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COMMERCIAL POLICY IN A PERIOD OF DISINFLATION

1. Declining growth, rising unemployment, high interest rates, runaway public expenditures, exchange rate instability, depressed commodity earnings and the growing tensions in national banking systems and the international financial system in general occupy the forefront of public interest. Within governments as well as in public discussion, it is beginning to be understood that the continued multiplication of trade restrictions represents in itself an important impediment to the recovery of the world economy. This issue, however, has to compete for attention with all the other economic problems which are generally considered more urgent.

2. Yet it is impossible to establish any ranking of the various aspects of the profound malaise affecting the world economy. They are all interconnected and compound each other. There are multiplying indications, for example, that current commercial policies are hampering the recovery of national economies mainly by increasing the already high degree of uncertainty - indeed, anxiety - in the financial sector. Judging from public discussion, the financial community has a keener appreciation of the dangers posed by the conjunction of rising protection and declining inflation than do the commercial policy makers.

3. This note, therefore, proposes to elaborate a single theme which with increasing clarity appears to be the central issue of the dangerous phase the world economy is traversing. It is that of the close interdependence of commercial, financial and monetary policies. It was raised in several previous secretariat publications but has not so far received the discussion it deserves.

4. The efforts to reduce inflation have begun to have an unmistakable impact on price trends. Estimates for the first quarter of 1982 for seven leading industrial countries, indicate that consumer prices were up 8.9 per cent on average relative to their level in the first three months of 1981; this compares with 10.2 per cent in the fourth quarter of 1981, and 10.6 per cent for the third quarter.[1] It should be added,

[1] The seven countries are the United States, Canada, Japan, the Federal Republic of Germany, France, Italy and the United Kingdom. If price changes are measured on a quarter-over-preceding-quarter basis (instead of comparing the corresponding quarters of two successive years), the annual rate of inflation of consumer prices in the seven countries during the first quarter of 1982 was 6.1 per cent (not seasonally adjusted); the corresponding figures for the first through the fourth quarters of 1981 were 10.8, 11.7, 10.0 and 8.2 per cent, respectively.

however, that the figure for the first quarter of this year is still well above the 7 per cent recorded in 1978 (the previous cyclical trough in the generally rising level of prices in these seven countries), and nearly triple the average inflation during the 1960s.

5. It is clear that the return to reasonable price stability, and thus to an environment in which sustained growth is possible, is beset by dangers. The main difficulty consists in choosing the appropriate speed. Economic theory is largely silent on the question of the optimum rate of disinflation, and this has given rise to disagreements over the pace at which different countries intend to approach, or are approaching, price stability.[1] The current debate over American interest rates is ultimately about the question of whether United States monetary policy is not aimed at reducing inflation too rapidly. Other countries are affected because, given the international role of the United States capital market, the rate of disinflation in the United States tends to set the pace for other currencies.

6. Formidable dangers lurk on either side of the path back to price stability. On one side lies the danger of premature reflation. Several times in the past the seductive appeal of the claim that a judicious dose of monetary ease would give an impetus to production and employment has proven irresistible. This time, the experience gained during the 1970s seems to have the upper hand, and the general consensus among the industrial countries that the fight against inflation must be seen through to the end still holds. As the disinflation process has begun to have an impact on the inflation rate, however, a coalition of numerous interests has become increasingly vocal in demanding what amounts to an abandonment of the inflation-control programme. Because a concern with rising unemployment is a key element in this demand, it is important to recall that experience since 1960 indicates that higher rates of inflation are associated with higher - not lower - unemployment rates (Chart I).

7. There is no doubt that the current disinflation is creating serious problems for debtors and others who are bound by contracts signed in anticipation of continuing inflation. But from the viewpoint of nations, these problems pale in comparison with the damage that would result if - for the fourth time since 1965 - stabilization programmes were abandoned prematurely and a resurgence of inflation occurred. The cost of the present disinflation has been raised because of the impact of the

