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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMEN

TOWARDS FULL EMPLOYMENT AND PRICE STABILITY

ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUE

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JUNE 1977

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A report to the OECD
by
a group of independent experts

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In 1975 the Secretary-General was invited by the OECD Council meeting at Ministerial level to appoint a Group of independent experts to study and report on the alternative policies OECD Member countries might follow to achieve full employment and price stability. The members of the Group, under the Chairmanship of Professor Paul McCracken, served in their personal capacities and it should therefore be understood that their report, published on the responsibility of the Secretary-General, is not an agreed OECD document and does not commit OECD Member governments.

LETTER OF TRANSMITTAL

8th April, 1977.

To:
Mr. Emile van Lennep,
Secretary-General,
Organisation for Economic Co-operation and Development,
Paris.

Dear Secretary-General,

Herewith we submit our report analysing the problems facing the OECD economies and the suggestions for policy which in our judgement would improve prospects for achieving a more enduring economic expansion. Our main findings are summarised on pages 11 to 33. While it is difficult to make a meaningful short statement about a long and complex report, and the problems governments face are formidable and fast-changing, our Group emerged from its labour cautiously hopeful. We believe that there are policies within the ambit of governments' political capabilities that can improve our prospects for achieving a more enduring expansion of real incomes, rising and high levels of employment, money in whose future purchasing power people can have greater confidence, and those enlarging markets for exports of developing countries so important to their own economic advancement.

Our terms of reference, as laid down in a note submitted to the OECD Council in July 1975, were:

> *" ...to identify and consider the main policy issues involved in the pursuit, by Member countries, of non-inflationary economic growth and high employment levels in the light of the structural changes which have taken place in the recent past; and to make suggestions on the alternative strategies and instruments that Member countries could adopt, both at national and international levels, in order to deal successfully with those issues."*

We were able to begin our work in November 1975, and have held, in all, nine meetings. Early in 1976 our French colleague Monsieur Raymond Barre was obliged to resign in consequence of his appointment as Minister of Foreign Trade. We were extremely fortunate in being able to persuade Monsieur Robert Marjolin to join our group.

In the course of our work we have benefited from the views put forward by the Trade Union Advisory Committee and the Business and Industry Advisory Committee to the OECD and by those parts of the OECD Secretariat specialising in Agriculture, Development Co-operation, Energy, Environment, Financial and Fiscal Affairs, Manpower and Social Affairs, Science, Technology and Industry, and Trade. In submitting our report, now, to you, we wish to thank you for the helpful and constructive attitude you have taken towards our work throughout the period of our existence, and for the services rendered to us by the whole of the OECD Secretariat. Our Group is deeply indebted to Stephen Marris, Economic Adviser to the Secretary-General, and to the Economics and Statistics Department, particularly the General Economics Branch under the direction of Rodney Dobell, for their enormous and effective work on behalf of our project. Without Mr. Marris' intense devotion to our work, this report would not have been possible. The Annex to this report containing supporting material and notes has been prepared by the Secretariat and is published under its responsibility.

The range of problems and possible solutions we examined in the process of writing our report are large and complex. So large and complex, in fact, that it became clear at a very early stage that we would need to place strict limits on both our temporal and geographical horizons. Inevitably, therefore, a number of very significant topics are not discussed, or discussed fully, important as they may be to each of us personally. Among these perhaps the most prominent is the whole cluster of economic, political, social and moral issues associated with the relationships between developed and developing nations. This omission is not because we do not, individually and as a group collectively, care deeply about the economic and ethical questions at issue, but simply because we feel these questions fall outside the scope of this study as we understand it. They are, of course, under active examination in bodies whose job it is to deal with the complex issues involved.

For much the same reasons, we cannot claim to have dealt adequately with the problems of the less-developed

OECD Member countries themselves. For these countries the issues of unemployment, emigration, and capital flow, though tied very closely to developments in the largest OECD economies, are very different in kind. We feel it is important that they be pursued energetically within the OECD. But, again, we have been forced to conclude, in allocating scarce time, that their characteristics are such that they fall somewhat outside the scope of a study directed essentially at the pursuit of price stability and high employment levels in the more industrialised OECD countries.

