CHAPTER 4

The World Economy: Coping with Transition

The economic challenges facing the United States which have been discussed in previous chapters of this *Report* are not unique to this country. The problem of continuing high inflation is broadly shared by many of the industrial (and developing) countries. The enormous increase in the price of energy has created difficult problems of adjustment everywhere. Productivity growth has slowed not only in the United States but also in other countries. At the same time that all countries individually take actions to deal with these problems, cooperation among countries is required to manage the ever increasing interdependence of the world's economies.

Over the next several years four major challenges will have to be surmounted to bring about the transition to a world economy with less inflation and higher growth.

First, a combination of demand restraint and vigorous efforts to improve supply must be employed to bring down inflation and raise productivity.

Second, the constraints placed on world economic expansion by limited supplies of energy must be loosened by policies to increase energy availability and reduce energy demand.

Third, continued close attention is needed to assure that the international financial system effectively handles the much enlarged flow of financial resources among countries.

Finally, the open trading system that contributed so importantly to rising prosperity in past decades must be strengthened in the face of increasing pressures to adopt protective measures and the temptation to indulge in "beggar-thy-neighbor" policies.

The energy challenge is well understood and its international aspects were discussed extensively in last year's *Report.* It will therefore be dealt with only briefly in this chapter. Following an initial discussion of recent and prospective economic performance in the major industrial countries, the chapter examines each of the remaining three challenges—the challenge to the conduct of macroeconomic and structural policies, the challenge to the financial system, and the challenge to trade relations.

In 1974–75, following the tripling of oil prices by the Organization of Petroleum Exporting Countries (OPEC), the industrial world experienced its largest recession since the second World War. In 1980, following a second major rise in oil prices, economic expansion again came to a halt. It is abundantly clear that price shocks of the size experienced in recent years cannot be absorbed without serious strains and disruptive side effects: real incomes are squeezed, inflationary forces are intensified, and output and employment are reduced. Fiscal and monetary policies cannot substantially offset or counteract all of these effects. Expansionary fiscal and monetary policies could moderate the decline in output, but at the cost of building yet higher inflation into the economy. Restrictive policies, on the other hand, could limit the rise in inflation, but they would also tend to accentuate the decline in output and employment. Following the second oil-price shock, most countries have opted for policies of moderate restraint. This choice reflects the judgment that such policies would stand the best chance of reducing secondary distortions in the structure of costs and prices and in the distribution of income among sectors, and thus would help speed the process of adjustment to the higher oil prices. That judgment appears to have been correct.

ECONOMIC ACTIVITY

Although all the evidence is not yet in, it appears that the second oil-price shock is being absorbed more smoothly than the first one was. Recent indicators and current projections show a smaller swing in output and a lesser surge in inflation for most countries. Table 28 shows recent growth rates and Organization for Economic Cooperation and Development (OECD) projections for the major countries. Except for the United Kingdom, the general pattern is one of relatively mild and brief recession concentrated in the second half of 1980, followed by a very modest but strengthening recovery in 1981.

TABLE 28.—*Real GNP growth in major industrial countries, 1976–82*

[Percent change from previous period; seasonally adjusted annual rates]

Country	1976 to 1979 annual average	1980		1981		1982 first half [3]
		Year [1]	Second half [1]	First half [2]	Second half [2]	
United States	3.9	−¾	−1¾	1	2½	3½
Japan	5.9	5	2¾	4	4¼	4¾
Germany	3.8	1¾	−3	½	1½	2
France [3]	3.3	1¾	½	1	2	2¼
United Kingdom [3]	1.5	−2¼	−5¾	½	−2½	0
Italy [3]	3.2	3¾	−3½	−1¼	2¼	2½
Canada	2.9	−½	−½	1¾	2	3¼
Total of above countries	3.9	1	−1¼	1¼	2¼	3

[1] OECD estimate.
[2] OECD projection.
[3] Gross domestic product.

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

There are several reasons why the recession appears to have been milder, and the rise in inflation less, after the second oil-price shock than after the first. In the first place, inventory movements are substantially smaller in the current cycle than they were in 1974–75. The massive inventory liquidation that marked the earlier recession is not being repeated. As a result, the decline in output has been smaller and the projected pace of recovery is initially slower.

Consumer spending also has been better maintained in relation to income. Saving rates rose sharply in all countries following the first oil-price shock, but they have not done so recently, except in the United Kingdom. Slowing consumer demand is fully accounted for in most countries by weakening household incomes, rather than by marked changes in saving behavior.

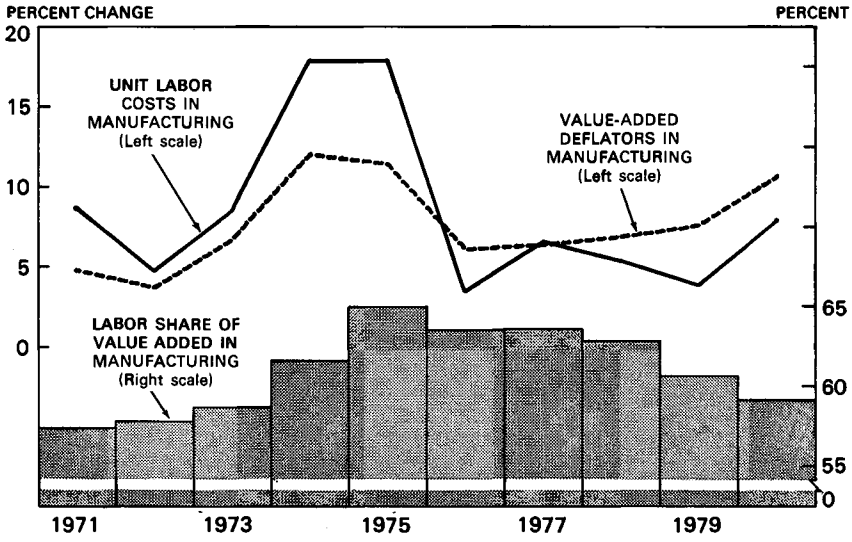
Finally, real wages in most countries have adjusted downward more rapidly in the wake of the recent oil-price rise than they did after the first one, and they have done so with a smaller acceleration of nominal wages. Both the different response of real wages and that of nominal wages have important consequences.

When the world price of oil rises, countries that import oil lose real income. This loss can be absorbed in several ways. If nominal wages rise in line with traditional productivity increments and also to match all increases in consumer prices that result when higher energy costs are passed through, then real wage incomes are protected. Corporate profits, however, are squeezed. In this case household consumption opportunities are preserved, but investment demand is likely to be curtailed as firms grapple with reduced cash flow and lower returns on new investment. Alternatively, if nominal wages rise by a lesser amount in relation to prices, then real wage incomes are squeezed, but the associated decline in real labor costs provides firms with a margin that offsets, in whole or in part, the increase in their energy costs. In this case, consumption may be curtailed, but investment incentives are better maintained.

Chart 10 shows the difference in how the real income loss was absorbed abroad following the two oil-price shocks. In 1974–75 unit labor costs rose much more than value-added deflators for manufacturing. This implied a sharp rise in the labor share of total value added, and a corresponding fall in the profit share, which was only gradually restored in subsequent years. The squeeze on profits was a major cause of low rates of investment in most foreign countries during the following years. And lagging investment largely explains the "hesitant recovery" abroad that was described in the 1978 *Report.* In contrast to the experience abroad, real wages fell in the United States in 1974–75, and investment demand grew apace during the subsequent recovery.

Chart 10

Labor Costs, Value-Added Deflators, and Labor Share in Six Major Foreign Countries



NOTE.—INCLUDES JAPAN, GERMANY, FRANCE, UNITED KINGDOM, ITALY, AND CANADA.
SOURCE: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

In 1979–80, the increase in unit labor costs in major foreign countries remained less than the rise in value-added deflators, thus giving manufacturers some room to absorb increased energy costs without a major squeeze on profit margins. Largely for this reason, but also because the needs to modernize production and improve energy efficiency are substantial, business investment abroad may not weaken unduly in the current recession and may begin to rise again at an early stage of the projected recovery.

The necessary reduction in real incomes, whether it is initially absorbed by wage earners or by their employers, can be associated with a larger or smaller acceleration in inflation. If nominal wages rise sharply, and firms resist the erosion of profit margins by further raising prices, then the adjustment will take place in an environment of rising inflation. By contrast, if nominal wages do not accelerate, then real wages will initially fall as higher oil prices are passed through, but the underlying rate of inflation will not accelerate. And once the pass-through of higher oil costs is completed, actual price rises will

begin to moderate. The second pattern is preferable, not only because it is more likely to sustain investment but also because it generates less inflation. The relative moderation of nominal wage increases in most countries recently, in sharp contrast to the nominal wage explosions that occurred in 1974, is therefore encouraging.

