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A COMMENTARY ON SELECTED ECONOMIC ISSUES FACING THE WORLD MARKET ECONOMY

A STAFF REPORT

TO THE

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FOREWORD

This staff report by Charles Meissner is a result of interviews and foreign travel taken over a 9-month period during 1976. The report was originally circulated as a monograph to committee members in early February 1977. Since the writing of the report, the U.S. economy has improved, thereby brightening world economic prospects. However, the basic problems presented in the report remain.

Given the upcoming London economic summit in early May and, in late May, the final ministerial meeting of the Conference on International Economic Cooperation in Paris (north-south dialogue), the Senate Foreign Relations Committee felt it would be of value to print and distribute the report publicly. The views in the report are those of the author and do not necessarily represent those of the committee or any of its members.

JOHN SPARKMAN, *Chairman.*

A COMMENTARY ON SELECTED ECONOMIC ISSUES FACING THE WORLD MARKET ECONOMY [1]

The international economic outlook is not good. The market-oriented international economic system of the non-Communist world is being under-utilized. Billions of dollars of potential production is being lost. Policy options are complex and made exceedingly difficult by the interdependent nature of the world economy.

The gloom in Europe over the impending economic situation is as thick as a North Sea fog. The poor economic condition of the United Kingdom, Italy, and Portugal is known, but similar problems can be found in Spain, Denmark, Finland, Iceland, Ireland, Australia, and New Zealand. Furthermore, numerous less developed countries, to include Mexico, Brazil, Argentina, and the Philippines, are facing possible international financial crises. The multilateral trade negotiations (MTN), in Geneva, are moving at glacial speeds and the north-south dialog is stumbling toward an uncertain conclusion. The December ministerial meeting in Paris of the Conference on International Economic Cooperation (CIEC) has now been postponed until late May. The Organization of Petroleum Exporting Countries (OPEC), continues to link the "success" of the CIEC and the ministerial conference to the size of the next oil price rise. Possibly of more importance is that Saudi Arabia has linked its restraint on oil price increases to the expectation of progress in these talks.

It is the objective of this paper to show the relationship between these issues, offer an explanation for the general disarray now found in the world economy, and propose certain policy directions that should be considered. Two points of caution need to be raised. First, the general themes in this paper are simplifications of very complex socio-economic and political interreactions. While these themes provide a theoretical framework in which to view the totality of the world economic problem, they do not necessarily represent a basis for prescriptions of policies in any individual national economy. Each country faces specific problems of political economy as is demonstrated by the appended brief discussions of the United Kingdom and Italy. A common theme does not necessarily beget a common solution.

Second, there is a need to back the general themes of this paper with sound analytical work. The themes are based on *a priori* analysis. They need to be established in fact. The Senate Foreign Relations Committee has neither the staff nor the computer capability to make these assessments. However, a recently printed staff study of the Senate Budget Committee supports the basic premises of this paper and should be read in conjunction with it. The report is titled, "The International Economy and the Federal Budget," 94th Congress, 2d session, December 30, 1976.

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[1] Conclusions appear on pages 13–15.

The Fundamental Economic Problem and the World Economic Situation

The fundamental economic problem in the international economic system is the high cost of energy. The world energy bill went from about $20 billion in 1973 to close to $100 billion in 1976. This means that roughly $80 billion has been subtracted from income available to support consumption. A large proportion of these dollars flowed to OPEC countries. This fact is reflected in the Organization for Economic Cooperation and Development (OECD),[2] table 1 below. The OPEC nations are the only nations running a positive current account balance in the world today.

TABLE 1.—CURRENT ACCOUNT BALANCES [1]

[In billions of dollars] [2]

	1974	1975	1976	1977 estimate [3]
OECD	−33	−5½	−20	−23
OPEC	65	40	51	55
Nonoil developing countries [4]	−17	−26½	−21	−23
Other [5]	−10	−15	−13	−12

[1] From p. 55, OECD Economic Outlook, 1976.
[2] OECD estimates, based largely on data recorded by OECD countries. The figures given in the table, particularly for non-OECD groupings, are tentative; work is in progress to improve the technique used for derivation of the estimates.
[3] Seasonally adjusted, at annual rates.
[4] All non-OECD countries except oil producing countries, the Socialist countries of Eastern Europe, the Soviet Union, China, North Korea, North Vietnam, South Africa, Israel, Yugoslavia, Cyprus, and Malta. It should be noted that this country grouping does not exactly correspond to the DAC or IBRD definition of nonoil developing countries as it excludes a number of both OECD and non-OECD Mediterranean countries.
[5] Sino-Soviet area, South Africa, Israel, Yugoslavia, Cyprus, and Malta.

These excess funds are actually concentrated in 3 out of the 13 OPEC states: Saudi Arabia, United Arab Emirates, and Kuwait. All of the other states are consuming their oil revenues by purchasing imports.

The collective OPEC current account surplus, shown above, flows back into the world economy through the banking/financial system and is made available for borrowing. These capital borrowings show up on balance-of-payments accounts as positive capital inflows, thereby netting out the negative current account figures and balancing the world accounts.

This cycle of payments has a number of effects on the OECD and less-developed countries. High oil payments cut consumer demand in the developed countries resulting in excess productive capacity. With excess capacity, firms do not invest and economic growth slows rapidly. This situation could be rectified if all oil revenues going to OPEC were spent by OPEC on consumer imports originating in the developed countries. This has not been the case. A majority of OPEC oil revenues are used to purchase capital goods or arms leaving overcapacity in consumer industries. The balance of the funds—almost all from Saudi Arabia, Kuwait, and the United Arab Emirates—has been deposited in the banking system or in some financial paper. These deposits, roughly the size of the current account surplus, represent a cut in demand unless the deposits can be lent to consumers or investors.

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[2] OECD is an organization of 24 of the most economically developed nations of the non-Communist world. It is headquartered in Paris, France.

