

Chapter 1

World recession and policies for recovery

Since 1973 most countries in the world have suffered bewildering economic changes. Western countries have experienced unemployment, stagnation of production in manufacturing industries, high costs of oil and some other raw materials, low profits, slow growth of real wages and of government revenues, and rapid inflation. For many developing countries the world recession has meant the threat or reality of western protectionism against their manufactured exports which, combined with high costs of imported oil, faces them with increasingly severe balance of payments constraints. There have been unusually large payments imbalances and exchange rate swings on world currency markets as well as cut-throat competition in world markets for manufactured products. Even the oil-exporting countries, whose real national income doubled between 1972 and 1975 as a result of the oil prices increase, have been worried by weakening of the international oil market and erosion of the value of their accumulated dollar savings by a falling dollar exchange rate.

These various phenomena are clearly inter-related, although in a complex way. It is not sufficient to focus on one or the other aspect of recent events, whether it be the shock effects of the oil price increase, the abnormal OPEC trade surplus, the US trade deficit, the overhang of third world debt, trade union militancy in industrial countries, or the development of cheap labour competition aided by multinational companies operating in the third world. Nor can international problems be analysed accurately by examining the prospects for countries individually. What is needed is a coherent analysis of the world economy as a system of trading and financial relationships between countries or blocs.

The purpose of this chapter is to analyse the world economy as an integrated system, using a rigorous if simplified quantitative model, in order to make a diagnosis of the recession and to identify obstacles to faster growth of production and trade and to see how they can be overcome in the future. The next section introduces the hypotheses and main conclusions. It is followed by a review of the recession since 1973, a survey of prospects for major blocs in the period up to 1985, and finally, an assessment of problems of the world system as a whole.

Hypotheses and main conclusions

International trade is the subject of multiplier effects

similar to those which intensify and spread growth or recession within each country. When, for example, OPEC increases its imports of manufactures from the UK, the rise in UK exports allows the UK economy as a whole to expand; imports to the UK then rise, passing on the benefits of higher trade to other countries which supply UK markets, and so on in a cumulative reaction. But while the multiplier processes of growth or recession of demand within single countries are habitually measured and analysed very carefully as a guide to the domestic policy-making of governments, international trade multipliers, which have recently so much disrupted economies around the world, have not been measured or studied systematically at all.

Conventional international trade theory considers fundamentally different questions from those analysed here. It assumes that employment and the pressure of demand in each country are independent of the level of trade and that trade itself is balanced by price adjustments which equilibrate each country's market shares. The subject of this chapter is a real-life disequilibrium situation, in which the level of employment and the pressure of demand in most countries depend on the level of world trade and on their share of trade. Implicitly, price adjustments cannot or do not readily equilibrate their trade balances. The conventional theory in effect assumes away the very situation of trade recession and widespread unemployment which now prevails and it offers no practical remedies for this situation.

To analyse growth and recession of world demand requires a model of trade flows between major blocs of the world and of policy decisions in response to these flows. Our model is defined in terms of variables – the volume of GNP, exports, imports, current balances of payments and world market prices – for which annual time series have been compiled for all major blocs in the world from 1960 onwards from United Nations and OECD statistical publications. The countries and blocs into which the world has been divided are the USA, Japan, the EEC, other developed economies, OPEC, other developing economies and centrally planned economies (in Appendix A the UK is also shown separately from the rest of the EEC). For trade in manufactures, where competition for markets is crucial, the full two-way breakdown of sources and destinations is recorded, in order to establish how the share of exports by each bloc has moved in each importing market, year by year since 1960.

The model (described fully in Appendix A) is projected up to 1985 to discover which medium-term factors will influence growth of trade and GNP in each bloc and in the world as a whole over that period. No allowance is made for short-term fluctuations, which are temporary and often due to miscalculations of the effects of policy. The slow-moving trends of competitive shares in markets for manufactures and in primary commodity supply potential, which in the long run govern the strength of different countries' trade positions, are taken as given. The question we seek to answer is how in a world of slowly-changing market shares and fuel, food and raw material supplies, the growth of markets in different parts of the world is determined by the changing balance of advantage between blocs and by adjustments to national policies which those changes make necessary. This is of crucial practical importance for almost all countries in the world; projections of the model under different policy assumptions show the problems and possibilities of recovery from recession for each country or bloc.

It is essential to distinguish between countries whose internal expansion and imports are limited by balance of payments problems and those, such as Japan, which have sufficiently strong balance of payments positions to be free to choose their internal policies, and hence the growth of their imports, with regard to domestic policy objectives. The former, which we call constrained countries, have to reduce growth of GNP and imports if their balance of payments starts to deteriorate. But the latter, which we call unconstrained countries, are not obliged to choose rapid GNP growth and expand imports fast when their balance of payments is strong. In any period some countries are on the margin between the two situations; whether they are constrained in fact then depends on the rate of growth of world trade. Over long periods some countries move decisively from one group to the other, as a result of secular improvement or deterioration in their relative industrial strength and their domestic fuel and raw material supplies.

The main factors which determine growth of world trade as a whole in the medium term are, under the above assumptions:

- (a) whether shares in manufactured markets shift in favour of constrained or unconstrained blocs;
- (b) whether world commodity prices and trends of primary commodity supply move in favour of constrained or unconstrained blocs;
- (c) whether unconstrained countries which are free to choose their own growth policies decide to grow fast and increase their imports rapidly, or whether, whatever the reason, they expand their imports slowly; and finally,
- (d) whether constrained countries borrow more and increase their trade deficits, or whether on the other hand they have to reduce their deficits and therefore cut back the growth of their imports.

Our projections to 1985 show that such structural factors will on the whole work against fast growth of trade in the next few years. Market shares in manufactured trade are moving in favour of Japan, which already has a dominant position as a balance of payments surplus country and whose imports cannot

grow fast enough to compensate for its export performance. This problem is compounded by the strength of the trading position of those EEC countries, notably Germany, which do not want to grow very fast and will earn surpluses to the extent that world trade recovers. OPEC, on the other hand, will no longer act as a major constraint on growth of world trade even if oil prices rise considerably, because its manufactured imports are now large enough to have almost eliminated its surplus, and are still rising.

