

Michalski, Wolfgang

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The Need for Positive Adjustment Policies in the 1980s

by Wolfgang Michalski, Paris*

In view of the close relationship between macro-economic performance, structural adjustment and international trade, the OECD Council established in 1979 a programme of work on Positive Adjustment Policies. Under this mandate, a Special Group of the Economic Policy Committee (under the chairmanship of Dr. Hans Tietmeyer, presently Secretary of State in the Federal Ministry of Finance in Bonn) was to review the macro-economic, structural and international implications of industrial, regional, manpower and other micro-economic policies, and to examine the adjustment policies of individual member countries. This work resulted in a Ministerial Declaration in 1982 on Positive Adjustment Policies and in a Final Report of the Special Group which is to be published shortly. The following article by Prof. Wolfgang Michalski, who directed this OECD project, is a résumé of the main conclusions.

Looking back at the economic performance of OECD countries in the 1970s, there can be no doubt that achievements fell far short of what now appears to have been the "golden age of economic growth and stability" of the 1950s and 1960s. Expansion of economic activity decelerated and productivity gains remained sluggish. Inflation of consumer prices in the OECD area rose sharply to a record level of more than 14 %, and only quite recently has it been brought down to below 7 %. Unemployment had reached more than 8 % by the beginning of 1982, and it is still rising. International trade, which grew faster than world production in the post-war period and was still increasing even when economic growth stagnated in the early 1980s, is now contracting. Clearly, these developments are not merely the consequence of just another downturn in the business cycle of overall demand; more lasting changes have occurred on the supply side, setting new conditions for production, employment, investment and trade.

Economic Performance and Structural Rigidities

The most visible factor that brought about a break in the underlying long-term trends was the oil price shock of 1973 and the inflationary recession that followed in its wake. In the ensuing period up to 1980 oil prices increased more than tenfold, adding substantially to inflation, depressing demand, and rendering much of the existing capital stock obsolescent. However, it is difficult to believe that the oil shock of 1973, the

* OECD.

subsequent wage-price spiral and the energy price increase in 1979 can fully explain why overall economic performance has been so persistently poor. Even if other factors which engender structural adjustment pressures are taken into account – for example, shifts in demand and relative prices, introduction of new technologies, the emergence of new competitors on the world market, and new patterns in capital flows – a properly functioning market economy should under normal circumstances be able to cope with such challenges. The presumption is, therefore, that the present economic difficulties are so troublesome to resolve not only because the adjustment requirements have been too great or too abrupt, but also – and perhaps more significantly – because in the industrialised countries the capacity and/or the willingness of the economy and society as a whole to respond positively to change has noticeably diminished.

The underlying socio-economic rigidities, which are hard to break up and which will probably continue to impair the adaptability of industrialised countries throughout the 1980s, seem to have four basic origins. First, they mirror attitudes and institutional developments which evolved during the period of uninterrupted high levels of employment, and which were slow to change under the entirely different circumstances of the 1970s. Second, they reflect the rapid growth of the public sector and of social programmes and regulations which, however desirable in themselves, have sometimes had unintended adverse effects on incentives to work, save and invest.

Third, they derive from attempts by governments to alleviate the social consequences of structural change by preserving given production and employment structures. Fourth, and most importantly, slow growth itself makes structural adjustment to new social, economic and technological conditions and to changing comparative advantages between nations more difficult.

In an expanding economy profits tend to be higher and more widespread. This leads to a rejuvenation of existing industries through the embodied technological progress in replacement investment and the enlargement of capacities. The dynamics of this process are further reinforced by investment in new ventures, risk-taking and innovation in yet unexplored areas. Under such conditions, the frictional losses of structural change are less severe because the process of adaptation finds an outlet in differential growth rates. By contrast, structural change in a stagnant economy necessitates to a much higher degree the absolute contraction of economic activities. In this context of slow growth, international competition normally also becomes fiercer. The advantages of intensified international division of labour, however – gains in overall economic growth and productivity, creation of new jobs in new sectors and new regions, contribution towards lowering inflation – are widely dispersed and often difficult to identify, while the burdens associated with international competition often occur in concentrated, visible form. Both these developments – the contraction in economic activity, and keener international competition – create interest-group pressure for defensive government intervention, and the tension between the need for structural adjustment and the actual capacity and motivation of the economy and society to meet this challenge is, on the whole, likely to increase in such circumstances.

