

Resolving Policy Conflicts for Rapid Growth in the World Economy*

The Oil Crisis and the Emergence of Policy Conflicts

The legacy of the oil crisis is still with us nearly five years after the fact. The fourfold increase in oil prices simultaneously had an inflationary and a deflationary impact on the world economy. On the one hand, it contributed to inflation by raising costs and prices; on the other hand, it reduced world demand by redistributing incomes towards income recipients with relatively high savings propensities. At the same time, it added to the profit squeeze in countries where wage earners were compensated for higher prices through formal or informal indexation as profits had to bear the brunt of the deterioration of the terms of trade that resulted from the increase in the price of oil.

In adding to inflationary pressures, the sudden increase in oil prices led to the application of stronger anti-inflationary measures than would have otherwise been taken in response to the 1972-73 world boom. The recession was further aggravated by policy reactions on the part of the industrial countries to the increase in their combined trade deficit vis-à-vis OPEC from \$17 billion in 1973 to \$67 billion in 1974.

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The paper has been broadly agreed to by the members of the Group, acting in a private capacity. Individual members naturally do not necessarily subscribe to every particular point.

In turn, whereas the United States has maintained a steady rate of economic expansion since mid-1975 with little regard to its balance-of-payments consequences, in the other developed countries the desire to lower inflation rates and/or to reduce balance-of-payment deficits has retarded economic expansion following the 1974-75 recession. In fact, following a temporary improvement in 1976, the growth performance of these countries has again deteriorated.

Thus, the U.S. gross national product increased by 6 percent in 1976 and by 5 percent in 1977, with only slightly lower growth expected in 1978. By contrast, after an increase of 4 percent in 1976, the rate of economic growth barely reached 2 percent in 1977 in Western Europe and it is not likely to exceed this figure in 1978. Finally, Japan increased its GNP by 6 percent in 1976 and 5 percent in 1977, and a higher growth rate is not expected in 1978.

Differences in growth rates have contributed to balance-of-payments disequilibria. According to IMF estimates, the U.S. current account deficit, including goods, services, and private transfers, reached \$17.4 billion in 1977 as against a surplus of \$11.2 billion in Japan, \$7.6 billion in Germany, \$3.7 billion in Switzerland, \$3.4 billion in Italy, \$1.9 billion in the United Kingdom, and \$0.3 billion for the Netherlands. In turn, a deficit of \$4.0 billion has been estimated for Canada, \$1.8 billion for France, \$0.1 billion for Belgium, and \$23.9 billion for the other European countries combined.

Balance-of-payments imbalances have been translated into exchange rate changes far exceeding changes in purchasing power relationships, in particular between the U.S. dollar on the one hand and the German mark and the Japanese yen on the other.¹ These changes, in turn, have reduced confidence in the dollar in financial markets.

Estimates for 1978 show more of the same. For one thing, all the Common Market countries as well as Japan are expected to further improve their balance-of-payments position, with their current account surplus rising to \$18 and 14 billion, respectively. For another thing, the U.S. deficit is unlikely to materially change.

The continuation of these imbalances creates obvious dangers for the world economy. Thus, with the United States being a reserve

¹ Between September 1977 and April 1978, the U.S. dollar depreciated by 12.2 percent in terms of the German mark and 16.0 percent in terms of the Japanese yen. During the same period, annualized differences in the rates of inflation, measured in terms of the consumer price index, were 2.9 percent between the United States and Germany and 3.6 percent between the United States and Japan.

currency country, there may be continuing shifts from the dollar into marks and yen, and even sterling. At the same time, given the existence of foreign dollar holdings of about \$200 billion and the possibility that U.S. holders of dollars will switch to other currencies, even a small shift would have a substantial effect on the balance of payments and hence on the exchange rate. In turn, as exports and imports react with a considerable lag, improvements in the balance of trade may not occur for some time.²

A further consideration is the existing cleavage between economic policy markers in the United States and the other industrial countries. While until late 1977 continued expansion in the United States was welcome in Western Europe and Japan because of its favorable effect on their economies, the rising balance-of-payments deficit and the depreciation of the dollar have since come under increasing criticism.³

Apart from differences in the rate of economic expansion, these conflicts reflect differences in strategies, with Germany and Japan pursuing export-based growth and the United States relying on the expansion of domestic demand. Similar conflicts exist, albeit to a lesser extent, within Western Europe where most countries base less reliance on export-led growth than do Germany and Japan.

