

CHAPTER 4

The World Economy—Testing Resilience

ABROAD, JUST AS AT HOME, oil price increases dominated economic developments in 1979. Both the sharply higher price for oil and the likelihood that oil supplies will continue to be uncertain in the intermediate future raise difficult questions for economic policy in all countries. Substantial adaptations within and among the world's economies are needed to respond to the changing energy situation.

Improvement in economic performance during 1978 had provided a solid base for further expansion in 1979. Outside the United States, inflation pressures had eased somewhat. Growth had begun to increase, partly in response to the less restrictive policies that the declining inflation made possible. As a result of previous changes in exchange rates as well as the altered pattern of relative growth among the United States and the major foreign countries, external imbalances were diminishing rapidly. Actions in November 1978 to strengthen and stabilize the dollar helped to reduce uncertainties in financial markets.

Other circumstances also favored continued expansion abroad in 1979. Declining real oil prices during 1978 and the appreciation of most currencies against the dollar had improved the terms of trade for many countries. The resulting gain in real incomes began to be reflected in higher spending in late 1978 and early 1979. With diminishing margins of spare productive capacity, strengthening profit positions, and improving business expectations, investment demand recovered sharply. Trade volumes also grew at a higher rate than had been generally expected despite a virtual collapse in exports to Iran.

Developments in oil markets, however, began to pose a growing threat to continued economic progress. In December 1978 the Organization of Petroleum Exporting Countries (OPEC) announced a schedule of gradual price increases to raise the average price of crude oil from about \$13 per barrel to about \$14.50 by the end of 1979. Following the temporary interruption of Iranian supplies, official OPEC selling prices rose sharply and prices in spot markets soared even further. With continued tightness in oil markets, stemming in part from a large inventory buildup by consuming countries,

world oil prices reached an average level of about \$28 by early January 1980.

Thus in the course of 13 months oil prices have more than doubled. The additional payments for oil imports resulting from this price rise represent just over 2 percent of the combined gross national product (GNP) of the industrial countries. Measured in this way the oil shock of 1979 is fully as large as that of 1974.

The dimensions of the 1979 price increase raise the question of whether the 1974-75 pattern of global recession and increased inflation will be repeated. There are a number of similarities in the two situations.

First, direct transfer of purchasing power from oil consumers to oil suppliers can be expected to lead consumers to spend less on other goods and services. As in 1975, this reduced consumer spending will not be replaced fully in the near term by increased purchases by the oil-exporting countries. On the contrary, internal conditions in a number of these countries suggest that the expansion of imports in response to higher revenues will be less rapid now than in 1974-75.

Second, as discussed in Chapter 2, the policy dilemma that became apparent in 1974 reappeared in 1979. Large oil price increases depress demand, output, and employment. But by sharply raising consumer prices, they also threaten to set off a new wage-price spiral as workers and other income recipients seek to prevent a reduction in real income. Stimulative fiscal and monetary measures designed to prevent the adverse effects on output and employment increase the likelihood that the oil price rise will become embodied in wages and other costs, and thus in underlying inflation. On the other hand, restrictive fiscal and monetary policies aimed at preventing a spillover of oil price increases into a more general inflationary surge exacerbate the harmful effects of the higher oil prices on output and employment.

Third, international financial markets will once again need to recycle very large flows of funds from OPEC countries to countries with current account deficits. While the 1974-75 experience demonstrated the versatility and flexibility of these markets, serious strains may still emerge.

There are also major differences between the current situation and the 1974-75 oil price shock. In one respect the situation is now more difficult. Following the rise in oil prices in 1974, the oil market began to ease and from 1975 to 1978 a buyers' market prevailed. An extended easing is less probable in the current situation since moderate reductions in the demand for oil may be matched by reduced supplies. Sustained price weakness is not likely unless rapid and substantial conservation can be achieved.

In other respects, however, the situation is somewhat more hopeful. Perhaps most important, there is now substantially less aggregate demand pressure on overall capacity and on labor markets than in the earlier period. All countries had reached cyclical peaks more or less simultaneously in early 1974, and clear signs of overheating had emerged. Inventory building in particular had become marked by speculative excess. In order to counter aggregate demand pressures, government policies had turned sharply toward restraint. The shock of rising oil prices reinforced these other tendencies toward weakness, and together they produced a global recession in 1975. The close synchronization of economic activity across countries in 1974–75 also intensified the transmission of recession from one country to another through rapidly declining world trade.

Currently elements of cyclical strength persist in a number of countries. Signs of a speculative surge in inventory building have not appeared, and prospects are good that a large inventory cycle can be avoided. Continued growth in a number of the larger countries—albeit at a much reduced rate—will help to sustain world trade in the face of weakening activity and imports in the United States; hence the secondary repercussions on growth from declining trade will be less pronounced.

Moreover a good deal has been learned since 1974. The major countries recognize more clearly the nature of the constraints imposed by the rise in oil prices. In at least some countries labor market participants appear to have recognized that higher oil prices cannot be fully compensated through higher nominal wages. A “wage explosion” like that in many countries during 1974 is therefore less likely. Government policies, too, seem better prepared to limit the spillover effects from the oil market, while avoiding the sharp swings of fiscal and monetary policy that characterized the earlier period. Finally, the mechanisms for gaining international cooperation and policy coordination have been strengthened since 1974, though much more can be done in this regard.

Although oil price increases and the problems they bring dominate the current economic scene, they cannot be viewed in isolation from other developments in the international economy. Appropriate policies in trade, international financial relations, and energy can make it easier to adjust to the rise in oil prices. Conversely if protectionist trade actions multiply, if energy policies work at cross-purposes, or if financial markets become disrupted, then overall economic performance will be that much worse.

The remainder of this chapter examines the direct economic aspects and policy implications of the oil price rise and then considers some broader questions of managing international economic interdependence.

The first section discusses recent and prospective overall economic performance in the industrial world and explores the challenges for fiscal, monetary, and energy policies to manage this performance.

The second section discusses recent developments in the international financial and monetary system. Three topics are of particular importance: the emerging pattern of international payments and the problem of recycling the OPEC surplus to finance the deficits of developing countries; the evolution of a system of "managed floating" exchange rates among major currencies; and the longer-run role of the dollar as the principal international reserve asset and medium of exchange.

The final section discusses trade and trade policies, focusing on the process of adjustment to changing patterns of comparative advantage.

DEVELOPMENTS IN MAJOR INDUSTRIAL ECONOMIES

Despite the sharp rise in energy prices, average GNP growth for the six major industrial countries other than the United States was about 4 percent in 1979, roughly unchanged from 1978. The momentum of growth appears to have been surprisingly well maintained into the second half of the year in most foreign countries. While virtually all forecasts suggest that growth will slow sharply this year, clear signs of a general weakening have not yet emerged.

Inflation rates in 1979, as measured by the personal consumption deflator, averaged about 7 percent for this same group of countries, a moderate increase from 1978. During the course of the year, however, inflation accelerated sharply as higher oil prices began to work their way through these economies.