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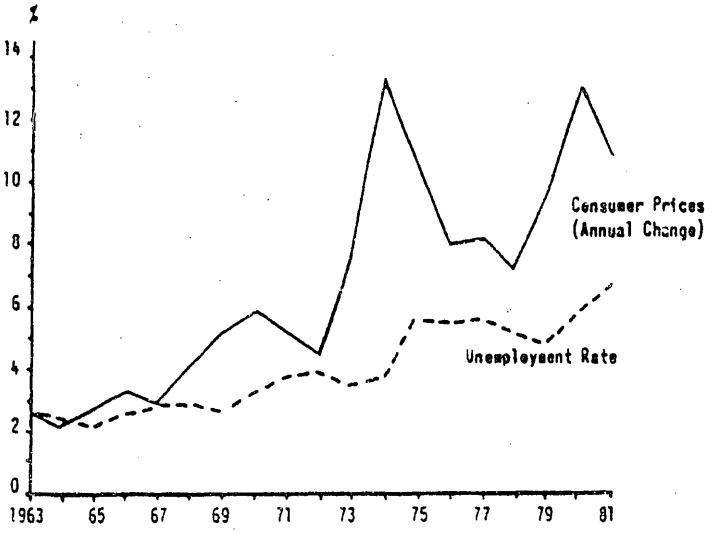
[1] A similar situation exists as regards the optimal rate of structural adjustment; in both cases, the theoretical vacuum has not prevented the emergence of an unthinking preference on the part of many analysts for slow over speedy disinflation/adjustment. The principal argument against the slow alternative is political, namely that experience shows that slow disinflation/adjustment increases the risk that the programme will not be carried through to the end.

CHART I

CONSUMER PRICES AND UNEMPLOYMENT IN THE MAJOR INDUSTRIAL COUNTRIES[a]



[a]United States, Canada, Japan, France, Federal Republic of Germany, Italy and the United Kingdom.

Sources: OECD, Economic Outlook, Main Economic Indicators, February 1982 and Labour Force Statistics 1963-1974, Quarterly Supplement to the Yearbook, May 1981.

previous three premature reversals of policy, and consequent reaccelerations of inflation, on the credibility of the current commitment to stabilize national price levels. A fourth instance would probably exhaust what credibility remains, and make monetary control impossible for a long time to come.

8. The opposite fear is that the anti-inflation policies will be pushed so hard that they trigger a sharp, cumulative decline in world liquidity, production, trade and employment. Sometimes this claim is made primarily in financial terms, raising the prospect of the liquidity squeeze causing several major debtors to default, and thus triggering a major crisis in the international financial system. Alternatively, the possibility is mentioned that the simultaneous pursuit of strict anti-inflation policies by several countries may set-off a downward multiplier process in which the world economy ends up at a much lower level of output than would be otherwise necessary.

9. This possibility has to be qualified in several important respects. The threat of general contraction of economic activity is not posed by the anti-inflation policy as such, but by the policies accompanying it. Anti-inflation policy attempts to slow down the growth in the volume of money, not to reduce it absolutely. In a competitive market, in which firms are not shielded from adjustment pressures, the unemployment accompanying the disinflation process would be limited to the frictional kind.

10. When, however, anti-inflation policies are pursued in conjunction with increasingly restrictive commercial policies, and with national economic policies which ultimately tend to inhibit market adjustment, it must be admitted that a degree of deflationary danger exists. This was demonstrated, in dramatic terms, in the decade of the Great Depression. Not even today can full agreement be said to exist on all points of the economic history of that unhappy decade. It is, however, agreed that the cause of that disaster lay in the combination of three abnormal conditions: (a) high level of international (and to a large extent deadweight) debt, (b) lack of an international system capable of preventing an escalation of protection and (c) inability of monetary policy in several nations to prevent an absolute shrinkage in national money supplies. It is worth noting that the international financial crisis occurred after the passage of the highly restrictive Smoot-Hawley Tariff Act in June 1930. The long Congressional deliberations on the Act were followed anxiously by other governments, and when it was signed into law, commercial retaliation by a number of countries followed promptly. It is also noteworthy in this context that the United States banking crisis started by runs on banks in the agricultural exporting districts in the South-East and Mid-West of the country.

11. The sluggishness of the world economy in the last decade can only be explained by the unusually high level of uncertainty inhibiting investment decisions, as well as causing a considerable mis-direction of investment and waste of real capital. This diagnosis forces itself on anyone who talks to businessmen, and is now accepted by governments themselves. It is in this context that we encounter the question as to the relative rôle of protectionism in creating the investment-inhibiting uncertainty.

12. As already suggested, it is technically impossible to isolate and measure the contribution of any particular factor to the uncertainty pervading a national or the world economy, both of which are closely interdependent systems. Nonetheless, the relative significance of trade uncertainty may be at least broadly indicated by the following three considerations.

