INTERNATIONAL TRADE IN 1981 AND PRESENT PROSPECTS

First Assessment by the GATT Secretariat

This is the GATT secretariat's first summary and assessment of world trade and major economic developments in 1981. Part I summarizes the main facts, while part II examines the current concerns about inflation and unemployment, and their relation to the state of international trade and payments.

PART I - DEVELOPMENTS IN 1981

World merchandise trade amounted to nearly $2,000 billion in 1981, 1 per cent less than in 1980. This was the first year-over-year decline in the value of world trade since 1958. The decline followed an increase of more than 20 per cent in the preceding year. It was essentially due to the movement of export unit values expressed in dollar terms, which had risen by nearly 20 per cent in 1980, but declined by 1 per cent in 1981. The rise in domestic prices of traded goods was thus more than offset by the strong appreciation of the US dollar against most currencies (see Table 1).

1 Later in 1982, when more complete information becomes available, these preliminary indications will be elaborated in greater detail in the GATT annual report, International Trade 1981/82.

2 Trade statistics covering all of 1981 are available only for a number of industrial countries. For the other countries, data referring to the year 1981 are rough estimates based on the months available and on the returns of those of their trading partners for which complete data were available.
TABLE I. - WORLD TRADE BY AREAS, 1979-1981
(Billion dollars and percentages)

<table>
<thead>
<tr>
<th></th>
<th>Exports (f.o.b.)</th>
<th>Imports (c.i.f.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value 1980 1981</td>
<td>Change over previous year</td>
</tr>
<tr>
<td></td>
<td>Value 1980 1981</td>
<td>Change over previous year</td>
</tr>
<tr>
<td>World</td>
<td>2 000 1 970 +21</td>
<td>-1</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
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<td>1 233 1 215 +18</td>
<td>-1</td>
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<tr>
<td>OPEC</td>
<td>296 270 +39 -9</td>
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<td>Other developing</td>
<td>250 265 +25 +6</td>
<td></td>
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<tr>
<td>countries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eastern trading area</td>
<td>176 179 +17 +2</td>
<td></td>
</tr>
</tbody>
</table>

*Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libyan Arab Jamahiriya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela.*

*bImports f.o.b.*

Note: Figures for 1981 are based on incomplete returns and are subject to revisions.


In volume terms, aggregate world trade stagnated in 1981, having risen by only 1 per cent in 1980. This was due to a drop in the volume of mineral exports, which offset expansion in other product categories. World exports of petroleum declined by 14 per cent and those of other minerals by 5 per cent, while world exports of agricultural products expanded by 5 per cent and those of manufactures by 3 per cent (see Chart I). Excluding crude petroleum, the volume of world trade grew by 2 1/2 per cent, compared with a 4 1/2 per cent increase in 1980. Even for this part of world trade, however, there was a pronounced weakening in the last quarter, which appears to have continued in the first quarter of 1982.

*In volume terms, 1975 was a worse year for world trade than 1981; this is not apparent from the value figures, because the change in unit values was very different in the two years (they increased in 1975 and declined in 1981). In 1975, the volume of total trade declined by 1 per cent and the volume of trade excluding fuels declined by 0.5 per cent.*
The growth in the volume of world production, was less than 1 per cent for the second consecutive year. World agricultural production increased by \(2\frac{1}{2}\) per cent, and manufacturing production was up 1 per cent; in contrast, world production of petroleum declined by 7 per cent, while the production of other minerals stagnated.

Changes in trade relative to production varied significantly among the main product categories. For mineral products, the steeper decline of world exports than of world production was mainly the result of stagnant or declining demand in the major markets. In the case of petroleum, production in the OPEC countries fell by 16 per cent, whereas the output of other countries, most of which is consumed locally, increased slightly. For agricultural products and manufactures, the fact that trade grew faster than production is quite remarkable, given the sluggishness of world demand and increased protectionist pressures.

In this paragraph, production refers to the combined output of agriculture, mining and manufacturing, that is, it excludes services and construction.
in industrial countries. It was largely the consequence of continued growth in import demand by developing countries, and will be examined further in Part II.

Dollar unit values for the major product categories entering world trade declined in 1981, with the exception of petroleum. Dollar prices of world exports of primary products (excluding petroleum) declined by 7 per cent, the fall being more pronounced for primary products exported mainly by developing countries (by 13 per cent) than for those exported by the developed areas (by 5 per cent). (See Table 2.) Dollar unit values of manufactured exports from the developed countries declined by about 5 per cent. This was the net outcome of a 12 per cent decline in dollar unit values in Western Europe, where most currencies depreciated sharply against the dollar\(^1\), and increases of 12 per cent in the United States and of 8 per cent in Japan.\(^2\) Dollar prices of world exports of crude petroleum were on average about 10 per cent higher in 1981 than in 1980, according to the UN index (see Chart II).