The lack of capital investment in the OECD countries due to overcapacity has meant that there has not been a heavy demand on the world capital markets for the monetary deposits from the OPEC countries. These funds, therefore, have been placed by financial institutions with borrowers of secondary quality—the governments of OECD countries needing financial support, the less-developed countries with relatively good credit ratings, and the Socialist bloc countries purchasing OECD goods. These loans have helped support aggregate demand, especially in Western Europe where purchases financed by these loans, plus OPEC buying, have provided some support during the last recession. The problem now is that the developed countries needing funds, the less-developed countries, and the Socialist bloc countries are approaching or have surpassed their credit limits. This avenue of demand stimulus is closing.

The disruptive economic effects of higher energy prices has been compounded by a number of other factors. First, the fixed exchange rate system under the Bretton Woods monetary agreement led, over time, to a misallocation of capital among the OECD countries, if not more broadly. Holders of overvalued currencies such as the dollar and the pound sterling were encouraged to invest their capital abroad, preferably in countries that had undervalued currencies—mainly Germany and Japan. The undervalued currency positions of these countries provided an economic stimulus to their export sectors. The long-term effect of this market perversion has been an overcapitalization of the German and Japanese export sectors.

The recent exchange rate realinements have had minimal impact on this situation. Actually the appreciation of the mark and the yen have lowered import costs and held down wage demands in Germany and Japan. When coupled with the tendency of purchasers to stay with known suppliers, the upward valuation of currencies has seen a continued strengthening of the current accounts of these countries. It will be only over the long-term that adjustments will be made to this overcapitalization. An example of this process taking place is the Volkswagen investment in the United States.

Second, floating exchange rates have destabilized economic conditions in those countries that have a large foreign trade sector and whose currencies were overvalued under the old system. For example, the United Kingdom has been unable to take effective advantage of the devaluation of its currency because investments in the export sector are long term in nature, and the short-term effects of the devaluation have been to drive up import costs and increase political pressure for wage increases. This cost push, coupled with the effects of long-term capital controls which forced marginal investment in the U.K., have compounded rather than alleviated the British economic picture. The United States, having a relatively small international sector in comparison to the European countries, was better able to absorb the devaluation of the dollar even though it did contribute to inflationary pressures in 1973 and 1974. This was especially true in food prices and imported raw materials which were set by the world market rather than U.S. domestic markets.

A third destabilizing economic factor in the OECD countries is inflation. No matter what its cause, inflation redistributes income within a society to those who have real assets or have the capability to

readjust their take-home pay upward to offset the impact of inflation on their real purchasing power. In general, the effect is to reduce the real income of consumers. Also, inflation erodes real savings causing consumer real liquidity positions to fall. The consumer response is to rebuild savings from current income, thereby further reducing total consumption.

A fourth factor has been the fiscal management policies introduced by the United States, Japan, and Germany. These countries for their own domestic reasons decided that it was best to suppress their domestic inflations at the expense of aggregate domestic demand and employment. These deflationary management policies, due to the size of these three economies relative to the world economy, contributed to a drop in world consumer demand. This statement is not meant to be critical. Its intent is only to point out that the selection of policy options brought specific results which contributed to a drop in world consumer demand relative to productive capacity.

A fifth contributing factor to the general economic malaise is the advent of true economic interdependence. The OECD countries are on the same business cycle. The post-World War II phenomenon of seeing Europe, Japan, and the United States in different phases of a business cycle has passed. This post-World War II countercyclical aid to world economic stability brought on by compensating highs and lows on the business cycle has disappeared.

The last months of discouraging economic statistics from the United States is another reason for the economic gloom in Europe. Europe and Japan, being more dependent on world markets than the United States, need U.S. market demand to stimulate their economies. A second reason for this gloom is the fear of continued increases in the OPEC price of exported crude oil. Europe and Japan are most directly affected by OPEC price rises because of their almost 100-percent dependency on imported oil. Increased oil prices mean a real drop in consumer income.

Table 2 shows the impact of the latest rise in the OPEC price on economic growth, added cost of imported oil and the impact on consumer prices. For example, the chart shows that a 10-percent price rise (about the expected average price rise in 1977) will cut United States growth rates by 0.4 percent, decrease U.S. consumer income by $3,487 million, and cause consumer prices to rise 0.5 percent. Table 3 depicts the impact on non-OPEC less developed countries. Here, the human cost is high because real incomes are closer to subsistence levels. Furthermore, the less developed countries have little chance of development if the developed economies are not growing. They are now in dire circumstances. Their credit has been exhausted, both private and public, and their exports depressed because of the recession. If the OECD economic outlook is gray, certainly theirs is turning black.

TABLE 2.—BIG 7 [1]

LOSS IN REAL GNP ASSUMING VARIOUS OIL PRICE RISES

[In percent]

	15 percent oil price rise	10 percent oil price rise	5 percent oil price rise
United States	−0.6	−0.4	−0.2
Japan	−1.2	−.8	−.4
West Germany	−.7	−.5	−.3
France	−1.0	−.7	−.4
United Kingdom	−.6	−.4	−.2
Italy	−1.4	−.9	−.5
Canada	−.6	−.4	−.2
Weighted average	−.8	−.6	−.3

CHANGE IN OIL IMPORT BILL ASSUMING VARIOUS PRICE RISES

[In millions of U.S. dollars]

Total	14,052	8,277	4,685
United States	5,232	3,487	1,745
Japan	3,460	2,306	1,153
West Germany	1,690	1,127	563
France	1,530	1,020	510
United Kingdom	700	467	233
Italy	1,280	853	427
Canada	160	107	54

CONSUMER PRICE INCREASE ASSUMING VARIOUS OIL PRICE RISES

[In percent]

United States	0.7	0.5	0.3
Japan	1.4	.9	.5
West Germany	.9	.6	.3
France	1.0	.7	.4
United Kingdom	1.8	1.2	.6
Italy	1.5	1.0	.5
Canada	.7	.5	.3

[1] United States, Japan, West Germany, France, United Kingdom, Italy, and Canada.

TABLE 3.—NON-OPEC LDC's: TRADE IMPACT OF HIGHER OIL PRICES

[In millions of U.S. dollars]

	Oil price rise (percent)		
	15	10	5
Oil import bill	1,905	1,270	635
Nonoil import bill	1,350	900	450
Export losses	200	100	----------

As tables 4 and 5 show, there are only three relatively healthy OECD economies of major size—the United States, Germany, and Japan. Of the greatest importance because of its size is the United States. Prosperity in Germany and Japan are linked to economic growth in the United States.

