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The Continuing World Economic Crisis

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Summary: In some ways, the world economic scene in 1980 was a rerun of 1979, with rapidly rising oil prices, a business slowdown in the industrial world, balance-of-payments trouble in developing countries, too little stability in financial markets, and too much inflation. But there was a significant change, too, in 1980, above all in the perception of the world's economic troubles and what to do about them.

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In some ways, the world economic scene in 1980 was a rerun of 1979, with rapidly rising oil prices, a business slowdown in the industrial world, balance-of-payments trouble in developing countries, too little stability in financial markets, and too much inflation. But there was a significant change, too, in 1980, above all in the perception of the world's economic troubles and what to do about them.

The most important change was the growing recognition that since the early 1970s the industrial world has been caught in a low-growth trap. One element of the trap that was particularly evident in 1980 was the volatility of financial markets. It has frustrated the efforts of governments to stimulate demand and create the conditions of rapid growth. Another perception is that the stubborn persistence of inflation cannot be overcome by a policy of reducing money growth gradually. Still another new perception is that real energy prices will continue to rise rapidly and indefinitely because the world's demand for energy is less responsive to high prices than was earlier thought. Above all, governments are coming to acknowledge that persistent high inflation in the United States and some European countries is the single most important feature of the world economic crisis and the leading cause of inadequate growth.

II

The year ended as it began, with the U.S. financial markets in disarray. Between early January and late March, short-term interest rates had climbed over four percentage points, before sweeping credit controls imposed by the Federal Reserve broke the interest-rate spiral. The now-familiar drama was repeated at the end of the year with most interest rates surpassing the record highs they had set in March.

These sudden financial explosions have much in common with the liquidity crises that used to trouble the United States before World War II-but with an important difference. In the past, money was in short supply when the Federal Reserve tightened credit or when gold flowed abroad. As a result, market interest rates climbed sharply. In 1980, by contrast, the two market panics followed on the heels of a sudden expansion, rather than a contraction, of the money supply (Graph 1). The outcome was nonetheless much the same as in earlier panics. For the burst of money growth signalled to the markets that there would be a subsequent tightening of Federal Reserve policy or even the imposition of direct controls on credit that might make funds unavailable at any price. The anticipation of a credit crunch became self-fulfilling and interest rates soared.

The U.S. money supply had begun to rise strongly in November 1979, despite the Federal Reserve's solemn promise only the month before to improve money control. This monetary surge, which persisted into late February 1980, came at a time when market expectations of more inflation and higher interest rates had just been excited by a wider than expected U.S. budget deficit together with the prospect of increased defense commitments caused by the Soviet invasion of Afghanistan. A further acceleration of the U.S. money supply late in January proved to be the last straw. In the last week of the month, interest rates took off as the markets became convinced that the Federal Reserve would now have to tighten credit sharply in order to slow money growth.

The Federal Reserve did tighten credit and succeeded in slowing money expansion late in February. But now a new psychological factor-the public's anticipation of credit controls-took over, and interest rates continued to race upward.

Federal Reserve officials were talking openly of a need for direct controls to stem the market's insatiable demand for credit, and these hints quickly proved to be self-fulfilling. On March 14, the Federal Reserve imposed for the first time in U.S. history comprehensive peacetime credit controls. Credit demand, cut off at its source, subsided suddenly, money growth fell, and interest rates plunged. The crisis was over.

But not for long. The sudden interruption of borrowing in March, coming at a time when U.S. business activity was already weak, dealt a severe blow to consumer confidence and retail spending, and the U.S. economy appeared to be headed into a severe recession. (During the April-June quarter real gross national product [GNP] fell at a ten-percent annual rate.) Not surprisingly-it was, after all, an election year-the Federal Reserve responded early in June with a policy of easing the money supply, which it maintained through the summer and fall. Once again, the money supply ballooned, rising far above the Federal Reserve's official target (Graph 1).

This about-face in Federal Reserve policy set the stage for the second financial panic of the year. As rapid money expansion persisted through summer and fall, the markets' hopes for less inflation evaporated. Interest rates surged again. Remembering the earlier crisis, the market began to anticipate still higher rates. Between the end of July and the end of October, short-term rates moved up five percentage points. Soon a panic psychology took over, and by mid-December rates had gained another five points as money growth and credit demand exploded. As this is written, the second crisis is subsiding-this time fortunately without the aid of credit controls-as markets begin to accept the evidence that the Federal Reserve is determined to slow money growth in the wake of Ronald Reagan's election as President.

Why has the behavior of U.S. financial markets changed so radically in recent years, topping all previous postwar records not only for the sheer magnitude of interest-rate gyrations but also for their frequency? After all, until the 1970s, such interest-rate movements had not been seen for generations.

The answer lies in the wild gyrations of policy that have characterized Federal Reserve management since the first oil shock in 1973-74. Typically, in recent years monetary authorities-and not only in the United States-have made little effort to calm or reassure financial markets. Instead, they have added to uncertainty by allowing wide gaps to develop between their stated intentions and subsequent behavior. Monetary targets are now routinely announced and routinely missed, and so the markets try to protect themselves from the vagaries of monetary management by reacting quickly to every sign of a change in the direction of policy. Interest rates go up sharply when the money supply balloons, in anticipation of still larger increases when the Federal Reserve again turns restrictive. And the same thing happens on the down side when the Federal Reserve finally gives evidence of a firm intention to slow money growth again.