<table>
<thead>
<tr>
<th></th>
<th>Food</th>
<th>Agricultural raw materials</th>
<th>Non-ferrous metals</th>
<th>Primary commodities(^a)</th>
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<td>Developed countries</td>
<td>-7(^{1/2})</td>
<td>-6(^{1/2})</td>
<td>-11</td>
<td>-5</td>
</tr>
<tr>
<td>Developing countries</td>
<td>-16(^{1/2})</td>
<td>-12(^{1/2})</td>
<td>-17</td>
<td>-13(^{1/2})</td>
</tr>
<tr>
<td>World(^b)</td>
<td>-10(^{1/2})</td>
<td>-8(^{1/2})</td>
<td>-12(^{1/2})</td>
<td>-7</td>
</tr>
</tbody>
</table>

\(^a\)Excluding crude petroleum.

\(^b\)Excluding the Eastern trading area.


The fall in export prices of primary products (excluding petroleum) is more pronounced if their level in the last quarter of 1981 is compared with that in the last quarter of 1980. On this basis, world export prices of these products declined by 10\(^{1/2}\) per cent, those of developed countries by 9 per cent and those of developing countries by 18\(^{1/2}\) per cent.

Comparing the average for 1981 with that for 1980, the currencies of most EC countries depreciated by 20 per cent or more, and those of other West European countries, by 12-20 per cent, against the US dollar.

The yen appreciated by 3 per cent against the US dollar in 1981.
As in the preceding year, the combined GDP of the industrial countries increased by about 1 per cent in 1981. Industrial production, which stagnated in 1980, increased marginally in 1981 as a whole, although it began to decline again in the last quarter. The near stagnation of output, together with the rise in the labour force, implied a further increase in unemployment in 1981. It exceeded 7 per cent of the labour force at the end of the year, compared with 5 per cent in the recession year 1975 and 6 per cent in 1980.
The rate of increase in consumer prices for the industrial countries as a group slowed down to 10 1/2 per cent in 1981, from 13 per cent in the preceding year. In about one-half of industrial countries, however, the inflation rate was higher in 1981 than in 1980. For 1981 as a whole, the effective exchange rates of the US dollar and the yen appreciated by about 13 per cent. Whereas the currencies of the UK, Norway and Switzerland depreciated only moderately, those of Germany, Austria, and the Benelux countries depreciated by about 7-8 per cent, and those of Denmark, France and Italy by more than 10 per cent.

The combined trade deficit of industrial countries fell by about one-third in 1981, the dollar value of imports falling by about 5 per cent and that of exports by 1 per cent. The terms of trade deteriorated by some 2 per cent (following declines of 7 1/2 per cent in 1980 and 3 per cent in 1979), as the dollar unit value of imports declined less than that of exports. In volume terms, imports declined by 2 1/2 per cent, whereas exports expanded by nearly 3 per cent. There was a significant decline in intra-area trade. Exports to the rest of the world continued to expand relatively rapidly, especially those to member countries of OPEC. Only imports from the non-OPEC developing countries continued to rise.

In the United States, the slight decline in GNP in 1980 was followed by growth of about 2 per cent in 1981, despite a deceleration in the second half of the year. Industrial production started to recover in the last quarter of 1980, but its growth was curtailed in the second quarter of 1981, giving way to a sharp fall in the last quarter which continued in January 1982. On a yearly basis, though industrial production rose by 2 1/2 per cent in 1981, it remained below its level of 1979. Partly owing to the level of interest rates, the US dollar appreciated strongly throughout most of 1981. The rate of inflation fell to 10 1/2 per cent, as against 13 1/2 per cent in 1980.

Unemployment, which had been steadily declining since 1975, rose sharply in the second quarter of 1980 and fluctuated around that level until the third quarter of 1981. A new rise brought the number of unemployed to 9 1/2 million, or 9 per cent of the workforce, at the end of the year. Unemployment has risen more rapidly for men than for women in the last two years, although the proportion of men who were unemployed at the end of 1981 remained slightly below the proportion of women. In the same period, there was a decline in the proportion of unemployment of those under the age of twenty (from about 25 per cent to 21 1/2 per cent) and an increase in the proportion of those in the twenty-five to thirty-five age bracket (from about 24 1/2 per cent to almost 27 per cent). The average duration of unemployment at the end of 1981 was about three months, with one-half of the total unemployed having been without a job for less than six weeks. While this is somewhat longer than in the preceding two years, it was about the same as at the end of 1977, despite the fact that total unemployment had risen by some 2 millions.

1On a seasonally adjusted basis.
The volume of imports rose by 1 per cent in all, with a strong decline in imports of fuels. Exports fell in volume by some 3 per cent. Nonetheless, owing to the rise in the terms of trade, there was only a moderate increase of the trade deficit and, with an improvement in the invisibles account, the current account surplus increased.

In Japan, the growth of GDP slowed from 4 per cent in 1980 to perhaps 3 per cent in 1981. In contrast with North America, Japan's domestic demand grew much more slowly than GDP (by around 1/2 per cent in both 1980 and 1981). The deceleration in production was most pronounced in manufacturing, output rising by only 3/2 per cent, or half the rate of the preceding year. Although the production of finished consumer goods continued to rise rapidly, the output growth of other product categories decelerated markedly or, in the case of intermediate goods, declined. In the last quarter of 1981, there was an absolute decline in GNP of almost 1 per cent - the first since 1975 - resulting mainly from a 4 1/2 per cent decline in the volume of exports. Exports continued declining in the first two months of 1982.