Growth prospects are worst for the newest constrained country, the USA, whose share of world manufactured exports is falling while its import propensity continues to rise. The USA already has a large current account deficit which it may have to reduce. If the USA does cut its balance of payments deficit, whether by deflation, devaluation or import restrictions, other constrained blocs – notably non-oil developing countries and weaker developed countries – will find their own GNP growth held down by continuing world recession. In the USA itself, GNP growth will be slow unless major import restrictions are introduced. If the USA restricts imports, what matters to the rest of the world is not primarily the danger of trade war but whether the USA maintains a large trade deficit. Contrary to what many people would expect, US import restrictions would *not* reduce world trade provided they were used to support internal expansion in the USA with an unchanged trade deficit. Indeed, our projections imply that the rest of the world should prefer US import restrictions to US deflation as a means of achieving a given target for the US trade balance, because US import restrictions would bear more heavily on Japan and less heavily on constrained blocs.

A still more satisfactory policy solution, but one which would require a degree of coordination between blocs which at present seems impossible, would be for Europe to reflate, Japan to restrain growth of its exports, Europe and the USA to discriminate actively in favour of imports from developing countries, while the USA restricted overall growth of its imports of manufactures – all these policy interventions being operated on just the scale necessary to allow every bloc to achieve fast growth of GNP with balanced trade and payments. Without some such internationally planned solution, the most that can be hoped for is very much a second best.

World markets and recession since 1973

Three really dramatic things happened on world markets between 1973 and 1975 (see Table 1.1). Prices of food and raw materials rose, relative to prices of manufactures, by over 25% between 1972 and 1973. Prices of oil and other fuels rose, relative to manufactures, by 125% between 1973 and 1974. The volume of trade in manufactures, which had been rising by an average of 10½% a year between 1965 and 1973, fell 5% between 1974 and 1975. Two of these three events have left a continuing effect on the world system. Although prices of food and most raw materials have since slipped back in real terms, the real price of oil remains at least double what it was before and the volume of trade in manufactures

Table 1.1 World market prices and volume of manufactured trade

	(indices, 1975 = 100)					
	1965	1972	1973	1974	1975	1978
World prices of foods and raw material exports relative to manufactures	91	91	116	117	100	94
World prices of oil and other fuel exports relative to manufactures	45	41	46	103	100	96
Volume of world trade in manufactures	43	84	96	105	100	128

remains some 20% below its pre-1973 trend growth path. While the reasons for the oil price increase are not in doubt, the causes of persistent slump in manufactured trade and output are more controversial.

An indication of developments in domestic production and employment in different parts of the world is given by recorded GNP growth rates (see Table 1.2). Between 1973 and 1975 growth in western countries came to a halt while growth in OPEC and other third world countries proceeded at least as fast as before. Since 1975 growth has resumed in the developed countries, although at a slower rate than before (with the major exception of the USA), but growth in third world countries has slowed down.

Although inflation rates have varied widely from country to country, the OECD weighted total rose from 4.9% to 13.6% between 1972 and 1974 and has since been brought down, although not to the pre-

1973 rate, to 6¼% in 1978.

The relationship between trade, GNP growth and inflation can be looked at from several points of view. There can be no doubt that the *immediate* cause of the slump in trade in manufactures was the recession in domestic demand and GNP in the developed countries. Imports of manufactures by these countries fell 7% in volume between 1973 and 1975 when their GNP fell ¼%, and the volume of their imports has since risen slightly slower than before 1973, as has their GNP. Imports of manufactures by the third world, including OPEC and centrally planned economies, rose unusually fast between 1973 and 1975, but not nearly enough to compensate for the effects of the slump in developed market economies: since 1975 these markets also have expanded a little slower than before 1973 (see Table 1.3).

Table 1.2 GNP growth rates

	(% per year)		
	1965-73	1973-75	1975-78
USA	3.7	- 1.1	5.4
Japan	10.8	0.1	7.5
EEC	4.5	- 0.2	3.1
Other developed market economies	5.3	1.9	2.8
Subtotal	4.9	- 0.2	4.5
OPEC	8.3	8.1	4.7
(OPEC excluding net fuel exports)	(2.8)	(22.1)	(6.7)
Other developing market economies	5.3	6.2	5.0
Subtotal	5.9	6.7	4.9
World total excluding centrally planned economies	5.1	1.0	4.6

Table 1.3 Growth of trade in manufactures

	\$1975 bn 1973	1965-73	Average growth rates, % per year	
			1973-75	1975-78
Imports to:				
USA	62.1	12.6	- 8.9	16.1
Japan	14.8	20.2	-17.0	12.4
EEC	173.8	12.2	- 2.9	11.7
Other developed market economies	104.0	8.6	0.3	2.1
Subtotal	354.7	11.3	- 3.5	9.6
Imports to:				
OPEC	22.8	10.2	45.2	10.4
Other developing market economies	81.6	8.2	5.6	10.7
Centrally planned economies	53.6	9.3	9.1	4.3
Subtotal	158.0	8.8	13.3	7.0
Total world trade in manufactures	512.7	10.5	2.0	8.6

The central question is why GNP growth was cut back so sharply in developed countries, and whether the rise in oil prices and OPEC surplus were significant constraints on world expansion. Many developed countries certainly believed at the time that the rise in oil prices required them to cut back growth to protect their balance of payments and to contain inflation stemming in large part from world oil and raw material price increases.

However, as Table 1.4 indicates, the USA deflated so much that it achieved a large balance of payments surplus in 1975, while strong currency areas such as the EEC and Japan, which could have afforded deficits, in fact brought their current accounts into balance. OPEC's surplus in 1975 was accommodated by deficits of other developed countries, non-oil developing countries and centrally planned economies. Nor were strong EEC members, Japan or the USA seriously constrained by balance of payments problems between 1975 and 1978. The OPEC surplus has almost vanished, while Japan and the EEC have moved into large surpluses. The USA, which now has a large

deficit, reflated its domestic demand and GNP exceptionally fast, increasing its manufactured imports by an average of 16% a year.

