Western Economies in Transition:

Structural Change and Adjustment Policies in Industrial Countries

edited by Irving Leveson
and Jimmy W. Wheeler

Hudson Institute Studies on the Prospects for Mankind

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with the editorial assistance
of Ernest Schneider

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Preface

This project is one of a number done by academic and other research institutions for the Department of State, as part of its external research program. This particular project was also supported by the Departments of Commerce and Labor. External research projects are designed to supplement the research capabilities of State and provide independent expert views to policy officers and analysts on key questions with important policy implications.

The idea for this study, to determine the outlook for the industrial structures of the OECD countries in the face of slower economic growth, shifts from industrial to service-oriented economies, and increasing LDC output, was proposed by the State Department's Bureau of European Affairs. The work statement for the project was developed by a department working group chaired by Warren H. Reynolds of this office on the basis of a draft prepared by Stanley Black, former special assistant to Richard N. Cooper, undersecretary of state for economic affairs. This working group, subsequently expanded to include representatives from the Departments of Commerce, Labor, and Treasury and the Agency for International Development, undertook the overall monitoring of the project.

The Office of External Research plans and manages this program for drawing on the independent expertise of the private research community. Queries about the program or comments on this study may be addressed to:

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The Policy Context

Robert D. Hormats

There could not be a better time to discuss structural change in the OECD countries.

We can look back with some satisfaction at economic developments in the OECD countries since the Bonn Economic Summit in July 1978. The United States fulfilled its Summit commitment to implement an antiinflation program and energy programs to reduce oil imports below what they otherwise would have been. Germany fulfilled its commitment to take stimulative measures of up to one percent of gross national product (GNP) and, as a result, could achieve 4 percent growth during 1979. Overall, we expect that, due to the convergence of growth rates in the industrial countries and the effects of exchange rate changes, the pattern of current account balances should be more sustainable in the near future. We expect that the U.S. current account deficit will be reduced by one-half or more in 1979 and that we will also see reductions in the persistent surpluses of Germany and Japan. This should contribute to a lessening of the volatility in foreign exchange markets that we witnessed prior to November 1, 1978.

Behind the talk of growth rates and current account balances, there is a sense that the OECD countries face some profound economic challenges. Fundamental structural changes in our economies will be necessary if many of the OECD economies are to continue stable internal growth and to engage in productive economic exchange with the more dynamic economies such as Japan and the rapidly industrializing developing countries.

But there is stubborn resistance to needed structural changes. In many developed countries growth is not vigorous enough to increase employment significantly. In some countries antiinflation measures have led to growing unemployment. In such circumstances adjustment to new employment patterns becomes more difficult because new jobs are not created rapidly enough to absorb unemployed workers. Workers in declining industries strongly resist adjustment, preferring to hang on to the job they have rather than take their chances on being picked up by an expanding industry. In this way, cyclical problems contribute to structural difficulties.

Having achieved a certain measure of prosperity in the 1970s, our citizens now have a stronger desire to preserve what they have. They are less willing to take risks; less willing to accept the burden of adjustment even to those changes which would increase general economic welfare in the long run. This aversion to risk is often reinforced by those unions which draw their membership from a narrow field. Unions in the OECD countries that cover a wide variety of activities tend to be less rigid in protecting jobs in particular sectors.

Finally the pace of change, in terms of patterns of trade among countries, patterns of production within countries, and the introduction, of new technology, has increased rapidly in recent years. The needed social and economic adjustments are not keeping up.

The bulk of economic dislocation results from productivity improvements, competition, and industrial consolidation within our countries. We live with these changes because we understand that they lead to growth, improved consumer welfare, and lower rates of inflation. It is somehow harder to reconcile ourselves to the more visible dislocations caused by foreign competition even though the beneficial effects are the same.

Looking over the agenda for this conference, I can see that various dimensions of the structural problems bedeviling the OECD economies will be covered. Three persistent structural problems deserve the most attention: inflation, which in 1978 averaged about 7 percent for OECD countries; unemployment, particularly among youth and minority groups, which continues to remain very high by historical standards; and private investment, which is sluggish in most countries. These problems are, of course, interrelated: low investment leads to a low growth rate in output and in productive capacity, with the consequence that unemployment and inflation will be higher than otherwise would be the case. With greater international equilibrium likely in 1979, we have the opportunity to devote more attention to these important structural problems.

The seemingly intractable problem of inflation has emerged in this country and in many countries of Western Europe as the dominant economic issue. The standard prescription, and often the right prescription, is tighter monetary and fiscal policy. But too often we ignore many of the causes of inflation which are built into our economies through legislation and regulation—through specific decisions in such areas as environmental protection, health and safety regulations, minimum wages, agricultural policy, and import restrictions. There are, from time to time, entirely appropriate reasons to take actions which also have the effect of contributing to inflation. But too often the inflationary impact of individual measures is not given sufficient weight compared to the possible benefits which might be attained. And too often rigidities caused by past actions have become embedded in our systems, and those who have a vested interest in them prevent their removal. There is no question that failure to allow needed structural change, for example, by protecting a dying industry, is an important cause of inflation.