Despite the economic slowdown, unemployment remained low in 1981 and employment in manufacturing reached its highest level since 1977. Interest rates, which had started to fall in mid-1980, continued to do so throughout 1981. The rise of consumer prices was limited to 5 per cent.

Although declining in the fourth quarter of 1981, on an annual basis the volume of exports increased (by about 10 per cent), whereas the volume of imports declined moderately. The fall in imports reflected, apart from the near stagnation of domestic demand, the weakness of production of investment and intermediate goods, for which the import content (especially of raw materials) is particularly high in Japan. In value terms, the increase of Japan's exports, combined with a modest rise in its imports, as well as the significant improvement in its terms of trade, resulted in a shift of the trade balance (f.o.b./c.i.f.) from a deficit exceeding $7 billion in 1980 to a surplus of nearly $9 billion in 1981. The substantial current account deficit in 1980 was also converted into a surplus in 1981, although there was an increase in the deficit on invisibles.

The combined GDP of Western Europe, which had increased by 1 1/2 per cent in 1980, fell by about 1/2 per cent in 1981. In the EC countries, GDP growth was slower than in the other European countries. Industrial production, which stagnated in 1980, declined by 2 per cent in 1981. The decline in inflation was less pronounced than in the United States, consumer prices rising by 12 1/2 per cent in Western Europe as a whole, and by 11 1/2 per cent in the EC, compared with 14 1/2 and 12 1/2 per cent, respectively, in the preceding year.

The unemployment rate rose sharply throughout 1980 and 1981, being of the order of 9 per cent at the end of 1981. Unemployment generally increased more sharply for men than for women. Concerning the age-structure of unemployment, there has been in most countries an increase in the proportion of unemployed workers below the age of twenty-five. For instance, this age-group accounted for almost 30 per cent of total unemployment in the Federal Republic of Germany in late 1981, compared with some 26 per cent two years before. There was also an increase in the average duration of unemployment. At the end of
1981, those workers who had been unemployed for more than six months, represented nearly 40 per cent of the total unemployed in the Federal Republic of Germany, and more than 50 per cent in the United Kingdom. (The comparable figure for the United States, where the average duration of unemployment is normally lower than in Western Europe, was only 12 per cent.)

The value of Western Europe's total exports fell by around 7 per cent in 1981, while the value of imports declined by about 10 per cent. The trade balances of most countries improved markedly and there was an improvement in the current account balance of the EC, deriving largely from the United Kingdom. The decline in the value of foreign trade is more "optical" than real, as it reflects mainly the strong depreciation of most West European currencies against the dollar, in which the trade totals are expressed.

Developing countries

Information on the developing countries' overall economic performance in 1981 is still fragmentary at this stage, precluding a systematic treatment by country groups. Petroleum production declined sharply in the OPEC countries, but expanded in other developing countries, allowing them to either increase their share in world exports (as did Mexico) or to further substitute domestic production for imports. Aggregate GDP growth of the oil-importing countries is thought to have fallen close to the rate of population growth in 1981, which, if confirmed, would represent the worst growth achievement in the post-war period. While agricultural output increased at its long-term average rate, non-fuel mineral production stagnated or declined and the growth of manufacturing output fell sharply. Of course, developments varied considerably from one country or area to another. For instance, in the Asian oil-importing countries, there was a recovery of agricultural production in 1981 and activity in the manufacturing sector was relatively well sustained, whereas in several Latin American countries (mainly Argentina and Brazil) absolute declines in GDP are reported to have resulted from a sharp contraction of manufacturing production.

The slow expansion of GDP in 1981 exacerbated the already difficult employment situation of most developing countries. In particular, the generally sluggish growth of the manufacturing sector, which absorbs an important fraction of the newcomers to the labour market, has undoubtedly brought about a sizeable increase in recorded unemployment rates, in addition to the traditionally high "under" employment which exists in most of these countries.

The aggregate exports of the OPEC countries fell by 9 per cent in value in 1981, reaching $270 billion. The volume of their petroleum shipments declined by about 20 per cent, while oil export prices, though tending to decline after mid- or late-1981, remained on average over 10 per cent higher than in the previous year. In most of these countries, exports fell in 1981, the largest revenue losses being experienced by Iraq and Iran (of 50 per cent), and Libya and Nigeria (of 30 per cent). Saudi Arabia was the only OPEC country to maintain the volume of its exports and significantly expand its earnings (by about 12 per cent).
These developments contrasted with the substantial growth in the volume and value of petroleum exports by Mexico and a few other developing countries (such as Egypt, Oman and Cameroon) in 1981. Mexico became the eighth largest supplier of crude petroleum to the world market in 1981: its oil exports increased by nearly one-half, to some $14 billion, representing about 70 per cent of the country's total export revenue.