The most recent projections by the Organization for Economic Cooperation and Development (OECD) are that the average growth of GNP for these six countries will fall to about 2½ percent in 1980 and that inflation will rise to about 9 percent (see Tables 26 and 27). The further increases in oil prices that have occurred since this projection suggest that these forecasts understate the extent to which economic performance is likely to deteriorate.

TABLE 26.—Growth in real GNP in major industrial countries, 1978–80

[Percent change]

Country	1978	1979 ¹	1980 ²
United States.....	4.4	2.3	-0.6
Japan.....	5.6	6.0	4.8
Germany.....	3.5	4.3	2.3
France ³	3.3	3.0	2.0
United Kingdom ³	3.3	.5	-2.0
Italy ³	2.6	4.0	2.0
Canada.....	3.4	2.8	1.5
Average excluding United States ⁴	4.1	4.1	2.6

¹ Preliminary.² Forecasts by OECD and Council of Economic Advisers.³ Data are for real gross domestic product.⁴ Based on 1978 GNP/GDP weights and exchange rates.

Sources: Department of Commerce (Bureau of Economic Analysis), Organization for Economic Cooperation and Development (OECD), and Council of Economic Advisers.

GROWTH IN 1979

The fact that growth abroad remained strong while our own growth was slowing stems in part from differences in the earlier pace of recovery. Through mid-1978, economic recovery from the global recession of 1974–75 was far more complete in the United States than in most other industrial countries. For that reason economic policies here and abroad moved in different directions. In the United States, where unemployment had fallen to a relatively low level and inflationary pressures were intensifying, a shift toward more restrictive monetary and fiscal policies was made. In a number of other countries, particularly Germany and Japan, policies to promote faster growth were set in motion.

TABLE 27.—Inflation in major industrial countries, 1978–80

[Percent change in prices¹]

Country	1978	1979 ²	1980 ³
United States.....	6.8	8.9	9.0
Japan.....	4.5	3.3	7.3
Germany.....	2.6	4.5	5.0
France.....	9.3	10.8	11.5
United Kingdom.....	8.3	12.3	15.5
Italy.....	12.1	14.8	16.5
Canada.....	7.3	8.5	8.5
Average excluding United States ⁴	6.1	7.1	9.2

¹ Change in implicit price deflator for private consumption expenditures for United States, Japan, Germany, United Kingdom, and Canada. Change in consumer prices for France and Italy.² Preliminary.³ Forecasts by OECD and Council of Economic Advisers.⁴ Based on 1978 GNP/GDP weights and exchange rates.

Sources: Department of Commerce (Bureau of Economic Analysis), Organization for Economic Cooperation and Development (OECD), and Council of Economic Advisers.

Perhaps the most important factor accounting for higher growth abroad in 1979, however, was the recovery in private investment,

which had been unusually weak since 1974. A pent-up demand for replacement investment and capacity expansion had developed because of low rates of investment over the preceding several years. Consequently, when business firms perceived a moderate improvement in the prospects for overall demand, investment responded rapidly. The recovery of investment was reinforced by improving profits and higher cash flows for enterprises. A substantial part of the gains in the terms of trade experienced by the major foreign industrial countries during 1978 apparently accrued to businesses in the form of higher profits, since the relative decline in the prices of imported goods was only partly passed through to final consumers. The generally moderate rise in wages in both 1978 and early 1979 also worked to strengthen profits. Profit positions were further improved in a number of countries by a sharp rise in productivity as output expanded.

The acceleration of growth in the second half of 1978 and the first half of 1979 was accompanied by an even sharper acceleration in the growth of imports. Import volumes, which had increased at an average rate of about 4 percent for the six major foreign industrial countries during the preceding year, grew by more than 11 percent over the year from mid-1978 to mid-1979. This more rapid increase in imports reflected not only higher final domestic demand but also a rise in inventory accumulation and, for Japan, the appreciation of the yen during 1978. The principal beneficiaries of this strengthened demand for imports were the United States and a number of the smaller countries of the OECD.

During the second half of last year, imports by the major foreign countries slowed; and their exports accelerated, primarily because of the rapid growth of purchases by the oil-exporting countries. The continuation of relatively rapid growth abroad in the face of the growing burden of higher oil prices is explained in large part by this strengthening of net exports. Another factor is that abroad as well as in the United States consumers apparently reacted to accelerating inflation by reducing personal saving rates, so that consumer demand slowed less than personal income.

It is difficult to judge whether the growth momentum that had become established abroad would have been sustained in 1980 if oil prices had not risen. Outside Germany, Japan, and a few smaller countries, inflation rates were still very high. Because they probably would have begun to increase, a strong recovery might have been difficult to sustain in any event. The serious structural problems brought on by rigid labor markets and other resource immobilities continue to limit the degree to which full capacity utilization can be approached without serious inflationary repercussions.

INFLATION IN 1979

With oil prices rising sharply, inflation increased everywhere. Table 28 shows the rate of consumer price increases during 1978 and 1979 in major countries. An attempt has been made to separate the changes in prices into energy and other components. For comparison, import unit values are also shown.

TABLE 28.—Changes in consumer prices, with and without energy, and import unit values, major industrial countries, 1978–79

(Percent change, annual rate ¹)

Country and item	Dec. 1977 to June 1978	June 1978 to Dec. 1978	Dec. 1978 to June 1979	Latest 3 months over preceding 3 months	Latest month (1979)
United States:					
Consumer prices ²	8.5	7.7	11.0	10.3	December
Energy ³	7.7	8.5	43.6	23.4	
Other.....	8.7	7.3	8.1	8.5	
Import unit value.....	17.2	5.0	24.2	36.2	November
Japan:					
Consumer prices.....	3.8	3.2	4.2	6.7	September
Energy ⁴	-5.6	-11.7	31.6	50.2	
Other.....	4.4	4.2	2.4	3.9	
Import unit value.....	-9.8	-12.3	63.2	73.8	October
Germany:					
Consumer prices.....	1.9	2.9	4.7	7.4	September
Energy ⁴	2.1	9.4	32.8	30.2	
Other.....	1.9	2.4	2.7	⁵ 5.8	
Import unit value.....	-2.2	-1.6	23.4	18.8	September
France:					
Consumer prices.....	9.6	9.7	10.7	12.6	September
Energy ⁴	10.3	14.2	17.3	30.8	
Other.....	9.5	9.3	10.1	10.9	
Import unit value.....	1.2	2.7	18.1	23.8	September
United Kingdom:					
Consumer prices.....	6.4	10.2	12.5	33.4	September
Energy ⁴4	8.0	18.1	82.4	
Other.....	7.0	10.4	11.9	⁵ 28.4	
Import unit value.....	2.9	6.0	10.1	8.9	September
Italy:					
Consumer prices.....	11.5	11.6	15.6	18.5	September
Energy ⁴	11.5	.0	8.1	⁶ 61.0	
Other.....	11.5	12.4	16.1	15.5	
Import unit value.....	6.8	8.1	25.2	35.9	September
Canada:					
Consumer prices.....	8.7	8.1	9.5	7.1	September
Energy ⁴	7.2	10.2	7.1	10.3	
Other.....	8.9	7.9	9.8	6.7	
Import unit value.....	11.0	16.7	6.6	30.6	October

¹ Consumer prices are seasonally adjusted; import unit values are not seasonally adjusted.

