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DEVELOPED COUNTRIES:  
GROWTH, INFLATION, AND TRADE

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Selected Articles  
from the  
Economic Intelligence Weekly

24 October 1975



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## DEVELOPED COUNTRIES: INVENTORIES IN PERSPECTIVE

Inventory-building was reduced sharply in early 1975 in four of the major foreign countries, as well as in the United States, halting the rapid accumulation of surplus stocks that occurred last year.\* In all of the countries examined, except the United Kingdom, cumulative surplus stocks appear to have peaked after the turn of the year. In Japan, Canada, and the United States, they hit record or near-record levels. Moreover, because surplus stocks of this magnitude are unusual at this stage of the business cycle, we expect stockbuilding to play an abnormally weak-and perhaps even a negative-role in recovery over the next few quarters.

### Recent Trends

In early 1975, companies attempted to bring their excess inventories into line with sagging sales. In three of the major developed countries, they reduced stockbuilding substantially, while in two others they actually cut inventories.

- In Japan, stockbuilding in the first quarter amounted to only one-fourth of stock additions in fourth quarter 1974; stocks probably declined in the second quarter.
- In Canada, stocks accumulated in the first quarter at about one-third the 1974 rate.
- In West Germany, stocks declined slightly in the first quarter, as they had in late 1974.
- In the United States, manufacturing and trade inventories fell in four of the first five months of 1975, sliding down at a record pace in May; total stocks, including raw materials, dropped by \$3 billion in the first quarter and \$5 billion in the second.
- In the United Kingdom, stockbuilding continued at about the same low rate as in fourth quarter 1974.

\* For a definition of *surplus stock accumulations* as used in this article, see the methodological note, which follows the second graphic. France and Italy are excluded from this analysis because of a lack of quarterly data.

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The decline in stockbuilding was a major factor in the first-quarter deterioration in real GNP (seasonally adjusted). In the United States, the stock drawdown accounted for the entire 3% drop in GNP. In Japan, even though final demand rose slightly in the first quarter, GNP fell because of inventory adjustments.

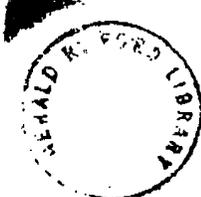
	Percent		
	First Quarter Change in GNP	Change Attributable To	
		Inventories	Final Demand
Canada	-1.4	-1.5	0.1
Japan	-0.8	-1.1	0.3
United Kingdom	0.1	-0.1	0.2
United States	-3.0	-3.0	....
West Germany	-3.1	-0.1	-3.0

Cumulative surplus stocks are the largest in Japan, having reached about 10% of GNP in the first quarter. Japan typically experiences wide swings in stock/demand relationships because of the reluctance of business firms to lay off workers. In West Germany and Canada, surplus stocks as shares of GNP are roughly half those in Japan. The United Kingdom is a special case, with no surplus stock accumulations at present. Low rates of stockbuilding since 1970, a large stock drawdown in early 1974 during the coal miners' strike, and a surprising firmness in final demand until recently have moderated accumulations.

#### Implications for Recovery

In sharp contrast with most earlier postrecession periods, when inventory rebuilding gave a strong boost to expansion, stock changes are expected to be a neutral force at best for several months to come. A key factor determining the role of stocks in upswings is the timing of the inventory cycle peak in relation to the business cycle. Usually, recovery begins at a time when inventories already have neared their low.

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On those rare occasions when the inventory cycle peak and the business cycle trough have overlapped-as now appears to be the case in the United States and Japan-stockbuilding has remained weak or negative for the first few quarters of the recovery period. In West Germany and Canada, the inventory overhang may actually delay the onset of recovery until late in the year.

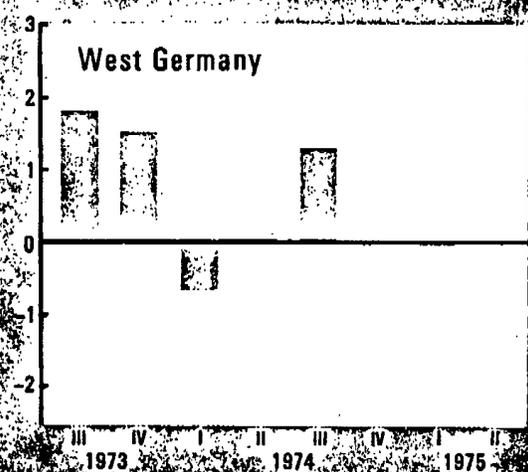
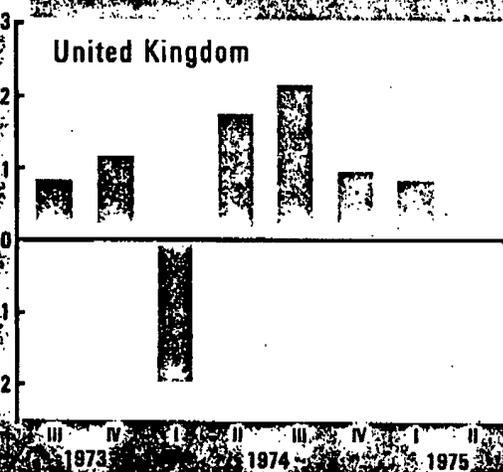
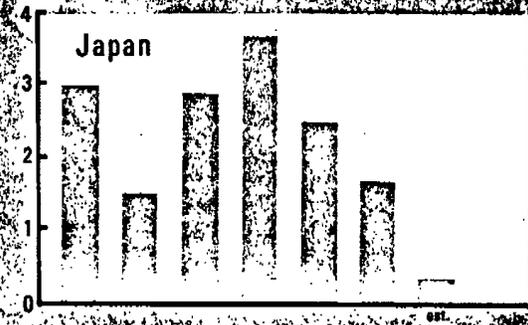
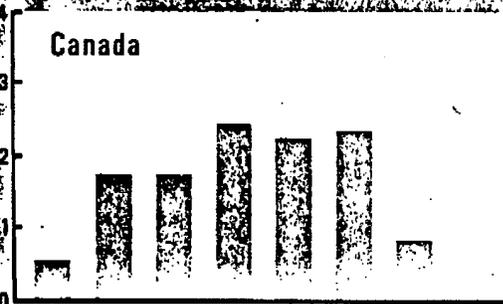
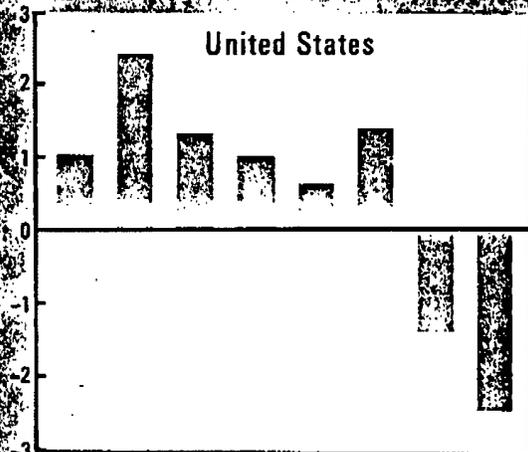
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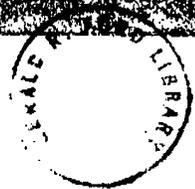
**Developed Countries:**