The value of exports of the oil-importing developing countries is estimated to have risen by 6 per cent in 1981. This is attributable to increased volume, as export unit values declined overall. Export prices of non-fuel primary commodities were on average about 13 per cent lower than in 1980, with coffee, cocoa, sugar, copper and tin, registering the strongest price declines. This, together with the generally sluggish demand for those commodities, resulted in a stagnation or decline of export revenue in many countries. There were, however, some exceptions to this general trend. For example, the large food import requirements of the Soviet Union in 1981 were partly satisfied by increased supplies from Argentina, Brazil, Uruguay, India and Thailand, among others.

Conditions were again more favourable for exports of manufactures from developing countries than for non-fuel primary commodities. For the first time, aggregate exports of manufactures by these countries surpassed their exports of non-fuel primary products. In particular, demand for engineering products, clothing and other consumer goods was growing at a relatively fast pace in the developing countries themselves (above all, the oil-exporting ones), as well as in some developed markets (such as Australia, the United States and the United Kingdom), and in China. The share of intra-area trade in the total exports of manufactures by developing countries continued to increase in 1981.

As a group, the OPEC countries remained the most dynamic market in the world economy in 1981, their imports increasing by roughly 15 per cent to some $155 billion. In dollar value, the rate of growth of their imports was half that in 1980, but volume growth remained by and large unchanged. The aggregate trade surplus (f.o.b./c.i.f.) is estimated to have declined by as much as $45 billion in 1981, reaching some $115 billion, of which nearly $100 billion were accounted for by Saudi Arabia and the small Gulf states. Though a number of OPEC countries still have relatively large financial reserves to cushion the shortfall in their export earnings, a slowdown in import growth coupled with borrowing on international capital markets is increasingly foreseen for some of them.

Imports of the non-OPEC developing countries are estimated to have increased by around 7 per cent in 1981, to some $330 billion. Rising income from petroleum exports enabled some countries to sharply increase the volume of their imports, the outstanding example being Mexico, where the value of imports rose by 28 per cent. A small number of oil-importing countries in the Far East, which had succeeded in expanding exports in 1981, also increased their imports significantly. Overall, however, the volume of imports into the oil-importing developing countries increased much less in 1981 than in previous years, and in many individual countries it declined.
Eastern trading area

In the Eastern trading area the rates of growth of aggregate production and trade declined further in 1981. There were significant differences, however, between developments in Eastern Europe, the Soviet Union and China.

In Eastern Europe (excluding the Soviet Union) economic aggregates were dominated by developments in the Polish economy. Eastern Europe's total production, which had grown by some 2 per cent in 1979 and about 1 per cent in 1980, showed a slight absolute decline in 1981. In Poland, there was a decline of 13 per cent. Similarly, there was a slight decrease in the dollar value of the area's total trade, while the value of Poland's exports declined by 22 per cent and its imports by 20 per cent. The value of imports by Czechoslovakia, Hungary and Romania also declined, but only slightly.

Trade between Eastern European and the developed market economies declined more markedly than the area's total trade in 1981. The fall was particularly pronounced, in the case of imports, reflecting a 30 per cent decline in the value of imports by Poland and 15 per cent declines in Czechoslovakia and Romania.

The balance of payments difficulties recently experienced by the East European countries, especially in their trade with developed market economies, resulted primarily from (i) the slow rise in their export earnings, due to a variety of factors on both the supply and the demand side; (ii) the deterioration in their terms of trade, resulting mainly from the sharp rise of energy prices; and (iii) the growing payments of interest and amortization resulting from the large debts contracted in earlier years, a problem aggravated by the strong rise in interest rates in 1981.

In the Soviet Union, aggregate production increased by 3 per cent, slightly less, than in the preceding year. Industrial production expanded by 3 1/2 per cent in 1981, while agricultural output declined for the third consecutive year (by 2 per cent). In contrast to Eastern Europe, the Soviet Union's trade, especially its imports, expanded markedly in 1981. During the first nine months of the year, merchandise imports from developed market economies rose by 11 per cent in dollar terms and those from developing countries (excluding Cuba) by nearly one-half, the increases in volume being even more pronounced. In value terms, imports from Argentina more than doubled, making the country the largest non-CMEA supplier during the first nine months of 1981 (outranking the Federal Republic of Germany). Imports from Brazil trebled and those from India rose by more than one-half.

All East European countries have become increasingly dependent on imports, both from the Soviet Union and from other suppliers, to meet their energy requirements.

1 The UN Economic Commission for Europe, in its Economic Survey of Europe in 1981, p. 311, has provided the following estimates of the net external debt of the East European countries at the end of 1981 (in billion US dollars): Poland, 22.4; German Democratic Republic, 11.3; Romania, 9.6; Hungary, 7.8; Czechoslovakia, 3.6 and Bulgaria, 2.3.
In China, the combined production of industry and agriculture appears to have increased in 1981 by some 3 per cent, which would be the lowest growth in the last thirty years. In line with the planned new pattern of development, light industry production increased by about 12 per cent, whereas heavy industry's output declined by about 5 per cent. The grain crop is estimated to have been only slightly below the record reached in 1979, while the output of cotton, oilseeds and sugar also rose markedly. The dollar value of imports increased by some 10 per cent, that of exports by 5 per cent.