Without under-estimating the macro-economic distortions which have inhibited progress towards sustained non-inflationary growth and higher employment, both theory and experience suggest that if production factors had been more mobile, economic structures more flexible, and producers more willing to take risks, there would not have been such a marked deterioration in the economic performance of OECD countries. Where there is a lack of micro-economic flexibility, fiscal and monetary management is frequently only successful in attaining its stabilization objectives after long delays and through the indirect means of first creating substantial unemployment of labour and other resources. Given the close interrelationship between economic growth and

structural adjustment, and bearing in mind how these interact with international trade, it is clear that more stable and sustained growth, higher employment, lower inflation and the maintenance of open multilateral trading cannot be achieved by appropriate demand management alone. It needs to be supplemented by conscious policies for positive adjustment. This means enhancing the flexibility and resilience of the market system and taking into account its functioning when implementing welfare, environmental and other social policies.

Flexibility versus Predictability

There is either a virtuous circle of micro-economic flexibility and macro-economic stability or a vicious circle of rigidity and instability. In a climate of steady political and social trends, entrepreneurs and workers alike find it easier to develop and maintain the kind of perspective which induces them to incur the typically short-term costs of structural adjustment in order to benefit from the eventual long-term gains. The overall social and economic objectives associated with structural adjustment are unlikely to be achieved if the time horizons of those who make economic decisions are too short and if there are too many erratic breaks in the underlying trends that affect individual decision making.

This applies especially to the macro-economic context. High employment, stable prices, steady growth in demand and external equilibrium are all factors which enhance responsiveness of markets to changing economic and technological conditions. However, if macro-economic disturbances distort market signals and create unnecessary risks for investment and innovation, markets become hamstrung in performing their role of increasing welfare efficiency. Conversely, an economy with mobile labour and capital and with flexible responses to changes in demand, technology or prices can be kept more easily on a macro-economic equilibrium path.

A properly and constructively functioning market system is also dependent on a reasonably stable international environment and on general confidence that an open multilateral system of trade and payments will be maintained. Major changes in the international climate, the threat or actual imposition of new trade barriers, interventions in international flows of capital, technology and enterprise, and major instabilities in exchange rates are bound to have effects on market efficiency, innovation and expansion of economic activity which go far beyond the markets in which government intervenes.

The interrelationship between flexibility of economic structures and overall economic performance poses serious problems for the design and implementation of macro-economic policies. On the one hand, they can help to dampen economic disturbances arising at home or stemming from abroad. On the other hand, too frequent changes in macro-economic strategy can in themselves be a source of uncertainty and disturbance. Hence the calls for providing a more stable and predictable medium-term framework for macro-economic policies. Desirable as this may be, its realisation in what has become a more uncertain world economic environment is bound to involve difficult judgements between the conflicting requirements of predictability and flexibility.

Coherence of Macro- and Micro-Economic Policies

A further crucial concern is income distribution and wage formation. Greater flexibility of wage levels, including non-wage labour costs, could bring about a marked improvement in the responsiveness of aggregate employment to given increases in economic activity, and could lead to fuller utilisation and more efficient allocation of the labour force and of resources in general. In this respect, governments have an important role to play in creating a climate which promotes responsible forward-looking collective bargaining and fosters greater consistency between real wage trends and macro-economic and structural policy objectives.

Improved health, education, and economic and social infrastructure are vital prerequisites of production and efficiency in a complex technological society. However, the rise in recent years in the proportion of GDP accounted for by government spending heightens the risk that a shrinking share of the national product is allocated by decentralised decisions under market conditions, while centralised administrative procedure determines an ever increasing share. Beyond certain limits, which may well have been passed in many OECD countries in the 1970s, the rise in public expenditure and the associated increase in tax burdens directly affect the ability of economies to adjust positively to changing economic and technological circumstances. There is therefore a strong case to be made for governments to review their systems of taxation and social security financing with the aim of removing unnecessary disincentives and rigidifying effects.

There is a great temptation for governments faced with varying constellations of high unemployment, unduly high labour costs, an overvalued exchange rate or unusually high interest rates to use micro-economic policies for alleviating adjustment pressure on sectors

or firms. In most cases, however, such efforts are likely to prove counterproductive over the longer run. Trade restrictions fuel inflation and reduce the potential for productivity gains. Interest rate or wage subsidies distort the allocation of resources. Direct subsidies to ailing industries and companies divert resources away from activities with a greater potential for growth and employment creation.