**Trends in Stockbuilding**

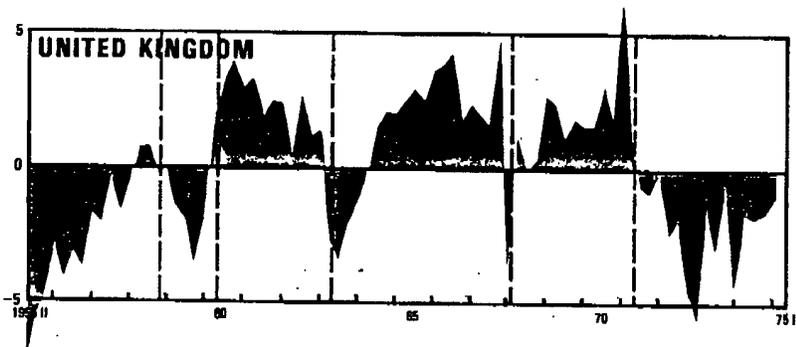
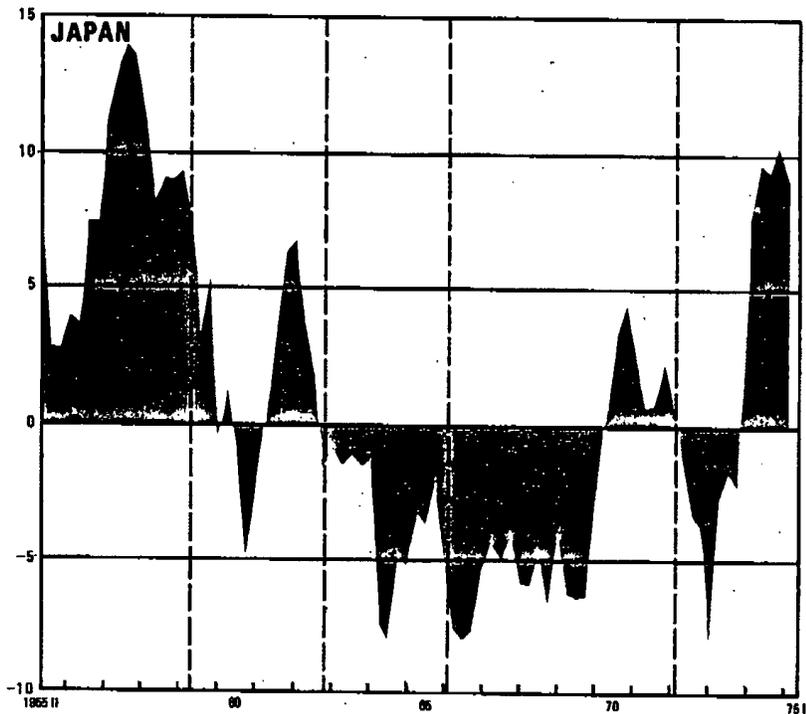
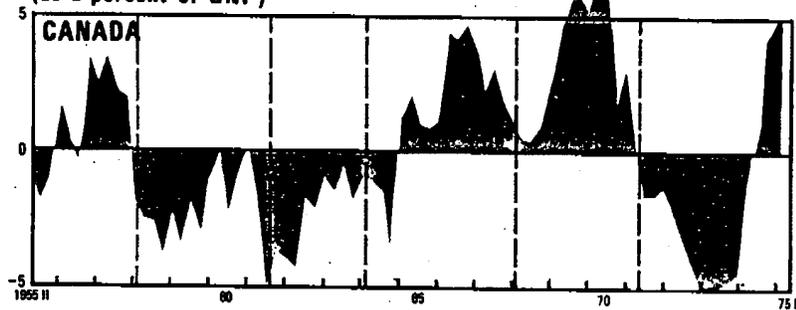
(Change in stocks as a percent of GNP)



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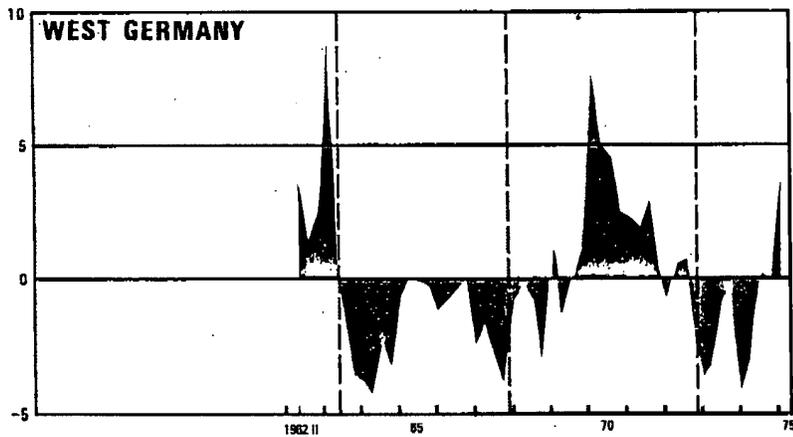
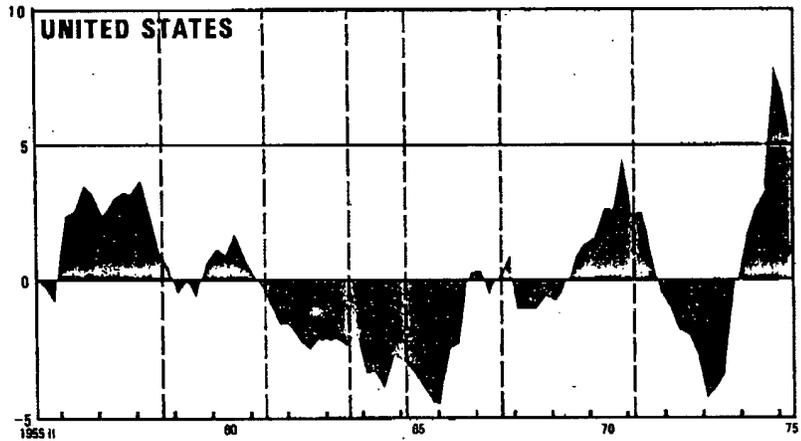
**Developed Countries: Deviation of Inventory Accumulations from Long-Term Trend  
(as a percent of GNP)**



