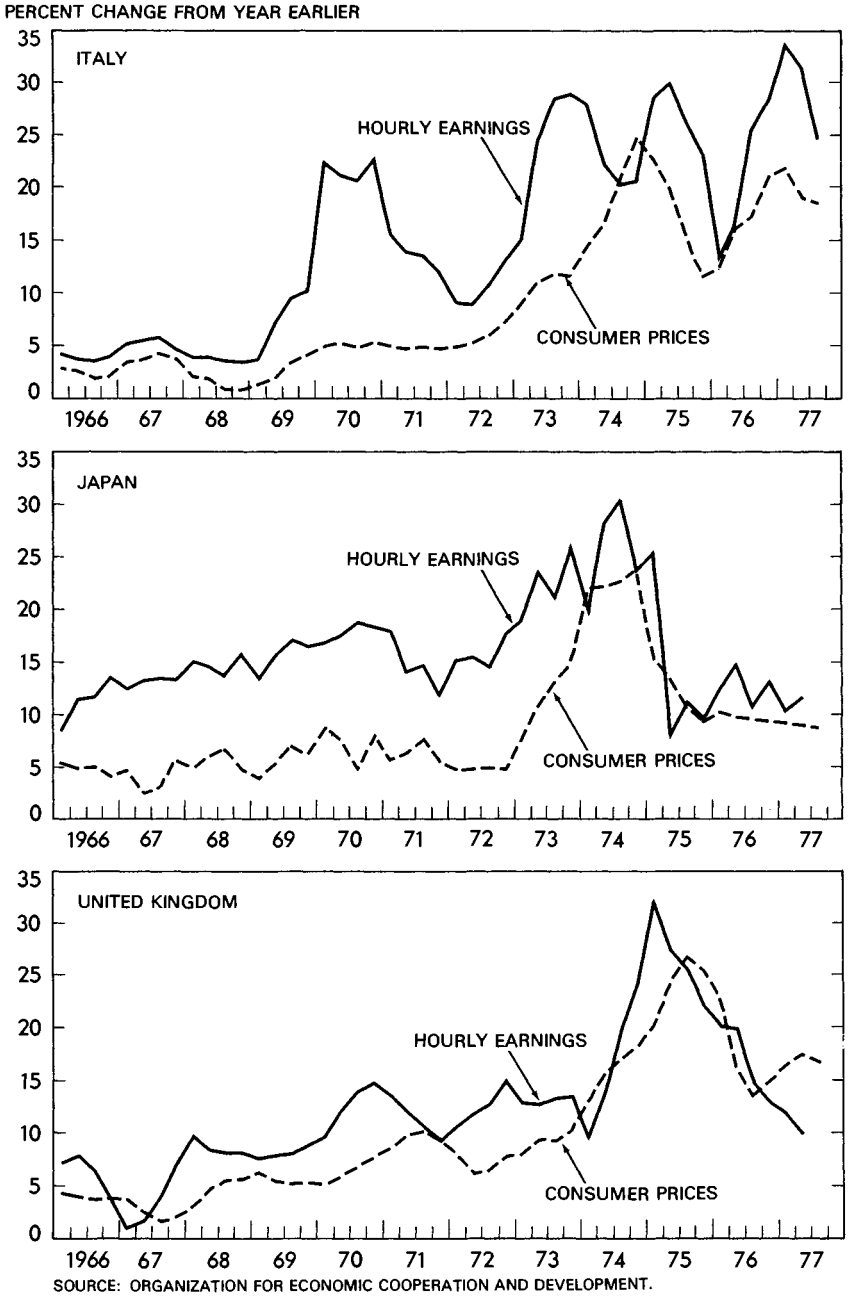
Consumer Prices and Hourly Earnings in Major Industrial Countries



SOURCE: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

Chart 6—Continued

Consumer Prices and Hourly Earnings in Major Industrial Countries



SOURCE: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

commodity prices (measured in dollars and excluding petroleum) rose 158.5 percent from December 1971 to December 1973. Less than one-twentieth of this increase can be attributed directly to the depreciation of the dollar in the early 1970s.

Grain prices also began to rise following declines in world harvests of wheat, corn, and rice in 1972 from year-earlier levels. World grain stocks (held mainly in the United States) had been whittled down from mid-1960s levels, so that poor harvests had a greater effect on prices than earlier. The food component of *The Economist* index rose 142.5 percent from December 1971 to December 1973.

Prices of manufactures also began to move up at a faster clip in 1973, reflecting higher input costs and strong demand. Consumer price increases in the large countries ranged from 7.3 percent in Germany to 15.0 percent in Japan over the 4 quarters ending in the fourth quarter of 1973. Wage pressures built up steadily in most countries. Trends in consumer prices and hourly earnings for the seven largest industrial countries are shown in Chart 6.

Although inflation rose in all countries during this period, there was considerable divergence of inflationary experience across countries. This divergence partly reflected differences in demand pressure and the extent and speed of wage responses to increases in the cost of living. The exchange rate realignments that began in 1971 also contributed to widening differences in inflation rates. Countries that had recorded above average inflation in the years up to 1971 and consequently experienced declines in their currencies faced additional inflationary pressure from rising import prices. Countries whose prices had been more stable, and whose currencies therefore tended to appreciate, received a dividend from slower import price increases. The shift to flexible rates among major currencies over the 1971–73 period also provided countries with more freedom to pursue policies with different consequences for inflation.

Inflation was already recognized as a serious problem in late 1973, when the world was surprised by the Arab oil embargo and a series of oil price increases that more than quadrupled the 1972 world price of crude oil. Of all the shocks of the early 1970s, the oil price increases have had the most profound and persistent effects. The direct effect alone added about 1½ percent to the price level in developed countries in 1974. Prices of substitute fuels were also bid up, thus further increasing price levels.

Coming at a time when upward price pressures were already intensifying, the oil price increases touched off an inflationary chain reaction. Fears that those who controlled supplies of other raw materials might succeed in emulating the Organization of Petroleum Exporting Countries (OPEC), speculation fed by fluctuations in exchange rates for major currencies, and a very tight supply situation led to another burst of industrial commodity

price increases. With stocks of grains having already reached very low levels, a second poor world harvest in 1974 contributed to further large increases in food prices.

The rise in oil, food, and other commodity prices reduced real incomes from wages and profits in manufacturing and service sectors. Attempts by workers and firms to restore previous positions put added upward pressure on wages and prices. The extent of these secondary wage-price forces varied with conditions in individual economies. Where automatic wage adjustments to compensate for consumer price rises were widespread, as in Italy or the United Kingdom, or where wages were adjusted annually, as in Japan, the pressures were greatest. Average increases in hourly earnings over 12-month periods reached 30 percent or more in these countries. Even in Germany, where wage pressures were more moderate, increases in hourly earnings approached 12 percent over a 12-month period.

The direct upward pressures from commodity prices abated as the world moved into recession in late 1974 and early 1975. Indeed, most non-oil commodity prices moved sharply downward. As a result, inflation rates receded, but the wage-price momentum that had been built into economies sustained rates of consumer price increase that continued to be roughly double what they had been in the late 1960s. In some countries such as Italy, the upward shift in the ongoing rate of price increase was substantially greater. The persistent high unemployment and low capacity utilization in the world since 1975 has had a relatively small effect in dissipating the momentum of the wage-price spiral.

CURRENT ACCOUNT IMBALANCES

The oil price increases of 1973 led to huge surpluses in the current accounts of most OPEC countries, and to their mirror image—large deficits—elsewhere. The OPEC countries could not immediately increase their imports to match their higher revenues. Hence their combined current account surplus, which measures the amount by which export receipts (including investment earnings) exceed payments for imports and net transfer payments, climbed from less than $10 billion in 1973 to over $60 billion in 1974. A large part of the corresponding shift in the position of the rest of the world was seen in the emergence of a combined deficit of more than $30 billion in the OECD countries, including the United States, after surpluses averaging $4.3 billion for 1971–73. The deficit of the non-OPEC developing countries widened to about $25 billion, from an average of $8 billion in 1971–73 (Table 14).

After being compressed by reduced oil consumption during the recession of 1975, the combined OPEC surplus expanded to the neighborhood of $40 billion in 1976 and 1977 as demand for oil picked up again. This surplus has become concentrated in the Persian Gulf states, whose revenues continue to outstrip their ability to absorb goods and services. The deficit of the non-OPEC developing countries has receded from a peak of $40 billion

in 1975 to less than $25 billion in 1977, while the deficit in the OECD countries has risen to more than $30 billion again.

TABLE 14.—*World current account patterns, 1973–77* [1]

[Billions of U.S. dollars]

Area and country	1973	1974	1975	1976	1977 [2]
OECD	2.8	−32.8	−6.3	−26.5	−32
United States	−.4	[3] −2.3	11.6	−1.4	−18
Canada	.0	−1.5	−4.7	−4.2	−4
Japan	−.1	−4.7	−.7	3.7	10
European Community	1.7	−11.3	.7	−7.8	0
West Germany	4.3	9.7	3.8	3.4	2
Developing countries:					
OPEC	9.0	61.8	30.8	42.3	40
Non-OPEC	−8.0	−24.5	−40.0	−26.3	−23
Other [4]	−5.5	−9.8	−18.0	−13.3	−11
Residual [5]	1.7	5.3	33.5	23.8	26

[1] Data are on the OECD basis.
[2] Preliminary estimates.
[3] Excludes cancellation of Indian debt (−$2.0 billion) and extraordinary grants (−$0.7 billion).
[4] Includes the Communist countries, South Africa, and non-OECD Europe.
[5] Residual arises from timing differences and inconsistencies in nationally collected data.

Source: Organization for Economic Cooperation and Development (OECD).

RECESSION

The massive increase in commodity prices—especially oil—led directly and indirectly to the worst recession since the 1930s. The direct effects were the result of a transfer from consumer incomes in the industrial countries to the revenues of oil-exporting countries. Spending generally declined in importing countries in response to the change in real incomes, while the OPEC countries increased their spending only slowly at first. Even after the OPEC countries made the initial adjustment of their spending to their increased wealth, their saving remained high. The result was a massive change in world saving patterns, as is dramatically shown in Table 14 by the pattern of current accounts in 1974. The change became increasingly evident as the total real gross national product (GNP) of the seven largest OECD countries fell at an increasingly rapid rate starting in the first half of 1974.

Two less direct responses added to the contractionary impetus of the price increases. First, consumers and business became progressively more pessimistic as 1974 wore on. There were extraordinary rises in saving rates in all major foreign countries, while sharp declines in real investment occurred in most areas.

A second depressing effect came in the reactions of policy makers. Virtually every country was faced with the dilemma of how to respond to the simultaneously inflationary and contractionary effects of the oil price rise. On the one hand, there was widespread reluctance to accommodate the inflationary effects by allowing nominal demand to grow at a sufficient pace to keep unemployment from rising. Many felt that such an accommodative policy would allow the new wage-price spiral to continue unchecked. On

the other hand, most analysts perceived that a continuation of restrictive policies—initiated to counter the tight markets in 1973—would lead to a sharp decline in real incomes and to a serious contraction.

Faced with this dilemma, countries chose different routes. The predominant response was to continue the restrictive policies initiated in 1973 into 1974. When the full contractionary force of the oil price increase was not felt immediately, monetary policy in some countries was made even more restrictive. Fiscal policy automatically became more restrictive when inflation raised tax liabilities by pushing individuals into higher personal income tax brackets and caused real corporate profits to be overstated.