Thus while the OPEC surplus was a contributory factor, especially between 1974 and 1977, the main cause of continuing recession has been slow growth in the EEC (taken as a whole) and Japan, which were not balance of payments constrained. The slump in manufactured trade which they induced has had multiplier effects, because it has restricted growth in constrained blocs, including weak EEC countries such as the UK and Italy. Continued recession since 1975 in Japan and the stronger EEC countries, with rapidly improving balance of payments positions, was due to anti-inflation policies which made their governments unwilling to accelerate growth of internal demand.

But deflation of demand has not helped developed countries as a group to contain inflation. Slow growth resulting in currency revaluation in the strongest countries may have helped them to reduce inflation, but only at the expense of weaker countries. The

Table 1.4 Balance of payments current accounts since 1973

	1969-73 annual average	(\$1975 billion)	
		1975	1978
USA	0.5	18.4	-18.8
EEC	6.5	0.4	11.2
Japan	5.6	- 0.7	18.9
Other developed market economies	- 2.3	-20.7	- 6.3
OPEC	3.1	28.1	6.9
Other developing market economies	-11.8	-27.5	-12.6
Centrally planned economies	- 1.0	-13.4	- 7.3

slump has more generally helped to reduce world prices of food, raw materials and even oil relative to manufactures. But against this, the counterpart slow growth in production and productivity in industrial countries has cut growth of their real incomes by a very large amount and has forced their governments to increase taxes and cut services in a manner which must have increased pressure for higher wages and made counter-inflation policies more difficult.

For those who believe that a cure for inflation is an essential economic or political condition for recovery, the remainder of our analysis has to be read as being conditional on the assumption that the cure has been or will be achieved by some means other than continued deflation and slump. Indeed, anyone who believed that inflation can only be held in check by continuing recession would be in the very weak position of ruling out any and all possibilities of recovery.

The aim of the next sections is to make an assessment of necessary conditions for faster GNP growth throughout the world. This is not simply a matter of reflation, led by appropriate groups of countries, because it is essential to check how expanding markets are likely to be shared and to discover whether and how faster growth can be made compatible with balance of payments equilibrium.

To examine these questions we have calculated solutions of our model of world trade and balances of payments up to 1985 on various policy assumptions. The starting point for each projection is a view on which of the major blocs will set the pace of expansion by their own domestic growth policies, and on which blocs will be obliged to adjust their internal growth rates in order to keep within balance of payments targets. Except where noted, the ratio of manufactured imports of each bloc to its GNP and the shares of competing suppliers in each manufactured import market are assumed to move in a manner similar to the past. Assumptions about future food, raw material and fuel supply and prices are described in Appendix A.

Before considering problems of the world system as a whole it will clarify the analysis to review projections for each bloc to see what range of constraints and policy choices it may plausibly encounter, without at this stage examining the mutual consistency of outcomes. Tables used to illustrate prospects for each bloc are derived from consistent but not necessarily plausible solutions for the world system; it will be sufficient to think of the figures as being conditional simply on fast (9% a year) or slow (6% a year) growth of world trade.

The USA

During the past year the USA has become balance of payments constrained in a more substantial sense than at any previous time since the second World War. How the USA reacts to this situation will strongly affect medium-term prospects for the entire world.

Dollar problems during the 1960s were mainly a matter of gold flows and capital movements, which were dealt with by demonetisation of gold, adjustment

of interest rates and comparatively minor changes of exchange rate parities. What has happened in the last two years is that the USA has for the first time developed a persistent current account deficit, such that external balance is no longer consistent with domestic growth objectives. Although the US deficit is small compared with its GNP or world trade as a whole, and not all that large compared with US exports, it is extremely disturbing for the rest of the world, which holds most of its reserves in dollars and which sees no prospect of the USA being able to pay off dollar holders as a group, should they wish to switch to other currencies. The implication is that the USA now has to adjust its internal growth policies in the light of their effects on its trade balance, at least so long as its trade balance remains in deficit and it remains broadly committed to liberal external policies. If the US government continued to reflate GNP at the expense of a rising trade deficit, there is little doubt that the dollar exchange rate would go on falling rapidly, that world currency markets would be in chaos and that international economic cooperation, not least that of OPEC, would swiftly disintegrate.

Although high oil imports have aggravated the US trade deficit since 1973, its origins can be found in long-standing trends very similar to those experienced by the UK. In 1965 US exports of manufactures were 50% higher than its imports of manufactures; the fact that imports rose faster than exports did not matter much, since the net deficit in trade in primary commodities and invisibles was small and indeed by 1973 had become a surplus. Since then, with exports and imports of manufactures roughly equal in absolute magnitude, it has become essential either for the growth of exports to accelerate or for the growth of imports to slow down, if a fast-rising deficit on manufactures is to be avoided. At the same time the US oil deficit came to exceed its earnings from net exports of food and raw materials and invisibles.

The dangers of this position are illustrated by projections of our model shown in Table 1.5. Supposing that the USA maintained 'full employment' 4% a year GNP growth, then even with a slower rise in penetration of its domestic markets by manufactured imports than in the past, and with a similar rate of growth of its manufactured exports, its deficit on manufactured trade would rise to about \$30 billion (at 1975 values) by 1985. With fast GNP growth and rising world oil prices, its overall current account deficit would be extrapolated to reach the staggering figure of \$70 billion at 1975 values (nearly \$100 billion in today's values) by the same year.

On the other hand, to go to the other extreme of policy, if one supposes that the US objective is to cut the current account deficit by deflation, regardless of the effect on GNP, then, allowing for adverse repercussions on world trade and hence on growth of US exports, it could be that GNP would not be able to expand at all over the next few years. With manufactured import penetration growing some 5% a year and sluggish export growth, this halt to internal growth would be necessary to prevent a rising deficit on trade in manufactures, while the oil deficit was being reduced.