² Consumer prices with rent substituted for home ownership.

³ Gas (piped) and electricity; fuel oil, coal, and bottled gas; and gasoline, motor oil, coolant, etc.

⁴ Fuel and light and gasoline.

⁵ Reflects increases in value-added tax rates in these countries.

⁶ Fuel and light only.

Note.—All data for breakdown of consumer prices between energy and other are estimates.

Sources: Department of Commerce, Department of Labor, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

While it is not possible to distinguish precisely between “internally” and “externally” generated inflation, a substantial part of the declining inflation abroad in 1978 can be traced to the relative modera-

tion in import prices during 1978. This moderation resulted not only from the stability of dollar prices of oil and primary commodities but also from the appreciation of most currencies against the dollar. Conversely the sharp acceleration in inflation in 1979 predominantly reflects the turnaround in import prices, a development exacerbated in Japan by the sharp depreciation of the yen.

The judgment that the domestic component of inflation in most countries did not accelerate much in 1979 is borne out by the behavior of wages, which have risen at a relatively constant rate in most countries (see Table 29). One exception is Italy, where widespread indexation (the *scala mobile*) leads inevitably to a rapid transmission of higher prices into wages. In the United Kingdom very sharp wage increases in new contract settlements signed in October may also signal an acceleration in wages, though the evidence is still scanty. Domestic cost pressures in most countries outside the United States were also eased by relatively strong productivity growth.

TABLE 29.—Changes in wages in major industrial countries, 1978–79

[Percent change]

Country	Change from same period a year earlier to				Latest month (1979)
	1978 1st half	1978 2nd half	1979 1st half	1979 latest 3 months	
United States.....	7.9	8.3	8.0	8.0	December
Japan.....	7.9	6.3	4.4	7.0	October
Germany.....	5.5	5.6	4.9	4.8	October
France.....	12.6	12.7	12.7	12.2	June
United Kingdom.....	13.2	15.6	14.5	15.1	October
Italy.....	17.3	15.6	17.0	20.8	September
Canada.....	7.4	7.4	9.1	9.3	July

Source: National sources.

THE RESPONSE OF ECONOMIC POLICY TO RISING OIL PRICES

The mechanism through which increases in OPEC oil prices reduce growth and worsen inflation is well understood and is much the same in all countries that rely heavily on imported oil.

Higher prices for imported oil raise the prices of petroleum products directly and also increase the costs and prices of goods and services requiring petroleum for their production. Consumers suffer a real income loss. The result is equivalent to a rise in excise taxes, hence the term "OPEC tax." Except temporarily, this tax cannot be offset by increases in nominal wages; such increases, when they occur, tend to lead not to a restoration of real incomes but to a rise in other prices, a sequence that builds the increase in oil prices into the underlying inflation rate.

In the longer run the loss in real income resulting from the OPEC tax need not result in a weakening of aggregate demand. To the extent that the higher receipts of OPEC countries lead to a commensurate increase in their demand for goods and services, aggregate demand would be unaffected. Lower real spending by consumers of petroleum products would be offset by stronger exports. Jobs lost in the consumer goods industries would be replaced by new jobs in export industries. Indeed, by 1978 the industrial countries as a group were exporting sufficient goods and services to the oil-producing countries to pay in full the tax imposed on them by the 1974 rise in oil prices.

In the short run, however, OPEC's imports will not increase as rapidly as its receipts. Indeed, as discussed in more detail below, it appears probable that the gap between OPEC receipts and expenditures that has now reappeared will remain very large for a number of years.

The adverse effects on aggregate demand of the current rise in oil prices could be offset, at least in the short run, by changes in private spending. For example, while the "oil tax" caused economic growth in the United States to decline in 1979 by more than had been expected early last year, the drag on the economy has been softened by a drop in the personal saving rate. A similar though less marked decline has occurred elsewhere. This decline may not be sustained, however. Historically, the greater uncertainty associated with higher inflation, the increased job insecurity resulting from adjustment to the higher oil prices, and the desire of consumers to restore the real value of financial wealth that has been eroded by inflation have all induced more cautious behavior by consumers.

Policy responses of most countries during the past year have not compensated for the OPEC tax. On the contrary, fiscal and monetary policies have shifted toward restraint. Germany and the United Kingdom both raised value-added tax rates during the course of 1979, though in the United Kingdom this was partially offset by reductions in income taxes. Almost everywhere, government deficits in 1979 were smaller than had been projected at the beginning of the year. Planned budgets for 1980, furthermore, are generally more restrictive than those of last year, Italy being the principal exception.

Monetary policies were also tightened during 1979 in all major countries. Short-term interest rates abroad rose by over 500 basis points on average during the year as monetary authorities attempted to maintain growth of the monetary aggregates within target ranges in the face of rising inflation. The fact that these target ranges were not changed implies in itself greater monetary restraint on real growth, since price levels are higher now because of the oil price rise

than had been expected when the targets were set. A number of countries have announced lower targets for growth of the monetary aggregates for 1980.

The major reason for pursuing relatively restrictive economic policies is the overriding need to limit the spillover from higher oil prices into higher nominal wages. In other countries, as in the United States, preventing an upward ratcheting of the wage-price spiral is viewed as the most pressing task of economic policy. Nominal wages in most countries have not, so far, shown signs of sharp acceleration. Prospects for limiting wage acceleration seem better in Germany and Japan than elsewhere. In those countries and some others the process of wage determination is relatively concentrated in wage rounds that terminate each spring when annual labor contracts for most workers are negotiated. In such circumstances it is easier to enforce the perception that an accelerated growth of wage claims cannot effectively raise real incomes. Synchronization of wage bargaining does not by itself assure a moderate wage outcome—both Germany and Japan experienced wage explosions in 1974 when the “consensus mechanisms” broke down. Recognition of this fact perhaps explains why those two countries, as well as most others, are currently practicing restrictive demand management as the principal means of limiting the inflationary effects of higher world oil prices.

THE OUTLOOK FOR 1980

Most major countries thus face the prospect that growth in 1980 will be slowed by both the direct effects of higher oil prices and the shift to more restrictive policies needed to limit the rise in inflation. However, if real oil prices do not rise substantially beyond the \$28 per barrel average that appears to have been established by early 1980, growth will probably remain positive in all major countries except the United States and the United Kingdom. Investment demand in a number of countries may be relatively well sustained. Japan is likely to benefit from a stronger growth in the volume of exports during 1980 as a result of the lower value of the yen (although the growth induced by yen depreciation will to some extent displace production in other countries). The United Kingdom's fall in output does not derive principally from the rise in oil prices but from the very sharp shift toward restrictive monetary and fiscal policies instituted by the new government.

For at least some countries the rise in inflation may be brief if the increases in oil prices now begin to moderate. To the extent that the cautious economic policies generally pursued during 1979 succeed in forestalling wage increases induced by higher oil prices, there may be more room for policy actions to support economic activity in some

countries as 1980 proceeds. Hence the slowdown in economic growth need not be prolonged.