Policies for the United States

In examining possible solutions, the first question is to what extent can the U.S. current account deficit be ascribed to the relatively rapid rate of expansion of the U.S. economy. If we assume an import demand elasticity of 2, which roughly conforms to past experience, a one percent increase in GNP would be associated with a \$4 billion

² In a study covering the period 1972-77 it has been found that changes in prices affect U.S. exports and imports with a lag of 12 to 18 months [R. Z. LAWRENCE, "An Analysis of the 1977 U.S. Trade Deficit", *Brookings Papers on Economic Activities*, 1978 (1), pp. 159-90].

³ The West German Chancellor, Helmut Schmidt, is reported to have said that, because of massive purchases by European banks to support the dollar, the European Economic Community is financing the U.S., and that these purchases, totalling about \$18 billion this year, have fueled European inflation (*Wall Street Journal*, December 7, 1977). Also, German and Japanese industrialists have strongly criticized the depreciation of the dollar that adversely affects their competitive position.

increase in U.S. imports of goods and services in 1978. On this assumption, if the United States had a GNP growth rate not exceeding that of Western Europe in both 1977 and 1978 (i.e. 2 percent instead of 4.5 to 5 percent), the cumulative effect of these differences would have made its 1978 imports \$22 billion lower.

This does not mean that one should advocate lower growth rates for the United States. For one thing, reducing the growth of the economy below its potential would have unfavorable effects on employment. For another thing, by reducing demand for imports, such a policy would further lower growth rates in other industrial countries and in the world economy as a whole.

Continued economic growth without increased inflationary pressures would, however, require greater reliance on private markets in the U.S. economy. There are sufficient signs in the form of business investment plans and increases in capital-goods orders that the long-awaited investment boom is in the making as capacities come to be fully utilized and bottlenecks are created. Correspondingly, a large federal budgetary deficit would tend to have adverse effects by syphoning off funds from financial markets. "Crowding out", repeatedly predicted in recent years, is becoming a reality as government demands increasingly compete for funds with private investment demands, resulting in a rapid rise of interest rates.

In order to remedy the situation, it would be desirable to reduce substantially the Federal budget deficit in the next fiscal year. Lowering the budget deficit, in turn, should involve cutting public expenditures so as to reduce public sector claims on available resources which appear to have had adverse effects on investment activity in the past.

Reducing the share of public expenditures in GNP would need to be accompanied by measures aimed at encouraging private investment that is necessary for future growth. Furthermore, there is need to avoid taking measures that contribute to inflation through higher prices (e.g. the farm program and the protection of domestic industries) or through higher labor costs (e.g. raising social security contributions by business firms). Last but not least, there is need for an energy policy designed to curtail oil imports by reducing the consumption of energy through higher taxes and encouraging the production of existing and new sources of energy through appropriate incentive measures.

Economic Expansion and Exchange Rates

It would appear that a rate of economic growth of 4 to 4.5 percent could be attained in the United States in the next year or so without accelerating inflation if appropriate policies are followed. Apart from a U.S. energy policy, remedying disequilibria in the balance of payments of the major industrial countries would then require higher economic growth rates in the surplus countries of Western Europe and Japan. World economic growth would be stimulated thereby, in part by increasing demand for the products of other countries and in part by lessening the balance-of-payments constraint under which they operate. While this proposition applies with particular force to Germany and Japan, it is also directed at Italy and the United Kingdom that have improved their balance-of-payment position to a considerable extent, as well as to Switzerland, Belgium, and the Netherlands among the smaller European countries. But, France too can increase its rate of growth provided that it does not have to do it alone.

