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Recent economic development and outlook in industrial countries

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Recent Economic Development and Outlook in Industrial Countries

by Adolf Ahnefeld, Dietmar Gebert, Jürgen Roth,
Joachim Scheide, and Norbert Walter

A U S D E M I N H A L T

- The upswing in Europe, North America and Japan since mid-1975 has been unsteady. It has been sufficiently modest to allow a — however slight — decline of inflation rates. Since economic policy refrained from massive reflation, the shortrun outlook remains for a moderate recovery with no rekindling of inflation.
- High unemployment and weak investment can partly be attributed to the abrupt change to a restrictive course in 1973/1974 which led to unintended increases of real wages and to a dramatic profit squeeze. Moreover, there have been increasing changes in the structure of demand and production techniques as well as political uncertainties which have prevented a marked improvement of the investment climate. This diagnosis calls for a steady economic policy, less aggressive wage policy, and incentives to promote innovative spirit and risk taking.
- Although money illusion and exchange rate illusion have largely vanished and reduced the effectiveness of short-term stimulation measures, most countries are far from pursuing a steady and pre-announced course.
- In strong countries — the United States, West Germany and Japan — the reduction of the share of public absorption especially through a shortfall of public investment since 1974 was a retarding factor for improving employment and growth. In weak countries — for example the United Kingdom and Italy — an easy money policy continued to produce high inflation rates and increasing external imbalances. Only after drastic exchange rate depreciations in 1976 did these countries — sometimes too drastically — turn to a restrictive policy course.
- Cooperation in matters of economic policy, often misunderstood as the sharing of evils, should be designed as help for self-help. International credits should be granted under the condition that the recipient country pursues a stability-oriented policy and refrains from restricting trade.

Report Prepared for the Meeting of the Association d'Instituts Européens de Conjoncture
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Introduction

In this report it is tried to present a general analysis of the present stance of the cycle and the outlook. This part is rather compressed in order to leave room for a more intensive discussion of the most relevant problems of the present economic situation: firstly, about causes and cures for unemployment; secondly, about the weakness of investment.

The last part of the report concerns the formulation of an economic policy strategy which is suited to promote growth without inflation and to avoid international disequilibria.

Highlights of the Report

1. The present recovery is to be qualified as an unsteady and rather modest one. The "engines" of the recovery are not far ahead of those countries which follow up. The upswing is mostly consumption-led and is accompanied by a sharp turnaround in inventories and a rather strong increase of international trade. During the recovery trade balance disequilibria have again increased coinciding with substantial exchange rate changes. Inflation differentials remained high; inflation rates decreased, however, not at a rapid pace.
2. The outlook for economic activity in 1977 is rather moderate as well. Again the United States, Japan and West Germany will be the fore-runners. While these engine countries will achieve an increase of capacity utilization and some progress in employment, most western European countries will experience no increase of

utilization levels and a stagnation at labour markets. Inflation will decline, however, modestly. Current balance disequilibria will decrease slightly, thus somewhat relieving pressure on exchange rates.

3. As the main causes for unemployment the combination of the following factors could be identified:

- the abrupt monetary and fiscal restriction in 1973 and 1974;
- the abrupt rise of the oil price;
- the intensification of the fight on the income distribution during most of the seventies;
- the rigidities in the wage structure as to regions and to professions.

No remedy for a short-term success at the unemployment front could be found. A number of measures are suggested to improve the employment situation in the medium run. Governments' help for more mobility is looked upon to be subsidiary. The main means to bring about higher employment is for the unions and employers in negotiating wages increases below productivity gains. This rule is to be followed as long as employment is looked upon to be too low.

4. Many of the factors causing unemployment are responsible for the weakness of investment as well. The profit squeeze developing in the seventies and accentuated in 1973/1974 is by far not corrected by the development in 1976. Additionally, structural changes as to demand and production techniques, as well as political uncertainty have hindered a more favourable investment development up to now.
5. Economic policy has undergone significant changes during the seventies. The Bretton Woods System was substituted by a manipulated float system. Anticyclical fiscal policy, looked upon as the

main means of economic policy throughout the fifties and sixties, proved to be less and less successful. Monetary policy, rather unimportant in the past two decades, became subject of major interest. Trendorientation - at least as the basic philosophy - was substituting anticyclical strategies.

Against this background, present pressures of the OECD and the Carter-Administration to reflate in so-called strong economies are analyzed and evaluated. While in many countries fiscal stimuli designed to support investment in the medium and longer run are desirable, neither short-term fiscal injections nor easy money policy should be pursued. International credits, which per se delay adjustment processes, should only be given, if they include obligations to introduce policies to cure the imbalances in both surplus and deficit countries.

A. Recent Economic Development and Outlook

I. The History of the 1974/1975 Recession Reconsidered

1. After a seesaw development of business cycles in most of the sixties, the seventies can easily be qualified as a period of a world-wide synchronized economic cycle. This difference between the two decades has its roots in a number of factors:
 - the intensification of international trade and international capital movements,
 - the intensification of the international exchange of information on government and private (especially firms) levels,
 - the change from a jumping peg-system to a manipulated floating system,
 - the oil crisis and the development of the North-South conflict,
 - and - probably as a result of all of the above mentioned factors - an increasing international synchronization of economic policy.

In the course of last years anticyclical fiscal policy - since it was looked upon to be less and less effective - lost the dominating position; instead a renaissance of monetary policy came about. Strong keynesian-type reflation packages were looked upon to be counterproductive. Thus a more moderate expansion policy was pursued in 1976.

2. On average the economic development under the new economic policy environment has up to now not brought about the desired results: Growth rates are in general still far below the rates achieved in the fifties and sixties; unemployment widened substantially and remained high; inflation rates in many cases remained double-digit; disequilibria in foreign balances became even more severe. These failures, however, should not be attributed to the 'new policy'. Market economies do react with a time-lag. A 'new

policy' requires even a longer time to translate into economic action. The very fact, that those countries which engaged in 1975/1976 in an old-fashioned keynesian-type reflation policy are worst off in terms of unemployment, inflation and external disequilibria, indicates, that anticyclical devices not even in the short run do show better results.

3. Before deciding to reintroduce anticyclical demand management, one should therefore recognize that the socio-political pre-conditions for such an economic policy have expired in the sixties: Money illusion largely disappeared. However, actual policy action during the last years should be examined. If the failure of the 1974/1975 recession is due to mistakes of the management of the stabilization policy, these mistakes should be avoided.
4. The roots of the economic difficulties in the mid-seventies are to be found in the late effects of the last strong anticyclical effort of most governments in the early seventies. In 1971 and 1972 monetary expansion was overheated, its effects artificially cooled down by wage- and price controls and its internationalization hindered by capital controls. These tensions led to an explosion in 1973: Prices shot up, and the fixed exchange rate system collapsed; the national authorities regained autonomy for economic policy.
5. After the Dollar- devaluation in early 1973 and the introduction of a free float of European currencies against the Dollar, some European central banks, especially the German and the Swiss central bank, misused the autonomy they had gained from the float: they decreased the money stock for a rather extended period. Because of the currency snake, the partner countries were to some extent forced to follow the Bundesbank's over-restrictive efforts.

6. This unannounced, abrupt monetary deceleration came into collision with an inflationary development fuelled by past expansionary policy, by decontrol of prices and wages and - on top of all that - by a quadrupling of the oil price. Under those circumstances a slowdown of real economic activity was unavoidable.

The very fact that wages react only with a lag to real and to price developments explains the rest of the dramatic nosedive of European economies in late 1974 and 1975.

7. Obviously, neither unions and employers nor governments (nor their economists) understood that the deterioration of the terms of trade had to be translated into lower increases - or even decreases - of all national real incomes. Since wage policy did not take account of that fact in 1974 and 1975, the cutback of incomes concentrated on profits, paving the way to a decline of investment, the increase of bankruptcies and to a cumulative deceleration of production and employment. The downturn was moderated in 1974 by a substantial increase of exports to OPEC- and Comecon-countries. In 1975 international trade reinforced the recessionary development in OECD-countries.

II. Impediments for a Rapid Recovery

8. In classical theory a recession is looked upon as a means to clear up imbalances: structural changes come about, inflation disappears, relative prices are shifted to a new equilibrium, thus generating the conditions to reach again full employment and to promote growth. Obviously, during the last recession a lot of obstacles prevented these results. Adjustments often were delayed. Therefore at the trough of recession in early 1975, none of the consequences of a classical recession had been achieved: inflation rates still were double-digit in most countries, real wages were out of step with

real development, thus squeezing profits and creating unemployment; precautionary investment decisions delayed the necessary structural changes.

9. On top of that, economic policy - at least in 1976 - was not conceived in the typical 'go-fashion' as entrepreneurs and unions were used to in recessionary periods in the sixties or the early seventies. High international and domestic indebtedness limited the inclination of governments to intensify their expansionary efforts. But not only constraints from this side led to a less expansionary course. Still high inflation rates and the belief that fiscal and monetary stimulation would be easily transmitted into a renewed inflationary spiral even in a situation of underutilized capacities brought about a tendency for trendoriented and less anticyclical monetary and fiscal policy.
10. Being conscious of all these difficulties to stimulate real activity without reaccelerating inflation, monetary expansion in important countries is moderate and geared to money supply targets, which are changed only gradually and - in some cases - after being pre-announced. Fiscal policy is conceived to solve two problems: consolidating the budget (as to volume of deficit and as to structure of expenditures) and at the same time to avoid negative effects on total demand. In many countries incomes policy complements the efforts to increase economic activity by changing inflation expectations in line with changing demand management policies, i. e. to diminish the downward rigidities of wages and prices.

III. The Shape of the Recovery

a) The Profile of Output

11. In spring 1977, the recovery in industrial countries which has been under way for roughly six quarters can be qualified as of moderate character. It has by no means developed in a steady fashion: after a

fulminating start in late 1975, the recovery stranded in a summer lull in 1976 almost everywhere. Obviously some countries are out of these duldrums and back on their upward trend since late 1976, as indicated by the increase of industrial production (Figure A 1).

12. The present recovery does not differ so much from previous recoveries in terms of rates of increase. The main difference is the level from which it started. In most countries the 1974/1975 recession brought about record levels of underutilization of capacity. Thus even six quarters of substantial increase of industrial production and GNP did not bring back 'normal' utilization levels. It should, however, be mentioned that due to the rapid structural changes during the first half of the seventies, some part of the existing physical capacity may be economically obsolete. Consequently, the factual utilization rates are not as low as statistically indicated.

Only around year-end 1976 industrial production reached again pre-recession levels. As GNP increased since summer 1976 on average only at the growth rate of the potential, no substantial progress as to utilization of physical capacity could be achieved; unemployment even tended to increase in some countries.

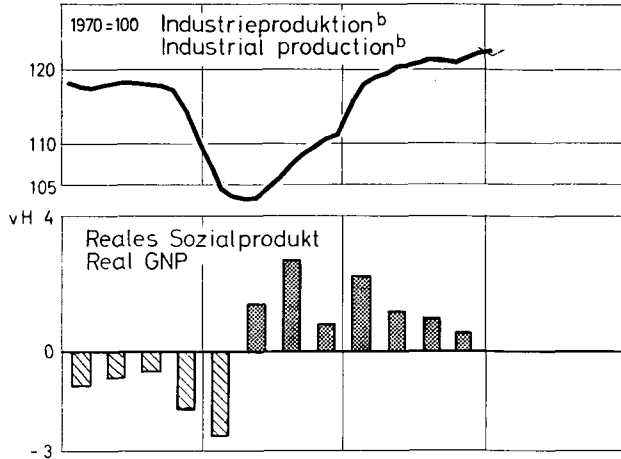
13. Several times since the beginning of the recovery it was expected that the economic development in industrial countries would again dissociate. Countries with structural current balance deficits were expected to lag behind the other countries in the course of the cycle in order to solve their foreign balance problems by an export-led recovery. This hope failed to materialize several times. In nearly all countries the recovery started at the same time, namely mid-1975. While it was less pronounced in Great Britain and Switzerland, it did not occur at all in Sweden. Most countries experienced the 'summer pause' 1976.

Figure A 1

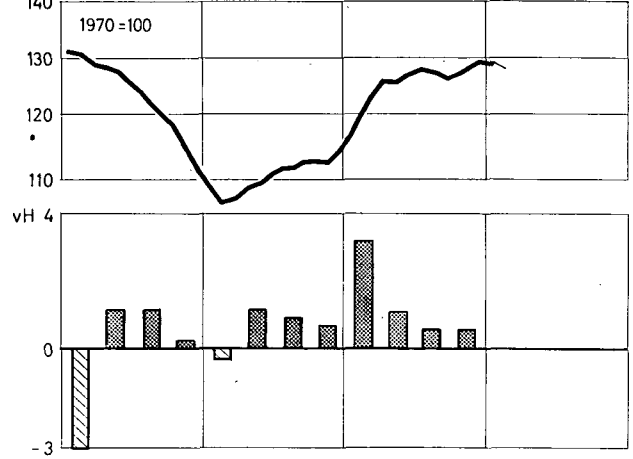
INDUSTRIEPRODUKTION UND SOZIALPRODUKT IN WICHTIGEN LÄNDERN^a 1973-1976^a

Industrial production and real GNP in six major countries 1974-1976^a

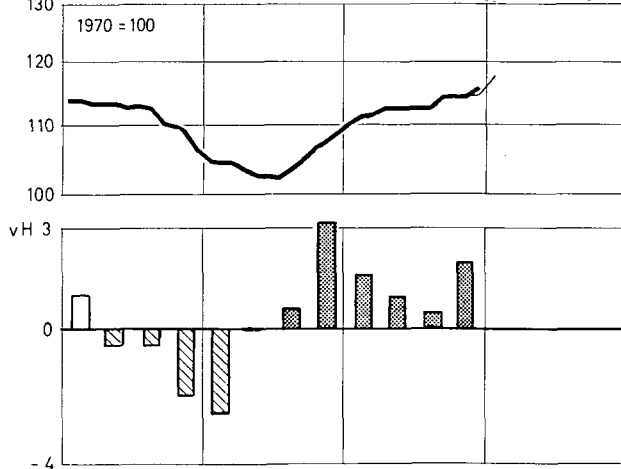
VEREINIGTE STAATEN - United States



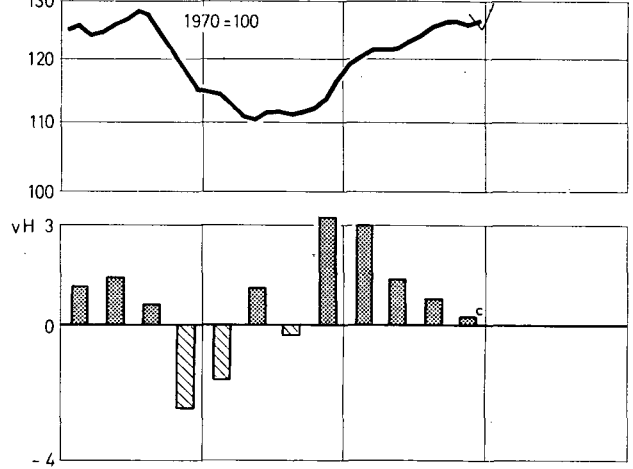
JAPAN - Japan



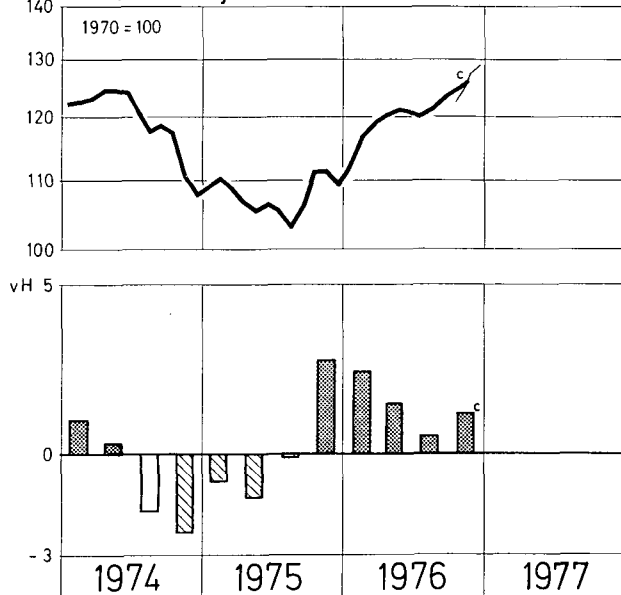
BUNDESREPUBLIK DEUTSCHLAND - Germany



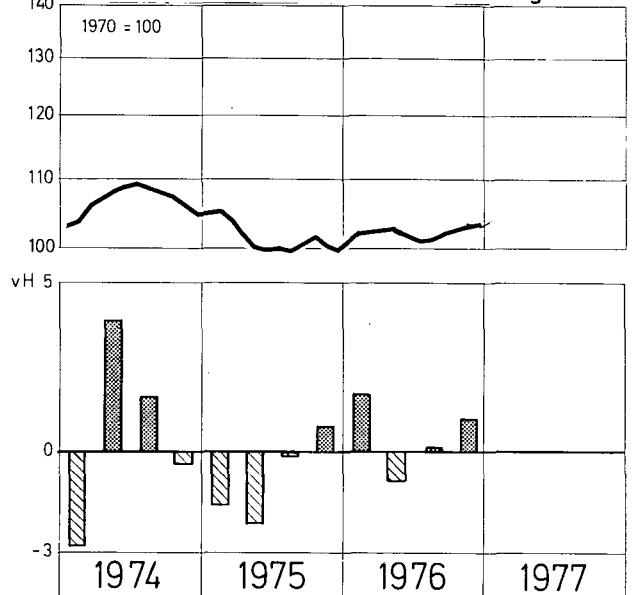
FRANKREICH - France



ITALIEN - Italy



VEREINIGTES KÖNIGREICH - United Kingdom



— Index der Industrieproduktion - Index of industrial production

▨ Reales Sozialprodukt (Veränderung gegenüber dem Vorquartal) - Real GNP; % changes from previous quarter

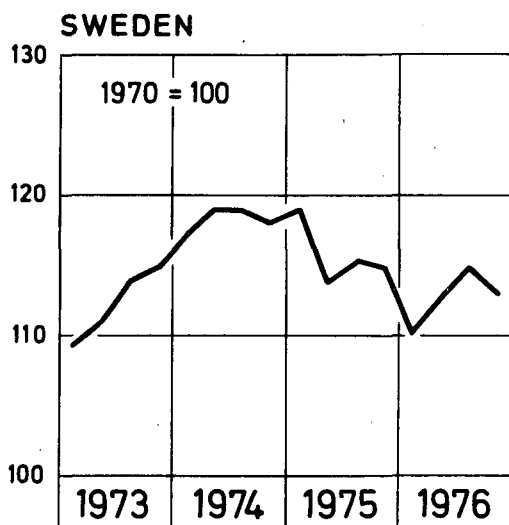
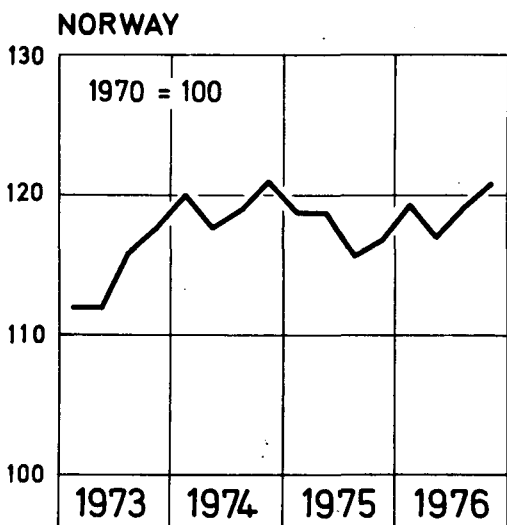
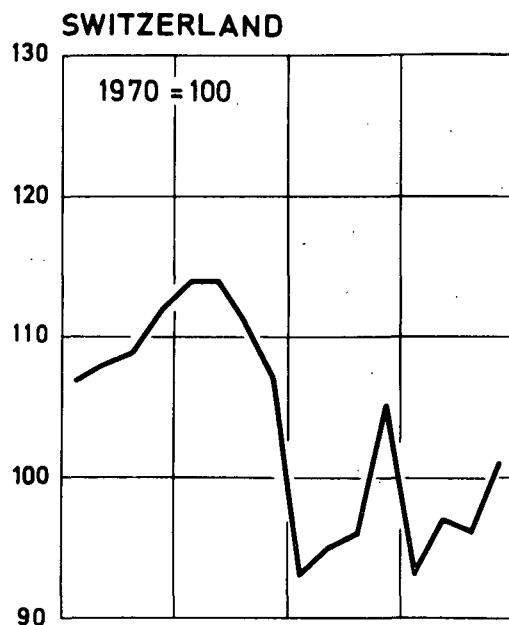
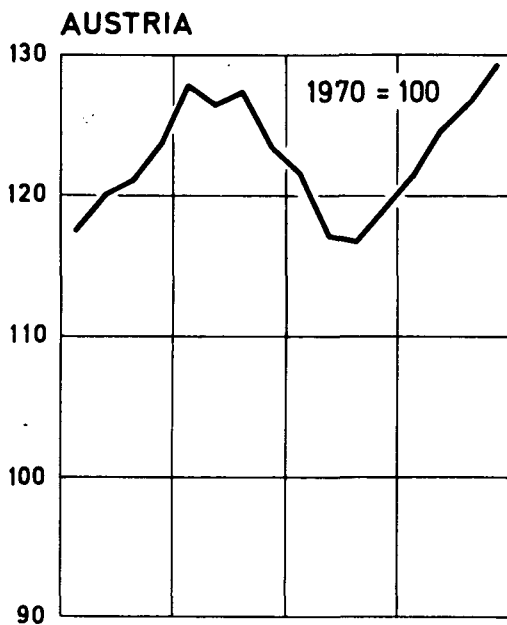
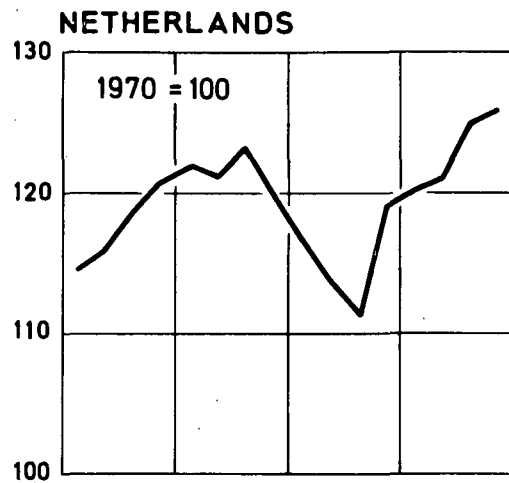
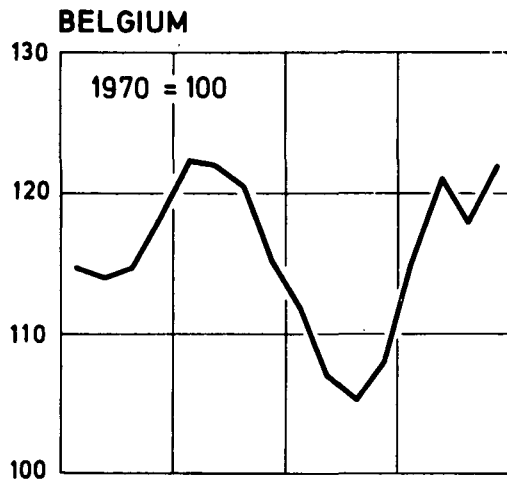
^a Saisonbereinigt - Seasonally adjusted.

^b Gleitende Dreimonatsdurchschnitte; für die letzten Monate wurde auch der ungeglättete Wert eingezeichnet. Three-month moving averages; for recent months the unsmoothed values are shown too.

^c Geschätzt - Estimated.

Figure A 1

INDUSTRIAL PRODUCTION IN SIX SMALLER COUNTRIES 1973 - 1976^a



^a Seasonally adjusted

After having announced and introduced measures to dampen inflation, many European countries, especially Italy, Great Britain, France and Denmark, were expected to have a slowdown of production during winter 1976/1977. However, in late 1976 practically all countries moved in upward direction after the protracted summer lull, as indicated by industrial production and quarterly GNP-data. Again, contrary to expectations, Italy experienced the steepest increase.

14. On the whole, 1976 proved to be a better year than expected by most forecasters. GNP increased on average by more than 5 percent in OECD-countries and by 4 percent in Western Europe. However, while a 6 percent GNP increase in the United States implies a 3 percent increase of capacity utilization, the 4 percent rate for Europe means stagnation of capacity utilization. In Europe only West Germany, Norway, and to a smaller degree Italy have achieved a substantial increase of capacity utilization during the recovery.

b) Demand Mix During the Recovery

15. In most cases the recovery was consumption-led and reinforced by a turnaround in inventories. This is not too surprising in the light of wage developments, postponed purchases of durable consumer goods after the oil-shock in 1973/1974 and the various efforts of governments to stimulate private consumption by fiscal measures. Lowering interest rates for consumer credits complemented these efforts. After a slowdown of consumption and the end of the first phase of the turnaround in inventories during summer 1976, the renewed increase of economic activity around year-end 1976 coincided in most countries with a reappearance of an upward trend of private consumption.
16. Investment remained weak during the first six quarters of the recovery. During previous cycles, investment had already increased

at substantial rates at this stage of the cycle. In some countries, however, investment in producer durables experienced an early pick up, mostly due to fiscal stimulation (West Germany, Austria, France, United States).

While GNP-developments are rather similar in most OECD-countries, the profile of investment differs substantially. Most striking is the sluggishness of investment in Japan. The United Kingdom, and many other of the smaller European countries still experience stagnating or even declining investment expenditures. This, however, has not only a delaying effect on the upswing, but also a negative impact on the longterm growth of the production potential.

17. The least favourable development - with the exception of the United States - can be observed for construction. On average it reached its trough in 1976; in some countries it is still declining in absolute terms. This reflects not only a cyclical slowdown but also a reaction to the inflation-induced construction boom of the early seventies. Still high longterm interests rates in many countries (Italy, France, United Kingdom, several smaller countries) and low confidence in future income gains explain the hesitancy to invest into real assets and especially into construction.

The performance of various sectors of construction differs substantially. Some government simulation programs helped temporarily, especially to stimulate activity in non-residential construction. In some countries (Germany, Japan) single family houses developed quite favourably, thus avoiding even more sluggishness of construction. In most countries public construction demand is rather weak often contributing considerably to the downward tendencies for total construction.

18. Due to the development of private consumption and especially the demand for durables, the first industry experiencing an upward trend

in most European countries was the consumer goods industry. This did not hold true for the United Kingdom, where real wages developed rather sluggishly in 1975. The next sector which experienced an upward development was the base material and production goods industry (Figure A 2).

19. Within each of the main groups of industries, however, the development was by no means homogeneous. The automobile industry, the early starter into the recovery, has continued to be one of the central upswing forces in countries - except in the United Kingdom - with important automobile industries. The chemical industry was another sector favourably affected. Its recovery was intensified by the inventory cycle.

While steel industry partly recovered - with the exception of West Germany - engineering remained sluggish in all countries until late 1976. During the winter there are first clear signs for a stronger upward trend in the United States and Germany, indicating that the second stage of the recovery may be entered at least in these countries. Still worse off is the shipbuilding industry in Europe, not only suffering from a breakdown of demand but also from increased competition of Japanese firms.

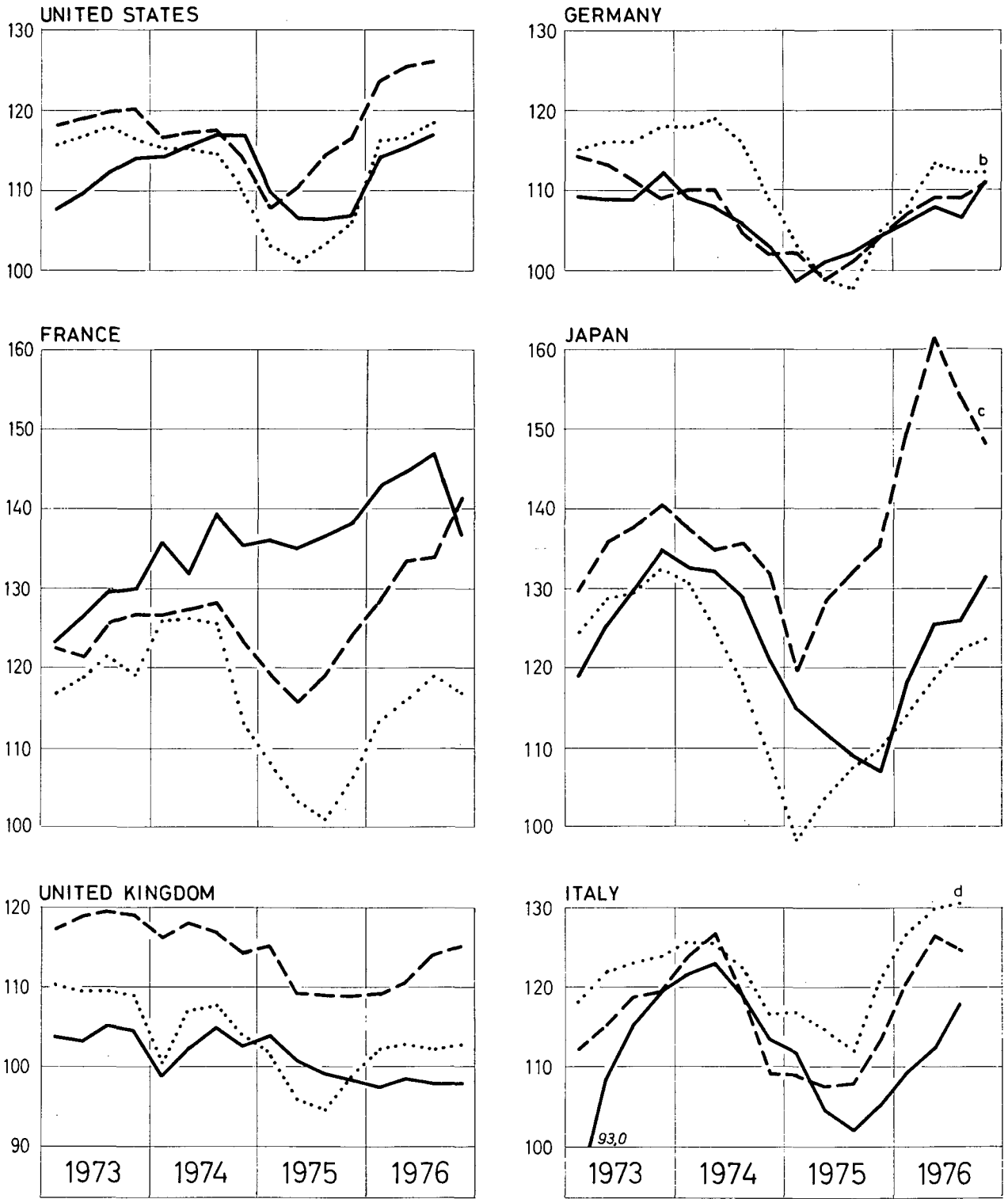
c) Labour Market Developments

20. While in practically all OECD-countries production - though at a different pace - has increased, labour market developments differ to a great extent. Whereas in the United States the pick up of the cycle coincides with the turnaround at the labour market, and in West Germany unemployment remained unchanged after some improvement in the first half of 1976, most other countries experienced a continuing rise of unemployment figures until recently. Developments during last months seem to indicate that the end of the deterioration of labour market conditions is being approached (Figure A 3).