By late 1974 the cumulative effects of the oil price increases and contractionary monetary and fiscal policies began to be felt more strongly. Rising saving rates added to contractionary forces as consumers became more cautious. Real investment fell with firms' growing concerns about the outlook for sales, high interest rates, and the structure of their balance sheets. Firms also moved to reduce inventories of materials that had been built up as a hedge against further commodity price increases. The combination of these forces produced the deepest recessions of the postwar period. Those few countries that were less affected by the oil price increase, like Canada, or that moved to counter its contractionary effects, like Sweden, had milder recessions. They were seriously affected by the subsequent prolonged period of weak demand in other industrial countries, however. Governments in these countries also ultimately adopted more restrictive policies to control inflation.

In 1975 authorities in most countries moved to counter their deepening recessions with expansionary fiscal policies. The view that increased rates of monetary expansion would raise inflationary expectations even under depressed conditions inhibited most countries from taking similar steps on the monetary side. The expansionary fiscal measures and the completion of inventory adjustments provided an initial burst of growth in most countries after the trough was passed. Since then real private spending has been relatively sluggish in most countries, and fiscal policies have become more restrictive. Hence output growth in industrial countries has slowed markedly outside the United States. Unemployment rates in most foreign countries now stand at or above the levels reached in 1975 and are rising (Chart 7).

THE WORLD ECONOMY IN 1977

Outside the United States, the major industrial countries virtually stagnated after the first quarter of 1977 (Table 15). Growth in the smaller industrial countries averaged even less than in the larger ones. Unemployment reached new highs in many countries. Commodity prices surged upward at the beginning of 1977, but the rise was short lived. Wage increases were smaller than a year earlier, and the momentum of inflation edged slowly downward. Sharply declining prices for food and many industrial commodities helped to bring inflation rates below underlying rates for most of the second half of the year.

Chart 7

Unemployment Rates in Major Industrial Countries

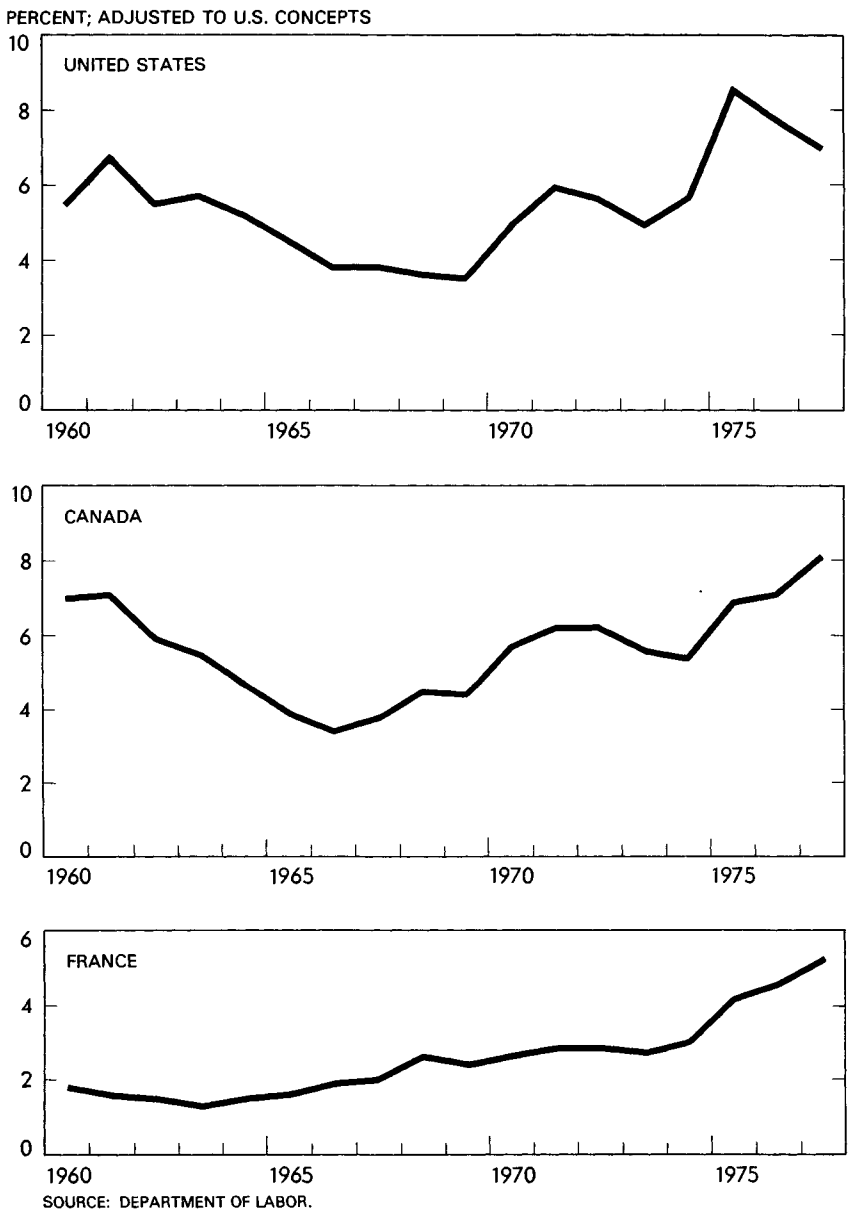
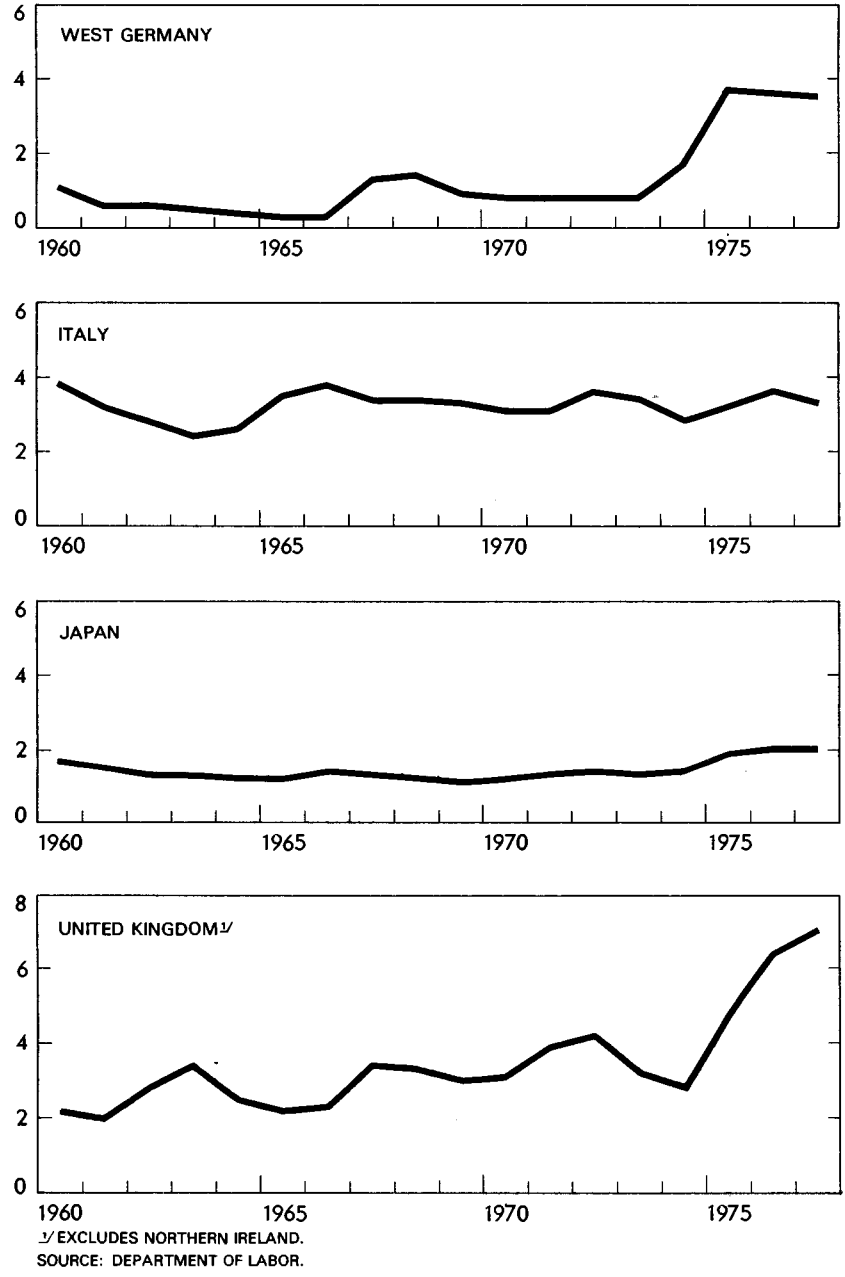


Chart 7—Continued

Unemployment Rates in Major Industrial Countries

PERCENT; ADJUSTED TO U.S. CONCEPTS



1/ EXCLUDES NORTHERN IRELAND.

SOURCE: DEPARTMENT OF LABOR.

TABLE 15.—*Real GNP growth in major industrial countries, 1976–77*

[Percent change at seasonally adjusted annual rate]

Country	1976				1977		
	I	II	III	IV	I	II	III [1]
United States	8.8	5.1	3.9	1.2	7.5	6.2	5.1
Canada	13.3	3.6	−1.3	−.8	7.8	−1.2	5.3
France [2]	7.4	4.9	1.6	1.6	8.8	−5.1	.9
West Germany	8.9	4.0	1.0	5.8	3.9	−.8	−.4
Italy [3]	10.0	5.5	1.0	7.6	7.5	−9.9	−2.4
Japan	12.0	6.0	1.6	3.4	8.8	6.8	1.8
United Kingdom [3]	10.8	−2.2	.7	3.7	−3.6	.4	−.4

[1] Preliminary.
[2] Gross domestic product excluding nonmarket activity such as compensation of employees in the government sector.
[3] Gross domestic product.

Source: Department of Commerce (Bureau of Economic Analysis), Organization for Economic Cooperation and Development, and national sources.

As inflationary fears receded, current account imbalances became the most serious constraint on expansion in many economies. Persian Gulf oil producers and several industrial countries continued to have large surpluses. Other governments were inhibited from adopting the more stimulative economic policies that were needed to restore the momentum of economic expansion, in part because of concerns that they would be unable to finance the larger current account deficits that would result. The emergence of a large current account deficit in the United States in 1977 was associated with some improvement in the positions of industrial and developing countries that had been hard pressed in 1976, but more than one-third of the U.S. deficit was offset by a jump in the surplus of Japan.

AGGREGATE REAL GROWTH

The growth of real economic activity in 1977 was disappointing—especially in Western Europe. Real output in OECD Europe increased only an estimated 2 percent. By the third quarter, the number of unemployed in these countries excluding Portugal and Turkey stood at about 7 million, or 900,000 above the figure a year earlier. This performance was, in part, the consequence of the restrictive policies adopted by a number of countries as a means of slowing inflation and reducing current account deficits. Italy and the United Kingdom accepted restrictions on their economic policies as part of the establishment of standby credits with the International Monetary Fund (IMF). Other countries—France, many smaller industrial countries, and many developing nations—also assigned high priority to reducing inflation and current account deficits, and maintained or adopted restrictive monetary and fiscal policies in 1977.

Because of the constraints on policies felt by many governments, hopes for sustaining a global recovery in 1977 were pinned to a group of "strong countries," those with relatively moderate inflation rates and favorable balance of payments positions. The United States, Germany, and Japan were the major states in this group, but Switzerland and the Netherlands

also fit the description. The United States was in a somewhat different position from the others in that it had moved to approximate current account balance in 1976. A deficit was seen as an acceptable position for the United States and, given the continuing OPEC surplus, even a desirable one from a global standpoint. It was expected that the other strong countries would also move toward and into current account deficit.

For world growth to be maintained at a satisfactory rate, it was necessary that growth in domestic demand in these strong countries be vigorous, thereby counteracting the restrictive measures taken in the "policy-constrained" countries. Reduction of current account deficits in the policy-constrained countries would be facilitated by such a strategy, and these countries would soon be able to move back to quicker recoveries.

