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Stability or Growth: The Rich Nations' Dilemma

by Dr Amar Nath Dutta, Calcutta *

The article discusses the economic difficulties from which the industrialized nations have been suffering for the past years giving special regard to the controversy as to what concept of economic policy should be adopted in order to overcome the present problems.

The almost fantastic bid for attaining successively higher rates of growth had made the industrial nations crazy until the spring of 1972 when the bubbles burst and the economy nosedived into a recession. Sharp fluctuations in raw materials and commodity markets destabilised the economy and the index for shares and stocks tilted further downward. Unemployment gained a steady rise in the capitals and the demand management policies needed modifications as the stop-go cycles did not operate on the desired frequency.

At the Rambouillet Conference, the world's six big industrial nations congregated to square up the major riddles of inflation, recession and the energy crisis. Though achievements fell short of expectations, the course of action chalked out by the participants had some bearing on the issues involved. The world recession which had begun a little over twenty months ago touched bottom mid-year in 1975 and recovery started thereafter.

Pronounced Differences in Inflation Rates

Another redeeming feature is the significant rise of international reserves in the oil exporting and industrial countries as a group while developing countries reported slight losses. At home, the continuous but fairly uneven deceleration in consumer price rises since the autumn of 1974 brought the OECD inflation rate down to a trend of roughly eight p.c. in the last quarter of 1975. This improvement essentially reflected the initial sharp fall and subsequent stabilisation of industrial materials' prices, the absorption of oil price increases and a marked moderation in manufacturers' pricing behaviour while food prices exerted a less unfavourable effect than in 1972-74.

It has been observed that inflationary pressures showed signs of becoming decidedly weaker in industrial countries during 1975 mainly because the pricing behaviour related to the abrupt drop

in final demand and inventory liquidation. Nonetheless, differences in inflation rates as between the nations remained very pronounced. In the 12-month period ended December 1975, the highest inflation rate was recorded by Iceland (43.6 p.c.) and the lowest by Switzerland (3.4 p.c.). The UK recorded a slight rise to 24.9 p.c. against 24.2 p.c. in the previous 12-month period. The US has brought down its annual rate of inflation from 11 p.c. in 1974 to 7 p.c. in 1975, Japan from 24.5 p.c. to 11.8 p.c., Germany from 7 p.c. to 6 p.c., and France from 13.7 p.c. to 11.7 p.c.

Striking Increases in Unemployment

A controlled process of recovery has since begun and hopeful symptoms predict a rise in demand and production in the industrial nations. But what is worrying (and perhaps more important) is that unemployment has gained phenomenal heights. The number of jobless doubled in New Zealand, Switzerland and Luxembourg, increased by more than half in Belgium, Chile, Portugal, Spain and Britain and up to 50 p.c. in Australia, Austria, France, Denmark, Japan, Norway, Puerto Rico, South Africa and Zambia. To give an idea, in Britain it crossed the one-million mark in July last year for the first time since 1940 and Germany had more than a million unemployed for the first time in 20 years. Unemployment rose noticeably but less than 30 p.c. in the United States, Canada, Germany, Greece, Holland and Yugoslavia. Such a disproportionate rise in unemployment as portrayed in the ILO report confirms that "measures using higher unemployment to stem inflation were a conspicuous failure".

The Stop-Go Cycle

It is here that a basic postulate correlating unemployment and inflation stands scrutiny. For most of the post-war period, Governments tailored their demand management policies to square up to inflation and balance of payments problems and they were successful in preventing unemployment returning to intolerably high lev-

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els. When unemployment at home was more pressing, demand was expanded. But boosts to home demand created balance of payments problems and the shortage of capacity and labour led to price and wage increases. To stabilise the situation, the brakes were applied. The result was thus a stop-go cycle. At each "stop", the level of employment needed to act as a cushion against inflation and foreign trade deficit eventually became higher and at each "go" the magnitude of trade deficit and the rate of inflation accelerated. The simple explanation is that both the rate of inflation and the balance of payments at full employment depend upon a wide range of structural and institutional factors the behaviour of all of which is subject to a high degree of uncertainty. If not for anything else, the rigour of wage increases during a boom could not be controlled and some countries are worse than others at the highly political battle of dividing their nations' incomes between labour and management.

The countries that have been most inflation-prone insofar as their wages and incomes policies are concerned are those like Italy and Britain having strong unions and decentralised forms of collective bargaining. It has been the experience that wage settlements (of any form) effective for a time become however unworkable during long booms when employers find it more profitable to settle than to risk cease-work.

The Phillips Relation as a Policy Instrument

The correlation of inflation and unemployment continued to remain a major instrument of policy in many countries towards stabilising cyclical fluctuations and the demand management policy was suitably fashioned to use. In technical jargon, it is what the monetarists call the "Phillips Curve" which postulates "a stable empirical trade-off relationship between the rate of inflation and the rate of unemployment, on which the policy making authorities can choose an optimal position" based on a cost-benefit analysis of their collective utility functions. Some assumptions, however, are necessary before the approach could be of any effective use as a policy measure. One such is the stable demand for money where the ex-

pected rate of inflation is preassessed and there is a rational adjustment of expectations to experience. In other words, the basic relationship is assumed to be a real one existing between the rate of unemployment and the rate at which the institutional factors (collective bargaining, strength of trade unions, the market pattern and the like) will push up expected or intended real wages and prices and that, theoretically, it is possible to arrive at a "natural" rate of unemployment consistent with price stability.