Figure A 2

INDUSTRIAL PRODUCTION IN SIX MAJOR COUNTRIES BY MAIN GROUPS OF INDUSTRY 1973 - 1976^a

1970 = 100

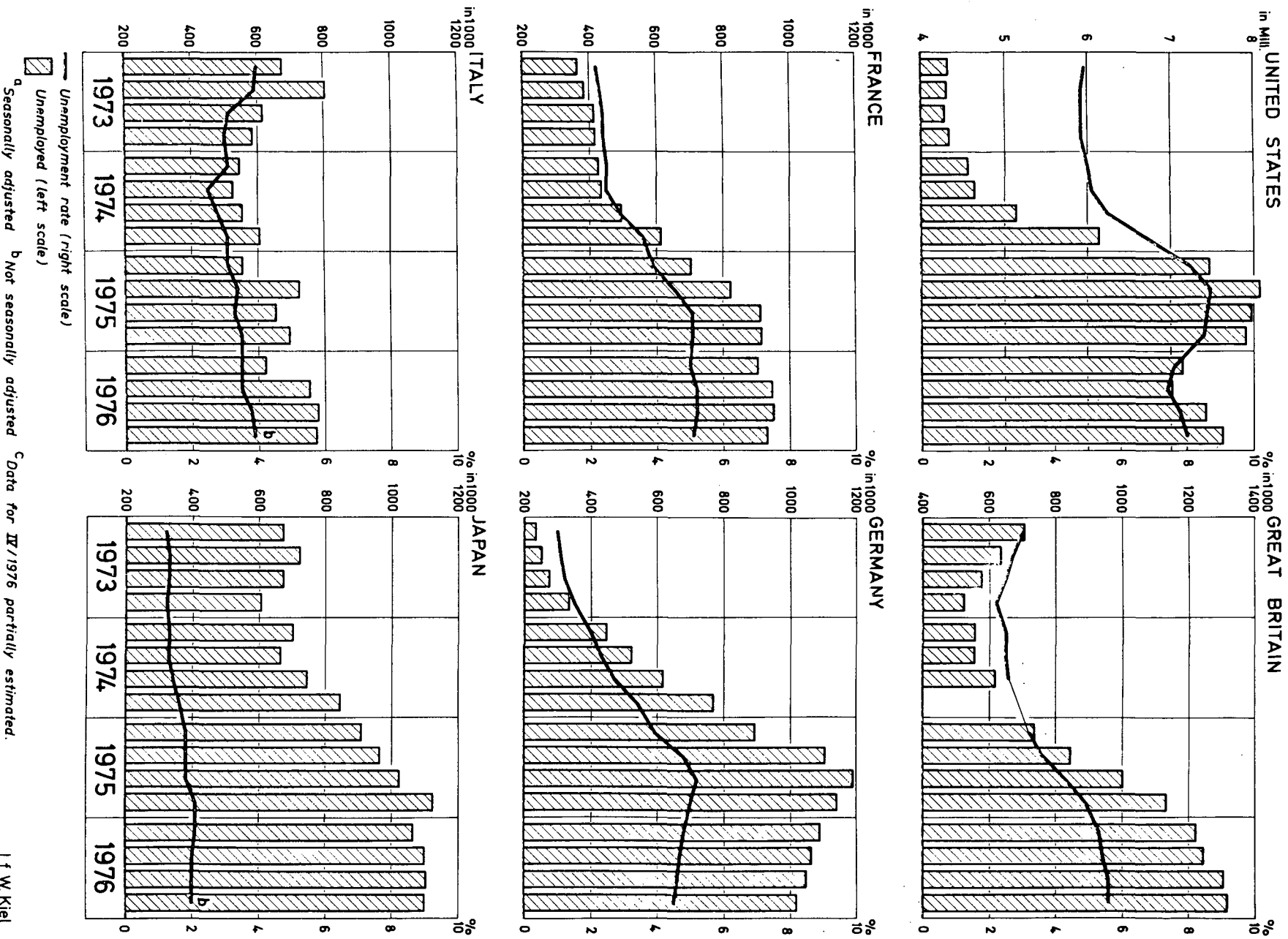


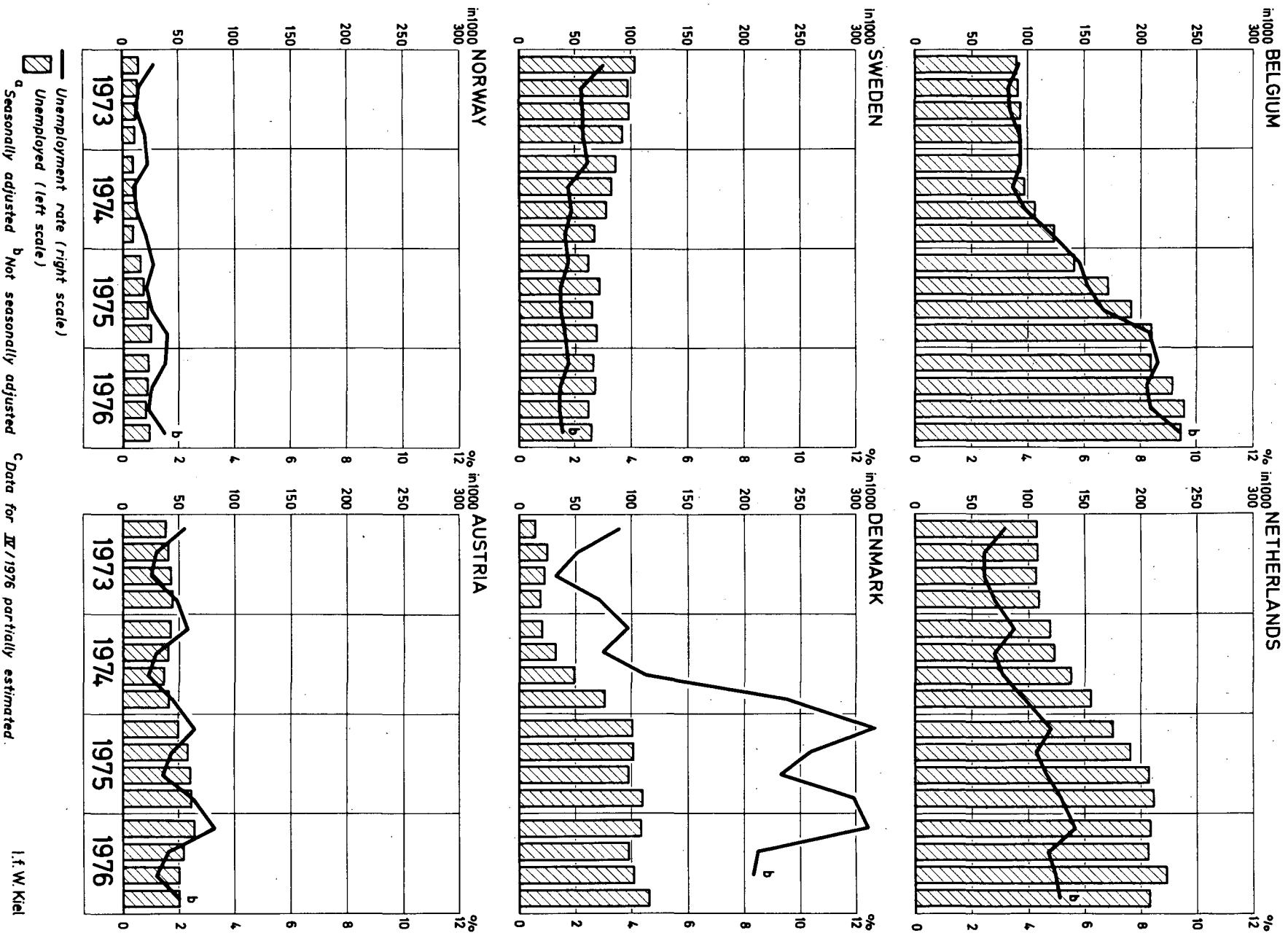
— Investment goods - - - Consumer goods Intermediate goods

^a Seasonally adjusted. - ^b Base materials and production goods. - ^c Consumer durable goods. - ^d Industrial materials.

Figure A 3

UNEMPLOYMENT^{a,c} IN SEVERAL COUNTRIES 1973 - 1976



UNEMPLOYMENT^{a,c} IN SEVERAL COUNTRIES 1973 - 1976

21. The reason for the weak labour market development is basically to be seen in the fact, that in most European countries the cutback of production in 1974/1975 did not lead to an equivalent reduction of employment. Thus production increases in 1975/1976 could be matched with the existent labour force and by re-instituting 'average' overtime. An increasing labour force - due to demographic developments - intensified labour market problems, especially in West Germany, Italy and France.
22. Analyzing national unemployment figures partly disguises the differences of labour market problems. In Europe the re-emigration of labour helps countries like Germany, Austria, Switzerland, and France to keep their unemployment figures down, whereas it complicates the problems of Italy, Spain, Yugoslavia, Greece, Portugal, and Turkey. A second factor, not showing up in unemployment figures is short-time working. This was an important instrument to avoid 'registered' unemployment. It has been and still is of major importance in Italy and Germany.

d) The Course of Prices and Wages

23. Despite the fact that in most countries inflation rates have been falling for almost two and a half years, the year-over-year increase of consumer prices in OECD-countries is still near 7 percent, in Western Europe almost 10 percent. Monetary deceleration in 1973/1974 and subsequent recession finally have had their lagged effects on wages and prices. While raw material prices, especially for non-industrial products, after a marked slow-down in 1975, have increased already in 1976 - though at a modest pace - and continue to do so in winter 1976/1977, industrial producer prices after a short acceleration period in early 1976 continue to increase only at low rates (Figure A 4).

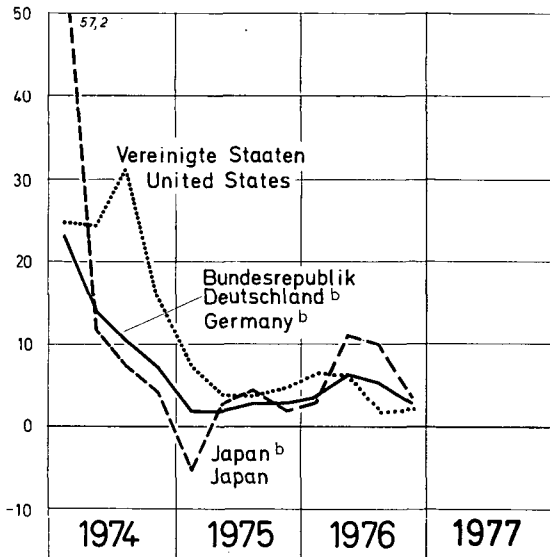
Figure A 4

GROSSHANDELS- UND VERBRAUCHERPREISE IN AUSGEWÄHLTEN LÄNDERN

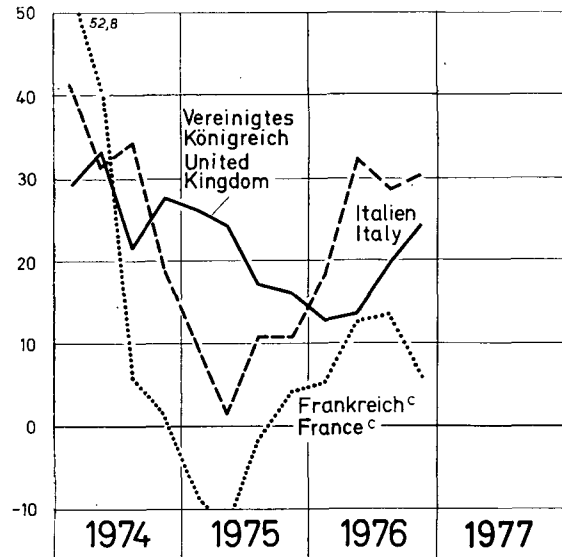
Wholesale and Consumer Prices in Selected Countries

Veränderung gegenüber dem Vorquartal in vH^a - % change from previous quarter

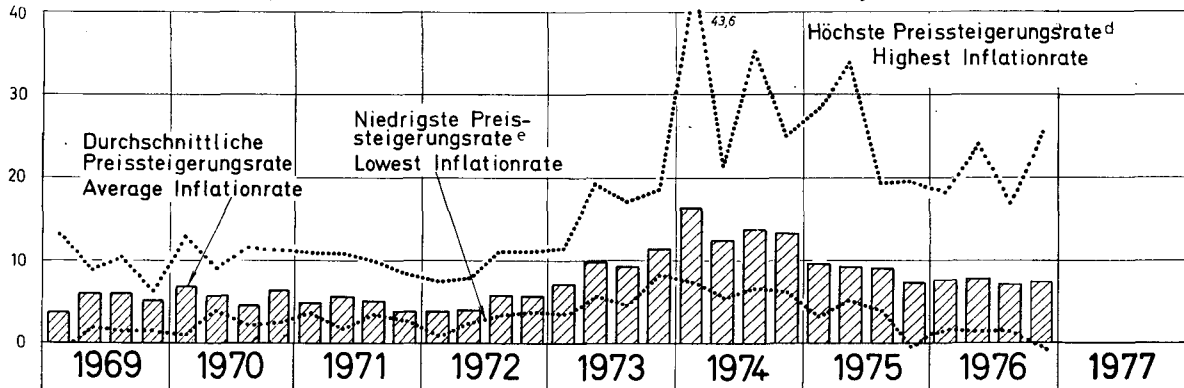
GROSSHANDELSPREISE, FERTIGWAREN



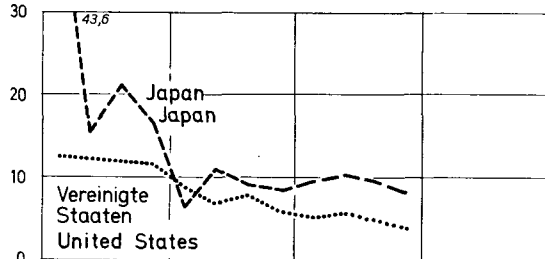
WHOLESALE PRICES, MANUFACTURED GOODS



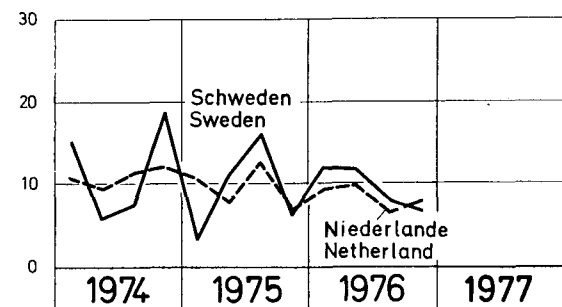
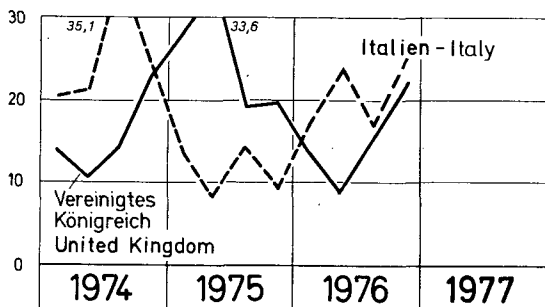
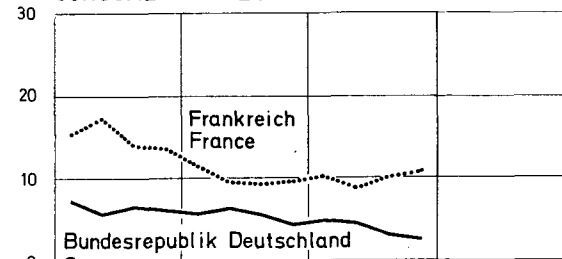
VERBRAUCHERPREISE, INDUSTRIELÄNDER INSGESAM - CONSUMER PRICES, ALL COUNTRIES



VERBRAUCHERPREISE



CONSUMER PRICES



^a Saisonbereinigt, auf Jahresbasis - Seasonally adjusted, annual rates.

^b Industrielle Erzeugerpreise - Producer prices.

^c Halbfabrikate - Semi-manufactured goods.

^d Jeweils Land mit dem stärksten Preisanstieg - Highest inflationrate experienced at times in one of the countries.

^e Jeweils Land mit dem geringsten Preisanstieg - Lowest inflationrate experienced at times in one of the countries.

24. Describing the average inflation performance of industrial countries does not mean very much: divergencies not only as to magnitude of inflation rates, but also as to directions can be observed. While on the one hand Italy and the United Kingdom - countries with the highest inflation rates - experience a renewed acceleration of inflation with current annual rates in winter 1976/1977 beyond 20 percent, countries like Switzerland, Germany and the United States on the other hand continue to hold down inflation rates successfully between one to five percent.
25. In 1976 increasing inflation rate discrepancies coincided with drastic exchange rate changes in 1976. In the deficit countries sharp devaluations were accompanied by strong increases of import prices, whereas revaluations induced low import price increases or even falling import prices in surplus countries. However, this is no reason to blame exchange rate movements for inflation divergencies. The basic reason for those discrepancies is the substantial difference in growth rates of the money supply from country to country. Exchange rate changes, which anticipate these lagged effects of monetary policy, speed up the transmission process from monetary impulses to price increases. During 1976 markets obviously became more aware of the relevance of divergencies in monetary policy, thus promoting rather drastic exchange rate changes.
26. The persistent existence of large inflation rate differentials, however, could not be explained without historically determined different socio-political preconditions as the basis for the reactions of wage settlements to external shocks and internal policy changes. Many countries have adopted an indexed wage-system (Italy, Belgium, Denmark, Netherlands). Adjusting wages to the development of prices has no negative employment effects nor inflationary consequences, if the change of real wages is oriented at 'real' develop-

ments. (i. e. productivity, terms of trade, shift from private to public sector). In any case, in the medium run inflationary consequences of wage indexation are only possible, if the central bank pursues an accomodating monetary policy.

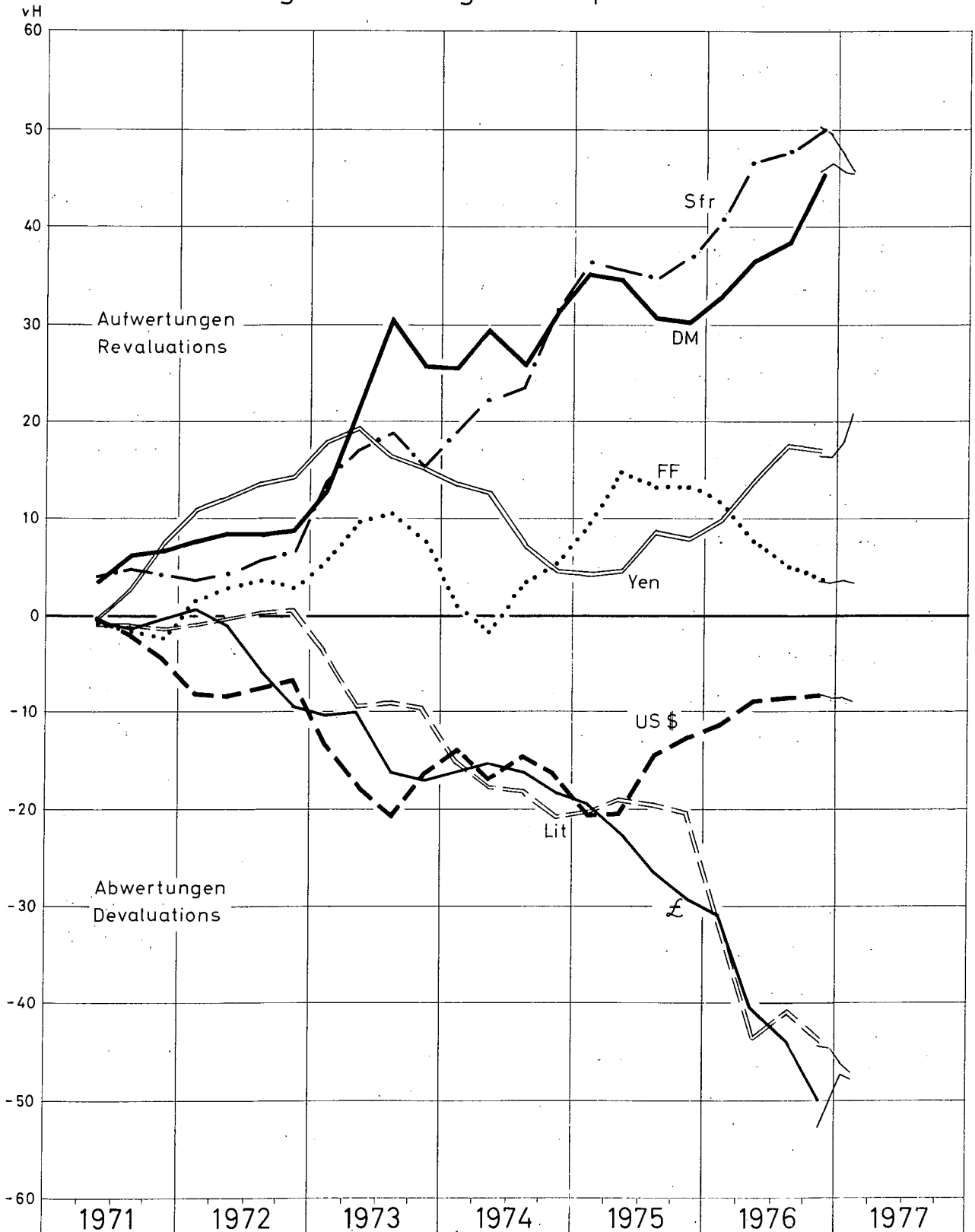
e) Exchange Rates and Balance of Payments

27. In 1975, the improvement of the current balances of deficit countries led to a calming-down of foreign exchange markets. When during the recovery in 1976 current deficits increased again, drastic devaluations took place. Most striking was the rapid fall of the Lira. The British Pound and French Franc - the latter after again having left the snake - were the other important currencies with a substantial devaluation. The D-Mark, the Swiss Franc, the Yen and - only until mid-1976 - the US-Dollar experienced a rather strong appreciation (Figure A 5).
28. The willingness of the deficit-countries to dampen the inflationary process by restrictive measures and the readiness of strong countries to give credits - motivated by the desire to hold up the own exports, an inclination increased by the meagre advances of the recovery - resulted in a big round of international credit arrangements. The most important ones were those for the United Kingdom. Deflationary measures and international credits brought about a calming down of foreign exchange markets: The Pound even appreciated recently, while - oddly enough - the Swiss Franc depreciated for several months.
29. The worsening of trade and current balance in 1976 was most pronounced in the United States. The trade balance development, however, should be interpreted mainly as a reflex of the cyclical lead of the United States. The worsening - and this should be recognized - only compensated an improvement of similar magnitude during the year before.

Figure A 5

EFFEKTIVE WECHSELKURSÄNDERUNGEN WICHTIGER WÄHRUNGEN^a

Effective exchange rate changes of important currencies^a



^aGegenüber den im April 1971 geltenden Paritäten - Against the parities of April 1971.
Eigene Berechnungen - Own calculations.

The worsening of the US-balance was obviously not to the advantage of most western European countries. Their structural deficiencies led to increasing deficits often via a strong deterioration of their terms of trade (i. e. in France, Denmark, Austria, Italy, and the United Kingdom). The improvement of trade balance and current balance of Japan is mainly due to a slow recovery and the export mindedness of Japanese firms. Germany, despite experiencing a rather strong increase of imports has experienced only a small worsening of its trade and current balance. Obviously the favourable product mix of German exports outweighed the effects of the earlier revaluations of the D-Mark (Figures A 6 and 7).

IV. The Short-term Outlook

30. Presently two scenarios are competing at the forecasting 'markets'. The optimistic alternative is a continued - though modest - recovery in 1977, including the expectation that private investment will increase. The pessimistic alternative is a new period of stagnation, including increasing unemployment and no pick up of investment. While the first alternative is shared by the majority of economic institutes and some private forecasting firms, the latter is favoured by the OECD.