87-703—77——2

TABLE 4.—CURRENT BALANCES [1]

[Seasonally adjusted; in billions of dollars]

	1974	1975	1976	1974, II	1975 I	1975 II	1976 I	1976 II	1977, I
Canada	−1.7	−5.0	−5	−1.5	−2.4	−2.5	−2½	−2½	−2½
United States	−.6	11.7	−3½	−1.6	5.3	6.3	−1	−2½	−3½
Japan	−4.7	−.7	3¾	−.8	1.1	−1.7	2¾	1	¼
France	−6.0	.3	−2¾	−2.6	.6	−.3	−1	−1¾	−2
Germany	9.7	3.7	2	4.5	3.4	.3	1¼	¾	0
Italy	−8.0	−.6	−2	−3.3	.7	−1.2	−1¾	−¼	1¼
United Kingdom	−8.7	−3.8	−2½	−4.4	−1.8	−2.0	−1	−1½	−1¼
Belgium-Luxembourg [2]	.6	.5	−¼	.4	.9	−.4	−¼	0	¼
Netherlands	2.0	1.6	2½	1.0	.9	.7	1	1¼	1¼
Other EEC	−1.6	−.6	−2	−.5	−.1	−.4	−1	−¾	−¾
Other North Europe	−3.8	−3.6	−2½	−2.4	−2.7	−.9	−1½	−1	−1¼
Other OECD	−10.2	−9.3	−8½	−6.2	−5.6	−3.7	−4½	−4	−3½
Total OECD	−33.0	−5½	−20	−17½	0	−6.0	−10	−10½	−11½
Memorandum item: EEC	−12.0	1¼	−5¼	−5.0	4½	−3¼	−2¾	−2½	−1¼

[1] OECD Economic Outlook, July 1976, p. 54.
[2] OECD estimates on a transactions basis.

Note: Detail may not add, due to rounding.

TABLE 5.—TRADE BALANCES AND CURRENT BALANCES OF OTHER OECD COUNTRIES

[In millions of dollars]

	Current balance				Trade balance			
	1974	1975	1976	1977 [1]	1974	1975	1976	1977 [2]
Australia	−2,673	−669	−850	−500	97	2,054	2,250	2,900
Austria	−472	−311	−455	−600	−1,420	−1,394	−1,705	−1,900
Denmark [3]	−910	−512	−1,500	−1,200	−1,812	−1,292	−2,250	−2,300
Finland	−1,212	−2,146	−1,600	−1,070	−919	−1,642	−1,000	−370
Greece	−1,238	−999	−1,150	−1,150	−2,419	−2,434	−2,850	−3,000
Iceland	−155	−144	−100	−80	−147	−138	−90	−70
Ireland [1]	−708	−50	−450	−400	−956	−400	−750	−700
New Zealand	−1,587	−1,456	−750	−700	−992	−834	−150	−100
Norway	−1,238	−2,542	−2,800	−3,250	−2,335	−2,859	−2,800	−3,350
Portugal	−829	−841	−1,400	−1,100	−2,002	−1,611	−2,200	−2,000
Spain	−3,270	−3,477	−2,550	−2,200	−7,054	−7,279	−6,550	−6,700
Sweden	936	−1,495	−950	−1,000	606	813	1,750	2,100
Switzerland	171	3,000	3,500	3,500	−1,745	600	900	900
Turkey	634	−1,808	−1,800	−1,500	−1,830	−2,818	−2,800	−2,600

[1] OECD Economic Outlook, July, 1976, p. 54.
[2] Seasonally adjusted at annual rates.
[3] Includes payments from the European Agricultural Fund.

Whether there will be economic recovery at acceptable rates of growth will be dependent on the policy choices made by these three countries.

The Multilateral Trade Negotiation

The economic gloom in Europe is having detrimental effects on the progress at the multilateral trade negotiations (MTN). Governments who feel economically insecure will not take the political risks associated with economic dislocations which may result from the removal of trade barriers. They prefer to wait until growth revives and dislocations may be more easily absorbed.

The four major trading nations in the world, the United States, Germany, Japan, and the United Kingdom, were the main advocates of the MTN. At the economic summit conference in Puerto Rico in

June 1976, the seven countries[3] attending made a commitment to end the MTN by the end of 1977. This deadline is now referred to in Geneva as a target date, and no one really believes that even the target date will actually be met.

The original proposal was based on the belief that the end of 1977 would provide a narrow political window in which a trade settlement could be reached. By this time, elections in the United States, Japan, and Germany would be out of the way and any settlement in the MTN could proceed through the U.S. Congress in early 1978 prior to the congressional elections in the fall that year. It was also felt that the end-of-the-year settlement in 1977 would provide a large enough cushion between any political impact of agricultural compromises that the French might make and their parliamentary elections in 1978. French farmers are considered to be conservative and in support of the center-right government of President Giscard D'Estaing. No major compromises on the agricultural issues could be made by the French close to the 1978 election.

This political window is now closing rapidly. Both the Japanese and the British for domestic political reasons are not in a position to support significant reductions in tariff and nontariff barriers. The low rates of growth in each of these countries and their generally high unemployment make it difficult for either government to make the political concessions necessary for significant compromises on tariff and nontariff barriers. The French have always resisted the MTN because they did not think that anything in their national interest would come out of the process. The Americans wish to link industrial concessions with agricultural concessions. This is seen as damaging to French interests. The Italian economy of course, is also in poor shape and the Italians themselves could not make substantial reductions in tariff and nontariff barriers at this point. In fact, the Italians and the British have erected new trade barriers in an attempt to assuage domestic political interests. Only the Americans and the Germans—the strongest economies—are pushing for major trade rereform at this time.

The change of administrations in Washington also bears ill for a 1977 completion. Ambassador William Walker, U.S. trade negotiator in Geneva, was closely tied to the Republican White House and is being replaced. The appointment of a new ambassador and his familiarization with issues may cause as much as a 6-month lag. It is felt by members of other delegations that this lag and the firm American position that simultaneous progress must be made both on agricultural and industrial negotiations will result in the closure of the 1977 windows and thereby force any final settlement to take place after the French elections.