However, to reject outright the necessity of such interventions in the market mechanism is to ignore the pressures of political and social reality. This governments cannot do, but they should be aware of the fact that the trade-off between the direct and visible benefits and costs of defensive and selective micro-economic policies worsens with time. They may also have more indirect and therefore less obvious repercussions in the short term. Not only can they contribute to the widening of public deficits but, more seriously, they may undermine the market forces on which policy-makers have to rely for the success of macro-economic demand management. The question arises therefore as to the scope available to governments to play an active, positive role in the design and implementation of micro-economic policies, while at the same time observing the need to follow, as in the case of macro-economic interventions, a forward-looking and consistent strategy which assists markets to fulfil their objectives.

Promotion of Promising New Activities

Accepting that innovation is vital to dynamic economic development, there can be no doubt that governments have an important role to play in promoting creative investment and the application of new technological and managerial ideas. The implications of this for a competitive market economy are that a general climate needs to be created which fosters skill acquisition, formation and turnover of capital, risk-taking and innovation. Such a climate could benefit considerably from policies which promote innovation over a wide range of areas, including macro-economic, capital market and regulatory policies, and not only from measures aimed specifically at technological progress. Support for long-range fundamental research by university and scientific laboratories and programmes to disseminate new non-proprietary, scientific and technological knowledge are also conducive to such an innovative climate.

However, a case is sometimes made for taking these measures a step further and granting more specific aids to promising new industrial activities. Numerous arguments are used to advocate such action. Firstly,

capital markets may be incapable of engendering sufficiently long-run perspectives for the long-term good of society. Secondly, the innovator may not be able to reap in full any external benefits generated by his work. Thirdly, the degree of risk involved in more revolutionary technologies and the sheer scale of projects increasingly overtax the resources of private enterprises. Fourthly, specific assistance may be the only way to break an international high-technology monopoly. Finally, where there is a technological gap, countries may wish to reduce their dependence on imported technology.

On the other hand, direct and selective support to promising activities meets with certain problems. A basic risk is that, in the long run, administrative involvement in innovation by private enterprise can lead to shifts in innovative behaviour. Private risk-taking is weakened as potential innovators find that, in order to succeed, they must lobby for public support. There are a number of other issues. For instance, there is a risk that the selective subsidisation of promising activities may crowd out other, perhaps equally promising, new activities; there may develop a propensity to favour prestige projects; particular problems might emerge for small countries which cannot spread their public resources over a large number of activities; and finally, in specific circumstances there may be a potential for international trade conflicts.

It is therefore of great importance that direct and selective government intervention should in principle be limited to activities which are subject to substantial, proven or reasonably foreseeable market failure, in which a number of competing enterprises can be involved and where national enterprises are, or can easily become, genuinely competitive on international markets. To ensure competition of ideas, aids given to specific activities should be made available to all potential developers of the new technology and not just to one or a few favoured firms. Furthermore, assistance

to promising activities should be temporary and great care must be taken that governments do not try to ensure the success of initial commitments by intervening on behalf of the favoured activity or by making the commitment open-ended.

Although the shift in comparative advantages caused by innovation is one of the driving forces behind economic progress, experiences in the slow growth climate of the 1970s and early 1980s have demonstrated that the loss of competitiveness consequent on innovation-related shifts in comparative advantage may lead to mounting political pressures to protect the threatened industry in the country using the outdated plant and equipment. This applies especially when the belief is held that such a development has some connection with R&D subsidies received by foreign competitors. Furthermore, if a number of countries resort to subsidising the same promising industry, there is a danger of worldwide excess capacity and the risk that the promising new activities of today might be transformed into the problem industries of tomorrow. Nonetheless, the likelihood of international conflicts resulting from government support to promising new activities would be reduced if the benefits derived from technological innovation were widely distributed in a world of expanding economic activity and any new forms of protectionism in the new growth industries were avoided.

Conditional Support for Industries and Firms in Difficulty

The rise and decline of specific activities is a normal feature of economic development and should not as such constitute a motive for government intervention. However, there are exceptional cases when temporary government assistance may be justified. For instance, when the secular decline of an industry is reinforced by conjunctural difficulties, it may be socially less costly to grant temporary subsidies than let large-scale job dislocation occur. Such a measure may reduce the rate

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of worker lay-off and facilitate the shift of labour to more promising activities. Another exception is the provision of temporary support to investment in new capital equipment needed to rejuvenate an industry which has fallen behind in process or product technology. This could be in line with positive adjustment and long-term growth because of the associated productivity increases but it rests of course on the assumption that the industry can once again become genuinely competitive in international markets. A third example may be an industry which is highly susceptible to fluctuations in economic activity.