The developments in recent months, which were quite favourable in most countries tend to support the optimistic version of the outlook. The developments caused several institutions to refrain from repeating their rather gloomy forecasts given around year-end 1976.

a) The Socio-economic Framework

31. Some of the 1976 economic difficulties are attributable to political problems. Four big countries were temporarily not fully capable to cope with economic problems due to general elections: Italy, West Germany, Japan, and the United States. Since no new cumula-

Figure A 6

HANDELSBILANZEN WICHTIGER LÄNDER UND REGIONEN

Trade balances of major countries and regions

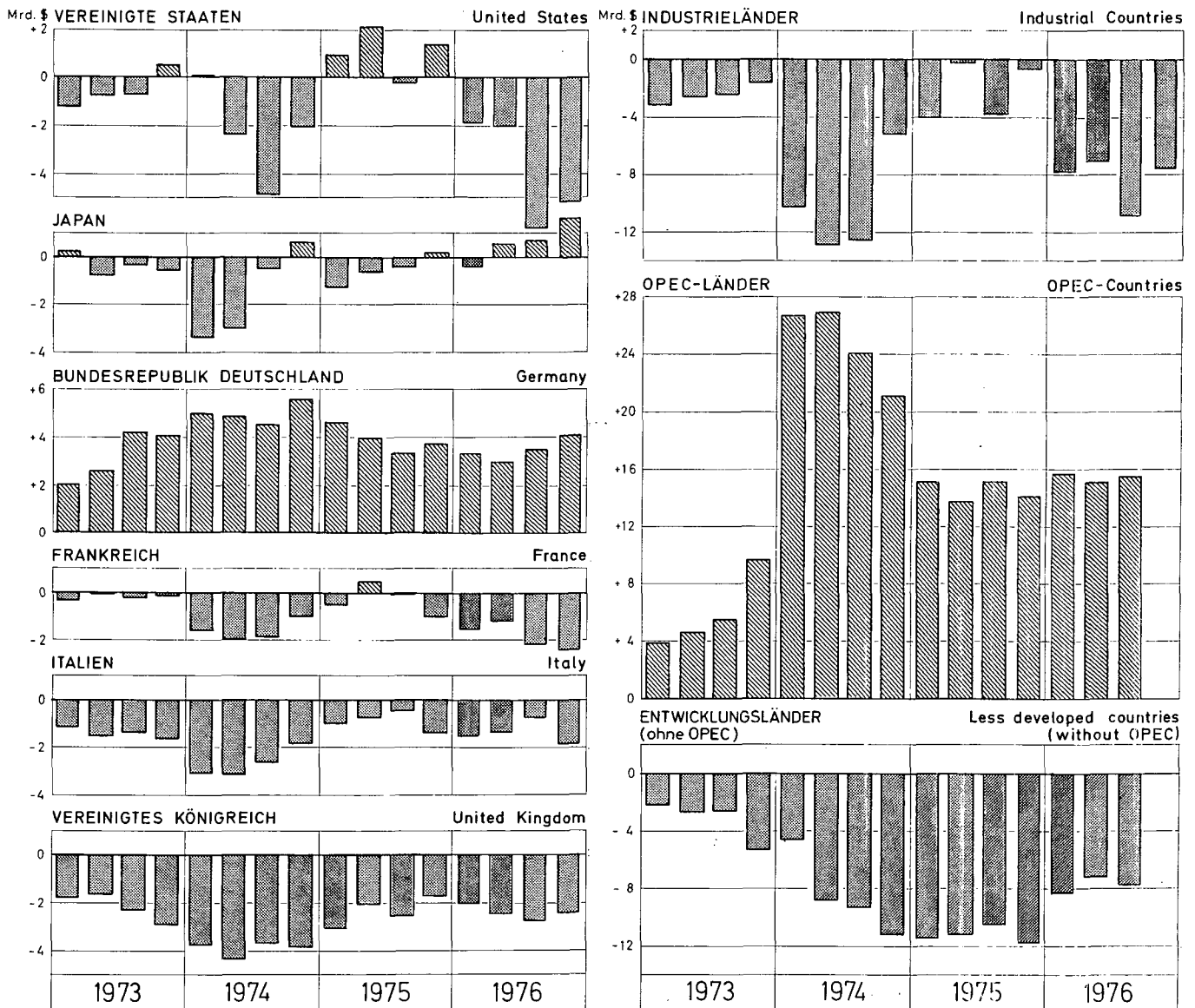
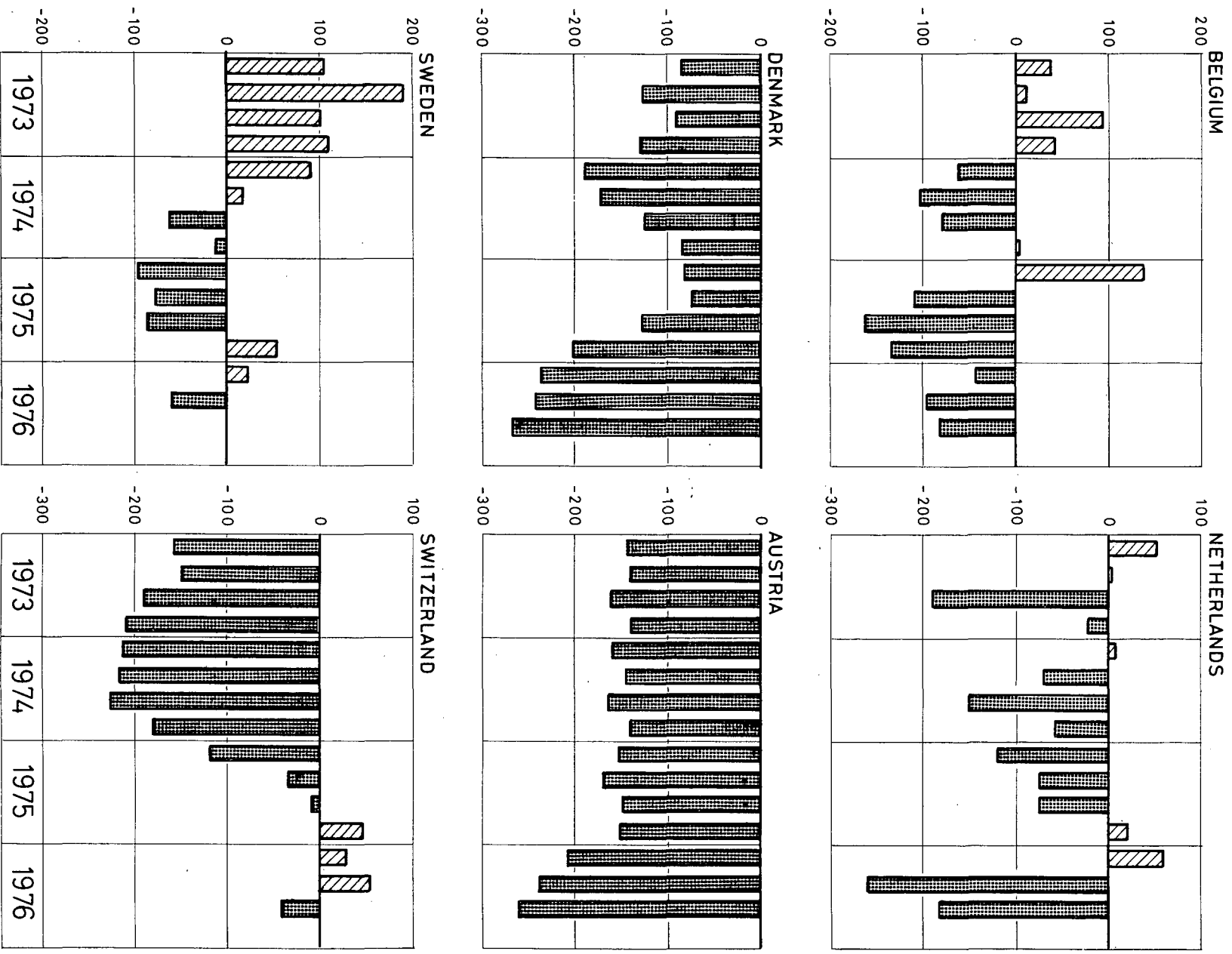


Figure A 6

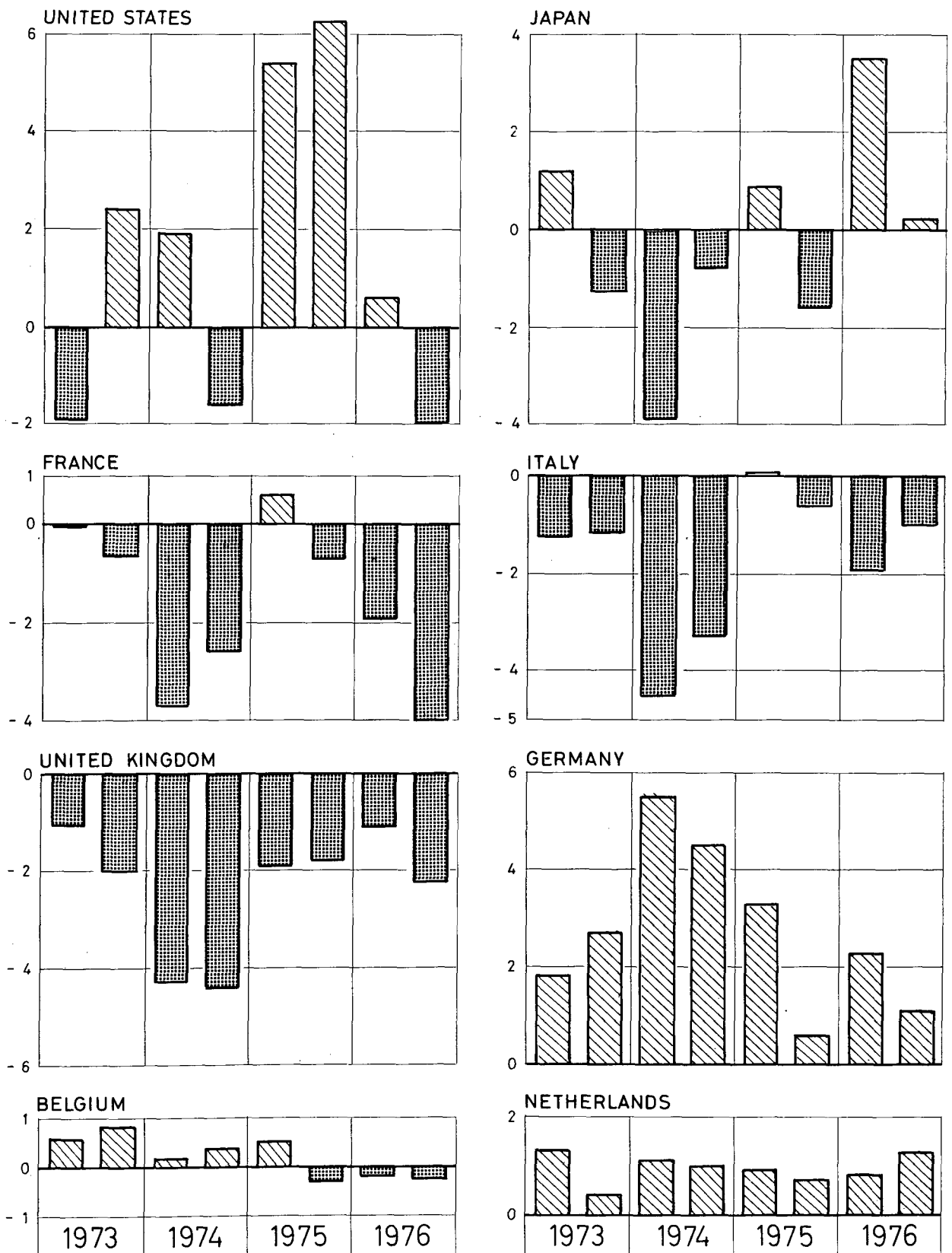
TRADE BALANCES OF WESTERN EUROPEAN COUNTRIES¹⁾



¹⁾ Seasonally adjusted in mil. US \$.

Figure A 7

CURRENT BALANCES OF INDUSTRIAL COUNTRIES¹⁾



¹⁾ Seasonally adjusted, bil. US \$.

tion of general elections will take place in 1977, one obstacle to a steady economic development does not exist. However, the 1978 election in France, the fragile majority of the Labour Government in Great Britain, a weak government in Italy and the dismissal of the Belgian and Netherlands Governments may cause difficulties.

32. While political events in 1977 are in general expected at least to be not more disturbing than in 1976, the continuing or even increasing problem of unemployment and consequently the necessity for low increases or even continuing decrease of real wages may induce unrest with employees and unions: the problem is less dramatic in so-called 'consensus countries', i. e. where concerted efforts of government, unions and employers associations exist (West Germany, Austria). In countries, where unions are not only associations of employees, but also feel as the only powerful political opposition, the continuing necessity to behave cooperative with government policy in order to strengthen investment by favouring profits, may no longer be accepted by unions. This may be especially true for the deficit countries United Kingdom, Italy, Denmark, where workers have already experienced a marked decline of real incomes. A renewed fight on the income distribution would, however, be to the disadvantage of all groups.
33. Many countries are engaged in some sort of statutory incomes policy. In the past most of the efforts in incomes policy in the context of an old-fashioned economic policy proved to be unsuccessful. Since mid-1976, however, it can be observed that in nearly all countries incomes policy - to hold down wage- and price increases - is not used as a substitute for a cautious demand management policy. Instead, it represents the comple-

mentary price and wage (downward-)flexibility to the efforts to slow down monetary overexpansion and the budget deficits, in order to avoid contractionary effects.

34. Since the economic summit at Puerto Rico and enforced since the IMF conference in Manila, international efforts have increased not to allow for an inflationary go-policy. Consequently, the deficit countries which ask for international credits from the IMF and other international lenders in order to avoid sharp depreciations of their own currency increasingly have to accept certain obligations concerning a moderation of economic policy.
35. Since mid-1976 most countries experience a slow-down of monetary expansion. Since it means in most cases a 'normalization' of expansionary efforts, it is desirable for stability- and for external equilibria-reasons. The very fact, however, that all countries slow down monetary expansion at the same time - and sometimes may overdo it - could endanger the still fragile recovery in industrial countries.
36. This danger is reduced, since most of the so-called strong countries have announced or released new fiscal stimuli since winter. These policies are to a large extent not only increasing demand temporarily, but include medium-term programs for public investment and a permanent tax reduction, i. e. a subsidization of private initiative (to work, to invest).
37. Up to now only the United States' monetary policy succeeded in pursuing a monetary course, which can be qualified as a steady stabilization-oriented course. Monetary policy in many countries - Germany, Japan, and Switzerland included - failed to consequently achieve a steady money supply expansion. However, after having made policy mistakes, governments and

central banks tried to correct them in the course of 1976.

In general, it is assumed that despite a zig-zag-course of economic policy through 1976, its effects will finally and on average be neither too restrictive nor too expansionary. In some cases, where deflationary measures to stabilize the exchange rate were undertaken during the second half of 1976, economic policy may be qualified as overrestrictive, thus preparing ground for a temporary slow-down of economic activity.

b) Outlook for Output in 1977

38. On average industrial countries expect a 4.5 percent increase of GNP in 1977 after 5.5. percent in 1976; the advance will be lower for Western Europe (3.5 percent). The majority of forecasts for most countries - especially in Western Europe - imply a rate of advance of GNP only as high as the growth rate of the potential, thus leaving the capacity utilization as low as it was in 1976. The 1977 slowdown of expansion will be the consequence of a moderation of government and central bank stimulation in 1976 and early 1977 (Table A 1).
39. Forecasts for 1977 differ substantially not only from country to country but also from forecaster to forecaster. In order to illustrate the uncertainty about 1977 the range of forecasts for the most important countries are assembled in table A 2. The spread of forecasts is as big as in 1976 (Table A 2).

The range of forecasts should become smaller as complete information about 1976 becomes more and more available for all countries and as current information for 1977 comes in at least for some of the major economies. Since the last quarter of 1976 proved to show the expected recovery from the summer lull in many industrial countries, and since 'problem countries' like Italy, the United

Table A 1 - GNP Development in Industrial Countries^a
(Assessment by the Member Institutes for Their Own Country)

Country	1974	1975	1976	1977
Austria	4.1	-2.0	5.2	4.5
Belgium	4.2	-1.9	4.0	3.5
Denmark	1.4	-1.3	5.0	1.0
Finland	4.3	0.6	0.3	4.0
France				
Chambre Comm.	2.8	-1.5	4.8	3.5
Rexeco	2.8	-1.5	6.2	4.0
Germany				
DIW	0.5	-3.2	5.6	5.5
IfW	0.5	-3.2	5.6	5.0
Italy	3.4	-3.7	5.7	2.0
Netherlands	2.3	-2.0	4.0	4.5
Norway	5.3	3.5	5.7	6.0
United Kingdom	-0.2	-2.1	0.9	0.9
^a Change over previous year.				

Table A 2 - Alternative 1977 GNP Forecasts for Major Industrial Countries^a

	United States	Japan	West Germany	France	Italy	United Kingdom
OECD ^b	4.5	6.0	3.5	3.0	-0.5	1.5
Average AIECE Members	5.0	6.3	5.0	3.7	1.6	1.2
Most Pessimistic AIECE Members	4.8	5.0	4.5	3.25	0	0.9
Most Optimistic AIECE Members	5.0	7.0	5.5	4.0	3.0	1.6
National AIECE Members of Respective Country	-	-	5.25	3.75	2.0	0.9

^a Change over previous year. - ^b OECD, Economic Outlook, December 1976.

Kingdom and France did - economically - better than expected, it is assumed that the general economic development will be more favourable than shown in table A 2.

40. Again it is believed that the United States, Japan and West Germany will be the engines of the world economy. While the United States and West Germany are expected to realize a 5 percent growth, Japan is expected to have a GNP-increase of 5.5 percent. While these rates mean an ongoing substantial increase of capacity utilization in the United States and West Germany, it implies on average for 1977 only a constant capacity utilization for Japan.
41. GNP increases for Western Europe are forecast on average below the growth rates of the production potential, thus increasing idle capacities and unemployment. While those countries, which are closely connected to West Germany are expected to experience a relatively good performance, the development in Italy, France, the United Kingdom, Denmark, and Sweden is believed to be less favourable.

If one analyzes which current developments are implied in the above mentioned year-over-year figures, it is obvious that the forecasters must have assumed zero-growth in the course of 1977, for example for Italy, Great Britain and Denmark. The carry-over at the end of 1976 was high enough to bring about the year-over-year advances shown in table A 1. In light of the development during recent months this assumption, however, seems to be overpessimistic. On the contrary, in some of the latter mentioned countries, the rate of increase of production will accelerate in the course of 1977.

42. Comparing the latest forecasts for 1977 with those made by A I E C E members in autumn 1976, a small downward revision can be observed. While it is due to a shortfall of the 1976 performance in the case of West Germany and the United States, it may be a

consequence of the assumption that restrictive measures in Italy, the United Kingdom, Denmark and France make for a less favourable profile of the development in 1977.

c) Demand Mix in 1977

43. The driving forces of the ongoing recovery in the United States, Japan, and West Germany will be - as a year ago - private consumption and - more pronounced - investment. However, the rates of increase of investment will be modest compared to previous cycles. While in the United States and Japan construction will stimulate activity, it will remain a retarding element for the recovery in West Germany.

In most Western European countries the GNP increase is forecast to stem from a rather good export performance, a moderate consumption increase and slowly increasing government expenditures. With the exception of West Germany, investment will be a retarding element for all European countries. Thus most European countries are predicted to rely mainly on an export-led recovery. Since only the United States and Japan are forecast to have a substantially higher increase in imports compared to exports, the forecast strong improvement of the trade balance of Europe requires an additional compensation outside the OECD-countries: whether a worsening of the trade balance of OPEC-, LDC- and/or Comecon-countries can match it, is at least an open question.

Two alternative scenarios may be therefore as probable as the above mentioned: either Europe's imports increase at a faster rate than forecast by AIECE members, or Europe's export advances are below the forecast given in table A 3.

d) Inflation Forecast

44. In general low capacity utilization and a rather moderate

Table A 3 - Development of GNP and Its Components for Industrial Countries^a
(Assessment by the Member Institutes for Their Own Country)

		Austria	Belgium	Denmark	Finland	France	Germany	Italy	Nether- lands	Norway	United Kingdom
GNP	1974	4.1	4.2	1.4	4.3	2.8	0.5	3.4	2.3	5.3	-0.2
	1975	-2.0	-1.9	-1.3	0.6	-1.5	-3.2	-3.7	-2.0	3.5	-2.1
	1976	5.2	4.0	5.0	0.3	5.5	5.6	5.7	4.0	5.7	0.9
	1977	4.5	3.5	1.0	4.0	3.8	5.3	2.0	4.5	6.0	0.9
Private Consumption	1974	3.7	2.6	-3.5	4.1	2.7	0.2	2.5	2.3	4.0	-0.9
	1975	2.5	0.9	5.0	3.8	3.3	2.6	-1.8	3.0	5.6	-0.7
	1976	4.0	3.5	6.0	-0.7	5.2	3.4	3.0	4.0	5.6	0.6
	1977	4.0	3.5	1.0	2.5	4.1	4.8	2.0	3.5	5.0	-0.6
Government Consumption	1974	4.0	3.6	1.4	4.2	1.7	4.6	2.1	1.4	3.3	1.9
	1975	3.0	7.2	4.7	7.6	-0.4	3.6	0.8	2.6	5.1	4.7
	1976	2.5	4.2	3.2	4.2	-	2.9	2.0	4.0	4.9	2.9
	1977	2.5	3.0	1.0	4.0	-	2.3	2.0	1.5	5.0	-0.2
Total Fixed Investment	1974	1.2	8.0	-6.7	3.7	1.3	-8.1	3.7	-	5.0	-1.9
	1975	-5.9	-3.3	-7.9	6.0	-4.3	-4.1	-12.7	-3.8	10.7	-1.2
	1976	5.7	2.0	7.0	-13.7	4.7	4.7	0.5	-2.5	12.3	-4.4
	1977	6.5	3.0	0	-2.0	2.9	5.0	2.0	7.0	1.5	-2.5
Exports	1974	8.6	11.3	5.0	-0.9	10.3	13.3	10.0	2.5	0.5	7.1
	1975	-7.2	-9.4	-1.1	-14.0	-3.7	-8.7	3.1	-2.9	3.1	-3.8
	1976	11.3	7.0	3.0	18.2	9.8	10.9	12.5	10.5	7.8	6.3
	1977	8.5	5.0	6.5	10.0	9.5	9.0	9.0	5.5	10.0	5.4
Imports	1974	6.8	12.3	-4.0	6.5	4.9	4.8	2.0	-1.0	4.4	0.5
	1975	-9.0	-10.3	-5.0	0.4	-7.0	0.8	-10.0	-4.0	6.9	-6.4
	1976	17.9	8.0	15.0	-0.8	19.9	11.4	13.5	11.5	10.3	5.8
	1977	7.5	4.5	1.0	5.5	8.0	8.8	3.5	6.0	3.0	3.2

^a Change over previous year.

monetary expansion in most countries should prepare ground for another period of declining inflation rates in 1977. However, cost push from various sides may emerge in 1977 - for example via an increase of wages or raw material prices or by an increase of administered prices or even sales taxes. A reacceleration of inflation may be fortified if at the London economic summit on May 7/8 new strong reflation programs will be propagated, which imply easy money policy.

45. Despite a moderation of current inflation rates in "high-inflation countries" and high probability for no further stabilization progress in "low-inflation countries", the inflation divergencies between countries will remain rather high. While Switzerland will be again on the low side with a consumer price increase (year-over-year) as low as 1.5 percent, Italy will remain to be the most inflationary economy with a year-over-year increase of consumer prices of nearly 20 percent. It should be mentioned, however, that these year-over-year figures imply a substantial deceleration of inflation in "high-inflation countries" and constant inflation rates in so-called "low-inflation countries". It is assumed that the remaining inflation differentials will have to be matched by changes of the nominal exchange rates. Otherwise the competitive position would deteriorate and an export-led growth for the inflation-prone deficit countries would not be probable (Table A 4).

e) Labour Market Tendencies

46. The labour market forecast for most European countries is rather gloomy. The expected increase of GNP will only be on average 3.5 percent, leaving capacity utilization rates practically unchanged. Therefore, it is not probable that employment will increase at all in the course of 1977; this is the more true, since short-time work has not yet disappeared and the average work time is not back to

Table A 4 - Price Development in Industrial Countries^a
(Assessment by the Member Institutes for Their Own Country)

Country	Consumer Prices				GNP Deflator			
	1974	1975	1976	1977	1974	1975	1976	1977
Austria	9.5	8.4	7.3	6.3	10.5	8.8	5.8	6.0
Belgium	12.7	12.7	9.2	7.0	12.8	12.3	8.5	9.0
Denmark	15.2	9.6	9.0	9.5	11.1	13.0	9.5	9.0
Finland	16.9	17.9	14.4	12.0	20.9	16.4	11.4	8.5
France	13.7	11.7	9.6	8.4	11.1	13.4	9.9	8.6
Germany	7.0	6.0	4.5	4.0	6.9	8.1	3.0	4.0
Italy	19.1	17.0	16.8	20.0	16.8	17.6	17.1	19.8
Netherlands	10.0	10.5	9.0	6.5	8.7	10.8	9.5	6.5
Norway	9.4	11.7	9.1	-	10.6	10.0	8.5	-
Portugal	29.2	20.4	19.3	-	18.6	14.7	18.7	-
United Kingdom	15.4	22.1	17.1	14.2	-	-	-	-

^a Change over previous year.

normal levels. As an increase of the labour force can be expected, unemployment will continue to increase, though not at substantial rates. The exception will be West Germany and Austria, where the comparably strong recovery will bring about a further reduction of unemployment. The United States will also experience a lowering of unemployment rates.

47. In addition to the cyclical problems of the labour market, there are - with differences from country to country - intensifying structural difficulties: increasing unemployment rates of young people and women - also due to higher than average increases of the labour force - are likely to emerge. Also, the lack of flexibility of wage levels and the wage structure on the one hand and the relatively small regional and vocational mobility of workers on the other prevent a faster adjustment to the structural changes in the economies. On top of that, the existing jobs became obsolete during the last recession. Thus even if demand increases, unemployment will not disappear, since, first of all, new job opportunities have to be created, i. e. investment has to take place.

f) Balance of Payments Outlook

48. The forecast of AIECE members as well as the OECD include a substantial improvement of the deficit countries' trade balance and the current balance in 1977. The positive swing for Western Europe is expected to stem mainly from a decline of the deficits of France, Italy, the United Kingdom and Denmark, while the surpluses of Germany and the Netherlands remain practically unchanged. This improvement is forecast to find its counterpart in a further deterioration of the US-balance and a worsening of the Japanese balance. Additionally, a decreasing surplus of the OPEC-countries is expected.

49. However, with the exception of a worsening of the US-balance, the process of changing the trade and current balance disequilibria still has not yet shown up clearly in the statistics. Until recently neither a worsening of the Japanese balance nor an improvement of the EEC balance has been observed. An obstacle for a durable improvement of the trade balance may be the attempt to stop the depreciation of Lira and Pound and some other European currencies, thus endangering international price competitiveness of these countries. Therefore, one should be prepared for either a revision of the balance of payments outlook towards a smaller improvement of the EEC current balance, or - as it is assumed more probable - for a further depreciation of most european currencies.
50. While it seems possible to have two really different scenarios for 1977, it does not seem to make sense to forecast a recession in 1978. Either the optimists are right for 1977, and investment will pick up in the engine countries. In this case, 1978 will be the third year of the recovery and the investment cycle should get momentum. Or the pessimists are right for 1977, and stagnation is developing in the course of the year. In this case governments and central banks would step in. Those stimulation programs would have their impact only in 1978, thus again restarting the interrupted recovery.

B. The Unemployment Problem - Causes and Cures

1. The current recovery in the industrialized countries has not yet led to a substantial increase of employment. Unemployment figures are still high - in some cases rising - even after a year since the trough of the recession. On the top of this very unsatisfactory picture of the present: hardly any forecasts for the coming years include a reduction of unemployment rates close to those experienced in the 1960's. In fact, other than cyclical - namely structural - factors are made responsible for a large part of the problem, which allow only for a very gradual reduction of the unemployment rates.
2. Various measures to solve the problems are discussed, planned or have already been taken. However, not all of them promise to be successful either in achieving the goal of higher employment and/or in avoiding negative impacts on other targets of economic policy.

I The Present Situation

3. In most of the OECD-countries, the rates of unemployment in the last recession have been much higher than during previous recessions. Table B 1 shows a large increase of unemployment during the 70's (up to four times the level of the average of the 60's for the case of Germany and the Netherlands). This substantial increase - besides structural factors - very much reflects the depth of the 1974/75 recession.

a) Slowly Declining Unemployment

4. In most of the countries mentioned here, the increase of unemployment has come to an end during 1976 (see Figure B 1). However,

Table B1: Unemployment Rates in OECD-Countries, 1960-1976

	1960-64	Averages 1965-69	1970-74	1970	1971	1972	1973	1974	1975	1976
United States	5.7	3.8	5.4	4.9	5.9	5.6	4.9	5.6	8.5	7.7
Japan	0.9	1.0	1.3	1.2	1.2	1.4	1.3	1.4	1.9	2.0
Austria	2.9	2.7	1.9	2.4	2.1	1.9	1.6	1.5	2.0	2.0
Belgium	3.6	3.4	3.4	2.9	2.9	3.4	3.6	4.0	6.7	8.5 ^a
Denmark	3.7	3.3	3.6	2.9	3.7	3.6	2.4	5.2	11.1	9.0 ^a
France	1.2 ^b	1.5	2.0	1.6	2.0	2.2	1.9	2.1	3.4	4.2
Germany	0.9	1.2	1.3	0.7	0.8	1.1	1.2	2.6	4.7	4.6
Italy	3.2	3.6	3.3	3.2	3.2	3.7	3.5	2.9	3.3	3.7
Netherlands	0.9	1.4	2.3	1.1	1.6	2.7	2.7	3.3	4.8	5.2 ^a
Norway	1.5	1.0	0.8	0.8	0.8	1.0	0.8	0.7	1.3	1.2 ^a
Sweden	1.6 ^b	1.7	2.2	1.5	2.5	2.7	2.5	2.0	1.6	1.6
United Kingdom	1.9	2.1	3.0	2.6	3.4	3.7	2.6	2.6	3.9	5.4

^aPreliminary. - ^b1962-64.

Source: OECD, ILO, national statistics.

only in a few countries has there been a significant turnaround: a reduction of unemployment has been observed in the United States, Germany and Austria, while the levels have roughly remained at their maximum in the other countries, also due to the general slowdown in the speed of the recovery after spring of last year. While the development in Italy does not really show a 'typical' cyclical pattern (due to institutional and statistical problems), it is worth mentioning, that Sweden experienced no substantial increase of unemployment at all, in spite of the recession. This may largely be attributed to the subsidies to firms in order to hold up their work force.

5. The comparison with two earlier business cycles¹ shows - with very few exceptions - the following characteristics for the ten countries (Figure B 1):
 - the 1974/75 recession brought about the largest increase of unemployment;
 - while the development had not been much different in the downswing period, the duration of high or even increasing unemployment levels is relatively long (extreme cases are Belgium, Japan and the United Kingdom);
 - there has - with the exception of Austria - not been a turnaround almost as fast as in earlier cycles, though the production gains have generally not been less than during former recovery periods.
6. The last two points suggest that up to now there have been large reserves of productivity. One factor explaining this phenomenon is short-time work, which had not been instituted to this extent in former recessions. In Italy, for example, more than two per-

¹ For the present cycle, the latest data cover mostly the fourth, sometimes the third quarter of 1976.

