<u>The International Economic Environment</u>

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Introductory Remarks

Considering the nature of this meeting, I thought it might be appropriate to lay out, not a complex analytical framework or detailed statistical display, but simply an informal, impressionistic summary. The drawback to this approach is that it's very subjective and personal, but it may also have the advantage of forcing some kind of coherence on the conclusions.

One preliminary observation. There will be a trend toward an increasingly polycentric, divergent political structure in the world. Therefore, one key general question is, how far can an increasingly integrated world economy be consistent with this disintegrated political setting? To what extent will there be a strong tendency toward "decoupling" among economic regions showing up in developments such as growing fragmentation within Europe and drives toward regional self-sufficiency in Third World groupings? Increasing strains within O.E.C.D. are evident; tensions amongst Japan, North America, and Europe are showing up in strong protectionist tendencies; how far are these likely to accelerate? The remainder of my comments will not address this question directly, but it is, I think, worth bearing in mind as an underlying concern.

THE LONG-TERM FUTURE

I would like to start with a very brief sketch of some of the issues examined by a group at O.E.C.D. charged with looking into the long-term future. The so-called Interfutures Project was asked to examine the prospects for the advanced industrial societies and their relations with the developing world, 25, 30 or even 50 years ahead. That group, after looking at the international economic environment in a number of ways, developed an analytical structure that began with the question of what is happening to values and social structures. It then went on to look at the prospects for economic growth. I would like to comment on two or three of the most important themes that emerged from this work.

1. Changing Social Values.

The first observation was that international economic prospects are clearly shaped by a number of changes in values and preferences. Rising incomes clearly have influenced those changes in values very substantially. Generational changes are important. One of the interesting features was the extent to which it seemed that the phenomena of changing values centred on the middle classes, in the European countries at least. Various surveys of changing social outlooks and attitudes seemed to identify the so-called middle class as a major element in the shift to what could be called "post-materialism", or "a search for an increase in quality of life". Some very peculiar paradoxes emerged, with the middle class being at the centre of these changing structures and values, but nevertheless showing a very strong preference for private income over social income.

The group identified what it called a dual fragmentation, with prospects--in almost all the countries in the O.E.C.D., at least --for continuing conflicts over income distribution accompanied by what could be referred to as a "proliferation of lifestyles". In other words, there will be a substantial diversity and hence a fragmentation of values in most of the O.E.C.D. countries--a loss of social consensus, if you like, but coupled with a continuing "struggle for income shares". The significance of this finding, is that it led to the proposition that there would be no change in the desire for economic growth as a way of easing or resolving conflicts in values in most of the O.E.C.D. countries. The general conclusion was that the demand for economic growth is going to continue, partly because there are many material needs yet to be met, and partly because it is a way of lubricating or easing many of the social changes that are necessary responses to changing values.

2. Prospects for Growth

Regarding the prospects for growth, in a very general way it appeared from the Interfutures work that neither physical resources nor the pace of innovation ought to be seen as a necessary limit to economic growth in the foreseeable future. Nothing in that set of considerations precludes the possibility of strong growth in the medium term. It is interesting that the group identified four areas in which the pace of innovation seemed particularly promising. One was the electronics industry; another was minerals and energy resources, including the oceans; the third was the search for new energy forms; and the fourth was "bio-industry". All seem relevant to future prospects for industrial development in Canada.

The group concluded that impediments to growth do not lie with underlying endowments of natural resources, nor with any structural characteristic of the high growth track itself. The full employment, balanced equilibrium growth track didn't seem to have any inherent structural contradications associated with it. The problem is with the transition to that high growth track. The problem is one of engineering a significant economic recovery and, in particular, of overcoming the important constraints on policies that would achieve that recovery. For example, there are questions about insufficient investment leading to production bottlenecks (particularly in the supply of raw materials), about the appearance of balance of payment deficits very early in the recovery process, and about the evident assymetry of international balance of payments adjustment mechanisms. In addition, of course, there is the fear of an early revival of inflation, since it is argued that wages and prices now respond directly to policy stimuli, anticipating market pressures whether they emerge or not.

3. Summary

The key question posed by the O.E.C.D. group was, in the long-run analysis, whether the community adapts to the prospects of slower growth or whether it just falls into it because of frustrated policy. More particularly, the issue is whether there is any prospect of the recovery process being sufficiently rapid to avoid drawing down the ceiling of potential growth before the world economy has returned to its potential high employment track. That is to say, the potential rate of growth is not given from outside; it is determined within the economic system. Persistent slow growth not only reduces output, it reduces future capacity through low investment, erosion of labour force skills and participation, and reduced rates of technical progress. If slack is not eliminated through rising demand, it will be eliminated through falling supply. Coupled with this overview was a substantial concern with the question of structural change and adaptation. The code word around O.E.C.D. at the moment is "positive adjustment policies".