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*Dashed vertical lines denote business cycle troughs.*





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*Dashed vertical lines denote business cycle troughs.*

**Methodological Note**

Because data on total stock levels are not available for most countries, direct examination of stock demand and supply over several business cycles is not possible. To provide a rough inter-cyclical comparison, we have calculated the deviation of actual stock accumulation from the trend since 1955 (1962 for West Germany). The trend is derived by a least squares regression of cumulative stock changes on cumulative final demand changes for the base period to the present. The deviation of actual cumulative stock changes from the trend measures the extent to which there has been a surplus or deficit accumulation of stocks in relation to demand since the base period. The deviations are expressed as shares of GNP in each quarter.



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DEVELOPED COUNTRIES: INTERDEPENDENCE AND ECONOMIC GROWTH

If fears of renewed inflation or payments problems cause the industrial nations to rely on the United States or any other single country for export-led growth, recovery will be long and slow. Except in the case of Canada, the exports of the Big Seven are too dispersed and their share in final demand too small for economic prosperity to hinge on deflation by one trading partner.

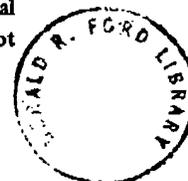
Induced Growth\*

Despite strong linkages among many OECD economies, only Canada among the Big Seven is strongly affected by economic growth in a single trading partner. Its exports account for 20% of GNP, with 65% of foreign sales going to the United States. We calculate that Canadian GNP rises by about one-third of a percent for every 1% increase in US GNP. This estimate takes into account the direct and indirect effects of US growth through enhanced demand for Canadian products in the United States and in third countries.

The induced impact of growth in any other major country is at most one-fifth of the initial rise in GNP in the "lead" country.

- France: West Germany, the United States, and the United Kingdom induce the most growth, in all cases less than 0.2% for each 1% increase in their own GNP.
- West Germany: France, the United States, and the United Kingdom each induce about 0.17% in GNP growth.
- Italy: A 1% rise in West German output adds a fifth of a percent to GNP growth.

\* To obtain the estimates for induced growth presented in this article, we devised a simple trade-multiplier model. For this model, we assumed that the degree to which growth in one country (the lead country) affects growth in another (the dependent country) is determined by (a) the income elasticity for imports in the lead country, (b) the share of the lead country in the dependent country's total exports and final demand, (c) the export multiplier in the dependent country, and (d) the extent to which growth in the dependent country is affected through third countries. We assume that both the import elasticity and the export multiplier are 2, values on the high side of most empirical studies. Constant trade shares are assumed, and feedback effects on the lead country are incorporated into the model. Other important international linkages - for example, the effects of monetary expansion on interest rates and capital accounts - are not covered by this methodology.



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- United Kingdom: The United States induces the greatest increase in GNP (0.17% for each 1%), followed by West Germany and France.
- Japan: A 1% increase in US GNP adds 0.1% to economic output; no other OECD country adds more than 0.05%.
- United States: Because of its small foreign sector, the United States is barely affected by isolated changes in foreign GNP.

The spillover effects of GNP growth in the Big Seven are much more important in the 17 smaller OECD countries, particularly those in closely integrated Western Europe. Expansion in West Germany and Britain has the most marked impact. A 1% increase in the GNP of either of these nations induces an average rise of more than one-fifth of a percent in the output of the smaller countries; in a few cases the impact is as large as one-half of a percent. Because of their dependence on foreign trade, the Benelux countries are the most sensitive to developments in the Big Seven.

#### Coordinated Recovery

Simultaneous expansion among the larger economies would have important spillover effects on growth in the OECD area. We estimate that a 1% increase in the combined national output of the three major countries with strong payments positions - West Germany, Japan, and the United States - would induce as much as one-third of a percent growth in the OECD as a whole. The impact would average 0.8% for the Small Seventeen; 0.4% for the six major foreign countries; and 0.1% for the United States. The psychological effects of a coordinated approach, which cannot be quantified, would supply an additional boost to growth.

#### Regional Groupings

Our analysis of the 24 economies shows that spillover effects from growth are much stronger within Western Europe than within the North America-Pacific area or between these two regions.

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Initial 1% Rise in GNP in

	Western Europe	North America-Pacific
Average spillover in:		
Western Europe	0.73%	0.19%
North America-Pacific	0.15	0.11
All OECD	0.44	0.15