Figure B 1

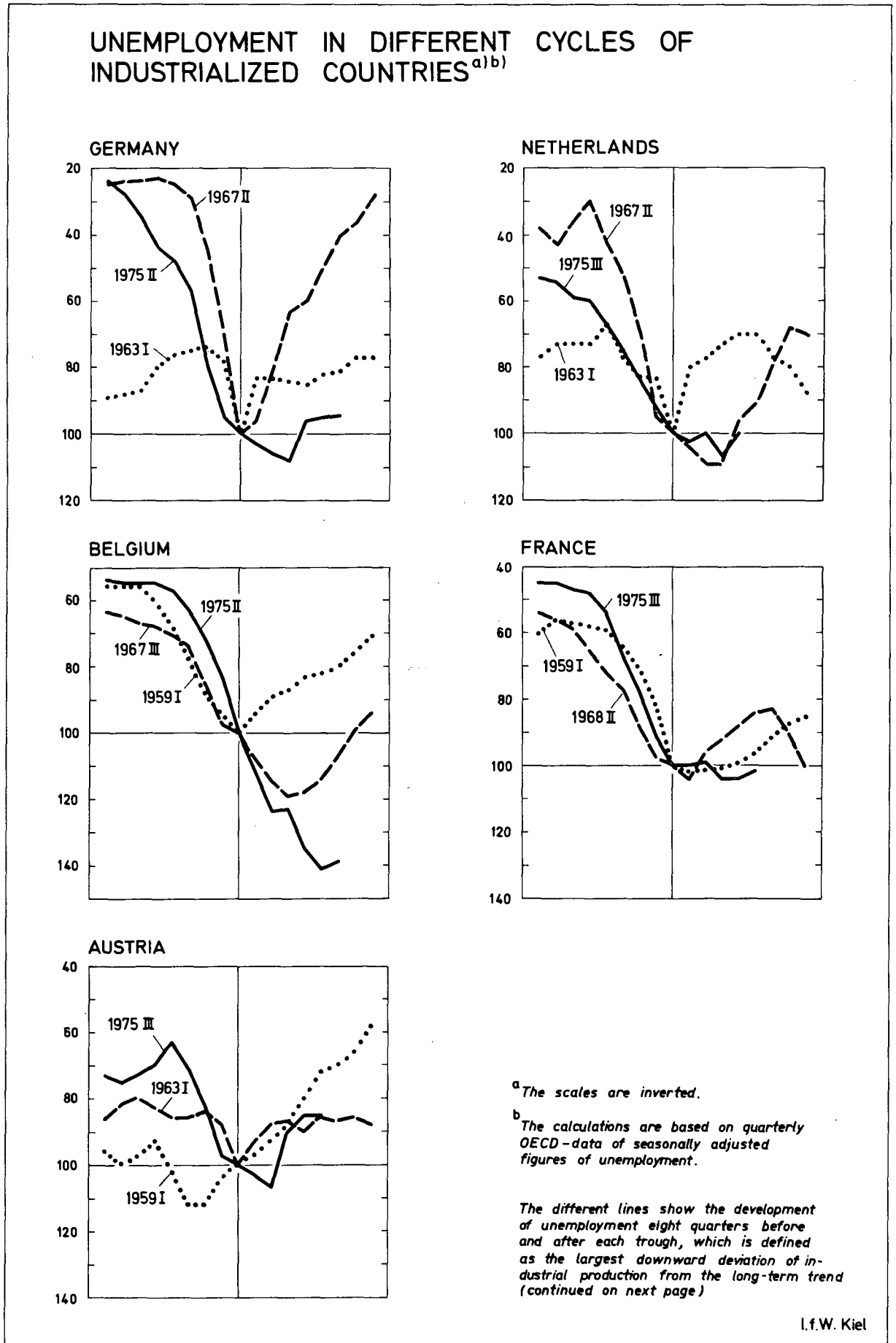
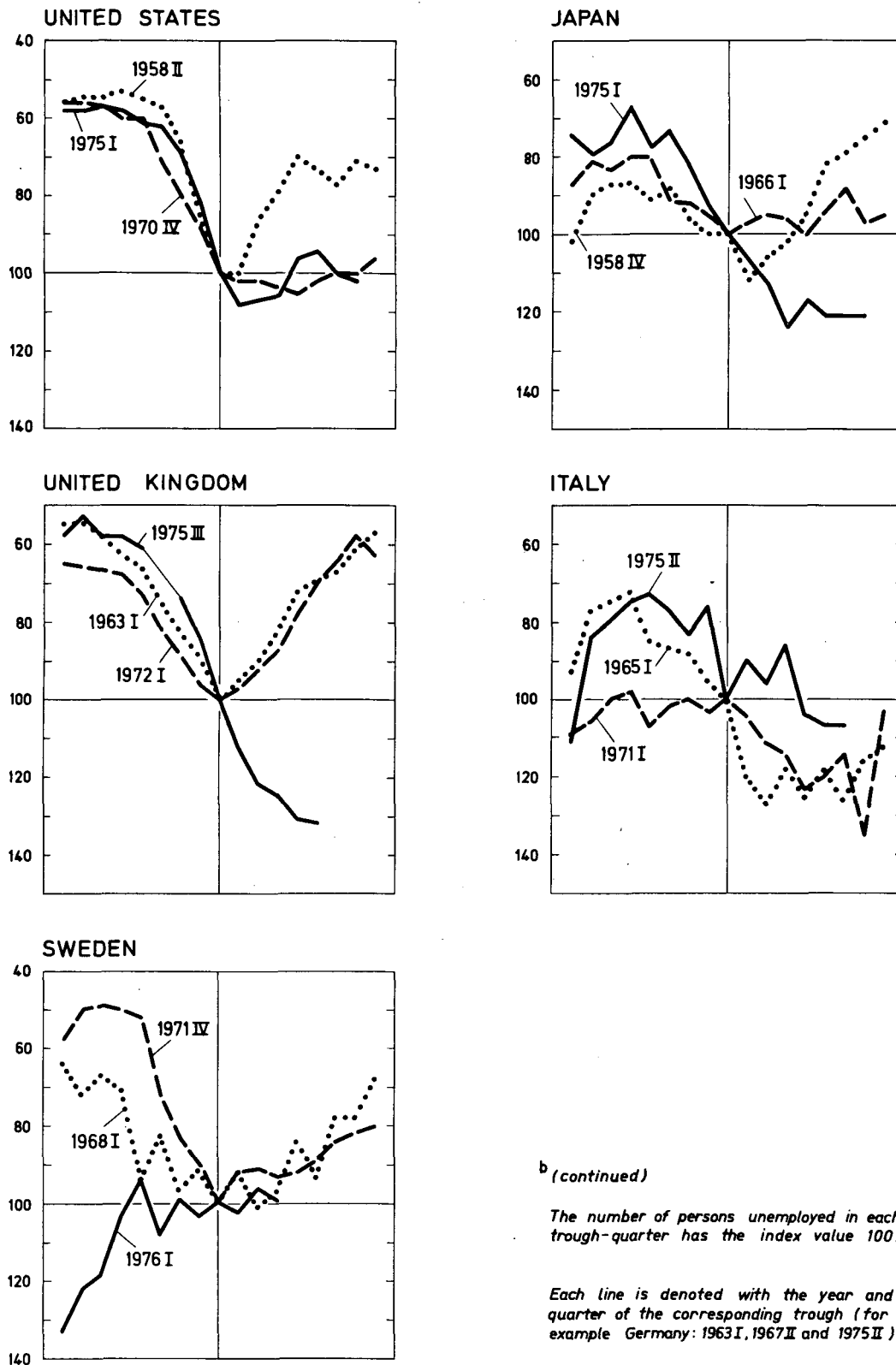


Figure B 1

UNEMPLOYMENT IN DIFFERENT CYCLES OF INDUSTRIALIZED COUNTRIES^{a)b)} (CONTINUED)



^{b)} (continued)

The number of persons unemployed in each trough-quarter has the index value 100.

Each line is denoted with the year and quarter of the corresponding trough (for example Germany: 1963 I, 1967 II and 1975 II).

cent of the persons employed were actually working short-time during 1975 and 1976; and in Germany, the number of short-time workers at time reached more than 75 percent of the unemployment level. This new phenomenon of sharing costs between employers and the government (or social insurance agencies) therefore had a dual impact on the unemployment situation: on the one hand, during the downswing, unemployment did not increase as much as could have been expected from the unusually sharp reduction of production. On the other hand, however, the recovery affected the labourmarket primarily through a reduction of short-time work rather than of unemployment.

Another factor preventing a faster reduction of unemployment was the normalization of the average work-time, including an extension of overtime, which had been very much reduced during the recession. Therefore, the increase of production was not reflected in a decrease of unemployment figures but rather in higher utilization of the labour force on the job.

7. It is also likely that the attitude of employers to hiring new workers has changed. Because of lacking security about the future course of economic policy on the one hand or because of the "new approach" of economic policy towards a more moderate expansion on the other, uncertainty about the development of demand and production existed.

Also, in recent years it has been made more difficult for employers to dismiss workers by more regulations. In Italy, for example, they have to pay subsidies to those they have dismissed, so that it is very costly to reduce the work force. Therefore, they are more cautious in hiring new workers and prefer instituting additional overtime in order to increase production. This was even more the case, because wage increases were - generally - still high.

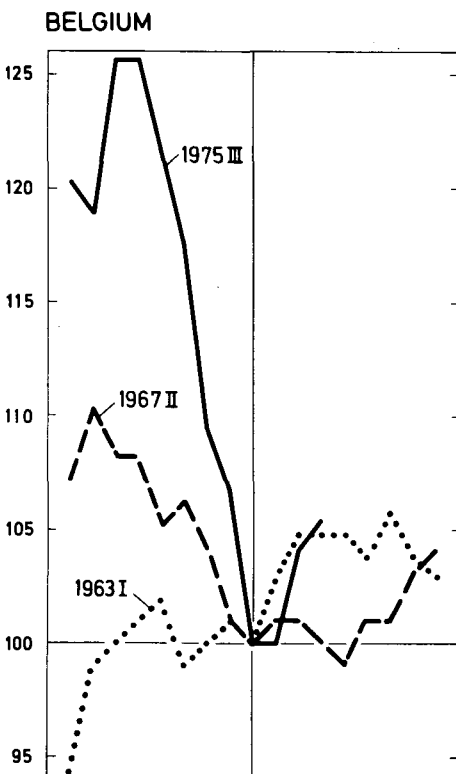
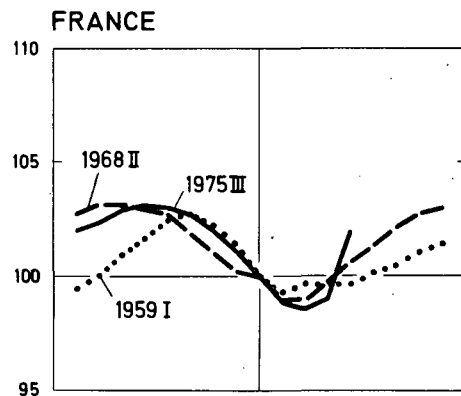
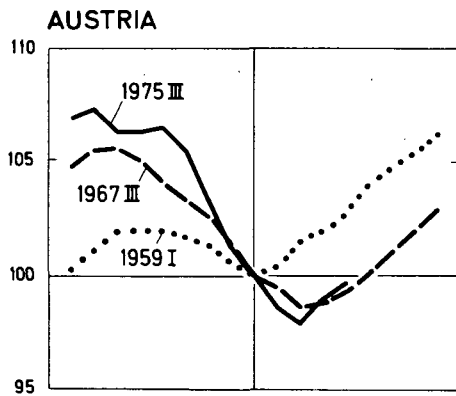
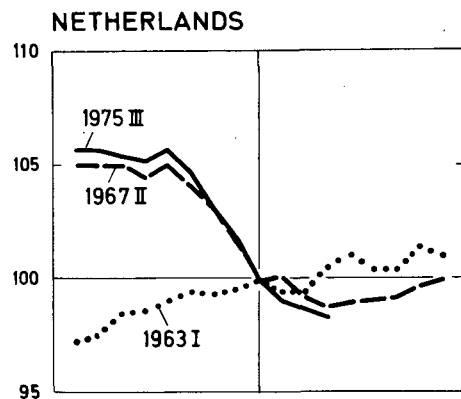
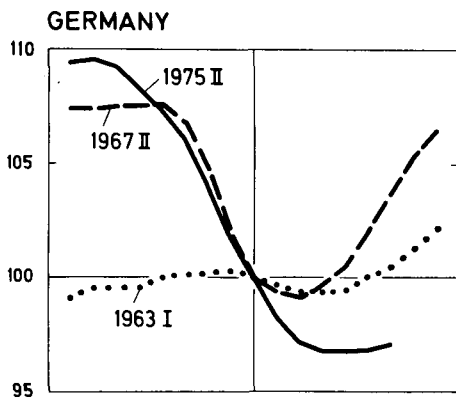
8. A factor concealing the size of unemployment to some extent is the fact, that in some countries (Germany, France, Austria, Switzerland) a large number of foreign workers returned to their home countries, mostly because their contracts were not renewed. Not only governments but also unions promoted this tendency in order to 'protect' domestic workers. However, this increases the unemployment problem of other - mainly southern European - countries.

b) Turnaround of Employment in Most Countries

9. A better indicator for the current recovery is the development of employment figures, because there are large differences between the countries' labour force developments. While in some European countries the number of persons in the labour force practically stagnated, the large gains of employment in the United States (total employment is about 6 percent higher than in the depth of the recession) were accompanied by a similar increase of the labour force, so that the decline of unemployment was much smaller.
10. A cyclical comparison is performed for the ten countries with respect to the important component of employment in industry or manufacturing (Figure B 2). The comparison reflects, on the one hand, structural changes in most industrialized countries: while the recession in the fifties and sixties - even severe ones - were characterized by only short-term interruptions of the upward trend of employment in industry (the extreme case is Japan), the more recent development shows that this trend has stopped or at least slowed down, partly due to the declining contribution of the industrial sector to the gross national product. This should dampen the expectation of an increase of employment in this sector.
11. The present situation is characterized by an increase of employment in most countries with the exception of the Netherlands (stagnation),

Figure B 2

EMPLOYMENT (INDUSTRY OR MANUFACTURING) IN DIFFERENT CYCLES OF INDUSTRIALIZED COUNTRIES^{a)}



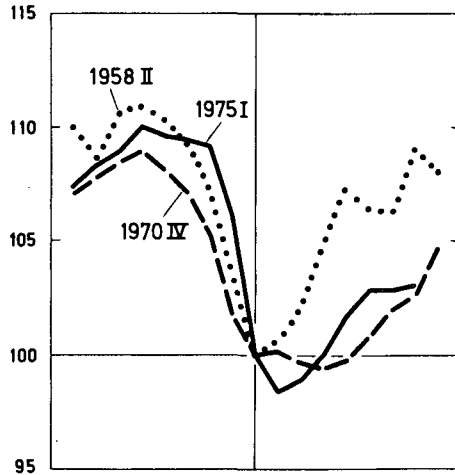
^a The calculations are based on quarterly OECD-data.

The different lines show the development of employment eight quarters before and after the trough, which is defined as the largest downward deviation (continued on next page)

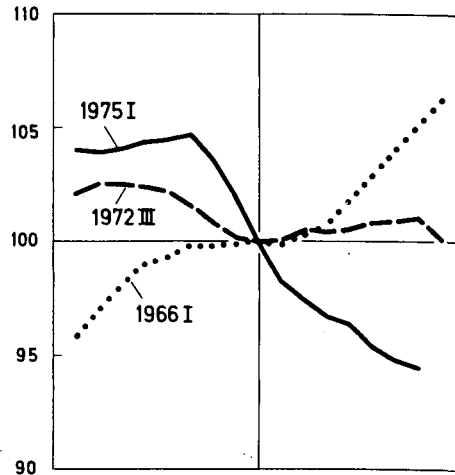
Figure B 2

EMPLOYMENT (INDUSTRY OR MANUFACTURING) IN DIFFERENT CYCLES OF INDUSTRIALIZED COUNTRIES^{a)} (CONTINUED)

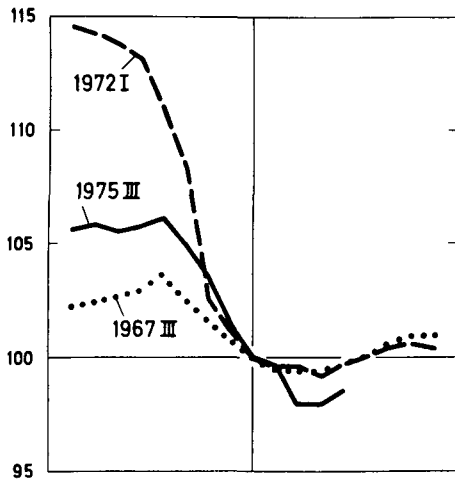
UNITED STATES



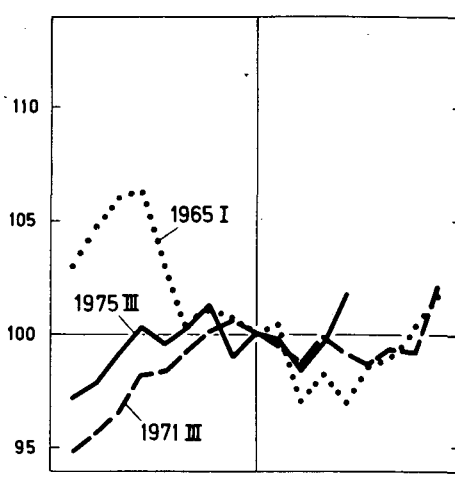
JAPAN



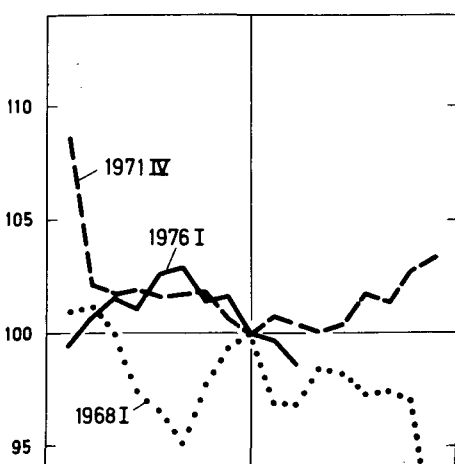
UNITED KINGDOM



ITALY



SWEDEN



^{a)} (continued)

of industrial production from the
long-term trend.

The number of persons employed in each
trough-quarter has the index value 100.

Each line is denoted with the year and
quarter of the corresponding trough (for
example Germany: 1963 I, 1967 II and 1975 II).

Sweden and Japan (still decreasing). Considering that industrial production has just about reached pre-recession levels in most countries and that productivity reserves had still been very high, one could not expect a fast increase of employment until now.

II. Causes of Unemployment

12. Most of the problems of unemployment is due to the coincidence of the following phenomena during the early seventies:

- the acceleration of inflation and the adjustment problems after the unexpectedly crude stabilization policies;
- the increasing need for structural changes in most industrialized countries - also due to drastic exchange rate changes after the collapse of the Bretton Woods system and the quadrupling of the oil price;
- the increasing tendency towards regulations on the labour market, causing a decline of the efficiency of the market mechanism.

Since these factors are very complex and since they are linked together, it is impossible to quantitatively attribute parts of the present unemployment to each of the causes.

a) Cyclical Causes of Unemployment

13. The acceleration of inflation in the early 1970's was brought about by a policy mainly designed to keep up or increase the level of employment: in most industrialized countries, expansionary fiscal policy was combined with easy monetary policy. This proved to be successful, as long as inflation rates were not fully anticipated.

Wage contracts thus included - though not intentionally - a lag of real wages behind productivity gains, so that an increase of employment was possible. But since inflation continuously accelerated, it caused

a fundamental change: money illusion vanished, inflation became more and more anticipated and therefore lost its stimulating effects.

The reversed effects occurred when monetary policy became restrictive in order to reduce the rates of inflation. Unannounced and/or not anticipated policy-changes brought about unintended gains in real wages since actual inflation fell short of expected rates. Consequently, increases of real wages were not compatible with the increases of productivity.

14. On top of this came the 'oil shock' in 1973, or one should rather say, the reaction of economic policy towards the price increase through the OPEC-countries. The increase of the relative price of oil should have been implemented in the wage contracts: because of the deterioration of the terms of trade of industrialized countries, a lower increase or a higher decline of real wages was necessary so that the unavoidable decline in real income was not mainly passed on profits. However, some countries continued for a while in pursuing an inflationary policy, bringing about a reduction of real wages this way.

In other countries - like Germany -, where monetary policy had already been designed to reduce the rates of inflation, real wages increased relative to productivity because of too high inflation expectations. This led to a decline of profits and a large amount of unemployment. Thus, the oil price increase indirectly intensified the 'stabilization crisis', which can basically be attributed to the failure of monetary authorities to announce reliable targets for the growth of the money supply compatible with a reduction of inflation rates and/or the failure of employers and unions to acknowledge such signals when wage contracts were negotiated, and to understand the very meaning of the 'oil shock'.

b) Structural Elements of Unemployment

15. A significant part of the present unemployment is attributed to structural - that is other than cyclical - factors. This means that there will not be enough jobs available to allow for full employment even at full utilization of the existing capital stock.
16. There is a very broad discussion about this factor of unemployment, especially in West Germany, and it is also very controversial, because it is possible theoretically to differentiate whether unemployment is of cyclical or structural nature, however, empirical tests are very difficult. In a recent survey, the IFO-institute, for example, stated that the number of the presently existing jobs would allow almost all of the unemployed to work again, if the overall level of demand would increase sufficiently. A completely different result is given by the 'Sachverständigenrat'¹: they estimated a sizable gap of almost one million (about 3 1/2 percent) between the potential labour force and the number of available jobs. Further, this expert council estimated the loss of jobs since 1973 to 800,000.
17. The hypothesis of 'structural' unemployment is based on the fact, that countries with a long lasting undervaluation of their currency - this is especially the case for Germany - suddenly had to face stronger competition after the rapid exchange rate movements since the end of the 1960's. Some industries, which had profited from the false exchange rate, were now outcompeted, and the jobs in these branches became obsolete.

Another factor - and this concerns most of the industrialized countries - is the increased competition from less developed countries. Since

¹ Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 1976/77: Zeit zum Investieren. Stuttgart, Mainz, December 1976.

the late 60's, they effectuated with growing success their comparative advantage in the production of industrial goods, incorporating mainly standardized production technology, and have increased their share in world trade - in spite of some protectionist policies of industrial countries. Consequently, there is need for more rapid structural adjustments in the industrialized countries. If economic policy is not conducive to structural changes, the jobs in the industries concerned become obsolete without an equivalent increase of job in other areas of the economy. This increases the component of structural unemployment.

c) Microeconomic Aspects of Unemployment

18. Within the labour force there are certain groups whose competitive position (to be defined as nominal productivity in relation to wage-costs) in the market is relatively low. Among these are mainly persons with lower than average qualification levels. This is the case mainly for women and young people. Though it can be observed in most countries, there are large differences: in Italy, for example, in 1975 the unemployment rate of young people under 25 years was about four times as high as the average rate, in France about 2.5 times, in Germany 1.5 times. These rates are even substantially higher for the group under 20 years of age. For women, the respective rates are roughly 1.5 times the average unemployment rate¹.

ca) Unemployment of Women

19. Part of the problem of female unemployment is concealed by the fact that - in spite of an upward trend - there are large fluctuations

¹ For the following description see also: R. Soltwedel, D. Spinanger, Beschäftigungsprobleme in Industriestaaten (Forschungsauftrag der Bundesanstalt für Arbeit), Nürnberg 1976.

of the participation rates of women. As the rate usually declines in recessions, unemployment only increases at a lower rate, so that the problem is incorrectly estimated. However, during recoveries the participation rate increases once again, causing - at least in the short-run - higher search unemployment, because of the relatively long time for women to find a job. This is the case - during the present recovery - notably in Germany and Belgium, but also in most other countries.

20. The relatively high medium-run unemployment rate for women may be explained by several factors:
- because of the lack of mobility (dependence on children or on the husband's job location) many women have to restrict their job search activities to a limited area;
 - many women prefer - due to the constraints mentioned above - part-time jobs, the supply of which is very sensitive to cyclical fluctuations;
 - because women - on the average - have qualifications inferior to those of men, they may get jobs with lower qualification standards, which are usually the first ones hit by structural changes, for example by rationalization efforts of firms;
 - because the expected working life of women is relatively short and often interrupted (for example by pregnancies or household reasons), firms cannot be sure that investment in on-the-job training will be compensated in the future by big enough returns.

The unemployment risk is even bigger because of the upward trend of participation rates in recent years.

21. These factors would not necessarily have a negative influence on the competitive position of women in the labour market, if the wage structure had the necessary flexibility. This is not the case, however,

because the attempts to equalize wages between men and women in many countries - though they are to be seen under the desirable intention of social equality - unfortunately endanger the employment chances of women. In light of all these influences it is not surprising that minimum wage laws and higher than average wage increases for low wage groups lead to particularly high unemployment of female workers. This is evident in most industrial countries. In France (where statistics about wages for equal qualification are available) one could observe until 1965, that the labour market even absorbed a higher-than-average increase of the female labour force. This was a period when the gap between wages for men and women increased. After 1968, however, the trend reversed: minimum wages rose relative to average wages, resulting in an increase of the unemployment rate of women.

In the United States, as another example, the unemployment risk of white women increased: the large increase of the labour force of this group was accompanied by a strong advance of income relative to that of men.

cb) Youth Unemployment

22. Higher than average rates of unemployment for young people in practically all countries is the evidence of the fact that they have a relatively weak competitive position in the labour market. The main reason for this is, that in the short-run the costs of vocational or on-the-job training exceed by far the receipts of the firms resulting from their work. This is due to a large extent by high training standards set by the state on the one hand and by fixed minimum wage levels on the other.

The fact that job-relevant training actually does reduce the unemployment risk, can be illustrated by the fact that the unemployment rates for young people without any vocational training (even with a

relatively high level school-leaving-certificate) are substantially higher than those of young people who have finished vocational schools. For example, in France (according to a sample in 1972), the unemployment rate for males under 25 years was 1.6 times, of females 4.4 times the average rate for those, who had finished vocational schools. For those without any training, the respective rates are 3.9 and 6.1 times the average rate of unemployment. In Germany the respective unemployment rates were even below average for young people with completed vocational training.

23. The problem of youth unemployment becomes more pronounced in cyclical downturns - this was also the case in the 1974/75 recession - when the propensity to invest in human capital declines parallel to the investment in fixed capital. Unemployment rates of young people rise in comparison to the average rate of unemployment¹.
24. In some countries, the employment problems of young people are increased by still other interventions in the labour market, for example by the protection of people already on the job or older workers. This is especially true for Japan and Sweden, but also for Germany and Italy. Further, minimum wage laws existing practically in all countries, but very strictly pursued in the United States, mainly reduce the demand for those workers with the lowest human capital standards. In the United States, this is mainly the case for black youths.

cc) Unemployment through Regulations

25. The problems of unemployment - described here for the groups of women and of young people - suggest that the risk of unemployment is generally increased by factors which are not resulting from

¹ Except for the case that the labour force of young people declines sharply, because they give up searching for a job (see, for example, in the United States during the last recession).

solutions of a competitive market, but rather introduced by collective bargaining or government policy. These hindrances can be summarized as follows:

- minimum wage laws affecting workers whose competitive position is often rather weak (young, female, old, black, less educated, immobile persons);
- market regulations like legal hindrances for (national and international) migration of labour, protection of specific groups already having a job or general protection against firing (Japan, Sweden, Germany, Italy);
- lack of flexibility of wages (low wage differentials between regions of a country or sectors of the economy);
- social security system reducing efforts to actively seek a job and/or enabling to search longer, because of lower opportunity costs of being unemployed.

26. In general, the increasing number of such regulations over the past years has contributed a great deal to the tendency of higher unemployment. Though these factors are always at work, they aggravate the problem of unemployment in the case of large downturns of economic activity. Only during an upswing period there is the 'wage drift' creating the necessary differentials to some extent.

III. Cures of the Unemployment Problem¹

a) More Expansionary Policy to Speed up the Recovery?

27. One of the suggestions made to reduce unemployment rates is more stimulation of economic activity through demand management. Because

¹ For the following description see also: Wege zur Überwindung der Arbeitslosigkeit. Beiträge zu einer Vortragsveranstaltung des Instituts für Weltwirtschaft. Kiel, January 1977.

of aiming at quick successes, the OECD, the Carter Administration and unions (in Germany or other countries) advocate these policies to be pursued again. But the experience of the beginning 70's showed that this policy would only be effective - if at all - in the short-run. As soon as expansionary fiscal policy combined with easy monetary policy is translated by economic units into inflationary expectations, this strategy has negative returns to scale, i. e. fighting acceleration of inflation would soon be on the agenda, with all the risks and negative consequences of a stabilization crisis experienced in the course of the last recession.

b) Fewer Working Hours to Increase Employment?

28. In many countries there is an ongoing discussion whether the work time should be reduced in order to absorb the people unemployed, either through a reduction of the average weekly worktime or of overtime or through an extension of vacation. Though the goal to increase leisure time is part of wage contracts most of the time, this measure has been introduced in Austria with the explicit aim to reduce unemployment.
29. In order to avoid an increase in unit labour costs (which would have a negative impact on employment), it would be necessary to reduce real wages if the average working time is reduced. Whether people are willing to exchange more free time for real income would have to be subject of negotiations between unions and employees.
30. There is considerable doubt whether a reduction of the average workweek would actually result in a significant increase of employment since it might well be compensated for to large extent by an increase of productivity or - if individual workers do not accept a cut of real income - by an increase of overtime. Also, already at present there is a lack of workers with special professional skills

in some areas. This problem would even be aggravated, if the average work time was reduced. Altogether, it may well be over-estimated how many 'new jobs' will become available through such a measure.

31. The long-term consequences of a strategy like this are even more doubtful:

- because the imposed regulation of lower real wages does not reduce unit labour costs. Because it does not increase investment incentives of firms, it is not conducive to more long-term growth of capacity potential and the creation of new jobs;
- because it would almost be impossible to increase the legal working-hours again, if labour becomes scarce in the long-run; this could become relevant in the 1980's, when the increase of the labour force will slow down substantially after expiring of the impact of the baby-boom.

A reduction of the working-hours - unless it is desired by employees and unless it would really be compensated by more free time in exchange for working-time - would be no solution of the unemployment-problem.

c) Subsidies for Employment?

