Policy Assessment

In the 1970s the world's reserves of oil began to run out. Recession and inflation became endemic in most developed countries, and many lower-income countries saw their economic development cut back. Especially in the West, there was a breakdown of the old optimism about growth. Was 'stagflation' on a world scale now inevitable? What if anything could be done to lift the limits on future development?

We shall argue that if the world economic system had been actively and sensibly managed there would have been no need for, or benefit from, any general recession. Growth could have been sustained and inflation kept down, albeit with some painful oil and energy adjustments in the developed countries.

In the event, policy reactions to oil shortage and high world prices had perverse results. A good part of the blame for this attaches to the structure of international institutions, a structure not designed to deal with the new problems of the 1970s.

In the absence of world government, policies around the world are co-ordinated by economic pressures in world markets and by rules and obligations imposed on national governments by institutions such as the IMF, the GATT and the OECD. The rules generally have some force since they reflect, and are reinforced by, the political influence of many governments. In our view the institutions have reacted to world problems in a largely negative way, insisting on the importance of existing rules rather than facing up to the need for change. The rules have made it difficult for individual countries to protect themselves from the world recession. Worse, they have reinforced a destructive process of financial restriction and diminished pressures for the oil saving and energy restructuring that is now so urgent.

This Review aims to assess the case for changes in international rules on the basis of a realistic view about what now determines growth in the world economy, and the distribution of that growth between countries and blocs. The policy proposals we shall discuss include additional aid and recycling of funds to developing countries, reflationary stimulus to the economies of developed countries, obligations to restructure industries and energy sectors in those countries, and new approaches to trade discrimination or protection. Our argument is based on empirical analyses in Chapters 1 to 3 which employ a model of the world economy, divided into nine groups of countries, to project developments in the early 1980s on a wide variety of assumptions. The three chapters examine, respectively, the scale of trade imbalances which might emerge if spending in all countries grew at adequate rates regardless of deficits, the logic and consequences of financial constraints, and the implications of structural changes in energy and industrial trade.

We start by reviewing explanations of what has gone wrong.

1. Diagnosis

It is by now common ground that the world is gradually running out of oil. Existing patterns of energy use are too wasteful and alternatives to oil are being developed too slowly. Indeed the world remains on the brink of immediate oil shortage despite a major slow-down in the rate of economic growth. In the medium term faster expansion of world income will only be possible to the extent that more rapid progress is made in energy saving and the provision of new supplies.

Oil producers have responded to, or taken advantage of, the limited availability of oil by raising prices dramatically. This causes a second, universally recognised problem — that of chronic external trade surpluses in 'low-absorbing' OPEC countries which mean that other countries, developed or developing, must incur large counterpart trade deficits.

A third problem is the difficulty experienced by non-oil developing countries in financing their rising trade deficits. One risk is that of spectacular bankruptcies embarrassing the international banking system. Alternatively the burden of debt may bring economic growth in debtor countries to a standstill. Apart from all this, there is an uneasy perception that deficits of non-oil developing countries are in some sense necessary for the maintenance of world trade since they are in practice the main offset to OPEC surpluses.

A fourth problem is worsening inflation in most developed countries. This affects the rest of the world not so much by raising world market prices as by inducing restrictive financial policies in developed countries which depress trade and diminish the export opportunities of developing countries. Opinions differ on the strict necessity of conservative financial policies in this situation. The IMF view is that they are imperative to restrain and if possible cure inflation. But the World Bank takes a less definite view, balancing the risks of continued inflation against the costs of reduced growth in the developing world.

A final problem which has intensified in the context of recession is conflict between blocs with respect to industrial trade. Protectionism is growing in Europe and the USA. This again reduces the scope for third world exports. It is suggested, notably by the Brandt Commission, that developed countries should instead adapt to a 'new international division of labour', giving developing countries increased opportunities for industrialisation.

Energy imbalance, OPEC surpluses and non-OPEC deficits, the debts of non-oil developing countries, inflation and incipient protectionism in developed countries, are problems which international institutions perceive to be the main obstacles to growth of world trade and income. The policy conclusions they draw are not reassuring. In general they would like to see developed countries saving energy and curbing their internal inflation more effectively and they would like OPEC countries to join developed countries in giving more financial aid to the non-oil third world. They also believe that it is vital that developed countries should keep as near as possible to free trade. However, on most of these points there is little they can do but exhort. Whether or not their recommendations are correct, prospects for the world economy remain alarming. In any case their views do not rest on a clear analysis of how energy problems, inflation, financial difficulties and industrial trade policies interact. It is this interaction between the different constraints which limit growth in the world economy and influence the distribution of growth that we shall now try to establish.