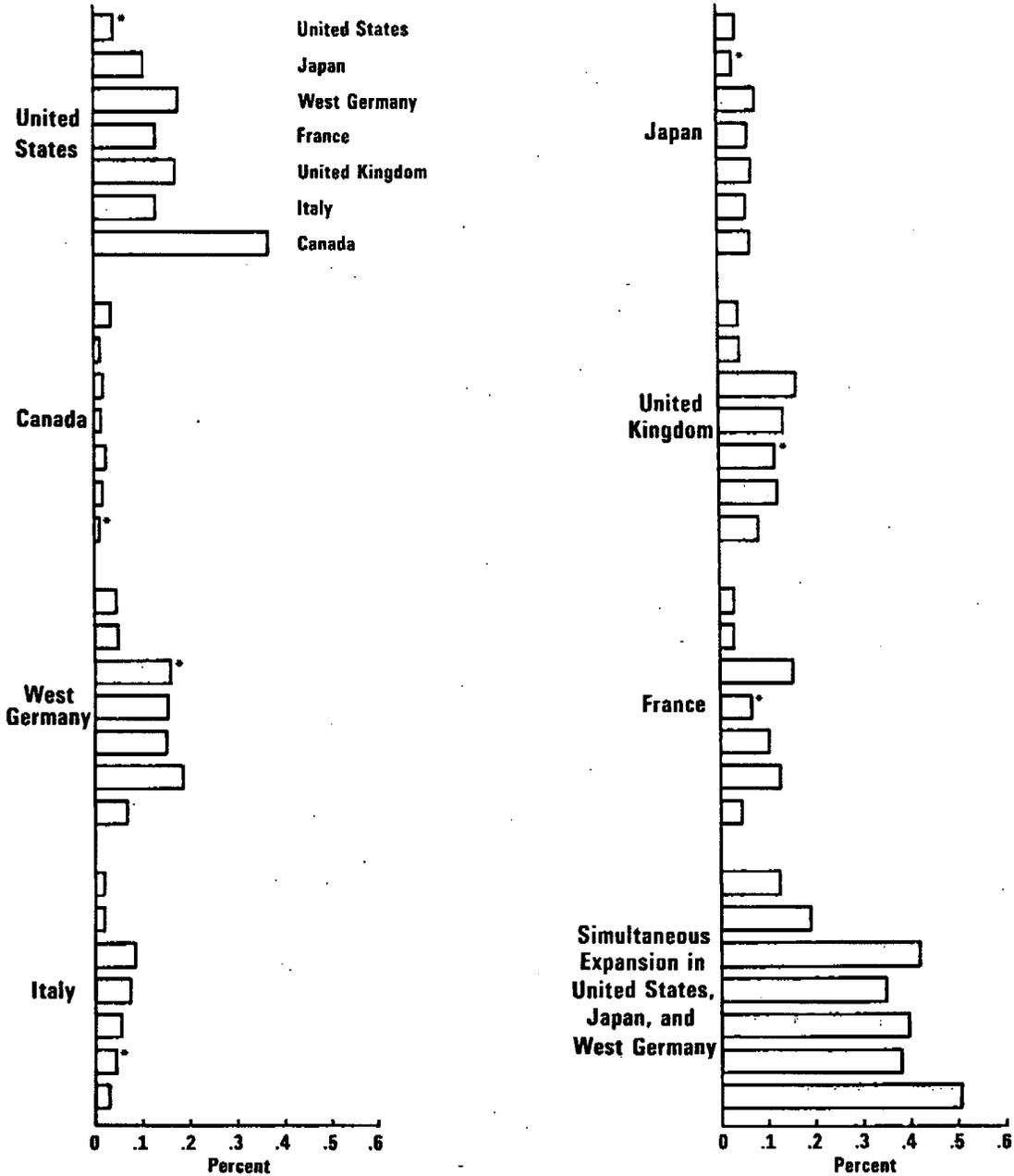
Implications

Our analysis suggests that continued European reliance on the United States or on West Germany to lead economic recovery would result in a lackluster revival. The impact on growth in the OECD from expansion in these countries is small (about one-tenth of a percent for each 1% increase in either German or US output). Moreover, a high proportion of the impact of an acceleration in US growth is through slow-acting secondary and tertiary effects. Simultaneous expansion among the larger countries, on the other hand, would substantially boost output, especially in western Europe. In Japan, domestic demand appears to be the key to recovery; a concerted 1% expansion in all other OECD countries would add only 0.4% to Japanese GNP.



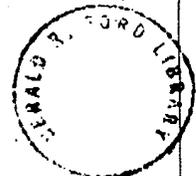
### Developed Countries: Effects of Growth in the Big Seven on One Another

(Growth Induced in Each Country by a 1% increment to GNP in the lead country)



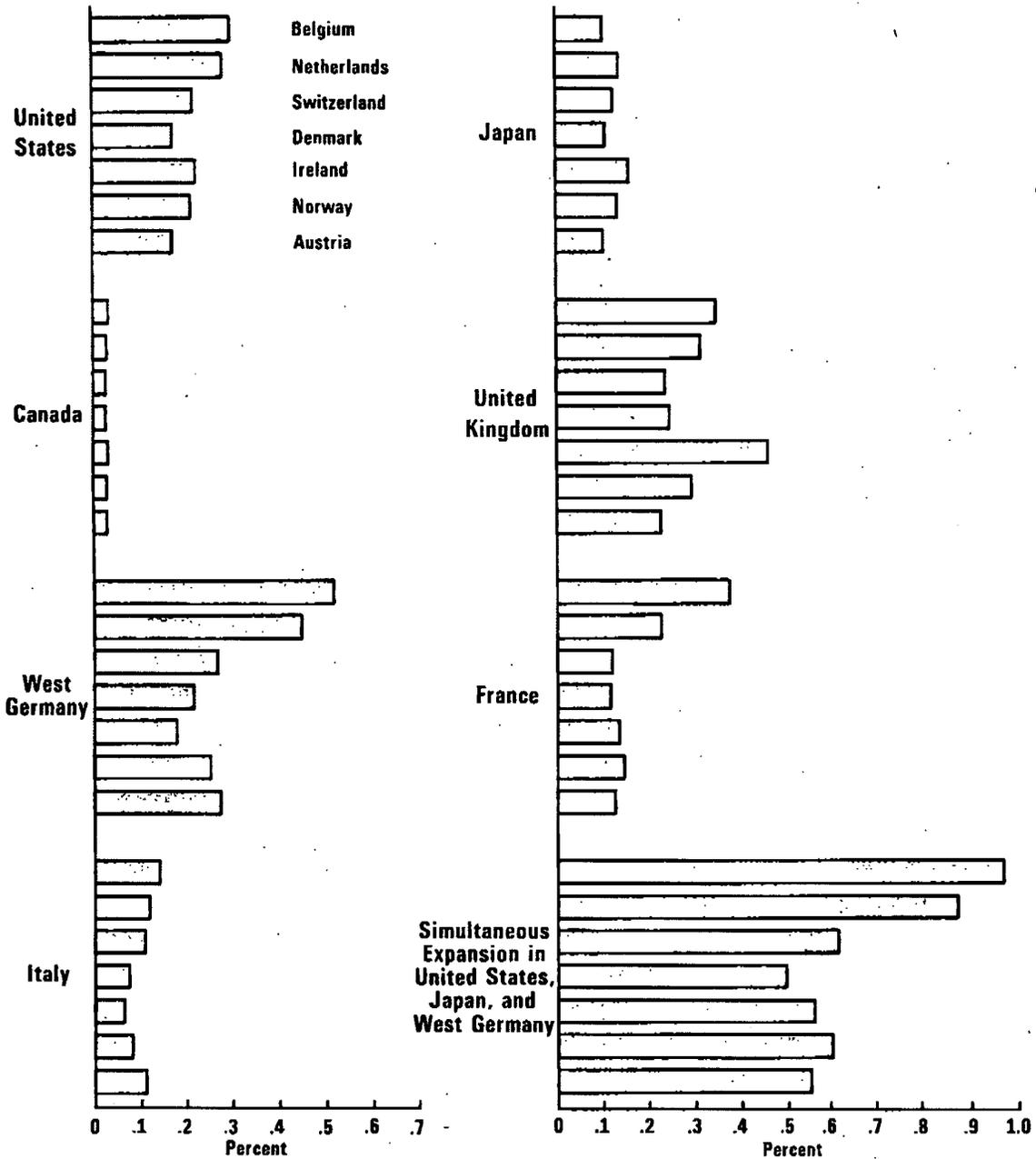
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\*Feedback effects from initial increment in the lead country