Despite these generally favorable developments, only sluggish growth is now projected for most countries during 1981. Two major factors account for this. First, as already noted, inventory building will not provide added strength. Second, fiscal and monetary policies will remain restrictive. Fiscal deficits in 1980 were little changed from those of 1979 in the major foreign countries, despite the slowing revenue growth and expenditure increases associated with weakening economic activity. Discretionary fiscal policy actions tended to work toward restraint. Announced policy intentions in most countries suggest a further shift toward restraint in 1981. Growth in government expenditures, in particular, is planned to stay below anticipated growth in gross national product (GNP) in most countries, thus reducing the share of government and limiting the rise in budget deficits.

EXTERNAL POSITIONS

For the OECD countries as a group, the two oil-price shocks have had similar effects on trade and current-account positions. In nominal terms, the current account of the OECD as a whole shifted from surplus to deficit by about 1 percent of GNP in 1974 and by about 1½ percent of GNP in 1979–80. In both periods, however, the volume of real imports fell relative to exports; real trade balances therefore rose, moderating the decline in GNP relative to domestic demand.

But in one important respect the 1974–75 and 1979–80 periods have been very different. Both the volume of imports and of exports declined precipitously after 1974, even in relation to the large fall in GNP. The current decline in trade volumes has been much more moderate, and more nearly in line with the path of GNP. A renewed expansion of world trade, albeit at moderate rates, is anticipated as recovery proceeds.

Although the aggregate shift in current-account positions was broadly similar after the two oil-price shocks, there are some important differences in the way this shift was distributed among the major OECD countries (Table 29). In general, a larger share of the total shift has been absorbed by those countries whose relatively good inflation performance and previously strong external positions made them better able to finance these deficits. Most notably, the remarkable performance of Germany in 1974, when its surplus increased by $5.7 billion despite the rise in its oil bill, has not been repeated.

Rather, the German current account shifted from a surplus of about $9 billion in 1978 to an estimated deficit of $17 billion in 1980. The Japanese current account also moved sharply, from a $17-billion surplus in 1978 to an estimated $13-billion deficit in 1980. This shift reflected not only higher oil payments but also the adverse short-term effect of yen depreciation during 1979 and the first quarter of 1980 on the nominal trade balance. These two effects more than offset the strong Japanese trade performance, in volume terms, during the past year.

TABLE 29.—*Current-account balances in major industrial countries, 1978–81*

[Billions of U.S. dollars [1]]

Country	1978	1979	1980 [2]	1981 [3]
United States	−14.3	−0.8	5½	19¾
Japan	16.5	−8.8	−13¼	−6¾
Germany	8.7	−5.5	−17¼	−10½
France	3.7	1.2	−7¾	−6¼
United Kingdom	1.2	−3.9	4½	4¼
Italy	6.2	5.1	−5¼	−2¼
Canada	−4.4	−4.4	−3½	−3
Other OECD	−8.7	−18.4	−37	−35¼
Total OECD	9.0	−35.5	−73½	−40

[1] Current account balances inclusive of official transfers.
[2] Preliminary OECD estimates.
[3] OECD projection.

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

By contrast, the current account of the United States improved by an estimated $20 billion over this same period, as discussed more fully in Chapter 3. Similarly, the United Kingdom moved into substantial surplus during 1980, both because that country has become largely self-sufficient in oil—so that its trade account was not strongly affected by the rise in oil prices—and because the recession has been relatively more severe in the United Kingdom than elsewhere, thus limiting imports.

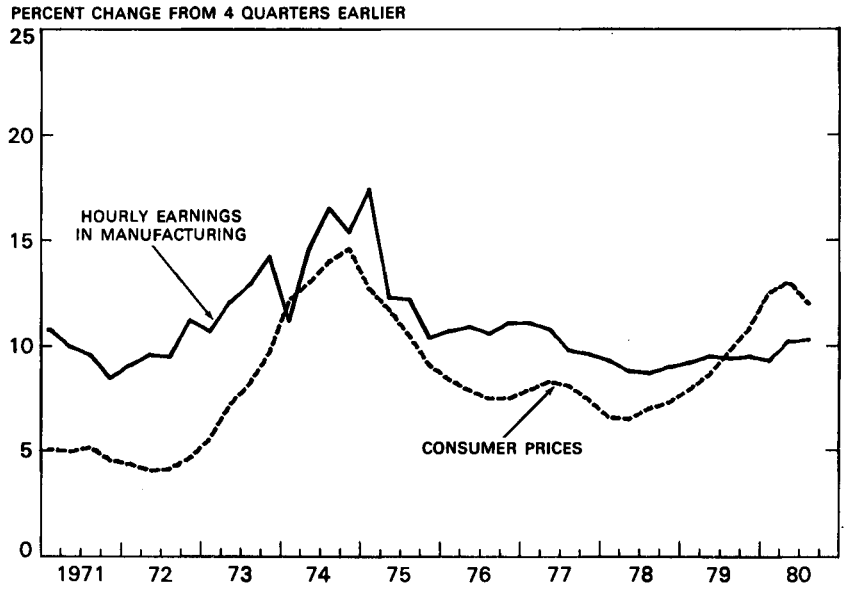
INFLATION

The different pattern of absorption of the recent oil-price shock compared to the earlier one shows up clearly in the movements of wages and prices. Chart 11 traces the movements of consumer prices and hourly earnings in manufacturing over the past decade for the major industrial countries. As measured by consumer prices, rates of inflation outside the United States tended to decline during 1978 to levels comparable to those prevailing in the early 1970s—though with substantial dispersion among countries. But consumer price inflation accelerated everywhere during 1979 and into 1980 under the impact of higher energy prices. In sharp contrast to the earlier period, however, hourly earnings accelerated only moderately, and lagged behind consumer prices in almost all countries. As oil prices

stabilized in mid-1980, inflation rates peaked and then began to recede in the second half of the year. On current projections, and assuming that oil prices do not again rise sharply, a continued reduction in inflation rates is in prospect for most countries during 1981—indeed, a somewhat more rapid reduction abroad than in the United States (Table 30).

Chart 11

Wage and Price Changes in Seven Major Countries



NOTE.—INCLUDES UNITED STATES, JAPAN, GERMANY, FRANCE, UNITED KINGDOM, ITALY, AND CANADA.

SOURCE: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

Substantial differences among the major countries will persist, however. At one extreme, inflation rates in Germany and Japan during 1981 are likely to return to the moderate levels that were achieved in 1977–78. On the other hand, relatively high inflation is likely to persist in a number of other countries—especially Italy, but also the United States, France, and Canada—where wage rigidities appear to be more significant. In the United Kingdom, the continued adherence to restrictive fiscal and monetary policies, the strength of the pound, and substantial slack in labor and product markets appear to be causing a rapid decline in inflation from the high levels reached in 1979 and early 1980. But even so, inflation in the United Kingdom will remain relatively high.

TABLE 30.—*Inflation in major industrial countries, 1976–82*

[Percent change in prices [1]]

Country	1976 to 1978 annual average	1979	1980 [2]	1981 [3]	1982 first half [3]
United States	6.2	8.9	10½	10	9½
Japan	5.5	3.1	6¼	5¼	5
Germany	3.2	3.9	5¼	4	3
France	9.4	10.9	13¾	11¾	9½
United Kingdom	11.7	12.2	15½	12	9
Italy	12.0	14.8	20¾	15¾	13½
Canada	9.8	9.1	9¾	10	9¾
Total of above countries	6.8	8.1	10½	9¼	8¼

[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. Percent changes for first half 1982 are from previous half year at seasonally adjusted annual rates, except France and Italy, not seasonally adjusted annual rates.
[2] Preliminary.
[3] OECD forecast.
[4] Based on 1979 GNP/GDP weights and exchange rates.

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

SUMMARY ASSESSMENT

It is not possible to provide a definitive explanation of why the oil-price rise was absorbed more easily during the current cycle than it was in 1974–75. Timing is certainly one important consideration. The most recent runup in oil prices came at a time when most countries were still on an upswing from the previous recession, rather than at a peak. Hence, cyclical factors tended to offset, rather than accentuate, the 1979 price shock. In addition, the 1974 shock followed hard upon a major surge in industrial and agricultural commodity prices, which generated strong speculative pressures and excessive inventory accumulation. Commodity prices—except for the explosion in prices of precious metals in 1979 and early 1980—have shown a less marked upward trend in the recent period.