Diagnosis: the views of international institutions

1. 'Among member countries of the Fund, there is general agreement on the fundamental need for governments to conserve energy and develop additional sources of supply, to adopt and maintain realistic domestic pricing policies . . . The problem of energy has become so pervasive that measures to deal with it must form an integral part of the whole process of formulating and conducting economic policies at the national level.'

   International Monetary Fund, *World Economic Outlook* (May 1980) pp. 39-40

2. '. . . if short term adjustment policies in the developing countries are insisted upon, a further round of deflationary impulses will be introduced into the international system as these countries individually attempt to cope with their external deficits. For the sum total of these deficits cannot diminish unless there is a reduction in the surplus of oil exporters or a widening in the deficit of developed countries.'

   United Nations, *World Economic Survey, 1979-80* (1980) p. 10

3. 'The situation of the non-oil exporting developing countries is aggravated at the present time by the course of events and policies in the developed market economies. These economies are currently seeking to moderate domestic inflation, partly by restricting aggregate demand and expenditure. In so doing, these countries reduce their demand for imports and shift external pressure to their trading partners. In the aggregate this means that pressure will be shifted from the developed market economies to the developing countries.'

   United Nations, *ibid.*

4. 'The Committee [of Governors of the IMF] remained convinced that the top priority being given in many countries to the fight against inflation must not be relaxed.'

   International Monetary Fund, *Survey* (13/10/80) p. 304

5. 'Industrial countries that restrain domestic growth to control inflation should minimize the effect on world trade by maintaining their demand for imports . . . They can do this by refraining from deliberate exchange rate depreciation, by avoiding subsidies to exporters and by opening their markets to imports.

   Each of these policies will also serve to dampen inflation.'

   World Bank, *World Development Report, 1980* (1980) pp. 18-19

6. 'The industrialisation of developing countries, as a means of their overall development efforts, will provide increasing opportunities for world trade and need not conflict with the long-term interests of the developed countries. It should be facilitated as a matter of international policy . . . Adjustment to new patterns of world industrial production should be accepted as a necessary and desirable process. Industrialized countries should vigorously pursue positive . . . adjustment programmes.'

   Independent Commission on International Development Issues (Brandt Commission), *North-South: A Program for Survival* (1980) p. 186

2. Oil exhaustion in a single country

The most important conclusion from our estimates in Chapters 1 and 2 is that energy imbalances will remain the principal limit on world growth through the early 1980s and for many years thereafter.

The essential properties of the oil constraint can be brought out by considering how a single country with a closed economy might be affected by gradual exhaustion of its oil reserves if alternative sources of energy were costly and took time to develop.

The worst scenario would be something like the following. When steady economic growth and rising demand for oil began to encounter supply limits and oil producers started to appreciate the huge economic value of remaining reserves, the price of oil would rise dramatically. If the rise in crude oil prices was passed through to consumer prices and money wages were formally indexed to the cost of living, a generalised price-wage inflation would ensue.

Oil producers might not wish to spend their windfall profits. There would then also be a classic 'over-saving' crisis, causing a fall in aggregate real demand and a reduction in the general level of non-oil production and investment. This need not cause a fall in oil prices since wealthy producers could keep oil in the ground to sell at a later date.

Now suppose the government was neither able to tax oil producers nor willing to engage in deficit spending. As recession cut tax receipts the government, worried by inflation, might increase tax rates in order to maintain a balanced budget, removing yet more purchasing power from the economy and deepening the recession. If the balanced budget policy continued, the slump caused by unspent oil profits could only come to an end when energy conservation and new sources of energy supply started to diminish the revenues of oil producers.

Would the recession and restriction of the government's budget deficit have been in any sense necessary, if only to prevent or cure the general inflation?

The tendency to inflation in non-oil sectors could certainly not be blamed on excess demand, since those sectors would be in recession. It could only come from income-maintenance pressures. In other words wages and prices in non-oil sectors would be rising, in the first instance, on account of attempts to compensate for losses of real income due to the 'terms of trade shift' in favour of oil producers.