### Developed Countries: Effects of Growth in the Big Seven on Selected Smaller Countries\*

Growth Induced in Each Country by a 1% increment to GNP in the lead country



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\*These smaller countries most affected by a 1% increment to GNP in the United States, Japan, and West Germany



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## DEVELOPED COUNTRIES: THE CAPACITY OVERHANG

By mid-1975, excess plant capacity in major developed countries reached the highest level in at least 20 years. With the large overhang, business firms are holding the line on capital outlays until capacity utilization rates improve. We conclude that fixed investment will provide only moderate push to economic recovery until well into 1976.

### Capacity Galore

Capacity utilization rates in the major countries stood about 20% below normal by mid-1975. Despite some subsequent increase in output, the amount of excess capacity remains substantially greater than at the low point of any previous postwar recessions.

- In Japan, industry is now operating 20% below capacity despite an 8% increase in production since February.
- In France and Italy, where production fell through midyear, industry is operating 15%-20% below capacity.
- In West Germany, industry is operating about 15% below capacity.
- In the United Kingdom, output has dropped almost 15% below capacity, and the economy is continuing its downward slide.
- In Canada, where industrial production has fallen less rapidly, idle capacity nonetheless amounts to 10%-15%.

Basic industries, operating near capacity 18 months ago, have been hit hard. By mid-1975, steel firms were operating at least 25% below capacity, with Japan and the United States accounting for most of the slack. Capacity utilization in the nonferrous metal, paper, and chemical industries is also down sharply, reflecting the 20% drop in output during the last year and a half. Most consumer industries are operating well below potential, although the gap has narrowed somewhat in recent months. Auto production, running 30%-35% below capacity in late 1974, was 20%-25% below capacity by mid-1975.



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### Impact on Investment

The capacity overhang remains a key factor depressing capital spending. In most major countries, plant and equipment outlays in constant prices, continued their downward trend through mid-1975. Capital spending by Japanese firms fell at a 10% annual rate in first half 1975 compared with the second half 1974, following an 11% drop last year. West German, British, and US outlays also fell, while Canadian spending flattened.

Leading indicators point to little or no improvement in business spending in the months ahead. Only in the United States have machinery and equipment orders -- the most important investment indicator -- turned around substantially. An upturn in West German orders in the first half was spurred by Bonn's investment rebate program, which expired in June; orders subsequently have fallen back. Surveys of investment plans suggest that Italian and French orders have also fallen in recent months.

In most countries, orders for nonresidential construction are also stagnating or declining. In Japan, these orders fell about 35% in the second quarter with no improvement since then. Canadian orders have remained level after turning up slightly in early 1975. In West Germany, construction orders have failed to respond to the investment rebate, staying nearly 40% below the 1970 average.

### Implications for Recovery

In previous recovery periods, fixed investment accounted for one-fourth of the growth in GNP during the first year of expansion. Although normally lagging the upturn by one or two quarters, these outlays provided a strong push once recovery began. This time, fixed investment is likely to mark time until capacity utilization rates improve substantially. Given the sluggish pace of final demand and exceptionally low operating rates, an upturn in fixed investment is likely to be far more moderate and probably more delayed than in the past.

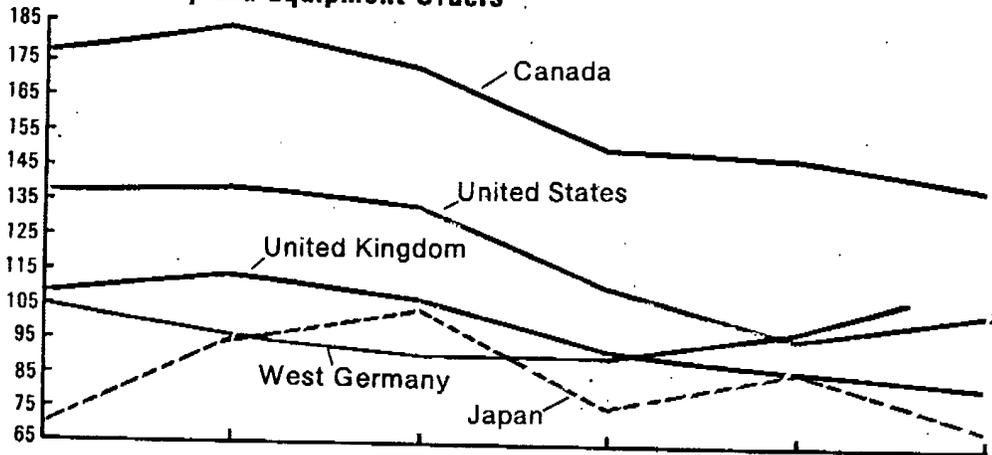
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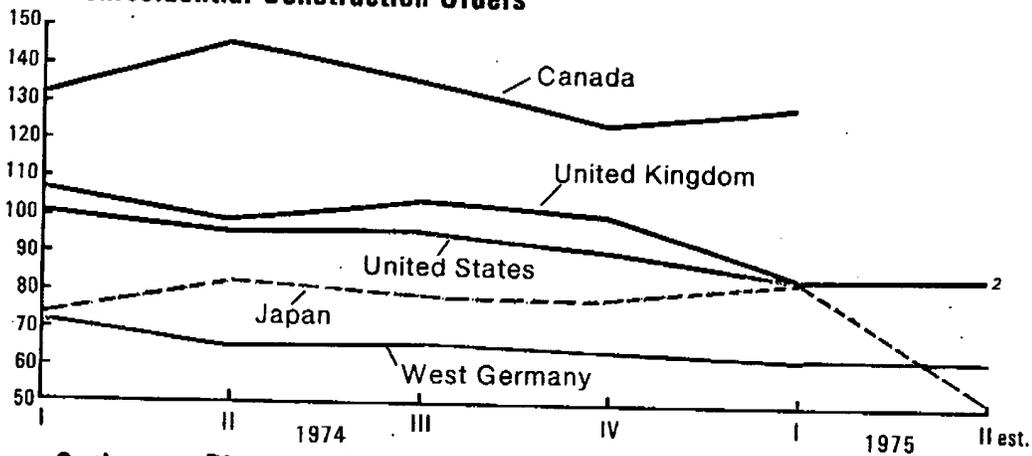
### DEVELOPED COUNTRIES: Investment Indicators