The financial markets' hair-trigger reactions to each blip in money growth enormously complicated the Federal Reserve's task of monetary control. The authorities and the markets simply chased each other up and down the interest-rate gamut, each blaming the other for the trouble.

This process of mutual frustration by the authorities and the markets has damaging effects on the general economy. A climate of gyrating interest rates and securities prices is naturally bad for business confidence, for investment, and for consumers' willingness to spend. Small wonder that at the end of the year, the U.S. economy was going nowhere fast, and that the semi-stagnation of business activity that had characterized the economy since early 1979 seemed likely to persist through 1981.

Although the U.S. domestic financial markets held the limelight in 1980, the wild swings of U.S. interest rates also affected other countries by inducing large fluctuations in the exchange rates of their currencies vis-à-vis the dollar. The two upthrusts of U.S. interest rates in the spring and fall attracted large financial flows into U.S. dollar investments. The resulting upward pressure in exchange markets pushed the dollar up against the German mark from 1.71 marks in early January to 1.98 marks in early April. When rates fell back in the summer, so did the dollar, only to explode again in the second half of the year from 1.74 marks at the end of July to over 2.00 marks in mid-December. The behavior of the other European currencies against the dollar was similar, except in the case of sterling, which remained high against the dollar right through the year.1

The dollar's unwarranted strength against currencies other than sterling had its own undesirable consequences. Through most of 1980, the countries with traditionally strong currencies-Germany and Japan-have been faced with major outflows of financial capital attracted by the high real interest rate available on dollar assets. The resulting downward pressure on the mark and the yen has tended to raise the domestic prices of oil and other imports, thus speeding inflation in both countries. In response, the German and Japanese authorities sought to strengthen their currencies by abolishing controls on capital inflows and by tightening their domestic monetary policies and supporting their currencies on the exchanges. Such moves had a restrictive effect on monetary conditions in the two countries, tending to worsen the business slowdown already developing there.

Thus, in 1980, erratic money management and oversensitive reactions of financial markets added new troubles to an already troubled world economy. The effect was to aggravate the general slowdown of economic growth that had afflicted the industrial countries to a greater or smaller degree ever since the first oil shock.

III

The past year will be remembered not only for the turmoil in U.S. financial markets but also for the beginning of a recession spilling over into 1981 and affecting all the industrial countries simultaneously. It will be the second such synchronized slump, in a world where the advent of flexible exchange rates was once thought to have weakened economic linkages among countries, rendering their business cycles more independent.

The first synchronized recession was in 1974-75, triggered by the first oil-price shock. The shock jacked up the price levels simultaneously in all the industrial countries and suddenly reduced real incomes. Spending and business activity were then further depressed because governments and central banks responded to the rise in prices by policy restraint. Almost exactly the same thing happened in response to the second oil-price shock. The world price of oil spurted from an average of $12.91 a barrel in the fourth quarter of 1978 to $23.54 in the fourth quarter of 1979 to an estimated $33.00 in the final quarter of 1980. Once again the authorities in all the industrial countries responded by tightening money supply more or less simultaneously. The result was a second synchronized business slowdown.

Early in the year, the 1980 slowdown seemed likely to be a lot milder than its 1974-75 counterpart, because the oil-price rise was proportionately smaller (180 versus 400 percent) and the slowing of money growth was also less. The official forecast of the Organization for Economic Cooperation and Development (OECD), in July 1980, foresaw a growth slowdown, with real GNP in the seven largest industrial countries slowing to 1.0 percent in 1980 compared with 3.5 percent in 1979. But now a full-fledged recession continuing into 1981 seems to be in the cards, principally because of the disturbances in U.S. financial markets discussed above and their impact on exchange rates and domestic policies in Europe and Japan.

Back in the 1960s-in the days of the Bretton Woods monetary system when most currencies were pegged to the dollar at fixed exchange rates-business cycles in the industrial countries were not closely synchronized (except in the case of Canada and the United States). The reason for the absence of synchronization was the way monetary impulses were transmitted internationally from the United States to other countries under fixed exchange rates. The world was on a dollar standard and the Federal Reserve controlled (albeit unwittingly) the pace of money growth in all countries that pegged their currencies to the dollar. This control occurred through the effects of U.S. monetary expansion and contraction on other countries' official foreign exchange reserves and money supplies. However, these effects occurred with variable time lags. As a result, business cycles in the United States and in Western Europe were generally out of phase. A boom in one country or region tended to offset a slowdown elsewhere. In the 1960s, properly speaking, there was no clear-cut international business cycle, but rather a series of more or less unsynchronized cycles within individual countries.

Against this background, it is not surprising that economists were so sure in the late 1960s and early 1970s that the breakdown of fixed exchange rates would further weaken economic links among countries. It is true that flexible exchange rates have given some countries-Germany, Japan and Switzerland in particular-the opportunity to follow less expansionary monetary policies than the United States and thereby to suffer much less inflation than in this country. In this monetary sense, flexible rates have provided some countries more independence. But in real or business-cycle terms, independence today appears to be less, rather than more, than under Bretton Woods. This is true not only because of simultaneous oil shocks and parallel policy responses to them, but also because flexible exchange rates force other countries' central banks to respond quickly rather than with a lag to shifts in Federal Reserve policy.