A comparison of major countries' publicly announced forecasts for 1977 with what now appears the likely outcome (Table 16) shows that, except for the United States, countries have fallen below their governments' growth expectations. Germany has probably fallen 2 to 2½ percentage points short of the 4½ to 5 percent growth rate discussed early in the year. German authorities had counted on strong private demand at home and growing exports to achieve satisfactory growth. Investment and exports did not rise as much as expected, however, and the government budget deficit was smaller than projected. As a result, output growth stalled after the first quarter. The government responded by postponing measures intended to reduce the public sector deficit and by adopting a small fiscal stimulus package in November. However, the package came too late to affect the outcome for 1977.

The Japanese announced a growth target of 6.7 percent for the fiscal year ending in March 1978. Although the Japanese economy fell well behind the pace needed to achieve this, stimulative measures adopted in September and a second set of measures taken at the end of the calendar year will make the gap less than it would have been. Japanese GNP growth was supported mainly by strong exports. Domestic demand expanded at an average rate of less than 4 percent for the first 3 quarters of calendar year 1977. Thus the pattern of Japanese growth in 1977, and the resulting in-

TABLE 16.—*National forecasts and realized real GNP growth for 1977*

[Percent]

Country	Change from	Early 1977 forecast	Realized [1]
United States	Fourth quarter to fourth quarter	5¾–6	5¾
Canada	Year to year	3–4	2¼
France	do	4.6	2¾
West Germany	do	4½–5	2½
Italy	do	2.6	2
Japan	Fiscal year to fiscal year	6.7	5
United Kingdom	Year to year	1.2	½

[1] Preliminary estimates.

Sources: Forecasts from public statements of government officials and other official sources; estimates of realized growth from Department of Commerce, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

crease in the current account surplus by nearly $7 billion, served to tighten current account constraints on other countries.

Economic growth in all other major foreign countries also fell short of expectations. The pervasively weak element in the growth of demand in 1977 was business fixed investment. Among the seven largest countries, only in Canada was real business fixed investment above 1972–73 levels. Business fixed investment has slowed in most countries since 1976, and virtually no growth appears to have occurred in the second half of 1977 in any of the large foreign countries.

Real private consumption expenditures rose only moderately in most countries in 1977. Consumption declined in the United Kingdom, where falling real wages depressed disposable income and hence real consumption, and was virtually unchanged in Italy because of sharply increased personal tax collections. In Germany and France, taxes net of government transfer payments also took an increased share of household income in 1977. Saving rates in the large foreign countries were lower than in 1976, except for Japan, but the declines since the recovery began were generally less than in the United States.

Government spending made only a modest contribution to demand growth in most countries. Authorities in Italy and the United Kingdom followed strongly restrictive demand management policies. Limiting the government share of total spending over the medium term is an independent policy objective in these and other countries. Authorities have therefore been reluctant to increase spending in the short run as an aggregate demand measure. Japan, where the government sector is still substantially smaller than in other countries, was an exception to the general pattern of slow growth in real government spending.

Despite the slower growth of world trade in 1977, the growth of real exports was relatively strong in Japan, Canada, Italy, and the United Kingdom. Except for Japan, these are countries whose exports benefited from substantial exchange rate depreciations, although in Canada the growth of the U.S. market was undoubtedly more important for exports, and petroleum exports played a role for the United Kingdom. In Germany and France exports grew more slowly, and in the smaller OECD countries they contracted, on average. Thus the smaller countries were most adversely affected by external developments, and these countries were the ones registering the slowest real growth—with output declining in many of them.

INFLATION IN 1977

While inflation rates in most countries remained high in 1977 (Table 17), they did come down somewhat—particularly in those countries where inflation had been highest. A surge in world commodity prices in late 1976 and early 1977 pushed up consumer prices in the first half of the year. However, these prices turned around by midyear. In some countries—the United Kingdom, Italy, France, and a number of smaller countries—price pressures

continued to be exacerbated in the first half of 1977 by large exchange rate depreciations that had occurred in 1976. These currencies were stable, even rising somewhat in 1977, and this source of price pressure abated or was reversed as 1977 progressed.

TABLE 17.—*Inflation in major industrial countries, 1976–77*

[Percent change in the consumer price index; seasonally adjusted annual rate]

Country	1976				1977		
	I	II	III	IV	I	II	III
United States	5.2	4.9	5.7	4.4	8.4	8.8	5.3
Canada	6.2	6.0	4.4	7.0	9.9	9.4	7.3
France	10.2	8.7	10.4	10.5	6.5	12.2	10.4
West Germany	4.4	4.5	3.3	3.1	5.2	3.8	3.7
Italy	15.1	26.9	14.6	28.2	20.8	16.4	14.5
Japan	7.9	10.8	9.6	8.9	7.8	8.9	6.1
United Kingdom	14.6	8.8	15.1	21.7	21.0	12.4	11.6

Sources: Department of Labor (Bureau of Labor Statistics) and Council of Economic Advisers.

A significant decline in inflation was achieved in 1977 in the United Kingdom, where a wage restraint program prevented import price increases from being reflected in wage settlements. Although no wage norm was agreed to following the end of the second year of wage restraint in August 1977, the government has been largely successful in preventing contracts from being reopened until 12 months after the previous settlement. Increases since August have not averaged substantially more than the 10-percent figure that the government views as consistent with controlling inflation.

Inflation also declined in 1977 in Italy. Italian wages, which are indexed to the cost of living, did respond to import prices and rose sharply through the first half of 1977. With the stabilization of the lira and the turnaround in commodity prices, cost-of-living increases in wages are now declining rapidly. The declining trend has been reinforced by some shrinkage of wage increases granted in addition to cost-of-living increases.

Thus inflation has been moderating in the two large countries where it had been most rapid. Elsewhere, however, wages and prices appear to be locked in a stable pattern of increases. Price increases in Japan have been held down by the appreciation of the yen in 1977; and other countries whose currencies appreciated substantially late in the year should post lower price increases in early 1978. It remains to be seen, however, to what extent these smaller price increases will lower inflation rates over the longer term by holding down money wage increases. In other countries there appears to be little risk that inflation will accelerate markedly, but also little hope that it can be brought down quickly from current levels. Wage settlements and prices of manufactured goods have proved to be relatively insensitive to the high unemployment and low capacity utilization now prevailing. Wage and price controls have been effective only when combined with very restrictive demand management policies and only for limited periods of time. The Cana-

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dian government is in the process of phasing out one of the few remaining general programs of wage and price controls. In addition, there have been tentative experiments with the use of taxes as measures to slow inflation. In one approach, governments have proposed general tax reductions in return for agreements by labor unions to accept lower money wage settlements. When tax relief is warranted on other grounds and labor negotiations are highly centralized, something may be gained through such a bargaining process. An alternative set of approaches, discussed in Chapter 4, would use decentralized tax incentives for reducing inflation. These approaches are novel and raise important substantive questions that must be answered before they could be responsibly proposed.

CURRENT ACCOUNT POSITIONS IN 1977

Four industrial countries that have had persistent surpluses—Japan, Germany, Switzerland, and the Netherlands—had a combined surplus of about $16 billion in 1977. The United Kingdom and Italy moved from deficit into surplus.

Efforts by other OECD countries to reduce their sizable deficits in 1976 met with little success because of slow growth in their export markets. Some countries within this group—Portugal and Turkey, for example—have encountered difficulties in continuing to finance deficits. The non-OPEC developing countries appear to have reduced slightly their combined current account deficit in 1977. Their export earnings were boosted by commodity price increases early in the year, and some of them had sharply curtailed imports as well. Brazil and Mexico achieved substantial reductions in their deficits and a number of Asian countries appear to have realized smaller shifts.

The $17-billion rise in the U.S. current account deficit from $1 billion in 1976 to about $18 billion in 1977 reflected a $20-billion increase in our trade deficit. Although an increase in the deficit was widely expected, the magnitude of the shift proved to be much greater than anticipated, since growth abroad failed to develop as strongly as expected and U.S. oil imports were pushed up by a series of unforeseen developments. Rising payments for oil accounted for more than one-half of the increase in our trade deficit in 1977. The weak U.S. export performance and rise in the trade deficit in 1977 does not appear to stem from trends in relative domestic prices. U.S. and foreign prices measured in dollars held about the same relationship in early 1977 as in mid-1974, although there have been fluctuations in the interim. There has been some shift in relative export prices for manufactured goods, however, suggesting a greater willingness on the part of exporters in some foreign economies to compete on the basis of price. Nevertheless the depreciation of the dollar in late 1977 should result in a noticeable improvement in U.S. competitiveness, with the trade volume response occurring after a lag of 1 or 2 years.

FOREIGN EXCHANGE MARKETS

The most notable development in foreign exchange markets in the first half of 1977 was the strength of the U.K. pound and the Italian lira after these countries completed standby financing agreements with the IMF. As the year progressed, exchange market attention focused increasingly on the dollar.

Concern over the large U.S. current account deficit generated downward pressure on the dollar—particularly vis-a-vis the currencies of countries with large surpluses. As market uncertainties grew over what measures would be enacted by the United States to control the rise in oil imports, and as demand in foreign economies showed few signs of strengthening, the pressures intensified. The decline of the dollar from December 1976 to December 1977 against a weighted average of the currencies of ten major foreign countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom) was 5.5 percent, weighting currencies by countries' shares of the total trade of the group. Weighting the same currencies by countries' trade with the United States gives a depreciation of only 2.4 percent during 1977. The difference is mainly due to the much larger weight of the weak Canadian dollar in the latter index. Indexes including more currencies also tend to show smaller depreciations of the dollar, since currencies excluded from the index of ten currencies were virtually all weaker than the average of those included.

The yen appreciated against the dollar by 22.3 percent from December 1976 to December 1977, the largest appreciation of any currency. Increases in the dollar value of several other currencies were also sizable: German mark, 10.8 percent; Swiss franc, 18.0 percent; and U.K. pound, 10.5 percent. On the other side, the Canadian dollar fell 7.2 percent.

The magnitude of these movements was not unusual for the floating rate period. In the period since the dollar floated, it has twice depreciated by more than 7 percent on a weighted average basis in 12 months or less. Three times the dollar appreciated by 7 percent or more, with the appreciation exceeding 13 percent in two cases. Individual rate changes of 10 percent have been common, and even the change in the yen rate this year has been matched several times by movements of other currencies. Rapid movements at the end of the year occurred under disturbed market conditions, however, with wide spreads between bid and ask quotations and large intraday gyrations in rates. Thus the efficiency of the current system of rate determination was called into question—a topic pursued below.

UNFINISHED BUSINESS

At the beginning of 1978, the world economy faces the same problems that have confronted policy makers since 1975—unemployment is high, margins of unused productive capacity are substantial, inflation continues at excessive rates, protectionist forces are strong, and current accounts are

extremely unbalanced. On the brighter side, the virulence of underlying contractionary and inflationary forces has abated as governments have taken cautious, and for the most part cooperative, steps to improve economic performance. The international financial system has adapted to the need to channel the large accumulation of savings in OPEC countries to countries in deficit.

The serious problems that have beset the world economy have led some to argue that we must permanently set more limited economic objectives. In some respects this is true—we must plan for a world of less secure and more expensive energy. Nevertheless, higher employment and output are achievable virtually everywhere without creating new inflationary pressures. The problems are global and the pursuit of appropriate domestic policies is constrained in many countries by international payments imbalances. Achieving the potential of the world economy will require bold policies and close international economic cooperation.

Four major economic challenges are discussed below. International cooperation is essential to meeting each one of them. If, instead of working together to sustain economic recovery and solve our other problems, governments accept a continuation of the poor performance of 1977 as inevitable, the world may well face a darkening economic future. Unilateral protectionist trade policies will flourish. Pressures for international arrangements to allocate markets in especially depressed sectors will grow stronger. The result will be a more rigid world economy, no longer capable of generating the rapid growth of trade and incomes that has characterized the post-World War II period. The developing countries, which are looking for opportunities to participate more broadly in world trade, will be particularly hurt by such an outcome.