The key element promoting smoother adjustment, however, has been the restrained response of nominal wages to rising prices in most countries. This restraint has served a double function. It has helped to preserve a relationship between costs and prices that will encourage a more rapid resumption of growth by maintaining profitability and thus investment. It has also limited the rise in underlying inflation rates and thus reduced the probable duration and severity of the fiscal and monetary policy restraint that is required.

A number of factors may explain the moderate behavior of wages, and different factors may be more important in some countries than in others. The unambiguous adoption, in almost all countries, of monetary policies that did not seek to finance the rise in oil prices with faster rates of monetary expansion has certainly been an important factor, as has the pursuit of moderately restrictive fiscal policies. "Jawboning" by government officials may also have had an effect in

some countries, and in the United States a more formal incomes policy has played a role. Wage moderation may also have reflected the higher average levels of unemployment and associated labor market slack that prevailed in 1979. In some countries—especially those where the oil-price shock has been absorbed most rapidly such as Germany and Japan—wage moderation may reflect an implicit social consensus under which unavoidable reductions in real incomes are accepted by wage earners in the understanding that the distribution of income will not thereby be shifted to their disadvantage.

Although the adjustment to the recent runup in oil prices has proceeded relatively smoothly in most countries, it cannot be denied that the process is very costly. While the increased oil bill due to the price rises of 1979–80 amounts to about 2½ percent of the combined GNP of the OECD member countries, the cost in lost output is much larger. Taking into account the effects of both the oil-price rise itself and the restrictive monetary and fiscal policies it called forth, the OECD estimates that the level of GNP in the OECD member countries may be some 6 percent, or about $500 billion, lower by the beginning of 1982 than it would have been in the absence of the oil-price rise. While this estimate might be somewhat on the high side, it is nevertheless clear that even smooth adjustment cannot prevent major secondary repercussions.

RISKS IN THE OUTLOOK

Excluding the United States, real GNP in the major industrial countries is projected to rise at about a 2 percent annual rate from the second half of 1980 to the first half of 1982—a pace unlikely to be rapid enough to prevent some further increases in unemployment. Inflation rates in the industrial countries outside the United States are projected to slow—averaging about 8.5 percent by the first half of 1982, as compared to 11 percent in the second half of 1980.

The possibility of worse outcomes cannot be dismissed, however. In particular, one cannot be entirely confident that the pattern of wage moderation will continue, inasmuch as the reasons for it are not fully understood. A continuation of relatively restrictive monetary and fiscal policies in most countries is widely viewed as necessary to contain this risk, but these policies may also slow recovery by more than is now projected. More critically, the situation in the oil market is once again precarious following the interruption of supplies from Iran and Iraq. A further large increase in oil prices in 1981 could undermine the still fragile process of consolidation and recovery. The following section addresses this issue in more detail.

Table 31 summarizes world petroleum production and use patterns over the past 8 years. The most striking aspect of the table is how small the year-to-year fluctuations in production have been. The major disruptions of 1974 and 1979 were associated with very modest shifts in the balance between consumption and production. It is the low price elasticities of supply and demand in the short run, rather than wide fluctuations in the quantities supplied or demanded, that make disruptive price movements possible.

TABLE 31.—*Global oil balances, 1973–80*

[Millions of barrels per day, except as noted]

Item	1973	1974	1975	1976	1977	1978	1979 [1]	1980 [2]
OECD consumption	39.3	37.6	36.3	38.5	39.4	40.3	40.4	38.0
Less: OECD production	13.9	13.4	12.8	12.7	13.3	14.2	14.8	15.0
Equals: Required OECD imports for consumption (A)	25.4	24.2	23.5	25.8	26.1	26.1	25.6	23.0
OPEC production	31.3	31.1	27.6	31.2	31.8	30.5	31.5	27.8
Less: Non-OECD consumption minus non-OPEC, non-OECD production	5.4	5.2	4.3	4.8	4.9	4.9	5.0	4.8
Equals: Available to OECD from rest of world (B)	25.9	25.9	23.3	26.4	26.9	25.6	26.5	23.0
Balancing item (B minus A) [3]	.5	1.7	−.2	.6	.8	−.5	.9	.0
Estimated stock levels, end of year (billions of barrels)	(*)	(*)	(*)	3.6	4.0	3.9	4.2	4.2

[1] Preliminary.
[2] Forecast.
[3] Stock-building and/or statistical errors.
* Not available.

Source: Council of Economic Advisers.

The 1979 rise in oil prices occurred despite increased oil production. The curtailment of Iranian supplies in late 1978 was more than made up in 1979 by production increases elsewhere. Nevertheless, a number of prior developments had created conditions favorable to price increases. First of all, world consumption of petroleum, though rising more slowly after 1975 than in the previous decade, nonetheless increased steadily from 1975 to 1978, reducing the excess production capacity that had emerged after the first oil-price shock. Second, the real price of oil fell during this period, thus encouraging consumption and also reducing the real value of OPEC revenues. Finally, stocks were drawn down during the course of 1978—perhaps because falling real oil prices had made stock building appear unprofitable. As a result, the margin of flexibility available to accommodate the curtailment of Iranian supplies was small, and the incentives for OPEC countries to raise prices were strong.

It is clear that smaller price increases than actually occurred would have been sufficient to balance consumption and production. Rising demand for stocks, however, kept pushing prices higher well into

1980. After midyear, when consumption had fallen sufficiently to accommodate and moderate the stock buildup, price pressures began to ease. In fact, excess supply conditions were avoided only because a number of OPEC countries cut back their production.

Hindsight also shows that a less ambitious restocking pattern during 1979 and up to mid-1980 would have made a smoother adjustment possible. One cannot be certain of all the reasons why this restocking occurred, but several factors may have been important. First, additional stocks may have been needed to keep the distribution system operating smoothly, given the growing fragmentation of the world oil market and the resulting decreased ability of the major oil companies to shift supplies around to accommodate shifting needs. In addition, the disruption in late 1978 and early 1979 greatly increased feelings of uncertainty about future supplies and thus raised the precautionary demand for stocks. Finally, the rise in prices itself tended to increase the incentives for stock accumulation in anticipation of capital gains—at least until prices had risen sufficiently to make further price rises appear less probable. This speculative motive may have been strengthened by the belief that OPEC countries respond asymmetrically to market conditions. If OPEC producers respond to tight market conditions by raising prices but cut back on production when markets weaken rather than allowing prices to fall, they in effect build a ratchet under existing prices. Stock building then becomes a particularly attractive form of speculation when prices begin to rise, since the risk of major financial loss from a subsequent fall in prices is much reduced.

Although the massive buildup of stocks during 1979 and 1980 was very costly because of the added pressure it placed on oil prices, these stocks have subsequently proved valuable because they have provided a cushion in the face of the Iran-Iraq war. The oil market would in all probability have been slack in 1981, with little pressure on oil prices, if the Iran-Iraq war had not occurred. Prior to the onset of hostilities, consumption per day was several million barrels below world capacity, and stocks were at very high levels. Now, however, the situation is more difficult to assess. The war has removed nearly 4 million barrels a day from world oil supplies for an undetermined length of time, but some of this loss is being offset by increased production elsewhere. At the moment, stocks are still above their normal historical levels, and severe market pressures have not emerged.

The margin, however, is a narrow one. If oil consumption continues to decline as further adaptation to higher prices outweighs the effects of resumed economic growth, if the war does not widen, and if stock drawdowns are permitted to occur as needed, then a balance

may be preserved. Stocks are in fact being drawn down, consistent with the objectives set for the major oil-consuming countries at the meeting of the International Energy Agency late last year. But if the disruption is more severe, or mismatches on a country-by-country basis between demands and stocks induce a scramble for extra supplies and a bidding up of prices in spot markets, or if expectations of price rises—warranted or not—induce speculative withholding of stocks in anticipation of capital gains, then acute market pressures could once again develop.

DIRECTIONS FOR ECONOMIC POLICY: NEEDS AND CHALLENGES

Despite the progressive absorption of the 1979 oil shock and the projected beginning of moderate recovery this year, the world economy will be grappling with several difficult problems in the years immediately ahead.