32. Another measure suggested and already performed in a few countries is a strategy following the 'Swedish Model' of subsidies. The government is paying marginal employment premiums to firms if they hold up or increase their work force. This policy is supposed to raise employment and at the same time reduce inflationary pressures for mainly two reasons:

- there are negative marginal costs of hiring workers, so that unit production costs are reduced;

- the increase of the fiscal deficit is comparatively small, because on the one hand the premiums paid are usually smaller than unemployment insurance expenses, and on the other hand total tax revenues are larger than they would be, if the people became unemployed and did therefore not pay any taxes.

33. However, there are several objections to be made against this model:

- it would reduce the flexibility of real wages and therefore have a negative impact on economic growth, because it hinders or at least procrastinates necessary structural adjustments. There would be less reason for firms to raise the productivity through, for example, rationalization;
- unemployment in a sector or a firm can also be the result of increased competition. The government would have to commit itself to keeping up an industry which is no longer competitive in the world market. This is, however, a kind of protectionist policy, which would prevent imports from, for example, low-wage countries. Thus, national employment would be increased at the cost of unemployment somewhere else;
- it may imply substantial costs of administration.

d) The Case for Market Solutions

34. The three strategies described above imply: more regulations and therefore more costs of bureaucracy; less mobility of workers (regional and vocational); less flexibility of wages; less productivity; more inflationary pressures; less incentives for structural adjustments. These factors are likely to bring about lower long-term growth rates. It illustrates that these policies of fighting unemployment cannot be pursued without deviations from other economic targets, which are on the agenda as well. Also, the deviations from the growth target or the target of price stability have adverse long-term effects on unemployment as well.

35. A successful strategy would rather have to be implemented into a solution assigning policy instruments to policy targets in a way that an optimal combination can be achieved. As far as the target of minimum involuntary unemployment is concerned (the whole strategy is described in Part D), the elements of the policy to be pursued should be:

da) Creating Jobs through Increasing Productive Capacity

36. Because of the recession in most industrialized countries the stock of capital, which is still economically useful, is too small to provide jobs for all who want to work at the currently expected real income. Investment in capital should therefore be the present priority, which will be productive in creating new jobs and thus contribute to the solution of the unemployment problem. }
37. What governments can do in this respect is to induce private investment through a permanent tax cut or more depreciation allowances for firms. This would contribute to cover the higher risk of investment and to overcome the shortage of capital. Also, governments should increase their own investment expenditures - mainly as a shift away from government consumption. This is, however, not to be understood as a short-run stimulation of economic activity but rather a long-run contribution to economic growth. A strategy like this has been suggested for West Germany¹.
- db) Reducing the Relative Price of Labour !
38. The key element conducive to more private investment and thus a higher level of employment is to reduce the price of labour relative to that of capital. Therefore, the responsibility for employment

¹ The program has been described as 'Wachstumspolitische Vorsorge' in: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 1976/77. Stuttgart, Mainz, December 1976.

rests on those who make decisions about the level of wages:

⇒ employers and unions. A necessary condition for an increase of employment is that the gain in real wages falls below the distributable increase in productivity.

39. The main consequences of this strategy will be

- that existing jobs which are less productive will become competitive again;
- that more investment will occur for the reason of expanding the capital stock rather than of rationalization;
- that it will help - together with a contribution from the government - to share the burden of the higher risk of innovation in connection with the creation of new jobs.

40. It should be possible for people having a job to show this kind of solidarity with the unemployed, instead of 'protecting' themselves through higher wage increases and leaving many workers outside. If monetary policy is geared to the reduction of inflation rates, they will not have to fear that their retention will be disappointed, but their negotiated real income will indeed materialize.

dc) Increase Wage Rate Flexibility

41. Not only more flexibility of wage levels is a means conducive to solve the unemployment problem but also more flexibility within the wage structure. Relative wages should be allowed to adjust in such a way that higher than average increases are paid for those meeting a higher demand, and gains below average are paid when there is a surplus in the supply of labour. This would imply regional as well as sectoral differences of wage contracts, but also the abolishment of the institution of minimum wages.

Consequently, the risks of several groups to become unemployed (see Chapter II c) would decline, because the wage structure would

be allowed to adjust to the structure of productivity. This would promote the equalization of the competitive position of all groups.

dd) Encourage Labour Mobility

42. Since it is not possible to forecast exactly in which regions and in which sectors new jobs will be created, it is necessary that workers are flexible enough to adjust to new situations. Therefore, there is a need for assistance to those people who have to move in order to get the job that suits them. Furthermore, educational and vocational training should be offered to those who cannot find a position in that field they had originally been employed in.
43. Some of the suggestions made in this section are being pursued in a few countries, however, one should not expect quick successes. Social groups, especially governments and unions, have to show patience rather than search for short-lived "solutions". The achievement of full employment is only possible in the medium-run because firstly, in order to avoid a rekindling of inflation, the recovery will have to be moderate. This means only a gradual increase of the utilization of the production potential. Secondly, structural changes to adjust to new demand and supply conditions take a longer time, especially since they have been to a large extent delayed in recent years.

C. Weakness of Investment Activity

I. Sluggish Investment Demand since 1975

1. One of the characteristic features of the current upswing in nearly all industrial countries has not only been the low level of demand for fixed investment but also its slow recovery. As a matter of fact the upturn of investment activity since the trough of the business cycle in 1975 has been weaker than in all post-war recoveries (Figure C 1).

In order to illustrate the difference between the course of real investment during various cycles, the volume of total investment for every cycle is transformed into an index and shown in Figure C 1. The respective base year is determined by the lower turning point of the business cycle, measured in terms of the utilization rate of overall capacity. For every major cycle, investment activity is shown for the two years before and after the trough.

2. Although common to all industrial countries, the weakness of investment activity is in some countries more pronounced than in others:
 - The most disappointing development of investment has been experienced in the United Kingdom, the Netherlands, Belgium and Switzerland. In these countries, investment activity did not increase at all in 1976, i. e. in the first year after the trough; in some of them a further - though slight - decrease is estimated for the second year. Even if total investment for 1977 should turn out to be higher than assumed at the beginning of the year, the course of investment spending during the present upswing will differ considerably from that one of the late fifties which also developed after a marked decline of investment. Italy is the major exception, where it was the recession of 1964/65 which led to the severest contraction of investment demand. However, even

at that time a greater part of the decline than now had already been compensated in the ensuing upswing.

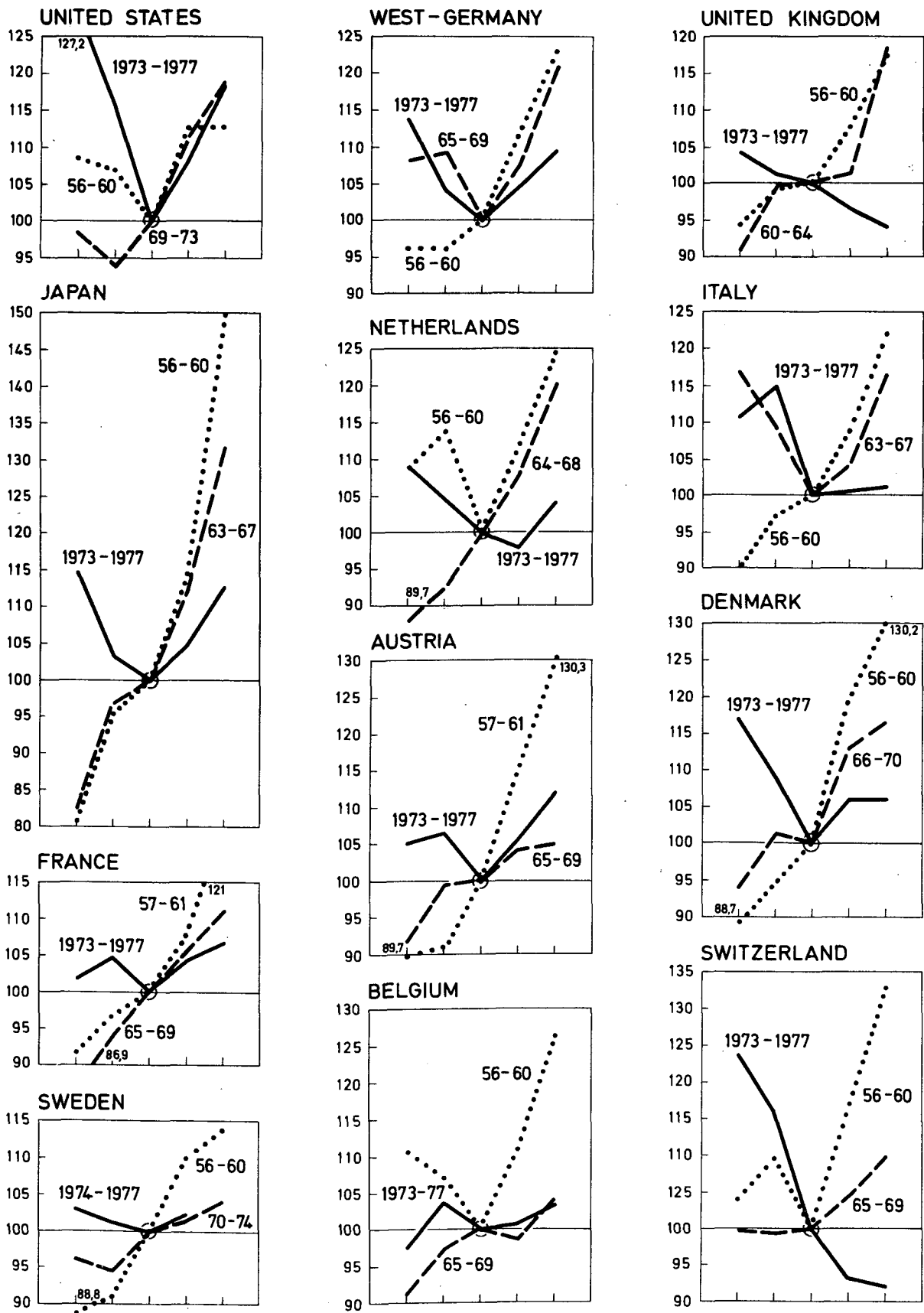
- In the United States, Japan, Germany, France, Italy, Austria, Sweden and Denmark, investment activity has risen since the beginning of the upswing, but mostly at a slower pace than in comparable phases of previous cycles. Even in the United States where investment demand has recovered comparatively fast, the pre-recession level of investment will not be reached after the two years' upswing as it was the case during the cycles 1956/60 and 1968/72. In some European countries - Austria and Belgium -, the increase of investment is, indeed, more pronounced than at the same stage of previous cycles. But those were cycles which did not see a decline during the downswing phase - consequently, investment demand faltered in those cycles rather early after the trough, defined as the lowest utilization rate of overall capacity.

3. In nearly all countries, investment in construction has been weaker than investment in machinery and equipment (Table C 1). The United States are the major exception where housing has expanded more rapidly; Belgium and the Netherlands seem to be the only European countries, where a similar constellation prevails. In all other countries, particularly in Germany, Austria and Italy, investment in construction has developed rather slowly or even declined.

Since specific information about the demand for structures is not available for all countries, the data for machinery and equipment were subtracted from those for total investment in order to get a rough idea of the development of economic activity in this section (Table C 1). Each series was measured as an index, for which the base is given by the year of a business cycle trough. A positive sign indicates that the recovery of construction is stronger than in the other parts of investment. The calculations cover also the business cycles in the late fifties. Table C 1 shows that the demand for

Figure C 1

INVESTMENT ACTIVITY OF INDUSTRIALIZED COUNTRIES IN DIFFERENT CYCLES^a



^a Total real fixed investment equals 100 in the year of a business cycle trough.

construction, mainly for housing picked up very quickly and strongly after every trough in the United States whereas such a pattern cannot be found for Europe.

Table C 1 - Development of Investment in Construction for Several Countries
1956-1960 and 1973-1977^a

	1956	1957	1958	1959	1960	1973	1974	1975	1976	1977
United States	-5.8	-9.8	0.0	1.6	-1.8	12.6	-0.1	0.0	4.7	11.6
Germany	-0.6	-5.1	0.0	5.6	4.0	6.4	4.7	0.0	-2.1	-4.8
France	0.5	-2.1	0.0	-7.7	-10.8	-4.2	-3.6	0.0	-0.5	-0.5
Italy	-10.8	-8.4	0.0	-1.3	-13.6	-1.5	-6.6	0.0	-2.8	-3.0
United Kingdom	3.1	0.1	0.0	2.6	3.4	-6.0	-7.3	0.0	0.5	-3.8
Austria	-	-2.4	-2.4	0.0	-2.8	-2.7	-2.3	0.0	-4.5	-4.0
Netherlands	-7.8	-10.4	0.0	-1.0	-9.6	7.6	0.0	0.0	5.0	-2.0
Belgium	-	-	-	-	-	4.5	-1.5	0.0	1.6	0.7
Switzerland	3.8	-0.2	0.0	6.7	8.1	4.1	-3.1	0.0	-2.0	-2.9

^a Difference between the data for total investment and for machinery and equipment - each measured as an index. Base years are the years of a business cycle trough (1958, 1975).

- The employment effect of total fixed investment has diminished in recent years, although the data do not permit an exact calculation. But the additional labour which could be hired after the implementation of one unit of new capital must be much smaller because of the increasing portion of social capital in total new capital which is designed to improve the infrastructure and the quality of life. In addition to that, a greater part of investment is assigned to the purpose of rationalization and replacement. In Germany, for instance, about 55 % of total industrial investment in 1962 was induced by the motivation to rationalize and to replace according to the investment

survey of the Ifo-Institut, whereas in 1976 this portion climbed up to 77 %.

II. Causes for the Weakness of Investment Demand

5. The fact that the demand for capital goods is weak in all western countries seems to suggest common causes. Perhaps the most important one is the synchronized, inflationary boom of 1972/73 and the way in which economic policy and economic units of all countries reacted during the following years. Consequently, the expectations of net return on investment no doubt fell considerably. The expectations have not only been influenced by the experience in respect to wages, prices, interest rates and sales but in some countries also by the fear that left-wing parties may alter the socio-political situation fundamentally and nationalize private capital. }

a) Low Level of Profits after the 'Stabilization-Crisis'

6. During the recession of 1974/75 profits fell to an unusually low level which has been too small a basis for a rapid recovery of investment. The profit squeeze was due to the cyclical phenomenon of the 'stabilization-crisis' of 1973-75, and to structural changes of supply and demand which are not easily to separate:
- The 'stabilization-crisis' was mainly characterized by the worsening of the terms of trade of firms: Whereas the input prices continued for some time to rise rather steeply, the upward movement of the output prices was dampened by monetary restraint which was initiated sooner or later almost everywhere. The housing sector was hit the most by the unexpected and decisive change of monetary policy. Moreover, the profit squeeze was intensified by the fact that depreciation charges as well as inventory accounting was mostly based on historical values instead of replacement values. Since the latter have rapidly

Figure C 2

INVESTMENT AND LABOUR INCOME IN MAJOR COUNTRIES 1956 - 1977

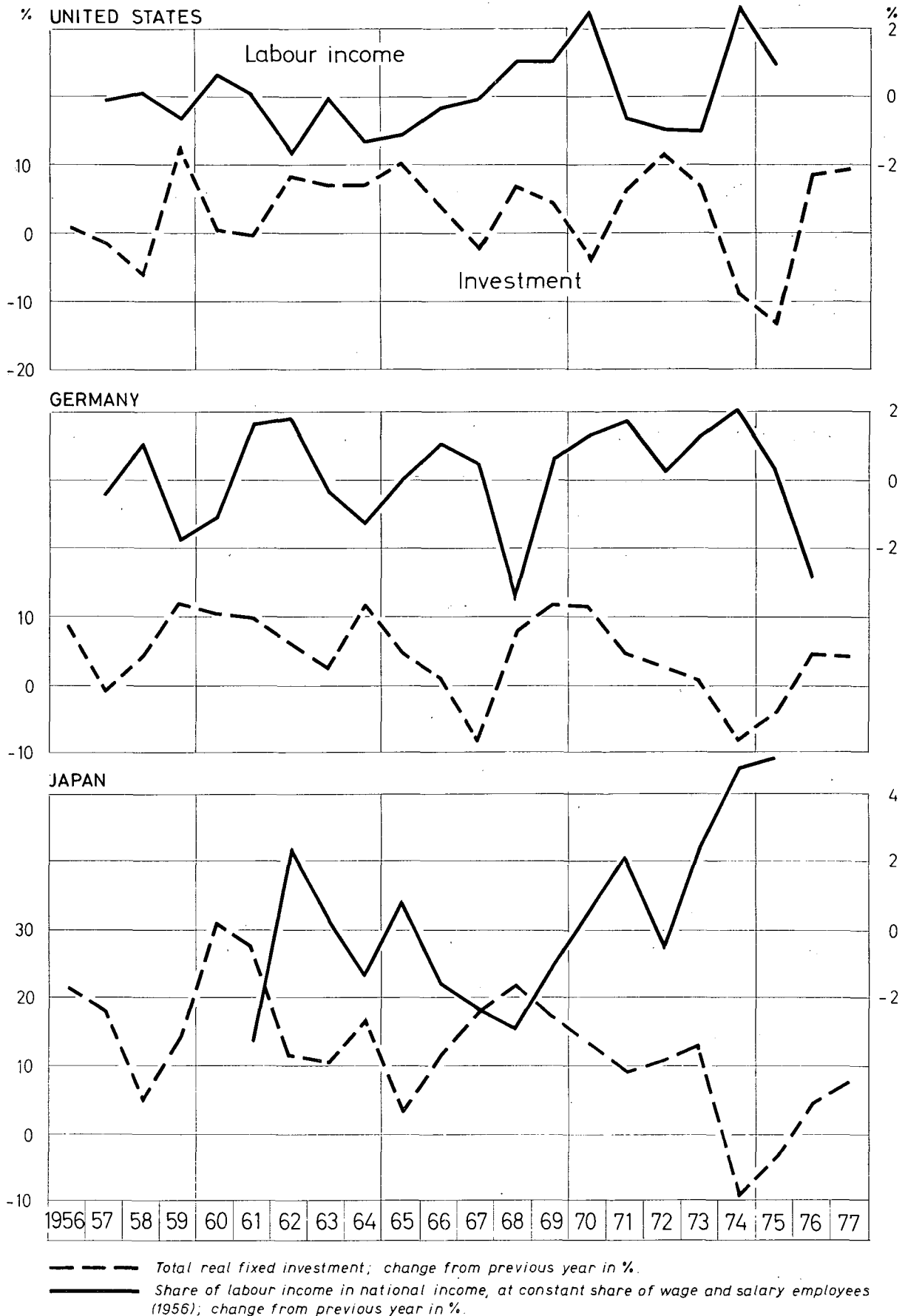
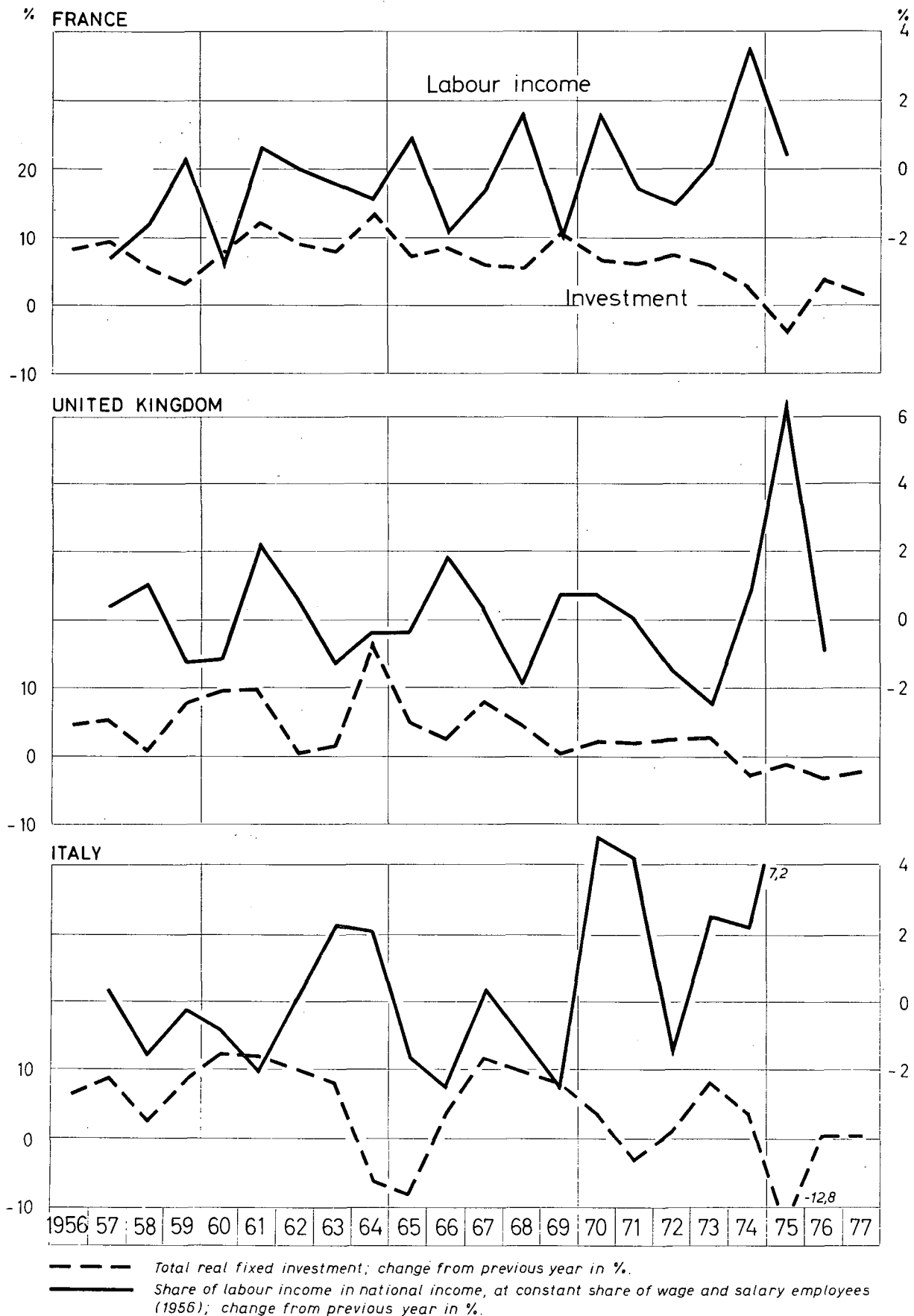


Figure C 2

INVESTMENT AND LABOUR INCOME IN MAJOR COUNTRIES 1956-1977



increased in the last years, only nominal profits were large.

Hence, taxes were too high in relation to real profits.

- As a consequence of the profit squeeze, firms dismissed workers or went bankrupt. The ensuing fall in income and employment induced further declines of economic activity at home and via the transmission of international trade also in other countries, causing sales' expectations to deteriorate even more.
 - The bad profit position was aggravated in the course of major structural changes: the huge rise in the price for energy as well as the intensified application of environmental protection regulations increased the obsolescence of parts of the existing capital stock. Capital became scarce relative to labour, a development which called for some downward adjustment of real wages in relation to real profits. Since nominal wages were rather sticky and the monetary authorities restricted the expansion of money supply, profits were even more depressed.
7. The alleged importance of profits for investment shall be demonstrated for some major countries. Being a major cost item, labour income influences largely the profit situation and investment demand. It is supposed that an increase of wages and salaries depressed the propensity to invest if it is not possible to neutralize this effect either by raising prices and the rate of productivity or by dismissing the workers who are overpaid. The negative effect on investment will be the more pronounced the higher the share of labour income in national income has already been.

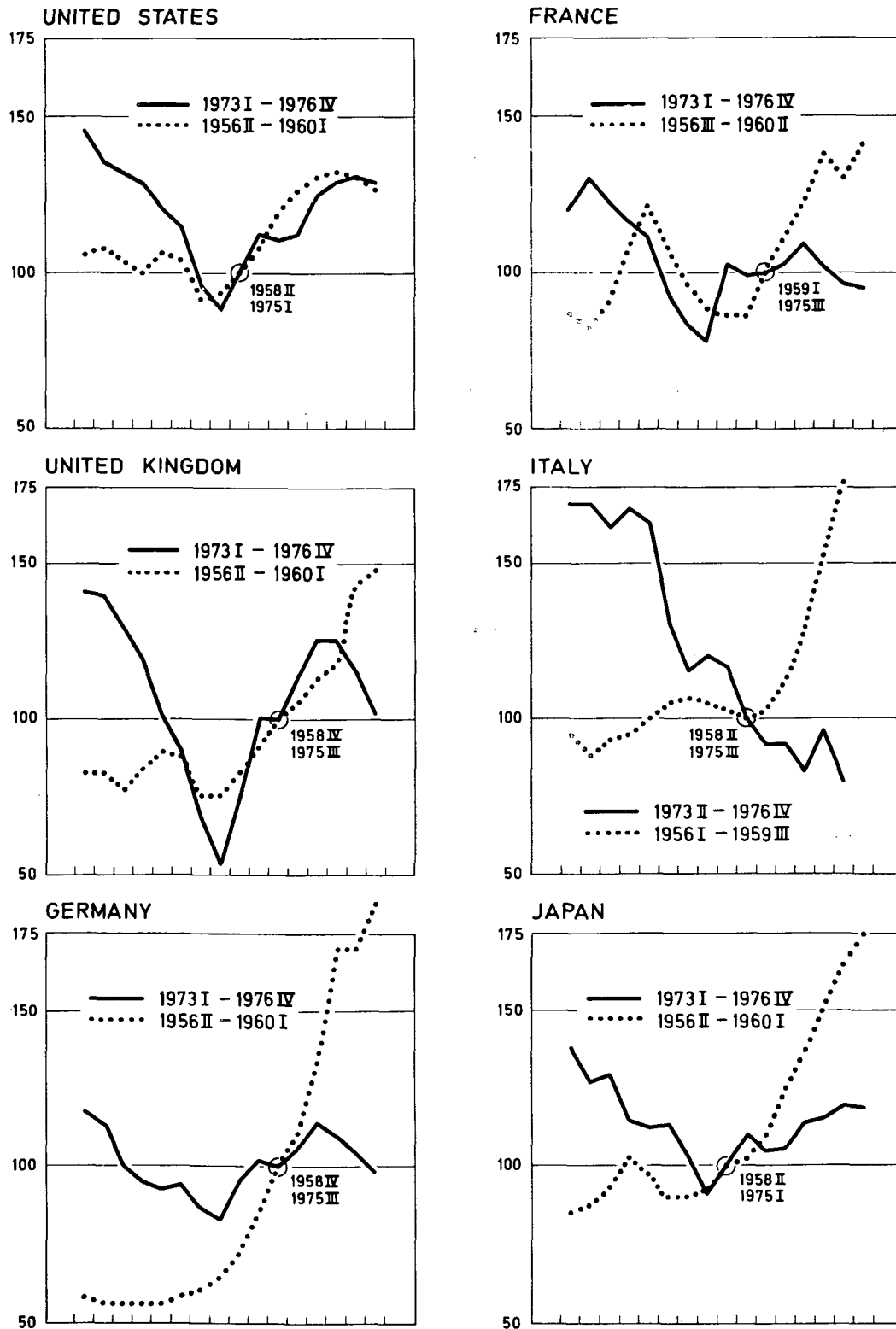
As a matter of fact, the suggested inverse relationship between investment demand and the share of labour income in national income is clearly shown for the United States, Germany and Japan (Figure C 2). In Germany and Japan, the persistent increase of the share of labour income since 1968 would seem to have contributed much to

the weakness of investment demand in the early seventies. In the United States, however, the decrease of the share in 1972 and 1973 may have favoured not only the investment upswing at that time but also the recovery in 1976 which is more pronounced than in all other countries. The decrease of the share in the two consecutive years 1972 and 1973 may have prevented too high a level of labour income in relation to profits which would have depressed investment. In the United Kingdom, France and Italy, the inverse relationship between the change of investment and the change of profits did not exist as clearly as in the countries mentioned above. This is partly due to the poor statistics which do not even allow of some more refinement in the analysis (profits after and before taxes, for instance), but partly also due to other factors than profit which influence investment activity. France and Italy are comparatively "young" industrialized countries in which a sufficient high return on capital can be expected for the medium run, whereas the United Kingdom is one of the "oldest" in which the prospects have been dampened systematically by the "stop-and-go-policy" during the sixties.

8. The level of profits has not only been very low at the bottom of the recession but has in general risen up to now only gradually; the fear that the profit situation would deteriorate further has vanished only slowly. The persistence of the low profit level is well demonstrated by the fact that the number of business failures has increased until quite recently as well as by the rather bearish performance of the stock-exchange. The share prices have gone up hesitantly in all major countries as well as in the smaller countries (Figure C 3). Some setback has occurred even in the United States and Germany, where the stock prices have risen markedly and well before the trough of the recession, measured as the lowest rate of capacity utilization in industry. The performance of the stock markets in all countries suggests that the prospects for profits have not been considered very good and that mostly it might not have been a

Figure C 3

SHARE PRICES OF MAJOR COUNTRIES IN DIFFERENT CYCLES^a



^a The index of share prices has the value 100 in that quarter in which the utilization rate in manufacturing is the lowest.

favourable time for lowering the ratio of debt to equity in corporate balance sheets. In Europe, the recent development of share prices has been disappointing both in comparison to the United States and to the late fifties and early sixties.

b) Higher Risks as an Impediment for an Early Upswing of Investment

9. The rather long delay of the recovery of investment activity may also be due to the fact that investors try to attain profit-standards which are now somewhat higher than a few years ago: a higher return and a shorter pay-off period may now be considered as necessary to compensate for an increase of risks. The risks which may not be equally felt by all investors reflect mainly the fear that the course of economic policy and economic activity would not be well established and sustained:
- The investors fear a rekindling of inflation entailing very soon the next recession - or, even in contrast to that, they expect the government to pursue a policy of only a moderate expansion of demand. In both worlds, sales would not rise for an extended period and not very much. Hence, they are not induced to widen the capital stock on a large scale as long as overcapacity exists in many industries.
 - The firms expect a new upsurge of wage claims very soon. This expectation is based on the experience of recent years in which it was only possible by incomes policy and very high unemployment rates to dampen real wages. A retention of wage claims was mostly overdue in view of the fact that the terms of trade of all industrial countries had deteriorated very much since the end of 1973.
 - The entrepreneurs fear that the lenders of capital would restrict business policy and raise the costs for credit more sharply and promptly in all those countries in which the monetary authorities

do not any longer pursue a highly permissive policy. This fear is based on the experience of the last years when they were heavily indebted and not free to take their own decisions. Hence, the entrepreneurs try to lessen the burden of external debt and are not ready to engage in new credits on a large scale. Real interest rates do not seem to have fallen sufficiently to overcome the lethargy of investors which is particularly valid for housing.