It is clear, however, that the outlook is precarious. Further substantial increases in the price of oil could induce a widespread recession as well as higher inflation. If wages accelerate more sharply than is now assumed and, in response, monetary policies tighten further, positive real growth will become less likely. Finally, a sharper slowing of world trade—because of a general move to reduce inventories, increased protectionist barriers, or forced retrenchment by developing countries unable to finance needed imports—could also lead to weaker growth than is currently expected.

REDUCING WORLD OIL DEMAND

The rise in petroleum prices reflects very tight conditions in world markets. If there are no further significant reductions in supply, some temporary easing in market conditions is likely, at least in 1980, because of price-induced conservation, slower growth in oil-importing countries, and reductions in the recent rate of stockbuilding demand. Given the relatively low price elasticity of demand for oil in the short run, however, the margin between ease and tightness is very narrow. Increased uncertainty of supply, as well as the erosion of previously established buyer-supplier relationships in the petroleum markets, have tended to raise the demand for oil inventories as a hedge against possible future scarcity. Decisions by a small number of oil-exporting countries to reduce production in response to market weakness could undo some or all of the benefits of reduced demand. Unless the reductions in demand are substantial, upward pressure on oil prices could continue, even as consumption declines, and thus further undermine the prospects for economic performance.

The current situation is marked by strong interdependence among oil-consuming countries. Increased demand for petroleum in one country, by putting pressure on world oil prices, affects inflation and growth prospects in all other oil-importing countries. Conversely the benefits of lower consumption in one country tend to be shared by all in the form of reduced price pressure in the world oil market. Such interdependence creates strong grounds for the coordination of energy policies among countries.

Considerable progress toward this end was made during 1979. But the problem is difficult, given both the strong perception of national interest that colors each country's views regarding adequate supplies of oil and the attendant pressure on each to secure its own position.

The basis for cooperation among oil-consuming countries since 1974 has been the Emergency Allocation Agreement within the Inter-

national Energy Agency, to which the major industrial countries except France belong. This agreement provides a mechanism for sharing available oil supplies among member countries when the supply shows a substantial shortfall (a 7 percent reduction or more). The agreement, however, does not provide a mechanism for limiting competition among countries when the shortfall is below this threshold.

Early in 1979 it was agreed within the International Energy Agency, and in parallel within the European Economic Community, that by the end of the year each country should reduce its consumption by 5 percent relative to trend. While the United States met this objective, there was significantly less success in doing so among most other countries.

At the Tokyo Summit meeting last June the leaders of the seven major industrial countries took several important steps to establish a framework for cooperation in energy over the medium term. Of central importance was the acknowledgment of interdependence and recognition of the resulting need for each country to commit itself to import levels that, in sum, would not exceed the volume of oil likely to be available. Firm targets for 1985 were laid down. It was further agreed to pursue discussions in the International Energy Agency and other forums on steps to reach these targets and develop cooperative approaches to limit demand for imports during the intervening years. These discussions resulted last December in a new agreement by the International Energy Agency, setting out individual targets for each country's oil imports in 1980. It was further agreed to review the targets each quarter and revise them if necessary to match reductions in supply. The successful carrying out of this approach would do much to moderate future upward pressure on oil prices, since it provides a means of averting a competitive scramble for limited oil supplies.

Over the long run, the cut in the availability of oil need not sharply check the growth of the world economy. Higher relative prices for oil will encourage conservation and additional production of energy from other sources. While the increased real price of energy may somewhat slow the substitution of energy-intensive capital for labor and thus curb the growth of productivity, most studies indicate that this effect is likely to be quite small. In the shorter term, however, given the wage and price rigidities in all industrial economies, the limited availability of oil acts as a constraint on growth through its impact on the price of oil and in turn on inflation. Coordinated policies to reduce the demand for energy and increase energy production are therefore essential tools not only of energy policy but of overall economic management.

THE GLOBAL PATTERN OF PAYMENTS

In 1977 and early 1978 the major imbalances in current account positions were among the largest industrial countries: sizable surpluses for Japan and Germany and a large deficit for the United States. During 1978 and into 1979 these imbalances were eliminated. The United States was near balance in 1979, and both Germany and Japan had deficits.

The large shift in Japan's current account, from a surplus of over \$16 billion in 1978 to a deficit of about \$8 billion in 1979, is particularly striking. Primarily as a result of the appreciation of the yen since mid-1977, the volume of imports into Japan began to accelerate sharply during 1978, while export volumes declined. From June 1978 to June 1979 import volumes grew by a remarkable 21 percent. Until late in 1978, however, these volume trends were not fully reflected in a declining current account balance. The reason was that the appreciation of the yen also caused the terms of trade to move strongly in Japan's favor. Import prices in dollar terms grew moderately while export prices surged. In late 1978 the yen turned around. During the course of 1979 the yen depreciated by 23 percent and at the same time both oil and other commodity prices rose sharply. The resulting 61 percent rise in import prices (October 1978 to October 1979), coupled with the trade-volume trends that had previously become established, led to a very rapid shift toward deficit in the current account. More recently the growth in the volume of imports into Japan has begun to slow and export volumes to rise again as the lower value of the yen has made Japanese producers more competitive in both domestic and foreign markets. Since Japanese payments for oil will rise substantially further this year, it is not now expected that these volume shifts will lead to a renewed current account surplus in 1980.

While current account positions within the OECD have become more nearly balanced, the increase in oil prices has led to a renewed and substantial imbalance in the pattern of payments among the three major groupings of countries—the OECD, the oil-exporting countries, and the other developing countries.

Table 30, which is based on estimates by the OECD, shows the pattern of surpluses and deficits among major groups of countries in recent years. The final column gives projections by the Council of Economic Advisers for the distribution of current accounts among major groupings in 1980. Between 1978 and 1980 the OPEC surplus is projected to rise by more than \$90 billion. The counterpart to this

is a near doubling of the deficits of the other developing countries and a shift into deficit of about \$60 billion in the aggregate position of the OECD countries.

TABLE 30.—*Current account balances, 1975–80*

[Billions of dollars; OECD basis]

Country	1975	1976	1977	1978	1979 ¹	1980 ²
OECD countries.....	-0.4	-18.2	-24.8	9.1	-30.0	-50
United States.....	18.3	4.6	-14.1	-13.9	.0	
Japan.....	-7	3.7	10.9	16.5	-7.5	
Germany.....	3.5	3.4	4.2	8.8	-3.5	
France.....	-1	-6.1	-3.3	3.9	1.5	
United Kingdom.....	-4.1	-1.5	.5	2.0	-5.5	
Italy.....	-8	-2.8	2.5	6.4	6.3	
Canada.....	-4.7	-3.9	-4.0	-4.6	-6.0	
Other OECD.....	-11.8	-15.6	-21.5	-10.0	-15.3	
OPEC countries ³	27.3	36.5	29.0	7.0	65.0	100
Other developing countries.....	-37.5	-25.5	-24.0	-36.0	-47.0	-70

¹ Preliminary.

² Estimates by Council of Economic Advisers.

³ Includes Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Saudi Arabia, United Arab Emirates, and Venezuela.

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

The projected rise in the combined deficits of the non-OPEC developing countries reflects not only the very substantial increase in their payments for oil but also more slowly growing export receipts. Slower growth in the industrial countries will reduce the demand for the goods that developing countries export. Rising external debt at higher interest rates will also add to their deficits, the more so because most of their debt to banks is contracted at a floating rate of interest.