First, policies of demand restraint are needed in all countries to fight inflation. This need is felt not only in those countries where inflation rates are highest, but also in those where considerable progress has already been made in bringing inflation down. For these latter countries, the concern is that an early relaxation of restrictive policies before inflationary expectations have been firmly laid to rest would allow inflation to reaccelerate. This would not only undo the progress achieved but would also undermine the credibility—and hence the effectiveness—of subsequent anti-inflation policies. The degree and duration of needed restraint, of course, varies among countries. Where inflation rates have been persistently high, continued restraint for a number of years may be necessary to bring inflation down and to convince people that it will stay down. Where inflationary expectations are less deeply entrenched and where inflation is lower, a shift to less restrictive policies may be possible sooner.

Because of the momentum of inherited inflation and rigidities in the setting of wages and prices, restrictive demand policies that aim to reduce inflation will also slow the growth of production and keep unemployment relatively high for some time. In this way, the inflation problem gives rise to an unemployment problem. Unemployment rates have risen in most countries during the 1970s, and no early reversal of this trend is in sight. High unemployment is costly not only because it imposes hardships on those who do not have jobs, but also because it fosters "preservationist" attitudes among society generally. Economic restructuring becomes more difficult when workers in declining firms or industries fear they will be unable to find other work, when pressure on governments to subsidize unprof-

itable activities intensifies, and when trade protection becomes more attractive.

The second fundamental problem is that in most industrial countries the growth of potential output has fallen because of lower productivity gains. The decline in productivity growth has generally been less marked abroad than in the United States, but it has occurred to some extent in all countries. Although all the reasons for this decline are not known, several common factors can be identified. Higher energy prices lead to the substitution of labor for energy, and thereby induce a slowing in productivity. Productivity growth has been slowed also by lower rates of investment in many countries, leading to a smaller rise in capital per worker and a slower pace of adoption of the technological innovations embodied in new capital goods. Finally, productivity growth outside the United States has been reduced because opportunities for technological borrowing have diminished as the "technology gap" between the United States and other industrial countries has diminished or, in many sectors, disappeared.

The decline in productivity growth directly reduces the scope for increases in real incomes and standards of living. Nevertheless, some have argued that as long as the growth of production is also limited by restrictive demand policies the decline in productivity is not all bad because it leads to more employment, and hence less of an unemployment problem, than would be the case if productivity growth remained higher. This argument, however, ignores the fact that lower productivity growth increases cost-push inflation. Since wage demands do not adjust downward when productivity growth slows, unit labor costs rise faster, putting increased upward pressure on prices. If nominal wage demands then accelerate in an attempt to achieve the real income gains obtained in the past when productivity growth was higher, the underlying inflation rate is increased still further. As a result, demand policies have to be more restrictive than otherwise to achieve a deceleration of inflation. In this way a slowing of productivity imposes a double burden. It reduces the growth of potential output, and at the same time it increases the degree of economic slack that is needed to achieve a given deceleration of inflation.

THE SEARCH FOR SOLUTIONS

While restrictive demand policies are needed to fight inflation, other policies must be put in place to reduce the costs that restrictive demand policies inevitably impose on the economy and to restore over time a more normal growth in productivity and living standards. Three broad approaches need to be pursued. First, supply-oriented policies that raise productivity and increase economic flexibility need to be put in place. Second, policies to increase energy supply and to reduce the demand for energy are needed to weaken the energy con-

straint on growth. Finally, policies that directly influence wage an price setting can play a role in some nations in lowering actual an expected inflation.

Supply-Oriented Policies

As discussed in Chapters 1 and 2 with respect to the U.S. econo my, supply-side measures can make a significant contribution to improved economic performance. Beyond the direct benefits that such measures can provide by increasing the efficiency with which resources are allocated, they can also serve to reduce the costs of restrictive demand policies. If flexibility in labor or product markets is increased, the effectiveness of demand restraint in slowing inflation also improves. If productivity growth is enhanced, not only does potential output rise but higher levels of capacity utilization can also be achieved, since cost-push inflation is reduced.

There is no master plan of supply-side policies that will be equally useful to all countries, given their different institutional arrangements and structural relationships. Earlier chapters of this *Report* discuss a number of policy approaches appropriate to the United States, and many of these may also be useful in other countries. Two approaches, in particular, stand out as important in most countries.

First, policies are needed to raise the share of GNP that is invested in new plant and equipment. Higher investment is necessary to raise productivity growth, to increase domestic energy production, and to accelerate the economic restructuring that higher oil prices and global shifts in patterns of comparative advantage have made necessary.

A potential problem exists with respect to greater investment, a problem which some have called the "low-growth trap." The argument is that if restrictive demand policies are used to fight inflation, investment will also be reduced because the existence of unutilized capacity will make companies unwilling to undertake investments that may not be needed until the more distant future. Lower investment, in turn, would reduce productivity growth and potential output, and hence reinforce the need for demand restraint. Thus, the final outcome might be a prolonged period of stagflation.

While there are indeed difficulties in trying to increase investment during a period of demand restraint, one need not accept the "low-growth trap" argument. Low rates of capacity utilization do, by themselves, have a negative effect on investment. Other factors, however, are also important and can offset this effect. As was emphasized earlier in this chapter, the recent oil shock has been absorbed in a way that has limited the erosion of profitability and cash flow to enterprises, and thus has supported investment. Moreover, the need for restructuring may require substantial investment even in sectors where

capacity utilization is low. The U.S. automobile sector is a clear example, and similar requirements exist in most countries. Finally, as discussed in Chapter 1 with reference to the United States, there is a good deal of evidence that policies to raise the return on capital investment or to lower the cost of capital can have substantial impacts on investment demand even when significant excess capacity exists. For all of these reasons it seems probable that countries can avoid a low-growth trap and, by pursuing vigorous investment-oriented policies, raise the share of investment in GNP even while continuing with policies of overall demand restraint.

The second supply-oriented approach is to increase the flexibility of labor and product markets by reducing unnecessarily burdensome regulation, by increasing competition within and across borders, and by improving policies for structural adjustment in industry and agriculture. Policies, for instance, that improve flexibility in labor markets through job training or other programs, or which reduce the downward rigidity of wages in the face of high unemployment, achieve several important objectives simultaneously. They reduce unemployment directly by easing frictional unemployment and stimulating the demand for labor in sectors where prevailing wage rigidities have made hiring unprofitable. Perhaps more important, greater labor-market flexibility increases the speed with which restrictive demand policies translate into lower rates of inflation. To the extent that this occurs, higher rates of real growth can be accommodated. Even if demand policies do not change so that nominal income growth is limited, real income growth is larger to the extent that inflation is less. Moreover, if inflation declines more quickly in response to demand restraint, both the severity and the duration of the needed demand restraint are reduced, thus further improving the prospects for higher growth and a more rapid absorption of the unemployed.

Other examples of policies that enhance flexibility include U.S. efforts in deregulation and regulatory reform, the progressive dismantling of price controls in France during the past several years, and the moves in some countries to allow more realistic pricing policies in nationalized sectors.

There are serious difficulties to be overcome, however. In many cases governments lack the tools for evaluating the costs and benefits of structural policies. Divisions of authority among agencies with different objectives or loyalties make coherent policy formulation, implementation, or evaluation difficult. There is, in general, a need to increase the "transparency" of government operations—both internally, so that governments themselves can come to a clearer perception of just what it is they are doing, and externally, so that those

outside government, both at home and abroad, can form a clearer idea of what is to be expected. A further inescapable difficulty is that strong political pressures arise to influence structural policies when potential gains or losses to particular sectors are at issue. More powerful techniques to enhance transparency can serve not only to improve the quality of decisionmaking, but also—by making costs and benefits clearer—to stiffen the resistance of governments to unbalanced political pressure.

Energy Policies

Increased investment in alternative energy sources, efforts to promote more efficient use of existing supplies, and measures to reduce vulnerability to supply disruptions are needed to improve growth prospects over the longer-term. So long as oil supplies are scarce and uncertain, and energy markets lack the flexibility to absorb disruptions in the flow of oil, the risk of recurrent oil-price shocks cannot be avoided.

While the market incentives provided by sharply higher energy prices will furnish the major impetus for many of the needed adjustments, government actions will also be needed in some cases. The development of some new sources of energy, for instance, may require government participation because of the long lead-times, very large scale, and technological risks associated with them. Furthermore, the building up and management of petroleum stockpiles requires a government role since private stocking provides insufficient protection against oil-supply disruptions for the reasons discussed in Chapter 2.