Whatever the case, it is absolutely vital to ensure that assistance definitely contributes to restructuring, to re-establishing financial viability or to strengthening the capacity to survive the consequences of extreme fluctuations. Situations must be avoided in which entrepreneurs look upon the assistance as a source of windfall profits, or in which workers attempt to appropriate part of the benefits accruing from such support via higher wages. Government assistance must therefore be made subject to certain conditions and criteria.

Of these, the most important is that action should be temporary and that, wherever possible, requirements should be reduced progressively according to a prearranged timetable. This necessitates considerable initiative on the part of management and labour to seek ways and means of improving the situation rather than merely deferring the problem. It may also lead to closer cooperation between the social partners and reduce the risk of aggressive wage claims which might further jeopardise the viability of the industry.

A further guiding principle underlying assistance measures to structurally weak activities is that they should hamper as little as possible the functioning of market forces. If, therefore, direct financial support is to be granted, it should be based on general viability criteria to avoid rewarding ailing firms and inefficient producers. It is also useful to subject government-assisted projects to the scrutiny of the capital markets by requiring the participation of private risk capital.

Fostering Labour Market Flexibility

The efficient functioning of the labour market is an important precondition for positive adjustment and, hence, for full employment and the proper allocation of the labour force and of resources in general. There are in principle two ways in which structural adjustment can be carried out in an open market economy. The first places prime emphasis on the shift of resources from

less to more productive activities. This would be consistent with high workforce mobility and rapid labour turnover to keep in step with adjustment, while wage differentials remained stable or narrowed. The second envisages less factor mobility but greater income flexibility by allowing wages to reflect more closely sector-specific trends in demand and supply conditions. Industries and firms experiencing rapid growth in demand and productivity would pay higher wages to attract new entrants into the labour market and draw skilled labour out of activities that are facing less favourable developments and are paying low wages.

The problem confronting many OECD countries is that the attempt is often made to try to maintain real wage levels and rigid inter-industry wage differentials while simultaneously attempting to ensure given levels of employment in less competitive industries. It would seem that this third approach is only feasible if governments are prepared to deviate from the principles of the market economy and to resort to assistance measures which are domestically and internationally protectionist. Although actual policies usually tend to be a mixture of all three strategies, under present conditions of prolonged slow growth and high unemployment, when there is considerable resistance to adjustment anyway, increased wage flexibility appears to be the most preferable option. Clearly, the decision on the optimal strategy mix is a political one. As governments can scarcely remain indifferent to the outcome of wage settlements, they do have a responsibility for creating an environment conducive to the efficient functioning of the labour market, and they may even have a role to play in promoting dialogue and consensus-finding between social partners.

Nevertheless, taking into account future growth prospects as well as current levels and patterns of unemployment, present adjustment problems, in general and in particular on labour markets, cannot be solved by relying solely on macro-economic demand management and improved wage flexibility. It is vital that additional steps be taken which tackle the underlying specific structural and qualitative causes of mismatches in labour markets. These should be aimed at improving the basic conditions of labour market responsiveness by increasing the efficiency and relevance of education and training, but they should also attempt to bring more immediate relief to specific groups of unemployed.

In the long-term perspective, positive adjustment policies serve social policy objectives, and vice versa. Many conflicts which arise between efficiency and

social policies are therefore essentially conflicts between short-term and longer-term considerations. But they may also be the consequence of inappropriate policy design. For instance, social policies may often have unintended side effects on the effective functioning of markets which derive from increased legislation and collective agreements on matters such as job security, redundancy pay, and prior notification of dismissals. In the difficult years ahead it will be a major challenge for policy makers to strike the right balance in the design of manpower and social policies between the objectives of promoting welfare and improving economic efficiency.

Structural Adjustment and International Trade

International trade is an important motor of economic growth and adjustment. It helps to redress international market imbalances and it stimulates innovation and the growth of new activities. Despite this, over recent years many observers have tended to accord lower priority to trade than to more immediate concerns such as growth, unemployment and inflation. Instead of employing trade as a weapon against these adverse developments, nations often appear to seek fast and facile solutions at the expense of other countries' trade and with insufficient regard to the long-term effects. Intervention

on behalf of immediate national interests through the imposition of new non-conventional barriers to trade were not an uncommon feature of the 1970s.