Suggestions made for expansion in the surplus countries have been objected to on the grounds that under flexible exchange rates the international transmission of economic expansion is greatly reduced.⁴ References to exchange rate flexibility fail to consider, however, the existence of lags in the adjustment of exports and imports to exchange rate changes. In the presence of these lags, initial changes in the trade balance may be perverse, with the depreciation of the currency resulting in an increase in the trade deficit.

As exchange rate changes affect the balance of payments and economic activity with a considerable time lag, they will not offset the effects of economic expansion on imports, and hence on the national economies of other countries. At the same time, for exchange rate changes to eventually exert an equilibrating impact on the balance of payments, it would be necessary to offset their deflationary effects in the surplus countries by expansionary measures. According to one estimate, in the absence of offsetting measures, the deflationary effects of the appreciation of the German mark and the Japanese yen since mid-1977 would reduce German and Japanese GNP by over 2 percent.

⁴ Cf., e.g. THOMAS D. WILLET, "It is too Simple to Blame the Countries with a Surplus", *Euromoney*, February 1978, pp. 89-91.

The last point leads to the question of asymmetrical reactions by businessmen and policy makers to changes in exchange rates.⁵ In devaluing countries, governments tend to follow cautious policies for fear that a vicious circle would emerge, running from exchange rates to prices to exchange rates and so forth. In turn, businessmen may postpone investment for fear that the inflationary effects of a devaluation would eventually lead to lower profits due to the combined effects of wage indexing and the governmental policies adopted to combat inflation.

By contrast, governments may welcome the beneficial effects on domestic inflation of lower import prices that result from the appreciation of their currencies without attempting to offset the deflationary effects of currency appreciation on the economy. At the same time, lower levels of economic activity and falling profit margins associated with the appreciation may discourage business investment.

Exchange rate changes may then further aggravate the economic situation in Western Europe and Japan, with adverse effects on investment and hence on future prospects for output and employment growth. At the same time, investment activity has not been sufficient in recent years to support economic growth. Thus, nonresidential investment in Japan and in the major European countries other than France was below the 1973 level in 1977.

Also, industrial production in these countries exceeded the 1973 level by only a small margin in 1977 while the rate of unemployment was substantially higher. Thus, in the four large European countries, the number of registered unemployed increased from 1.9 million in 1973 to 5.0 million in 1977; in Japan, the increase was from 0.7 million to 1.1 million. At the same time, the data are likely to underestimate the extent of unemployment, especially in Japan.

Unemployment, Inflation, and Exchange Growth

Unemployment has increased notwithstanding the measures taken by the individual countries to safeguard employment in the form of import protection, employment subsidies, as well as regulations that make it difficult for business firms to fire labor. The application of these measures has, in turn, introduced rigidities in the economic

⁵ This analysis of asymmetrical reactions to exchange rate changes is based on ideas put forward by Stephen Marris.

system that are inherently inflationary and adversely affect prospects for future growth.

The measures applied have included increased protection in the form of the imposition of quantitative restrictions; "negotiated" reductions in foreign exports in the framework of the Multifiber Arrangement and so-called orderly marketing arrangements; increased reliance on anti-dumping, countervailing, and escape clause actions; as well as cartel-type arrangements. The application of protectionist measures contributes to inflation by enabling domestic producers of import-competing goods to charge higher prices, and it obstructs the structural changes necessary for economic growth by sheltering inefficient industries.⁶

European countries have further taken measures to subsidize employment. In Britain, the Temporary Employment Subsidy scheme compensates firms for keeping workers on the job who would not otherwise be needed, while the French government has provided subsidies to firms which employ young people entering the labor force. Similar schemes have been applied in several smaller European countries, too.