There is also a strong rationale for a broader international coordination of energy policies. The potential gains from a more rapid expansion of U.S. coal production, for instance, are increased if other countries, anticipating the increased availability of coal, at the same time increase the capacity of their electric-power systems to use coal instead of other fuels. More broadly, part of the social benefits that arise when one country increases its energy production or reduces its energy demand accrue abroad, since energy consumers in all countries will benefit from the resulting reduced pressure on world energy prices. Joint projects and other forms of international cooperation may therefore be particularly appropriate in the field of energy.

The rationale for international coordination of government policies is especially strong with regard to oil stocks. If countries attempt to increase their own security by bidding for stocks and thereby create conditions of excess demand, all countries will suffer the consequences of sharply higher oil prices. Conversely, the willingness of one country to use existing stocks in times when markets are tight may depend on the extent to which other countries do the same. A

coordinated use of stocks may forestall a surge in oil prices, but few countries would act individually to draw down their stocks if they thought that others would then exploit the opportunity to protect or increase their own.

Incomes Policies

The adoption of policies to influence directly the process of wage and price setting is another approach to improving economic performance. Elsewhere in this *Report* the possibilities as well as the problems of implementing tax-based policies to encourage wage and price restraint in the United States are discussed. The major foreign countries do not now have formal incomes policies—though interest in using them has at various times been evident in several of them. It does appear to be the case, however, that those countries with the greatest downward flexibility in wage and price behavior, and hence also the lowest inflation rates, have a stronger social consensus than those countries with higher inflation. Ironically, it may be that explicit incomes policies would be easiest to implement in those countries where the implicit social consensus makes them least needed.

MONETARY POLICY AND EXCHANGE RATES

In addition to the fundamental economic and social issues involved in designing and carrying out sustained policies of demand restraint and supply enhancement, there are problems of a more technical nature that must be dealt with. One of these, which has received a good bit of attention recently, arises from the interaction between domestic monetary policy and the foreign-exchange markets.

If it is perceived that different countries, through their monetary and fiscal policies, have significantly different objectives, especially with respect to inflation, then exchange rates are likely to move. For instance, if some countries use monetary policies aggressively to achieve a rapid decline in inflation while others pursue more expansionary policies that are judged likely to increase inflation, the currencies of the former countries will tend to appreciate against those of the latter. Such exchange-rate adjustments are both unavoidable over the longer run and necessary to prevent the building up of distortions in relative price levels across countries, so long as different policy objectives persist.

Exchange-rate adjustments do not always proceed smoothly, however. Exchange markets may at times become disorderly, and exchange rates may move more sharply than necessary to accommodate differences in policies or in other fundamental economic variables. Such risks probably increase when the divergence in policy objectives becomes more marked and expectations about future economic performance correspondingly more diverse. Particularly when inflation

rates are high, differences in policy objectives may have a magnified effect on exchange rates if the countries that attempt to ease policy are viewed as giving up on the fight against inflation. For these reasons, some combination of broad consistency in economic policy objectives and cooperation in exchange-market policies is probably necessary to ensure the smooth functioning of the international monetary system.

As discussed earlier in this chapter, most countries are now pursuing broadly similar policies of demand restraint aimed at reducing inflation, and exchange markets have not been subject to major disruptions over the past 2 years. Monetary policies in many countries have focused on keeping the rates of money growth—differently defined in different countries—on target or within target ranges. These targets are themselves set with an eye toward steady reduction in the rate of monetary expansion so as to be consistent with the hoped-for reduction in inflation. Even though monetary policies have shared the same general objectives and approach, they have had different consequences in different countries with respect to both the level and the variability of interest rates. For various reasons these differences have been particularly wide in the recent past and have raised several questions about the relationship between domestic monetary policies and the variability of exchange rates.

To the extent that actual and expected rates of inflation differ across countries, nominal rates of interest tend to be different even when monetary authorities pursue policies that restrict nominal demand growth to a comparable extent. If different interest rates simply reflect differences in underlying inflation expectations, international financial markets should not, in theory, be disrupted. Market participants would recognize that higher nominal yields on assets denominated in some currencies do not necessarily translate into higher rates of return if exchange rates move over time to reflect differences in inflation. For a variety of reasons, however, this mechanism may not always function smoothly. Purchasing power parities do not hold with any great precision in the short or even the more medium term. Therefore, market participants need not assume that depreciation will offset higher nominal yields over the period during which the asset is held. Furthermore, if asset holders perceive that monetary authorities are likely to resist incipient currency depreciations through intervention, they may be tempted to seek out high nominal returns on the expectation that they will be able to unwind their positions before the depreciation occurs. In such circumstances downward pressure on the exchange rates of countries with lower inflation and nominal interest rates might arise.

The large differences in monetary structures and instruments of monetary control across countries may also produce substantial differences in real interest rates for comparable degrees of monetary restraint. In particular, monetary systems which rely more heavily on nonprice rationing effects to achieve restraint may tend to have lower real rates of interest than those which have fewer such rigidities (though such rigidities may also cause greater dispersion of interest rates across different financial markets). Where such real interest rate differences arise, exchange-rate pressures may emerge even when nominal interest rates are properly discounted for inflation.

A second problem on which attention has focused has been the greater volatility of interest rates. As discussed in other chapters of this *Report,* both the change in the operating procedures of the Federal Reserve and major changes in the structure of U.S. financial markets have led to increased variability in U.S. interest rates. If foreign exchange markets are highly sensitive to interest rate movements, then variations in U.S. interest rates may lead either to greater variability in the exchange rates of other countries vis-a-vis the dollar or else to greater fluctuations in their interest rates. Of course, a reduction in the volatility of interest rates in the United States would be desirable on domestic grounds as well, if it could be accomplished without compromising the ability of the Federal Reserve to achieve its monetary growth objectives.

Although it is clear that considerations of exchange-rate volatility may sometimes reduce the freedom of monetary authorities to conduct monetary policies solely on the basis of domestic objectives, the problem may have been overstated in recent public discussions. Moderate movements in exchange rates, even if not strictly necessary from the perspective of fundamental economic conditions, need not impose significant costs on economic performance. Furthermore, if longer-run expectations concerning inflation and current-account balances are such as to provide stability to exchange rates, interest rate differences are not likely to be a major and continuing source of trouble.

The strength of the dollar in the latter part of 1980, for instance, reflected not only high interest rates but also the strong current-account position of the United States. At the same time, the weakness of the German mark, not only vis-a-vis the dollar but also against the other currencies of the European Monetary System, was also due to the large and unaccustomed German current-account deficit in 1980. The yen, to take another example, strengthened during the second half of last year and yet further in early 1981 despite a lowering of Japanese interest rates and a large, although declining, current-account deficit. This strength probably reflects the relatively buoyant

Japanese trade performance in volume terms, and also perhaps the ability of the Japanese authorities to attract OPEC funds. Again, the continued strength of sterling during 1980 was only in part the result of high nominal interest rates. Oil independence, the strengthening current-account position, and the general credibility of the British government's commitment to policies of restraint were also important.

To sum up, it appears that even with broad consistency in monetary policy objectives, problems can sometimes arise from the potential flow of funds across borders in response to differences in nominal interest rates. While the threat of such flows can complicate the conduct of monetary policy, this threat need not be so severe as to deprive carefully managed monetary policies of the flexibility they need to meet domestic objectives. Flexibility in monetary policy may, of course, occasionally require somewhat greater fluctuations in exchange rates than would otherwise be the case, but if fundamental economic conditions are such as to promote stability, such movements should not pose major problems.

CHALLENGES TO THE INTERNATIONAL FINANCIAL SYSTEM

The international community possesses a marvelously articulated set of private and public financial institutions through which funds are channeled from short-term lenders to long-term borrowers, from surplus to deficit countries, from one currency to another, and from capital-rich countries to capital-poor developing ones. The smooth functioning of this financial system has helped to make possible a rapid expansion of international trade and a relatively sizable transfer of resources to developing countries, both of which have contributed importantly to postwar economic growth and development. While the system has periodically required attention to keep it up to date with changing financial conditions, it has adapted and performed its critical functions well over the last three-and-a-half decades.

The huge increase in the volume of international financial flows occasioned by the recent oil-price rise, following upon a similar increase only 5 years earlier, has placed a major strain upon international financial institutions. Making sure that these institutions can continue to conduct vitally needed financial transfers soundly and efficiently is a second major challenge to economic policymaking in the years immediately ahead. If the needed transfers of resources from surplus to deficit countries are not made, or if they occur in ways that permit countries to avoid the painful adjustment to higher oil prices, the prospects for sustainable world economic growth and development will be seriously harmed.