Index: 1970=100, Seasonally Adjusted, Constant Prices

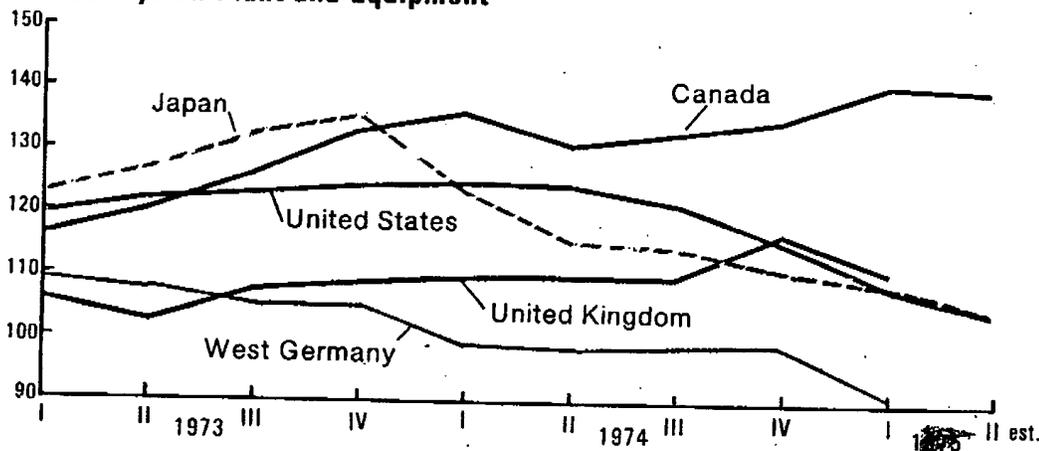
#### Machinery and Equipment Orders<sup>1</sup>



#### Nonresidential Construction Orders<sup>1</sup>



#### Outlays on Plant and Equipment

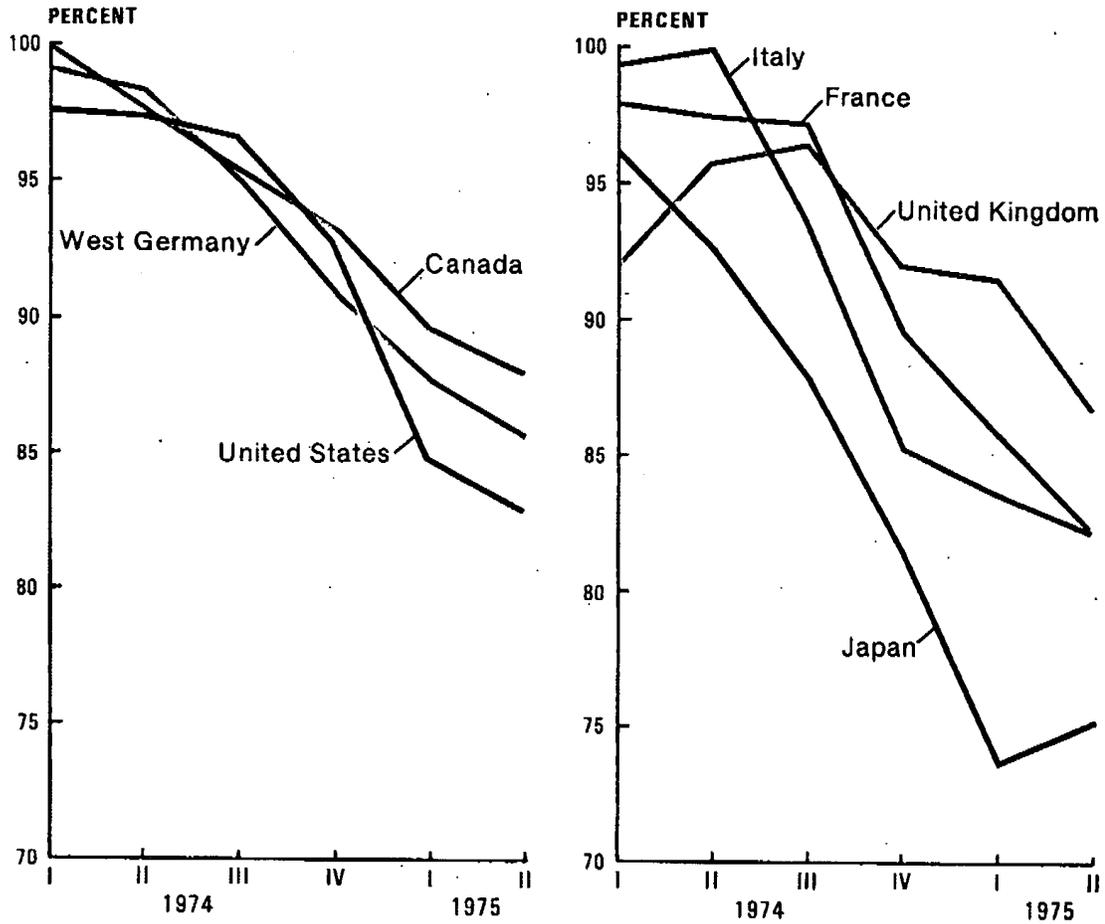


1. Data shown are similar, although not identical in their coverage. Where necessary, data series were deflated by appropriate price indexes.  
2. Based on April-May data.