Similarly, the further our work progressed the more we became convinced that our attention should be concentrated on the visible and pressing problems of the near-to-medium term, rather than on the future landscape. We have consequently confined ourselves in the report to the problems that must be confronted and solved over the next decade or so. We set for ourselves this horizon because the first requirement for a more orderly economy in the longer run is that economic policy in the years immediately ahead get the industrial economies moving along the path of sustainable and enduring expansion. In taking this decision, we were also influenced by the fact that the OECD has set up a parallel project called Interfutures, whose reports on these longer-run prospects we shall await with great interest.

Finally, questions about how these problems of economic policy might work out if our social and economic systems were substantially altered would have required more time and resources than we had at our disposal.

Our report, then, is focused primarily on the better management of the market-oriented economies of the industrialised democracies in their own interests and in the interests of the world at large. It is, to an important extent, concerned with the years immediately ahead when the path our economies take will determine whether we can experience a sustained growth in employment rates and material levels of living or whether we shall see a continuation of a stop-go pattern. At the same time, many of our recommendations relate more to achieving a longer-run improvement in growth and price performance than to the specific problems of any particular date.

We hope that our report will clarify some of the choices to be made in the management of economic affairs. We hope, also, that it will stimulate further work on questions which we have been able to identify as being of central import-

ance but on which we have been unable, in the time allotted to us, to do justice.

The range of views within a group of eight economists, representing widely varying backgrounds and experience, is great, and inevitably the report is not what any one of us individually would have written. Comments by some individual members of the Group are appended at the end of the report. While each member reserves, of course, the right to his own views on specific matters where they may diverge from those in the report, we do commend this report to the Council as an analysis, on which there was a substantial measure of consensus within the Group, of our problems and policy options.

Paul McCRACKEN,

Chairman,
Professor at the University of Michigan,
former Chairman of the United States Council of Economic Advisers.

Guido CARLI,

President, Confindustria,
former Governor of the Bank of Italy.

Herbert GIERSCH,

Director of the Institute for World Economics at Kiel University,
former Member of the German Council of Economic Advisers.

Attila KARAOSMANOGLU,

Director of Development Policy at the IBRD,
former Deputy Prime Minister for Economic Affairs in the Turkish Government.

Ryutaro KOMIYA,

Professor at the University of Tokyo.

Assar LINDBECK,

Director of the Institute for International Economic Studies at Stockholm University.

Robert MARJOLIN,

former Secretary-General of OEEC and Vice-President of the Commission of the European Economic Community.

Robin MATTHEWS,

Master of Clare College, Cambridge,
former Drummond Professor of Political Economy, Oxford University.

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* Conventional signs in Tables :

.. Not available.

— Nil or negligible.

SUMMARY*

INTRODUCTION

In the quarter of a century following World War II, the industrial world enjoyed growth to an extent unprecedented in economic history. In part, this was due to the process of postwar reconstruction, rapid and widespread technological progress, stable supplies of raw materials and energy, and the rise in volume of international trade. This potential for rapid growth would not have been realised, however, had it not been for the favourable economic climate created by governments—first by their assumption of responsibility for the achievement of high employment, and second through their commitment to economic integration in the framework of an open multilateral system for international trade and payments. [1-8]

During recent years, by contrast, the industrial economies have experienced substantial slack in the use of their productive potential, and both unemployment and inflation remain disquietingly high in all but a few countries. Adjustment among the industrialised countries to the new situation created by large OPEC financial surpluses has been unsatisfactory. And there is some danger that the edifice of free trade, so carefully built, may begin to disintegrate. [9-12]

In the light of these developments, public confidence in the ability of governments to manage the economy has waned, and belief in the likelihood or even desirability of continuing economic growth in the industrialised world has weakened.

This is the background against which this report seeks answers to the three fundamental questions:

— What went wrong and why?

— What are the objectives of, and constraints on, policies over the next ten years or so?

— What are the broad policy options open to us?

Present economic conditions are obviously abnormal in terms of capacity utilisation, inflation and international payments equilibrium. Hence an important part of our policy prescriptions is addressed to the problem of re-establishing a more satisfactory situation on all three counts—which it is imperative to achieve within the next few years. But we also seek to lay down some guidelines for maintaining a more enduring expansion of output, employment and real incomes, without running into similar problems again, once that objective has been reached.