Some procedural progress has been made at the MTN in that all major countries have tabled their tariff-cutting formulas. Five formulas have been presented: the American, the Japanese, the European Community, the Swiss, and the Canadian. All tend to be self-serving and are seen as negotiating positions. The American formula would reduce all tariffs by roughly 60 percent. Given the American tariff structures of either high protection or very little, the American formula will allow a degree of protection to remain for sectors now receiving the

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[3] United States, Germany, Japan, United Kingdom, Italy, France, and Canada.

greatest protection. The European and Japanese suggestions desire to harmonize all tariff structures at a relatively low level. This would significantly reduce the protection to those sectors of the United States that receive the most protection, and would aline American tariff schedules roughly in correspondence with the already harmonized European schedules. The Swiss and Canadian formulas are attempts at compromise, but representing smaller tariff reductions.

The MTN, of course, is much broader than the previous Kennedy round, and a much more ambitious negotiation. There are major decisions beyond the tariff issue that must be made over a wide variety of subject matter, including nontariff barriers (quantitative restrictions, subsidies, countervailing duties, standards, customs matters), safeguards, GATT reform, commodities, tropical products, and access to supplies. But even in the area of tropical products, where there is minimal conflict, hope for rapid action has faded.

Progress in tropical products has halted because of the American insistence on reciprocity. It is an American negotiating principle that all trade negotiations take place on the basis of reciprocity. Each side must give something in any negotiation. The less-developed countries do not wish to recognize this principle because they insist, in the rhetoric of the new international economic order, that the system of international economic institutions is so discriminatory that there is no necessity for them to give anything in a negotiation. They state that they have a moral right to economic concessions from the developed countries. Further progress on tropical products may well have to wait for the evolution of events at the U.N. Conference on Trade and Development and the Conference on International Economic Cooperation.

Reductions in trade barriers can have an impact on world consumer demand by increasing the efficient allocation of economic resources for production and the development of comparative trading advantages. A side benefit of such changes is a reduction in prices, and therefore of inflationary pressure. However, there are strong domestic political pressures in the world for increased rather than decreased trade barriers. These pressures could damage what has been a major economic benefit of the MTN to date: the creation of a strong multinational commitment to more open trade during a period of severe economic recession. Individual countries have been loath to introduce new barriers in the face of their commitment to the MTN.

United Nations Conference on Trade and Development (UNCTAD)

The progress at the MTN in tropical and other products of less developed countries is related to the progress being made in UNCTAD on international commodity agreements. At the May 1976, UNCTAD IV conference in Nairobi, the developed countries agreed to discuss negotiations on a proposal for a common fund for the purpose of financing commodity agreements. The previous position had been that such negotiations could only take place after the negotiations on the commodity agreements. These concessions have now led to discussions of a common financing fund and a series of commodity negotiations encompassing some 18 tropical products, both vegetable and mineral. These commodity negotiations are just beginning to be

scheduled in Geneva. Prenegotiating sessions have begun with the aim of establishing common objectives on which negotiations may focus. Once objectives have been agreed upon, then formal negotiations may actually start. The United States has not stated whether or not it will participate in actual negotiations on the common fund or on any of the commodity agreements. However, it is believed by most analysts, that the new Democratic administration will be more forthcoming in these negotiations than the past administration.

Another aspect of the May Nairobi compromise was the authorization of an Ad Hoc Committee to oversee the progress of all the negotiations. The major issue at the UNCTAD Trade and Development Board meeting held in Geneva in October 1976, was to define the powers of this new committee. It was the U.S. position that the Ad Hoc Committee should be administratively under UNCTAD, and that it should operate under UNCTAD's supervision. It was the LDC's contention that the Ad Hoc Committee should operate separately from UNCTAD, and that it should take directions from the Secretary General of UNCTAD when the Trade and Development Board was not in session. The United States and other industrial nations objected to this arrangement because they think that the UNCTAD Secretariat and the Secretary General are highly partial to the position of the less developed countries.[4] If the Ad Hoc Committee functions under the jurisdiction of the UNCTAD plenary or the Trade and Development Board, the developed countries believe they can have more influence.

The less developed countries desire to use the price structure within the world market system to transfer to themselves real economic resources. They have received encouragement from the OPEC nations and they view the OPEC cartel structure as a model to emulate. However, the less developed countries recognize that they need the cooperation of the consuming countries to establish and finance most commodity agreements; hence the negotiations in UNCTAD.

The United States is presently a member of the coffee, wheat, and tin agreements. Only in the last case are there economic provisions operating. It is the U.S. position that it will consider joining commodity agreements on a case-by-case basis. The U.S. economic objective in instances where it might join an agreement would be to stabilize prices and aid the efficient operation of the market, not to transfer real resources to the LDC's. The United States believes that agreements are only feasible in six to eight commodities. Whether the United States would join such agreements would depend on an evaluation of U.S. national interests and concurrence of Congress.

Should agreements on specific commodities actually come into existence, and should they actually result in a real income transfer, there would be no direct or immediate expansion of world consumer demand. The effect would be only to transfer aggregate income from one group to another. Assuming that the less developed world spent all the new, real assets it received, the most likely effect would be a sectoral shift in demand in the OECD countries from consumer goods to investment goods.

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[4] This bias in UNCTAD is a point of major contention with UNCTAD's critics. They state that the United States pays for 25 percent of the U.N. budget, and, therefore, pays for 25 percent of UNCTAD's direct costs. For these funds, the United States receives little and its negotiating adversaries are staffed. UNCTAD critics desire to see a more balanced presentation of economic debates by the Secretariat.

The December, 1976, Oil Price Rise and the Linkage to the Conference on International Economic Cooperation

An OPEC ministerial meeting was held on December 20, 1976, in Doha, Qatar. At this meeting, Saudi Arabia and the United Arab Emirates (UAE) refused to accept the 10-percent increase advocated by the other members. Saudi Arabia committed itself to expanded production in order to increase supply and thereby hold world prices at the level of a 5-percent increase. The Saudis justified their position partially on the grounds that their stance would keep pressure on the developed countries to expedite progress in the Paris CIEC meetings.