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### DEVELOPED COUNTRIES: Capacity Utilization<sup>1</sup>



<sup>1</sup> We have estimated the trend in productive capacity by linear extrapolation through two postwar cyclical peaks in industrial production. This procedure yields a conservative estimate of capacity levels because some branches were not producing at full potential when the industrial sector as a whole reached its peak.

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## INFLATION: PATTERNS, TRENDS, AND PROSPECTS

Policymakers have found their flexibility severely limited by the rapid price increases of the past few years. In spite of a substantial moderation in price pressures in first half 1975, inflation remains a bothersome problem over the next 12 months. The diversity of inflation factors, together with differences in government policy, means that rates will vary widely from country to country.

By mid-1975, wholesale prices in major countries on average were 44% above the level of mid-1972, when the price spiral began. Consumer prices were up 34%. Inflation will persist at least through the middle of next year because of: (a) labor catchup wage raises; (b) an increase in the OPEC oil price which we expect to be about \$1.50; (c) a recovery in other raw material prices; and (d) a gradual upturn in economic activity, stimulated by reflationary moves.

### Patterns of Inflation

The price spiral has gone through several distinct phases. The initial phase began in 1972, when many governments adopted expansionary monetary policies to spur growth. The resulting simultaneous surge in demand in developed countries led to soaring raw material prices in 1973; together with high food costs, they accounted for about half the rise in overall prices. In that year, increased profits also contributed to the price bulge; shortages of many products and strong overall demand allowed firms to widen profit margins.

Since late 1973, higher oil costs have contributed heavily to inflation. By early 1974, consumer and wholesale prices in the major countries were increasing at annual rates exceeding 15% and 35%, respectively. Higher oil costs contributed 40% to the rate of inflation in the first half of 1974 and about 10% in the second half. The Arab oil embargo in late 1973 caused commodity prices to climb rapidly, primarily because of speculative buying to hedge against shortages. By mid-1974, non-oil commodity prices began to decline sharply as demand-pull inflation dissipated.

After mid-1974, soaring labor costs took over the lead role in the inflation process. Anxious to regain previous

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losses in real income, labor in the major countries held out for pay hikes averaging 20%. Labor productivity declined as recession worsened. These two factors pushed up unit labor costs at a record pace. With aggregate demand sagging, however, firms were forced to absorb much of the cost increase by cutting profit margins sharply. This, together with declining commodity prices, helped slow inflation rates through early 1975. Measured by consumer prices, inflation in the developed countries was 10% in first half 1975, compared with an average of 13.4% in 1974.

#### Current Phase of Inflation

In recent months, continuing cost pressures appear to have prevented further progress in slowing inflation. Consumer price rises remain stuck at 10% while wholesale prices are gathering steam after a period of relative stability in early 1975. Government efforts to take the starch out of wage demands by letting the economic slide run its course are having only mixed success. At the same time, an increasing number of business firms are raising prices to avoid further erosion of profit margins. US and Japanese steel firms, for example, have already announced price hikes, even though demand for their products remains weak. Higher prices for grain and other commodities are also posing a threat.

#### Labor Costs

While high unemployment has checked extreme wage demands, wage rates are still rising unusually fast for this phase of the business cycle. A growing number of workers have won contracts with escalator arrangements. Other workers have also come to expect "catchup" wage increases. Recognizing political realities, governments have not opposed workers' attempts to maintain real wages. In the first half of 1975, hourly wage rates in the major countries had risen an estimated 14% (annual rate), even faster than the rise in consumer prices. At present, Japan is the only major foreign country where the rise in productivity is keeping pace with gains in money wages.

#### Other Factors

Food prices continue to play a prominent role in consumer inflation. A poor Soviet grain crop and reduced harvest expectations elsewhere are beginning to affect

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international commodity markets. The London Economist index for 16 internationally traded foodstuffs has increased 12% since June, after declining 17% in the previous six months. The impact on consumer prices will be felt later this year. The sharp decline in industrial raw material prices which helped offset rising labor costs earlier this year has also halted.

Because most of the fat appears to have been squeezed out of profit margins, many companies are no longer absorbing cost increases as they did over the past 12 months. In Japan, for example, unit profits by the start of 1975 had dropped nearly 50% below their 1973 peak, to their lowest level in 15 years. The profit squeeze in West Germany has also been severe. To cover recent cost increases, producers in some highly concentrated industries, including automobiles and aluminum, are beginning a round of price hikes. Weak demand, high inventories, and large excess capacity nonetheless make it difficult for many industries to fully pass forward cost increases.

#### Prospects for Inflation

We estimate that consumer prices in the major foreign countries will increase on average at annual rates of 9% in second half 1975 and 8% in first half 1976. These rates, although down substantially from 1974 and early 1975, are more than double the average annual increase of 3.5% in 1960-1971. Wholesale prices will be more stable, increasing perhaps 4% between mid-1975 and mid-1976. Among major foreign countries, Japan and West Germany will have the lowest consumer price inflation rates.

#### Balance of 1975

Several factors already in train will prevent a more rapid improvement in inflation during the remainder of 1975. At least part of the first-half rise in labor costs and more recent increases in agricultural commodity prices will not be felt at the retail level until later this year. The \$1.50 OPEC oil price rise we expect in October will raise wholesale prices by roughly 0.5% and consumer prices by nearly as much if fully passed forward.

#### First Half 1976

Aside from higher food and energy costs, the pace of economic recovery in large measure will determine the rate of inflation during the first half 1976. In countries such

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as the United Kingdom, where recovery will be slow and halting, productivity gains will be small and inflation consequently high. In countries with better recovery prospects, notably Japan, productivity gains should compensate for wage increases. Industrial raw material costs will probably show some increase by early 1976, although large inventories of most commodities will restrain their prices.