13. When the rules of the international trade order lose their binding power and credibility, the resulting uncertainty affects most directly all the trade-related productive activities in the economy - that is to say, enterprises which export, use imported inputs, compete with imports in the domestic market, have subsidiaries operating abroad, or contemplate such foreign investments. Rough calculations suggest that something in the order of 20 per cent of total business investment in the United States is made by firms whose profits are sensitive to national

and foreign commercial policies. The comparable figure for the EC may be put at 40 per cent.[1]

14. The level of non-residential investment is sensitive not only to the level of uncertainty specific to each industry, but also to the degree of uncertainty surrounding the economic outlook for the economy as a whole. This opens up two additional avenues through which protectionist developments depress investment.

15. One - which is at present by far the most important - is through the impact on the financial sector. This effect is closely related to the financial squeeze that inevitably accompanies an effective disinflation. All the heavily indebted countries, and many of the heavily indebted firms are involved in international trade, and as a result their earnings (or profitability in the case of firms) are determined to an important extent by developments in world trade. As is well known, the level of world trade has been virtually stagnant for two years - a trend which preliminary data for the first quarter of 1982 suggest is

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[1]Manufacturing investment has accounted for about 20 per cent of non-residential investment in the United States in recent years, and approximately 20 per cent of manufacturing output is exported; thus about 4 per cent of non-residential investment is directly related to exporting. Investment in import-competing industries is also affected by uncertainty surrounding commercial policies, as is investment in firms whose profitability is dependent on access to low cost imported inputs; adjusting the 4 per cent figure upward to take these effects into account, we arrive at a rough estimate of 10 per cent for the share of non-residential investment which is influenced by uncertainty surrounding future trade in manufactured goods.

Investment in agriculture, mining and services accounts for about 80 per cent of non-residential United States investment. Output from the first two sectors is heavily traded; it is harder to generalize about services because it is such a heterogenous grouping, but it is generally acknowledged that the direct export of services (including the financing of foreign trade) is an important component of many countries' trade. Making the arbitrary (but arguably conservative) estimate that the profitability of one-eight of the combined investment in agriculture, mining and services is sensitive to trade policy developments (compared with one-half for manufacturing investment), we pick up another 10 per cent of non-residential investment. Added to the 10 per cent share from manufacturing, this yields a very rough estimate of 20 per cent as the share of non-residential investment which is sensitive to uncertainty stemming from commercial policy developments. This figure also happens to be more or less equal to the ratio of United States exports plus imports to GDP.

Given that the EC's ratio of trade to GDP is nearly triple the United States figure, a doubling of the 20 per cent United States estimate would seem to be a conservative rough estimate of the share of EC non-residential investment which is sensitive to commercial policy developments.

continuing. This has been one of the major factors in creating the financial squeeze for the indebted countries and firms, and in raising questions regarding the level of their indebtedness, creditworthiness, and - ultimately - solvency.

16. When new trade restrictions are introduced into such a situation the scope for profitable export activities shrinks, and the chances of the sick firms and industries regaining financial viability through adjustment or restructuring involving conversion to new lines of production are reduced further. As their foreign exchange earnings (profits) decline, the concerns over their ability to service their debts and over the solvency of their creditors intensify, often to the point where bankruptcy - the most radical form of economic restructuring - becomes inevitable. Obviously it is not only border measures that can have these effects. Subsidies granted to industries in one country equally reduce the ability of financially weak firms in other countries to plan their adjustment. Even the fear that measures of this kind may be introduced in the future will have this effect.

17. To put it differently, protectionism reduces the quality of the banking sectors' assets. Important among these assets are, of course, loans to foreign countries, as well as to domestic firms that produce for export, are dependent on low-cost imported inputs, and/or have trade-oriented foreign subsidiaries. The "quality" of these assets refers simply to the probability that the loans will be serviced and repaid on time. This is where we find the nexus between the international trade and financial systems. In the financial sectors of the industrial economies, the worry about the declining quality of bank assets in general is becoming pervasive. In such a business climate, both industrial and financial firms tend to postpone commitments of long term capital.