* The numbers in square brackets refer to the relevant paragraphs in the report.

In view of the abnormal starting point, and our related concern with the deterioration of performance regarding growth, employment and prices, as well as with the instability of expectations, we devote considerable attention to demand management and other policies with a more short-term focus. We do not reject or neglect the role that longer-term policies must play to achieve less inflationary growth and continuous adaptations of economic and social structures, institutions and behaviour patterns. But, at the same time, we believe that by following more stable and predictable demand management policies, governments can make a major positive contribution to a steady improvement of the performance of our economies, including the stabilization of expectations and the rebuilding of confidence. To restore confidence is, perhaps, the most important though least tangible facet of the task facing governments.

The report concentrates on the experience and problems of the major OECD countries, while making generalisations for the "OECD area" as a whole. Economic integration within the area has reached a stage where it is the sum total of policy actions and consequent economic impulses that dominates events in all but the largest of the Member countries. It is obvious, however, that our generalisations concerning what went wrong and what should be done need to be interpreted with caution in the light of specific circumstances when applied to individual countries. [13-14]

WHAT WENT WRONG?

Going back to the 1960s, in the United States, failure adequately to finance the war in Vietnam and major new social programmes through higher taxes led to increasing excess demand, despite monetary restraint. In Europe demand fluctuated around a high level, and towards the end of the decade price inflation accelerated following a series of wage explosions and labour-market disruptions. All these led to restrictive policies and the 1970-71 downturn on both sides of the Atlantic. That recession, however, did not eliminate the higher inflation that had become a central concern by the end of the 1960s. Moreover, the attempt to maintain the parity of the dollar in the face of years of deteriorating competitiveness, which had led to loss of confidence in the dollar, massive United States external payments deficits, and a rapid increase in liquidity elsewhere, led ultimately to the breakdown of the pegged-exchange-rate system. [15-27, 32-36]

1972 was election year in an unusually large number of OECD countries. Memory of labour-market unrest—and, indeed, of social and political unrest more generally—was probably still strong in some countries. Thus, even though major wage increases were still working their way through the system, there were thought to be good domestic reasons for a strong shift to expansionary policies in 1971, and this continued into 1972. But part of the explanation for the pursuit of such expansionary policies lay in the absence of the normal balance-of-payments constraints on the monetary policy of deficit countries during the progressive breakdown of the pegged-exchange-rate system and the large United States deficits on current and capital account which preceded and accompanied it. There would have been a strong upswing in 1972-73 anyway, but because of these external events more expansionary action was taken than would otherwise have been the case and, especially, more of it took the form of *monetary* expansion. [28-31, 37-40]

It was the excessive rate of monetary expansion which accounts for the typically speculative features of the subsequent boom. The price of real estate, gold and other traditional havens of nervous capital in inflationary times soared; hedging and speculation in commodities developed for stockbuilding purposes but also as a store of value in an uncertain world. On this situation was superimposed a series of agricultural harvest failures. [43-44]

The 1972-73 boom was exacerbated by the fact that bottlenecks appeared relatively earlier than expected. In some basic industries inadequate investment in earlier years had resulted in insufficient capacity to meet the surge of demand. More generally, the problem lay not so much in the absolute level reached by demand, as in the *speed* of its increase. A scramble for inventories led to shortages even in sectors where labour and physical capacity were no more stretched than in earlier booms. Prices of food, raw materials and industrial products all increased disproportionately compared with earlier upswings. International linkages also played a crucial role. Demand expansion in individual countries that would not have been excessive in isolation became so when demand was rising rapidly elsewhere. [41-42, 45-54]

One reason why the 1974-75 recession was so severe was that, when the oil crisis came, the world economy was already beginning to respond to restrictive policies put in place in 1973. To these policies was added the massive, though somewhat delayed, contractionary impact of the unspent OPEC oil revenues. The continued pursuit of strongly restrictive policies after the oil price rise was a controversial decision, but in most countries there was no practicable alternative, given that the OPEC decision set off a resurgence of speculative behaviour and a major new price/wage spiral. The impact of these policies, however, was greater than expected. [55-78]

The recovery which began in the middle of 1975 was intended to be moderate but sustained. It has so far proved rather fragile. An equally striking aspect, which still prevails as we write, was that although inflation rates dropped nearly everywhere, they remained highly divergent as between countries. [79-89]