10. Besides these risks of a more cyclical nature there are those due to major structural changes. The shift of relative prices during the last years has intensified the search for new products, techniques and locations. Since this process needs some time and the old production lines have become economically obsolete, the net result is a flat development of investment activity. This is well demonstrated by the two following cases:

- Whereas the profitability of investment in the automobile industry of the industrialized countries is widely held not to be very high for the medium run, although the boom in this industry since 1975 has pushed up the profits, it has recently been made more difficult to calculate the profitability of investment projects in energy-related industries, i. e. in those industries which are regarded as the leading ones: the public has become much more sensitive to factors affecting the quality of life which may result in a delay of investment decisions and an increase of the costs of new capital.
- In Germany, Belgium, the Netherlands and perhaps in Switzerland, too, the revaluation of the currencies have induced the firms to shift their investment activities from the respective home country to foreign countries. For Germany, this tendency is clearly to be seen in the increased outflow of capital for direct investment. This diversion of investment funds may have been intensified by the fact that some less developed countries have become more attractive for investors in the last years. In those countries, however, which

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have increased their competitiveness by large devaluations of their currencies and for which an export-led upswing of investment could have been expected, the propensity to invest has been dampened by the fear that the return on capital may be diminished substantially: the fear is based on the expectation that left-wing parties will come into power and introduce some form of co-determination or even socialize private capital.

III. Policies Adopted to Stimulate Investment Activity

11. In all industrial countries, global as well as selective measures have been taken since 1975 to stimulate private investment. Outstanding examples of the selective incentives are the investment tax credit in the United States, the temporary investment subsidy in Germany, the acceleration of depreciation allowances in France and Denmark and the release of funds for investment purposes in Sweden and Switzerland. The policy to encourage investment which is pursued by monetary and fiscal authorities in all countries may be characterized in the following way:

- firstly, the measures have been taken step by step. The basic idea was to prop up investment demand without rekindling inflationary expectations, widening the public deficit too much or worsening the external balance;
- secondly, the measures have been mostly part of greater programs. This holds true not only for 'strong' countries but also for 'weak' countries which tried to pursue a less expansionary course in general. In the latter countries tax relief for firms, particularly for small and medium-sized enterprises, as well as government loans at subsidized rates have been granted; credits to investors have been exempted from credit controls.

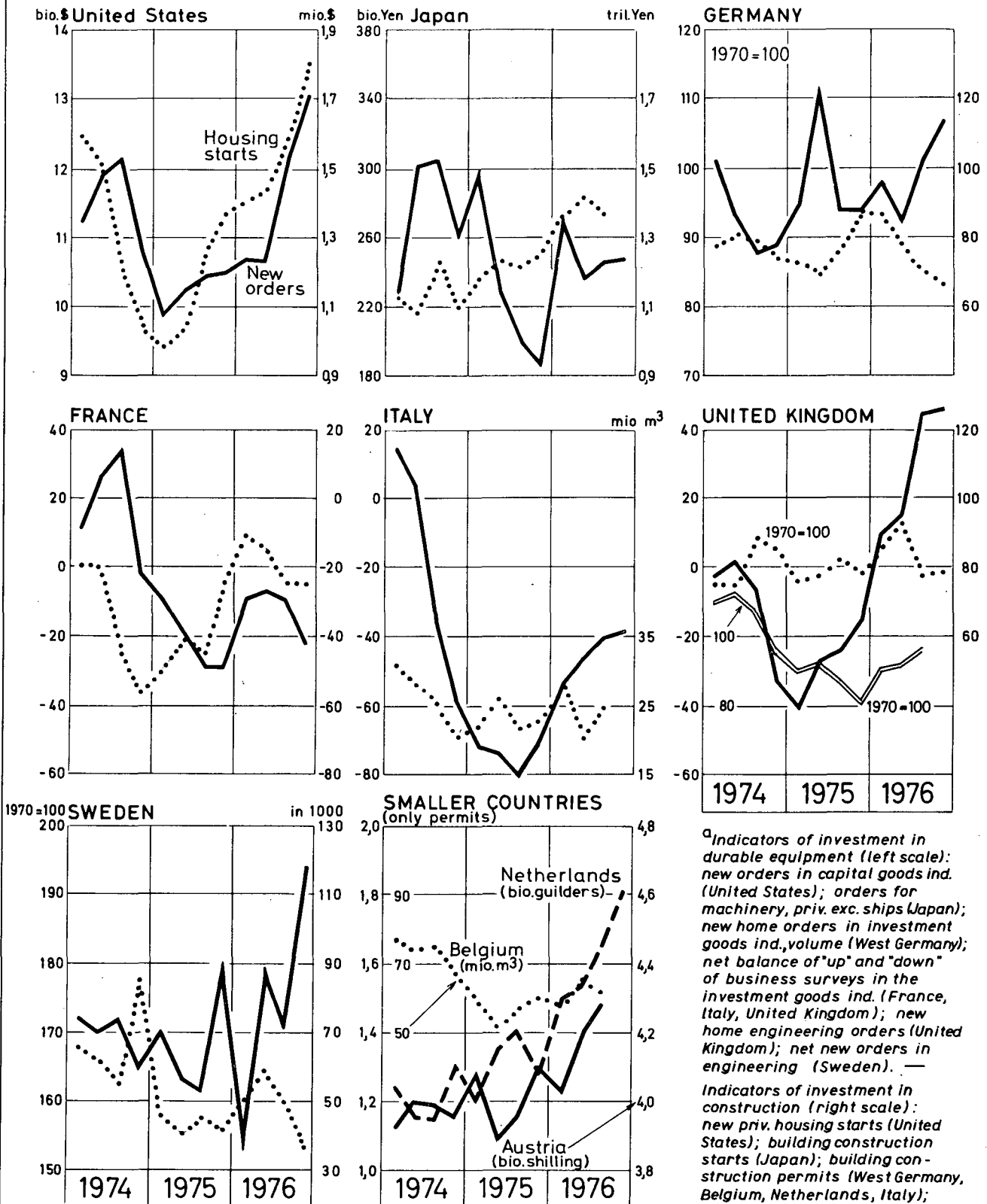
12. The policy measures have brought about the turnaround of investment demand and shortened the delay which otherwise would have taken place because of all the dampening factors mentioned above. However, by their very nature, the measures have not brought about a steady upswing: since they were mostly terminated, at least initially, and since the prospects for the medium term had not improved very much, the investors were induced to realize many of those projects which otherwise would have been undertaken at a later date. Hence, investment demand in Germany and France have moved in a zig-zag-line (Figure C 4). The more technical setback has sometimes been interpreted as a more general setback, indeed. But it was overlooked that the stock of orders has risen, thereby improving the business climate. Thus, the more recent incentives will be more successful than those of the earlier programs. Moreover, the increase of public investment as well as the official support of private research projects in Germany and France for instance are of special interest because these measures will help to raise the productivity of private capital even in the longer run.

13. The demand for machinery and equipment, measured by new orders or indicated by business surveys, has recently picked up in some countries thus fore-shadowing a further upturn of investment activity in the coming months (Figure C 4). Although the statistics should be read very carefully, the countries can be classified into the following groups:

- In the United States and Germany, there is now a solid basis for a further increase of investment demand both through the policies pursued and the profit situation already achieved. As to the performance of leading indicators, the United Kingdom and Sweden may fit into this group as well.

Figure C 4

LEADING INDICATORS OF INVESTMENT IN DURABLE EQUIPMENT (—) AND IN CONSTRUCTION (.....)^a



^a Indicators of investment in durable equipment (left scale): new orders in capital goods ind. (United States); orders for machinery, priv. exc. ships (Japan); new home orders in investment goods ind., volume (West Germany); net balance of "up" and "down" of business surveys in the investment goods ind. (France, Italy, United Kingdom); new home engineering orders (United Kingdom); net new orders in engineering (Sweden). — Indicators of investment in construction (right scale): new priv. housing starts (United States); building construction starts (Japan); building construction permits (West Germany, Belgium, Netherlands, Italy); work put in place (France, Austria); new orders for construction (United Kingdom); dwellings in progress (Sweden).

- In France and Japan, investment demand will start to rise in the coming months. This view is supported by the recent programs to encourage investment and the improvement of the profit situation, which has been particularly strong in Japan. In Italy, however, the upturn of investment will lose some of its momentum in the course of 1977.

14. The prospects for investment in construction, as indicated by permits and housing starts, are generally not as favourable as for machinery and equipment. The main causes are that this type of investment has been less supported by governments and that many firms, engaged in building and selling houses on a large scale, have gone bankrupt in recent years.

A rather strong upturn of investment in construction can be expected for the United States, Netherlands, Japan and Austria, whereas in the United Kingdom and perhaps in Switzerland, too, there will be a decline. In all other countries, the upturn will be rather mediocre.

15. Investment demand will accelerate somewhat in the months to come as it was the case in all upswing periods up to now. But the hindrances discussed above do not support the view that this process of self-inducing investment will be very strong. A fundamental change to a more normal course of investment is to be expected after money illusion has vanished and economic policy has abandoned the "stop-and go-cycle". This change implies a smoothening of the investment cycle by preventing too strong a recovery at the beginning and too strong a decline at the end of the cycle. This view holds also true for the inventory cycle which is very difficult to analyze because of the lack of reliable statistics.

D. The Case for New Strategies of Economic Policy

1. Extremely high unemployment in nearly every country and a weak propensity to invest - i. e. too low capacity growth - are the most urgent, but not the only problems for economic policy makers this year. Rather, they also have to fight inflation, to reduce the balance of payments disequilibria and besides that to keep budget deficits under control.

Obviously, economic policy authorities are expected to solve these problems simultaneously. Given this complex task, we shall argue in this section,

- that conventional demand management methods cannot be applied as a multi-purpose weapon for fighting unemployment as well as inflation and external imbalances: expansionary monetary and fiscal measures for fighting unemployment run the risk of higher inflation; austerity measures for improving the balance of payments worsen the employment situation;
- that, instead of this, a rational policy mix must be implemented including flexible exchange rates and a definite assignment of monetary, wage and fiscal policy to the price, employment and growth target, respectively;
- that such a strategy for stable expansion has not been fully realized in economic policy up to now: while a number of so-called strong countries have implemented a steadier policy stance with some success, many so-called weak countries have again experienced the disadvantages of stop-and-go measures;
- that international co-ordination of economic policy therefore should be designed as an attempt not for preserving but for eliminating international structural imbalances.

Table D 1: Unemployment, Inflation and Current Balances in Selected Countries 1960 - 1976

	Unemployment Rates				Inflation Rates ¹				Current Balance ²			
	average 1960-69	average 1970-74	1975	1976	average 1960-69	average 1970-74	1975	1976	average 1960-69	average 1970-74	1975	1976
United States	4.8	5.4	8.5	7.7	2.3	6.1	9.1	5.7	1.97	-3.54	11.70	-0.6
Japan	1.0	1.3	1.9	2.0	5.5	10.9	11.8	9.2	11.44 ³	616.80	-210.70	+3699
Austria	2.8	1.9	2.0	2.0	3.3	6.5	8.5	7.3	-0.90	-4.68	-5.44	-27.10
Belgium	3.5	3.4	6.7	8.5 ^e	2.7	6.7	12.7	9.2	2.14 ³	41.80	24.90	-12.40
Denmark	3.5	3.6	11.1	9.0 ^e	5.3	8.6	9.9	8.9	-1.34	-3.21	-3.07	-11.50
France	1.4 ⁴	2.0	3.9	4.2	3.9	7.5	11.7	9.7	0.70 ^e	-5.40	-0.29	-27.50
Germany	1.1	1.3	4.7	4.6	2.5	5.6	6.0	4.5	3.15	9.07	9.48	7.50
Italy	3.4	3.3	3.3	3.7	3.7	9.1	17.0	16.7	734.90	-813.20	-361.00	-2380.0
Netherlands	1.2	2.3	4.8	5.2 ^e	4.2	9.4	10.2	8.9	0.18	2.71	4.20	6.40
Sweden	1.6 ⁴	2.6	1.6	1.6	3.7	7.6	9.7	10.4	n.a.	0.37	-6.58	-10.46 ^e
Switzerland	n.a.	n.a.	n.a.	n.a.	3.1	7.1	6.7	1.8	1.19 ⁵	0.57	6.67	9.08
United Kingdom	2.0	3.1	4.4	5.4	3.5	9.6	24.3	16.6	-0.04	-0.51	-1.64	-1.42

¹Increase of consumer prices against previous year in per cent; ²in bill. units of the respective national currency;

³since 1961; ⁴since 1962; ⁵since 1965; ^eestimated; n.a. = not available.

Sources: OECD, Main Economic Indicators, current issues. ILO, Bulletin of Labour Statistics, current issues. National sources.

I. Still Far Away from Economic Targets

2. Since the beginning of the worldwide upswing in 1975, the progress in approximating satisfactory levels of the main policy target variables has been generally very limited. Presently, the deviations from a high employment level, from price stability and external equilibrium are still by far too large. This becomes particularly clear in comparison with the situation of the 60's and the early 70's, as shown in Table D 1. In 1976, rather low unemployment rates could only be kept by a few small countries, e.g. Sweden, Austria and Switzerland. Moreover, Switzerland was the only country which approximated price stability in 1976, while the average inflation rate of the whole OECD area amounted to 11 percent on a year over year basis. Additionally, the current balance disequilibria widened drastically last year after they had decreased considerably during the recession 1974/75.
3. In addition to the problems of unemployment, inflation and external imbalances, the 1976 public deficits were extremely high again, although in some cases smaller than 1975, when record increases occurred due to cyclical shortfalls of revenues and to reflationary fiscal packages.

Governments are also deeply concerned about the level of national and international indebtedness, primarily in countries like Italy, United Kingdom and Denmark. The raising of domestic and international funds became increasingly difficult for these countries in 1976. Consequently, governments were forced to renounce their expansionary policies in favour of a somewhat more moderate course and the monetary authorities had to give up their attempts to keep the exchange rates unchanged.

II. Demand Management Strategies Outdated

4. In the course of the inflationary period of recent years, demand management policies have become more and more ineffective, because money illusion has largely faded out. In the international context exchange rate illu-

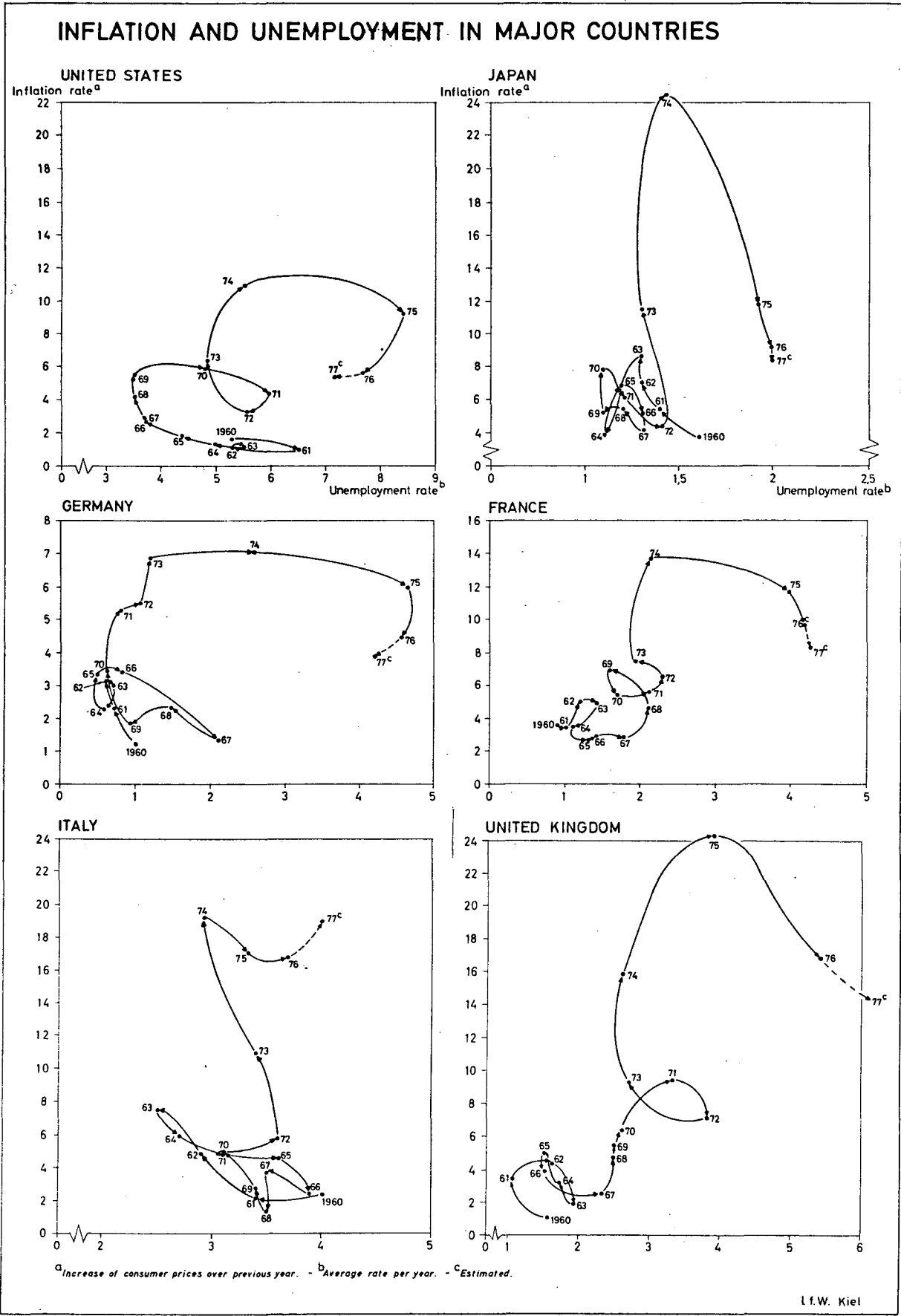
sion has also decreased: it has become more and more clear that variations of exchange rates do not change international competitive positions as far as they only compensate for inflation differentials from country to country. Thus, in order to reduce external disequilibria, real exchange rate changes are necessary, i. e. exchange rate variations which more than outweigh inflation differentials.

a) No Trade-off Between Unemployment and Inflation

5. Looking at the two tasks of increasing employment and reducing inflation, empirical evidence shows that one should not take for granted a certain, relatively stable Phillips-type trade-off between unemployment and inflation. In Figure D 1, the different combinations of the rates of unemployment and consumer price increases were depicted for six major countries. Instead of Phillips curves, one can rather - more or less clearly - identify a sort of "Phillips curls", a phenomenon which is characterized by growing fluctuations of unemployment and inflation rates around an increasing trend.

The mechanism which has seemingly determined this unstable process since 1960 can be explained as follows: If a certain unemployment level is considered as too high, governments use to take expansionary monetary and fiscal measures to stimulate aggregate demand and to increase employment. Whereas the inflationary impulse is limited at first - due to ample capacity and time lags in price formation - inflationary pressure will grow during the following phase, when capacity utilization increases. At the same time, the balance of payments of those economies accustomed to high import elasticities use to deteriorate. Payments deficits, devaluation tendencies and high domestic inflation rates are signals for a

Figure D 1



change of the policy course: governments deem it necessary to restrict aggregate demand by a monetary-fiscal "stop" policy. The outcome will be a reduction of production and employment, accompanied by an improvement in the balance of payments. The subsequent cooling-down of inflation, however, will be the smaller the more downward rigidity in inflation expectations prevails.

The U.S. economy seems to be a good example to elucidate this process of increasing fluctuations along a trend of more and more unfavourable combinations between unemployment and inflation¹.

6. Taking into account the price and employment forecasts for 1977, the question arises whether the period of recession-related deceleration of inflation rates will soon come to an end or whether the re-ignition of inflation in Italy and the United Kingdom will only be the exception. The threat of a new round of resurgent inflation in spite of very high unemployment rates will be the more probable, the more policy authorities will take expansionary monetary measures to support the upswing. As there seems to exist a spiral with increasing fluctuations instead of a stable trade-off between inflation and unemployment, such a development must be avoided.

b) The Dilemma of Unemployment and External Deficits

7. Besides the trade-off problem between unemployment and inflation there is another unfavourable combination of target variables: the combination of unemployment and external deficits. Since last year this problem has become very important again for the

¹ The development in Japan and Italy does not prove the 'Phillips-curl thesis' as clearly as in other countries, for their unemployment levels are kept low by specific institutional factors - such as the principle of lifelong employment or laws restricting dismissals.

so-called weak countries, - those countries characterized by structural current balance deficits which are not compensated by a corresponding private net capital inflow.

8. During the recovery of demand and production, the rise of real imports in countries like France and Denmark exceeded by far the increase of their real exports (see Figure D 2). Hence, their trade deficits, in volume terms, widened considerably. This is also true for the United States, whereas notably Japan and the Netherlands increased their real surpluses.

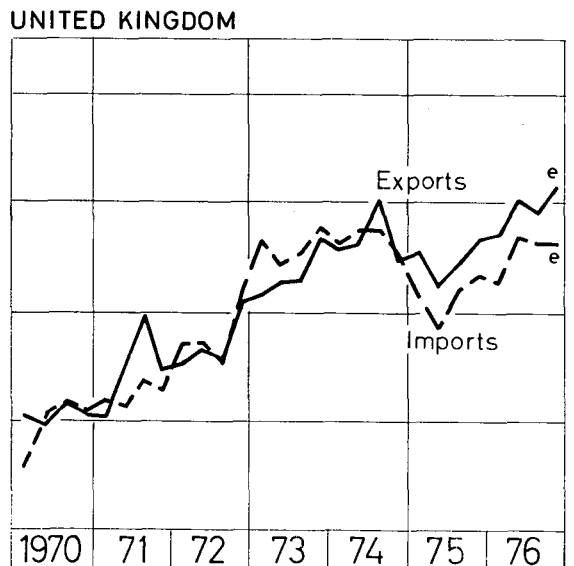
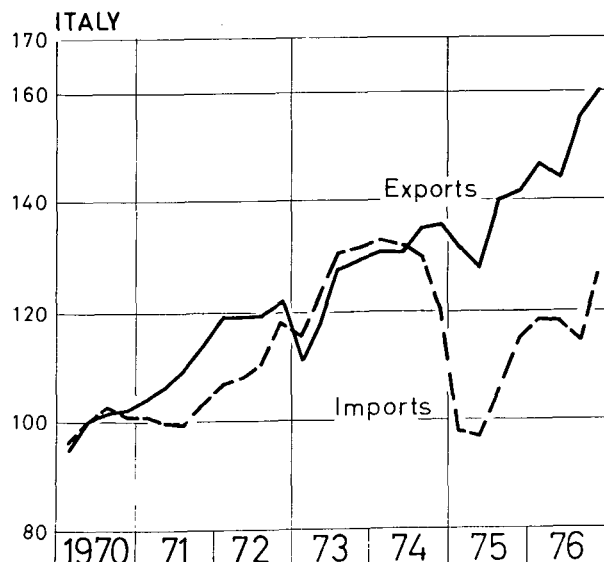
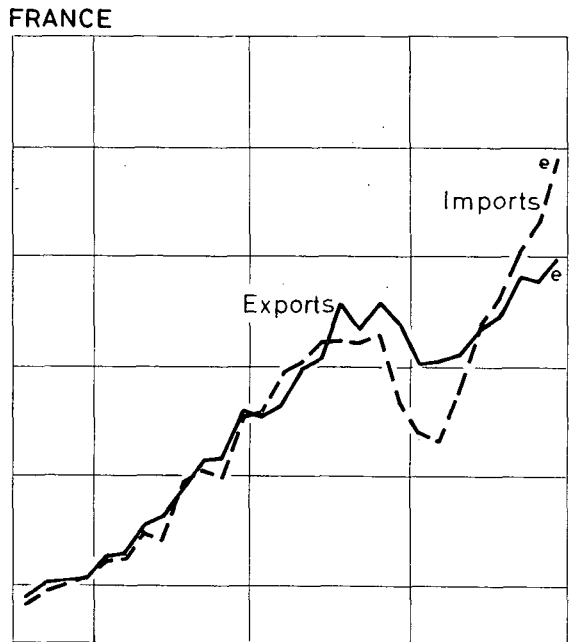
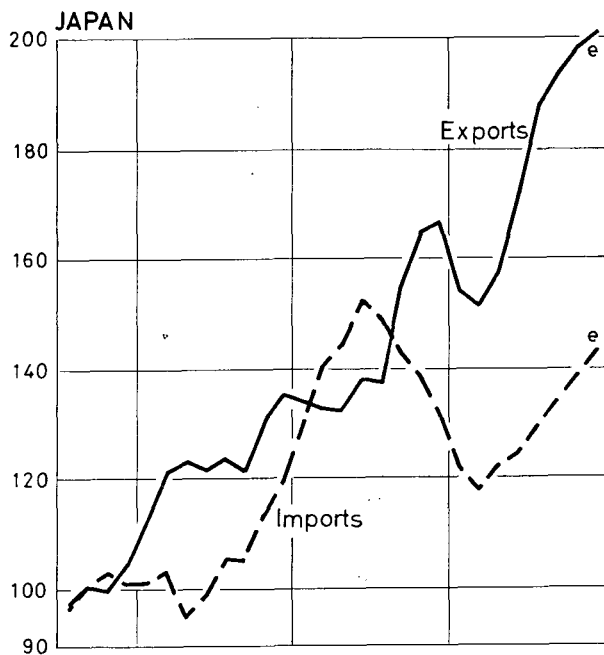
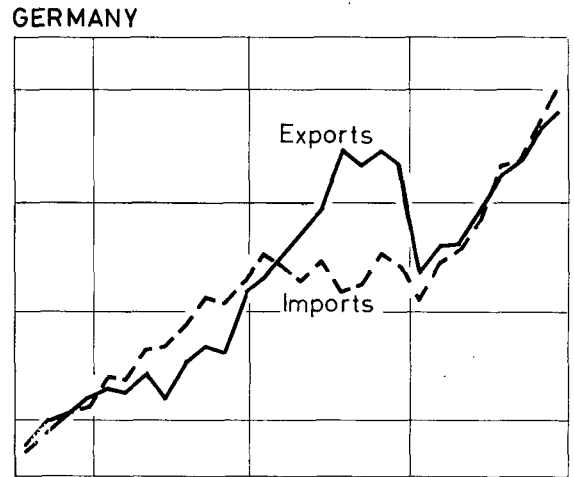
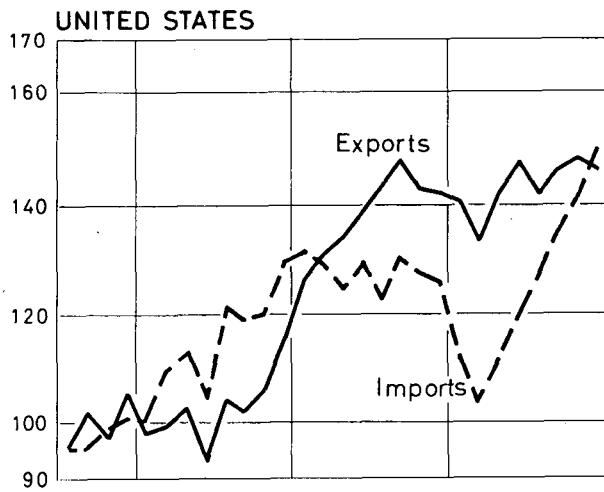
Many of the deficit countries still try to maintain their exchange rates. Instead of supporting adjustment processes by changes in international price relations, they apparently resort to restrictive demand policies in order to reduce external deficits and, at the same time, to curb inflation. But these "stop" measures lead inevitably to a worsening of the employment situation. The policy dilemma - either more employment, but increasing external difficulties, or a better external position, but higher unemployment - is sometimes looked upon to be unsolvable.

9. Obviously, the difficulties cannot be eliminated by frequent shifts of priorities between the employment and the external target - and, additionally, the stabilization target - using "stop-go" demand management methods; this can only bring about a short-term relief. Rather, in order to solve the particularly severe problems of "weak" countries a new path of economic policy must be followed which is suited to tackle the problems simultaneously.