TO RESTORE HEALTH TO THE INTERNATIONAL ECONOMY

Foreign industrial economies as a group have shown only scattered signs of renewed strength following their extreme weakness in mid-1977. The Japanese economy is experiencing very slow growth. Even with the stimulative measures announced at the end of 1977, the appreciation of the yen, together with a high personal saving rate and depressed investment, raises questions whether growth in 1978 will exceed 1977. In Europe, the economic outlook with existing policies is for rising unemployment of labor and falling capacity utilization. For the OECD as a whole, GNP growth is likely to average 3½ to 4 percent in 1978, unless there are major policy changes in addition to those announced for Japan and those proposed for the United States in this *Report*.

At the same time, most forecasts indicate that the rate of increase of consumer prices in the OECD should slow somewhat from about 8 percent in 1977 to around 7 percent in 1978. There continues to be sufficient slack in most economies to permit growth at rates moderately higher than

current forecasts without forgoing a gradual reduction in average inflation rates.

Governments recognize the need for stronger expansion. In November 1977 the member countries submitted their preliminary objectives for 1978 to the OECD. In the aggregate these goals would lead to 4½ percent real GNP growth for the OECD as a whole. Such an outcome would be the minimum that could be expected to arrest the rise of unemployment abroad.

The generally sluggish behavior of business fixed investment has been a major factor keeping countries from achieving their goals. Stronger investment is important in the short run to provide stimulus for sustained recovery. Over the longer run, some are concerned that capacity constraints may have become relatively more important limitations on noninflationary expansion. Thus when capacity limits are reached, unemployment may still be above levels that would be inflationary on the wage side. Greater business fixed investment during the recovery period would reduce the potential for capacity constraints and make possible a further reduction in unemployment.

A number of explanations have been offered for the weakness of investment. No single explanation will suffice for all countries. Nevertheless a substantial portion of the current weakness of investment in every country is accounted for by the low current and prospective rates of capacity utilization and the effects of low levels of output on profits. In addition, the persistence of inflation has undoubtedly added to concerns that recoveries may not be sustained. Much investment that has occurred has been for modernization projects that promise to save more in labor, energy, and other inputs than their capital costs; projects that would add to capacity have in many instances been deferred.

Considerable attention has been focused, as well, on low after-tax returns on capital and the poor outlook for improvement as explanations for sluggish investment. Measures of profits and the total return on capital must be treated with some reservations, but there is substantial evidence that over the past 15 to 20 years they have declined relative to GNP and relative to capital stocks in many foreign countries. Moreover it appears—in contrast to the U.S. experience—that the fall in the return on capital has been too large and too prolonged to be entirely attributable to the recent recessions, at least in Germany, the United Kingdom, and Italy.

Investment is not being held back by insufficient savings. Given the savings represented by the OPEC current account surplus and with consumer saving rates in most foreign economies high by historical standards, there is no shortage of savings in the world today. Thus a higher return on capital is not required today to assure an adequate supply of funds for investment. Rather, to encourage firms to make use of the available pool of savings for productive investment, what is needed is a sufficient margin of the expected return on capital over the cost of capital.

One way to increase this margin and call forth more investment is to raise expectations and reduce uncertainties concerning after-tax returns on capital.

Many government actions can have an effect on these expectations by achieving continued economic recovery, reducing tax liabilities associated with new investment, and reducing uncertainties and inefficiencies that result from the government regulatory process. A second way to increase the margin is to maintain an expansionary monetary policy, which reduces the cost of capital. Monetary policy is more flexible than policies that work by raising the rate of return on capital, but there is a role for both kinds of policies. Each generates higher expected incomes for those who are willing to accept the risk of new investment. But the two kinds of policies do, of course, have different effects on the distribution of income, and these must be taken into account.

To some extent, views concerning the indicators of macroeconomic management threaten to prevent some countries from reaching their goals. As discussed below, the significance of current account positions has changed in view of the OPEC surplus. In addition, attitudes about budget deficits and the growth of monetary aggregates should be formulated in the light of current economic conditions. As noted in Chapter 2, it is difficult to hold down deficits in government budgets when the drag on industrial economies from external deficits is as high as it is now, and especially so when investment is weak as well. Similarly, rates of monetary expansion must make realistic allowance for the inherited momentum of price and wage increases and the rate at which this momentum can be dissipated. It is important to avoid such a progressive tightening of monetary conditions that investment objectives are thwarted.

In recent years, the appropriate use of monetary and fiscal policies has sometimes been constrained by views on their significance and impact. The principal tools of macroeconomic policy are not themselves the ultimate objectives of policy. In reality, monetary growth rates and budget deficits are strategic variables, and they must adapt to economic conditions. The significance of these strategic variables lies in their effects on output, unemployment, and inflation.

Sometimes it has been suggested that monetary growth or budget deficits affect inflation rates directly through expectations, aside from their effect through actual or expected demand. Expectations of inflation are indeed important determinants of economic behavior, but these expectations are linked to actual price pressures that are expected to develop in markets. It is difficult to see how inflation (or the expectation thereof) would be raised significantly more by monetary or fiscal policy measures that moved an economy toward full utilization of its productive potential, compared with a fortuitous shift in exports or in saving behavior that had the same effect on demand. A more carefully articulated view is that monetary and fiscal policy affect the level and composition of economic activity—and thus affect inflation through this linkage.

A program for achieving full recovery in the industrial economies must begin with measures to raise domestic demand and capacity utilization. Only then is sufficient investment likely to be forthcoming to achieve structural

objectives such as reducing dependence on export demand and forestalling potential imbalances between capital stocks and labor forces. Both monetary and fiscal policy can make a contribution. With excess capacity everywhere, world recovery can proceed without undue concern that reasonable expansionary policies will trigger a new round of inflation. As recovery continues and utilization of capacity reaches high levels, unemployment may still remain unacceptably high in some countries. A more cautious approach to further reductions in unemployment would then have to be taken. It may be necessary to move progressively toward fiscal restraint to keep demand within the productive potential of the economy, and meanwhile continue to promote investment with continued stimulative monetary policy and special incentives for investment.

Improved cooperation in economic policy making will be essential if countries are to succeed in carrying out such a program. The consequences of insufficient attention to the global implications of national policies are seen in the inflationary pressures generated by the simultaneous expansion of 1973 and in the poor performance resulting from too great a reliance on export-led growth in 1977. The mechanisms for international cooperation have improved in recent years.

The heads of state of the largest industrial countries have met three times since 1974 to address economic problems. At the London Summit last May the heads of state discussed their domestic economic goals and agreed to monitor progress toward them.

While not all of the specific goals for 1977 that were laid down at the London Summit have been achieved, the exercise has proved a useful tool in improving international economic cooperation. When the German and Japanese economies proved to be weaker than officials in those countries had expected, the Summit commitments reinforced domestic considerations that led both governments to implement stimulative measures in the fall. Summit commitments also supported the efforts of other governments to maintain policies directed primarily at reducing inflation and current account deficits.

The process of setting economic objectives and examining their consistency and desirability is being extended in the Economic Policy Committee (EPC) of the OECD. The EPC will continue to monitor economic activity in 1978 relative to countries' own internal goals and to the overall balance of demand and supply in the world economy. The international discussion of goals and the means to achieve them is necessary to assess the consistency of individual countries' aims, to guide the formation of policies that have good promise of achieving them, and to respond to developments that push economies off their desired courses.

TO DEAL WITH EXTERNAL IMBALANCES

A country's current account balance measures its net receipts from trade in goods and services (including investment income) plus net transfers from the rest of the world. It is closely related to the level of economic activity.

Higher demand at home generally leads to more imports and thereby to a smaller surplus or larger deficit. Moreover, a decline in the balance generated by external forces must be offset by stronger domestic demand if GNP growth is to remain unchanged. Thus a country's current account position is an important indicator for setting demand management policies.

A country's current account balance is a useful economic indicator for a second reason. A current account surplus must by definition be matched by a net outflow of private and official investment to the rest of the world, while a deficit must be matched by a net inflow of investment. Policy makers must consider the sustainability of a current account deficit—whether the willingness of foreign investors to acquire claims on a country or the willingness of domestic investors to reduce claims on foreigners will remain strong enough to finance a given deficit. Changes in a country's current account position may require exchange rate changes to reconcile domestic objectives with a current account position that can be sustained. But neither the current account nor the exchange rate should be viewed as an ultimate objective of policy in the same sense that real income and the rate of unemployment are. These external variables do not directly affect the welfare of citizens, although they have important effects on variables that do.

The presumption in the past has been that a mature industrial country like the United States would normally be in current account surplus, thus supporting a private capital outflow to capital-poor developing countries where the productivity of capital was thought to be relatively high. The emergence of the OPEC countries as major capital exporters and the troubled state of the world economy have altered this presumption, at least for the present. Although developing countries continue to welcome small current account deficits—that is, an inflow of capital—large deficits are not welcome, since these countries' export earnings are insufficient to meet the resulting increase in debt service. Thus industrial countries following appropriate policies are more likely to have current account deficits under today's conditions. Surpluses most often occur when domestic demand is particularly weak, when the currency is undervalued, or when there are barriers to imports or inducements to exports which are disruptive to world trade.

Over the last 4 years, there has been an extraordinary divergence in countries' current account positions. Surpluses have been common among those countries best able to finance a deficit—including the United States in 1975. As a result, borrowing by many weaker countries with large deficits strained the limits of international lenders' willingness to extend credits to them, and the fabric of the international financial system was stretched thin. The movement of the United States into deficit has relieved these strains somewhat but has led to new strains in exchange markets.

Some perspective on the relative current account positions of the OECD countries in 1977 is given in Table 18. The current account positions of

the OECD countries in 1977 (as projected by the OECD) are shown, as well as the size of the surpluses or deficits relative to gross domestic product (GDP). The scaling by GDP is intended to facilitate comparisons of countries of different size, not to suggest a norm for current account positions. As can be seen in the table, the relative size of the estimated deficit is somewhat larger for the United States than for the OECD countries as a whole. Several major countries and many smaller countries have relative deficits substantially larger than the U.S. deficit, however. The table also shows clearly the extreme positions of many small countries.

In time, as the United States and others finally accept the need to take effective measures to limit oil consumption, the OPEC surplus will dwindle and the corresponding deficits will shrink. But in the interim only action by OPEC members to reduce oil prices or dramatically raise imports, or a repetition of the 1975 world recession, would significantly reduce the OPEC surplus. The latter would be an extraordinarily costly way to reduce oil imports. Hence, for some time to come, appropriate national policies and international cooperation will be particularly important to ensure that the international financial system remains adequate to the demands that will be made on it and to reduce the large imbalances that exist aside from the OPEC surplus.

TABLE 18.—*OECD current account estimates for 1977*

Country	Billions of U.S. dollars	Percent of 1976 gross domestic product
Switzerland	3¼	5¾
Japan	10	1¾
Belgium-Luxembourg	½	¾
Italy	1	½
Netherlands	½	½
West Germany	2¼	½
United Kingdom	¾	¼
Iceland	0	0
TOTAL OECD	−32	−¾
France	−3	−¾
Finland	−¼	−1
United States	−18	−1¼
Canada	−4¼	−2¼
Spain	−3	−2¾
Australia	−3	−3¼
Sweden [1]	−3¼	−4½
Denmark	−1¾	−4½
Greece	−1¼	−5¾
New Zealand	−¾	−5¾
Ireland	−½	−6½
Austria	−2¾	−6¾
Turkey	−2¾	−7
Portugal	−1¼	[2] −8½
Norway	−5¼	−16¾

[1] Estimates not comparable with those shown in national sources because of an OECD correction for a once-and-for-all negative impact of $¼ billion on the current account balance due to a change in Sweden's method of statistical reporting.