The reason is the greatly increased sensitivity of financial markets-in this case, the markets for foreign exchange-to changes or anticipated changes in Federal Reserve policy. So on two occasions in 1980, as we have seen, the dollar's swift rise on the exchanges (in anticipation of Federal Reserve tightening and thus higher U.S. interest rates) forced the German central bank to tighten domestic credit, thereby turning a mild business slowdown in Germany into what is likely to be a 1980-81 recession.

Britain, too, is in the midst of a severe recession, worse in fact than in 1974-75. Unemployment, now close to eight percent, is the highest since World War II. In Britain's case, though, the synchronization with the European and U.S. business cycles is more accidental. The British recession is mainly the result of the financial markets' belief that Prime Minister Margaret Thatcher means business and that she may yet succeed in making the Bank of England bring down money growth and reduce inflation. This state of mind has led not only to the pound's exaggerated strength on the exchange markets but also to an increase in the public's willingness to hold pounds, which has reduced the velocity of circulation of money in Britain, thereby slowing spending and lowering business activity.

Once again, market reactions have taken the play away from the authorities, yielding economic consequences as untoward as they were unexpected. Perhaps 1980 should be called "the year of the markets," to underline this emergent phenomenon. So far, its economic consequences have been unfavorable-in Britain, the United States, and the world at large.

IV

Protectionism is one of the hardiest of the economic perennials: it thrives in hard times. So it is not surprising that the current recession and condition of stagflation in the industrial world are yielding a luxuriant new growth of protectionism. This has occurred in the face of repeated official pledges of loyalty to economic liberalism in international commercial policies-most recently by the OECD governments in June 1980.

Back in the mid-1970s, in the wake of the 1974-75 recession, the focus of protectionism in Europe and North America was the labor-intensive industries that were feeling strong competition from the rapidly industrializing developing world, particularly from East Asian countries such as Taiwan, Hong Kong, Singapore and South Korea, and from Latin America, where textiles and consumer electronics exploded during the last years of the great postwar boom. These labor-intensive industries, along with steel-making and shipbuilding, which were suffering from Japanese competition as well as competition from "less-developed" countries (LDCs), succeeded during the 1970s in persuading governments in the industrial countries to put in place a network of new protectionist devices. One example was the U.S. steel import trigger-price system, established in 1978.

Other measures less visible but no less damaging to economic efficiency were also adopted, many of them under the rubric of "positive adjustment" or "industrial policy." Such measures amounted for the most part to subsidies to firms or industries in financial difficulties, to enable them to maintain employment in the face of weak domestic demand and intense international competition. In some cases, the extent of public aid is so large that it verges on nationalization. In 1980 the Chrysler Corporation joined British Leyland as a ward of the state.

The new wave of protectionism also reflects in part the rising relative price of energy. The U.S. automobile industry has long felt the pressure of European and Japanese competition. But until the second oil-price shock, the superior energy efficiency of foreign cars was not a major factor in the U.S. market, perhaps because price controls have held down the price of gasoline. Also, many Americans, fond of their big cars, were willing to believe that the first oil-price shock was a unique historical event. Now, however, fuel efficiency has become a big competitive factor in the U.S. auto market, leaving the U.S. auto makers with a major problem of adjustment. Nor does it help the U.S. industry that the United Automobile Workers is an unusually powerful union that has been successful in holding U.S. auto workers' wages above international standards, even after adjusting for productivity differences.

In short, the rising real price of energy, along with price controls, has impaired the comparative advantage of this critical U.S. industry, which for so long enjoyed a dominant world role. The response has been a major shift in sentiment in the industry, management and labor alike, toward protectionism. For an industry that had for so long been the symbol of U.S. productive efficiency, it is an ironic dénouement.

V

The 1980 developments-interest-rate explosions, synchronized recessions, growing protectionism in advanced industrial nations, and the second oil-price shock-have also been deeply troubling to developing (or less-developed) countries. The 1979-80 rise in oil prices, together with the business recession in the industrial world, has again put severe pressure on LDCs' international payments, swelling the excess of their imports over exports and the need for international credit. At the same time, high interest rates have added substantially to the burden of their foreign debt, because for the most part the interest rates they pay on both new and outstanding loans are geared to current rates in the U.S. and Eurocurrency markets. The magnitude of the balance-of-payments blow may be seen in the combined deficit of non-OPEC developing countries, which widened from $36 billion in 1978 to $55 billion in 1979 and a projected $68 billion in 1980.2

As a result, LDCs' growth prospects are now a good deal less favorable than they appeared to be a year or two ago, after these countries had successfully weathered the first oil shock and enjoyed two consecutive years of real growth in excess of five percent. This incipient growth slowdown is the LDCs' real economic problem. Too often it has been hidden or upstaged by apocalyptic visions, in the media, of massive defaults and financial collapse.