PART II - CURRENT ECONOMIC ISSUES

The facts outlined above show little change from the preceding year. Production and trade are depressed, unemployment is still rising, inflation in the industrial countries, while generally declining, is two percentage points above its previous cyclical trough and triple the average level of the 1960s, and interest rates are well above the average levels of the 1970s. What has changed is the tone of the economic policy debate, national and international. Claims and counter-claims concerning the implications of current developments and appropriate policy responses are increasingly acrimonious.

Current accounts, indebtedness and capital markets

The information available on current account balances is highly tentative, perhaps increasingly so; in fact, the only safe conclusions it permits pertain to the direction of annual changes. The largest changes in estimated current account balances between 1980 and 1981 occurred in the consolidated balance of the industrial countries as against that of the OPEC countries. The industrial countries moved from an estimated $45 billion deficit in 1980 (excluding official transfers) to a balanced current account in 1981, while the surplus of the OPEC members fell by more than a third, from about $115 billion to some $70 billion. For the aggregate of other developing countries, in contrast, the estimated deficit increased modestly, from $65 billion to about $70 billion.

Data on international borrowing and on changes in countries' international reserves, which are somewhat more reliable, indicate that in 1981 the aggregate gross indebtedness of the non-OPEC developing countries increased further, by some $50 billion, while their foreign exchange reserves were drawn down by about $5 billion. The question of the indebtedness and future borrowing capacity of the non-oil developing countries thus continues to be one of the major international economic issues. Although it is complicated and has given rise to a variety of tentative answers, certain key aspects are apparent. One is that population growth and the need to generate corresponding employment opportunities will maintain the demand of developing countries for foreign capital. Another is that the combination of increased
indebtedness and rising interest rates makes it unlikely that the very high rate of borrowing observed since 1974 can be sustained in the years ahead. 

As we have noted in previous reports, the issue of the international indebtedness and credit standing of the debtor countries constitutes a link between the international trading system and the international financial system. A rising proportion of new international borrowing in the last few years has been used for the servicing of outstanding debt. It is inevitable that the availability of international credit for this purpose is shrinking rapidly.

These financial trends must be viewed against the background of two years of stagnation in world trade, comprising in 1981 an absolute decline in the volume of industrial countries' mutual trade in manufactures and a pronounced deceleration in their manufactured imports from developing countries. In the period 1970-1979, the volume of developing countries' exports of manufactured goods to the industrial countries grew at an average annual rate of about 10 per cent; estimates suggest that from 1979 to 1981 the average growth rate was less than half the earlier figure.

It is clear that a resumption of at least the previous rate of trade expansion constitutes a genuine common interest of all countries. For the developing countries, it is needed for the continued growth of their imports, which today consist largely of inputs into current production and investment, and thus virtually determine the level of domestic activity. They also need a more rapid trade expansion in order to maintain access to the international capital market, which has enabled them, since 1974, to raise the investment ratios of their economies by a few percentage points on the average and thus to considerably speed up the creation of employment opportunities. For the countries in Eastern Europe, an expansion of exports is the only available means by which they can continue to service their growing external debts without further reducing their imports from industrial countries. These imports, it may be noted, have shown an absolute decline in the last two years. Finally, for industrial countries, a primary consideration must be the continued viability of the international financial system, although the importance of markets in developing areas for a continued growth of industrial countries' exports deserves equal attention. As Table 3 shows, in the two most recent years, purchases by the non-OPEC developing countries from the industrial countries accounted for nearly one-third of the increase in the volume of world trade in manufactured goods. It should be noted

1 In the third quarter of 1981, the OPEC members as a group switched from being net lenders in the international capital market to being net borrowers. This is connected with the decline in their combined current account surplus and, in the view of many financial analysts, marks the beginning of a trend. The net impact of this change on the capital market depends on whether the reduced current deficits of the industrial countries cause their borrowings to decline by more or less than the net borrowing of the OPEC countries.

that developing countries were much less important as world suppliers. In 1980 and 1981, purchases by the industrial countries from the developing ones accounted for only 5 and 10 per cent, respectively, of the increment in the volume of world exports of manufactures. In the same years, the deficits of the non-OPEC developing countries in their trade in manufactures with industrial countries were $90 billion and $95 billion, respectively.

TABLE 3. - CONTRIBUTION OF THE MAIN TRADE FLOWS TO THE OVERALL INCREASE IN THE VOLUME OF TRADE IN MANUFACTURES a IN 1980 AND 1981

(Percentages)

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<thead>
<tr>
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<th>1980</th>
<th>1981</th>
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<td>100</td>
</tr>
<tr>
<td>Intra-industrial countries</td>
<td>20</td>
<td>-10</td>
</tr>
<tr>
<td>Exports of industrial to OPEC countries</td>
<td>25</td>
<td>45</td>
</tr>
<tr>
<td>Exports of industrial to other developing countries</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Exports of industrial countries to Eastern trading area</td>
<td>-2</td>
<td>-3</td>
</tr>
<tr>
<td>Exports of developing countries to industrial countries</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Intra-developing countries</td>
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</tr>
<tr>
<td>Other trade flows</td>
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</table>

aBased on values at 1979 constant prices.