Table 1.5 The US balance of payments problem

	\$1975 billion		Average growth rates % per year
(a) Historical changes			
	<u>1965</u>	<u>1978</u>	<u>1965-78</u>
Exports of manufactures	38	78	5.8
Imports of manufactures	- 24	- 80	9.8
Other trade and invisibles	- 2	- 17	-
Current account of balance of payments	11	- 19	-
GNP	1161	1779	3.3
(b) Assuming 4% GNP growth and 4% a year rise in world prices of fuels relative to manufactures			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	78	118	6.1
Imports of manufactures	- 80	- 151	9.4
Other trade and invisibles	- 17	- 41	-
Current account balance of payments	- 19	- 73	-
GNP	1779	2341	4.0
(c) Assuming reduction of current account deficit to \$5 billion and 3% a year rise in world prices of fuels relative to manufactures			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	78	101	3.6
Imports of manufactures	- 80	- 109	4.4
Other trade and invisibles	- 17	3	-
Current account balance of payments	- 19	- 5	-
GNP	1779	1709	-0.6

If the dilemma for the USA turns out to be anything like as acute as this, radical changes in US policy seem inevitable. There are three obvious possibilities. One is for the USA to put pressure on the EEC and Japan to reflate their economies and help expand world markets for US exports. A second is for the US to pursue a modified reflation of its own, calculated to keep its own balance in deficit and force the EEC and Japan into surplus, counting on revaluations of European currencies and the Yen to alter market shares against those countries in favour of US exporters. A third possibility is that the US will impose import restrictions to prevent fast growth of its manufactured imports. The consequences of each of these strategies will be assessed when we examine projections of the world trading system as a whole.

Japan

The Japanese tendency to trade surplus will be a formidable obstacle to fast growth of world trade as a whole. Japan's exports of manufactures have persistently risen more than those of other major manufacturing blocs, while since the late 1960s its imports of manufactures have scarcely risen at all relative to GNP (see Table 1.6). Japan now has the opposite structural problem from the USA, in the sense that its imports of manufactures are still so small relative

to its exports that even if its imports grow fast the absolute difference between its manufactured exports and imports is certain to rise.

Thus, even with slow growth of world trade, Japan's \$65 billion surplus in trade in manufactures is projected to rise to \$100 billion or more (in 1975 values) by 1985 and its net import bill for food, raw materials and fuel, which was about \$40 billion in 1978, will not increase enough to offset this.

Japan's exceptional trading position means that it is effectively free to determine its own growth rate in accordance with its own domestic priorities. From 1965 to 1978 its GNP growth averaged over 8% a year. The growth rate it chooses from now on is of considerable importance to the rest of the world. The last two years bode ill, since despite a rising trade surplus Japan's GNP has been growing at only 5% a year. Our projections assume that Japan will not want to grow quite as fast from now on as it did up to the mid-1970s.

OPEC

The GNP growth of most OPEC countries in the next few years need not depend too critically on rising oil revenues, because they can if necessary reduce their very high import ratios and draw on accumulated reserves of foreign assets. For world trade as a whole

Table 1.6 The problem of the Japanese surplus

	\$1975 billion		Average growth rates % per year
(a) Historical changes			
	<u>1965</u>	<u>1978</u>	<u>1965-78</u>
Exports of manufactures	16	79	13.0
Imports of manufactures	- 3	- 14	11.0
Other trade and invisibles	- 11	- 45	-
Current account balance of payments	2	19	-
GNP	216	608	8.3
(b) Assuming 6% GNP growth and fast growth of world trade			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	79	168	11.4
Imports of manufactures	- 14	- 29	10.2
Other trade and invisibles	- 45	- 84	-
Current account balance of payments	19	60	-
GNP	608	914	6.0
(c) Assuming 6% GNP growth and slow growth of world trade			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	79	134	7.9
Imports of manufactures	- 14	- 29	10.5
Other trade and invisibles	- 45	- 76	-
Current account balance of payments	19	29	-
GNP	608	914	6.0

what matters is whether growth of OPEC oil revenues will be so slow as to cause OPEC countries to incur current account deficits, or fast enough to move them back into substantial surplus.

Two possible future balances of world trade in oil and other fuels are shown in Table 1.7. Even with slow growth of world trade OPEC's revenues are projected to rise in real terms, because Japan and many developing countries will substantially increase their oil imports, implying that the volume of OPEC oil exports required to balance world demand will be higher than in 1978, if not back to the 1973 level, while the long-run prospect of exhaustion of world oil reserves should be sufficient to enable OPEC to secure at least some improvement in the real price of oil. With fast growth in the USA and other developed economies, demand for OPEC oil exports may rise well above the 1973 level, in which case world prices are likely to be still higher. Conceivably, with a 40% rise in the volume of OPEC exports and a 40% rise in real oil prices, the real value of OPEC revenues could double from the 1978 level by 1985.

However, OPEC could absorb a rise in oil revenues of this magnitude without a large permanent balance of payments surplus (see Table 1.8). With a projected 7% growth of non-oil GNP and a gradual continued rise in imports relative to GNP, OPEC's bill for imports and invisibles would rise by 1985 just about enough to match a doubling of its revenues. Steep

and immediate price rises might temporarily push the OPEC surplus back up to \$10 or \$20 billion. This would at worst place OPEC on a par with Japan as a source of payments disequilibrium and the surplus would soon fall because of continuing growth of OPEC imports.

EEC

The EEC as a whole is projected to be on the borderline between surplus and balance of payments constraint in the period up to 1985. If world trade grows fast, its share of world exports of manufactures is strong enough and its present surplus large enough to allow most EEC countries to grow, if they so choose, by 4-5% a year, despite a rising import bill for fuel and raw materials. But if world trade is very depressed, EEC countries may only be able to avoid current account deficits by holding GNP growth down to 2-3% a year (see Table 1.9).