Subsidies to employment introduce rigidities in the industrial structure, which are aggravated by regulations that induce firms to keep workers by increasing the cost of firing them or limit the freedom of the firm to reduce its work force. As a result, in most European countries and Japan, employment has not fully adjusted to the slow growth of demand. Labor hoarding is particularly important in Italy and the United Kingdom, where, according to some estimates, it accounts for over 2 percent of the labor force.

Employment subsidies cover only part of the increase in labor costs due to labor maintenance programs and the existence of a fixed component of the labor force further adds to costs. All in all, with slow expansion accompanied by labor hoarding, unit labor costs in the four major European countries increased, on the average, by 12 percent between 1976 and 1977 as compared to a rise of 4 percent between 1975 and 1976. In turn, labor costs increased by 3 percent in Japan as against a decline of 4 percent in the previous year.

Also, high unemployment compensation and welfare payments

⁶ For a detailed discussion, see BELA BALASSA, "World Trade, and the International Economy: Trends, Prospects, and Policies", *Journal of World Trade Law*, September 1978.

provided over a protracted period tend to discourage the unemployed from seeking jobs and give rise to increased "black market" work. Moonlighting has also increased in Germany where part-time workers receive 70 to 80 percent of the difference between the full-time wage and the wage actually earned.

To conclude, subsidizing employment *and* the unemployed does not permit adjustments to take place, thereby lessening the effects of deflationary policies on wages and prices. At the same time, labor maintenance programs contribute to inflation by directly or indirectly raising costs to business firms, and protectionist measures, too, are inflationary. Last but not least, the rigidities introduced in the economic system hinder structural transformation and economic growth.

Policies for the Future

While it is conventionally assumed that the application of deflationary policies would lead to a permanent decline in the rate of inflation at the cost of temporary unemployment, the above considerations point to the adverse effects on price stability and long term economic growth of the measures that have accompanied the application of deflationary policies in the recent past. But, the prospects for growth with price stability have also been adversely affected by the deflationary policies themselves.

For one thing, over-and-above the loss of employment and incomes during the period of the application of deflationary measures, there is a loss in future periods due the shortfall of investment. For another thing, with ever-rising expectations, slow productivity improvements associated with the low rate of investment contribute to inflation as increases in nominal wages are translated into higher prices.

In turn, economic expansion would lead to lower unit labor costs in cases when business firms had not fully utilized their labor force and by increasing the ratio of production workers to office employees. Expansion would also permit lessening rigidities resulting from government actions that are inherently inflationary and hinder economic growth.

It should be recognized, however, that the indiscriminate application of expansionary policies may carry the seeds of their own defeat by contributing to inflationary pressures. Correspondingly, the policies

applied should aim at promoting long-term objectives. In promoting these objectives, attention needs to be concentrated on the desirable composition of aggregate demand.

It will generally be desirable to avoid increasing current government expenditures. For one thing, changes in government programs entailing increases in current expenditures are difficult to reverse, so that countercyclical measures assume a permanent character. For another thing, the cost of such measures is often directly or indirectly borne by business firms, thereby contributing to lower profits.

At the same time, increases in after-tax profits are necessary to provide incentives as well as funds for new investment. Profits have declined to a considerable extent in recent years, with rates of return in manufacturing falling from 8-10 percent in the sixties to 5 percent in 1974 in Germany and from 11-12 percent in 1972-74 to 5 percent in 1977 in Sweden.⁷ Apart from cyclical effects, this decline may be attributed to the application of measures that have increased the cost of labor to the firm.

After-tax profits could be increased by lowering corporate income tax rates or by reducing the cost of labor to the firm. The latter alternative assumes particular importance since employment considerations require that new investment entail capital widening rather than capital deepening. Labor costs per unit of output could be reduced by shifting part of social security contributions as well as the cost of firing labor to the government budget.

