Economic prospects for industrial countries abroad

Domestic demand in most foreign industrial countries expanded at a fairly rapid pace during the last several quarters. Earlier this year, there were strong indications that this pattern of growth would be sustained for some time, even without further stimulative economic policies by national authorities. Private spending was strengthening in both the consumer and the business sectors. Yet the expansion of demand, particularly in the second half of 1978, had not brought an immediate upsurge in domestic inflation rates, which had slowed substantially over the previous year or so. At the same time, all larger foreign industrial countries, except Canada, registered current account surpluses for 1978. Thus, for many industrial economies, there was little or no evidence of significant external or internal strains that could impede continued growth.

The implications of that outlook were broadly favorable from an international perspective. With a slowdown in United States economic activity, the improved growth performance elsewhere would have been a step toward restoring a growth pattern more typical of the 1960's and early 1970's. One desirable consequence would have been to reinforce a trend toward adjustment of United States and foreign countries' balance-of-payments positions—a smaller deficit here and smaller surpluses in several important countries abroad.

However, the combination of threatened oil supply disruptions, a series of abrupt increases in oil prices, and several other unfavorable factors have cast doubt on this optimistic scenario for the major industrial economies abroad. The question is how much of an adverse impact on growth and prices might there be and how soon might it be felt. To shed light on that question, this article begins by reviewing the main features of the foreign growth experience during the current cyclical expansion. It analyzes the factors that seemed to justify a relatively optimistic outlook earlier this year. It then assesses the implications of new developments for growth prospects over the next year or so.

The main conclusion is that the relatively mild cost-price pressures and comfortable wage-productivity-profit relationships that prevailed abroad at the beginning of 1979—especially in Germany and Japan—would promote continued improvement in economic activity through the end of this year. But the likelihood of a marked reduction in growth rates during 1980 has definitely increased now that the full extent of the oil shock has become apparent and other cost pressures are intensifying.

Growth experience since 1975

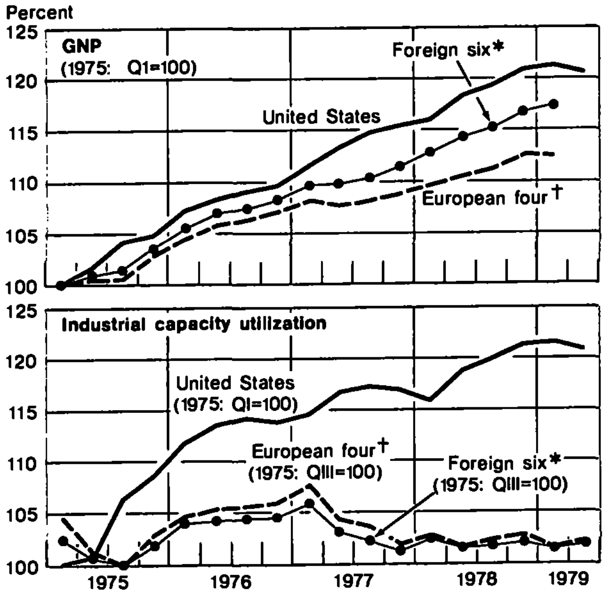
During the current expansion, until early this year major foreign economies grew at a substantially slower pace than the United States economy. That performance stands in sharp contrast to the previous cyclical expansion of 1971-73, when the reverse was true. Cumulative United States real GNP (gross national product) growth, measured from the trough in the first quarter of 1975 to end-1978, was almost 4 percentage points above weighted average real growth for the six largest foreign industrial economies (Chart 1). Even more striking, on a fourth-quarter to fourth-quarter basis, the United States growth rate was consistently above the average foreign growth rate in each of the four years. Comparing the United States with Europe, the output gap was considerably larger.

The divergence in output performance was especially marked in the industrial sector. For instance, in the four quarters to end-1977, average industrial growth was near zero abroad, whereas United States industrial output expanded almost 6 percent. And, even as foreign industrial growth picked up to nearly 6 percent last year, the United States expansion of about 7½ percent remained higher.

The differential performance was reflected in utilization rates in manufacturing and in employment. During 1975-78, industrial capacity utilization rose very rapidly in the United States while elsewhere, after showing an initial rebound, utilization rates slid back to near 1975 trough levels. Even after a modest improvement in capacity utilization rates abroad during 1978, on average, those rates were still substantially below the United States rate at end-1978 (Chart 1). Throughout 1975-78, unemployment levels remained persistently high in all foreign countries and employment actually declined in a number of them. By contrast, during that period, United States employment rose by more than 11 million and the unemployment rate declined by about 3 percentage points to under 6 percent.