[2] Calculated using 1975 gross domestic product.

Sources: Organization for Economic Cooperation and Development (OECD) and Council of Economic Advisers.

When current account imbalances arise for a given country, there are several alternative courses of action. If a deficit appears temporary—from, say, a bout of cold weather or a sharp cyclical movement—one would expect extraordinary deficits to be financed by private and official capital flows. For large and unsustainable surpluses or deficits, which are likely to persist and reflect underlying trends, adjustment must come either through adjustment of macroeconomic variables, such as a change in interest rates or economic activity, or through changes in the exchange rates. Finally, there are a number of "microeconomic measures" that can be pursued, such as trade policy, protective actions, changes in the tax structure, or export promotion. By and large these latter measures are not appropriate to promoting adjustment between regions: they greatly distort the underlying priorities of an economy with little payoff in adjusting imbalances. The roles of exchange rate adjustment, macroeconomic measures, and financing are explored further in the following sections.

Exchange Rates and Current Account Adjustments

During the first half of the 1970s, the industrial world moved from the Bretton Woods system of predominantly par value exchange rates to one in which the exchange rates between major currencies are determined primarily by market forces. The role of the exchange rate in the adjustment of countries' current account positions is potentially a powerful one. Exchange rate changes can help to eliminate persistent current account imbalances, and they can forestall imbalances that otherwise would arise in a world where inflation rates and real growth rates differ widely. Now that we have several years of experience operating with more flexible exchange rates, it is useful to review events and ask how, and how well, the system has functioned.

The present system of flexible exchange rates is not a pure floating rate system. Many smaller countries have continued to maintain the exchange rates of their currencies within specified limits with respect to one or more major currencies. The European Joint Float (the so-called "Snake," currently consisting of the currencies of Belgium, Denmark, Germany, the Netherlands, and Norway) is a significant regional arrangement for keeping exchange rate movements among members within fixed limits. The existing exchange rate system is also distinguishable from a pure floating rate system in that governments and central banks buy or sell foreign currencies in intervention operations to counter disorderly market conditions, to slow movements in rates, and occasionally to prevent rates from moving.

In the period since the dollar floated in March 1973 exchange markets have gradually adjusted to the new regime. Although there have been large rate movements during this period, these movements have generally reflected fundamental developments. The historical record indicates, however,

that exchange market attention has focused on different factors at different times.

Soon after it was allowed to float in March 1973, the dollar came under downward pressure once again, and by July it had fallen to levels that with hindsight appear too depressed. To a certain degree, the further decline was caused by those forces that had generated pressure under the par value system—at the old exchange rate the United States was not competitive. Also important, however, was the desire of foreign holders of dollars to diversify their foreign exchange positions, given the initial uncertainty in the market about how the new system would function and the likelihood of larger, more frequent, and less predictable changes in exchange rates. One piece of evidence for this diversification is the substantial decline in the dollar share of gross Eurocurrency assets that occurred in 1973. Evidence that central banks stood willing to enter the market forcefully to counter disorderly market conditions helped to dispel some of the uncertainties and contributed to a stabilization of the dollar in July 1973.

Following the Arab oil embargo and the announcement of higher OPEC oil prices in late 1973, exchange markets focused on individual countries' dependence on foreign oil. In view of the United States' relatively high degree of self-sufficiency in energy, as well as the central role of the dollar as an investment vehicle for OPEC surpluses, the dollar appreciated by 12.7 percent on a weighted-average basis from October 1973 to January 1974.

During the recession and early recovery period from mid-1974 through the end of 1975, exchange rate movements were dominated by differences in interest rates. U.S. short-term interest rates fell relative to rates in other major countries during the U.S. recession. The decline in interest yields on dollar assets relative to yields available in other currencies caused investors to attempt to shift out of dollars, and the dollar depreciated over a 6-month period by 8.1 percent against a multilateral weighted average of ten currencies. Short-term dollar interest rates turned around as the U.S. recession bottomed out in the second quarter of 1975, while rates in other countries continued to fall. As a result, the dollar rose, wiping out the earlier depreciation by September. It is interesting to note that neither the swing in the U.S. current account from a deficit in 1974 to a surplus at an annual rate of $16 billion in the second quarter of 1975, nor the subsequent turnaround in the current account—developments that were largely the result of the depth and timing of the recession in the United States and in major foreign economies—had a major impact on the value of the dollar during this period.

In 1976, exchange market participants seemed most influenced by differential rates of inflation. Market commentary, at least, was preoccupied by these differences although countries whose currencies depreciated also had current account deficits. The dollar appreciated by a small amount during the year, in line with the better-than-average U.S. price performance.

The currencies of the two major countries with the highest inflation rates—the United Kingdom and Italy—depreciated against the dollar by 17.0 percent and 21.3 percent respectively.

Most accounts of exchange rate movements in 1977 relate these movements to trade and current account developments. Indeed the initial pressures on the dollar developed in the wake of a string of record monthly trade deficits—reflecting a major increase in oil imports and differences in growth rates between the United States and other OECD countries. As it became clear that these deficits were unlikely to shrink over a reasonable period of time, the pressure on the dollar intensified. The countries with the largest appreciations, Japan, Germany, and Switzerland, were those with the largest and most persistent current account surpluses. The turnaround in the pound sterling also coincided with the turnaround in the U.K. current account.

Although Germany and Switzerland had somewhat lower inflation than the United States, only a small fraction of the appreciation of these currencies could be attributed to actual differences in inflation rates. Moreover, developments during the year did not warrant a shift in expectations of future inflation large enough to account for a substantial part of the movement in exchange rates.

The dollar depreciation in 1977 ran counter to a strong rise in U.S. interest rates and declines in most foreign interest rates. During the year, U.S. short-term interest rates rose about 350 basis points relative to those in major European countries. In the past, interest rate movements of this magnitude generated substantial private capital inflows or exchange rate changes.

The size and timing of the exchange rate changes in the episodes recounted above illustrate some implications of the fact that trade and price developments affect exchange rates through their effects on the supply and demand for assets denominated in different currencies. Among the most important determinants of the price of any asset are portfolio risk, current return—for example, interest—and expectations concerning its own future value. Interest rates and perceptions of risk have been major determinants of exchange rates, as seen in the 1973 and 1975 episodes. Moreover, relative price and current account developments have strongly affected exchange markets, primarily by altering expectations concerning future exchange rates. Thus exchange rates have responded to inflation and current account developments as market participants have concluded they would persist. Rate changes have sometimes led to actual changes in underlying variables and often followed them. When nonfinancial developments have been viewed as temporary, such as the U.S. current account surplus in 1975, they have had little effect on expectations and therefore on exchange rates.

While exchange rate movements during the flexible rate period have broadly reflected underlying developments, sustained large movements in one direction, followed by reversals, have occurred surprisingly often. These

movements have often not corresponded to discounts or premia on forward exchange rates. They have been of sufficient regularity and magnitude to cast doubt on whether large exchange rate changes have always reflected the workings of a market in which new information is efficiently incorporated into currency prices. Markets have also been characterized from time to time by very thin trading, much wider than normal bid-ask spreads, and large intraday rate movements in the absence of significant fundamental developments. When these disorderly conditions prevail in the market, there is a question whether the longer-run prospects for currencies may be lost from sight. Critics of floating exchange rates have pointed to these features of the current regime to underscore the need for more active intervention by central banks and governments.

Responding in part to these concerns, as well as to domestic policy needs, foreign central banks in 1977 made heavy purchases of dollars to smooth, and in some cases to limit, the appreciations of their currencies against the dollar. These activities are crudely indicated by reserve movements over the year. British official reserves rose $16.2 billion through October, when large-scale intervention was suspended. Japanese reserves rose $6.6 billion and German reserves $5.3 billion for the full year.

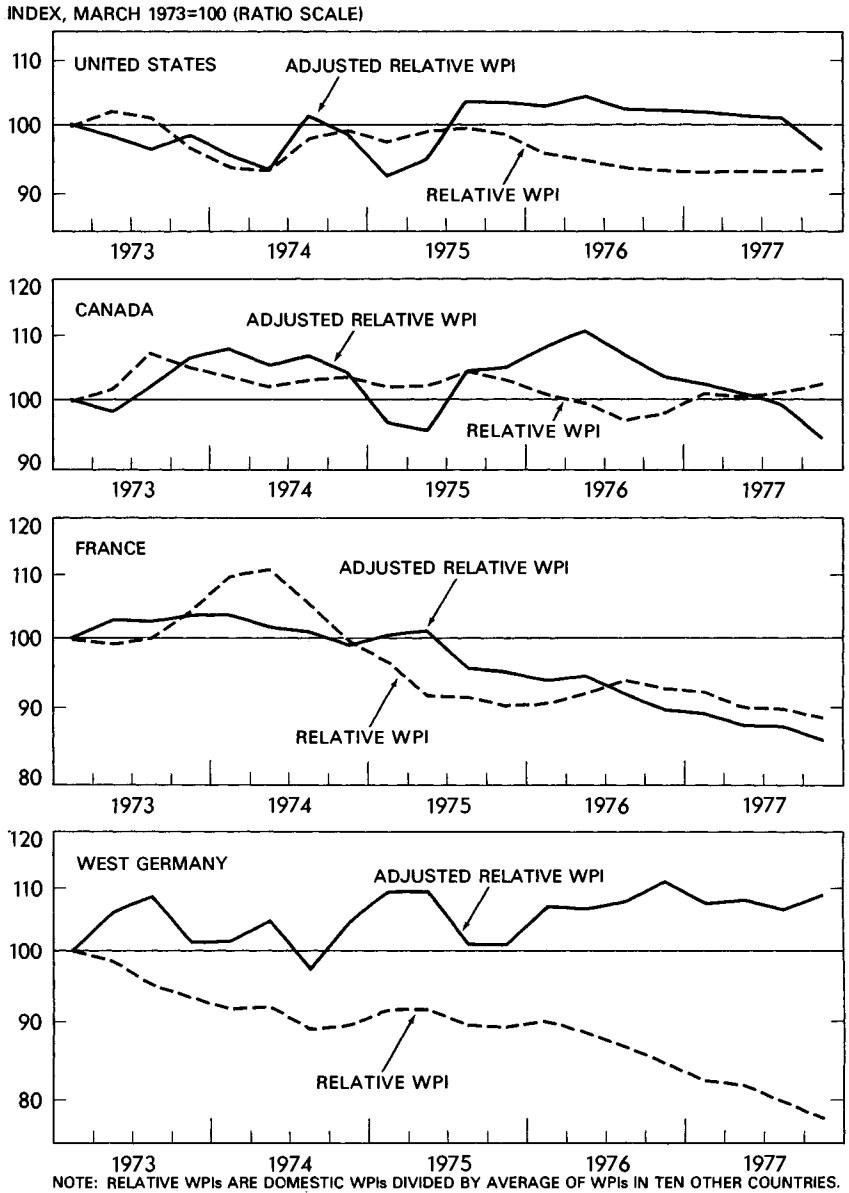
It is unlikely that intervention had a major lasting impact on exchange rates. The large volume of liquid funds in international financial markets and the one-sided risks that arise when central banks come into the market heavily on one side have meant that a large and continuing flow of intervention would be needed to keep rates from moving in response to changing expectations among managers of private foreign exchange positions. Thus the volume of intervention required to keep a rate from moving is not a reliable indicator of how far the rate would go if it were permitted to adjust freely. When the Bank of England suspended its massive intervention on October 31, 1977, the pound moved to a level only 1.8 percent higher against a weighted average of foreign currencies than the level at which it had been held. Even with the later weakness in the dollar the weighted average pound was only 5.0 percent above its October level in mid-January. While intervention can be a useful tool in restoring order to exchange markets, substantially larger intervention than seen in 1977 would be necessary to have a large effect on rates for any time.