In relation to GNP, however, the projected rise in the deficit of developing countries is less than that in 1974–75. To some extent this is explained by the generally better maintenance of world trade that is foreseen. As a further point, in 1975 most developing countries chose to finance large deficits, rather than reducing them by slowing their demand for imports. It seems probable that adjustment actions now will be somewhat more prompt. Most important, however, the collapse in prices of raw materials, which greatly weakened the terms of trade of the developing countries in 1975, is not expected to be repeated. First, raw materials prices are currently quite low compared with production costs, whereas they had soared in 1972–73. Second, low investment since 1975 to expand capacity for producing raw materials has resulted in fairly low levels of excess capacity. Finally, international commodity agreements may moderate price fluctuations for a number of commodities.

THE RECYCLING PROBLEM

The pattern of large surpluses for OPEC and large deficits for developing countries (as well as for some more developed ones) requires that international financial markets once again "recycle" funds on an enormous scale. The problem, while not insuperable, is more difficult than in 1974-75 in three respects. First, the OPEC surplus is likely to persist longer. Second, debt burdens for many developing countries are larger now than they were in 1974. The increased indebtedness that higher oil bills will once again impose comes on top of the debts incurred when oil prices rose in 1974. Finally, banks and other lenders now have a substantially larger exposure in many developing countries than they did in 1974 and may become increasingly reluctant to add yet further to their exposure.

Persistence of OPEC Surpluses

In 1974 it was widely predicted that large OPEC surpluses would persist for many years. In fact, however, the OPEC surplus of 1974 was cut roughly in half in 1975, largely because the recession in the industrial countries greatly reduced the demand for oil, while OPEC imports continued to rise sharply. The surplus widened somewhat in 1976 and 1977 but was increasingly concentrated in the hands of a small number of "low-absorbing" countries whose revenues were large relative to their populations. In 1978 the overall surplus declined to modest proportions, and a number of OPEC countries began to incur deficits.

The reduction of the OPEC surplus is likely to be less rapid and complete this time. After the initial marked increases in oil prices in 1974, world oil prices then declined relative to the prices of the goods that OPEC imported. Conditions in oil markets likely to prevail during the next several years, however, suggest that a sustained decline in the relative price of oil is less likely. In a number of important OPEC countries—and most notably in Iran—trends toward social conservatism may limit the growth of imports, as governments scale back development plans in order to minimize the disruption and social strains that rapid growth sometimes entails.

Debt Accumulation

Judgments differ on the rate of debt accumulation that developing countries can sustain. The external debts of developing countries have grown rapidly since 1974. Debt service obligations have increased even faster, since maturities have shortened on average and interest costs have risen as a result of the increased role of commercial relative to concessionary financing. If developing countries incur deficits on the projected scale, their indebtedness will accelerate substantially in coming years. However, the debt-carrying capacity of

many developing countries has also been increasing rapidly. With few exceptions, the most rapid rises in indebtedness have been among countries whose growth rates are also high and whose exports are expanding rapidly. Consequently debt burdens—as measured by the ratio of debt-service payments to exports, for instance—have not risen sharply on average. Where substantial increases have occurred, they have been largely in those countries whose prospects for longer-term growth are quite favorable.

In such circumstances it is difficult to judge the appropriate combination of adjustment policies to reduce deficits and additional borrowing. Faced with sharply higher bills for oil imports, a developing country may borrow to sustain the flow of imports devoted to investment and growth. If the borrowed resources are being effectively invested, the productivity growth that is preserved by borrowing should more than cover the debt-servicing costs. While the country's living standards will improve more slowly than they would have done in the absence of the oil price rise, borrowing to pay for the increased oil import bill can be appropriate and manageable.

For most developing countries, however, some actions to curtail the growth of imports will be required to compensate for higher oil bills and weaker export revenues. Some countries, where past adjustment has been inadequate, may have to begin a stringent retrenchment. On balance, a general shift to highly restrictive policies is not likely to be necessary if the rise of oil prices now begins to slow.

Lenders' Exposure

To some extent OPEC countries directly provide loans or grants to developing countries. To a far larger extent, however, they have deposited their surpluses in the banks of industrial countries and their foreign branches. These banks, in turn, have extended loans to countries needing to finance their balance of payments.

Balance of payments financing is not of course exclusively carried out through banks. Historically the largest portion of developing countries' deficits has been financed through other mechanisms, including direct investment flows, official financing from international financial institutions, and bilateral development assistance. In recent years, however, bank credit has become a major source of funds for an increasing number of developing countries. The sustainability of large deficits therefore depends very greatly on the amounts, and terms, of resources made available through this channel.

Banks making international loans incur a variety of risks. Two in particular have received the most attention: "maturity risk" and "country risk." Maturity risk arises from the fact that banks use relatively short-term deposits to make longer-term loans. In 1974-75

some feared that this risk would inhibit the recycling process. If OPEC deposits proved volatile, individual banks would have difficulty meeting sudden demands of depositors for cash. Such apprehension proved unwarranted, partly because OPEC deposits were less volatile than feared. More important, however, was the functioning of the interbank lending market. While autonomous deposits in individual banks fluctuated, the aggregate level of such deposits to the international banking system as a whole was fairly stable and on a strongly rising trend. Individual banks could therefore attract funds from other banks to offset deposit shifts. The depth of this interbank market is indicated by the fact that interbank deposits account for over two-thirds of total gross Eurocurrency liabilities.

Country risk arises from the recognition that countries may be unable or unwilling to repay all or part of the principal or interest on their loans, thereby forcing a rescheduling of loans, which might entail losses to the bank. Such reschedulings have occurred periodically with respect to individual countries, and no doubt they will continue. Nevertheless, losses to banks from such events have been minimal. In 1978, for instance, the ratio of losses on foreign loans to outstanding claims averaged .01 percent for a sample of 30 U.S. banks. The comparable loss ratio on domestic loans was .34 percent. On the record to date at least, international lending is comparatively safe. It is likely, however, that country risk will become an increasingly important consideration as the debt burdens of a number of countries rise beyond historical levels.

By far the greatest share in the projected rise of the other developing countries' aggregate deficit will accrue to a small number of generally more prosperous nations that have been substantial borrowers in international markets for a number of years. A further acceleration in borrowing by some of these countries might encounter resistance from banks reluctant to increase commensurately their exposure to risk. To some extent banks may be restricted by internally set "country limits," which specify the maximum lending to be undertaken in any one country. National banking authorities, moreover, may exercise increased surveillance or, as Japan seems to have done recently, issue more direct guidance to their banks to limit the growth of international lending.

In practice, however, there appears to be a great deal of flexibility in banks' international lending. The number of banks participating in international lending has grown rapidly. Even if individual banks become more cautious, the overall flow could well be maintained. Indeed a striking development in the last few years has been the eagerness of the banking system to provide financing. Interest rate spreads over the London interbank offered rate have steadily tended down-

ward for most developing countries seeking loans. These countries have used the opportunity to refinance outstanding debts and build up their reserves by substantial amounts. Larger demands for credit and somewhat tighter monetary conditions in national markets suggest that spreads over the London rate on new loans may widen over the coming year. Front-end fees have already become a little more expensive and maturities on new loans have shortened.