Inflation and unemployment

There is a danger that in the current discussion about interest rates, the nature of the difficulty facing the world economy as a whole will be misconstrued. Interest rates are of course one of the most important determinants not only of domestic investment and economic activity levels but also of international flows of goods, services and capital. A useful discussion of them must, however, recognize the complexity of the issues they pose in the present context.

It is impossible to estimate the exact magnitudes of the investment which the world economy now requires. First of all, investment is needed to correct the accumulated backlog of adjustment which stands between us and a new period of sustained growth; in the absence of this adjustment, world trade can grow only sluggishly. Additional investment will be needed to maintain and intensify the progress in energy saving and substitution, to absorb the existing margin of unemployment and generate a more rapid, sustainable productivity growth thereafter. All that can be said is that very large volumes are involved here. It is
also fairly clear that on all the plausible assumptions that can be made about private saving, public budget balances, and the flow of OPEC liquidities into the international markets, real rates of interest in Europe and most other countries would be unlikely, in such a period of new growth, to be much lower than they are at present. Only in the United States, among the major countries, could one expect somewhat lower real rates of interest. There is nothing paradoxical in this statement. To realize that the world economy can grow rapidly with real rates of interest close to present levels, it is sufficient to recall that the vast flood of investment which transformed the European economies in the 1950s occurred at long-term real interest rates which were not significantly different, and at times higher, than the present ones. That flow of investment, it may be recalled further, could get under way only after the European countries started dismantling the tight network of controls on trade and payments among themselves. One of the original justifications of payments controls had been, precisely, that they would enable each country to maintain a low level of interest rates domestically. In a close parallel to that historical experience, the very low or negative real interest rates which prevailed for much of the 1970s did little to stem the steady decline in the economic performance of the industrial countries.

This leaves open the question of why interest rates are so high at present, when the level of business investment is relatively low and, as various surveys of business investment plans show, more or less flat into the near future. The short-term rates are high due to a number of factors; chief among them are the combination of the monetary restraint needed to reduce inflation, and the continued high demand for short-term finance. The high long-term interest rates seem to mainly reflect a fear that monetary policy may become inflationary again. A glance at the jagged upward path of inflation over the past fifteen years (Chart 3) suffices to suggest that the fear is not entirely unreasonable. The worry is precisely about what may happen to interest rates and the price level when private investment demand picks up, and collides in the capital market with the demand for funds by governments.

Those demands have become quite substantial. Estimates for 1981 of the deficits in the general government financial balance (which includes federal, state and local budgets), as a proportion of gross savings, range from just under 4 per cent in the United States, to around 11 per cent in Japan, France and the United Kingdom, about 19 per cent in the Federal Republic of Germany, and just over 40 per cent in Italy. In the case of the United States, the net figure reflects the fact that more than half of the estimated federal budget deficit was offset by budget surpluses of state and local governments.

1 The real rate of interest is equal to the nominal rate of interest minus the rate of inflation. This can only be accurately calculated ex post, whereas for many purposes one is interested in the ex ante real rate, that is, the current nominal rate of interest minus the rate of inflation expected for the duration of the loan.

2 The calculations are based on data taken from the OECD Economic Outlook, December 1981; the gross savings figures used in the calculations are averages of the figures for 1978-80.
The historical experience of European postwar reconstruction suggests that it is not the level of nominal interest rates as such, in the crude sense of production costs, that deters investment at present, but the uncertainty reflected in these rates. In the present state of inflationary expectations, still highly sensitized, an attempt to loosen up credit, step up the creation of money, is more likely to send interest rates up than down. Even if interest rates temporarily declined, the lower line in Chart 3 indicates that the employment relief would be highly transitory and its cost, in terms of accelerating inflation, extremely high.

There is a real danger that in order to maintain larger interest rate differentials than are warranted by inflation differentials, the would-be low interest countries might resort to capital controls to prevent funds from moving internationally in search of higher rates of return. It is obvious that for this objective to be attained, capital controls alone would be insufficient and control would have to be extended over current payments as well. Having control over current payments, however, is equivalent to controlling trade flows directly. The international trade and financial systems are closely integrated; one cannot function without the other.
Only indirect approaches to reducing interest rates therefore appear to hold out any promise. There are two possibilities, to be pursued simultaneously: namely, policies aimed at increasing private saving and at reducing public budget deficits. The saving potential of many contemporary economies has been reduced by a number of measures adopted in the period of Keynesian policies, motivated by the apprehension that excessive savings would lead to a recession. Possible corrective actions in this area would include the repeal of tax measures which discriminate against savings and in favour of consumption. Since most of the feasible ways of increasing private savings involve some loss of tax revenue, the main possibilities of reducing public budget deficits appear to lie on the expenditure side.

The need for policies strengthening the demand for investment runs parallel with the policy efforts to reduce interest rates. Policies of this kind, the central objective of which is to strengthen investment incentives by reducing uncertainty, are an integral part of the more general effort to reduce unemployment and will be discussed in this context in the following section.