Chart 1

GNP Growth and Industrial Capacity Utilization



*Foreign six include Germany, Japan, Canada, United Kingdom, France, and Italy.

†European four include Germany, United Kingdom, France, and Italy.

Sources: GNP: various national data publications. Industrial capacity utilization: Wharton School estimates and Federal Reserve Bank of New York staff updates for foreign countries; for the United States, index of the Board of Governors of the Federal Reserve System.

The persistently slow pace of foreign growth relative to the United States in the present expansion led to growing differences in demand pressures and consequently to divergent cost-price patterns. By end-1977, the divergence in cost-price patterns and in relative inflation rates had become firmly established (Chart 2), as differences in demand pressures widened and economic policies in most foreign countries tended to become more restrictive. Moreover, the exchange rate movements widened the divergent trends of inflation. A sharp depreciation of the dollar led to considerable upward pressures on costs and prices in the United States. In several foreign countries, by contrast, appreciating exchange rates helped offset domestic cost-price pressures in 1977-78.

The contrast is particularly pronounced with respect to Germany and Japan, where cost-price pressures have been substantially lower than in the United States. Cumulative increases in GNP deflators, manufacturing unit labor costs, and wholesale prices—measured from the first-quarter 1975 trough to the fourth quarter of 1978—are 10 to 23 percentage points smaller than for the United States (Chart 3). Moreover, compared with the 1971-73 cyclical expansion, cumulative increases for Germany and Japan are much smaller and indicate only a modest buildup of cost-price pressures. Most notably, at end-1978, average manufacturing unit labor costs were only 2½ percentage points above the 1975 trough level for Germany and Japan. This suggested that both countries could absorb further increases in costs, at least for a while, without serious consequences for inflation. In that relative sense, their cost-price patterns could be called "durable". That is, they would carry a relatively low risk of deteriorating into a domestic cost-price spiral.

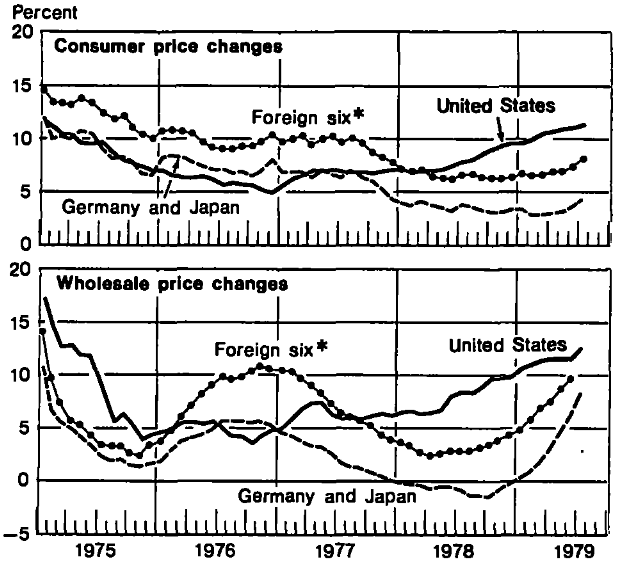
In part, the modest cost-price pressures reflected the relationship between increases in real wages and productivity growth. Unlike the United States, productivity growth was substantially higher than the average increase in real wage rates for Germany and Japan (Chart 4). By helping maintain mild cost pressures, this allowed for development of comfortable profit margins.

The durable cost-price patterns and comfortable wage-profit-productivity relationships had set the stage for a period of strong growth abroad centered on Germany and Japan and sustained by private domestic demand. Thus, toward the end of 1978, the situation characterized by fast growth in the United States and slow growth abroad appeared to be changing. Domestic demand—domestic components of GNP—was expanding much faster in Germany, Japan, and several other countries than in the United States. With higher profits and rising capacity utilization, business invest-