The impact of the 1979-80 oil shock on the LDCs was in essence a repetition of what happened in 1974-75, when these countries faced rapidly escalating oil-import bills that reduced their command over other resources. Their relatively low oil consumption rates made significant cuts difficult in the short run, with the result that hard choices had to be made with respect to much-needed domestic investment. If the oil shock had been the only problem, these countries-especially the more industrialized among them such as Brazil, South Korea and Taiwan-might have paid their oil bills by expanding exports rapidly. But the synchronized recession in the major industrialized nations has made this less possible, just as it did in 1974-75.

A significant difference between the two oil-shock-cum-recession episodes was in the LDCs' own policy responses. In 1974-75, responses diverged: Taiwan, for example, responded by immediately restricting domestic demand, thereby cutting imports and making large foreign borrowing unnecessary. Brazil and South Korea, on the other hand, along with several other countries, sought at first to cushion the impact of the external blows on domestic income and employment by maintaining domestic demand through fiscal and monetary expansion, borrowing in the international capital markets to finance their widening trade gaps. But the recession in the industrial world lasted longer than expected, and these countries finally had to restrict domestic money growth and demand and devalue their currencies sharply.

Nevertheless, the principal non-oil LDCs as a group did succeed in large part in insulating their growth from the external shocks. In 1975, when the industrial countries were in deep recession with real GNP down one percent below 1973, the non-oil LDCs turned in a 4.5 percent positive growth performance, only a little less than 1974's 5.5 percent.

In 1979-80, however, the heavy burden of international debt, acquired in the earlier episode, is a new factor that forces all the countries to respond more promptly with restrictive domestic measures than in 1975. Moreover, this time around, soaring interest rates have compounded the LDCs' foreign debt-service problem, narrowing further the range of their discretion in domestic policy. The sharp escalation in LDCs' external debt since the first oil shock has also made the international capital markets more wary of financing their balance-of-payments gaps.

This growing external financing constraint means that the LDCs' domestic growth rates have become far more sensitive to oil shocks and foreign recessions than was the case in 1974-75. And now a third oil shock developing out of the Iraq-Iran war threatens not only to prolong the industrial countries' recession but also to force further restrictive policy measures on LDCs. In consequence, growth in 15 non-oil LDCs, which was down to 4.5 percent in 1980 (against 6.2 percent in 1979), will slow even more in 1981.

Slower prospective growth in LDCs is not good news for international lenders, but not because it makes defaults or debt rescheduling much more likely. The incidence of such debt-management problems depends more on the adequacy of the LDCs' own policies than on external conditions. Lenders will suffer along with their borrowers simply because, in a slower growing world economy, there is less business to be done. Developing countries are now less able to insulate themselves from external shocks, but, as we have seen, this implies that their growth rates will be lower, not that they will go bankrupt.

The response of some authorities, notably the International Monetary Fund (IMF), to the non-oil LDCs' widening balance-of-payments deficits, and to reluctance on the part of international lenders to finance them, has been to call for major new concessionary lending facilities to ease the constraints imposed by the private markets. The wisdom of this proposal is doubtful. It is not clear why countries should be encouraged to follow domestic policies that the markets deem unwise and are unwilling to finance.

No doubt some developing countries will get into debt trouble from time to time and require special assistance. Some may have the political clout or the strategic importance to persuade their allies to bail them out, as Turkey did in 1980. In general, however, assistance ought to be provided under regular IMF procedures, accompanied by strict conditions to assist the local authorities to take the measures necessary to hold down domestic spending and put the balance-of-payments right. Healthy nations cannot, after all, live indefinitely on charity or political handouts. A major new official concessionary credit facility would only weaken market discipline without helping developing countries to make better use of their own resources and to live within their own means.

VI

In the advanced industrial nations the frustrations of governments and central banks are part of a larger phenomenon: not only interest rates and exchange rates but also inflation, business activity, and employment have passed beyond the authorities' control. Broad economic management, whether in the traditional, Keynesian, "fine-tuning" mode or in the up-to-date form of monetary targets, seems to have reached a dead end. In the high-inflation countries at any rate, the end of the road is a condition in which the authorities are powerless either to stimulate business activity and employment effectively or to overcome inflation. This condition of stagflation was well established in Britain, France and Italy as early as 1977. In 1979-80, it took firm root in the United States, where it bids fair to continue indefinitely.

In this country the Carter Administration, with its "new economists" from the early 1960s, aided and abetted by an anti-monetarist majority on the Federal Reserve Board, had responded to the deep 1975 recession in the Keynesian manner with a powerful dose of fiscal and monetary stimulus. At first the U.S. economy responded with a vigorous recovery; in 1977 and 1978, real GNP rose 5.3 percent and 4.4 percent respectively. But then in 1979 inflation, which had subsided to less than five percent in 1976, had its innings. Prices began to rise swiftly, and the rise continued to accelerate in 1980, while the real economy stagnated, despite several new bursts of monetary expansion. Now it is evident to all that the United States has joined Britain, France, Italy and Canada as a member in good standing of the stagflation club.