The volume of international financing is reflected in Table 32, which describes current-account positions, net of official transfers, for broad country groupings, as compiled and projected by the OECD. The table provides an indication of the orders of magnitude involved, but specific numbers should not be overemphasized since even the historical numbers are subject to substantial margins of error. The projections for 1981 are particularly uncertain because the assumption of a constant real oil price that underlies these projections is at risk on account of the Iran-Iraq struggle.

Very large financing needs will persist over the next several years. While the OPEC surplus is expected to decline if oil prices do not rise sharply again, the decline will be more than matched by a projected improvement in the current-account positions of the larger OECD countries. The deficits of the smaller OECD countries will remain roughly unchanged at levels that—while broadly financeable—are nevertheless viewed as a problem by the countries themselves. The already substantial deficits of a number of the non-oil developing countries are projected to rise further, but whether financing on the scale implied by such deficits will be forthcoming must remain a question of serious concern.

TABLE 32.—*Global current-account balances, exclusive of official transfers, 1978–81*

(Billions of U.S. dollars; OECD basis)

Country	1978	1979	1980[1]	1981[2]
OECD	28	−13	−47	−12
Big Seven [3]	35	2	−14	21½
Other	−7	−15	−33	−33½
OPEC	5	70	120	86
Non-oil developing countries	−30½	−47	−62	−69
Other [4]	−9½	−3	−6	−9
Residual [5]	7	−8	−5	4

[1] Preliminary.
[2] OECD projection.
[3] United States, Japan, Germany, France, United Kingdom, Italy, and Canada.
[4] Centrally planned economies, Gibraltar, Malta, South Africa and Yugoslavia.
[5] Reflects statistical errors and asymmetries. Given the very large gross flows of world balance of payments transactions, statistical errors and asymmetries easily give rise to world totals (balances) that are significantly different from zero.

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

At an aggregate level, of course, the borrowing needed to finance deficits must be matched by the lending that surplus countries undertake. The relative ease, compared to expectations, with which the "recycling" of funds was carried out after the first oil-price shock no doubt owes a great deal to this "adding-up" property. The sharp increases in liquidity arising from massive inflows of OPEC funds into the major national and Eurocurrency banks provided the funding for the large increase in lending by these banks to the deficit countries.

No "Say's Law" operates in international financial markets, however, to assure that desired lending matches intended borrowing on a country-by-country basis. Much of the money available for lending comes from countries, especially OPEC countries, who wish to place their funds in short-term liquid deposits. But much of the borrowing, especially on the part of newly industrialized countries with relatively fragile debt-servicing capacity, is for long-term needs. Between these two different sets of preferences stand the intermediaries—some official international institutions and some international capital markets, but principally the large private banks of the industrial countries which accept liquid short-term deposits, make illiquid long-term loans, and in return for the profits they earn bear most of the risks involved. Channels of intermediation, however, can become clogged or overburdened. Perceptions of risk may limit the willingness of intermediaries to expand their lending to certain countries, or high borrowing costs may simply preclude countries with low incomes from borrowing, since they lack the resources needed to service this debt.

FINANCING THE DEFICITS OF THE NON-OIL DEVELOPING COUNTRIES

The broad financing pattern for the non-oil developing countries over the period from 1973 to 1979 is shown in Table 33, taken from IMF compilations. The character of the flows that finance these countries' deficits has changed markedly since 1973 when a large share of the financing was with funds, such as government transfers, that did not create debt. Since 1975, however, deficit financing has come to depend increasingly on sources that do create debt, especially on long-term borrowing on market terms from private sources. Beginning in 1979—and partial evidence suggests the trend continued into 1980—the share of private long-term financing declined. Offsetting that decline were a small rise in official financing, a stronger increase in short-term borrowing, and a slowing of reserve accumulation.

The aggregate data in Table 33 mask considerable diversity among countries, but two main groups can be identified. One group consists of the low-income developing countries which, largely unable to afford market terms, rely heavily on official financing on concessional terms. For them the continued availability of official finance on affordable terms is a major concern. In particular, the expansion of World Bank resources through the Sixth Replenishment of its soft-loan affiliate, the International Development Association (IDA), is critical for these countries. Yet without the approval of the U.S. Congress, IDA resources cannot be replenished. Unfortunately, that approval did not come out of the post-election Congressional session. If replenishment is not forthcoming, IDA will exhaust its commitment authority in March, and it will have no resources with which to meet the rising

requirements of the low-income countries it serves. Speedy action by the new Congress is therefore essential.

TABLE 33.—*Non-oil developing countries: current-account financing, 1973–79*

[In billions of U.S. dollars]

Item	1973	1974	1975	1976	1977	1978	1979
Current-account deficit [1]	11.5	36.9	45.9	32.9	28.6	35.8	52.9
Less: Financing through transactions that do not affect net debt positions [2]	9.8	[3]13.2	11.7	12.1	14.4	16.2	19.4
Plus: Accumulation of reserve assets (decumulation—)	9.3	1.2	−2.0	12.7	11.9	18.2	11.0
Equals: Net external borrowing [4]	11.0	[3]24.9	32.2	33.5	26.1	37.8	44.5
Long-term from official sources, net [5]	5.5	[3]9.6	11.4	10.2	12.4	13.3	15.9
Other long-term borrowing from nonresidents, net	6.6	10.2	14.7	17.6	15.8	25.1	23.4
From financial institutions [6]	4.0	8.6	9.2	10.9	15.6	19.3	17.3
Other, net [6]	2.6	1.6	5.5	6.7	.2	5.8	6.1
Use of reserve-related credit facilities, net [7]	.3	1.6	2.4	4.3	.4	.7	.2
Other short-term borrowing, net	([9])	5.1	6.5	3.9	−.8	1.1	5.0
Residual errors and omissions [8]	−1.4	−1.6	−2.8	−2.5	−1.7	−2.4	

[1] Net total of balances on goods, services, and private transfers (with sign reversed).
[2] Net unrequited transfers, net direct investment, SDR allocations, gold monetization, and valuation adjustments.
[3] Excludes the effect of a revision of the terms of the disposition of economic assistance loans made by the United States to India and repayable in rupees, and of rupees already acquired by the U.S. Government in repayment of such loans. The revision has the effect of increasing government transfers by about $2 billion, with an offset in net official loans.
[4] Includes any net use of nonreserve claims on nonresidents, errors and omissions in reported balance of payments statements for individual countries, and minor deficiencies in coverage.
[5] Public and publicly guaranteed borrowing only.
[6] Principally bond issues (public and publicly guaranteed borrowing only) and supplier credits, net of acquisitions of long-term assets.
[7] Comprises use of Fund credit and short-term borrowing by monetary authorities from other monetary authorities.
[8] Errors and omissions in reported balance of payments statements for individual countries, plus minor omissions in coverage.
[9] Less than $50 million.

Source: International Monetary Fund.

A different set of concerns arises for other developing countries such as the exporters of manufactured goods whose long-term deficit financing has come to a large extent from the private capital markets. For them it is obviously critical, first, whether the slowdown in long-term bank lending since 1978 is a "pause" that will shortly be reversed or a more permanent development; and, second, whether official resources—on which the poorer countries often have first claim—will be adequate to fill any remaining gap.

Private Financing

It is probable that the slowing of long-term bank lending to developing countries reflects both a greater unwillingness on the part of the banks to lend and an increased reluctance on the part of some developing countries to borrow. The relative importance of these two factors is hard to establish. There is considerable evidence that a number of developing countries have deferred borrowing. Whether they have done so because of high interest rates or, perhaps more critically, because they are unwilling to accept higher spreads over the London interbank rate (LIBOR) is unclear. Higher spreads raise

the cost of the loans, and they may also be interpreted in the financial markets as evidence that the borrowers are less creditworthy than countries borrowing at lower spreads. There are also clear indications of reluctance on the part of the banks to continue to increase their exposure in developing countries, either because of portfolio management considerations or because of pressures from bank examiners to limit and diversify risks. Numerous factors affect the willingness of banks to extend loans to particular countries. Chief among these are the external debt which a country has already incurred and judgments by potential lenders about the risk that a country may become unable to service its debt.

The problem of country risk arises most acutely if borrowing is perceived to lead to debt-service payments which can be managed only by still larger borrowing in the future. Several implications flow from this perspective.

First, the willingness of banks to continue lending depends importantly on their perception of the longer-run economic prospects of the borrowing country. A country that borrows to finance consumption—including the consumption of petroleum—is a riskier proposition than one borrowing to finance productive investment. The investment generates a return that can, in turn, be used to service the debt.