Figure D 2

VOLUME OF EXPORTS AND IMPORTS OF MAJOR COUNTRIES¹⁾

1970 = 100

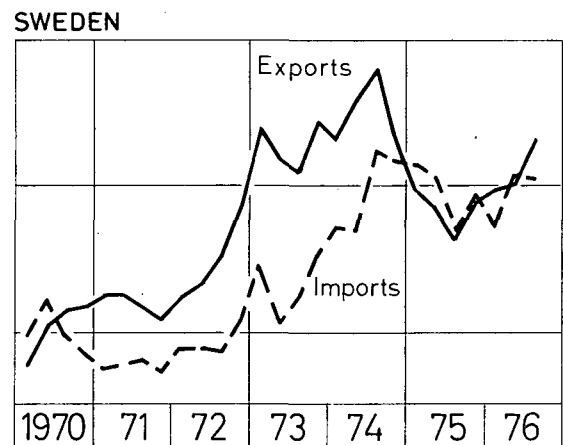
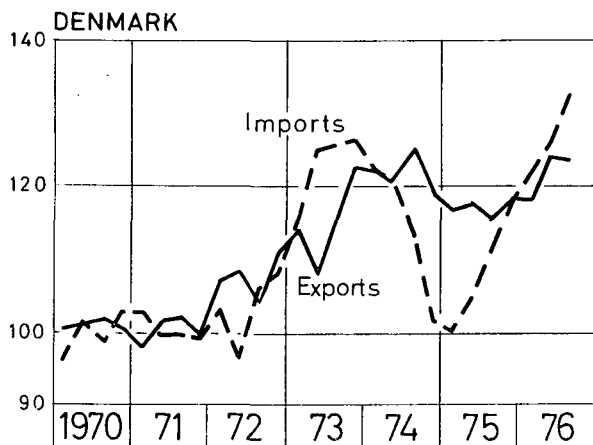
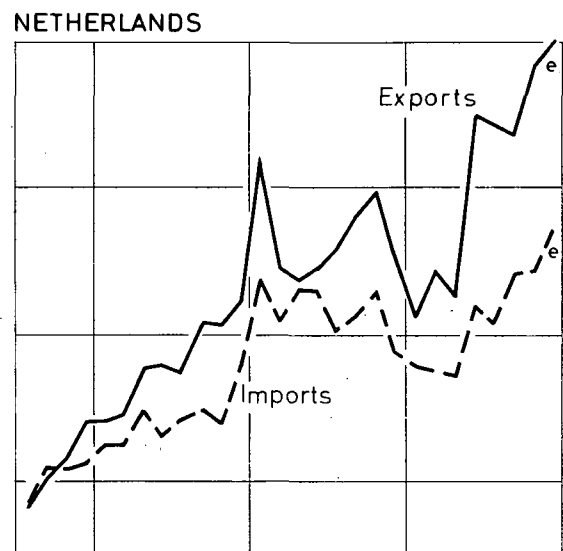
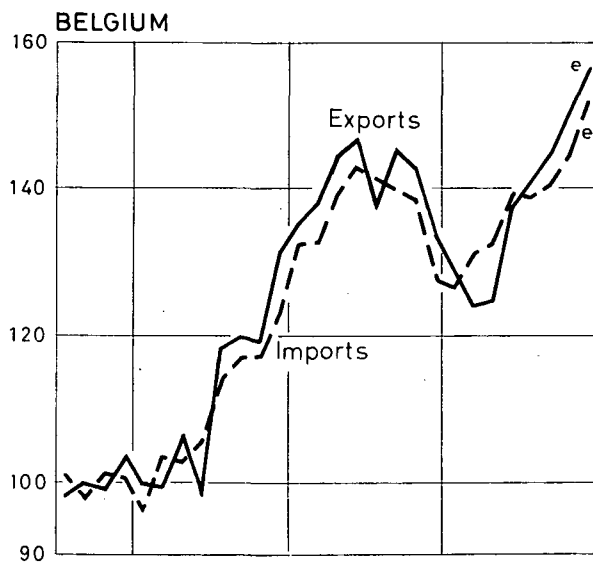
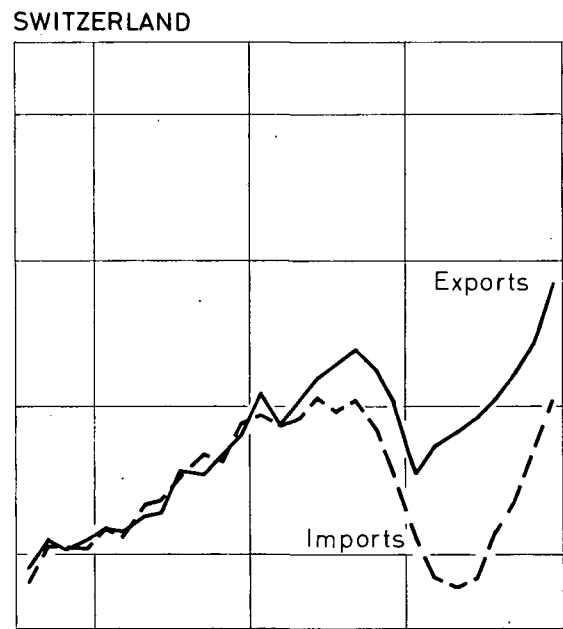
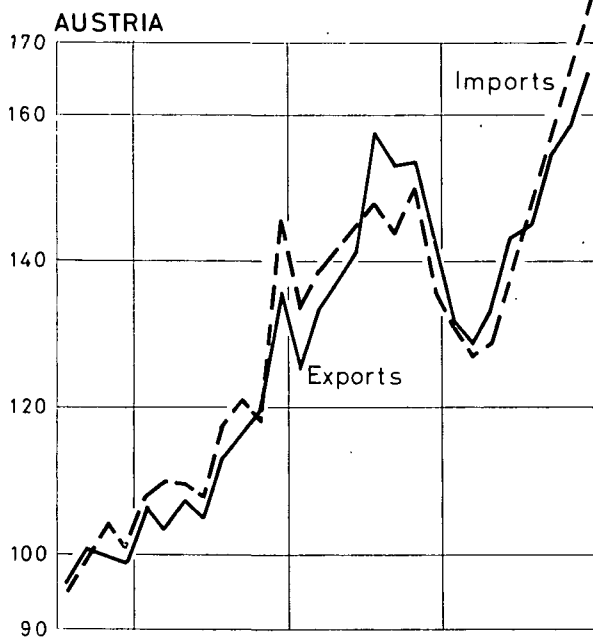


¹⁾ Seasonally adjusted. - ^e Estimated.

Figure D 2

VOLUME OF EXPORTS AND IMPORTS OF SMALLER COUNTRIES¹⁾

1970 = 100



¹⁾ Seasonally adjusted. - ^e Estimated.

III. General Features of a Strategy for Stable Economic Expansion

10. The strategy which is needed to overcome the current difficulties without producing new future problems, must comprise a rational mix of policy instruments which is appropriate to attain high employment, low inflation rates, external equilibrium, and a suitable growth rate at the same time.

Since private decision making should be backed by a steady economic policy, discretionary interventions must be abolished as far as possible.

11. The main elements of a rational assignment of measures and aims are

- flexible exchange rates: they are the only means which lead to balance of payments equilibrium by market forces; they provide the necessary condition for the autonomy of domestic stabilization policies;
- a steady, trend-oriented monetary policy: a pre-announced, steady and moderate course of the money supply provides the frame for price and wage behaviour and thus contributes to more predictability in the trends of price and wage levels; moreover, a gradual deceleration of monetary expansion down to the growth rate of potential GNP leads to price stability without substantial frictions;
- flexibility of real wages: the relation between real wages and labour productivity - adjusted for changes in the terms of trade and relative capital costs - determines the employment level. If the rate of real wage increases stays below the rate of distributable productivity gains, then the demand for labour will rise; this should be the guiding principle for the wage policy of employers, unions and governments in order to reduce the under-utilization of the labour force;

- a steady course of fiscal policy: instead of intervening anti-cyclically, governments should guarantee that the proportion of potential output which is absorbed by the public sector - i. e. the proportion of real public expenditure - does not vary substantially in the course of a cycle. (This does not exclude changes of the public share in the medium and long run.) Taxes should operate as an automatic stabilizer during the cycle. Whereas the success of fiscal activities to counteract short-term fluctuations has to be viewed as very limited, fiscal measures are suited as a means of growth policy if the expenditure side as well as the tax system is geared to support investment.

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IV. 1976: Economic Policy Towards Moderation

12. Compared with the above mentioned strategy for stable expansion, the stance of monetary and fiscal policy in most western countries was still by far too volatile since 1975. Whereas in 1975 many countries started with a highly expansionary drive of their demand management policies, most of them turned to a moderation of their policies in the course of 1976. Compared with former recoveries this change occurred at an early stage of the upswing. However, some moderation was indispensable in the light of comparatively high inflationary pressures on the one hand and extensive balance of payments deficits on the other.
13. The characteristics of the policy developments in 1975/76 were:
 - the actions and reactions of monetary and fiscal agencies in many countries have shown the well-known go-stop pattern. Only in a few countries, such as the United States, Japan and - not so impressively - in Germany, economic policies have followed a relatively stable path;

- the 1976 events in demand management policies have demonstrated the dominance of the strong countries like the United States, Japan and West Germany. Countries with high balance of payment deficits and an important external sector sooner or later aligned their internal policy towards more moderation in order to avoid further sharp devaluations of their currencies;
- along with the moderation of monetary and fiscal policies, most countries came up with intensified incomes policies in 1976 in order to restrain wage and price claims. This reflects the more and more acknowledged fact that the employment level lastly is determined by private market behaviour;
- the sharp exchange rate adjustments in the course of 1976 brought about sizable changes in international price competitiveness which were favourable in respect to a settlement of the international balance of payments problems.

a) Turnaround in Monetary Policy

14. Monetary policy in the industrialized countries during 1976 was characterized by a - more or less clear - departure from the highly expansionary path of 1975. This step was unavoidable because inflation dynamics had to be reduced further. Whereas the monetary aggregate M_1 accelerated worldwide by an annual rate of more than 10 percent until spring 1976, the rate has slowed down to about 7 percent since then. However, behind these general figures there is a considerable divergent development from country to country: in the United States and Japan the monetary path was relatively steady. On the contrary, countries like France, the United Kingdom, Italy, the Netherlands and Denmark introduced sharp restraints in 1976 (Figure D 3) in order to limit pressures for further massive devaluations.

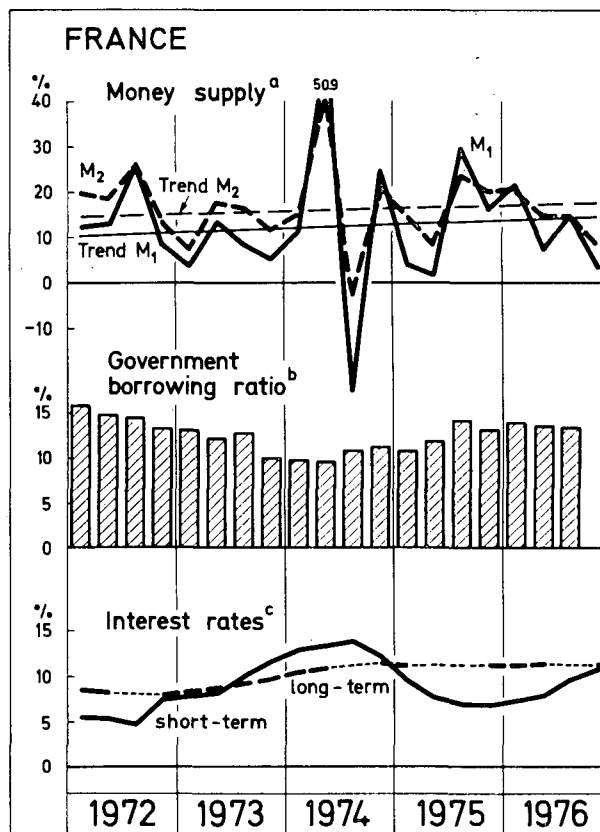
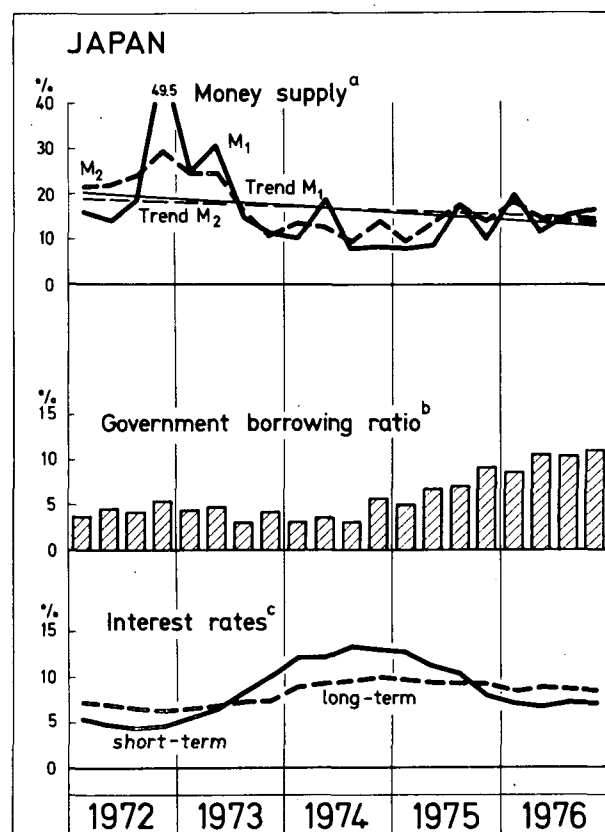
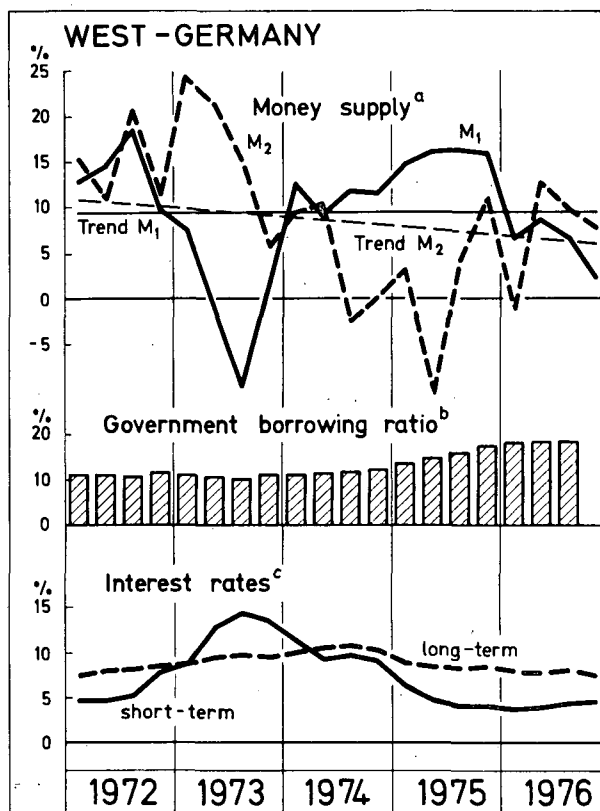
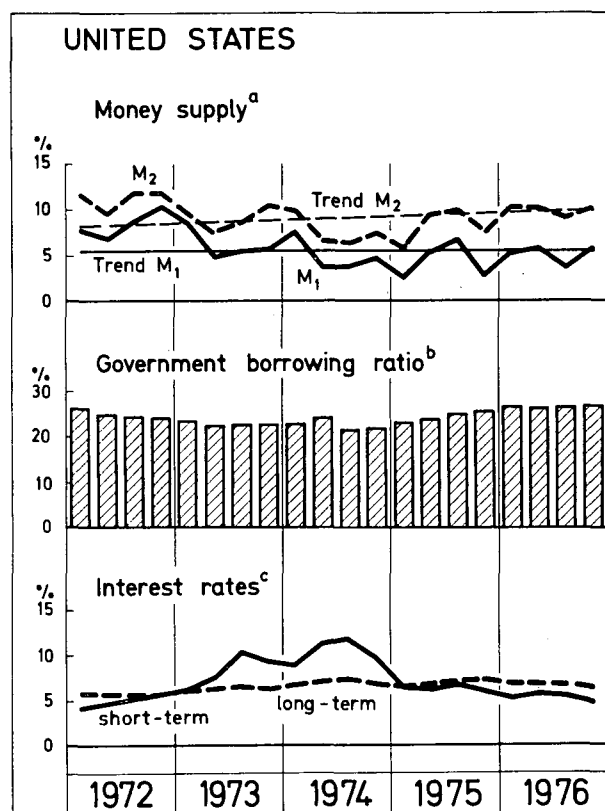
15. As a result of these policy changes, the differentials between short-term interest rates on international money markets temporarily widened substantially. To a much less extent this was true for long-term interest rates. This indicates steps towards an operation-twist in several deficit countries: central banks tried to discourage capital outflows by high short-term rates and, at the same time, to encourage domestic investment by relatively favourable long-term interest rates thus providing even for negative real rates of interest.

In the "strong" countries (United States, Japan, Germany) long-term interest rates tended only slowly downwards in the course of 1976, indicating that inflation expectations were reduced only gradually in these countries. To some extent this might be due to the debt management of governments, which, given its expectation background, considered a lengthening of the maturity of public borrowing more profitable than a reduction of nominal interest rates for shorter maturities. Only since autumn 1976 when public credit demand expanded more slowly, long-term interest rates have started to decrease markedly in some countries.

b) Cautious Fiscal Policies

16. Like monetary authorities, fiscal agencies also pursued a less expansionary policy in 1976 than in the year before. In most countries public expenditures increased at substantially lower rates. At the same time a strong fiscal drag due to a rather high nominal income expansion and to unchanged nominal tax tariffs retarded the growth of private net incomes. Additionally, many temporary stimulation measures like tax cuts, higher transfers and public expenditure programs expired in 1976. Some governments, notably in Italy and Denmark, even increased direct and indirect taxes to restrain private consumption in order to reduce high import surpluses.

Fig.D.3 MONEY SUPPLY, GOVERNMENT BORROWING AND INTEREST RATES IN WESTERN COUNTRIES



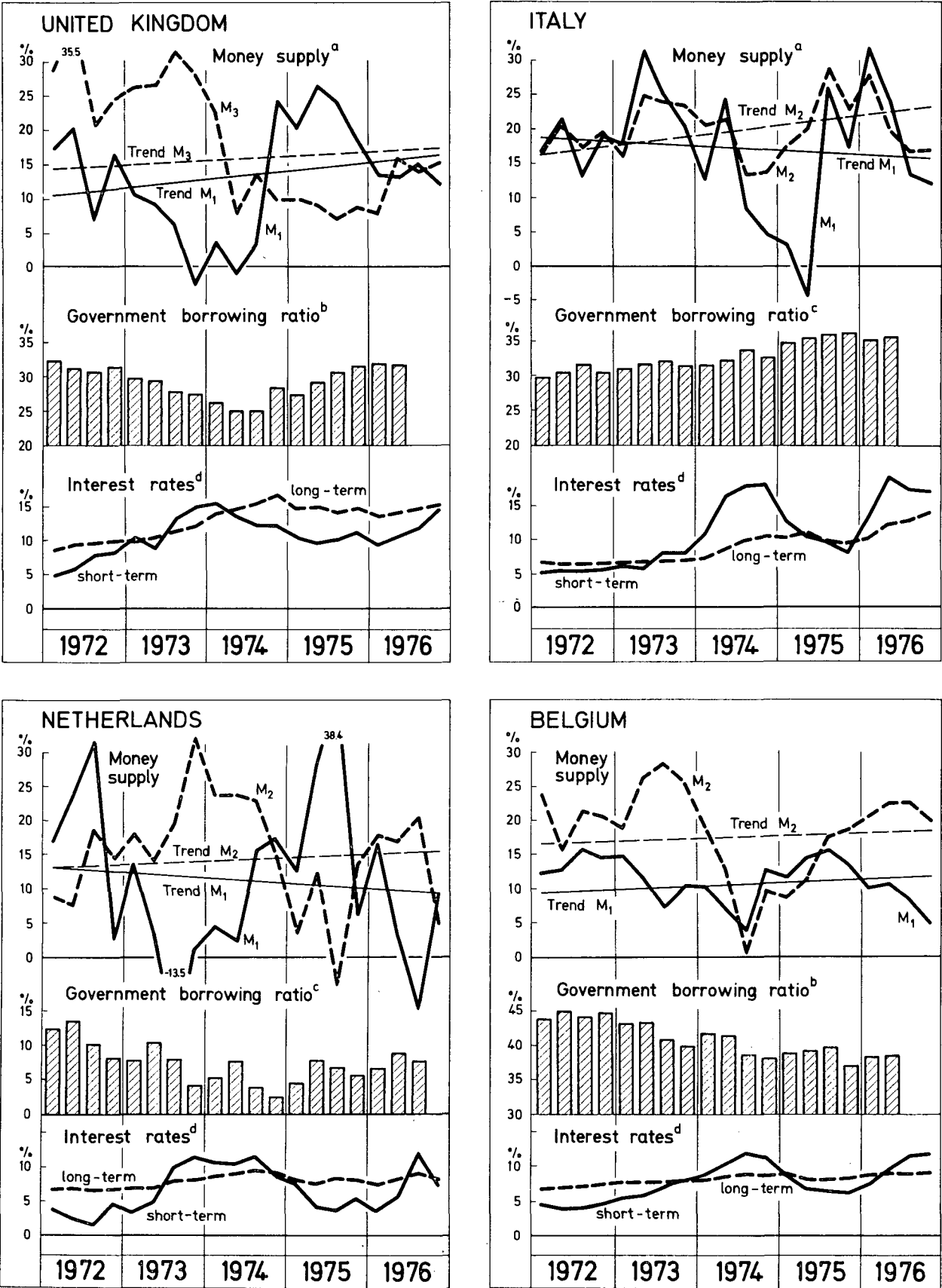
^a % change over previous quarter at annual rate. The trend of change rates is calculated for the period 1969 (1. quarter) to 1976 (4. quarter).

^b Ratio of government bank credit (net of gov. deposits) to total domestic credit.

^c Short-term interest rates: 3-4 month money-market rates.

Long-term interest rates: Domestic government bond yields.

Fig. D.3 MONEY SUPPLY, GOVERNMENT BORROWING AND INTEREST RATES IN WESTERN COUNTRIES



^a % change over previous quarter at annual rate. The trend of change rates is calculated for the period 1969 (1. quarter) to 1976 (4. quarter).
^b Ratio of government bank credit to total domestic bank credit.
^c Ratio of government bank credit (net of government deposits) to total domestic bank credit.
^d Short-term interest rates: 3-4 month money-market rates.
Long-term interest rates: Domestic government bond yields.

17. The dampening fiscal measures occurred in a relatively early stage of upswing. They were brought about mainly in concern of the substantial public deficits which accumulated since 1974. Limiting net borrowings was considered to be necessary because of the fear of a crowding out of private investment, recognizing the behaviour of the central banks to hold monetary expansion under control. That is why most countries experienced a reduction of the ratio of public deficits to nominal GNP in 1976 which had increased considerably in previous years due to the high underutilization of capacity (see Table D 2). This policy, however, implied that real public expenditures mostly increased much more slowly than potential real GNP. Apparently, such a policy has dampened the dynamics of recovery (see Table D 3).

c) Intensified Efforts of Incomes Policy

18. If real wage increases exceed the distributable labour productivity gains over a longer period of time, the employment situation inevitably deteriorates sooner or later. This fact can be illustrated by Figure D 4 and B 2.

In 1975, for example France and Austria experienced a gap between real wage increases and productivity changes of temporarily more than 10 percent, Italy of nearly 20 percent. (These figures, however, are partly determined by cyclical factors.) On the other hand, the United States experienced even absolutely falling real wages for two years up to the end of 1975. Switzerland, Germany, and the Netherlands have had relatively small real wage rises which have not come up to productivity increases for longer periods either. Therefore, these economies seem to be in a better-than-average position in respect to reducing unemployment. (Indeed, at least in the United States employment has increased markedly since 1975.)

Table D 2 - Government Deficit (-) or Surplus in Selected Countries 1970 - 1976

		1970	1971	1972	1973	1974	1975	1976	1970	1971	1972	1973	1974	1975	1976
		- In national currency, bill. units -							- Ratio to nominal GDP (%) -						
United States	US \$	-11.38	-24.80	-17.37	- 7.95	-10.88	-75.40	-56.00	-1.2	-2.3	-1.5	-0.6	-0.8	-5.0	-3.3
Japan	Y	- 319	- 181	- 1457	- 1825	- 1798	- 7052	- 3290	-0.5	-0.2	-1.6	-1.6	-1.4	-4.8	-2.0
West Germany	DM	- 0.56	- 1.36	- 3.64	- 2.85	-10.10	-34.06	-30.09	-0.1	-0.2	-0.4	-0.3	-1.0	-3.3	-2.6
United Kingdom	£	0.67	- 0.63	- 1.61	- 2.34	- 3.49	- 8.38	- 6.70 ¹	1.3	-1.1	-2.6	-3.2	-4.3	-8.1	-5.6 ¹
France	FF	3.68	- 3.45	6.32	7.33	4.31	-43.01	-20.00 ¹	0.5	-0.4	0.6	0.6	0.3	-2.9	-1.2 ¹
Italy	Lit.	- 2247	- 3336	- 4085	- 5761	- 4967	- 9854	- 7500 ¹	-3.9	-5.3	-5.9	-7.0	-5.0	-8.8	-5.4 ¹
Netherlands	hfl.	- 1.23	- 1.66	0.20	0.57	- 0.96	- 6.07	- 8.43	-1.1	-1.3	0.1	0.3	-0.5	-3.0	-3.6
Belgium	BF	-23.80	-33.80	-63.70	-51.10	-59.30	-109.30	-133.10	-1.9	-2.4	-4.1	-2.9	-2.9	-4.8	-5.1
Norway	NKr.	- 2.49	- 2.33	- 2.21	- 2.69	- 3.49	- 6.75	- 7.00 ¹	-3.1	-2.6	-2.3	-2.4	-2.7	-4.6	-4.3 ¹
Austria	Sch.	- 7.22	- 7.75	- 7.69	- 7.08	-11.89	-30.99	-30.00 ¹	-1.9	-1.9	-1.6	-1.3	-1.9	-4.7	-4.0 ¹
Switzerland	SFr.	0.30	- 0.87	- 0.05	- 1.43	- 0.88	- 1.77	- 0.50 ¹	0.3	-0.8	-0.1	-1.1	-0.6	-1.3	-0.4 ¹

¹ Estimated.

Source: International Monetary Fund, International Financial Statistics, current issues. - National sources.

Table D 3 - Government Consumption Expenditure in Selected Countries 1970 - 1976

	1970	1971	1972	1973	1974	1975	1976	1970	1971	1972	1973	1974	1975	1976
	- In constant prices, % change over previous year -							- In current prices, ratio to nominal GNP (%) -						
United States	-2.5	-0.3	1.2	0.6	0.8	1.7	1.4	19.0	18.8	18.7	17.8	18.4	19.3	18.7
Japan	6.3	7.9	7.8	7.3	4.4	7.0	4.8	8.2	8.7	9.0	9.1	10.0	11.1	11.2
West Germany	4.9	7.3	3.9	4.1	4.6	3.6	2.9	15.9	17.1	17.6	18.2	19.8	21.0	20.7
United Kingdom	1.5	2.7	4.1	4.2	1.9	4.7	2.8	17.8	18.2	18.7	18.6	20.2	22.2	22.1
France	4.6	3.4	2.7	3.3	2.7	2.8	4.7	13.4	13.4	13.2	13.2	13.6	14.4	14.4
Italy	1.9	5.4	5.0	2.5	2.1	0.8	2.0	12.7	14.4	14.9	14.3	14.1	13.8	13.3
Netherlands	5.9	3.2	2.2	0.2	1.4	2.6	4.0	16.3	16.7	16.7	16.3	17.2	18.0	18.1
Belgium	3.1	6.0	5.7	4.5	3.4	7.2	4.5	13.7	14.4	14.9	14.8	15.0	17.1	17.4
Sweden	8.3	3.4	2.4	2.6	3.4	5.1	4.0	21.4	22.7	23.0	23.0	23.6	24.9	25.5
Denmark	11.9	7.4	3.5	2.0	1.4	4.7	3.2	19.8	21.3	21.2	21.2	22.9	24.7	24.4
Norway	.	5.4	3.9	4.5	3.3	5.1	4.9	15.4	16.1	16.2	16.2	16.2	16.9	16.7
Austria	3.6	2.9	4.8	3.8	4.0	3.0	2.5	14.7	14.7	14.6	15.3	15.7	16.6	16.4
Switzerland	2.3	5.7	2.9	2.4	1.6	1.4	6.2	10.6	11.1	11.0	11.4	11.8	12.9	13.7

Source: International Monetary Fund, International Financial Issues, current issues. - National sources.

19. A great deal of the large fluctuations of real wages, which could be observed in recent years, is not only attributable to the abruptness of monetary policy but also to the pay settlements between trade unions and employers.

Since the beginning of the seventies, the dynamics of the inflationary process of wage and price increases were particularly strong in Italy, the United Kingdom, and Japan: between 1973 and 1975, nominal wage rates went up by 25 to 30 percent (year over year; see Figure D 4), and consumer prices¹ sometimes by more than 20 percent. In other countries, nominal wage increases ranged from about 10 percent (United States, Germany, Switzerland) to about 20 percent (France, Belgium, Austria). Generally, nominal wage increases decelerated during 1976 although the development was still rather different from country to country.