What lessons can be learned from this experience? There has been a severe deterioration in the short-run trade-off between activity and inflation. In the late 1960s and into the early 1970s this partly reflected changes in wage-bargaining and price-setting behaviour resulting from growing confidence in governments' ability to ensure full employment, declining fears of unemployment and insolvency, the rapid rise in public expenditure, and more aggressive income-bargaining. At the same time, the level of recorded unemployment corresponding to a given level of capacity utilisation increased as a result of the changing composition of the labour force and—possibly—of more generous unemployment compensation in some countries. This further worsened the apparent trade-off between unemployment and inflation. [102-104, 193-198]

But in the last few years this deterioration was sharply accelerated by a series of shocks—the harvest failures and explosive rise in oil prices—which together accounted for a considerable part of the price acceleration from 1972 to 1974. This was compounded by overly-expansionary fiscal and monetary policies followed by most countries, in part induced by events surrounding the move to a more flexible exchange-rate system. In contrast to the 1960s, this bout of inflation originated less in labour markets and more in product markets, both national and international. In particular, the very general and rapid increase in monetary aggregates contributed *significantly to the build-up of demand pressures and stubborn inflationary expectations.* [90-94]

Taken by themselves, neither the shocks nor the policy errors might have led to greater disruption than was experienced, for example, at the time of the Korean War. But the combination of the two was decisive, and their legacy is still with us in the form of adverse expectations about inflation, employment and growth. [95]

This does not mean that demand management is no longer effective in reducing inflation. Although less favourable, the strikingly close correlation between inflation in the OECD area and demand pressures 12-18 months earlier has continued to hold. Inflation has slowed down from a peak of about 15 per cent to about 8 per cent as demand pressures have eased and the exogenous factors which caused most of the earlier acceleration have ceased or been reversed. Restrictive demand management policies are decidedly effective against the type of inflation in product markets we have been experiencing. Moreover, without significant restraint of demand the wage-price spiral would not have slowed down; on the contrary, the rate of inflation would have risen further. [105-107]

Adverse expectations born of recent experience will be with us for some time. But there is no fundamental reason why, in more favourable circumstances and with improved policies, they cannot be reversed. As " expectational " inflation subsides, however, we may find that there has been an acceleration of the inflation that can broadly be attributed to competing claims and malfunctioning of market mechanisms—which was apparent at the end of the 1960s, but was then obscured by the various striking developments just described. [108-112]

To sum up, the immediate causes of the severe problems of 1971-75 can largely be understood in terms of conventional economic analysis. There have been underlying changes in behaviour patterns and in power relationships internationally and within countries. But *our reading of recent history is that the most important feature was an unusual bunching of unfortunate disturbances unlikely to be repeated on the same scale, the impact of which was compounded by some avoidable errors in economic policy.* The continuing legacy of 1971-75 makes for unusual difficulties in framing policies for the years immediately ahead. We reject, however, the view that existing market-oriented economic systems and democratic political institutions have failed. What is needed is better use of existing instruments of economic policy, and better functioning and management of existing market mechanisms. [96-100]

THE DESIRABILITY AND FEASIBILITY OF GROWTH

Continued economic growth in the industrialised countries, providing for a reasonable rate of expansion in the available supply of goods and services, remains an essential objective. It is needed to satisfy people's aspirations for a rising standard of living and to provide adequate employment opportunities. [163-168]

Although economic growth has costs—which in conventional national accounting either appear perversely as benefits (i.e. as output), or are not counted at all—it is positively correlated with welfare. And growth makes it easier to change the pattern of resource allocation and output so as to achieve such collective goals as protection of the environment, improvement of the quality of life, and assistance to the disadvantaged. *There is little point in pursuing the fastest possible economic growth at all costs. But reasonably rapid growth remains an appropriate objective.* [169-172]

The major qualification to this statement lies in issues concerning the distribution of income—both nationally and internationally. From one point of view, economic growth can help the redistribution of income by providing the support for increased assistance programmes and by opening up new opportunities for employing under-privileged groups and for trading with developing countries. Beyond a certain point, however, conflicts may arise in any economic system between equality and efficiency. We believe that such conflicts can normally be reconciled in the light of the preferences existing in each country and in each period, with the reservation that—in an integrated world economy—the margin of manœuvre of individual countries is constrained by an international " demonstration effect ", coupled with the threat of capital flight and brain drain. [173-174]