The situation facing individual EEC member countries varies, depending on the strength of their currencies and their trading positions. Given the ultra-cautious attitudes of stronger members - Germany and Benelux countries - towards internal deflation, there is a presumption that the EEC may accumulate a rising balance of payments surplus if world trade grows fast and that the caution of these countries will limit growth of most EEC members to the 3-4%

Table 1.7 World fuel balances

		(\$1975 billion)		
(a) Historical balances	<u>1965</u>	<u>1974</u>	<u>1978</u>	
World prices of oil and other fuel exports relative to manufactures (1975 = 100)	45	103	96	
Volume of net imports:				
USA	5	25	34	
Japan	6	27	24	
EEC	17	53	39	
Other market economies	13	31	27	
Total	42	136	124	
Volume of net exports:				
OPEC	37	130	113	
Centrally planned economies	4	6	11	
(b) Possible balances in 1985		Slow growth of developed economies	Fast growth of developed economies	
World prices of oil and other fuel exports relative to manufactures (1975 = 100)		118	127	
Volume of net imports:				
USA		25	52	
Japan		36	35	
EEC		40	47	
Other market economies		34	42	
Total		135	176	
Volume of net exports:				
OPEC		125	161	
Centrally planned economies		10	16	

range. If this happens, the EEC will be acting as a significant brake on growth of the whole world trading system.

Other developed and developing economies

Other developed countries and non-oil developing countries are still for the most part dependent on net exports of food and raw materials, as well as aid and capital inflows, in order to finance net imports of manufactures (see Table 1.10). Both groups, but particularly the developed countries, have since 1973 suffered a reduction in their capacity to finance growth of imports of manufactures; the GNP growth of the developed countries had to be cut back from over 5% to about 2½% as a result, and developing countries also are now growing slightly slower than before.

Both groups will be very much affected by the future growth of world trade and by shifts in world commodity prices. The developed countries risk slow growth since their share of world manufactured exports is not rising. Non-oil developing countries could probably maintain growth rates roughly in line with the past, even if world trade remains depressed,

provided they are allowed to continue to raise their share of manufactured imports by developed countries and provided they continue to receive significant net capital inflows. Both groups are certain to remain balance of payments constrained.

Centrally planned economies

Now that centrally planned economies have built up trading relations with OECD countries, their role in world markets is quite significant. Since 1973 they have provided substantial net demand for manufactures, financed by net exports of fuels and by borrowing. The two aspects of their trade which most affect growth of world trade are their net fuel exports and their overall current account deficit. Our tentative assumption is that these will be maintained and thereby help support world expansion.

Growth of the world system as a whole

Putting trends and policy assumptions together, projections of the model have been calculated for the world system as a whole, in which supplies and demands for manufactures, food and raw materials

Table 1.8 Prospects for OPEC

	\$1975 billion			Average growth rates % per year	
	1965	1974	1978	1965-74	1974-78
(a) Historical changes					
Net exports of oil and fuels	17	134	109	26.0	- 5.1
Imports of manufactures	11	33	65	13.4	18.7
Other trade and invisibles	- 6	- 34	- 37	-	-
Current account balance of payments	0	67	7	-	-
GNP	97	201	248	8.4	5.4
(b) Assuming 8% GNP growth and fast growth of world trade					
	<u>1978</u>	<u>1985</u>		<u>1978-85</u>	
Net exports of oil and fuels	109	203		9.3	
Imports of manufactures	65	139		11.5	
Other trade and invisibles	- 37	- 59		-	
Current account balance of payments	7	5		-	
GNP	248	426		8.0	
(c) Assuming slow growth of world trade					
	<u>1978</u>	<u>1985</u>		<u>1978-85</u>	
Net exports of oil and fuels	109	148		4.5	
Imports of manufactures	65	100		6.4	
Other trade and invisibles	- 37	- 56		-	
Current account balance of payments	7	- 8		-	
GNP	248	314		3.4	

Table 1.9 Prospects for the EEC

	\$1975 billion		Average growth rates % per year
	1965	1978	1965-78
(a) Historical changes			
Exports of manufactures	104	302	8.5
Imports of manufactures	- 69	- 229	9.6
Other trade and visibles	- 33	- 62	-
Current account balance of payments	2	11	-
GNP	944.9	1467.6	3.4
(b) Assuming fast growth of world trade			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	302	534	8.5
Imports of manufactures	- 229	- 415	8.9
Other trade and invisibles	- 62	- 93	-
Current account balance of payments	11	26	-
GNP	1468	1910	3.8
(c) Assuming slow growth of world trade			
	<u>1978</u>	<u>1985</u>	<u>1978-85</u>
Exports of manufactures	302	449	5.8
Imports of manufactures	- 229	- 369	7.1
Other trade and invisibles	- 62	- 78	-
Current account balance of payments	11	2	-
GNP	1468	1707	2.2

Table 1.10 Prospects for other market economies

	\$1975 billion			Average growth rates % per year	
1. Other developed market economies					
(a) Historical changes	<u>1965</u>	<u>1973</u>	<u>1978</u>	<u>1965-73</u>	<u>1973-78</u>
Net export earnings and invisibles	45	104	105	11.0	0.2
Imports of manufactures	54	104	111	8.5	1.3
Current account balance of payments	- 9	0	- 6	-	-
GNP	425	641	722	5.3	2.4
(b) Prospects for 1985	Slow growth of developed economies		Fast growth of developed economies	<u>1978-85</u>	
				Slow growth	Fast growth
Net export earnings and invisibles	151		181	5.3	8.1
Imports of manufactures	159		189	5.3	7.9
Current account balance of payments	- 8		- 8	-	-
GNP	864		1015	2.6	5.0
2. Other developing market economies					
(a) Historical changes	<u>1965</u>	<u>1973</u>	<u>1978</u>	<u>1965-73</u>	<u>1973-78</u>
Net export earnings and invisibles	31	77	99	12.0	5.2
Imports of manufactures	43	82	112	8.4	6.4
Current account balance of payments	- 12	- 5	- 13	-	-
GNP	387	583	762	5.3	5.5
(b) Prospects for 1985	Slow growth of developed economies		Fast growth of developed economies	<u>1978-85</u>	
				Slow growth	Fast growth
Net export earnings and invisibles	157		181	6.8	9.0
Imports of manufactures	170		194	6.1	8.2
Current account balance of payments	- 13		- 13	-	-
GNP	1025		1154	4.3	6.1

and fuels are balanced, while GNP growth of balance of payments constrained blocs is adjusted to hold their current account deficits to target levels. Depending on the assumptions, one or more blocs emerge as being free from balance of payments constraints, in the sense that they can meet targets for GNP growth while maintaining a better current account balance than the minimum assumed necessary in their case. These projections, described more fully in Appendix A, are the basis of tables used here to illustrate structural problems of the world system between now and 1985.