For more than a decade, economists of a monetarist persuasion have bitterly criticized Keynesian demand management for its reliance on fiscal and monetary stimulus and its relative indifference to, or irresponsibility toward, inflation-which the managers usually attributed to oil prices, "wage push" or other causes for which they could not be blamed. The monetarists advocated "monetary targeting"-adherence by central banks to a steady, low rate of growth of the money supply-as the appropriate alternative to Keynesian policies.

In all the large industrial countries and several others, money supply targets were in fact adopted during the 1970s, and in a few countries-Germany, Japan, Switzerland-the targets were low and reasonably met; in these three disciplined countries, the targets accomplished their purpose. Inflation subsided to tolerable levels and the three economies grew at rates that were adequate, even if well below those of the 1960s. But in the other main industrial countries, high inflation persisted, and stagflation was the order of the day.

The trouble in these high-inflation countries was that by the time monetary targeting was adopted, inflation had taken deep root. Economic agents-firms, individuals, even governments themselves-had come to expect rapid continuing inflation and had developed a profoundly skeptical view of the will or the political ability of governments and central banks to put into place an effective stabilization program. In these circumstances, it came to be accepted that setting money targets low enough to maintain a low rate of inflation would be politically suicidal. So powerful appeared to be the momentum of the public's expectations of inflation that a major slowing of money growth was expected to yield not less inflation but rather massive unemployment. Political reactions would then destroy the stabilization effort before it had fairly begun.

Such is the conventional wisdom regarding stabilization in the United States and most of Europe. The notion is that stabilization can be achieved-if at all-only gradually, by adopting relatively high money targets and lowering them slowly over a period of years. "Gradualism," as it is now called, is the official policy line in Britain, France and Italy as well as in Canada and the United States.

From the mid-1970s on, the central banks in the high-inflation countries began to announce relatively high annual money-supply targets with the promise that the targets would be lowered gradually over a period of five to seven years. Representative of the approach was a 1977 statement by U.S. Federal Reserve Board Chairman Arthur Burns:

It should be abundantly clear by now that a healthy and prosperous economy can be achieved only by pursuing policies that are consistent with steady progress toward restoration of general price stability. That principle is continuing to guide Federal Reserve policy. Over the past year, growth rates of the major monetary aggregates have not been excessive, and our projected ranges for the future have been gradually reduced.3

The Barre Plan in France, adopted in 1976, and Margaret Thatcher's 1979 austerity program for Britain, are likewise based on the philosophy of monetary gradualism.

Alas, in 1980, the emptiness of the gradualist promise to reduce money growth and inflation slowly and painlessly was revealed. In all three countries the central banks overshot their money targets by wide margins. Meanwhile, inflation remains as high or higher than when the programs began, unemployment has risen, and growth has slowed. The high hopes that greeted these programs when first announced have evaporated, particularly in France and the United States. The verdict is not yet in on the Thatcher program, and as noted, the markets are still half-betting on some slowing of British money growth and a reduction of inflation. But rapidly rising unemployment, high wage settlements in the public sector, the large public-sector deficit, the Bank of England's scarcely concealed skepticism about its own money targets, and British industry's growing resistance to an overvalued pound-all bode ill for the Thatcher program.

Monetary gradualism fails in part because central banks have failed to alter their procedures so as to take into consideration the volatile market conditions in which they must operate today. They have as a result consistently missed their money-supply targets, for the most part on the high side. In consequence, the authorities have failed to convince the public that their commitment to stabilization is serious. Thus, even at times when money targets are met, inflation is sustained by the momentum of the public's expectations. Thereupon, rising unemployment forces the central banks to raise their money targets (frequently by the transparent device of adopting a new, higher base), so as to validate the higher price level and halt the rise in unemployment. In this way, what purports to be a policy of reducing inflation gradually, turns out to be a policy of accommodating the going rate of inflation. Small wonder the public refuses to lower its expectations of future inflation and that inflation goes on as before.

Traditionally, central banks concerned themselves with interest rates rather than the money supply. They sought to influence conditions in the general economy by altering a key interest rate such as the discount rate, the rate at which the central bank lends reserves directly to banks, or (in the United States) the "federal funds rate," the rate at which banks lend each other reserves. By altering either the discount or the federal funds rate, the central bank would increase or reduce the supply of reserves to the banking system which would increase or reduce the money supply. This would in turn raise or lower the general level of interest rates in the economy by tightening or easing credit-market conditions. The authorities did not traditionally think of bank reserves or the money supply but rather of interest rates and credit-market conditions as the objective when they altered the discount or federal funds rate.

Central banks have experienced great difficulty in adapting this operating tradition to present-day conditions in which the objective is to achieve a certain regular growth of the money supply. In order to achieve this by altering an interest rate, the central bank must be able to forecast with reasonable accuracy how banks and the public at large will respond to that interest rate. In other words, the authorities must be able to forecast the demand of banks for reserves and of the public for money, in order to hit their money supply targets.

In the disturbed conditions of the credit markets today, central banks-especially the U.S. Federal Reserve and the Bank of England-have been singularly unsuccessful in such forecasting. They have tended on average to underestimate the demand for reserves and money and thus to hold interest rates below a level consistent with achieving their announced money targets. And the forecasting difficulty has been compounded by an official reluctance to allow interest rates to rise sharply-a reluctance born in part of a traditional desire to stabilize interest rates and in part to political pressures to hold rates down in order to cope with unemployment. In a nutshell, this is why, in the high-inflation countries, money targets have been consistently exceeded.