OPEC leaders had previously stated that the size of the price rise at the Doha meeting would be dependent on the progress in the now postponed December 15, 1976, CIEC ministerial. The Doha meeting was planned to fall after the CIEC meeting to allow the application of maximum diplomatic pressure. It is important to understand how and why OPEC leaders feel the CIEC linkage is necessary.

The CIEC is a result of the initial producer-consumer conference held in Paris in April 1975. The United States at this time preferred to have a conference between the industrial nations and the oil exporting nations of OPEC to discuss only energy questions. The OPEC nations desired to have the talks broadened to discuss the entire spectrum of problems that face the less developed countries. This was an excellent diplomatic move by the OPEC countries. They could explain the severe hardship of the oil price rise on the less developed countries by saying to them that they were using OPEC economic leverage to better the welfare of the less developed world. The United States held to the idea of narrowly defined discussions in April 1975, and the preparatory conference collapsed.

The following fall, a new preparatory conference was reconvened in Paris. During the summer months, the United States had reassessed its position, was willing to accept the concept of a broader conference, and proposed a negotiation with some 27 representative nations. This idea was accepted and CIEC was formed in December with 8 developed country seats (the G–8), the 9 EC countries having 1 seat, and 19 less developed countries (the G–19), including the leading OPEC nations. The conference was broken down into four commissions—energy, finance, development, and raw materials. The last three commissions were a compromise to include the desires of the OPEC countries and the less developed countries to discuss broader issues of economic development in the less developed world. Deputy Secretary of State Charles Robinson, then the Under Secretary for Economic Affairs, flew around the world getting acceptance of this idea during the summer and fall of 1975.

The CIEC was formally consummated at a ministerial level meeting in December 1975. Its first 6 months were to be months of planning, and its last 6 months to be months of action. The months of action were to culminate with a now postponed ministerial meeting on December 15, 1976. However, negotiations stalled in the summer of 1976; with a post-UNCTAD IV ultimatum by the less developed countries in CIEC that their two major demands, for a debt moratorium and an indexation of LDC export prices, were not negotiable. It is felt by observers of CIEC that the indexation issue is probably a throwaway. However, the OPEC countries and the other LDC's

representing the Group of 77 at the conference believe that they must obtain significant concessions on the issue of debt to make the CIEC conference successful and not be accused by their fellow less developed countries of selling out. It was felt by many nations at UNCTAD IV that the debt issue was sacrificed for the compromise to open commodity agreement negotiations. These countries are now demanding a strong position in CIEC on LDC debt. OPEC, for diplomatic reasons, feels it must make good on its pledge to use oil power for the LDC's.

The U.S. position on a debt moratorium still remains the same. The United States will look at national debt problems on a case-by-case basis. The United States has been willing to agree to establish procedural rules on how individual debt negotiations will take place. However, it will take no part in sanctioning any multilateral debt moratorium. The United States has argued that, should there be a general moratorium on debt, the major beneficiaries in public sector debt would be only four countries—India, Bangladesh, Pakistan, and Egypt. Similarly, if there was a moratorium on commercial debt, the major beneficiaries would be limited also—Brazil, Mexico, South Korea, Taiwan, and a few other wealthier LDC's. This latter group has no desire for discussions of a general debt moratorium either. Such discussions would close private capital markets to them or raise the rate of interest they might need to pay.

The United States categorically refuses to discuss the issue of an indexation program. This position by the United States, which has been backed by most of the other industrial nations, has put the CIEC's 6 months of action on ice.

It is felt by some American and European political analysts that the less developed countries purposely put forth the proposition of non-negotiable items that were not acceptable to the industrial nations in an attempt to forestall actual decisions in CIEC prior to the American and German elections. After the November defeat of the Ford administration, it became clear that the G–19 preferred a delay and a CIEC consensus was reached to postpone the final ministerial meeting in December 1976. The G–19 believe, according to Paris observers, that it may well be possible to obtain more from a Carter administration than from the Ford administration. It was reasoned that a spring ministerial meeting with new Carter administration appointees could be no worse and possibly better than the present Ford administration positions.

Given the consensus for postponement of the CIEC December ministerial, it is difficult to explain on the grounds of a CIEC linkage why 11 of the 13 OPEC members wanted a 10-percent crude price increase. Only the Saudis desired a lower rate of increase and only they publicly attempted to tie their position to the non-oil economic desires of the LDC's. It has to be concluded that the OPEC countries, in general, are still covering their own self-interests with the rhetorical cloak of the north-south dialog. The Doha price rise and the split in OPEC over the percentage of rise can be best explained by internal OPEC politics.

Politics in OPEC are extremely important. Presently, Saudi Arabia controls the marginal barrel of oil. The Saudis have an 11.8 million barrels a day capacity. They are only producing at 8.5 million barrels a day and have 3.3 million barrels a day closed in. Most of this closed in oil is sweet crude, the highly preferable, low sulfur oil. By

controlling their production, the Saudis are able to control the market price and dominate OPEC. Their cooperation in the past has been essential to any OPEC decision. The 10-percent price position of a majority of OPEC is a direct challenge to Saudi leadership.

The Saudis have no desire to bring down the international economic system of the industrialized nations. Their economic welfare and strategic security rests with these nations. Saudi Arabia is a very exposed and vulnerable society. The collapse of the Western industrial democracies or general economic chaos could cause severe instabilities in Saudi Arabia. Such a situation would limit the attainment of the Saudi international objective of keeping communism out of the industrial nations as well as out of the Moslem world. The Saudis, therefore, stand as a conservative force within the OPEC discussions.

The Saudis also do not desire any sort of mechanical OPEC indexation formula. Any mechanical formula for raising the price of oil in relationship to the price of some other group of products completely undercuts the Saudi diplomatic bargaining position. They want to control the situation, not allow a formula to determine price rises. Nor, however, do they desire to destroy OPEC, and their current position is strained by these dual objectives.