Apart from lowering the cost of labor to the firm, it would be desirable to reduce existing disincentives to work, which take the form of relatively small after-tax income differentials between working and not working, and to eliminate employment subsidies. Finally, in countries where the social climate is favourable, it would be desirable to negotiate social contracts with labor unions to restrain wage increases following the application of expansionary measures.

The question arises, however, if investment incentives will suffice to generate expansion or whether weak domestic demand would hinder investment. While the answer to this question will vary from country to country, it may be suggested that creating a better investment climate would improve confidence and induce people to increase consumption, and that higher profits would have the same effect via

⁷ Sachverständigenrat, *Annual Report*, 1977-1978, Table 14 and Erik Lundberg in Skandinaviska Enskilda Banken, *Quarterly Review*, 1977, pp. 3-4.

increases in stock market values.⁸ Nevertheless, some reduction in indirect taxes may be desirable, in part to supplement incentives to investment and in part to lower prices paid by consumers.

It would further be desirable to reverse recent tendencies towards protectionism and, in particular, to reduce quantitative barriers to imports. The resulting expansion of world trade would not only permit resource allocation according to comparative advantage but would tend to raise productivity levels in export industries, where economies of scale can be obtained, and contribute to improvements in import competing industries. Reducing barriers to the imports of the developing countries would also have desirable long-term effects as it would contribute to the movement of resources from low to high productivity industries.

The expansion of modern high-productivity industries, in which the comparative advantage of the industrial countries lies, would also be served by increasing foreign aid to the developing countries. This is because the developing countries spend their incremental foreign exchange earnings to a large extent on the importation of machinery and equipment.

Domestic objections to increases in foreign aid may be reduced if such increases are undertaken with the participation of OPEC countries. At the same time, the size of the OPEC balance-of-payments surplus could be reduced by limiting petroleum imports. The United States has a particular responsibility in this regard as it has considerable possibilities to reduce the consumption, and to increase the production, of energy.

Concluding Remarks

In this paper, the application of measures has been suggested that would reduce policy conflicts among industrial countries and contribute to the growth of the world economy while minimizing inflationary repercussions. In the case of the United States, it has been proposed that reliance be placed on market forces to continue the expansion, involving substantial reductions in the Federal budget deficit, with government fiscal policy being oriented towards providing incentives for private investment.

⁸ The author is indebted to Rudiger Dornbusch on this point.

Parallel with maintaining the rate of expansion in the United States, considerations of self-interest, as well as the desirability of reducing policy conflicts, call for accelerating economic expansion in Western Europe. At the same time, rather than the indiscriminate application of expansionary policies, the measures employed should be oriented towards stimulating investment while minimizing the risk of inflation so as to assure noninflationary long-term growth. The pursuit of these objectives would necessitate reducing corporate taxes and decreasing the cost of labor to the firm. Incentives to investment may be supplemented by reductions in indirect taxes that lower prices paid by consumers.

However, conditions differ within Europe, necessitating a differentiation of the measures taken. Thus, faster than average expansion is warranted in the surplus countries, and especially Germany, in part because of their favorable balance-of-payments position and in part because of the need to offset the deflationary effect of the appreciation of their currencies. At the same time, expansion by these countries is of great importance for the other European countries that are in balance-of-payments difficulties.

From the point-of-view of long-term growth, it would further be desirable to reverse recent protectionist tendencies in the industrial countries. Japan has particular responsibilities in this regard, in part because of the continued application of import restrictions and in part because of its large balance-of-payments surplus. The existence of this surplus would also call for the use of strong expansionary measures in Japan.

Reducing protection in the industrial countries would further help economic growth in the developing countries and, with these countries spending their foreign exchange earnings to a large extent on the importation of machinery and equipment, it would ultimately benefit the industrial countries. The same conclusion applies to increasing foreign aid to the developing countries.

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