Second, while the additional loan needs of many borrowers stem from the need to pay for an increased oil bill, the ability to obtain financing depends partly on how well the borrower is deemed to be adjusting its economy to the reality of higher oil prices. To some extent, the greater the signs of progress toward reducing oil imports or expanding exports to pay for them, the easier it is to finance the remaining deficit.

Third, banks' concerns about debt rescheduling may be an important influence on the pattern of lending, but the direction of influence is ambiguous. If countries which were unable to service all of their external debts were to reschedule their official debts while continuing to meet payments to private lenders, the banks would have little incentive to assess borrowers' long-term prospects, or to lend in ways that foster appropriate adjustment by borrowers. Instead, banks have a clear incentive for caution when they are required to participate in rescheduling and to bear some reasonable portion of the burden. Banks are then more careful about making loans to countries where the longer-term prospects are uncertain. For this reason, the United States and other official creditors have insisted on requiring countries experiencing debt crises to seek relief from private as well as official creditors in order to assure a comparable sharing of burdens among all categories of creditors. When rescheduling is unat-

tractive to banks, however, a somewhat contradictory possibility arises: banks can defer rescheduling by continuing to lend. Delay may enable both borrower and lender to ride out a troubled period, but it can also exacerbate the troubles to be faced later on. Of course, banks' willingness to postpone rescheduling in this manner is limited by the increased risks involved. Furthermore, bank examination procedures—particularly in the United States and increasingly in other countries as well—are designed to signal the emergence of excessive exposure to risk.

Fourth, the future scope for bank lending will depend strongly on the continued expansion of world trade and the ability of developing countries to participate fully in that expansion. If export opportunities are blocked, then even borrowing for productive investment may not be sustainable because such investment may not yield, either directly or indirectly, enough foreign exchange to service the debt. Conversely, with ample trade opportunities, developing countries can earn the foreign exchange that enables them not only to service existing debt but also to demonstrate their continuing dependability as borrowers. This interaction provides one of the major avenues for developing countries to accelerate adjustment without sacrificing longer-run growth prospects.

Although it is possible to set forth in general terms the considerations that will determine the extent of private bank lending to the developing countries, it is impossible to predict with any precision or confidence the extent to which the recent pause in long-term lending will be reversed. On balance, the likelihood of somewhat reduced growth in private lending is high enough to place great importance upon the role of official agencies like the International Monetary Fund (IMF) and the World Bank.

Official Financing

Over the past year, the ability of the IMF and the World Bank to take the lead in promoting financing and adjustment patterns that are appropriate in current economic circumstances has been strengthened. The resources available to these institutions have been increased, and their operating procedures have been modified.

The role of the IMF has been substantially enhanced. A 50-percent increase in quotas, negotiated in 1978, went into effect on January 1 of this year. It will raise substantially the liquid resources available to the Fund over the coming years. Beyond this, the IMF is exploring the possibility of further increasing its resources by borrowing—first from member countries, particularly OPEC countries with large surpluses, but, if appropriate, from private sources as well. While such borrowing could not, and should not, supplant quotas as the primary source of Fund liquidity, it could play an important supporting role.

At the same time, access to the IMF by countries facing actual or incipient balance of payments difficulties has also been substantially increased. The quota increase itself has this effect, and it has been complemented by adaptations in the structure of Fund lending programs. The adaptations effectively increase the cumulative amounts that countries can borrow in relation to their quotas and lengthen the adjustment period for IMF supported programs. Finally, increased emphasis is being placed on structural considerations in the formulation of IMF stabilization and adjustment programs.

World Bank resources have also increased, albeit without full U.S. participation. In the last days of its 1980 session, Congress did appropriate $328 million toward the Bank's 1977 Selective Capital Increase. But the Congress has yet to approve the U.S. share of the 1980 General Capital Increase. This increase went into effect in October 1980 with the formal agreement of 75 percent of the Bank's voting power.

The World Bank, too, has modified its programs in the past year. While continuing to expand its traditional project and sector lending, the Bank has begun to develop a new type of lending program aimed specifically at structural adjustment. This lending is intended to complement the shorter-term borrowing that countries engage in for balance of payments reasons with long-term funding to restructure economies in ways that will strengthen their underlying external positions. Furthermore, ways are actively being sought—perhaps through a new energy affiliate of the Bank—to increase sharply the resources available for energy exploration and development in developing countries. Over time, the resulting increase in domestic energy availability will tend to ease the financial burden of developing countries by lowering their oil imports. Increased world supplies and more suppliers may also make future energy price shocks less likely.

The extent to which the official institutions will be able to meet the future financing needs of the non-oil developing countries will depend in part upon the size of the gap which must be filled after private financing and bilateral assistance—particularly OPEC assistance for oil-deficit countries—has been accounted for. The size of this gap is very difficult to predict. But the recent expansion in the resources of the official institutions and their demonstrated capacity to adapt to changing needs suggest that they are capable of dealing with a very wide range of possible problems.

CHALLENGES TO INTERNATIONAL TRADE RELATIONS

The progressive dismantling of trade restrictions during the post-World War II period and the resulting rapid growth of world trade

were of central importance to the worldwide rise in prosperity during the 1950s and 1960s. But the open trading system has come under increasing pressure in the 1970s. Economic growth has slowed, unemployment rates have risen, and the balance of payments positions of oil-importing countries have deteriorated. As a result, protectionist sentiments have strengthened, and the promotion of exports has become a more explicit aim in many countries. Furthermore, mounting structural difficulties in a number of key sectors have encouraged the view that cartelization or market-sharing agreements among countries can ease the burdens of adjustment. As a consequence, the climate for trade has become more clouded despite the ratification in 1979 of the agreements reached in the Multilateral Trade Negotiations. These agreements strengthen the international trading system by limiting the use of trade-restrictive practices and improving the mechanisms for the settlement of disputes and thus represent an important step forward. They are unlikely to prevent an intensification of trade frictions, however, if the underlying commitment of governments to open trade is eroded.

An important but perhaps inevitable cause of the emergence of a more difficult environment for trade is the decline in the relative dominance of the United States in the world economy. In the early post-World War II period the United States was in a strong position to promote a more liberal trading order without much regard to strict reciprocity. Because imports constituted only a small share of the U.S. market, the growth in imports that freer trade entailed was not viewed as disruptive. At the same time, the demand for U.S. exports was strong because foreign production capacities had been damaged by the war and because American goods embodied technologies not available elsewhere. Thus, open trade was not perceived as a threat to the overall U.S. trade position. For other countries, on the other hand, the promise of increased access to the vast U.S. market made the opening of their own borders to imports seem a favorable exchange.

While the conditions that made it so easy to support no longer prevail, open trade nevertheless confers substantial benefits on the world economy. Preservation of an open trading system must therefore become a truly multilateral effort and the shared responsibility of the major trading nations. It is probable that few governments today can effectively resist taking actions to redress what are viewed domestically as the unfair trade practices of others. All countries must therefore practice self-restraint, not only in the traditional sense of minimizing protectionist measures against imports, but also in avoiding measures that artificially promote exports at the expense of other countries. It must be recognized that the only real alternative

to closer cooperation is to risk a cycle of trade retaliation that would leave all countries substantially worse off.

Three specific challenges to open trade are taken up in the following pages: the heightened pressures to use trade barriers to save domestic jobs, the increased use of direct and indirect subsidies to promote exports, and the emerging reliance on market-sharing arrangements to ease adjustment.

PROTECTION AND EMPLOYMENT

The pressure to protect domestic sectors from import competition is, to a large degree, a pressure to preserve jobs. Imports are seen as substituting foreign for domestic employment and income abroad for income at home. This pressure increases when economic growth slows and unemployment levels rise, since alternative employment possibilities are reduced.

Job losses of course occur continually within an economy as some sectors contract. But meanwhile new jobs are being created in expanding sectors. International trade is but one of the pressures behind such shifts. Indeed, the evidence suggests quite strongly that, at least in the United States, changes in consumer demands and differential productivity gains from capital investment and technological change have been far more important than increased imports in accounting for relative employment declines in lagging sectors.