The Saudis, on the other hand, are presently producing approximately 50 percent more oil than necessary to sustain their own budget expenditures. They are pumping more oil than they actually need. They argue that they are doing this as a contribution to stability in the Western industrialized nations. For this, they would like the industrial nations to insure the purchasing power of the extra oil they pump. They desire a guaranteed return on the financial assets that they receive from their oil exports to protect these assets from inflation. The United States and other industrial nations have resisted providing the Saudis with such a unique guarantee, noting that no other investor or nation is so protected.

The Saudis have stated that if the Western industrial nations will not guarantee their financial savings, then it would be necessary for them to support within OPEC periodic price increases to guarantee that their oil and financial assets retain a constant value. If they do not do this, they argue, it's better for them to leave the oil they do not need in the ground.

The close identification of Saudi national interest with a healthy Western economy argues against production limited to their own economic needs, but they do have an interest in trying to preserve the equity of their savings. Therefore, the Saudis are in a position to advocate a minimum increase in oil prices in an attempt to hold their equity, while at the same time not wishing to raise the rate so high as to cause major dislocations within the weaker Western economies. They are being pushed, of course, by more radical political forces in OPEC, as well as by those countries who have smaller petroleum reserves and would like to maximize revenue from those reserves. These countries include Venezuela and Iran.

The Saudis are also interested in using their oil leverage in OPEC to enhance the possibility of a Middle East peace settlement. It must be remembered that Saudi participation in the 1973 oil embargo was politically and not economically motivated. The Saudis joined the embargo in 1973, thereby making it effective, after the congressional approval of the $2.3 billion military replenishment of Israel. The

embargo was withdrawn, not at the end of hostilities, but the following spring when negotiations at kilometer 101 had progressed to the point of an Israeli withdrawal from the Suez Canal. By this time, OPEC had come to realize its economic potential and prices never returned to pre-1973 war levels.

The Saudis believe that only the United States has the power to persuade the Israelis to reach a Middle East peace agreement recognizing Arab concerns. The threat of an oil price rise that would damage the Western economic recovery is, therefore, a Saudi bargaining tool in the peace negotiations. Saudi control over OPEC oil prices is a demonstration of this leverage. Saudi Petroleum Minister Yamani has made explicit the Saudis' linkage between a Middle East settlement and their moderate position on oil prices. In December, both President Ford and President-elect Carter thanked the Saudis for their restraint, but refused to make any linkage to the Middle East peace settlement. However, it is implicit in the totality of the situation.

Should the Saudis lose control of OPEC price policy, U.S. economic interests may well be damaged. An OPEC controlled by more radical countries or countries content with maximizing monopoly profits irrespective of world economic impact could cripple the OECD economies. It is in the U.S. economic interest that the Saudis control the marginal barrel of oil on the world crude market.

The United States desires to continue some form of a truncated CIEC after the final May ministerial meeting. The United States would like an informal energy committee to continue as a forum for discussion of international energy problems. The less developed countries want to have a forum where financial issues can continue to be discussed. A possible compromise is that the Energy Commission and the Finance Commission will carry on in some form.

The United States desires to confine the results of the CIEC conference to an energy-oriented result. The industrial nations, and especially the United States, do not want to have a broad conclusion to the CIEC, such as endorsement of the goal of 0.7 percent of GNP official development assistance figure or sweeping statements on commodities and debt moratoriums. The Americans want to have the conference still be seen as an energy conference with other related issues, rather than as a development conference which has energy as a related issue. This, of course, is reflective of the original U.S. position in April 1975.

Conclusions

The economic situation of the OECD countries is not going to get better without an expansion in aggregate consumer demand to stimulate investment. Within the OECD, there are only three countries who have the economic size and strength to increase aggregate demand: the United States, Germany, and Japan. It is conceivable that the United States could reflate its economy enough to pull the other OECD countries with it, but not likely since the linkages to the German and Japanese economies, while important, are not so large as to guarantee success. Exports to the United States by both economies represent less than 5 percent of their GNP. There also would be a considerable risk of igniting double digit inflation again in the United States.

A more favorable option would be a coordinated United States/German/Japanese fiscal and monetary policy to stimulate the OECD. Vice President Mondale already broached this issue with Japanese and European leaders on his recent trip. It will be a major policy focus of the Carter administration's international economic policy and one of the central subjects at the May economic summit in London.

As part of a policy to stimulate aggregate world demand, thought should be given to substantially increasing monetary flows to the less developed countries through both bilateral and multilateral aid channels. The fact that the economic assistance legislation will be before the Congress this session enhances the viability of this option. Legislation on the expanded capitalization of the International Bank for Reconstruction and Development (World Bank) and the fifth replenishment of the International Development Association (IDA V) provide an opportunity to expand real resources flowing to the less developed world. Critical to such a program is a guarantee that additional assets go into productive investment and not consumption. Sustaining unrealistic consumption levels with international capital transfers only postpones the day of reckoning.

There are numerous questions that need to be answered prior to the initiation of such a worldwide program to stimulatc aggregate demand. What magnitudes are necessary? What are the legislative lags, the planning lags, the production lags? What are the inflationary effects? How will such a program be financed? How is additionality guaranteed, that is, how can it be guaranteed that investments being made, with the additional funds provided by a new program, would not have been made anyway?

A program of this type which includes a large increase in monetary flows to LDC's could help defuse the major diplomatic thrust by the less developed world to reorganize the pricing mechanism of world commodity markets to transfer real resources to their countries. The market system is an inefficient mechanism for such transfers. Direct grants and loans are much more desirable from the point of economic efficiency.

The present world economic situation is replete with the Catch 22's of political economy:

(*a*) Expanded economic growth stimulated to raise employment levels increases oil consumption, which enlarges current account surpluses of OPEC nations and retards western economic growth.

(*b*) Rapid increases in oil consumption resulting from economic growth could quickly utilize Saudi surplus production capacity, thereby turning oil pricing policies to more radical OPEC countries. Any increase in oil prices will retard economic growth.

(*c*) Western reliance on Saudi good will links unemployment, economic growth and western economic strength to the conditions of a Middle East settlement.