Yet experience should tell us that little can be gained and much lost by overt and covert economic nationalism. The maintenance of an open multilateral trade system and the effective implementation of the GATT rules is essential for achieving the objectives of positive adjustment. At the same time, however, many, if not most, of the major trade issues have their deeper roots in long-term structural difficulties and maladjustment in specific industries. Thus, international trade is not only a means to enhance structural adaptation but, equally, a positive response to changing economic and technological circumstances is a precondition for reducing the risk of major trade conflicts.

Governments must, however, also bear in mind the international implications of their domestic policies. International integration among industrialised countries has now reached such a stage that virtually all domestic economic measures have some impact on foreign economic interests. Employment or wage subsidies to declining labour-intensive activities may serve as an example. While they may be successful in conserving

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jobs, they also conserve production capacities which under normal market conditions might not have survived and which now put additional pressure on competition on both home and foreign markets. There is a risk, therefore, as in other cases of government intervention, of adjustment burdens – and especially unemployment – being exported abroad.

Strategic Concept

To sum up: positive adjustment policies are neither a special range of policy instruments nor a simple set of criteria for the specific design of particular measures. Rather, positive adjustment policies represent a basic conceptual approach to the formulation of overall economic policy in a market economy. Of course, the question of how to combine decentralised, individual decision-making co-ordinated by the market with more centralised, administrative forms of decision-making is primarily a matter of political choice. However, once there is basic consensus to rely predominantly on market forces, important economic dimensions cannot be neglected without jeopardising the functioning of the market mechanism. The options open to governments derive from four basic approaches to structural adjustment.

First, a preventive policy by which governments rely primarily on macro-economic management and on competition and regulatory policies to improve the basic, self-regulating functioning of markets. This approach stresses factor mobility and price flexibility as vital preconditions for the movement of resources from declining into more promising activities. It would set the socio-political and economic framework for the enhancement of private initiative and the capacity of market participants to cope with change.

Second, an anticipatory structural policy whereby governments interested in promoting economic growth, innovation and restructuring might strengthen the ability of market participants to plan ahead more directly, but still leave the evaluation of market opportunities and the investment decisions to private entrepreneurs. Such a strategy could be realised by supporting the movement of businesses into promising new activities through the provision of consistent structural projections and other forward-looking information on sectoral developments. In certain circumstances there may be a role for government here to offer indirect guidance through the means of subsidies or other interventions aimed at advancing the restructuring process.

Third, a defensive adjustment strategy, under which governments intervene in order to reduce the rate of

structural change while still accepting that markets play a major role in bringing about the required adaptation to new circumstances. Governments may adopt this approach in response to requests for support to structurally weak industries if this can be justified on the basis of the criteria already mentioned in connection with government assistance to industries and firms in difficulty. In exceptional cases it may also be in the interests of society to defer the introduction of new activities or technologies if these are expected to generate incalculable negative side effects or considerable social costs.

And finally, a fourth approach in which governments intervene directly in production or investment to achieve given structural objectives. The means of exercising such control range from the direct regulation of economic activities, through public control of management, to public ownership. While such a course of action may assist the creation of new activities which would not have materialised under normal market conditions, it may also have the effect of sheltering inefficient production capacities and impeding adaptation.

The adjustment policies actually pursued by OECD member countries usually comprise in varying combinations and degrees all four of these strategies, whereby the composition of the policy mix is generally determined by the political, economic, social and institutional conditions specific to each country. Nonetheless, experience indicates that on the whole preventive and anticipatory policies are more in accord with positive adjustment than selective, defensive policies or direct government involvement in production or investment. This is also one of the main conclusions of an OECD report entitled "Positive Adjustment Policies – Managing Structural Change" which will be published shortly.

The OECD Council which met at ministerial level in May 1982 fully recognised the implications of the close interrelationship that exists between macro-economic performance, international trade and structural change. Attaching great importance to these issues, Ministers adopted a new Statement on Positive Adjustment Policies and entrusted the OECD with the continuation of work in this field. In view of these circumstances and decisions, it is evident that during the 1980s positive adjustment policies will form one of the central planks on which OECD countries need to build their overall economic strategy for restoring the conditions for sustained non-inflationary growth and higher employment.