The main factors

The central problem shown by the projections is that of a large potential Japanese surplus, which has to be kept down by slow growth of world trade, unless other blocs are willing and able to incur sufficiently large counterpart deficits. The Japanese surplus could be far more persistent than the OPEC surplus because trade in manufactures, on which Japan's surplus depends, has a potential for cumulative long-run

growth far in excess of trade in oil, from which OPEC's surplus is derived. OPEC's surplus is already smaller than that of the EEC and is likely to remain that way.

The other main strategic issue is the severe medium-term balance of payments constraint on growth facing the USA. The rest of the world now derives benefit from this and may continue to do so if the consequence is that the USA goes on running a large trade deficit which helps to counteract the Japanese surplus. Although the quantitative projections are obviously uncertain in their detail, our main argument and conclusions depend essentially on the two tendencies to US deficit and Japanese surplus, which look sufficiently robust and persistent to warrant serious consideration of corrective policy measures.

The examination of world prospects starts with the worst case from the point of view of world trade - reduction of the US balance of payments deficit to a modest level by means of deflation in the USA - and then proceeds to consider the impact of strategies aimed at avoiding the acute problems to which such deflation would give rise, both in the USA itself and

Table 1.11 The worst case: balance of payments equilibrium achieved by US deflation

	Current account balance of payments, 1985 (\$1975 billion)	Average growth rates, 1978-85 (% per year)		
		GNP	Manuf. exports	Manuf. imports
World total	—	2.2 ^a	6.0	6.0
USA	— 5	—0.6	3.6	4.4
Japan	29	6.0	7.9	10.5
EEC	2	2.2	5.8	7.1
Other developed market economies	— 8	2.6	5.9	5.2
OPEC	— 8	3.4	—	6.4
Other developing market economies	—13	4.3	9.4	6.2
Centrally planned economies	—10	—	4.1	3.5

^a Excluding centrally planned economies.

in other blocs.

The worst case – US deflation

Deflationary policies in the USA designed to reduce its current account deficit will depress growth of world trade as a whole; almost all countries except Japan will find themselves balance of payments constrained while Japan still maintains a large surplus. The growth of world trade would depend on the extent to which other countries were willing and able to take over the US deficit and compensate for the Japanese surplus. If the EEC as a whole was unwilling to incur a deficit, the volume of world trade in manufactures would rise as little as 6% a year (see Table 1.11). Developing countries would then achieve GNP growth rates of little over 4% a year, OPEC would move into balance of payments deficit, the EEC and most other developed countries would manage GNP growth of only 2-3% a year and the USA itself no growth at all. This latter result makes the policy assumptions of the projection implausible; if the figuring is at all correct, the USA is bound to adopt some other strategy.

A second worst case – US deflation moderated

If the USA were to relax its objective of reducing its current account deficit and if the EEC were prepared to incur even a small deficit, world prospects would improve very considerably. So long as each country other than Japan passed on any trade gains it received by expanding its GNP and its imports, a cumulative expansion could take place, which would end only when the target deficits of all other blocs had been transferred to the Japanese surplus.

Thus if we assume that the USA maintains its

current account deficit at the 1978 level and the EEC accepts a \$1 billion deficit, growth of world trade is brought up to nearly 8% a year (see Table 1.12). GNP growth of most countries is increased by 1-1½% a year compared with the extreme deflationary case. This outcome would be much in line with trends since 1975, except for the very low GNP growth rate of about 1% a year required in the USA and a Japanese payments surplus rising to over \$40 billion by 1985, substituting for the post-1973 OPEC surplus.

Oil prices

It is sometimes suggested that future growth of the USA and the world as a whole will depend critically on the movement of world oil prices, which are at present starting to rise again in real terms.

The more the USA maintains a reflationary strategy, or persuades others to do so, the more likely it is that rising demand in the international oil market will encourage early and substantial oil price increases which would aggravate US balance of payments problems. It is important to assess the significance of these effects quantitatively, allowing for their full impact on the whole trading system, not just the USA. Table 1.13 illustrates the effects of what is probably the maximum assumption – an additional 25% real price increase between now and 1981 superimposed on the steady 3% a year rise assumed hitherto.

Although OPEC's surplus would inevitably rise in the short run, some OPEC members at least would use part of the extra revenues to expand faster, giving manufactured exporting blocs partial compensation for the oil price increase. Oil importing countries which were also balance of payments constrained, notably the USA, would have to reduce their GNP

Table 1.12 US deflation moderated

	Current account balance of payments, 1985 (\$1975 billion)	GNP	Average growth, rates, 1978-85 (% per year)	
			Manuf. exports	Manuf. imports
World total	—	3.6 ^a	7.8	7.8
USA	-19	1.1	5.1	6.1
Japan	45	6.0	9.6	10.4
EEC	-1	3.7	7.6	8.9
Other developed market economies	-8	3.9	7.6	6.6
OPEC	-8	6.1	—	9.1
Other developing market economies	-13	5.3	11.0	7.2
Centrally planned economies	-10	—	6.6	6.6

^a Excluding centrally planned economies.

Table 1.13 Example of the effects of maximum world oil price assumptions

(Changes compared with Table 1.12, assuming oil prices are 25% higher by 1981 and 11% higher by 1985)

	Current account balance of payments		GNP		Manuf. exports		Manuf. imports	
	1982	1985	1982	1985	1982	1985	1982	1985
	(change in \$1975 billion)		(% change)		(% change)		(% change)	
World total	—	—	-0.9 ^a	+0.2 ^a	+1	+2	+1	+2
USA	0	0	-2.6	-0.7	+1	+2	-3	-1
Japan	-5	-1	0	0	+1	+2	-1	0
EEC	-6	+1	+0.1	+0.2	+1	+1	0	0
Other developed market economies	0	0	-1.5	-0.1	0	+1	-2	0
OPEC	+11	0	+4.4	+8.7	—	—	+13	+12
Other developing market economies	0	0	-1.7	-0.5	0	+1	-2	0
Centrally planned economies	0	0	—	—	+4	+4	+6	+5

^a Excluding centrally planned economies.

growth. But the higher OPEC surplus would be matched by lower EEC and Japanese surpluses without too much general deflation, because the latter areas are themselves heavy oil importers and are likely to have sufficiently strong balance of payments positions to absorb the loss without having to cut back their internal growth. The net cost to constrained oil-importing countries like the USA would be a reduction in the level of GNP of 1½-2½%. Their loss of real national income would be up to 1% greater than this, due to the adverse effect of higher oil prices on their terms of trade.