Chart 2

Consumer and Wholesale Price Inflation

Percentage change from 12 months earlier

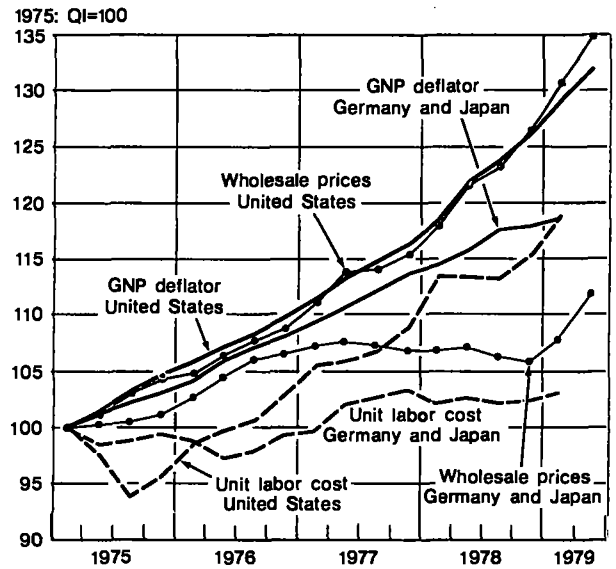


*Foreign six include Germany, Japan, Canada, United Kingdom, France, and Italy.

Sources: Various national data publications.

Chart 3

GNP Deflators, Wholesale Prices, and Unit Labor Costs in Manufacturing



Sources: Various national data publications and the International Monetary Fund.

ment was beginning to grow rapidly, making a strong contribution to aggregate demand. A part of the rise in investment activity was attributable to the acceleration in public expenditures during the second half of 1978, as the authorities implemented expansionary policies. The pickup in private investment and increased public expenditures led to a higher absorption of excess savings in the private sector of Germany and Japan, thus helping correct a persistent imbalance between domestic savings and investment. That imbalance had been important in explaining the large current account surpluses recorded by those countries.

After allowing for the effects of bad weather and strikes in some countries, the underlying pattern of domestic demand abroad remained strong in the first half of this year. In most countries, industrial output growth was essentially similar to that in the second half of 1978. Private consumption demand continued to be buoyant in virtually all foreign countries. And, in Japan and Germany, private investment in machinery and equipment made a particularly strong contribution to growth.

However, several new developments now threaten the foreign expansion. The most important, of course, is the new oil shock that is leading to large consumer and wholesale price increases and may be affecting consumer and business confidence. Uncertainties about the price of oil and its supply remain. Other major negative influences on foreign growth prospects include commodity price increases other than oil, potential labor cost pressures, and the slowdown in United States economic activity. Moreover, as external factors began to push up domestic inflation rates above acceptable levels, several countries started to take restrictive policy actions. Those actions could have substantial adverse impact on real growth next year.

Impact of the oil shock

By the end of 1979, the average price for OPEC (Organization of Petroleum Exporting Countries) oil is projected to rise 55-60 percent over the end-1978 level.[1] Comparing average 1979 oil prices with average

[1] The average weighted price is based on price and quantity weights for OPEC producers. For the United States, the weighted price will be 4-6 percentage points higher, on a year-end basis, because the imported oil contains a larger than average share of more expensive high-quality crude, whose price has been rising more sharply.

1978 prices, this is equivalent to a year-on-year increase of 35-40 percent. An oil price rise of this size entails serious consequences for prices and real growth in industrial countries, including the United States.[2] It is difficult, if not impossible, to estimate those effects precisely. There are substantial problems in calculating not only the magnitudes of various consequences but also their timing. Notwithstanding those difficulties, this section attempts to provide some rough estimates of the overall effects on prices, real growth, and the current account for the industrial countries as a group.

At present, industrial countries' oil imports from OPEC account for somewhat less than half of their total energy requirements and are running around 2.3 percent of their total domestic demand. Given these magnitudes and assuming full adjustment of energy prices in general to foreign oil prices, the 1978-79 oil price hikes may contribute 2.0-2.5 percentage points to the domestic demand deflator (somewhat less to the GNP deflator) in the course of one year. The estimate abstracts from any immediate wage response to the oil price changes. The longer term effect on prices may be higher since the new environment is likely to stimulate revisions in price expectations and induce increases in money wages. These changes, in turn, could lead to wage-price interactions that ratchet inflation higher.