Income-maintenance pressures would only be compounded by loss of income due to recession. Costs of unemployment relief would mount; tax rates would be increased to pay for this and to compensate for the shrinking tax base; utilities would put up charges to cover their fixed costs; money wages would increase faster to offset higher taxes and charges; and so on.

The only possible justification for financial restriction in the context of this type of inflation would be that if the recession were made deep enough, income-maintenance practices might be suppressed or eradicated. But in that case recession would have been used as a device for achieving indirectly what the government might better have done openly and directly. The cost of the indirect approach would have been huge in terms of unemployment, depression of living standards, reduced investment and damage to the future development of non-oil industries. Worst of all, efforts to save energy and develop new supplies would be reduced or postponed.

Monetary restriction and 'balanced budget' policies are a valid corrective to a general excess of demand but they are a thoroughly perverse response to inflation induced by shortages in a single sector. They actually make general inflation worse, not better, and they put off the day when constraints in that sector are overcome.

Our programme for the government of a hypothetical single country facing oil exhaustion would be entirely different.

(1) Ration oil and intervene to promote long-term energy saving and development of oil-substitutes.

(2) Allow oil prices and other energy prices to rise and compensate any groups who are particularly badly hit by the price increases.

(3) Assuming that oil producers cannot be taxed, increase the government's budget deficit to match unspent oil profits and prevent any fall in aggregate real demand in non-oil sectors.

(4) Use the proceeds of this extra government borrowing to subsidise the general cost of living.

(5) Do not raise interest rates or restrict credit. If oil producers want to deposit their savings in the banking system, make sure the money supply rises correspondingly.

These policies would maintain the pace of economic expansion, stabilise the overall price level while oil prices increased, and secure a rapid restructuring of energy supply and use. There would be no problem of financial recycling since in the very act of deciding not to spend oil profits the producers would be choosing to hold bank deposits or other financial assets which the government could readily borrow. Far from being bad for the rest of the community, the oil producers' willingness to save their profits would be a benefit. In effect they would be providing oil in exchange for goods and services at a future date, freeing present resources for use in the period of transition to a new energy system.

3. Oil exhaustion in the real world

What happened in the 1970s in the real world roughly corresponds with the non-intervention outcome in our single-country example. Oil prices rose without much effort being made to ration oil consumption or to stimulate aggregate real demand and prevent recession in non-oil sectors. The consequence was reduced growth of output, rising unemployment and aggravated inflation.

The only unavoidable cost paid by the non-OPEC world on account of high oil prices — the supply of additional goods and services to OPEC countries — has so far been small. Since 1973 the rise in OPEC imports, expressed as a proportion of the combined income of their main suppliers, the USA, Japan and