In the longer run the impact of a sudden rise in oil prices would be mitigated by two factors: first, the likelihood that it would be followed by a period of stability or even decline in real oil prices, as happened after 1974, and second the eventual absorp-

tion of higher oil revenues by OPEC through increased manufactured imports.

Our projections thus imply that a new round of steep OPEC price increases need not cause more than a minor disturbance to medium term prospects for world expansion, provided that developed countries do not over-react. The price increase itself could not be anything like the same order of magnitude as in 1973-74 and the EEC and Japan, at least, will be in a good position to absorb the price increase without major deflation.

Similar arguments apply even more strongly in reverse. Lower real oil prices would marginally assist the USA but would not significantly assist world expansion, because it is the surplus of Japan and the potential surplus of the EEC, not that of OPEC, which now constitute the main obstacle to faster

growth.

Effects of exchange rate changes on shares of trade

The second possibility which needs quantitative examination is the effects of exchange rate changes on shares of world markets for manufactures. The assessments of growth prospects given so far have been based on the assumption that market shares will move in future in a manner similar to the past, and therefore reflect at least the impact of past exchange rate shifts, notably the fall in the US dollar relative to European currencies and the Yen, insofar as these shifts had any effect up to 1978.

The tendency for continuing US deficits and EEC and Japanese surpluses makes it likely that the US dollar will continue to fall rapidly on currency markets relative to the Yen and European currencies. Indeed, the USA could bring this about deliberately by undertaking sufficient reflation to ensure a continuing large current account deficit. It is highly unlikely that it will be the policy of any of the governments concerned to promote continuing major exchange rate shifts. On the US side, the fall in the dollar is increasingly seen as a cause of inflation, while on the European and Japanese side very high exchange rates are seen as an immediate threat to industrial profits and a long-run threat to a prosperity which is based on industrial exports.

Nevertheless, as an extreme assumption, suppose that exchange rate changes take place at a sufficient rate to give the USA a cumulative improvement of 2-3% a year in the trend of its export shares at the expense of Japan and the strong EEC exporters. The effects are illustrated in Table 1.14. GNP growth in the USA would certainly be more satisfactory, although still rather below what is probably needed for full employment. Other countries would benefit from faster growth of world trade, and the EEC and Japan could still maintain their growth rates without serious erosion of their balance of payments positions — indeed Japan would still have a very large surplus.

Thus if the USA maintained its large current account deficit while a continuing fall in the dollar and rise in the Yen and stronger European currencies achieved a large readjustment of market shares, the prospects for world growth would be much improved. But even on these extreme hypotheses, the EEC and Japan would still tend to be holding back growth because of their excessively strong trading performance. The reason for this is not only that their past trends and present trade balances are so favourable, but also that they would benefit very strongly from US expansion, because of their high share of US imports and of OPEC imports, which would be fed by rising US demand for oil.

Reflation led by Japan and the EEC

Given the balance of payments problems of the USA, there may well be renewed interest in the 'locomotive' theory of world reflation, according to which the strongest economies should assist recovery by expanding their own GNPs at a faster rate than they would choose in relation to purely domestic objectives. Attempts to secure such action have been unsuccessful in the past two or three years, but persistent world recession and dollar crisis might well make the Europeans and Japanese more willing to cooperate in future. It is not self-evident that coordinated reflation by OECD countries is in practice possible, since it might require the strong economies to grow at unreasonably fast rates.

Table 1.15 illustrates the effects of assuming accelerated GNP growth in the stronger EEC countries and Japan. The outcome is of little comfort to the USA. The problem is quite simply that the EEC and Japan will benefit too much from the expansion of EEC and OPEC markets and that the US share of expanded trade will be too small. The main beneficiaries would be the weaker European countries, which have relatively high shares of EEC markets. To reinforce the point, hypothetical projection of our model to enable the USA to grow at 4% a year with a constant

Table 1.14 Example of the effects of maximum changes in trends of market shares brought about by continuing dollar devaluation

	Current account balance of payments in 1985 (\$1975 billion)	Average growth rates, 1978-85 (% per year)		
		GNP	Manuf. exports	Manuf. imports
World total	—	4.5 ^a	9.0	9.0
USA	-19	2.7	9.2	8.0
Japan	37	6.0	9.2	10.4
EEC	1	3.9	7.9	9.0
Other developed market economies	- 8	5.2	9.5	8.0
OPEC	- 1	8.0	—	11.5
Other developing market economies	-13	6.2	12.8	8.3
Centrally planned economies	-10	—	9.7	10.0

^a Excluding centrally planned economies.

Table 1.15 Reflation by Japan and the EEC

	Current account balance of payments in 1985 (\$1975 billion)	Average growth rates, 1978-85 (% per year)		
		GNP	Manuf. exports	Manuf. imports
World total	—	4.6 ^a	9.0	9.0
USA	-19	1.8	6.3	7.0
Japan	41	8.0	10.8	12.7
EEC	2	4.7	8.8	9.9
Other developed market economies	- 8	4.9	8.8	7.7
OPEC	- 7	8.0	—	11.2
Other developing market economies	-13	6.0	12.2	8.1
Centrally planned economies	-10	—	8.4	8.8

^a Excluding centrally planned economies.

balance of payments deficit requires the 'locomotives' — Japan and the EEC — to grow at the absurd rates of 16½% and 8½% a year respectively.