Eliminating most cumulative rate movements would not be desirable even if it were easier. Flexible exchange rates have been beneficial because they have helped to reduce the large changes in countries' relative price levels that would have occurred as a consequence of differential price movements among trading partners (Chart 8). Some significant and lasting changes in relative price levels have resulted from exchange rate changes, however. These changes have generally helped to reduce unsustainable current account surpluses or deficits.

It is not an indictment of flexible exchange rates that current account imbalances have continued to occur and in some cases have proved to be

Chart 8

Relative Wholesale Prices Unadjusted and Adjusted for Exchange Rates

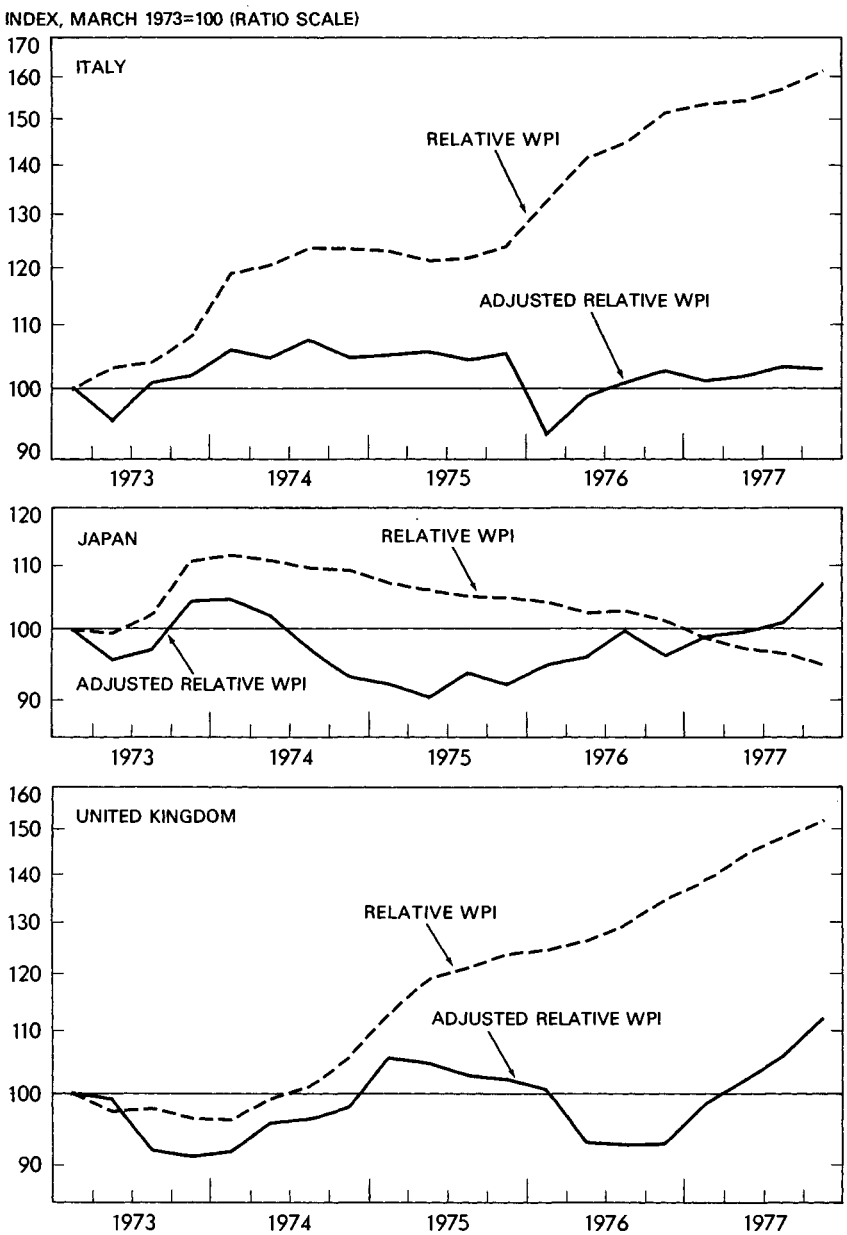


NOTE: RELATIVE WPIs ARE DOMESTIC WPIs DIVIDED BY AVERAGE OF WPIs IN TEN OTHER COUNTRIES. ADJUSTED RELATIVE WPIs ARE RELATIVE WPIs MULTIPLIED BY WEIGHTED AVERAGE EXCHANGE RATE OF DOMESTIC CURRENCY.

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

Chart 8—Continued

Relative Wholesale Prices Unadjusted and Adjusted for Exchange Rates



NOTE: RELATIVE WPIs ARE DOMESTIC WPIs DIVIDED BY AVERAGE OF WPIs IN TEN OTHER COUNTRIES. ADJUSTED RELATIVE WPIs ARE RELATIVE WPIs MULTIPLIED BY WEIGHTED AVERAGE EXCHANGE RATE OF DOMESTIC CURRENCY.

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

persistent. Not all imbalances can or should be dealt with through exchange rate adjustment. As noted above, it is normal and sustainable for some countries that have especially attractive investment opportunities to be capital importers, and therefore to have a deficit while others have surpluses. In addition, the aggregate deficit that is the counterpart of the OPEC surplus cannot be eliminated by exchange rate changes, although exchange rates can play a role in allocating this deficit among countries.

Finally, while exchange rate changes can have a significant impact on current account balances after 1 to 2 years, their effect initially may be perverse, since the strongest immediate effect of an exchange rate change is to raise many import prices and thereby increase the size of the deficit. This fact has two important implications. First, if imbalances seem to be temporary—owing to demand conditions that are likely to be reversed or to supply disruptions such as droughts—expectations will not be changed, and such imbalances normally will be financed by private capital flows. Exchange rates need not change. Second, when exchange markets are orderly and functioning efficiently, exchange rates will respond quickly, even abruptly, whenever it becomes clear that a country's underlying position has moved away from what is sustainable over the longer term. Once exchange markets have moved to reflect the new assessment, a return to exchange rate stability is possible even though the adjustment in trade flows may take considerable time. Capital flows can be expected to finance imbalances during the period of transition without the need for significant changes in interest rates.

The Administration's policy toward dollar exchange rates has been to let market forces determine them but to intervene when necessary to counter disorderly market conditions. This approach is based on the view that it is better to give market forces continuous influence on rates, rather than to have a period of officially determined rates followed by a sharp and disruptive adjustment. The historical experience with attempts to fix exchange rates is not an enviable one. Such policies more often than not sustained inappropriate exchange rates rather than correcting the underlying values of currencies; more often than not they generated large private capital flows that led to serious dislocations in financial markets and spilled over to affect other policy objectives.

While the Administration does not believe it is appropriate to maintain any particular value for the dollar, it recognizes its responsibility to act forcefully when market conditions become disorderly. Many managers of private foreign exchange positions normally help to stabilize the market by adjusting their positions on the basis of careful assessments of factors affecting currency values over the medium term. These managers tend to cover more of their foreign exchange exposure in the face of the increasing risks associated with market disorder. Rates are buffeted by the flow of commercial transactions and the buy and sell orders of traders whose time horizon is measured in days or at most weeks. Under these circumstances, intervention can help to restore

markets to their normal functioning. It is not the objective of such intervention to maintain a particular rate. To fix a rate would endanger the leeway that a flexible exchange rate system has provided for countries to pursue domestic objectives.

In summary, while exchange rate fluctuations sometimes have been undesirably large and are often unpleasant reminders about unsatisfactory aspects of underlying economic conditions, the evolution of the system of market-determined exchange rates has been a major achievement of this decade.

Macroeconomic Policy and Current Account Adjustment

In setting policies to achieve domestic objectives, authorities must consider the strong two-way interactions between domestic growth and inflation on the one hand, and the current account balance and exchange rate on the other. Going one way, stronger domestic demand tends to result in a larger current account deficit within a short time. Going the other way, an increase in the current account balance resulting from an exchange rate change or external factors will raise domestic output and employment.

In considering policies to achieve domestic goals, authorities sometimes find that policies appropriate for achieving domestic objectives also move the current account toward a more sustainable position. At other times, they face a dilemma. Two easy cases present no dilemma. One of these occurs when a country is falling short of its domestic goals and has a current account balance that is in surplus. Authorities should then view the current account position as an additional signal to adopt expansionary measures. The second easy case occurs when demand threatens to strain the potential of the economy. A current account deficit then reinforces the need to adopt restrictive measures. In both cases current account adjustment may take place without sacrificing domestic objectives and with policy actions reducing the need for exchange rate adjustment.

The dilemma arises when there is conflict between domestic goals and the requirement for the current account to be maintained in a sustainable range. This may occur when an economy with inflationary demand pressures has a surplus. In the world economy today, however, nations more often face the dilemma of a sluggish economy with an unsustainable current account deficit. In this case, the appropriate response is to use domestic fiscal and monetary policy to attain domestic objectives, while allowing exchange rate adjustment to restore sustainable external positions. Especially for large countries like the United States, where the economic cost of changing domestic growth is large relative to the improvement in the current account that would result, it is not appropriate to modify domestic objectives for economic growth in order to reduce the current account deficit.

A second way in which macroeconomic policy can affect the external balance is through a shift in the mix of policies. Thus a country might shift to a tighter monetary policy and a more expansionary fiscal policy when

faced with a large current account deficit and a weak currency. In principle, such a change in the policy mix could be made with an unchanged GNP growth target. If investment were undesirably strong, and if it were thought that the current account deficit would soon improve, such a change in the mix of policies might be appropriate. In practice, however, differences in the lags with which each policy works and the uncertainties surrounding their effects make a shift of this kind difficult to achieve. Such policies also have effects on the composition of demand and output. First, to the extent that they strengthen the currency they reduce exports and increase imports with a significant time lag. Second, they tend to shift demand away from private investment and toward other forms of spending, thus reducing the rate of capacity growth.

It should be noted that allowing exchange rates to adjust when a country's domestic objectives and external positions are inconsistent has effects on the domestic economy that must be taken into account in setting domestic objectives and policies. Appreciation of a country's exchange rate tends to depress demand. Depreciation tends to add to inflationary pressures by raising import prices, and to reduce real incomes as imports become more expensive.

Thus, when exchange rate changes do occur, they must be supported with monetary and fiscal policy if an unchanged domestic growth target is to be met and if the full adjustment of the current account is to be realized. Countries with appreciating currencies will face a slowing of demand growth as exports are reduced and imports rise. If these effects are not offset by stimulative policies, the economy will slow and some of the potential adjustment will not be realized, since import growth will be retarded along with the slowing of domestic demand. Countries with depreciating currencies will experience a stimulus to demand that may also have to be offset. Whether the adjustment of policies should be greater in countries with appreciating or with depreciating currencies should depend on whether the countries are undershooting or overshooting their internal goals for output and employment.

It should also be noted that adjustment through exchange rate movements succeeds only if the improvement in competitiveness of countries with depreciating currencies is not undone by higher wage and price increases to maintain workers' purchasing power or to obtain higher profit rates. In those economies where such wage and price adjustments are rapid and nearly proportional to exchange rate changes, gains in competitiveness from exchange rate depreciation evaporate quickly. Adjustment through exchange rate change is much more difficult and costly in terms of inflation. Such countries may be forced to accept depressed demand as the only effective way of reducing a deficit. Hence structural measures by authorities that retard the pass-through of import price increases into domestic prices and wages have a high payoff in allowing less costly external adjustment.