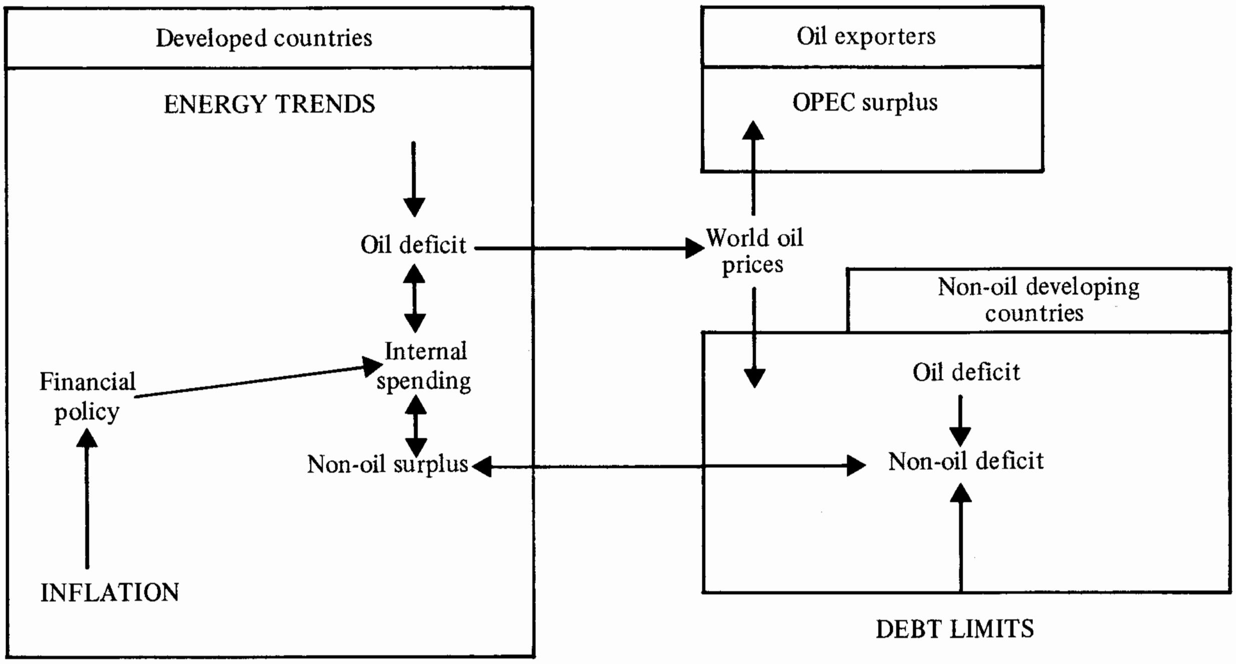

Figure 1 Principal constraints on world economic growth

Western Europe, has averaged well under ½% per year.

On the other hand the rate of growth in real output in developed countries has been cut back since 1973 by about 2% per year, implying a loss of output in 1980 of about 15%. It is the recession, not high oil prices as such, which has been predominantly to blame for scarcity of resources and cost-push inflation.

The mechanism of the recession involves three distinct groups of countries. The main oil-exporters take advantage of strong demand for oil by raising prices without necessarily being willing or able to spend additional revenues on imports. Instead they accumulate external financial assets, mainly in the form of securities of Western governments or deposits with international banks. Governments of developed countries, reacting to inflation and external trade deficits, maintain tight credit policies and try to prevent their own budget deficits from rising. This, together with the rise in oil prices, causes depression of real income and spending in developed countries, reducing their imports from each other and from non-oil developing countries. Fortunately for the rest of the world, the recession has so far been cushioned by higher borrowing by the latter group. Rising third world deficits have closed the circle, indirectly providing funds to pay for the oil-exporters' surplus.

But success so far in financing third world deficits is no cause for satisfaction. World activity has been held down by the failure of developed countries to contribute by sustained borrowing and deficit-spending on their own account. The level of OPEC surpluses is determined, not by oil-exporting countries, but by the net borrowing of the rest of the world. For the greater the borrowing, the more world activity expands, and the higher oil prices are driven. The resulting OPEC surplus cannot be more, or less, than the net borrowing of all other countries taken together.

It may seem reckless to suggest that world economic growth should be pushed ahead regardless of the level to which oil prices are forced up. But unpleasant though high oil prices may be, the alternative is far worse. Holding back world economic growth to prevent or slow down the rise in oil prices not only has a huge present cost but reduces the impetus for energy saving and development of new sources of supply. With oil reserves due to be exhausted in a few decades, this is a very dangerous policy. Up to now the rise in world prices, although it shocked developed countries, has not been anything like enough to put energy restructuring at the top of their list of priorities. Indeed some still expect that they will be able to solve their energy problems by continuously expanding their surpluses in industrial trade.

Very high world oil prices would provide a stronger inducement to developed countries to reduce their energy consumption and would help a wide range of countries to develop less accessible oil reserves and other natural energy resources. Some countries which used to be oil importers could become net exporters of energy and others could at least become more self-sufficient. The only countries bound to lose from very high prices are those with minimal energy sources and high energy consumption, of which the main example is Japan; however, provided non-oil markets continued to grow, Japan, as the most successful industrial exporter, is likely to manage reasonably well.

The above analysis points to three central conclusions.

(i) Even if restrictive financial policies are in force, policies to save energy and develop new sources of supply yield immediate and long-term benefits to world economic growth and help to alleviate inflation. However, while restrictive financial policies remain in force the world oil price will not rise so much and the stimulus to countries to undertake such policies will be weakened.

(ii) Borrowing, whether by non-oil developing countries or by developed countries, helps to maintain world economic activity and to push oil prices up, increasing the pressure for stringent energy policies. By augmenting real income it helps to mitigate inflationary pressure in the non-OPEC world.

(iii) Changes in industrial trade have no direct impact on world economic growth so long as industrial exporters need all the income they can get to pay for energy imports. But changes in industrial trade do redistribute income between countries. This may have indirect effects on world growth by altering the pressure on countries to borrow or to operate effective energy policies.