US protection

Most countries in the world which face serious balance of payments constraints — nearly all developing countries and some primary-exporting developed countries — restrict their imports of manufactures by means of tariffs or direct controls, so as to allow GNP growth and industrialisation to proceed without the constant danger that their internal expansion will be brought to a halt by rapid increases in imported competitive manufactures. It is natural that, as some of the older industrialised countries, notably the UK and the USA, have faced rapid penetration of their own markets by imports, combined with a steady erosion of their share of world export markets, putting the growth of their whole economies and their manufacturing sectors increasingly at the mercy of their external trading performance, the possibility of using import restrictions to avert recession should be considered more and more seriously.

In earlier *Policy Reviews* we have demonstrated that there is a strong macro-economic case for the UK to restrict its import propensity in order to accelerate its GNP growth. Given the serious prospect of stagnation in the USA, due to unfavourable trends in its manufactured trade as well as its oil imports, the same case needs to be assessed for the USA. Even more important, it is essential to determine what effect the imposition of restrictions on imports of manufactures by such a large country as the USA would have on the growth of the world system as a whole.

The purpose of US import restrictions should be to permit faster GNP growth, not to cut down imports in total. The composition of imports would then shift to some extent in favour of those which were complementary, notably oil and raw materials needed for faster growth, and against those which were competitive, notably manufactures.

On the assumption that the USA maintained its present large current account deficit and achieved 4%

a year growth of GNP, its imports of manufactures could still be allowed to rise from their present level, although only slowly (see Table 1.16). Primary commodity exporters, particularly OPEC, would benefit directly from higher US demand for oil and raw materials. Exporters of manufactures, particularly Japan, would lose from restrictions on their access to the US market, but would gain indirectly through expansion of the import markets of OPEC and raw material exporters.

Overall, assuming that US import restrictions have an equal proportionate effect on all suppliers of manufactures to the US market, and that they are not used as a device for reducing the US current account deficit, world trade in manufactures would be slightly increased as a result of US restrictions, because they would shift the balance of trade against Japan in favour of constrained blocs. Most countries would find their balance of payments and GNP growth rates were almost unchanged. The few who would suffer would be manufactured exporters particularly dependent on the US market, and the few who would gain significantly would be those exporting oil and raw materials to the USA or those specialised in manufactured trade in non-US primary-producing areas.

More positive benefits to the pattern of world trade could be achieved if the USA were to restrict imports in a manner which discriminated between suppliers, exempting constrained countries specially dependent on its markets and concentrating the restrictions on Japan, which can best afford a substantial loss of markets. In this way the benefits of US reflation could be passed on not only to oil and raw material exporters, but also to developing countries supplying its market for manufactures, positively assisting faster growth of world trade as a whole.

US import restrictions would damage growth of world trade only if they discriminated in a perverse sense, bearing most heavily on weak suppliers, or still more serious, if used to cut the US balance of payments deficit below the level which the USA could otherwise have afforded. On the other hand, European or Japanese retaliation against US import restrictions would not damage the level of world trade much. A

Table 1.16 The effects of general US restrictions on manufactured imports

	Current account balance of payments in 1985 (\$1975 billion)	Average growth rates, 1978-85 (% per year)		
		GNP	Manuf. exports	Manuf. imports
World total	—	4.5 ^a	7.7	7.7
USA	-19	4.0	5.4	1.4
Japan	37	6.0	9.2	10.4
EEC	1	3.7	7.7	8.8
Other developed market economies	- 8	3.8	7.0	6.5
OPEC	- 2	8.0	—	11.5
Other developing market economies	-13	5.2	10.0	7.2
Centrally planned economies	-10	—	7.7	8.2

^a Excluding centrally planned economies.

variant projection, in which all developed countries retaliate against US import restrictions by discriminating against the USA, merely alters the directions of trade with rather little effect on the overall volume of trade or on the GNP of different blocs.

A Growth-Inducing System of Trade

Although the USA could assure its own growth by means of import restrictions combined with internal expansion, this would still leave the rest of the world heavily dependent on US willingness to incur continuing large trade deficits, and even with such deficits the growth of world trade would not be sufficient to meet the needs of other weak developed countries or of developing countries. The Japanese surplus and potential EEC surplus would still remain as obstacles to a general recovery.

A considerably better result could be achieved by broader trade and policy coordination, aimed at reducing the Japanese surplus and keeping the EEC surplus within reasonable limits. The policies to achieve this could include, for example, restriction of the growth of Japanese exports (whether by Japan or by importing countries) and faster internal expansion and discrimination in favour of developing

countries by the EEC, as well as discriminating import restrictions imposed by the USA. Such a package is illustrated by the results in Table 1.17 of a solution of our model in which Japan's export growth is reduced to little over half the growth of world exports of manufactures, while the EEC accelerates its GNP growth to nearly 5% a year and the USA combines 4% GNP growth with a reducing current account deficit. Japan's GNP growth rate is assumed to be maintained at the same rate as in other projections through faster expansion of internal demand.

The combined result of these policies is much superior to any previously discussed. Other developed countries and non-oil developing countries could bring their GNP growth rates at least back up to what they were before 1973. The current account balances of payments of all blocs would be more or less manageable. However, it must be emphasised that a recovery of this kind could only work with really effective policy coordination. The various elements of discrimination and reflation would only provide the basis for faster growth of trade and GNP in all blocs on that basis. In particular, if the USA reduces its deficit without effective action to reduce the Japanese surplus, world trade cannot grow fast and most economies are bound to remain in recession.

Table 1.17 A Growth-Inducing System of Trade

	Current account balance of payments in 1985 (\$1975 billion)	Average growth rates, 1978-85 (% per year)		
		GNP	Manuf. exports	Manuf. imports
World total	—	5.1 ^a	8.9	8.9
USA	- 5	4.0	6.9	1.9
Japan	2	6.0	5.2	10.6
EEC	8	4.7	9.1	9.9
Other developed market economies	- 8	5.1	9.1	8.0
OPEC	13	8.0	—	11.5
Other developing market economies	-13	6.5	13.0	8.6
Centrally planned economies	-10	—	10.2	10.8

^a Excluding centrally planned economies.