(*d*) Strong energy conservation efforts to hold down imports of oil will retard economic growth and may well increase unemployment.

(*e*) LDC economic problems have been linked by OPEC to the energy issue and only expanded economic growth in the developed

nations can alleviate their economic doldrums. However, OPEC threatens to raise prices, retarding this needed growth, if something isn't done immediately.

(*f*) Rising economic growth stimulated by the United States, Japan and Germany must be accompanied by a willingness of these strong economies to assume large negative current account balances to offset the OPEC surpluses on world accounts. Politically, this will be extremely difficult for both the Japanese and the Germans.

The next 4 years are going to be extremely difficult years for the market oriented world economy. As the earlier cited Senate Budget Committee staff report so vividly points out, the success of the Carter administration's domestic policy will rest on the success of the world economic recovery. To achieve this, policymakers will have to cast aside many shibboleths of the past. For instance, current account balances must be viewed as part of a world business cycle, not in annual increments. Like the Federal budgets, there should be periods of deficits and periods of surpluses. There is a need for a world view of aggregate consumption and aggregate investment, as well as the world monetary supply. As the country producing one-third of the goods and services of the world market economy, the United States has a critical responsibility to establish stable economic growth within this system.

Strategically, the United States cannot tolerate a sharp increase in political unrest in Europe caused by economic stagnation. It cannot tolerate the economic collapse of the wealthier, oil-importing less developed countries. Economic interdependence has changed the structure of world diplomatic interaction. There is a necessity to look at U.S. domestic economic problems as being global problems. The same economic drummer is beginning to beat for all nations. The problem is that the nations of the world have yet to learn even to walk together not to mention marching together.

APPENDIX

The United Kingdom and Italy

Both the United Kingdom and Italy are suffering the fallout from the quadrupling of oil prices between 1973 and 1975. In both cases, these prices, compounded by the worldwide inflation of 1973–74 and the recession of 1975–76, exposed more deep seated and fundamental problems in these two economies. Both countries built their standard of living on cheap oil from the Middle East. They are now faced with the problem of how to keep political stability in face of a reduction in the real income of their populations. The population has become politically sensitized to the difference between their nominal and real (take home against what it really buys) wages, while at the same time institutionalized cost of living escalators and politics have inhibited the economic readjustment process.

United Kingdom

In the United Kingdom, the drop in real living standards has been manifested in the drop in the British sterling pound. The pound has fallen from about $1.80 early in 1976 to approximately $1.60. Rumors have abounded that it may bottom as low as $1.50. The drop in the value of the pound theoretically means that the price of British imports rises and that the cost of British exports declines in relation to the exports of other countries. In theory, increased exports should stabilize the pound and provide the market with confidence in the British economy. In reality, this has not happened.

One reason offered is the amount of sterling held overseas by foreign individuals and governments, the "sterling overhang." These sterling accounts are kept for reasons of doing commercial business in sterling and because the pound is used as a reserve currency by a number of countries. At present, there are roughly $6.3 billion worth of sterling in foreign hands. One-half of it is held commercially and one half by governments, mostly by oil exporting countries. As the chart on page 17 shows, these sterling reserves were accumulated since the oil price rise. The British financed their oil consumption in 1974–75 by allowing foreign sterling balances to rise. It is these OPEC government balances that are being sold and are increasing the downward pressure on the price of sterling. However, sterling would not be sold if there were a basic confidence in the British economy, or on the other hand, sterling would be purchased at higher prices if others had more confidence in the British economy. The sterling overhang is a symptom, not the disease.

The lack of confidence stems from two sources, short-term economic/political problems and long-term socioeconomic problems. The short-term economic problem is inflation. British inflation is running at a rate of 14 percent this year. This is partially a result of the devaluation of the pound. As a rough indicator, every 4-percent drop in the value

of the pound represents a 1-percent rise in the cost of living in the United Kingdom. The rate of monetary expansion is another factor. The money supply is expanding at an annual rate of 12–15 percent. A third contributor to inflation is the deficit spending of the central government. The British Government is now borrowing the equivalent of 10 percent of its gross national product each year to finance its deficits.

EXTERNAL BALANCES HELD IN STERLING [1]

Mm end of quarter	Private balances	Total reserves	Non-OPEC	OPEC	Percent of OPEC exchange reserves in M
1973: IV	2,284	3,689	2,730	959	18.4
1974:					
I	2,231	3,957	2,675	1,282	17.9
II	2,386	4,155	2,287	1,868	16.4
III	2,447	4,721	1,958	2,763	17.9
IV	2,500	4,634	1,533	3,101	17.1
1975:					
I	2,519	4,862	1,413	3,449	17.8
II	2,984	4,559	1,320	3,239	14.9
III	2,985	4,179	1,236	2,943	12.9
IV	3,228	4,102	1,263	2,839	11.6
1976:					
I	3,237	4,016	1,394	2,622	10.8
II	3,224	3,111	1,147	1,964	7.2

[1] Morgan Grenfell & Co., Ltd., Economic Review, Sept. 30, 1976.

The Labor government in the U.K. is attempting to bring expenditures and revenue into line. However, this is exceedingly difficult under the present fiscal management system within the U.K. The central government has now placed a ceiling on municipal expenditures. Previous to the implementation of this policy, expenditures were not controlled and bills from municipalities were just forwarded to the central government as expenditures were made. In some cases, due to lags in billing and paper processing. The central government did not know for 3 years what the actual expenditures had been.

It is feared by many a financial analyst that the drop in real income for British labor caused by the inflation and the cut in real government service will erode the support of the Government's income policy. The second year wage package that went into effect in August 1976 had an average wage increase of 4.8 percent. The expectation at the time of the negotiations last spring was that the British inflation would be reduced to 7 percent by the spring of 1977. It was projected that by the third year of the income policy the rate of inflation and the rate of wage increase would equate and the real drop in income would end. But the present 14-percent inflation means almost a 10-percent drop in real wages this year with no expectations of anything better next year. The fear by monetary analysts is that British labor will break with the Government and push for major wage hikes this winter. This would bring another round of accelerated inflation in Britain eroding the value of the real devaluation of the pound sterling.