A widening of spreads can be expected to serve a useful rationing function. Wider spreads, by raising the profitability of lending relative to the cost of obtaining funds, may increase the supply of funds that banks make available. By raising the costs of borrowing, wider spreads will also induce borrowing countries to shift their policies in the direction of greater adjustment in their current account and less financing. This process does not always work smoothly. A general widening of spreads may be difficult to achieve even when it is warranted by market conditions. Borrowers have resisted such movements strongly because they, and other lenders, view a narrow spread as an indicator of creditworthiness. If an increase in the spread is confined to one or a few countries, other potential lenders to these countries might shy away, with the possible result of a sudden, sharp interruption of financing.

While judgments differ on the seriousness of these risks, existing international channels are probably capable of preventing severe disruptions. The International Monetary Fund in particular has substantial resources that can be drawn upon temporarily by countries encountering financing difficulties while they institute programs to overcome problems with their balance of payments. Implementation of such programs, in turn, is likely to restore the confidence of private lenders.

Many developing countries, particularly the poorer ones, do not have sufficient standing to borrow on international markets. For such countries an incipient increase in deficits cannot be financed by private recycling, and in consequence a forced adjustment could arise. While some adjustment may be necessary, retrenchment is not an acceptable solution for poorer countries where large portions of the population are near or below subsistence levels.

In practice, the poorer countries have received a substantial flow of resources through bilateral and multilateral development assistance from outside. This Administration, like the governments of many other industrial countries, and the International Development Banks have policies under which a growing proportion of official financing and other aid flows is directed to these countries. Further additions to such flows would be appropriate even in the absence of the incremental oil price rise.

While current assessments indicate that existing financing mechanisms can prevent major widespread disruption, the rise in oil prices cuts severely into the incomes of most countries. Even rapidly growing countries will be forced into some combination of higher debt service and lower investment, both of which will adversely affect living standards. The poorer countries especially can ill afford any such losses. Furthermore, financing mechanisms cannot cope with any and all increases in oil prices and the associated financing needs. The cumulative effects of large further rises in oil prices could increasingly threaten to overload the international financial system.

FOREIGN EXCHANGE MARKETS IN 1979

The strong coordinated actions taken by the United States and other major countries in November 1978 to strengthen the dollar, which had been under almost continual downward pressure for more than a year, had beneficial effects in exchange markets in 1979. On a trade-weighted basis against an average of foreign currencies, the dollar fluctuated within a relatively narrow range during the year. In December 1979 the weighted-average dollar exchange rate was 2.5 percent lower than a year earlier.

This relative stability of the dollar reflected divergent movements with respect to individual foreign currencies: a depreciation of about 5–10 percent vis-a-vis the mark, most other currencies of the European Monetary System, and the British pound; and an appreciation of about 23 percent vis-a-vis the Japanese yen.

Shifts in expectations about inflation rates, uncertainties about the oil market, perceptions of central banks' intentions with respect to intervention policy, and, perhaps most importantly, the conduct of monetary policy by the major countries affected movements in exchange rates at various times during 1979. Except for Japan, external balance considerations played only a small role, since successful adjustments had been made. Occasional downward pressure on the dollar in the second half of 1979 primarily reflected the market's assessment of the strength of continued inflationary pressure in the United States. Rising oil prices and a less secure supply of oil had an especially important effect on the yen. The United Kingdom's favorable outlook respecting oil independence tended to strengthen the pound during much of the year, despite an acceleration of inflation. The market's perception of the new government's policies, particularly the emphasis on tight monetary policy, also helped strengthen the pound.

Exchange rate movements between the dollar and the German mark, as well as between the dollar and those currencies linked to the

mark through the European Monetary System, tended to reflect changes in the market's expectations about relative rates of inflation in the United States and Germany and about the course of monetary policy. Prior to October 6 exchange markets tended to consider interest rates in the United States to be low relative to those in Germany, given the inflation rates in the two countries. The dollar strengthened notably vis-a-vis the mark after the Federal Reserve announced a shift in its operating strategy on October 6, and short-term interest rates in the United States rose strongly; but at the end of the year the dollar weakened again, largely because of the increased uncertainty caused by the Iranian situation.

The substantial depreciation of the yen is perhaps the most striking aspect of exchange market developments during the year. Some portion of the decline may represent a reversal from the overshooting during the yen's previous period of appreciation, but the reversal went beyond that. Of course Japan is particularly vulnerable to the rise in oil prices and to a diminished security of supply. Prices of other raw materials on which Japan is dependent have also risen sharply. For the major industrial countries, Table 31 shows estimated changes in terms of trade that would have stemmed from the 1979 changes in oil prices if exchange rates had remained at their December 1978 levels. The terms-of-trade loss is substantially larger for Japan than for other major countries except the United States. Unlike the United States, Japan does not have large potential sources of alternative forms of energy. Some decline in the real value of the yen would thus be consistent with needed longer-term adjustments in exports and imports. Changes in long-term trade volume in response to exchange rate changes are large, however, and the actual depreciation of the yen may have exceeded the requirements of the adjustment process.

TABLE 31.—*Impact of oil price increase on terms of trade*
 (Increased oil bills at 1978 oil import volume as percent of value of 1978 merchandise exports)

Country	Percent
United States.....	31.4
Japan.....	29.8
Germany.....	11.0
France.....	17.2
United Kingdom.....	12.2
Italy.....	23.1
Canada.....	7.6

Sources: Central Intelligence Agency, International Monetary Fund, and Council of Economic Advisers.

The Japanese government generally resisted the depreciation of the yen, notably through heavy intervention sales of dollars. Its monetary policies also became somewhat more restrictive, although the

rise of interest rates during the year was less in Japan than in a number of other countries.

At several times during 1979 the market's perception of the intervention policy of central banks also affected exchange rates, especially the dollar-mark rate. Early in the year the stability of the dollar may have been due to perceptions in the market that coordinated actions by central banks could effectively counter large short-term rate movements. Under such conditions market participants faced a "two-way risk" and acted in ways that helped to keep rates relatively stable. By contrast, after midyear, market participants were less certain about the goals of intervention policy, and their testing of the intentions of the monetary authorities led to greater volatility in exchange rates. Problems of this sort inevitably arise when intervention is used as a tool for limiting erratic fluctuations in exchange rates. On balance, however, the mechanisms of coordination among monetary authorities have kept such problems minor. More important, it is clearly and generally recognized that intervention per se has limited usefulness when the market is convinced that prevailing exchange rates are inconsistent with its perceptions of underlying economic conditions and of monetary and other macroeconomic policies.

Foreign exchange intervention and monetary policy actions affect exchange rates in different ways. Intervention results in a change in the market supply of financial assets denominated in one currency relative to those denominated in another. If demands for the two currencies are stable, this shift in relative supplies leads to a rise in the exchange value of the currency whose supply is reduced. Because assets denominated in the major currencies appear to be close substitutes, however, this exchange rate effect is correspondingly small. The consequences of intervention are therefore likely to be determined mostly by the way market expectations respond. Intervention is most likely to succeed in stemming large unwanted changes in rates if accompanying actions signal an intention to pursue policies that will justify the existing exchange rate level over the longer term.