As regards the international dimension of the problem, we reject the argument that growth in the developed countries must slow down so as to provide more room for growth in the Third World. Because of the scope for productivity increase in both the industrial and developing countries, growth of the world economy should not be regarded as a zero-sum game involving a struggle for a fixed amount of world resources. But the international dimension does require a *pattern* of growth in the developed world that helps growth in the developing countries based on increasing their exports, and on a flow of real resources to them in the form of capital exports. This can be achieved on a basis which is to the mutual benefit of both the industrialised and developing countries. At the same time, the terms of trade are likely to shift in favour of countries—many developing, some developed—with large resources of certain raw materials and land; this process should not be resisted. [175-180]

As we get richer, demand may gradually shift towards leisure and things such as personal services which cannot be mass-produced. This is already happening; as it does, there will be a slowdown of growth as presently measured—but not necessarily of the increase of welfare. [181]

Is growth likely to be restricted importantly by a major break in the trend of supply potential? We do not find the arguments behind this suggestion convincing, even though in most countries a complete return to previous trend rates appears unlikely. In our view, *growth over the next decade or so will be limited not so much by constraints of a physical or technological kind as by the need to overcome the present economic and social stresses and imbalances of which inflation is one of the main symptoms.* [182-184]

The supply of labour in the industrialised countries of the OECD is likely to rise somewhat more slowly in the future. Demographic trends, changing attitudes towards migration and a lower outflow from agriculture are the main reasons involved, counter-balanced to some extent by a further rapid rise of female participation rates. These changes in the aggregate supply of labour should not have much impact on real income per head, and their significance is rather that they imply some loss of flexibility in the adjustment by the labour force to changes in the pattern of demand. [185-199]

The crucial component of growth is, and will remain, the development of labour productivity. There may be reason to be concerned by the declining trend in research and development expenditures and, more importantly, by the risk that if pessimism concerning future profits and corporate cash flow persists, both investment in the research and development of new techniques and the exploitation of existing technological opportunities will be inhibited. We are more agnostic as to the risk of a slowdown in productivity brought about by future sectoral shifts from high to low productivity sectors and to sectors where the rate of growth of productivity is low, or by a possible exhaustion of economies of scale. Productivity growth in the post-war period owed much to the rapid expansion of international trade, permitting much greater specialisation and the realisation of substantial scale economies. There may be less opportunity for future progress along this line by the further expansion of trade among the industrialised countries, but this could be offset by increasing trade with developing countries. [200-207]

We do not find doomsday predictions about the exhaustion of depletable natural resources, over any reasonable time-horizon, to be persuasive. Changes in relative prices should, in due course, produce the necessary shifts in output, recycling, substitution and saving. But *serious short-term problems could emerge, for prices because of inelastic output or supply interruptions.* In the field of energy, the resource cost of reducing dependence on a small number of suppliers of oil appears now to be much higher than was thought a few years ago. We also note with some concern that after 1990 there may be increasing problems of overall oil supplies, and that because of very long lead times difficult decisions concerning development of alternative energy sources will need to be taken in the next few years. [208-212]

As far as OECD countries are concerned, it is unlikely that food supply will constitute a constraint on future growth, but there is a risk that the recent instability in the world markets for agricultural products will continue and could even increase in magnitude. As regards industrial raw materials, the available evidence suggests that there will be no generalised supply problems or disruptive price increases over the next few years, on the assumption of a moderate and steady growth path for OECD demand and output. But present information on investment intentions suggests that in the early 1980s productive capacity for some industrial raw materials might become insufficient, given the present combination of political uncertainties and unstable market conditions. [213-216]

In brief, *we see nothing on the supply side to prevent potential output in the OECD area from growing almost as fast in the next five to ten years as it did in the 1960s and we repeat that we find reasonably rapid growth desirable.* Whether it is achieved will depend heavily on our ability to obtain a desirable level and structure of final demand and the accompanying distribution of income without arousing disruptive conflicts which exacerbate inflation. Expectations and aspirations which rise more rapidly than the available economic capacity entail competing claims that can be