But regardless of the source from which the pressures for adjustment come, intersectoral shifts in employment cannot be achieved without transition costs. The skills no longer needed in declining sectors may not match the skills required in growing sectors. The regional distribution of employment opportunities may shift, but workers may not be in a position to move. And, even if workers who lose jobs find new ones, their wages and job satisfaction may be lower if specialized skills acquired over many years are made obsolete. The more rapid the pace of adjustment, furthermore, the greater these transition costs will be, since less of the adjustment can then be accomplished through natural employee attrition and ongoing demographic shifts. Because of transition costs, governments are often tempted to intervene in an attempt to slow the pace of adjustment. Such policies can perhaps be justified when the pressure for rapid adjustment is very strong or when it is thought that the pressure will subsequently be reversed. The risk is, however, that government efforts to ease adjustment may have the effect of deferring or preventing it. Experience suggests that this has often been the case. Such outcomes are costly. Although transition costs are avoided for a time, productivity is impaired, inefficiency is increased, inflationary pres-

sures are strengthened, and in the longer term employment too may suffer.

In seeking a balance between justified intervention to reduce transition costs and undue protection of uneconomic sectors, careful assessment of the broad range of costs and benefits is needed. This is particularly the case with regard to the use of trade-restrictive policies, for three reasons.

First, pressure to restrict imports can easily arise even when imports are not themselves the major threat to existing jobs because the tools are more readily at hand to restrict imports than to deal with other adjustment problems. In the United States the President has considerable discretionary power to impose trade restrictions—subject, however, to prior findings of injury by the International Trade Commission. In other countries too, import restriction is generally easier to implement than adjustment policies requiring government budget resources.

Second, there is mounting evidence that trade protection is a very expensive way to preserve jobs. In case after case that has been examined, the cost to consumers per job saved—that is, the extra costs faced by consumers in the form of higher prices when imports are restricted—has turned out to be at least several times higher than an average worker's income. Although these consumer costs are large in the aggregate, in no one instance do they seem large on a per capita basis. As a consequence they are not highly visible and therefore easy to overlook.

Finally, trade restriction, like other forms of domestic protection but more clearly so, impairs employment prospects over the longer run. Jobs saved in the protected sectors are saved in part at the expense of jobs elsewhere in the domestic economy. Higher prices for protected goods reduce consumers' ability to purchase other goods, and thereby limit employment growth. If imports are restrained, export opportunities and employment in the export sector are also reduced—directly if foreign countries retaliate, and indirectly even if they do not, because the exchange rate tends to appreciate to restore balance between exports and imports over the longer term. Moreover, trade restrictions increase prices directly and further exacerbate inflation by limiting productivity growth. As a result, the ability of governments to pursue expansive policies to support employment is further reduced. Thus the jobs saved by trade restrictions are likely to be matched by job losses elsewhere. As is so often the case, however, the jobs saved are immediate, specific, and highly visible; the jobs lost are in the future, diffused throughout the economy, and almost invisible.

While all countries, in attempting to balance long-term gains against short-term pressures, may find the need for trade-restrictive actions compelling from time to time, the risks are that such policies will be resorted to excessively. These risks become considerably larger to the extent that other countries aggressively use subsidies to promote exports. The following section takes up this issue.

EXPORT SUBSIDIES

Countries subsidize exports directly or indirectly for a variety of reasons. Faster export growth is seen as a way of overcoming the balance of payments deficits that higher oil bills have caused for many countries. Subsidies may form part of an industrial strategy to promote the growth of key sectors and to exploit economies of scale when they dictate a global marketing approach. Subsidies may also be a counterpart to other policies, for instance, policies to limit excess capacity and job losses in declining sectors by selling abroad. Subsidies to exports can also arise indirectly—for instance, from domestic policies that keep the price of energy, and hence the cost of production in energy-intensive sectors, artificially low. Or they can arise when investment incentives to particular regions or industries reduce the cost of capital to firms that produce certain goods.

The Subsidies Code that was negotiated in the Multilateral Trade Negotiations places certain restrictions on the use of subsidies and permits the adoption of countervailing duties in cases where subsidies can be shown to cause injury to trading partners. However, given the various and often complex forms that subsidies can take, and the fact that subsidies of exports may often arise as by-products of policies directed at domestic goals, the Code by itself is unlikely fully to resolve the problems that subsidies sometimes create. Self-restraint among countries in the use of subsidies is therefore necessary. Two considerations are of critical importance in this regard. First, subsidies often end up losing their effectiveness in promoting exports. Initially, profits and employment in a subsidized activity will increase and a competitive advantage will emerge. Gradually, however, the extra profits that are created by the subsidy may be diluted by higher wages for the workers in that activity, or—if the activity is a large user of scarce resources—in higher prices for those resources. A familiar example is the bidding up of the price of farm land suitable for a particular crop when the price of that crop is supported by the government at higher levels. The bidding up of costs of production in this way ultimately tends to eliminate the competitive advantage that the subsidy provides, thus increasing pressures for yet further subsidization to restore the advantage and making removal of the subsidy increasingly difficult.

Second, the pressure for countries to match the subsidies provided by other countries means that the opportunity to increase market shares through subsidies is far less than it appears to each country in isolation. This consideration is particularly important in the area of export-credit subsidization, which has increased sharply in recent years. Most of the major industrial countries have official export-credit agencies that provide medium and long-term financing at fixed rates of interest for "big ticket" exports, such as power plants, aircraft, and manufacturing plants. These interest rates have not risen in step with rises in market rates, thus greatly increasing the subsidy element of such trade financing. Yet, because export agencies in all countries are under pressure to match or perhaps improve on the terms provided by others so as to help secure the sale for a domestic producer, the likely result is a costly standoff, with global overcapacity in subsidized sectors persisting. The heads of state of the major countries made a specific commitment at the Venice Summit in June of last year to bring export-credit rates more closely into line with market rates. Efforts to renegotiate an export-credit agreement based on this commitment failed, but negotiations may resume this year. In some countries—particularly some members of the European Community—it may not be clearly perceived how wasteful and counterproductive export-credit subsidies are.

MARKET SHARING

Antitrust laws in the United States prohibit firms from attempting to divide up markets by allocating market shares, formally or informally. The anticompetitive and price-raising consequences of such arrangements are well known. On an international level, however, there are increasing temptations for governments themselves to develop or to bless such market-sharing arrangements for sectors facing structural difficulties. The Multi-fiber Agreement, which sets a framework within which individual countries have negotiated a complex system of quotas on textile and apparel imports, is an example. Relatively longstanding agreements exist with respect to shipbuilding. The issue of automobile imports, so important in the United States, has also been of great interest and concern internationally—and indeed informal or formal industry agreements between European and Japanese auto producers are widespread.

The temptation to "organize" world markets when adjustment pressures arise is understandable. If a number of countries need to adjust, the pressures to assure that each country bears its fair share of the adjustment burden are powerful. Negotiated arrangements may appear both more effective and less confrontational than the use of formal grievance procedures under the General Agreement on Trade and Tariffs (GATT). As short-term responses to serious

threats of disruption, market-sharing arrangements may indeed be preferred if the alternative is a resort to predatory behavior.

There are serious risks, however, in following this course. First, the substitution of informal, ad hoc agreements for the more formal mechanisms of the GATT reduces the transparency of the trading system. The "rules of the game" become more complex and less visible to public scrutiny, and procedures for redress become uncertain. Second, such agreements may perpetuate themselves. In seeking to assure that adjustment is fairly distributed, they may in fact delay the needed adjustments and perpetuate the excess capacities that gave rise to the problem in the first place. Finally, such arrangements, by requiring balance among countries in the degree of adjustment, almost always guarantee that it is not the least efficient capacity which is eliminated.

NEEDED RESPONSES

Pressures on all countries to use trade policies to promote shorter-term gains for particular sectors, to ease the process of adjustment, or to protect jobs in sensitive areas will almost certainly remain acute. It is also quite certain that in some cases such pressures will not be resisted. Indeed a simon-pure attitude is unwarranted on the part of any country, and unrealistic when other countries also yield to such pressures. From a broader perspective, however, it is highly important to keep restrictive trade policies within circumscribed limits. First, the achievement of both higher exports and lower imports is not feasible—strictly so for the world as a whole, and to a very large extent for individual countries. The only effective choice is one between slow trade growth or more rapid trade growth, and the historical record makes clear that the latter is to be preferred. Second, it is imperative to aim for consistency in the formulation of policy. The overriding need in all countries is to reduce the current inflation, and also to reduce the inflation-proneness of economies that have become more inflexible and less competitive. Trade policies that aim for short-term protection intensify inflation directly by reducing competitive pressures, and they increase economic rigidities by sheltering excessive wages, profits, and other incomes in particular sectors from the discipline of the market. Better integration of trade policy into overall economic policy formulation is needed in all countries to provide a clearer perspective on its real costs and benefits.