There is concern about the pressures for structural adjustment that emerge from demographic changes and from changes in the composition of final demand--in particular, the public/private sector composition--as well as the pressures for structural change that emerge from the increasing cost of exchanges with the physical environment. In the latter case, I am referring to adverse movements up the supply curves for raw materials and for waste disposal. In addition, of course, there is the whole question of changing international competitive positions: the concern about changes in relative wage and non-wage labour costs across countries, the worry about artificially low capital costs in the newly industrialized countries, and the general observation that the industrial countries are trying to have it both ways in our search for economic security: we're trying to preserve both employment and relative wage levels. But when international competitive positions change, one or other of these patterns has to give. We're resisting any significant change at either end and as a result, the market signals are getting very badly blurred with respect to the need for industrial and occupational shifts.

Thus, we have strong pressures for change, and significant resistance to these pressures. The O.E.C.D. group concluded that the future of the international economy really comes down to a tension between resistance to structural adaptation that flows from legitimate social objectives and resistance for purely cyclical "conjunctural" reasons. The pursuit of the quiet life is a legitimate social objective, for example, while the accumulation of ineffective institutions and ineffective procedures and rules, designed primarily to preserve employment by preventing necessary adaptation of the economic structure is not. The adverse consequences stemming from growth of neo-protectionist attitudes were heavily stressed.

THE MEDIUM TERM OUTLOOK

Let me turn now to the question of whether we can anticipate substantial recovery in the world economy in the medium term or whether we're looking at a transition to some new regime. More particularly, do we reject the idea that the period from 1968 to 1975 was one of crisis and bust followed by a period of recovery from 1976 to 1983, in favour of an argument that says that 1950 to 1970 was a long boom, that 1970 to 1980 is a watershed, and that 1980 to 2000 is a period of adaptation to reduced prospects for economic growth and possibly reduced standards of living? Will the future be characterized by an aging society displaying reduced social cohesion, greater pressure for regional and national self-sufficiency, and a breakdown of any sense of community? This prospect is consistent with what the Interfutures Group called a moderate growth scenario.

1. Medium-Term Issues

Before I comment directly on the outlook for the O.E.C.D. region in the 1980's, let me comment upon one immediate issue that is of particular concern in the whole growth scenario discussion. That is the concern with the risk of a crisis in oil supplies. It's a very familiar scenario: a tight oil market, possibly a result of political disruptions, leads to soaring spot prices, a sharp increase in the O.P.E.C. market price, and a strong further impetus to inflation. There is a subsequent depressive effect, sharply worse current account deficits for O.E.C.D. countries, and restrictions on policy options as a result.

Obviously Canada's situation and Canada's policy options in these sorts of circumstances are sharply different from those of O.E.C.D. as a whole. As far as the world economic environment is concerned, the assumption has to be, I think, that the policies adopted by the O.E.C.D. countries will avoid any extreme version of an oil supply crisis. However, the fact that we're vulnerable to that worry really does, I think, shape the picture one has of the prospects of the O.E.C.D. over the next few years. More particularly, for Canada, the risk is not so much of an energy crisis directly, but that fear of the price consequences of tightening oil markets will lead to a very cautious policy stance and slow growth of demand throughout the international economic environment to which we are so crucially tied.

Putting that question into the background for a moment, it has already been noted in this meeting that the 1960's were unique. There was almost five percent real growth in the O.E.C.D. area accompanied by rapid structural change, very active investment, and more liberal trading conditions. This contributed to about eight percent real growth in world trade, less than three percent growth in the Gross Domestic Product deflator for the O.E.C.D. as a whole, and less than 1.5 percent growth in trade prices. In contrast, there was accelerating inflation during the early 1970's for the O.E.C.D. area as a whole, as well as deterioration in the relationship between capacity utilization and employment rates. There was a deflationary rise in world saving as a result of O.P.E.C. in 1974, accentuated by the deflationary pressures on policy due to the balance of payments deficits which resulted from that experience. Then there was a major slump in 1974-75, followed by incomplete recovery, rising uneasiness in ~~the~~ currency markets, and exchange rate instability. By 1978 the cumulative results were high inflation rates, substantial economic slack, large O.E.C.D. deficits with O.P.E.C., and large imbalances in current accounts within O.E.C.D. Within most O.E.C.D. countries there were very substantial swings to government budget deficits, and hence~~,~~ growing concern about the stock of the public debt.