Five years after it began to announce money targets, the Federal Reserve conceded that its customary operating procedures were at fault. On October 6, 1979, the Fed stated that "more emphasis will be placed on controlling the provision of reserves to the banking system, which ultimately governs the supply of deposits and money, to keep money growth within our established targets."4 The implication appeared to be that direct control of the level of bank reserves would take precedence over other considerations, including the level and stability of interest rates, in the Federal Reserve's operations. More than a year has passed since this statement was made, but there seems to have been little change in Fed operations. The Fed's money target has once again been exceeded by a wide margin (Graph 1). The central bankers are still reluctant to allow interest rates to rise rapidly enough to keep bank reserves and the money supply under control.

To be sure, the disturbed condition of credit markets makes the Fed's task a difficult one, because it makes the demand for bank reserves and money harder to forecast. But, ultimately, that difficulty itself is traceable to the authorities' failure to establish public confidence in their monetary targets and in the seriousness of their commitment to stabilization.

This pattern of failure has undermined whatever confidence the public may have had in monetary gradualism. Even the authorities appear dubious. In September 1980, Federal Reserve Governor Charles Partee remarked that holding down money growth is "pretty tough for an election year."5 Subsequently, Chairman Volcker expressed the view that the Federal Reserve's money target for 1981 was too low to finance the 12 percent growth of nominal GNP that would be needed to sustain the recovery-a remark that could be interpreted to suggest that monetary policy ought to accommodate something close to the going rate of inflation.6 When leaders' trumpets emit such uncertain sounds, how can the public base its economic behavior on the premise that a serious stabilization program is in effect?

In sum, monetary gradualism has become a euphemism for accommodating inflation. A gradualist approach to stabilization requires the public to maintain confidence in the program over a long period, without convincing evidence that the program is working or even that the authorities themselves believe it will work. In democracies, the electoral cycle is simply too short for that. There is not the time to make the program credible before it is overwhelmed by political resistance.

Effective stabilization presupposes a program that convinces the public that reduction of inflation to a low level is the authorities' overriding priority. The countries that have succeeded in doing this-Germany, Switzerland, Japan-did not do so gradually. They applied shock therapy. Money growth was reduced abruptly to a level consistent with achieving an acceptable rate of inflation and then held there. There followed two or three years of relatively slow growth and high unemployment but the effort succeeded. Inflation dropped and stayed down, and growth and employment eventually picked up again. In the United States and the other high-inflation countries, the meaning of this experience has been widely ignored.

VII

The sense of policy failure in the West that has accompanied the frustrations of broad economic management has been greatly reinforced by evidence that economic growth rates have slowed dramatically since the early 1970s. Yet it is only in the last couple of years that the growth slowdown has been clearly perceived and that a search for causes and solutions has begun. Witness, for instance, the repeated official references during the last year or so to the dramatic slowdown in the growth of productivity-output per man-hour in the industrial countries. The United States presents by far the most distressing picture of all the rich industrial nations, with real GNP per employed person registering declines of 0.3 percent and 1.0 percent respectively in 1979 and 1980. These adverse productivity trends have not only meant slower economic growth but, in conjunction with the hike in energy costs, lower average standards of living in most industrial nations.

Both the perception of low growth and suggestions for correcting it are of relatively recent origin. As late as June 1977, a blue-ribbon commission of experts assembled by the OECD rejected the suggestion that potential GNP growth in the industrial countries had indeed slowed. The experts attributed the slower growth of actual GNP in the 1970s to insufficient demand.7 Consistent with this thinking, the Carter Administration pressured Germany and Japan in 1978 to build up economic steam to pull the world economy out of its stagnation.

The delay in perceiving the new reality is, of course, understandable. It is only sustained evidence that allows observers to distinguish between the effects on growth and productivity that are due to temporary changes in demand during a business cycle and those of a more lasting nature. During the 1970s, unemployment in OECD countries was high by the standards of the 1960s, while utilization of industrial capacity (as officially measured) was low. These indicators seemed to show that demand was insufficient rather than that potential output was growing more slowly. But, in fact, the indicators were misleading. The unemployment rates were swollen by an increase in unemployment that was due to "structural" causes. Moreover, economically usable industrial capacity had been reduced in the 1970s by the steep rise in the cost of energy. But this reduction was invisible to the official measures of capacity, which therefore understated the degree of capacity utilization.

It was not until 1979, when the OECD economies reached a cyclical peak (as indicated by bottlenecks and accelerating inflation) that these misreadings of the indicators came to light. It then became clear that, since 1973, potential GNP had slowed considerably. (Graph 2).

A number of factors account for the slowing in productivity and economic growth. The most obvious and oft cited is the sharp increase in oil prices. Their impact on growth has been felt in several ways. For example, a considerable proportion of the existing stock of capital equipment in industry and transportation has become too expensive to use because of the jump in petroleum prices.