Monetary policy affects exchange rates primarily by influencing the demands for different currencies. For example, a rise in interest rates in the United States increases the demand for dollars because the interest return on dollar assets is raised. The result is a bidding up of the exchange rate for the dollar. There is a limit to such appreciation, however, if it is expected that the dollar exchange rate will subsequently move back toward its longer-run equilibrium value. For this reason exchange rate changes due simply to changes in interest rate differentials ought not to be very large. Stronger effects, however, are likely when shifts in monetary policy are taken to be a sign of changed objectives for overall macroeconomic performance. Thus a

rise in interest rates that is interpreted as a shift to a more restrictive policy will lead to expectations of slower growth and less inflation. Expectational effects will then reinforce the exchange rate movements generated by the attraction of higher interest returns.

How effectively monetary policy can be used to stabilize the domestic economy depends on how accurately exchange markets assess the policy implications of changes in interest rates. In recent years a number of countries have begun to define monetary objectives in terms of quantitative targets for one or more monetary aggregates, rather than targets for interest rates. Last October the Federal Reserve Board modified its operating techniques to place greater emphasis on achieving target rates of growth in the monetary aggregates. In such a world, even when monetary objectives remain unchanged, short-term interest rates will tend to fluctuate in response to changes in real growth, or the rate of inflation, or other factors. Thus an economy in which inflation is moderating or economic activity is weakening will experience a decline in interest rates in the context of unchanged monetary policy. To avoid unwarranted exchange rate movements, exchange markets must recognize that such interest rate declines do not represent a shift in monetary policy toward expansion, but in fact spring from developments that are anti-inflationary in character.

THE DOLLAR IN THE INTERNATIONAL MONETARY SYSTEM

For many years the dollar has been the key currency of the international monetary system. It is the largest component of official reserves, although not the only one. Relatively smaller amounts of other currencies are also held; holdings of special drawing rights (SDRs) and credit positions with the International Monetary Fund are also reserve assets. Gold holdings are counted in reserves, though their official use is now quite limited.

The dollar is also the principal intervention currency. For example, if Switzerland wishes to intervene to support the Swiss franc in relation to the German mark, it is likely to do so by selling dollars to buy francs. This can put pressure on the dollar if the seller of the Swiss francs is unwilling to hold the new dollar balances.

Beyond its role in official transactions, the dollar is also the principal international medium in private transactions; international borrowing is conducted in dollars, and settlements for international transactions in goods and services take place in dollars, even for trade contracts denominated in other currencies. While an international monetary system based on a single currency offers certain multilateral advantages, there is no inherent reason why the dollar

should continue to play this dominant role. Indeed, the international importance of other currencies has been increasing. International and foreign bond issues, for instance, were 71 percent dollar denominated on average in the 1960s; in 1978 only 37 percent were denominated in dollars. Despite considerable reluctance by the Swiss and German monetary authorities to have their currencies held as official reserves, such holdings have been growing. Recently the Swiss have allowed foreign governments to hold deposits of Swiss francs directly with the Swiss National Bank. Until now such holdings have been primarily Eurodeposits. Intervention in other currencies is also increasing, particularly with the establishment of the European Monetary System, where member countries often intervene directly in each other's currencies to maintain bilateral rates within agreed margins.

Over the longer term a declining relative role for the dollar would seem a natural consequence of a changing world situation. The U.S. economy today accounts for a smaller share of world trade than it did when the dollar-based system evolved, and the U.S. economy has become relatively smaller. The European Economic Community's GNP is almost the same size as that of the United States; the Japanese economy alone is almost half the size of the U.S. economy. The relative preponderance of U.S. capital markets has also diminished. The share of worldwide long-term funds (essentially bonds and equity issues) raised in the United States has declined from 45 percent in the 1960s to 32 percent in 1978.

However, the evolution of the international monetary system from a system based on the dollar to one based on a number of currencies could be unsettling. The process of reserve and private portfolio diversification through which such an evolution would proceed requires a gradual increase in the supply of assets denominated in foreign currencies and a relative reduction in dollar-denominated assets. If such shifts in relative supplies do not take place to match shifts in demand, exchange markets would come under pressure. Furthermore, demand shifts may not always be gradual. Pressures for diversification are likely to become greater when expectations for a weaker dollar are strongly held, and to be arrested when expectations for an appreciation of the dollar predominate.

There are, however, certain constraints limiting the development of an international role for other currencies. Private holders of liquid dollar assets will continue to need these dollars to finance international transactions. Many holders of dollar assets also hold dollar-denominated debts and would therefore increase their exposure to risk by selling dollars. Official diversification on a large scale has not taken place; and it is inhibited by the limited availability of suitable

alternative assets, as well as by the recognition that the attempt to sell large quantities of dollars would weaken the dollar and hence cause capital losses on remaining reserves.

Nevertheless it is possible that, if left to evolution, the process of diversification could generate episodic downward pressure on the dollar. Such a result might not be welcomed internationally if it tended to generate large current account surpluses for the United States; and it would be unwelcome domestically if it increased inflationary pressures.

It is also widely perceived that a multicurrency system—even without considering the transition costs—is far from ideal. Exchange rates in such a system might be destabilized as a result of shifts in the composition of reserve assets by central banks, or of attempted shifts in private holdings. Transaction costs for both official and private agents would be raised by the need to manage complex portfolios.

Such considerations have given rise to renewed interest in an alternative movement that would place greater reliance on a single international reserve asset, the special drawing right, in preference to the development of a multicurrency reserve system. A number of steps have been taken to strengthen the role of the SDR. Most recently the International Monetary Fund has been considering the possible establishment of a substitution account into which countries could deposit dollars and perhaps other currencies and receive claims denominated in SDRs in exchange.

Such an account could not resolve all the issues raised by the current role of the dollar in the international monetary system. It would not directly address, for example, the role of the dollar as the principal intervention currency. Countries would still need currencies for intervention. SDR claims could only be used directly for intervention if they were widely held in private portfolios and so could be sold directly in foreign exchange markets to nonofficial participants, a possibility that could be considered at a future stage of the evolution of the SDR. In the near term, however, a substitution account would establish a mechanism to reshape the trend toward a multicurrency system in a form that did not destabilize exchange markets.

In October 1979 the Interim Committee of the International Monetary Fund agreed that a properly designed substitution account could make a useful contribution to improving the international monetary system. A number of difficult and complex problems must be addressed, however, before such an account can be established, and it is not clear when or whether these issues can be resolved. They will be the subject of continuing international discussion during the coming year.

WORLD TRADE: PATTERNS AND ISSUES

The slower average rate of growth in the industrial world since 1973 and the more marked decline in the average growth of trade over the same period have tended in general to intensify the difficulties of absorbing the continuing structural adjustments that trade necessarily imposes. At the same time the large benefits that come from open trade are less visible when markets are growing more slowly. The challenges facing trade policy are difficult: to preserve, and indeed enhance, an open trading system in the face of strengthened protectionist pressures; to accommodate and absorb the increasing ability of a number of developing countries to compete in a widening range of product markets; and to ensure that market processes are not subverted as the primary determinants of evolving comparative advantage.