20. In many cases, the recent cooling down of wage increases coincides with - more or less tough - measures of incomes policy. Since 1975, they were applied particularly by those countries where - in spite of the deep recession - the dynamics of the wage-price spiral were very strong.

In the United Kingdom pay rises have been limited by a "social contract" between the government and the trade unions since mid-1975. It is going to be renewed in summer 1977. Denmark and the Netherlands - like the United Kingdom for a long time familiar with incomes policy activities - have also tried successfully to keep control of wage increases. In France, the Barre-Plan of September 1976 includes limits for wage and price rises, coupled with a price freeze for some months. Price freezes have also been applied in Spain and Portugal.

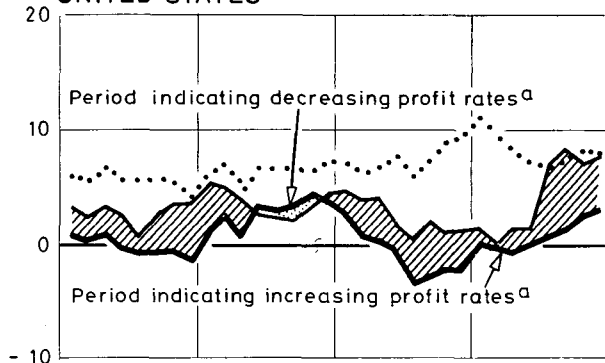
¹ Figure D 4 shows the inflation rates as the difference between the curves of nominal and real wage rate changes.

Figure D 4

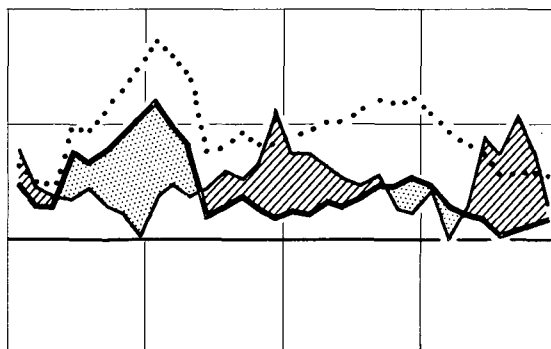
NOMINAL WAGES, REAL WAGES AND PRODUCTIVITY IN MAJOR COUNTRIES

Quarterly changes in per cent over previous year

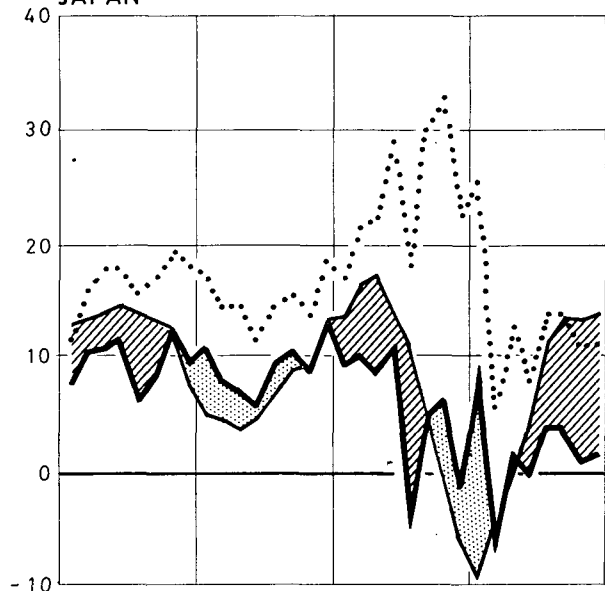
UNITED STATES



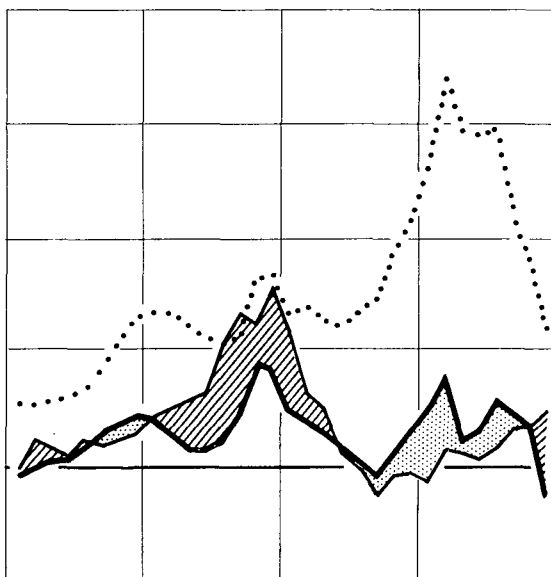
GERMANY



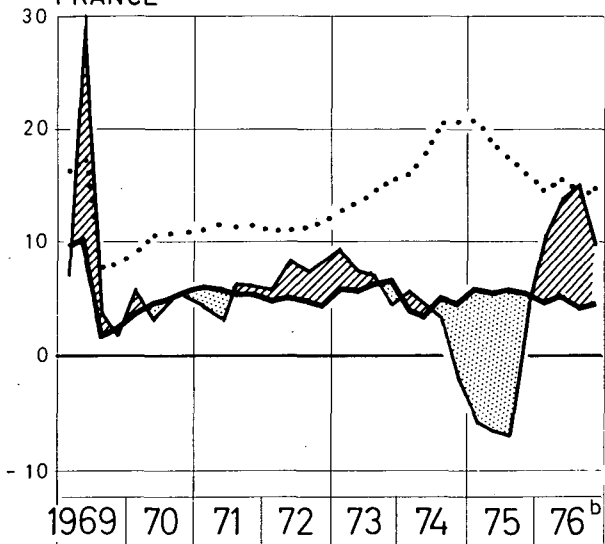
JAPAN



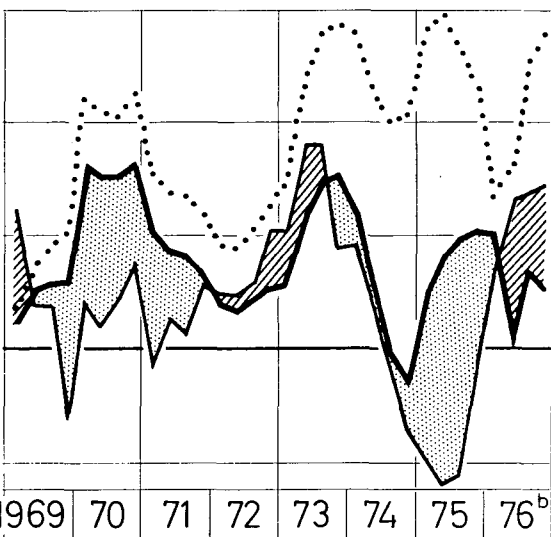
UNITED KINGDOM



FRANCE



ITALY



..... Hourly wages (US: hourly earnings, Japan: monthly earnings)

— Real wages: nominal wages deflated by consumer price index.

— Productivity in manufacturing industry.

Inflation rates: difference between dotted and thick line.

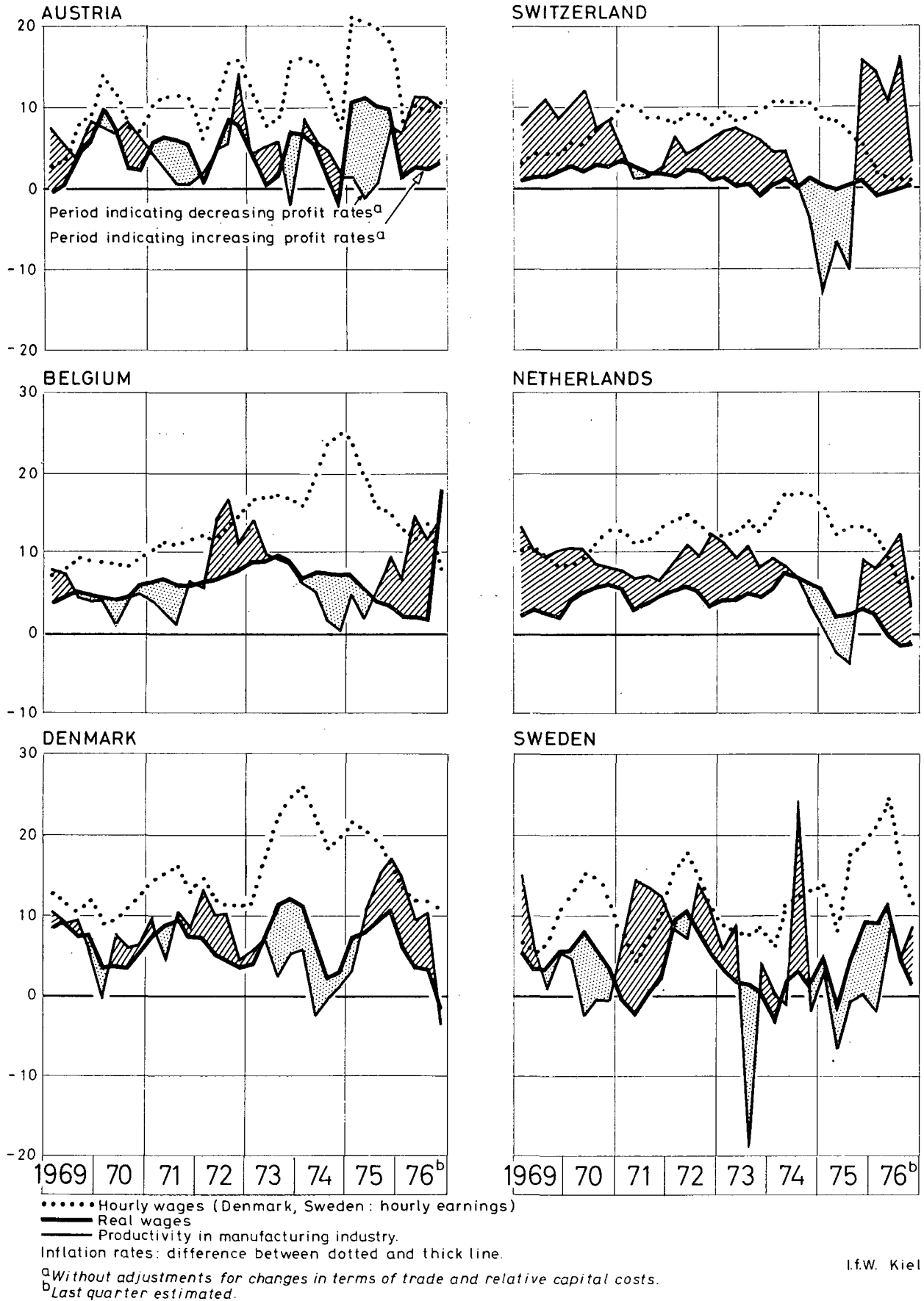
^a Without adjustments for changes in terms of trade and relative capital costs.

^b Last quarter estimated.

Figure D 4

NOMINAL WAGES, REAL WAGES AND PRODUCTIVITY IN SMALLER COUNTRIES

Quarterly changes in per cent over previous year



On the other hand, wages in Germany and Austria, for example, have increased only modestly since 1975 and 1976, respectively, because of the high degree of "social consensus" between unions, employers and the government.

21. In assessing the recently applied incomes policy measures, one has to keep in mind two critical points:

- If wage and/or price increases are fixed (voluntarily or on a statutory basis), the mechanism of relative prices cannot operate any longer. Consequently, adjustment needs are accumulated, which must be met sooner or later. Usually, they materialize as sharp price and wage jumps after expiration of the agreements.
- Up to now, the coordination of incomes policy and monetary policy has proved to be rather insufficient. Inconsistencies have often occurred, because monetary policy was directed to the interest rate or balance of payments target; that is why incomes policy measures used to be only "tough on pay and weak on prices" as long as they are not complemented by a steady and moderate policy of monetary expansion.

d) Economic Policy Dominance of "Strong" Countries

22. One of the obvious features in economic policy in the mid 70's is the fact that the speed in economic stimulation, worldwide and in each particular country, is ultimately determined by the "strong" countries.

In the United States, Germany and Japan demand management policies were governed by the conviction that a durable upswing after the sharp 1974/75 recession can only be achieved by a policy geared to a further slowdown of inflation. In pursuing such a policy, central banks defined targets for monetary expansion in terms of

money supply aggregates (as in the United States and Germany) or bank credits (Japan). The implementation of these concepts, nevertheless, shows some deficiencies:

- in Germany the money supply (monetary base) in 1975 and 1976 exceeded the announced targets. The same is true for the money supply in the definition of M_2 and M_3 in the case of the United States;
- in addition to failing the average targets, central banks did not avoid sharp fluctuations of monetary expansion during this period. Especially Germany experienced pronounced phases of monetary acceleration and deceleration. The ultimate reason for this is that up to now central banks pursue not only money supply targets but, at the same time, interest rate targets. This is illustrated by the fact that even short-term interest rates showed a higher stability over time than monetary expansion rates.

23. Total credit expansion in the three major countries remained moderate in the course of 1976 after it had gained some momentum in Germany and Japan during 1975. In each of the three countries the credit expansion was largely brought about by the public sector. In Japan the share of government borrowing requirements on total bank credits nearly tripled between mid-1974 and 1976, whereas in West Germany there was almost a doubling of the corresponding ratio (see Figure D 3).

The strong expansion of public sectors' credit demand until the end of 1976 was accommodated by monetary policies indicating strong links between fiscal and monetary agencies: in Germany and Japan the money supply expanded to that extent necessary to keep interest rates on money and capital markets on their downward trend despite an increasing total credit demand. In the second half of 1976, this interdependence worked in reverse direction: following a slower

credit demand by public authorities, monetary expansion decelerated considerably.

24. The slowdown in public sectors' credit requirements reflects higher tax receipts since mid-1976 on the one hand and accentuated efforts to cut the expansion of public expenditures on the other hand. In addition to the growing concern about public deficits, the behaviour of fiscal authorities during budgeting in the first part of 1976 was determined by the conviction that the reflation measures pursued in 1975 would have been successful in bringing about a self-sustained upswing. In the case of Japan and, to some extent, of Germany the favourable export performance - in connection with their improved international competitiveness between 1973 and 1975 when nominal exchange rate changes lagged behind inflation differentials - might have been important for the rather cautious stance of fiscal policies.

e) External Constraints for "Weak" Countries

25. The moderate course of monetary and fiscal policies in the "strong" countries has operated as a policy constraint for all other countries: since 1975, demand management policies in most European countries were characterized by changing priorities between the employment and external target. The outcome was a sharp up and down in the monetary expansion and in the development of interest rates. This highly unsteady policy course could not prepare the ground for a balanced recovery in these countries.

The United Kingdom, Italy and France registered a monetary acceleration, measured in terms of M_1 , in the range of 25 to 30 percent between mid-1975 and 1976. Since then, the money growth rates slowed down to 10 percent or less, accompanied by sharp increases of interest rates in the course of 1976, especially in Italy and in the United Kingdom, producing temporarily very large interest differentials against the "strong" currencies.

26. The reason why countries like the United Kingdom, Italy, France and Denmark started with a relatively expansionary monetary and fiscal policy in 1975 must be seen as a wrong interpretation of the improvement of their balance of payments in 1974/75: it was not fully recognized that this was mainly the impact of the recession and not of an increase in international competitiveness. The diminished deficits led to the expectation of relatively stable exchange rate developments. As to their competitiveness many European countries had in fact experienced a substantial deterioration since 1973, because inflation differentials prevailed. These developments coincided with international stand-by credits after the oil crisis of 1973 which prevented rather than enforced structural adjustments.
27. In 1976 a great disillusion materialized in most deficit countries: already at the beginning of the upswing the balance of payments of these countries deteriorated heavily once again. This indicated both debtors and creditors that real exchange rates had to be reduced, i.e. nominal exchange rates had to be changed to a much greater extent than current inflation rates differed.

Instead of recognizing this fact, national authorities, wrongly understanding the task of international cooperation, initiated extensive interventions on foreign exchange markets as long as possible. Finally, however, considerable depreciations, notably of the Italian Lira and the British Pound, could not be avoided. This was the signal for the deficit countries to turn to a moderation of their expansionary policy course.

28. The only alternative to avoid a further acceleration of inflation was to dampen the overexpansionary policy course. Nevertheless, the turnaround in policy was brought about too abruptly. This must be judged as harmful for a balanced and steady economic development.

The restrictive measures - above all the drastical changes of short-term interest rates - were conceived not only to diminish further inflation differentials but also to stop exchange rate adjustments for accumulated inflation differentials. This was the case particularly in a number of European "snake"-countries. The mini-realignment of October 1976 brought about some relief, but obviously a more pronounced adjustment would have helped the small countries like the Netherlands, Denmark, and Sweden to pursue a more steady monetary policy. The new exchange rate alignment of March 1977 met lately with this necessity.

f) Sizable Changes in International Competitiveness by Exchange Rate Adjustment

29. The sharp changes in nominal exchange rates, which occurred in the course of 1976, brought about considerable corrections of most countries' international price competitiveness. As effective nominal exchange rate changes exceeded the differentials in current inflation rates, they led to adjustments in real exchange rates, which prepared the ground for structural shifts in international trade and hence for a settlement of international balance of payments problems. But in many cases only those real exchange rates were restored in 1976 which had existed already in 1973.
30. To analyze the competitive position of a number of industrialized countries, nominal effective exchange rate changes were transformed in real effective exchange rate changes by the use of consumer prices (all goods less food), export prices (average values) and unit labour costs (industry)¹. The differences which were found

¹ The first step in calculating real effective exchange rate changes was to divide the nominal exchange rates for each country by the specific price or cost index. These "real" exchange rates were then used as an input to produce for a given country a trade-weighted sum of real exchange rate changes of all other currencies vis-a-vis this country. The calculations were made on the basis of 14 industrialized countries. The exchange rate changes refer to the first quarter of 1971.

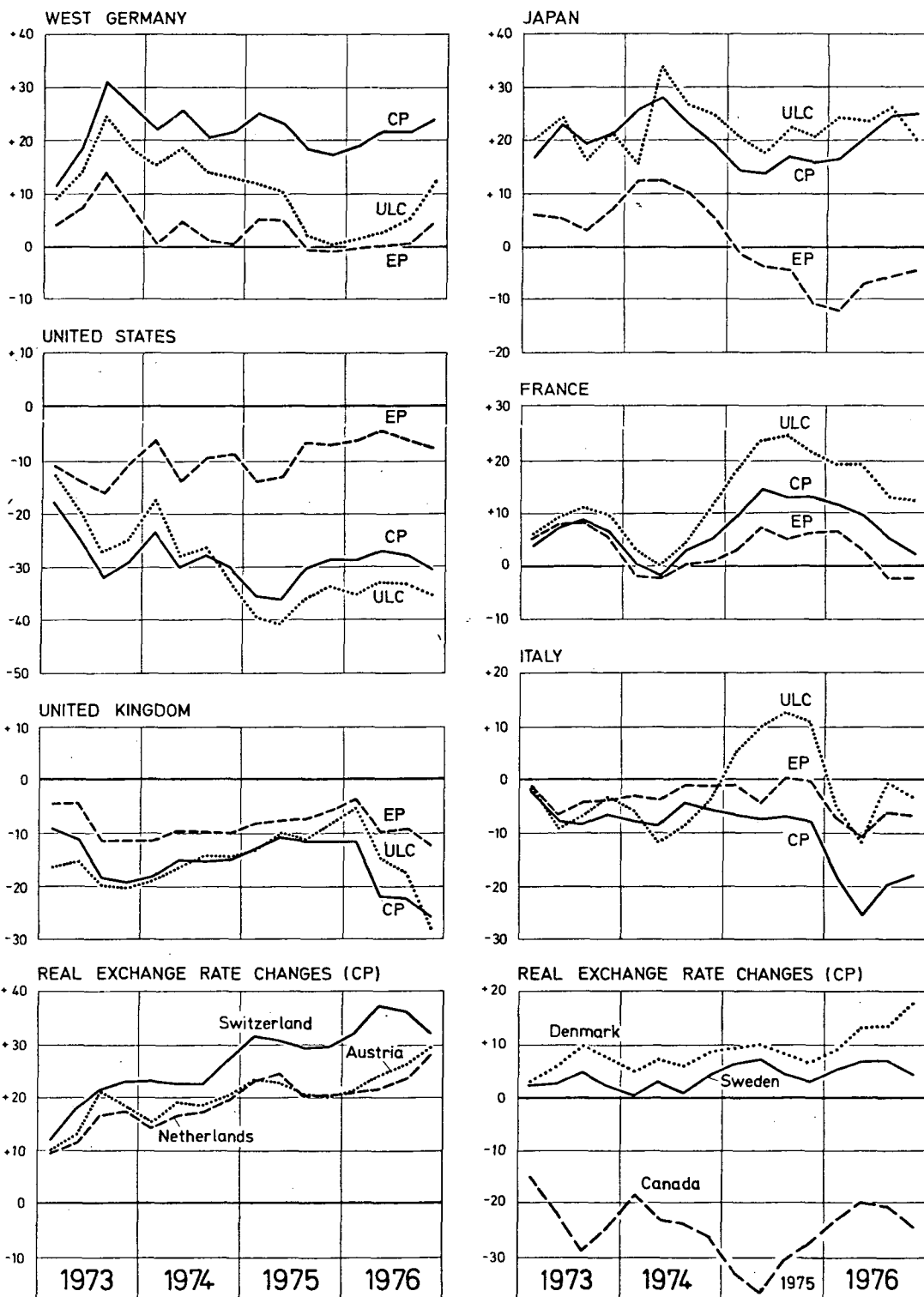
between the various calculations - see Figure D 5 - allow conclusions concerning the price behaviour and the profit situation of firms in different countries.

31. The analysis showed that in the course of 1976 the surplus countries Germany, Japan, and Switzerland experienced a substantial real appreciation of their currencies after, however, two years of real depreciation. In the case of Japan and Germany, the change of competitiveness proved to be different according to real exchange rates on the basis of consumer prices or on unit labour costs: whereas for Japan one could observe a less extensive deterioration of international competitiveness in terms of consumer prices compared to unit labour costs, the opposite was true for Germany since the beginning of 1975. This may be partially explained by the behaviour of German firms: they apparently tried to correct the income distribution in their favour also by forced price increases on domestic markets.
32. In each of the surplus countries, especially in Japan, it is striking that the real revaluation calculated on the basis of export prices was considerably lower than that on the basis of consumer prices and unit labour costs. Until the beginning of 1976, the real exchange rate of Japan and - to a smaller extent of Germany - which was measured in export prices, fell short of the level of early 1971. This reflects the strong export mindedness of firms in these two countries. In particular, the sharp real depreciation of the Yen since 1974 may be an explanation for Japan's increasing share in world trade since autumn 1975.
33. Similar to the development of the D-Mark the Gulden, Shilling, the Danish, Norwegian and Swedish Krone as well as the Belgian Franc experienced an increase of their real values in 1976, however, to a smaller extent. On the basis of export prices their international

Figure D 5

Figure D.5.-REAL EXCHANGE RATE CHANGES 1973-1976^a

Revaluation : + Devaluation : -



CP : Effective nominal exchange rate changes, deflated by consumer prices (goods without food)
 ULC : Effective nominal exchange rate changes, deflated by unit labour costs (industry)
 EP : Effective nominal exchange rate changes, deflated by export prices (average values)
^a Against first quarter of 1971 in percentage.

competitiveness - with the exception of Denmark and Norway - even improved, indicating persistently reserved price policies of internationally engaged firms. This behaviour reflects the fact that internal activity in these countries depends to a high degree on external demand.

34. The US-Dollar continued its real appreciation in the first part of 1976 which had started mid-1975. This resulted both from the development of nominal exchange rates and the relatively good progress in stabilization. It is to be noted that the competitiveness in terms of unit labour costs was much better than in terms of export prices. To some extent this outcome may be due to the U.S. export structure: a great deal of the exported goods (food, raw materials) experienced a relatively strong price increase on world markets in recent years.
35. Italy and the United Kingdom could improve their international competitiveness considerably in 1976. In both countries, most of the real depreciation which was already reached between 1971 and 1973, had disappeared until the end of 1975. For Italy as well as for the United Kingdom it seems to be characteristic that the improvement in competitiveness, which came along with nominal devaluations, was substantially lower on export markets than on domestic markets. Firms in these countries - contrary to those of most other countries - were apparently inclined to pass cost increases mostly on to export prices, even if thereby the chances for higher external shipments were omitted, - a behaviour which contrasts to the hope of reducing the trade deficits of these countries.
36. If the 1976 development in real exchange rates should continue - a goal which seems suitable to diminish international balance of

payments problems - it is unavoidable that nominal exchange rates have to be flexible in the future, i. e. free of all interventions. Only in such an environment deficit countries can reallocate their resources in favour of export branches. Attempts to stop this would, sooner or later, have negative impacts on total employment and - in the case of accommodating monetary policy - would reinforce inflation as well as exchange rate changes. Along with this the surplus countries should avoid all measures designed to limit increasing competition from abroad.

V. Need for International Coordination of Economic Policy?

37. International consultations on economic policy problems in the near future - particularly the London conference in May 1977 - will concentrate on the question whether and to what extent the "strong" economies should further boost the upswing and, by that, whether they could help to diminish the external imbalances between "strong" and "weak" countries.
38. The fundamental idea behind the international coordination approach - as developed by the Carter administration and supported particularly by the OECD - seems to be that the "strong" countries should play their part as engines of the world economy with more energy than they have done in 1976: intensifying monetary and fiscal "go" measures in "strong" countries in order to stimulate demand - especially for imports - seems to be more sensible than curbing the import demand of "weak" countries by means of unemployment-creating "stop" measures. According to this view, the outcome should be a worldwide proliferation of expansionary impulses from the major economies instead of a preservation of large divergencies in the economic performance between surplus and deficit countries.

39. However, the concept of short-term stimulating demand in "strong" countries as well as the concept of austerity measures in "weak" countries are subject to the same criticism: they mainly rest upon customary Keynesian-type demand management methods, i. e. monetary and fiscal policy instruments are - incorrectly - assigned to the balance-of-payments target and adjustments via changes in relative prices - notably of (real) exchange rates - are considered to be more or less irrelevant.

Therefore, in comparing the coordination approach with the strategy of stable economic expansion - as outlined before - it becomes clear that internationally "concerted" reflationary efforts hamper medium-run adjustment processes, as far as they are bound for short-term effects.

The coordination approach stresses the need for international economic solidarity mainly in order to ease the precarious situation of the deficit countries. In contrast to that, a strategy of stable expansion will primarily strengthen the adjustment forces within the "strong" as well as the "weak" countries and - by that - will diminish the international structural imbalances.

40. As such a medium-term strategy has not yet been implemented, the efforts to do this should be intensified. If economic policy makers follow this line, expansionary measures of "strong" countries, e. g. extending public investment in infrastructure or in education or permanent tax reductions for private investors, may indeed be sensible, in other words: these measures should be growth-oriented instead of demand-oriented.

Additional stimulating impulses are primarily suitable in those "strong" countries where the growth rate of real public expenditure remained below the rate of potential GNP growth in 1976 - like in West Germany - or where it is going to undershoot the respective rate for 1977. If a change - e. g. a reduction - of the public share

of GNP is required, it should be brought about in the medium, not in the short run. Thus, 1977 will not be the year of balancing public budgets; consolidation will be the task of a period when the upswing will have got sustained momentum.

Reflationary measures should not only contribute to increase the utilization of resources, but should also - in combination with an effectively operating system of flexible prices, wages, interest rates and exchange rates - support necessary shifts of resources between the internal and external sector, the public and private sector and between consumption and investment.

In order to avoid new inflationary effects the desired fiscal stimuli have to be financed by the capital market without central bank accomodation; i. e. monetary policy has to remain stabilization-oriented.

41. The fiscal measures of the US and Japanese governments as well as the - intended - measures in West Germany include elements which fulfill the postulated properties of being growth-oriented and being backed by a cautious monetary policy.

However, the increasing imports of the major countries will not considerably ease the balance of payments situation of the deficit countries, because the "weak" countries will only get a small share of the whole expansionary impact; thus, the contribution for reducing external imbalances will be fairly limited.

42. International credits should be supplied for facilitating the necessary structural adjustment in the deficit countries. This instrument has to be preferred to any kind of trade restrictions, such as import quotas. Private as well as official credits should be more market-oriented, and they should not be used to preserve inadequate exchange rates. Credit conditions will be the more favourable for the borrowers the more the international lenders

can trust in a moderate, stable course of monetary and fiscal policy in the borrowing country. The method of the International Monetary Fund to impose certain additional conditions for keeping the economic policy of deficit countries under control, seems to be helpful.

43. To summarize: The best way for achieving a sustained worldwide upswing is to employ a rational strategy of economic policy in each country, which comprises

- a steady, moderate course of monetary policy which is geared to further reducing inflation; steadiness should materialize not only in the achievement of certain monetary targets per year but also in the elimination of significant fluctuations of current money supply during the year;
- wage settlements which are aligned to smaller increases of real wages than of labour productivity; this will considerably improve the conditions for higher employment; agreements on moderate nominal wage increases - e. g. in the context of a voluntary incomes policy - should be supported;
- flexible exchange rates not only as a means of matching international inflation differentials, but also to effectuate real exchange rate changes which are needed for reducing external imbalances and - as far as necessary -
- fiscal policy measures to strengthen structural adjustment processes, i. e. to support economic growth.

Thus, international coordination of economic policy should essentially mean a harmonization of the efforts to overcome the national economic problems of each country by applying the same strategy. Reflationary programs and international credits are only sensible if they support internal and international structural adjustments instead of preserving outdated demand structures in deficit countries as well as in surplus countries.