Strengthening International Financial Institutions

Private financial institutions have been the main source of financing for the large current account deficits since the oil crisis—accounting for roughly three-fourths of the total flows from 1974 to 1976. During this period, current account deficits totaled $225 billion, and countries in deficit borrowed over $300 billion. Some inflows, particularly in industrial countries, have been a private response to market incentives. A large share of the financing for many countries, however, has been raised by governments or by government-controlled corporations from private international banks. Private and official net borrowing from international banks by countries in deficit totaled an estimated $160 billion over the 1974 to 1976 period. These banks in turn received funds directly or indirectly from countries in surplus. Funds raised by countries in deficit from other private sources, including international bond issues and direct investment inflows, totaled about $100 billion.

About one-fourth of all current account financing, or more than $50 billion, was financed through official credits. These credits have played a crucial role in the overall financing process by providing assistance to countries with limited access to financial markets. Without official financing a number of countries would have been forced to take overly drastic measures and reduce their current account deficits at an excessively rapid pace. Such measures would have been disruptive to their own economies and to the world trading system. Moreover, in the absence of official financing, deficits would become concentrated in fewer countries. Some countries that have been able to meet their needs from private markets would find their access to private credit jeopardized by larger deficits. Thus the availability of a continuing flow of official financing to countries has been essential to the stability of the world financing system and to the continued flow of financing through private financial institutions.

Two long-established sets of multilateral institutions have played a major role in providing financing during the recent period: the international development banks and the International Monetary Fund. The international development banks—the World Bank group and regional development banks—provide financing for sound development projects and assist developing countries to formulate appropriate development strategies. In doing so they help meet countries' overall financing needs while fostering investment in productive activities that will generate the funds needed to service the debts. Their new credits totaled $9.2 billion in the year ending June 30, 1977. These institutions had more than $60 billion in loans outstanding then.

Part of the resources of these institutions are provided by governments in the form of capital subscriptions and direct contributions. For their nonconcessionary activities, however, the development banks rely heavily on securities issued in international markets and this reliance on debt has been increasing. In order to preserve their well-deserved reputation for prudent and sound financial management and their key role as a source of

capital to developing countries for productive long-term investment, an increase in resources contributed by governments is needed.

Strong U.S. support for the development banks is essential to their continued ability to assist developing countries. Through such support, the United States can both enhance the stability of the international financial system and respond to the needs of the developing countries. Moreover, U.S. resources devoted to these institutions are multiplied by contributions from other countries and by funds raised from markets. In 1977, legislation was enacted authorizing over $5 billion for increased U.S. participation in these institutions. Appropriations in support of the development banks for fiscal 1978 were $1.9 billion, an increase of 70 percent over the year before. This demonstrates strong U.S. commitment to these institutions, but further large sums will be needed in the years ahead to maintain their strength.

The International Monetary Fund was established at the end of World War II specifically to augment the resources available to finance temporary payments imbalances in a par value system of exchange rates. While the nature and circumstances of countries' needs have been altered by the introduction of more flexible exchange rates, the need for official financing of deficits has continued. A country that draws on Fund resources must satisfy conditions laid down by the Fund to assure that policies are consistent with adjustment of the country's external position. The goals are a current account that is sustainable without continued official support and repayment of the drawing. Thus the operations of the Fund not only finance deficits but also constructively influence policies.

The large current account imbalances since 1974 have resulted in heavy demands on the Fund. It provided about $15 billion of financing in the 1974–76 period. The IMF has also found it necessary to broaden its view of appropriate adjustment. Whereas the previous expectation had been that adjustment could take place and drawings could be repaid within 3 to 5 years, it has not been possible to eradicate the aggregate oil deficit so quickly. The IMF membership has responded to the new circumstances by increasing the resources of the Fund's general account and raising the limitations on countries' drawings. In addition, a temporary "oil facility" was set up in 1974 to help countries meet their larger oil bills. The resources for this facility, which concluded its lending program in 1976, were provided primarily by oil-exporting countries, but several industrial countries also contributed substantially.

As OPEC countries have continued to pile up assets, a continuous flow of new financing has been needed. The IMF's usable resources have fallen to about $5 billion, with another $3 billion available from larger countries only for lending to other large countries under the General Arrangements to Borrow. These resources will be increased by another $6 to $7 billion when the sixth quota review has been ratified by enough member governments. Even with these additions, however, the Fund's resources will be in-

adequate to assure available financing for those countries that need it. Moreover, there is a particular need for long-term funds.

To meet this need the decision was made to seek to establish the Supplementary Financing Facility, which initially would have about $10 billion provided by seven industrial countries and seven OPEC members. These funds would be available over the next 2 to 3 years to countries whose balance of payments needs exceed the amount available under the IMF's regular policies and require a longer period of adjustment than provided for under regular IMF policies. Borrowing countries must undertake to adopt corrective economic policy measures to deal with their balance of payments problems. When established, the Supplementary Financing Facility can make an important contribution to the stability of the international financial system for the next several years.

There will be a continuing need for growth in IMF resources, however, even if the Supplementary Financing Facility is established. Discussions are now under way in a seventh review of quotas. A further increase in quotas will be required to ensure that the IMF has sufficient resources to meet the legitimate demands on it over the longer term.

TO ACHIEVE GREATER STABILITY OF COMMODITY PRICES

The central role of food, fuel, and other raw materials in the domestic and world economies in recent years has been noted in every chapter of this *Report*. Although price fluctuations are always the norm, commodity prices have shown more than normal volatility over the last 5 years. The 56.4-percent rise in *The Economist* index during 1973 was the largest rise in the last 80 years. Nonfuel commodity prices have leveled off since 1974, but the economic aftershock and fears of renewed bursts continue to be of concern today.

The increased volatility of commodity prices has caused serious economic dislocations in virtually all countries. In consuming countries, rising commodity prices in 1973 and 1974 were reflected in final product prices, fueling an inflationary wage-price spiral. Yet because of asymmetries in response, the subsequent decline in several key commodity prices did not evoke a comparable downward movement of wages and prices. Periodic declines in the prices of certain commodities over the past few years placed severe external constraints on developing countries that derive a substantial fraction of export earnings from sales of those commodities. Consequently, these countries have borrowed heavily on world markets and have been forced to curtail their purchases of goods from industrial countries in an effort to conserve their foreign exchange reserves.

The Need to Reduce Volatility

Random variations in weather, cyclical movements in demand, and political disturbances, along with the relative insensitivity of supply and demand to price changes, have made sharp price movements the rule rather than the

exception for primary commodities. Private precautionary and speculative stockpiles and the development of organized commodity markets have in general allowed these fluctuations to be partially buffered. Private participants in these markets who sell their stocks when prices are relatively high and accumulate stocks when prices are relatively low exert a price stabilizing influence. The importance of these stocks is illustrated in the case of grains, where prices are more closely related to stock levels than to production flows (Chart 15, Chapter 5).

A reduction in the volatility of commodity prices would serve a number of useful purposes. Aside from the relatively modest advantage to consumers of having more predictable price movements, moderation of price fluctuations lowers inflation by reducing the impact of the asymmetries in the relationship between commodity prices and general inflation. Producers also benefit, as countries in which price movements in a single commodity have a major impact on national income can achieve more stable economies. Furthermore, a lower level of price volatility would reduce producers' risks and remove an important deterrent to the development of greater supplies. Finally, major price movements sometimes induce governments to introduce rigid price and income support programs, with the kinds of problems discussed in Chapter 5. Once introduced, these programs develop their own momentum and can engender a new set of inefficient and price-raising side effects.

Unfortunately commodity price stabilization is neither politically easy nor economically costless. The economic costs of stabilization schemes are often paid through direct government outlays. Alternatively, the costs of stabilization may be paid directly by consumers through higher average prices. Some types of programs require capital outlays that could otherwise be used for investment in productive equipment. The benefits of any proposed program to reduce volatility must be weighed against these costs.

One price stabilizing technique is to encourage large stockholdings by the private sector. In the United States this is done for grains by subsidizing interest and storage costs, as in the Administration's farmer-held reserve discussed in Chapter 5. The costs are direct budgetary outlays that can be compared to the benefits of holding larger stocks. Outside of agriculture the United States has no major programs to encourage stockholding; but some European countries have instituted tax preferences for inventories, thereby encouraging larger commodity stocks and smaller price fluctuations.

Publicly held buffer stocks are another widely recognized stabilization tool. These usually require purchases and sales of the commodity to defend predetermined floor and ceiling prices within the limits of available financial resources or commodity stocks on hand. The effectiveness of such programs depends largely on the financial resources available for the programs, and on the rules governing the prices at which buffer stocks are bought or sold. In international discussions the United States has therefore favored pure

buffer stock programs, which, if properly designed, would not raise the average of the price over time.

Commodity stabilization programs may include production and export controls to defend established price floors. While direct budget outlays are thereby avoided, systems involving production controls are likely to involve serious economic inefficiencies. While the ability of a buffer stock to affect prices is limited by its financial resources, production and export controls can indefinitely hold prices higher than they would be without them. Because the productive potential is unused rather than used to build buffer stocks, such programs can prevent prices from falling, but they cannot be used effectively to keep prices from rising.

Producers' vulnerability to sharp changes in income because of commodity price and quantity fluctuations can also be reduced through international efforts providing loans or grants to producer nations. Such transfers do not affect the price of commodities in the market place, but they can ameliorate the adverse impact of sharp price declines on producing countries. Compared to actions that raise the level of commodity prices, these compensatory measures are a more efficient and less inflationary way to transfer resources between countries. The Compensatory Financing and Buffer Stock facilities of the IMF and the STABEX system of the European Economic Community are operating at present to mitigate the impact of commodity price instability.

Recent Policy Developments

Since 1972, increased attention has focused on arrangements to stabilize commodity prices through internationally managed stockpile programs. International discussions under the auspices of the United Nations Conference on Trade and Development (UNCTAD) led in 1976 to enunciation of the UNCTAD Integrated Commodities Program. This program has provided the framework for discussions on a number of commodities of interest to the developing countries and on a "common fund" for international commodity agreements.

In 1976, and again in 1977, the idea of a common fund to provide additional financial support for international commodity agreements was a focal point of the North-South economic dialogue. As envisioned by the developed countries, the common fund would pool the resources of individual commodity agreements (ICAs) and enable those ICAs needing additional funds for stock accumulation to borrow through the common facility from other ICAs and from the private market. By pooling resources in a common fund, overall financial contributions by member nations to individual stockpiling agreements could be reduced because all ICAs would generally not be accumulating stocks at the same time. Moreover, because it would have broader-based financial backing, a common fund would probably find more ready acceptance in world credit markets than individual com-

modity agreements. The United States is prepared to participate in a common fund that is structured along these lines.

At the London Economic Summit in May 1977, the seven heads of state noted that it was their goal "to secure productive results from negotiations about the stabilization of commodity prices and the creation of a common fund for individual buffer stock agreements."

Developing countries envision a broader common fund financed by direct government contributions. Such a fund would serve as a source of finance for commodity agreements and would also supplement the functions of existing international financial institutions. Negotiations during 1977 were unable to bridge the conceptual gap between alternative versions of the common fund. However, negotiations will continue in 1978.

The United States attaches great importance to talks on individual commodities. While discussions on a common fund proceed, the United States is participating in talks involving several individual commodities. The United States joined the International Tin Agreement in 1976. Discussions on a commodity agreement for natural rubber, in which the United States has taken part, have made progress, and preliminary discussions on other commodities are getting under way.

Discussions on a system of nationally held wheat reserves, begun in June 1975 under the auspices of the International Wheat Council, are continuing in 1978. The United States favors a new International Wheat Agreement with a reserve system to replace the expiring agreement, which has no such provisions. In the U.S. proposal, each participating country would release or acquire reserve stocks at specified target price levels. Member consultations on additional measures would also be required in the event of extreme oversupply or shortage situations.