18. As the following quotations suggest, the combination of high real interest rates and depressed earnings has caught many debtors - firms and countries alike - in the tightest financial squeeze of the postwar period:

> Whether the recession persists much longer or not, the business-failure rate [in the United States] for 1982 seems likely to set a postwar record. ... Estimates place the comparable profit drop thus far in this recession at about double the postwar average. By no coincidence, other barometers of corporate financial health, such as a ratio of cash-type assets to current liabilities, show the feeblest readings of the postwar era.
>
> Wall Street Journal
> 7 June 1982

An economic research organisation yesterday predicted a more than 30 per cent increase this year in personal and business insolvencies in West Germany. ... Schimmelpfeng GmbH forecast 15,200 insolvencies for 1982 compared with the 1981 figure of 11,653 - the largest number of bankruptcies since the war.

Financial Times
15 June 1982

With the steep rise in foreign debt in 1981 ... the limits of indebtedness of individual developing countries as well as of a number of OPEC countries and centrally planned economies have probably been reached or are quite close. ... At all events banks will have to be even more prudent when granting international loans, especially since their earnings position has been weakened by other developments as well and their capital base does not always seem to be sufficiently strong.

Report of the Deutsche Bundesbank for the Year 1981 (p.62)

19. Two aspects of the debt problem are especially worrisome in the present situation. One is the sheer volume of the debt. Many oil-importing developing countries have been borrowing heavily since the first oil price increase in 1974 (current estimates indicate a total indebtedness at the beginning of 1982 of some $500 billion, to which some $80 billion of estimated indebtedness of Eastern Europe should be added), and the depressing effect of inflation on equity markets beginning in the early 1970s forced firms to increase substantially their reliance on borrowed capital. In both instances the burdens imposed by the growing indebtedness were lightened for a time by the very low or negative real interest rates which prevailed for much of the 1970s, but that unusual and inherently temporary "benefit" is no longer available.

20. The other worrisome aspect is the apparent increase in the proportion of deadweight debt - that is, debt to which there correspond no new productive facilities. This happens when borrowed funds are used to finance consumption rather than investment, to finance, in other words, the postponement of adjustment, or to support a firm's or country's cash flow position (which often involves new borrowing to service existing indebtedness) rather than to purchase plant and equipment.[1]

[1] Borrowing motivated by cash-flow problems has been advanced as one reason why short-term interest rates have remained high despite the recession. Some analysts have suggested that economic recovery could actually reduce the overall demand for loans because it will relieve cash-flow problems and - through higher profits - improve firms' opportunities for equity financing.

21. The second way in which protectionist developments contribute to the investment-inhibiting uncertainty operates through broader political considerations. When governments attempt to reduce the uncertainty of outlook for particular industries by securing their domestic market against foreign competition, they cannot but generate a still more general form of uncertainty, namely uncertainty about the very future of the country's economic system. A situation is in fact created which feeds on itself. Inappropriate monetary and fiscal policies generate inflation, which hampers firms in planning their response to changing market conditions. As general economic activity begins to stagnate, governments seek to restore confidence in specific industries by granting them increased protection and/or subsidies. But outside the favoured sector(s), such ad hoc responses - which frequently involve turning a blind eye to the country's international obligations - raise the level of uncertainty surrounding future government policy. In fact, measures of ad hoc assistance to particular industries also tend to (a) intensify inflationary pressures and (b) rigidify industrial structures; on both counts, they reduce further governments' ability to implement the difficult reforms needed to get the economy back to the self-sustaining, non-inflationary growth path of the 1950s and 1960s.

22. It is in these three ways - through the direct effect on investment in trade-related sectors, through the impact on financial structures, and through doubts about the future of the economic system itself - that protectionist developments in the last few years have fed the uncertainty which, among other things, keeps real interest rates high and firms postponing their investment decisions. The discussion in the preceding pages also suggests the main outline of appropriate corrective policies. A clear and convincing collective refusal by governments to implement additional measures of protection, subsidization and other forms of trade-distorting intervention would contribute to maintaining both international and domestic stability throughout the process of disinflation. The gain from "holding the line" would be only a limited one, of course, for the existing situation is far from satisfactory, as the decision to hold a Ministerial meeting itself suggests. Ultimately, the difficulties besetting the world economy can only be overcome through an agreement to actually reverse the trends of the last decade, and to begin unwinding all the recently imposed trade distortions. The restoration of reliable, respected rules to govern international trade would provide the dynamic impulse needed by the production side of national economies to counteract the inevitable dampening influence of the disinflation process. In this way, economic policy would also serve the urgent need for the banking sector to improve the quality of its assets by being able to finance more secure and profitable ventures. It should not be forgotten that the post-World War II period of general economic growth - unique both in the duration and in the speed of expansion - was initiated by a radical liberalization.