It also follows that the present views and policies of international institutions and governments in most developed countries are thoroughly perverse. They have sought stabilisation of oil prices without introducing oil rationing or devising any other method of obliging countries to undertake energy restructuring. They have responded to inflation and recession by restricting credit and trying to reduce government deficits in developed countries, making both inflation and recession worse. They have left non-oil developing countries to offset OPEC surpluses by running trade deficits, imposing a huge burden of debt on countries ill-placed to carry it. Thus, with widespread excess capacity in all sectors except energy, international institutions now find themselves policing a stagnant world economic system, administering national bankruptcies and trying to prevent trade war.

To end world recession, either developing or developed countries will have to incur much larger trade deficits. We shall now consider policy changes which might achieve this in either of the two groups of countries.

4. Deficits of non-oil developing countries

The export possibilities of most third world countries are still small, limiting their capacity to import machinery, raw materials, oil or even food and severely constraining their internal development. Thus although nearly all countries would prefer to export on a sufficient scale to pay their way, many third world countries would in practice incur larger trade deficits if only they could finance them safely. There are many proposals for increasing the funds available to such countries for financing trade deficits.

The least plausible is that they should be enabled to borrow more. Their debt has already increased enormously through the 1970s, imposing a heavy burden of debt service. Lenders and debtors alike are placed in difficulty if the debt becomes too large: developing countries can only stabilise or pay off debt by cutting their deficits at the cost of great hardship to their populations and damage to their economic development. This is not to say that additional loans on 'soft' terms have no value — rather that the only benefit comes from the softness of the terms.

The most effective method for funding higher deficits of middle and low income countries is straightforward financial transfers, i.e. grant aid. But contrary to the hopes of many who advocate increased aid, this will not in general raise the level of world income as a whole. The reason is that grant aid is normally financed from government budgets of donor countries within an overall ceiling on that government's deficit. Increased aid implies smaller 'non-aid' government spending in the donor country.

The only aid likely to increase world spending and income in aggregate is that paid out by oil-surplus countries from their accumulated financial reserves. This will indeed augment world demand, pushing up the oil price. If the aid is spent in full by recipient countries it will ultimately increase OPEC's surplus by an amount about equal to its cost. In theory, therefore, OPEC countries acting together are in the position of being able to reflate the world economy at no cost to themselves simply by pouring out vast sums of aid which they are bound to recoup through higher oil prices and revenues. But such a course of action seems in practice out of the question. OPEC is not a unified entity which could manage the world economy as the USA did after World War II. It is held together only by pressures in the world oil market to which its members must in one way or another respond. Discrete aid-giving by individual member countries is one thing. Using their combined financial power to regulate demand in the world economy as a whole would be quite another.

A final, often-canvassed, aid possibility is systematic creation and distribution of SDRs to low income countries by the IMF. As a long-term proposition this encounters the objection that a continuous and rising flow of SDR creation would soon imply a vast total of SDRs outstanding. A large interest bill would have to be paid by the IMF to SDR holders. There seems no possibility that the major developed countries would agree to continuous 'printing' of any such form of international money, adding to the complexity and instability of their already-precarious multi-currency financial system.

5. Finance: developed countries

The most natural counterpart to a rising OPEC surplus would in principle be a rising deficit in wealthy developed countries which could most readily carry a large debt burden. The relevant magnitudes are worth considering. Developing Asia, Africa and Latin America have for two decades been running trade deficits equal to about 2½% of their GDP (the equivalent now of some $25 billion per year). Their net borrowing has recently been much greater than this because receipts of aid and direct investment have fallen below their payments for services and debt interest. If developed countries borrowed on a comparable scale, increasing their net external debt by 2½% of GDP each year, the deficits of the USA, Western Europe and Japan would amount to a grand total of about $170 billion at 1980 prices. Even in the aftermath of a sudden large rise in oil prices their actual combined deficit on current account and direct investment flows in 1980 was only about $50-60 billion, and this is once again fast being reduced by restrictive internal financial policies. The stimulus to world expansion which they could provide is thus far in excess of what they are now doing and dwarfs the actual or potential contribution of non-oil developing countries.