There were several major policy developments for sugar in 1977. In March the U.S. International Trade Commission (ITC) found, upon petition, that the domestic sugar industry was being threatened with serious injury by increased imports. It recommended a 5-year annual quota on sugar imports of 4.275 million tons. The President rejected the recommendation, however, and established an interim program of direct payments to U.S. producers. Congress later mandated a program to support the price of sugar in the U.S. market at a minimum of 13.5 cents per pound, but stipulated that it could be terminated if an international sugar agreement would achieve the same objective.

The Sugar Conference sponsored by the United Nations concluded an agreement in October 1977, which comes before the U.S. Congress for ratification early in 1978. The agreement sets minimum and maximum price targets of 11 and 21 cents, respectively. These targets will be defended through a system of export quotas and reserve stocks held by exporting countries. The carrying costs of the stocks will be financed through a fee levied against all sugar traded by member countries. Export quotas will remain in effect until

the world market price rises above 15 cents, a feature that may lead to production cutbacks after exporting countries have accumulated their mandated stockpiles.

This review of the analytical aspects of commodity price stabilization, alongside the reality of actual agreements, highlights critical issues of their design. On the one hand, policies to increase the size of private stockpiles or to develop public buffer stocks can help reduce long-run inflationary pressures. The history of the last 5 years has shown that drastic commodity price movements can hinder economic growth. Yet these commodity programs prevent prices from falling as stocks are acquired, and they absorb scarce capital in stocks that are essentially sterile outlets for a nation's savings. In addition, an agreement that restricts output will raise the long-run average price of a commodity and should be avoided. Higher long-run prices impose costs on commodity-importing developing countries that rank among the world's poorest nations. Alteration of the long-run price trend would also impair the ability of the price system to allocate resources efficiently. For these reasons, the United States will continue to give priority to pure buffer stocks as a price stabilizing technique. Each prospective commodity agreement must be examined in great detail to determine whether it contributes to or detracts from economic performance.

TO MAINTAIN THE GROWTH OF WORLD TRADE

Over the past 25 years world trade has grown more rapidly than world output, playing a key role in economic expansion by widening available markets for raw materials, industrial products, and agricultural goods. During this period the volume of world trade showed a fivefold increase—an average growth of 6.6 percent per year. This growth was facilitated by a major movement to reduce tariffs and other trade restrictions under the auspices of the General Agreement on Tariffs and Trade (GATT). The Kennedy Round of tariff negotiations, which was completed in 1967, resulted in an average reduction of one-third in the tariffs set by industrial countries on industrial products. The growth of world trade was also supported by the reduction of trade barriers on a regional basis, such as the elimination of tariffs within the European Common Market. In 1970 agreement was also reached on a generalized system of preferences for industrial countries' imports from developing countries.

The growth of world trade has slowed since 1974; trade volume was estimated to have expanded only 4 percent in 1977. The slower growth of trade is mainly attributable to the general weakness in the world economy. However, there has been a disturbing reversal of the trend toward trade liberalization; this development has also contributed to the slowing growth of trade. The GATT Secretariat has estimated that new restrictive trade measures have been imposed on 3 to 5 percent of world trade since 1974.

The worldwide pressure for protection from imports was also evident in the United States. In 1977 the ITC investigated petitions for import relief by over 20 industries, covering imports of nearly $5 billion. The ITC recommended increased protection in the form of tariffs or quantitative restrictions on $3 billion of trade, including shoes, color television receivers, mushrooms, and above-ground swimming pools.

The Benefits of an Open Trading System

Despite rising domestic pressures for protection from imports at home and abroad, the Administration remains committed to a policy of open markets for both U.S. exports and imports. The case for open markets and against import restrictions is strong. In an open trading system a country will export those goods it can produce at relatively lower cost than other countries and import goods that other countries can produce at lower cost. Countries thereby realize gains from trade that make possible higher levels of consumption and investment. Import restrictions reduce these gains. Through an open trading system the United States can obtain larger quantities of goods for consumption and investment than it could by restricting imports and diverting resources from export industries to import-competing industries.

In addition to reducing the gains from trade, the imposition of import restrictions has an immediate inflationary impact. Consumers pay higher import prices and usually higher prices for domestic substitutes as well. Competition from imports not only helps to keep prices down but fosters efficiency and responsiveness among domestic producers. For example, production of attractively priced American small cars has obviously been hastened by the availability of small, low-priced, fuel-efficient imports.

Import restrictions do not increase employment, even if potential retaliation against exports is ignored. As a result of decreased imports and higher domestic prices, there may be an increase in domestic output and employment in the industry that is granted protection from imports. But the higher prices associated with reduced import competition reduce real consumer incomes and hence tend to reduce real consumption and output. In the absence of changes in overall economic policy, the net effect of these opposing tendencies in the protected industry and in the rest of the economy is usually a *reduction* of real output and employment. Only in the rare instances when import protection results in very small price increases and very large import reductions will protective measures increase employment.

Responses to import restrictions will make the net employment reduction larger. Unilateral imposition of new tariffs or quotas invites retaliation through higher barriers for our exports. Indeed GATT rules allow tariffs to be raised on imports from a country that imposes unilateral trade restrictions. Induced upward exchange rate adjustment also decreases the demand for exports. Thus, in most cases, import protection has the effect of shifting

employment from dynamic export industries to contracting import-competing industries, while reducing aggregate employment.

Recent restrictions have primarily taken the form of quotas, import licensing requirements, and other nontariff barriers to trade. Quantitative restrictions are more damaging than equivalent tariffs to an open system of world trade. During recessions they provide less protection from imports at a time when business and labor are in a weaker position; during expansions they do not permit imports to play their role as safety valves, limiting sharp price increases when supplies are tight.

Dealing with Trade Problems

Although the advantages of an open trading system are widely understood, two conditions give rise to demands for protection. First, as markets evolve, countries lose comparative advantage in some products and gain comparative advantage in others. For example, as developing countries have entered markets for products that rely primarily on well-established technologies, the more advanced industrial countries have found their comparative advantage shifting to products using more skilled labor and more sophisticated technology. However, firms in industries that have lost markets to new competitors have capital in place, and their workers have specialized skills that make shifting to new industries costly for them. Their demands for protection from imports are often more effectively voiced than the demands of consumers for lower prices, even though the gains to consumers from an open trading system outweigh the costs to domestic firms and workers.

Second, excess capacity and high unemployment increase domestic sensitivity to competition from imports. Under these conditions, displaced labor and capital are less likely to be absorbed in industries where the United States has a comparative advantage. Moreover, imports that might have been considered a welcome supplement to limited domestic production in some industries during periods of high employment are blamed for domestic unemployment during periods of low utilization. Economic slack abroad also adds to trade tensions because it provides an incentive for some foreign producers to increase exports by cutting prices in the U.S. market. Selling abroad at less than home market prices constitutes grounds for assessing countervailing duties under GATT rules if the domestic industry is injured.

Adjustment assistance. The Federal trade adjustment assistance programs are designed to facilitate the adjustment of workers, firms, and communities injured by import competition. They provide readjustment allowances, training, and relocation payments for workers displaced by import competition. Technical and financial assistance is provided to affected firms, and public works money is allocated to trade-impacted communities. The Administration reviewed these programs in 1977 and is implementing a number of administrative improvements. A major effort has been undertaken to speed up and improve the delivery of assistance, and efforts have also been made to tailor assistance to the needs of particular industries.

Import relief. Problems created by rapid growth of imports in several industries were so acute that the Administration established temporary import restrictions. These restrictions were intended to provide an opportunity for the affected domestic industries to stabilize, to permit firms to take measures to restore competitive positions, and to allow for more orderly adjustment. In two major cases—footwear and color television receivers—where the International Trade Commission had found that increased imports were a substantial cause of serious injury to the domestic industry, the Administration decided to provide temporary import relief. Temporary orderly marketing agreements (OMAs), which are negotiated quotas, were established with major exporting countries. These OMAs will halt the rapid rise of imports and give domestic producers an opportunity to adjust to import competition over the longer term.

Steel trigger prices. Developments in the carbon steel industry presented the Administration with a particularly difficult trade policy problem. Steel industries throughout the world have been especially hard hit by the protracted weakness of economic activity in the industrial countries. Even under moderately optimistic assumptions about the growth of demand, excess steelmaking capacity is likely to persist through 1980.

The cost of production of steel in the United States rose by 89 percent over the past 5 years, according to a study by the Council on Wage and Price Stability (CWPS). The increase in costs was to a significant extent the result of developments within the industry itself. In part, they were the reflection of broader economic forces. Steel wages have risen 27 percent faster than the average manufacturing wage from 1972 to 1977. Raw material and energy costs—particularly coal—have shown very sharp price increases, while pollution abatement costs have risen sharply and will be an increasingly important component of costs in the future. According to CWPS, however, costs have also risen rapidly abroad and the domestic cost of production is not significantly above that of efficient foreign producers plus transportation and tariffs.

Poor domestic sales, reflecting sluggish demand and an increase in the import share, led to a drop in steel production in 1977. This development and other factors led to a series of layoffs and plant closings in 1977. These were concentrated in older steel plants in Ohio, Pennsylvania, and New York. This pattern was dictated by the desire of domestic firms to consolidate their operations in their most efficient installations. The timing and allocation of the layoffs were also affected by provisions in the new labor contract that will increase the cost of layoffs after 1977. The cost of meeting environmental standards at older facilities also played an important role. Thus, the layoffs reflected efforts by the industry to reduce costs over the long term, as well as to respond to the immediate problem of weak demand and import competition. Although several factors contributed to the layoffs, public attention focused on the problem of imports.

The industry filed a series of dumping cases in 1977, some of which led to findings that foreign steel was being sold in the United States below full

costs of production. In light of evidence that significant volumes of foreign steel may have been dumped, the Administration developed a program designed to respond to the problems of the steel industry. The centerpiece of the program is a system of trigger prices for steel imports, based on the cost of production in the most efficient foreign country—currently Japan. If imported steel is sold in the United States below the trigger price for that product, an antidumping investigation will be initiated immediately by the Department of the Treasury. The industry maintains the right to file petitions under the regular procedure. Nevertheless, it is hoped that the system will eliminate the necessity for anti-dumping actions.

The trigger price concept has significant advantages over alternative measures. Although in a static and certain world of perfect competition a trigger price, a quota, and a tariff that gave the same protection would have the same effects on prices, their effects differ in practice. A tariff that assured the same protection would have directly increased steel prices by more than the trigger prices will. A quota would have resulted ultimately in an even larger rise in the price of imported steel and reduced competition in steel markets; it would also have undermined incentives for domestic producers to control costs and prices. Under the trigger price system, domestic producers will continue to face foreign competition at prices that reflect the costs of effiicent foreign producers. If domestic steel prices are set to meet this competition, domestic producers should be able to regain the market share they lost in 1977.

Progress in Multilateral Trade Negotiations

The Administration has been working with foreign governments to reverse the worldwide slip toward more restrictions on imports and restore the trend toward trade liberalization. These efforts are centered in the round of multilateral trade negotiations now being held in Geneva. After being stalled for some time, the negotiations made significant progress in 1977 with agreement among the major participants on key procedures that will guide the negotiations during 1978. A working hypothesis was developed calling for an average reduction of tariffs on industrial products of about 40 percent. Procedures were established for participants to exchange requests for the reduction of agricultural tariffs and of specific industrial and agricultural nontariff barriers to trade. Draft texts aimed at improving international trading rules were prepared for use as the basis for further negotiation. In January 1978 countries are exchanging specific offers for reductions of tariff and nontariff barriers. This exchange marks the beginning of the final phase of the negotiations.

The trade negotiations are being conducted under difficult conditions in the world economy. These same conditions make it essential that agreement on significant liberalization be reached, however, so that further steps toward protection can be averted, the dynamism of world trade can be restored, and the potential contribution of trade expansion to overall economic growth can be realized.