But inflation is not only a result of resistance to structural change; it is also a cause of that resistance. The persistant inflation of recent years has undoubtedly had a depressing effect on capital investment. By postwar standards, the recovery of investment in the United States since the trough of the recession in 1975 has been weak and slow. Furthermore, investment as a percent of GNP is lower in the United States than in any other major advanced industrial country. Many factors have been cited as causes: lack of confidence in the ability of our economy to grow at an adequate rate, uncertainty about the cost and availability of energy, and the effect of burdensome regulations. Real factors such as low capacity utilization rates and low after-tax rates of return on investment are probably just as important as, if not more important, than the psychological factors.

The corollary of lagging investment is lagging productivity. The rate of growth of labor productivity has been sinking since the mid-1960s. One explanation offered is that employment has shifted out of manufacturing to the service industries. Another is that governments have not been sufficiently supportive of research and development (R&D) needed to increase technical progress and thus labor productivity. In the United States, real federal expenditures on research and development have declined since the mid-1960s. Other analysts cite antitrust, patent, and other regulations as creating an unattractive climate for investment in technology. Still others decry what they consider to be excessive U.S. emphasis on defense-related R&D at the expense of the development of new production processes which result directly in higher productivity and competitiveness. These questions are critical to continued U.S. export competitiveness which today rests on a comparative advantage in technology-intensive products. They are also important to the other industrial democracies whose growth has been spurred by U.S. technological advances.

Slow growth is obviously a cause as well as an effect of lagging investment and slowing industrial innovation. Slow growth and resultant excess capacity discourage firms, particularly those which have heavily committed their resources to present production processes, from undertaking the capital costs required to switch to new technologies. This is a major explanation for the failure of many firms to replace the energy-intensive capital stock made obsolete by the sharp increase in oil prices, even though some of this equipment now lies idle. Slow growth also forces many firms and governments to curtail their research and development efforts. We thus have a vicious circle; the absence of capital investment and technological advance ensures that we will continue to have slow growth in the future.

The third critical structural problem which must be addressed is unemployment of low-skilled workers. In this country, these people tend to be young, between the ages of 15 and 24, and they tend to be black or belong to other disadvantaged groups. The unemployment rate for minority teenagers continues to be a frightening number—close to 35 percent as opposed to a rate of 3.5 percent for white adult males. Throughout the OECD area, unemployment rates for the young average three times overall unemployment rates. Behind these cold statistics is a real threat to social cohesion in the industrial democracies as we create a large group of people who feel that they have no stake in the existing society.

We need a fresh look at government regulations to determine whether the benefits of taxes on employment, policies to assure equitable wage levels and fringe benefits, and policies to increase job security outweigh their costs in terms of reduced employment opportunities. We need more creative approaches to the problem of encouraging the unskilled worker to acquire those skills for which there is greater demand. We need to ask whether our educational systems are developing the kind of people who have the skills and adaptability to operate in a modern industrial economy. Labor mobility is a problem in much of Europe but less so in the United States. Our educational system, however, may be weaker in developing the specific skills needed in today's economy.

A particularly troublesome manifestation of the failure of the OECD countries to address adequately the problems of structural change is the persistence of protectionist pressures. We face a serious challenge in the form of a small number of developing countries (Mexico, Brazil, Taiwan, South Korea, Malaysia, Singapore, and the Crown Colony of Hong Kong) which have in this decade been increasing their exports of manufactured goods to the United States and to Europe at annual rates between 30 and 50 percent. The exports have largely been concentrated in certain categories, including textiles, footwear, and consumer electronics, but many of these countries are now moving into capital-intensive sectors such as steel and autos.

Countries in Western Europe are particularly sensitive to this issue. They are uncertain about their ability to compete with the United States in future growth sectors such as computers and aircraft. They already face intensive competition from what they call the "supercompetitive" developing countries in labor-intensive goods and are concerned that these developing countries will exacerbate present overcapacity in traditional capital-intensive industries (including steel, paper, and chemicals). These concerns underlie the strong European position in the Geneva trade negotiations in favor of legitimatizing selective action against imports from certain countries.

The OECD countries can meet this challenge either through appropriate adjustment or by increasing protectionism. Governments have found it hard to resist protectionist measures even in the knowledge that they reduce productivity, increase inflation, and reduce the ability of other countries to buy their exports. While the U.S. record relative to that of other OECD countries is good, we have nevertheless taken some restrictive measures in textiles, electronics, and shoes.

The Bonn Summit participants, nevertheless, came down clearly on the side of adjustment, by endorsing the guidelines on "positive adjustment" drawn up in the OECD. The positive adjustment approach is based, to the extent possible, on market forces to encourage the movement of capital and labor to their most productive uses. In those infrequent cases where protective actions can be justified, the actions are to be temporary, progressively reduced, and linked to plans to phase out obsolete capacity. Emphasis is placed on positive measures such as training and improved labor mobility in order to facilitate adjustment to shifting demands, technological progress, and changing patterns of trade. Adjustment will result in dislocations, which those specific groups affected will understandably resist. Failure to adjust, however, is to waste the opportunities which appropriate adjustment and trade expansion create. The export sector is the most dynamic sector in our economy, and our fastest growing markets include the very countries which are perceived as "supercompetitive." We should look upon the success of these countries as an opportunity rather than as a threat.

The OECD countries must adjust to changes in the world economy or face a continuous decline in their economic strength and ability to exercise global leadership. International cooperation in the management of these problems becomes increasingly important as the health of our domestic economies becomes more and more dependent on the world economy. Economic summits and meetings under the auspices of