Unemployment and protection

It is natural that in the present conditions, employment policy is receiving intensive consideration. The realization is beginning to spread that the current rise in unemployment cannot be understood in terms of the theoretical scheme which explained the much higher unemployment of the 1930s. With inflation into two digits, it is difficult to see how aggregate demand could be deficient in contemporary economies. The question then is, which employment policy measures carry a promise of success when implemented in the framework of a resolute anti-inflation policy?¹

Protection against imports can only aggravate the employment picture on the whole. A government engaging in this policy must, if it expects to be successful, believe that it is doing so alone. In the present circumstances, when all governments are confronted with increasing protectionist demands stimulated by similar economic problems, a glance across the border (or back to the 1930s) should be sufficient to demonstrate the futility of assuming that protection could remain localized. The impossibility for a number of important trading countries to simultaneously cut back on imports without reducing each other's exports requires no explanation. Indeed, a well-known and by now well-tested theorem of economics explains why a country that reduced its imports would by that policy reduce its exports as well, even if other countries continued trading without restrictions.

¹"Such [employment policy] efforts can only be pursued with success in the framework of a concomitant and effective combat against inflation, as well as in the context of active international co-operation and open trading relationships...." Communiqué, OECD Ministerial Meeting on Manpower and Social Affairs, 5 March 1982.

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The heavy concentration of unemployment among young people calls attention to another danger. An attempt to use protection to provide new jobs would greatly increase the likelihood that many workers would acquire their first skills and job experience in uncompetitive firms that can survive only with the aid of import restrictions and/or government subsidies. This would only reduce the prospects for a successful structural adjustment and tend to perpetuate current problems.

New ideas for promoting employment are most likely to be found through a detailed examination of recent experience. Between 1970 and 1980, there was a net increase of 19 million jobs in the United States (24 per cent), as against the creation of 2 million new jobs in the European Community (a 2 per cent gain on 1970). A careful study of this contrast might enrich national employment policies by a number of useful insights.

The United States experience has been statistically analyzed on a sample of an unusual size—over 5 million business establishments for the period 1969-1976. The most striking finding has concerned the importance of new or young, and therefore small, firms in employment creation. Four-fifths of the new jobs created in this period were in enterprises with less than one hundred employees, and two-thirds in enterprises with less than twenty. The category of the largest firms, measured by employment, contributed less than 15 per cent of the new jobs.

The next most important finding concerns the sector in which most of the new jobs were created. Nearly nine-tenths (87 per cent) of these additional wage and salary earners were accommodated in the service sector. Before the plaintive chant of "de-industrialization" is raised, the economist would inquire into the influences operating on this ratio; for surely it must respond to policy, at least within certain limits.

One factor in these developments has been continuing specialization. An aspect of this process is that service activities formerly carried out inside manufacturing firms, thus counted as a part of value added by manufacturing, are now being provided by specialized independent firms. This development in fact strengthens manufacturing activities by increasing their efficiency. Another likely factor behind the slow growth of employment in the largest firms was their wage

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2 Similar developments might have taken place in many West European countries, where what has been referred to as the 'informal' or 'parallel' economy has become a significant feature of the national economy. Discussing this phenomenon, the European Community notes: "The growth of the parallel economy may in part reflect the qualities of small-scale decentralized activities, but also shows the importance of severe rigidities in labour markets, in pay and State regulation aspects, and the heavy burden of taxation on employment and production." The European Economy, July 1981, p. 28.
setting process which led in many instances to above-average increases in real wages; this interacted with the very low or negative real interest rates of the period to create a strong additional incentive for labour-saving investments.

Manufacturing in general now depends for expansion to a large extent on access to foreign markets. Though the extent is difficult to quantify, this dependence is certainly larger for manufacturing than for services. It is likely to be even higher on the margin than on the average (as suggested by the fact that international trade in manufactures continues to grow more rapidly than global manufacturing production), for new manufacturing ventures are usually producing highly specialized products for which the possible economies of scale exceed the initial absorptive capacity of the national market. The uncertainty of access to markets abroad, which has grown throughout the 1970s, can therefore explain, at least in part, why such a preponderance of the new jobs created in the last decade have been in the service sector rather than in manufacturing. In this context, the United States statistics referred to above seem to illustrate a general situation.

More generally, the risks and uncertainties which a new venture must face are at all times, but particularly in a period such as the present one, considerably greater in manufacturing than in most service activities. The required initial capital investment per employee is substantially larger and also the cash flow profiles of the two kinds of ventures are different. Services are sold (contracted for) before they are performed while manufactures can be marketed only after they have been produced. Thus all the economic uncertainties which have been repeatedly described in these reports in explaining the cause of stagflation - monetary uncertainties affecting financial planning of firms, uncertainties created by regulation and general policy instability, and the special uncertainties impinging on all international transactions - affect manufacturing activities much more strongly than the production of services.