The cutbacks in government spending have also reduced the option of countercyclical fiscal spending to increase aggregate demand and economic growth in the U.K. Economic growth has been further inhibited by high interest rates in the U.K. which are felt necessary to hold the external sterling balances and absorb some of the excess

liquidity in the monetary system. The liquidity absorption, however, has not met with great success because the insecurity of the British economic situation has holders of monetary assets demanding relatively short-term liquid positions.

Confidence has been further eroded by what are considered by many close observers to be serious socioeconomic problems inherent in the society. For instance, as a broad generalization, the U.K. is a class society. There is minimal social mobility. People are typed by their speech patterns or their educational background. Politics is carried out between the Conservatives (Tories) and Labor. The "old boy" network dominates upper management in business and government. Social incentives to move through the system are therefore restrictive.

Similarly, British critics believe the economic incentives in the society have been skewed. Government jobs pay better than private industry. Taxes take away incentives to invest or gain higher income. Presently, the return on investment in the U.K. averages about 2 percent real return. Government benefits such as public housing—30 percent of Britain is in public housing—are so good that it does not pay to move to find a new job. If you are unemployed, it is best to stay in your present housing than look for a job in another locality where it may be 4 or 5 years before you can get into public housing.

More than one severe critic of the British economic scene stated dryly that a major problem with the United Kingdom is that it never had a social revolution. In other words, in the view of these critics, Great Britain's economic problems run deep in the social fabric of the society. The country has not been able to adapt a social system compatible with the needs of the industrial revolution as well as the economies with which it must compete.

It is these deeper sociopolitical problems that make many observers skeptical of North Sea oil as a savior for the British economy. The optimists believe that the British economic problem is only one of bridge financing for 3 or 4 years until the full flow of North Sea oil is running. By this time, the U.K. will be self-sufficient in oil and possibly even be a net exporter. But the skeptics raise the question of just how much of the oil proceeds have already been mortgaged by U.K. Government borrowing. Her Majesty's Treasury is very loath publicly or privately to lay out its public debt repayments. It is also known that the contractual relations with the oil companies allow the companies to take larger percentages in the first years of production. Furthermore, there seems to have been little planning in the U.K. Government on how to handle the North Sea oil revenues. The policy question of whether these revenues will be consumed or invested has not been decided, nor has the question of how the foreign exchange "dividend" will be allocated been settled.

How Britain is going to solve these problems is now being debated in international financial circles. Last May, a group of the larger industrial countries extended the U.K. a 6-month credit line of $5.3 billion in the hopes of stabilizing the pound sterling. The Bank of England expended approximately $1.6 billion of this credit attempting to defend the pound on the world market at $1.77. This effort failed and the U.K. has gone to the IMF to borrow $3.9 billion to repay the $1.6 billion and reestablish its reserve position. The United Kingdom also established a $3 billion credit line with the Bank of International Settlements (BIS).

The British anxiety arises over conditions placed on these loans. The question is how much "economic religion" can the British stand without bringing political instability. If the Labor government falls, few political analysts see an alternative that can control the labor unions. The United States has taken a hard line with Great Britain, asking for stringent economic sanctions.

Italy

In Italy, there is no financial bridge to build to some future date because there is no pot of oil, even for the optimists. Italy is a processing economy. It imports raw materials and semiprocessed goods, processes these goods, and exports them, taking the value added as Italy's economic contribution. In performing this function, Italy is a heavy user of energy, energy which is imported. Therefore, Italy was especially hard hit by the quadrupling of crude oil prices. And, as in the case of the United Kingdom, structural rigidities in the economy have prohibited an effective adaptation of the Italian economy to these new economic realities. However, these rigidities do not run as deeply into the social fabric of the society as many believe is the case in the U.K.

The Italian economic miracle of the late 1950's and 1960's was the result of a significant increase of labor productivity brought about by the transfer of cheap agricultural labor from southern Italy to the industrial cities of Italy's north. There was created in these cities a true working class proletariat which by the end of the 1960's had been effectively unionized. Throughout the early 1970's, the unions secured settlements which reduced the flexible use of labor and reduced its productivity. There were reduction in work hours, limitations on overtime and the use of double shifts, restrictions on location of new capital investment and even restrictions on the shifting of labor within existing plants. Labor objectives were the creation of jobs and security. The result was an undermining of the Italian comparative advantage.

The government response to the balance-of-payments crisis caused by the oil price increase was to close down the Italian economy by suppressing imports. However, labor demanded that there be no decrease in employment. In response, the Government moved to support failing firms, increased unemployment compensation to 80 percent of salary, forced firms to keep on redundant labor, and negotiated a 100-percent passthrough of standard-of-living costs to labor. The result was a large government deficit, falling profits, falling productivity, and a rising real wage for labor. These structural economic barriers meant that the Italian economy was not and could not adjust its production to the realities of new energy costs or changes in its terms of trade. Furthermore, attempts at adjusting the economy through the devaluation of the lira were totally frustrated by the passthrough into wages of all import costs. These circumstances led up to the Italian currency crisis of January 1976.

During the last quarter of 1975, Italy began to pull out of the recession. There was evidence of both an expansionary monetary and fiscal policy by the Government. The economy began to grow rapidly, 15 percent on an annual basis. Large imports of raw materials and the rebuilding of inventories caused a severe deterioration in the

current account, and in January 1976, the Government closed the foreign exchange market which did not reopen until March. Low profitability, over capacity and apprehension over the summer election led to a hiatus in investment. The Government continued to pump money into the system through an expansion of the monetary supply and large deficit spending. The result has been a soaring inflation approaching 20 percent in 1976 with minimal real growth in the economy.

The Government now faces the highly political proposition of how to reduce the 100-percent cost-of-living passthrough, how to lower government expenditures, how to increase revenues, and how to stimulate investment, private and public. The achievement of these tasks, analysts believe, will take structural changes in the Italian economy. Italy's economy has changed significantly from the days of the miracle. Italy too, like the United Kingdom, is faced with the problem of how to reorder its society in order to adapt it to the industrial revolution in such a way that it can stay competitive in the world market-oriented economy.

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