A continuing effect on growth is also felt because of the channeling of an increasing amount of new investment in the oil-consuming countries toward the production and conservation of energy. For instance, in the United States 7.7 percent of gross non-residential investment in 1978 was devoted to production and distribution of petroleum, compared to only 4.9 percent in 1973, just before OPEC flexed its muscles. As more of the nation's savings are devoted to developing new energy sources or to conserving energy, less investment capital is available for the rest of the economy.

Finally, oil and its derivatives have, over the years, become an indispensable part of household budgets, so that every increase in petroleum prices has brought forth only a partial adjustment in the form of reduced use. As a result, household outlays for energy-for gasoline, utility bills, etc.-have commanded a greater proportion of household budgets. This has left oil consumers poorer and reduced both their savings and their consumption. Both factors have tended to reduce growth.

Apart from oil shocks, there have been a number of trends in the industrialized world that have impinged directly on productivity and growth. The most obvious one is the growing cost of government, direct and indirect. Rising marginal tax rates in an inflationary environment have boosted the tax bite faster than wages, reducing the incentive to work. Equally important, all the OECD governments have greatly increased transfer payments programs-unemployment compensation and social security benefits to name only two-in recent years. Once again, by transferring resources from the productive to the idle, governments have taxed work and rewarded leisure. Such effects on productivity and investment have been further compounded by a proliferation of regulatory requirements such as pollution controls and product-safety requirements.

By and large, governments have financed their growing activity through two mechanisms-deficit financing and inflation. The 1970s have been characterized by unusually large public-sector deficits in all of the major nations. Indeed, a number of governments, such as those in France, Germany and Japan, abandoned their long-standing policies of balancing the public-sector budget. With such budgets showing chronic red ink, governments in these nations have become the largest borrowers in the domestic and international capital markets. Since sovereign governments carry the best credit ratings, they have first call on available funds, thus "crowding out" private borrowers. The other favorite tool of governments to finance their expenditures has been the printing press.

However governments have financed their budgets, the consequences have been adverse to investment. Investment rates and economic growth rates have been lower in both the low-inflation and the high-inflation countries. But in the high-inflation countries, inflation has been a main factor reducing economic growth. To begin with, most of our traditional forms of financial and business contracts-for instance, long-term wage contracts or long-term bonds-were developed on the basis of a long history of price stability under the gold standard. But chronic and uncertain inflation has set in motion a search for alternatives. Floating-rate financial agreements, increased use of cost-of-living adjustments in wage contracts and government transfer payments, and a substantial increase in the frequency of product price changes, are some of the ways markets have found to reduce the impact of unanticipated inflation. From the standpoint of economic efficiency and growth, such devices are far inferior to price stability and fixed contracts.

The variability in recent inflation has itself created problems. It has reduced the value of price signals to producers. Take the case of a farmer faced with the choice of planting wheat or corn. Presumably, he would pick the crop that is expected to command a higher value in the marketplace. But when prices generally are rising at ten percent annually, this kind of judgment is difficult to make. Compounding the difficulty is the erratic nature of the high inflation. Relatively modest errors in forecasting inflation could easily turn what appeared to be a profitable venture into a money-loser. The response has not only been a reduction in investment rates but also a growing preference for shorter term investments; witness the public's withdrawal from the long-term bond market in 1980.

The final and most important effect of inflation on real growth has come from abortive attempts to stabilize prices. In the higher inflation countries, efforts to cope with inflation are more or less continuous. Because they are based on the philosophy of gradualism, they are too halfhearted to overcome the momentum of the public's inflation expectations. But they do result in a weak and wavering progression of overall demand. As a result, business lacks confidence and investment lags. Britain and Italy in the 1970s, and the United States in the past two years, provide the clearest examples.

The importance of these various negative effects of high and variable inflation on growth is shown by a comparison of what happened to rates of investment in the high- and the low-inflation countries in the latter half of the 1970s. Investment and productivity growth declined proportionately much more in Britain and the United States than in Germany and Japan, where inflation was both lower and less variable.

VIII

Of the three major components of the industrial countries' low-growth trap-inflation, energy, and the oversized public sector-inflation remains the problem that is most pervasive in its anti-growth effects. It is also the most accessible to policy.

Inflation is in all probability the major independent cause of the world's growth slowdown, though its effects are so intertwined with those of other causes that economists have not yet succeeded in measuring them separately.

The second most important cause, the price of energy, is not a policy variable; it is, rather, a fixed condition. The rising real cost of energy must simply be lived with and coped with. It cannot be eliminated. The essence of a rational energy policy is to allow the rising marginal cost of energy to bring about its natural consequences for the allocation of the community's capital and technological resources, and, where necessary, to help the market to make these adjustments more rapidly and efficiently than would otherwise occur. Energy policy in this sense is growth-inhibiting, in anything less than the very long run. It is not a way out of the growth trap.

The third major component of the world's growth problem-namely, the explosive growth of the public sector in the industrial countries-is not for the most part a truly independent factor. As we have seen, it is mainly a negative feedback from low growth and inflation. For this reason, an attempt to move directly to reduce burdensome transfer payments caused by high unemployment, without having first succeeded in speeding growth and reducing unemployment, is bound to fail politically. The public sanctions such payments-and the resulting public-sector deficits-because it identifies with the unemployed and considers them victims of an injustice which the state is bound to mitigate as best it can.