There are three main obstacles to be overcome. The most difficult is perhaps the political commitment in developed countries to internal financial restriction as a means of combatting inflation. It is a distressing paradox that the more such policies succeed in perpetuating inflation by cutting real income and intensifying cost-push pressures, the stronger the case for persevering with them is made out to be.

A second problem is the instability of confidence in the foreign exchange market. When governments of major currency countries like the UK in the mid-1970s or, far more important, the USA after the mid-1970s, have sustained economic activity in their countries through more relaxed financial and budgetary policies, the foreign exchange market has sooner or later lost confidence in the soundness of their currencies. Even the US government was eventually led to initiate a new internal recession when the dollar fell rapidly in 1978.

The third problem is that the relevant international institutions are, not surprisingly, very much influenced by political commitments in the main developed countries and by opinions in the foreign exchange market and the commercial international banking system. Attitudes are thus mutually reinforcing.

The main hope is that as recession and inflation continue, the damage done will become evident even to bankers and finance ministers and that pressure for changes of policy will become irresistible. However, even then it may not be easy to stabilise the foreign exchange market. Regulation of international banks and some control over currency-switching by depositors would seem to be essential since it was essentially on account of the volatility of movements of financial capital that the former fixed-exchange-rate regime broke down and the present system came into being. In any case some guarantee to oil-surplus countries on the market value of the currencies they hold will be ever-more necessary as their holdings become very large.

The internal aspects of deficit financing within developed countries are comparatively straightforward. With the cooperation of their Central Banks and a certain amount of regulation of domestic bank lending (particularly to restrict loans which might be used for speculation), the government or governments in each currency area can readily fund deficits and administer interest rates. Thus essentially what we must wait for is a general reversal of policy attitudes in major developed countries and financial institutions as well as specific measures to regulate and stabilise the foreign exchange market. Without the protection of a general agreement on deficit financing and exchange stabilisation it will remain very difficult and risky for individual countries to go ahead on their own.

6. Protection and trade policy

As noted earlier, a chronic state of generalised recession with widespread under-utilisation of capacity is bound to increase protectionist pressures. It is inadequate, and may in the end be futile, for international institutions to respond solely by exhortations or threats. This posture ignores the real problems which give rise to protectionist demands. One answer must be to do everything possible to alleviate the recession itself by, as we have suggested, encouraging developed countries to save oil, implement expansionary financial policies and borrow on a far larger scale. But this may not be enough to restore high demand everywhere.

Protection cannot be dismissed out of hand if, for example, it enables the protecting region to accelerate its own economic expansion without damaging that of the rest of the world. This has obviously been true in the case of many newly industrialising countries, now and in the past, and explains why, sensibly enough, such countries have not been required to reciprocate for trade liberalisation in developed countries even though, under the most-favoured-nation rule they are generally entitled to benefit from the improved terms of access to liberalised countries.

We have argued before* that 'senile' industrial countries such as the UK should be allowed a similar oportunity. Protection may help any or all less-successful countries to stimulate internal economic growth and improve the efficiency of their industries without destroying demand in other countries (which could only occur if they reduced their *net* purchases, or in other words used protection to earn trade surpluses). A further potential advantage of protection by developed countries is that it would make trade preferences in favour of low-income countries very much more valuable and, if it made employment in developed countries more secure, could in general make it easier for those countries to accept third world development.

In the present oil-constrained situation, protectionism in developed countries does present a specific danger — namely, that those countries may use import restrictions as a substitute for solving their energy problems. For if large oil-importing countries use protection as a device for expanding their economies, they will tend to increase their oil deficits and cut down imports of other commodities. If all constrained countries or blocs started to do this, they would not collectively achieve anything at all (except a full-scale trade war). And if less successful countries

*See earlier *Economic Policy Reviews* and Cripps and Godley, 1978, 'Control of imports as a means to full employment and the expansion of world trade: the UK's case', *Cambridge Journal of Economics, 2, 327-334.*

Protection: Rules and Exhortations

(a) Rules

1. '. . . no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.'

   International Monetary Fund, *Articles of Agreement* (194), Article VIII

2. 'The products described in . . . the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory . . . be exempt from ordinary customs duties in excess of these set forth and provided for [in the Schedule]. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with importation . . . in excess of those imposed on the date of this Agreement. . .'

   General Agreement on Tariffs and Trade (1955), Article III 1, (b)

3. 'Quantitative restrictions on importation and all measures with equivalent effect shall . . . hereby be prohibited between Member States.'