It is something of a commonplace to say that an economy must exhibit a relatively high degree of structural flexibility if it is to maintain a satisfactory level of employment together with satisfactory progress. The US study allows us to go a step further and identify two closely related elements making for such a flexibility. Clearly, a large and steady flow of investment is one condition of it; and a certain minimum rate of formation of new enterprises is the other. Only when these two conditions are satisfied can labour mobility be sufficient to permit some industries to decline while others are expanding, without unemployment constituting an acute social problem.

An effective employment policy must be informed by a more thorough study of the conditions favourable to new economic ventures than could be presented here. It is nonetheless possible to say that a policy to promote new ventures will have to rely more on removing existing obstacles and disincentives to the formation of new enterprises than on direct positive measures. The large number, the small size and the variety of the firms involved would make for very high administrative costs of positive promotional measures.
Another experience may be recalled in this context. It has been repeatedly observed that a substantial liberalization of a country's trade - such as that effected in Western Europe in the late 1940s and early 1950s, and a number of developing countries in the subsequent decades - is almost immediately followed by the emergence of large numbers of new manufacturing and processing firms, most of them starting from a small scale, in the export sector. This phenomenon can be explained by the long-standing theoretical presupposition mentioned on page 16 above.

**Policy conclusions**

From more than two decades of experience it has been generally acknowledged that import-substitution development strategies have not been successful in promoting economic growth in developing countries. There is little reason for hoping that equivalent strategies would work better in the industrial countries, whether they be applied to traditional industries or to the high-technology ones.

Full participation in the international division of labour remains the necessary condition for sustained, stable growth. Upon this basic idea, the international economic order was reconstructed after World War II. Its central objective was to ensure that national economic policies would be conducted in a stable fashion according to internationally agreed rules. The inherent reasonableness of this objective was subsequently tested by two decades of satisfactory experience. More recently, however, economic policy accommodation has increasingly been sought through arrangements reached between two, or several, countries outside the framework of agreed rules. This failure to abide by general rules is without doubt one of the major causes of the present economic difficulties.

How, then, is the world economy to return to a more satisfactory state? The main condition appears to be a more differentiated and a more comprehensive diagnosis of its present ills. There is a need to recognize the complexity and, indeed, the long and slow historical growth of the causes of the economic malfunctions which now beset industrial economies. The policy chickens coming home to roost were not born yesterday. They are fully grown, and therefore tough.

There is an unfortunate tendency in public policy discourse to focus attention on a single, simple explanation to the virtual exclusion of all others. Ten years ago inflation was being explained by the disappearance of the anchovy from the Humboldt Current. Then for a number of years, oil prices served to explain all ills. Now all that is wrong in national economies is due to interest rates. And in a few months, it will be something else again. Yet we know that the ultimate causes of stagflation are much more complex than that. They have to do with money creation and the credit mechanism; with public budgets and the levels of public and international indebtedness, the underlying social systems and the growth of their claims on public expenditure; with the wage setting mechanisms and the terms of trade; with the weakened incentives for private effort and excessive regulation inhibiting entrepreneurial initiative; and with many other developments of the last twenty years.

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Commercial policy seems similarly dominated by ad hoc problems—or better, by issues which appear to be problems because they are artificially isolated, taken out of context. Attention increasingly focusses on bilateral trade imbalances and bilateral reciprocity, on the needs of particular industries, suffering under imports from particular countries, while trade in the aggregate languishes.

Another example of the lack of comprehensiveness of the current economic policy analysis is the compartmentalization of concerns relating to international trade issues on the one hand, and international monetary and financial issues on the other. The debtor countries' access to foreign markets, and thus their opportunity to earn the foreign exchange needed to service their foreign debt, is the most graphic illustration of the need for a more comprehensive approach.

It may be objected that this criticism fails to acknowledge the necessarily pragmatic nature of all economic policy. The policy maker has to respond to particular social concerns, and must focus on one issue at a time. While not entirely untrue, this view represents a potentially dangerous simplification. Policy typically selects—it has to select—the social concerns to which it will respond; and it typically must deal with many issues at the same time. Thus it needs focus, a global conception, if it is to deal with particular issues in a coherent manner. A global conception also ensures the necessary economy of effort; it prevents attention being diverted to non-problems. In a multilateral trading system with convertible currencies, trade and payments imbalances between any two countries are a non-problem. Similarly, in a trading system based on a pledge of unconditional most-favoured-nation treatment, bilateral reciprocity is a non-problem. In such a system, each country must weigh the advantage to itself of trading with all other countries on the basis of equal treatment voluntarily granted, against the discipline and self-restraint which it must accept if the system is to be maintained. Reciprocity cannot be determined exactly; it is essentially a matter of broad, probabilistic assessment and, above all, agreement. Discrimination, on the other hand, is amenable to exact determination and the existing multilateral procedures for complaint and remedy therefore appear adequate.

One should not draw pessimistic conclusions from this report. It is possible for policies to change the direction of events. Good management of the economic order requires, however, a global approach: that is, a rethinking of the proper balance between national policies designed to secure the needs of particular industries, the needs of the national economy as a whole, and those of the international system. A correct appreciation of the degree to which national economic prosperity depends on the smooth functioning of the international system would make possible a return to the observance of principles and rules which all can accept.