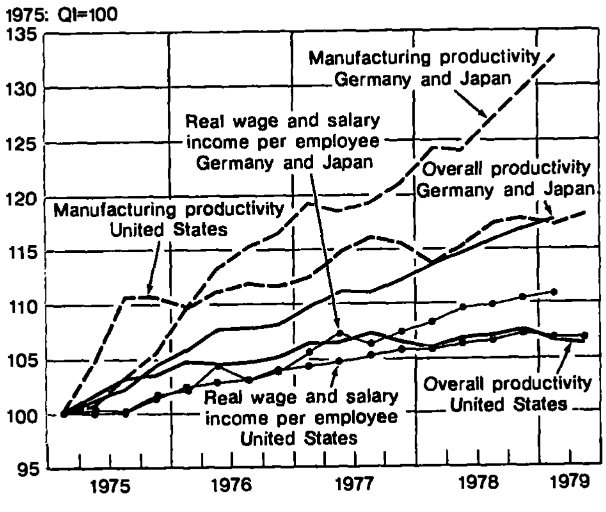
To the extent the oil price rise increases the total domestic demand deflator without corresponding increases in nominal income, it must directly reduce real income. Moreover, since OPEC will spend only a portion of the increased revenues, real domestic spending and hence GNP in industrial countries indirectly would be depressed. The direct and the indirect effects of the OPEC price rise may add up to a real income loss of 1.2-1.5 percent in the course of one year.[3] The calculation assumes that (1) OPEC spends somewhat less than half of 1979 additional revenue of roughly $55 billion in industrial countries and (2) there is no substantial change in government budgets or overall economic policy postures. With the average oil price level at end-1979 sustained throughout 1980, the depressing effect on real income over a period of perhaps two years would be greater as OPEC revenues rise by another $25 billion. The effects for any individual country are likely to differ according to the size of the income "multiplier" and the degree of dependence on imported oil. But, with the exception of Canada and the United Kingdom, the real income effect for each of the major countries should be roughly similar to the average for the group.

For various reasons, this range of estimates may be viewed as being on the low side. Negative effects on consumption and investment expenditures resulting from changes in consumer and business confidence have not been taken into account explicitly. Moreover, during 1979-80 the oil-exporting countries may spend substantially less than half of their additional revenue in industrial countries—the proportion assumed to be spent in the above calculations. There is also the strong possibility that the oil shock will reduce output by making some existing production capacity obsolete, although it will provide incentives for investment in energy-saving equipment. Over a longer period, the transmission of higher oil import prices to production costs and additional OPEC spending in industrial countries may lead to partially offsetting price and volume effects on exports and output. But these additional output and income effects are likely to be small.

These estimates of the real growth effect assume that the energy requirement for additional growth will be met. Given the current evidence on the relationship between energy and growth, the energy requirement for increases in output may be relatively

Chart 4

Productivity and Real Wage and Salary Income per Employee



Sources: Various national data publications.

[2] The International Monetary Fund classification of industrial countries is used: Austria, Belgium ,Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

[3] The calculation is based on a one-year income "multiplier" of about 1.7 for industrial countries as a group.

modest.[4] It could possibly be met by a rundown of inventories or by cuts in wasteful oil consumption. However, the ability of industrial countries to conserve energy in the short run is limited. Therefore, the growth consequences of even a modest shortfall in energy supplies could be significant.

Implied in the preceding discussion are substantial adverse current account effects for industrial countries. Well over three fourths of the 1979-80 additional OPEC oil revenue will be reflected in industrial countries' oil import bill. Somewhat less than half of that increase would be offset by higher exports to OPEC and from higher export prices. Moreover, slower growth would by itself tend to reduce import expansion. On balance, the adverse impact on current account for the group of industrial countries might amount to $22-23 billion in 1979 and another $10-11 billion in 1980.

In sum, this year's oil price increase is estimated to add about $80 billion at an annual rate to OPEC revenue by 1980. That would compare with about $75 billion for the 1973-74 oil shock. As a percentage of domestic demand in industrial countries, the increase in oil costs will amount to about 1.3 percent of the 1979-80 average, compared with about 2 percent for 1973-74.

Other cost pressures

There are other actual and potential pressures on costs and prices which may have serious consequences for growth abroad. Commodity prices other than oil have risen sharply since the beginning of this year. The overall dollar-based commodity price index of the *Economist* rose at an annual rate of nearly 30 percent between end-December and end-September. The raw materials component (especially metals) of the index rose very sharply in the first quarter, but the food component was relatively stable over that period. In the last two quarters, however, both food and raw materials prices have advanced considerably. Although a general slowdown in economic activity may lead to downward pressures on commodity prices during the next several quarters, commodity price increases to date have the potential to increase production costs and eventually to become imbedded in consumer prices.