Since then, exchange rates appear to be moving toward a re-convergence after this spell of very strikingly divergent behaviour. It seems clear that the next decade is going to be marked by a variety of attempts to increase the stability of the exchange rate system, either through formal currency bloc~~k~~s or through active, collaborative, exchange rate intervention and management. It also seems clear, however, that there is unlikely to be any serious attempt to return to a general fixed rate regime. It's worth adding that in the last few years there have been some very important real adjustments in competitive positions as a result of changes in exchange rates that do not reflect simply differential inflation rates.

There has also been a return toward what one might consider a more rational pattern of world current balances, and a reduction of some of the extreme imbalances within O.E.C.D. In the first place, the O.E.C.D. as a whole is no longer in a substantial deficit position, which corresponds to a more appropriate redistribution of real resources in the world economy. Some of the most extreme imbalances involving large deficits for small O.E.C.D. countries have been worked down. The German and Japanese surpluses and the U.S. deficit have all been reduced, so that one of the major constraints on the expansion of effective demand in the

O.E.C.D. region, while not removed, at least has been ameliorated.

The dicussion of the O.E.C.D. "growth scenario" produced by Working Party 2 of the Economic Policy Committee identified substantial labour market slack for almost all the countries concerned. Such slack seems evident from an examination of participation rates relative to trend, employment rates, and working hours. But, although there appears to be substantial labour market slack, most countries would argue that it's not really related directly to demand deficiencies. It is not a cyclical slack which can be easily removed by expansionary demand management. Rather it reflects capital shortage and structural change within the labour force, and the failure to adapt quickly enough to changing relative prices (especially oil) and a changing economic environment.

There is a major concern about the question of declining productivity that we discussed earlier. The experience in Canada may be generalized throughout the western industrialized countries. There are many explanations but none of them are fully persuasive. Some of them include the once-and-for-all shift due to the change in relative prices of energy; the limited scope for further liberalization in world trade, and therefore for increases in productivity through international division of labour; the little scope left for shifts in resources out of agriculture; and the substantial shifts in resources towards services. There is also an argument that says that the shift to sophisticated new products means smaller production units and production scales and therefore less scope for productivity gain through economies of scale ~~of~~ in manufacturing; there have also been references to growth in regulation, declines in research and development efforts, the allegedly changing attitudes of the labour force; and so on.

Most of Canada's major trading partners are experiencing this decline in productivity and are unable to explain it. Most, therefore, would argue that significant output gaps do exist, and that it would be possible to accommodate rates of growth significantly faster than those that have been observed in the last few years. The estimates of the growth of potential output for the O.E.C.D. region's "Big Seven", at least, are around the four percent per year level that seems to be emerging from the Conference Board's own estimates for Canada as well. Of course the rates of growth that ought to be possible given the existing degrees of slack, ought to be in excess of that four percent level, perhaps around four-and-a-half percent per year.

Price performance in the O.E.C.D. area is not expected to improve. If anything, it's likely to worsen in the next short while, at least. The inflationary momentum stemming from built-up pressures for wage rate increases in excess of the rates possible, given real income prospects adjusted for terms of trade changes, is substantial. For many countries, that inflationary momentum is a very significant restraint on policy.

There are prospects that the O.E.C.D. will move from its present small surplus balance of payments position as an area back into a deficit position with O.P.E.C. in the near future, as a result of deteriorating changing terms of trade. There will be a somewhat better balance within O.E.C.D., as I mentioned earlier. But the balance of payments constraint seems likely to remain severe for many individual countries.

Thus, the conclusion seems to be that the chances for achieving balanced and sustained non-inflationary growth with full employment over the next years are poor.

2. The Outlook to 1985

The O.E.C.D. working party concerned with this growth scenario considered what would be required to get back to full employment by the mid-1980's. If you remember, the old growth scenario from O.E.C.D., published in 1976, anticipated a return to full employment by 1980. That date was successively moved back and is now around 1985. The chances of achieving full employment for the area as a whole even by 1985 look very poor. The working party rejected the scenarios that saw a return to conventional full employment by the mid-1980's on the grounds that past short-falls in investment, and hence current capital shortages, meant that the investment requirements entailed in a return to full employment, conventionally defined, would be unrealistically high. Unacceptably high inflation risks would attend any such attempt, at least in Europe. There was some question whether it might be relatively easier to achieve this goal in North America, primarily in the United States, or in Japan. Certainly it was clear that for the area as a whole, a standard business cycle upturn was not going to be feasible, even over that extended horizon.