If the policy is to keep the unemployment rate below the natural rate, the trade-off between inflation and unemployment will shift continually upward, a lever for the monetary authorities to opt for more inflation. If, on the other hand, a certain degree of inflation is allowed consistent with an initial unemployment target, a rational consumer behaviour will assert itself and unemployment will gradually rise to a level where prices would tend to become stable after a period. But the simple mechanism fails to work in the long run for costs and benefits would continue to flow in the reverse direction or both sides will remain constant. Although it is fundamentally a statistical relationship, its empirical validity is limited because of the adjustment lags that are sufficiently long for the purpose.

The Monetarist Approach

The relation between inflation and unemployment therefore remains a riddle and as such defies solution. The search for suitable policy measures continues while the relative merits of fiscal and monetary policies to achieve stability and full employment are now a subject of a controversy. Branding the post-war Keynesianism as largely responsible for erratic management of the economy, the monetarists suggest the Government permitting each year a "fixed throttle" increase in the money supply commensurate with increases in productive capacity. For instance, a 4 p.c. to 5 p.c. annual increase in money supply matched against a 2.5 p.c. to 3 p.c. annual rise in productivity may keep the system flexible and immune from the risks of inflation. Overmonetisation could simply wreck the system.

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All this, however, does not imply that the existence of high unemployment finds favour with the monetarists but they are sceptical of the Government's ability in the long run to push the rate of unemployment below its "natural" level which is more often determined by structural and institutional forces. For a time, however, the Government may find it possible to pull the level of employment upward to an "over-full" level by the conventional tool of deficit financing. But this becomes all the more risky because the budget deficit usually leads to an excessive expansion in money supply and thereby an accelerated inflation. Wage demands are pitched high and with a new set of expectations built into the system, the rates of inflation at every "stop" remain successively higher. As the time span gets prolonged to feed the cost inflation in an effort to create more employment, the ultimate level of unemployment needed to cure inflation will go up at every level. There is also a qualitative difference. The effect of unemployment is immediately felt while the pinch of inflation is felt after a time.

The industrial nations are now busy chalking out policies to cut unemployment to size. Some countries like Japan and the US have already opted for higher spending in the hope of attaining quick recovery. Japan, for instance, has taken steps to restimulate demand by increasing Government outlays by 12 p.c. in addition to three packages of measures intended to provide additional help for vulnerable sections like housing and ship-building. In France, the Government have already decided to inject into the economy a total of Francs 15 bn which accounts for about 1.2 p.c. of its GDP designed to stimulate investment in various sectors.

Doubtful Empirical Validity

The basic problem continues to remain whether and how far inflation would stimulate the economy and in its turn reduce unemployment to the desired extent and, secondly, the questionable increase in unemployment (socially tolerable too) effective to combat the burgeoning rise in prices. The inflationary spiral although caused primarily by the boom in raw material prices compounded with the prices of oil, the increase in wages and profit margins cannot be dismissed as unimportant factors once the world economy starts moving upward. For, wage bills were in no way related to improvements of productivity in most of the industrial economies. A recent ILO report highlights that more redundancies did not quench inflation and that longer working hours did not raise productivity, findings that challenge established economic theories. In the opinion of the experts, the stop-go mechanism because of

its more bumpy and uneven ride has proved to be of doubtful empirical validity and therefore needs a reshuffle. Considering the alarming rise in unemployment and a steep fall in demand in the recessionary period which fast developed into a slump, it is not surprising that the financial experts urged Governments instead to maintain high employment and sustained pay rises as far as the traffic could bear.

In any case, a new inflationary outburst is inevitable in countries entering a sustained recovery and the OECD report is suggestive on this point. It is a sellers' inflation as opposed to buyers' inflation, a resultant of cost-push factors. Further improvements in price performance in 1976 will critically depend upon the ability of countries to wind down cost-push inflation. But the conventions of wage settlement and industrial factors in countries are quite at odds to have a sizeable impact upon escalatory clauses of wage settlement during the boom. There has to be a way of reaching some kind of national consensus to begin with. A synchronised central bargaining system, particularly for the inflation-prone countries may be a pragmatic course to begin with and thus there is no reason why they cannot just pull off.

Lessons of Past Experience

No less important is to sustain the course of recovery that has been under way after a windy spell of 18 months. It pays to recapitulate the lessons of past experience. A reflat demand in all major countries caused a simultaneous expansion in money supply after August, 1971. A serious shortage occurred in raw materials and semi-manufactures while excess demand merely fanned a gargantuan price rise. Scared by a roaring inflation in 1973, the countries drastically squeezed money supply below the warranted rate of growth which bred the world recession in 1973-74. An artificial boost to Governments' saving prompted by the successive oil price hikes further deflated the world economy down the way into a slump. This togetherness has now to be avoided at all costs. A step-break has to be allowed for and the catching up with the fore-runners has to be paced with longer gaps, preferably a three-to-four year trade cycle.

The Rambouillet Conference urged the participant countries to join hands to stave off the world monetary crisis. The context was different. It was more for promoting trade and sharing world prosperity as between the developed and the developing countries. Togetherness has to be carefully avoided in efforts to sustain recovery. After all, recovery cannot be passed from one country to another.