   European Economic Community, *Treaty of Rome* (1957), Article 30

4. 'Member States shall refrain from introducing, as between themselves, any new customs duties on importation or exportation or charges with equivalent effect and from increasing such duties or charges as they apply in their commercial relations with each other . . . Customs duties on importation in force between Member States shall be progressively abolished by them. . .'

   European Economic Community, *ibid.* Articles 12 and 13

(b) Exhortations

1. 'Industrialized countries . . . [should avoid] . . . beggar-thy-neighbour support for exports. They can do this by refraining from deliberate exchange-rate depreciation, by avoiding subsidies to exporters and by opening their markets to imports.'

   World Bank, *Development Report 1980* (1980) pp. 18-19

2. 'Attention may be drawn to several specific aspects of international cooperation. One of these relates to the need for constant vigilance against protectionism. Resort to protectionism under any guise is harmful, and particularly troublesome are the adverse effects it is having on the efforts of developing countries seeking to promote economic growth through outward-looking policies . . . Another aspect concerns the importance of countries not trying to shift current account deficits to their trading partners through the adoption of internationally undesirable measures or practices . . . Also of critical importance is the cooperation of member countries in supporting and strengthening the role of the Fund in the exercise of surveillance over exchange rate policies.'

   International Monetary Fund, *World Economic Outlook* (May 1980) p. 41

3. 'Protectionism threatens the future of the world economy and is inimical to the long-term interests of developed and developing countries alike. Protectionism by industrialized countries against the exports of developing countries should be rolled back.'

   Independent Commission on International Development Issues (Brandt Commission), *North-South: A Program for Survival* (1980) p. 186

start to do it, there is a danger that successful industrial exporters might be tempted to seek ways of retaliating since even they suffer recession on account of oil deficits. Thus while restriction of oil imports can only be beneficial to other countries, cuts in non-oil imports to pay for additional oil imports would be genuinely damaging.*

Existing rules against protection are gradually breaking down and in any case miss the crucial point. Thus, for example, restrictions like those under the Multi-Fibre Agreement now in force and now-widespread steel quotas almost certainly have the side-effect of allowing developed countries to import more oil at the expense of non-oil developing countries.

The new rule which is urgently needed is that countries, whether they resort to protection or for that matter internal deflation, should strictly limit the size of the surpluses they achieve on non-oil trade. If they do expand their economies they should either save oil, substitute for it, or borrow directly or indirectly from oil-surplus countries to finance their additional oil imports.

Given this rule, there is no reason why countries with industrial problems should not use general measures of protection if this helps them to achieve economic expansion. Indeed when an international solution to recession is so difficult, countries should be encouraged to do more on their own rather than being prevented from so doing. Under our oil safeguard clause, general import controls would internalise the costs and benefits of action to overcome the oil constraint on expansion within each protected bloc. Blocs which saved oil or borrowed more externally would reap the full benefits from so doing.

*This, in the terminology of our 1978 article, would be a case where import controls shifted the composition of imports away from 'relatively unsuccessful' countries in favour of 'relatively successful' countries. We underestimated the point about oil imports in our first study of the world economy (*Economic Policy Review*, No. 5, 1979) because we then still assumed that the surpluses of oil exporters were a transient phenomenon.

Blocs which wasted oil or failed to borrow could not so readily pass on the ill-effects of these failures to others. The stimulus to all to take appropriate action would be very much sharpened.

It is not possible to internalise costs and benefits to anything like the same degree if present rules in favour of free trade are strictly enforced. For under those rules countries which fail to tackle their energy problems and indulge in financial restrictions pass on much of the penalty to others as their non-oil imports are depressed. This is precisely what happened in developed countries in the second half of the 1970s. Under present rules, too, countries which do save oil, develop new energy supplies or stimulate activity by borrowing, see much of the benefit passing to others as the gains from those policies leak away from their own economies to industrial exporters in other countries which feed on their markets. It is hardly surprising that under free trade rules developed countries have each held back, waiting for others to act first and reflate their economies for them. The preference for export-led recovery may be rational for some countries individually, but it is disastrous for all countries collectively. Free trade has thus contributed to the perverse response of developed countries to the onset of oil exhaustion and has been an indirect cause of chronic recession and inflation. Protection, with the correct safeguards, could promote better solutions to the problem.