By the same token, the favorite proposal of the newly elected Reagan Administration-a deep cut in personal and corporate income tax rates along with special tax breaks for business investment-is likely to prove disappointing. In the context of stagflation, growth is held down by causes more powerful than high marginal tax rates; deep tax cuts would therefore reduce public revenues, not raise them. Public-sector deficits would accordingly widen dramatically, aggravating the competition for funds in capital markets and putting pressure on central banks to expand money too fast.

Something else-something more immediately effective-has to be done to speed investment and economic growth before a major tax reform is undertaken. That something is economic stabilization, the key to the low-growth trap.

To conclude that overall stabilization comes first, and all else depends on it, may seem discouraging. Have we not just recounted the failure of economic stabilization in Britain, France, and the United States? Indeed so, but the repeated failures of stabilization policy in these high-inflation countries are due, as we have seen, to the inherent incoherence of the gradualist approach which accommodates and reinforces expectations of inflation even as it attempts to eliminate them. Gradualism, in short, is a cop-out. Some things, like a swim in a cold lake, are so much easier to start quickly and decisively that a gradual approach is virtually impossible.

As to the technical means of stabilization, there are three issues: (1) monetary control; (2) fiscal policy; and (3) which country takes the lead.

Back in the last century, after the Civil War, there was a long public debate about how to put the dollar back on the gold standard-how to "resume specie payments," as it was put at the time. During the 1872 campaign in which he ran unsuccessfully for President, Horace Greeley coined the slogan, "The way to resume is to resume." And eventually that is what was done, without any of the dire deflationary consequences opponents of resumption had predicted.

There is a lesson in this history for today. The way to control the money supply is to control it-i.e., to eliminate other considerations such as the level and stability of interest rates and unemployment that compete with the money target in monetary management. This means keeping bank reserves growing steadily at a rate consistent with a low money target and allowing interest rates to move as they will. At first, rates would doubtless gyrate considerably, though probably no more than they did in 1980. Then, as the markets began to accept the seriousness of the new stabilization effort, rates would settle down and inflation would follow the same course.

It goes without saying that the Federal Reserve would need full backing from the White House and leaders in Congress to make such a move credible. In this connection, the idea of a new monetary "accord," mooted in Reagan Administration circles, is worth considering. In 1951, the Truman Administration reached an agreement with the Federal Reserve Board, known as the "Accord," which relieved the Fed of its prior commitment to hold interest rates down in order to help the Treasury finance the public-sector deficit. The 1951 Accord, allowing the Fed to tighten credit, marked the beginning of a successful postwar stabilization effort that eventually brought price stability not only to the United States but to much of the world economy.

The recent experiences of Germany, Japan and Switzerland show that a relative stabilization can be achieved by monetary policy even in the face of a large public-sector deficit. It is fortunate indeed that this is so. For there is no prospect of achieving in the near term a major reduction in public spending in any of the high-inflation countries. In short, tax reform, however desirable, like stability of interest rates, must be preceded by monetary stabilization itself.

Among the high-inflation countries, it is up to the United States to take the lead in stabilization. Because the dollar is still the world's leading reserve currency, the Federal Reserve has more freedom of action in monetary policy than do Britain and France simply because the Fed need not watch the exchange-rate implications of its monetary actions as closely as must the Bank of England or the Bank of France. By the same token, a successful U.S. stabilization program would create an international zone of stability that would include the United States, Germany and Japan. It would, in time, attract Canada, France and Britain as well as most of the smaller European countries into an international monetary system similar in essentials to the present European Monetary System but covering most of the industrial world. Creation of such a system would be the first step toward an escape from stagflation and the low-growth trap.

The experience of 1980 has demonstrated that there is no substitute for an immediate monetary stabilization. In that sense, 1980 was a watershed year. It was a year when all other expedients on which the industrial countries had pinned their hopes, from monetary targets to flexible exchange rates to gradualism, proved inadequate. As in the 1930s, so in the 1980s. Economic recovery in the West and in the world at large demands a monetary reform that has international as well as domestic dimensions. It is time to begin.

1 The strength of sterling reflected domestic market reactions quite similar to those in the United States. British monetary growth was well above the Bank of England's target range. The authorities attempted to slow credit demand and thus money growth by successively raising interest rates. The high rates had the same effect on sterling as they had on the dollar. All year long, the pound fluctuated around a level far above that justified by economic fundamentals-in particular, by a comparison between British prices and those of its main trading partners. As a result, British exports sagged and domestic unemployment began to shoot up in the second half of the year.

2 World Economic Outlook, a survey by the staff of the International Monetary Fund, Washington, D.C., May 1980.

3 Testimony of Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, before the House Banking Committee, February 3, 1977.

4 Statement by Paul A. Volcker, Chairman, Federal Reserve Board, before the Joint Economic Committee of the U.S. Congress, October 17, 1979.

5 The New York Times, September 23, 1980, p. D1.

6 Remarks by Paul A. Volcker before the 43rd annual dinner of the Tax Foundation, New York, December 3, 1980.

7 Towards Full Employment and Price Stability, A Report to the OECD by a Group of Independent Experts, Paris, June 1977.

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