THE MULTILATERAL TRADE NEGOTIATIONS

The signing last December of the agreements reached in the Tokyo Round of the Multilateral Trade Negotiations strengthens the framework for world trade at a critical time. This set of agreements is an important commitment by industrial and developing nations to resolve current and future trade problems in ways that preserve the benefits to world growth that derive from free trade.

The Tokyo Round agreements include significant reductions in tariff and nontariff barriers to trade, and they introduce through a series of codes a set of procedures designed to limit nontariff distortions of trade patterns. The United States and its trading partners have made reciprocal tariff cuts; the U.S. reductions average about 30 percent, those of Japan 22 percent, and those of the European Economic Community 27 percent. Negotiations have not been completed on a safeguards code to sharpen and clarify the conditions under which exceptional relief action could be taken. Five major codes, however, have been agreed upon in the Tokyo Round. The government procurement code significantly improves the opportunities for suppliers to compete equally for government orders. The agreement on standards should speed the certification of foreign products. The agreement on customs valuation ensures more consistent practices and thus reduces the scope for offsetting tariff concessions by changes in valuation rules. The agreements on subsidies and countervailing duties and on antidumping actions restrict the use of subsidies and clarify the circumstances in which countervailing and antidumping duties may be imposed.

These agreements may owe their greatest significance to the specific rules they establish to help regulate the process by which nontariff

barriers to trade are implemented. They emphasize the importance of transparency—that is, making visible the requirements for licensing and bidding on contracts, and using explicit rather than arbitrary measures to regulate imports when this is unavoidable. The role of procedures is stressed; in practice, trade policy is made on a case-by-case basis, and procedural safeguards are needed to ensure that relevant information is brought to bear on any decisions. The agreements embody the realization that the processes whereby trade policy is implemented must be considered fair by all signatories.

The agreements themselves do not guarantee success in resolving these difficult and detailed nontariff issues. Only when they are applied in individual circumstances will the procedures specified in the agreements reveal their adequacy. But in facing these questions squarely, the parties to these agreements have made significant progress in the continuing effort to reduce barriers to trade and strengthen the rules under which trade and investment are conducted. The agreements should improve markets for U.S. exports and help reduce inflation by lowering our own import barriers.

SOURCES OF RISING PROTECTIONISM

Much needs to be done to consolidate the progress represented by the Tokyo Round agreements. The growing interdependence of the world economy and the increased frequency of shocks during the past decade have led in recent years to a growing skepticism about the benefits of trade. These doubts have several roots: the significant increase in current account deficits following the oil price increase of 1973; the recession and associated high unemployment experienced in many industrial countries for most of the last 5 years; the development of long-term structural difficulties in several leading industrial sectors; and the rapid industrialization of a group of middle-income developing countries, whose growing exports have increased competition in markets for certain manufactured goods.

Oil price increases in 1979 will give further impetus to calls for greater protectionism. Current account deficits have already widened substantially in a number of countries and are likely to be reduced at a much slower rate than that which followed the 1974 oil price rise. Individual countries may attempt to curtail imports and accelerate penetration of foreign markets to pay for increasingly expensive oil. The slower rate of growth of domestic markets over the next several years will also invite actions to limit imports and to subsidize exports.

The need to adjust capacity and employment so as to reflect changed patterns of world consumption and production became acute in several sectors of the major industrial economies after the 1974-75 recession. The steel industry has begun the process, and its

experience suggests the difficult choices that must be made in determining the burden of adjustment within and among countries. The shipbuilding industry has completed somewhat more of the requisite adjustment of capacity and employment. The automobile industry is in the early stages of a complex rationalization and consolidation. As the adjustments continue, the temptation will be great to put off the difficult choices by limiting imports.

Calls for higher import barriers will intensify as industrialization continues in a number of developing countries. Though accelerated growth in these countries began in the 1960s, the exports integral to the process aroused concern in the major industrial countries only during the period of rising unemployment after the 1974-75 recession. They can be expected to occasion continuing concern in the near future.

The world economy has witnessed several instances of rapid industrialization earlier in the postwar period. Italy in the 1960s is a particularly good example. Such developments in part reflect the exploitation of significant cost advantages in the use of labor or other resources. In part they are a natural consequence of the maturation of product design and technology, which allows production to be transferred from more industrialized countries to regions that were initially served by exports. These regions subsequently become able to export back to the industrialized countries, or to third countries. In recent years this cycle has accelerated. Technology has been diffused more quickly, capital has moved more rapidly, and labor skills have grown impressively outside the major industrial countries. The international spread of production processes by transnational companies has also quickened the cycle, particularly for newly industrializing countries enjoying political stability.

The industrial countries, whose own innovations triggered this process, have responded by focusing production toward more sophisticated, knowledge-intensive products, the direction in which their comparative advantage is evolving. Problems of adjustment have occurred, in particular because the increases in exports from the newly industrializing countries have been concentrated in a few very narrow product lines, such as certain textiles, specific standardized items of electronic equipment, or footwear. In the aggregate the share of exports from newly industrializing countries to OECD countries is still quite small. Furthermore most of the former countries, using the debt-servicing capability that rapid export growth provides, have increased their imports by even larger amounts. Thus increased exports by these countries to OECD countries have been more than matched by an increased flow of goods (especially capital equipment) and services in the opposite direction.

NEEDED RESPONSES

In developing policies to address these problems one must take into account a number of important considerations. The first is that protection, even when it appears attractive from the point of view of an individual country, is very costly to all countries—including the one initiating protection—once the likely retaliatory responses of other countries are taken into account. Trade actions, when judged necessary, must therefore be implemented in ways that minimize the risk of an escalating retaliatory cycle. The emphasis on transparency and procedural safeguards in the Tokyo Round agreements is important in this regard.

Another consideration is that the counterpart to the adjustment costs imposed on some industries that are facing increased competition from abroad is the benefit to consumers from cheaper goods and the benefit to the nation from lower inflation. In assessing the appropriateness of trade actions, one must weigh such costs and benefits. The increased use of direct or indirect export subsidies by many countries creates particularly difficult problems in this regard. In the short run, subsidies provide importing countries with bargain-priced goods. In the longer run, however, the adjustments that the subsidies induce are likely to be generally harmful. A country that adjusts out of a sector in which its underlying comparative advantage is favorable, because foreign subsidies have made the sector appear less competitive, will ultimately face higher prices if foreign subsidies are removed in the future, or if the market power that subsidies promote is later used to extract monopoly rents. Because, in the long run, export subsidies reduce the efficiency with which resources are allocated globally, such subsidies are undesirable. Where foreign subsidies create injury to domestic sectors, countervailing action may therefore be justified to assure an appropriate worldwide pattern of production.

A final important point is that, over the longer term, expanding imports will be matched by a concomitant growth of export markets through the adjustment process. The loss of jobs in sectors of declining comparative advantage will be offset by the growth of new jobs in higher-wage, high-technology industries. The principal focus of trade policy must therefore be on adjustment not preservation. Only in this way can foreign trade approach its potential for improving productivity and reducing inflation.