Most foreign industrial countries are also likely to face some upward pressures on prices from labor costs and other factors:

- In Canada, wage increases in the first half of 1979 have been large due to catch-up movements following the sharp decline of real wages during 1978 and the recent dismantling of wage controls.
- In the United Kingdom, after the final phase of the incomes policy, average earnings have been rising at a rate of 13-14 percent per annum. Moreover, the value-added tax increase of 7 percent announced in the new budget is estimated to have added close to 4 percentage points to consumer price inflation this year.
- In France and Italy, significant increases in total unit labor costs are expected as persistently high inflation is rapidly transmitted to wages, in part because of formal indexation arrangements.
- For Japan, some rise in total unit costs may be forthcoming as a result of higher utility charges, special bonus payments to workers associated with higher profits, and the depreciation of the yen early this year.
- In Germany, labor costs are not expected to be an important factor behind a rise in the inflation rate in 1979, but some analysts have questioned whether that would continue to be the case in 1980. Moreover, a 1 percent increase in the value-added tax, effective July 1, and sharply rising construction prices will add momentum to cost increases from oil and other commodity prices.

Finally, there is a substantial risk that over time cost pressures will be passed through to product prices. Monetary growth continues to be high in virtually all industrial countries at a time when domestic demand is strong.

Policy dilemmas abroad

In these circumstances, foreign industrial countries—particularly Germany and Japan—face a difficult policy dilemma. The problem is that, at the present pace of economic expansion, rising inflation rates could begin to accelerate rapidly. On the other hand, if inflation control is overemphasized at this time, it would stifle growth unduly. The latter course of action could stop, or at least markedly retard, progress toward restoring a more balanced long-term pattern of economic performance among the industrial countries abroad and the United States. In view of the relatively comfortable cost-price conditions, both Germany and Japan could

[4] Recent studies indicate an energy elasticity—the ratio of percentage changes in total energy requirements to percentage changes in GNP—in the range of 0.7-0.8. With nearly half of the energy requirements in industrial countries being met by imported oil, a 3 percent annual real GNP growth rate implies about 0.5 million barrels per day increase in oil import volume.

be in a position to accept some further moderate increases in inflation without sacrificing their growth objectives. But cost-price pressures are beginning to build up and a long delay in reacting to these pressures could lead to another period of high inflation rates. Thus, the timing of any major changes in policy actions would be the most crucial element in determining the balance between growth and inflation over the next two or three years.

So far, foreign industrial countries have shown little inclination to offset the deflationary effects of the oil price rise, unlike the response of several countries to the 1973-74 oil shock. On the contrary, many countries have adopted more restrictive economic policies in the last six months. Official interest rates have risen considerably in most countries, including Germany and Japan. Several countries have also taken various direct monetary policy measures to restrict liquidity and to reduce monetary growth. On the fiscal policy side, the United Kingdom has adopted a substantially deflationary stance in the budget proposal for 1979-80. Elsewhere, attempts to reduce public-sector expenditures and/or deficits remain an important objective.

In view of the severity of the actual and potential cost pressures, inflation control may be given increasingly greater priority in most foreign industrial countries. The prospects for restrictive policies are reinforced by the fact that the oil price rise is generating substantial adverse effects on current accounts. For some countries, external objectives are thus likely to be a more important constraint on policies during the next several quarters than in the last year or so.

Conclusion

Foreign growth prospects for this year remain good, although for the closing months of the year they seem less optimistic than they did only a few months ago. For 1980, however, the growth outlook is guarded. There is a risk that most larger foreign countries will experience very little real growth. At this stage, probably the best that can be hoped for next year is a moderate slowdown, with major foreign countries as a group experiencing growth of around 2.5 percent. Such a scenario is suggested by the underlying strength of recent data on GNP and business investment, and movements of the leading indicators—such as the ratio of prices to unit labor costs, corporate profits, and real monetary aggregates. This view is also supported by the fact that the relatively stable pattern of private consumption demand and planned public investment programs in several countries will continue to provide at least a small contribution to real GNP growth through early 1980. Nevertheless, the achievement of even this moderate growth might be associated with continued high inflation.

M. A. Akhtar