The argument was that not only were the investment requirements unreasonably high in objective terms, but also that the investment demand was not likely to be there anyway. The factors that were cited normally emphasized the weak profitability picture in many countries and in a number of sectors, although clearly the weak profit experience isn't uniform.

A second argument is that a great deal of uncertainty is arising out of policy changes, regulatory changes, and changing international competitive positions, and that these are deterring investment. Another is that there really is an aspiration gap; that is, there are intrinsic inflationary bargaining pressures. All these features had to be taken into account in anticipating the likely response to any kind of expansionary policy, and the whole tone of those discussions, I think, added up to a feeling that in almost all countries a very tight policy stance was either necessary, for reasons of internal concerns about wage and price response, or it was being forced, as in the case of the Nordic countries, simply by fears for the external position. These fears effectively precluded any attempt to get back to full employment, at least in Europe.

In summary there may be no real obstacle to economic recovery, but there are many political obstacles. There is an inflation constraint, an energy constraint, and there are budget deficit problems. The kind of policy that could return the O.E.C.D. to full employment by the mid-1980's appears unachieveable. The picture which emerged from this O.E.C.D. discussion suggested that an outlook of four percent growth per year, on average, for the world economy over the period up to the mid-1980's, would be very optimistic. For the centrally-planned economies of the Eastern bloc, growth of five percent per year certainly seems to be planned, but efforts to restrict imports are likely to be very substantial, and will have an impact on O.E.C.D. trade with the Eastern bloc. Concerns with debt problems and credit conditions are likely to inhibit the growth of imports in the planned economies, and hence, may affect their overall growth.

The O.P.E.C. countries may grow substantially faster--perhaps at six percent per year. However, their share of world output is small, in the four to five percent rage, despite their importance in financial flows. Regarding the developing countries, excluding O.P.E.C., prospects for growth at about six percent per year would be otpimistic.

Overall, the world economy might grow at four-and-a-half percent per year. This would imply both an overall growth rate and a rate of trade expansion lower than during the 1960's, with a substantially higher price component.

I suppose this outlook could be characterized as an international economic environment with very sluggish growth and with persistent slack. This slack will have to be distributed among the unemployment rate, the participation rate, hours of work, and productivity. That is, there will be substantial unemployment, and it is likely that much of it will be hidden in the form of unnecessarily low productivity, with all the obvious consequences for production costs and price pressures. There will be a great deal of labour hoarding and a great deal of employment with relatively little growth in output. Obviously there's a social choice here. The demand constraint which emerges from this growth scenario could be distributed in many different ways. Countries with different social environments are going to make different choices, but the results have to appear somewhere.

The outlook is also characterized by continuing inflation and substantial protectionist tendencies, the latter likely because adjustment to a changing competitive environment will be resisted, given the degree of slack implied by the outlook. New activities to absorb the changes will not be evident. In addition, there's a prospect of a continuing substantial risk of bottlenecks in some raw materials supplies, because many raw materials prices are still not high enough to induce the necessary investment outlays, given the barriers that are imposed by all the uncertainties that I mentioned earlier, and the long lead times characteristic of these investment activities.

CONCLUDING COMMENTS

The macro-economist always wants to give a thumbnail characterization of complex problems. Recognizing the dangers involved, let me attempt a couple of concluding general observations. In short, the problems are first, oversaving, due to O.P.E.C., to uncertainty, and to an unwillingness to accept government budget deficits to offset other savings intentions in the economy. Second, there is under-investment because of unusually large risk premia, uncertainty in the conditions for foreign investment, and uncertainty arising from speculation in currencies and commodities. All of these uncertainties add to a prospect for less rapid growth than would be desirable.

The only thing one can say for sure is that that's almost certainly not going to be the way things evolve. The least likely scenario is that the world economy can go on for another seven or eight years as it has been going for the last four. We are now poised near a choice between a situation in which the economy will break loose from these policy constraints, in a scenario in which there is a very substantial shaking-out that will loosen some of the present structural rigidities, and a situation in which we will have to see some significant social accommodation to prospects for stagnant or declining real incomes in Canada. Thus, despite this picture painted above, extended moderate growth track with relatively low rates of increase in potential output, it seems to me very clear that you can't have that kind of a long drawn-out recovery. The potential output ceiling will come down before you get there, and something more dramatic will have to give.

Mr. Chairman, it is clear that these are "interesting times" and that the only certain thing about the international economic environment is its vast and growing uncertainty. I have resisted the temptation to say "on the other hand . . ." and have outlined a rather one-sided view of the outlook. It is only necessary to remember that both events and our own decisions are likely to prove most of these speculations wrong.