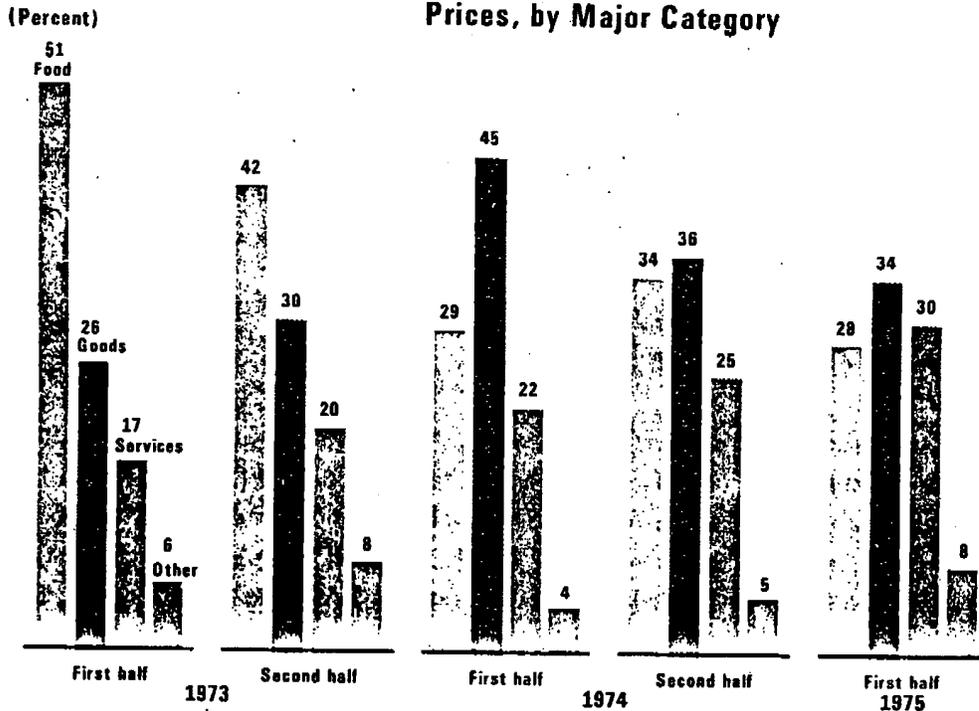
As demand gains strength, business attempts to raise profit margins will become a more important element in price increases. Firms will attempt to recoup past losses to the extent possible without endangering their market shares.

Because economic slack is so large, governments could probably stimulate demand more rapidly than at present without adding appreciably to near-term inflation. Most governments have kept a particularly tight lid on the money supply growth to avoid a repetition of the 1972-1973 experience. Since the start of 1975 the money supply in the major countries grew on average at an 8% annual rate, compared with 12.5% in 1972, when all countries were operating closer to capacity. Policymakers remain concerned that rapid growth in money supply would eventually spark another round of demand-pull inflation.

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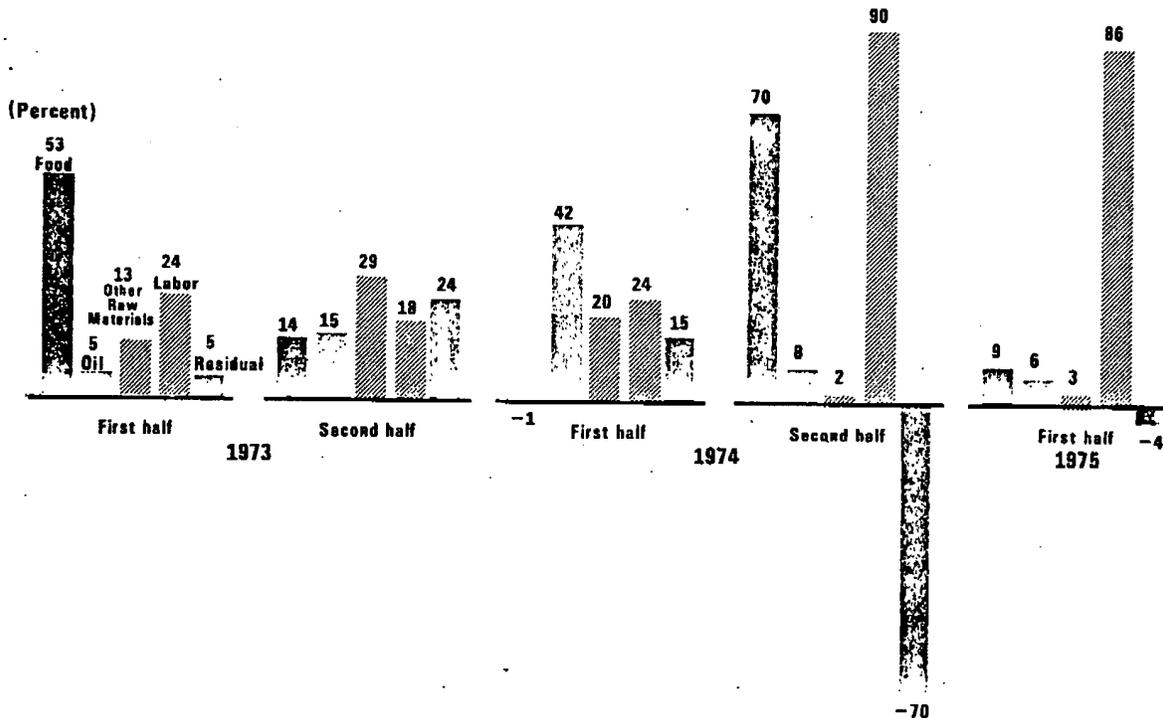
**DEVELOPED COUNTRIES<sup>1</sup>: Contributions to Changes in Consumer Prices, by Major Category**



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<sup>1</sup>Including Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany.

**DEVELOPED COUNTRIES: Contributions to Changes in Wholesale Prices<sup>1</sup>**



1. To measure the impact of higher import prices on wholesale prices, we have used input-output tables for France, Japan, the United Kingdom, the United States, and West Germany. The influence of higher costs for foodstuffs, crude oil, raw materials, and labor was measured by increasing the relevant rows in inverted input-output tables by the amount of the cost increase. In following this procedure we were assuming that changes in costs are passed through dollar for dollar during a six month period. The residual—the difference between calculated and actual wholesale price changes—essentially reflects errors and omissions, plus changes in profit margins. A positive residual suggests an increase in profit margins and a negative residual a decline in profit margins.



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## INFLATION IN THE EUROPEAN COMMUNITY, JAPAN, AND CANADA

Although the causes of the current inflation transcend national boundaries, striking differences in the strength and timing of the price surge among the developed countries have emerged since mid-1973. Inflation - as measured by consumer prices - varied in 1973 from 7% in West Germany to about 24% in Japan and Italy. Whereas inflation has now subsided in most major countries, the United Kingdom has moved into the 25% range this year, and a resurgence appears possible in Italy and Canada.

National variations in inflation patterns mainly reflect differences in government policy and in the attitudes and strength of organized labor. In West Germany, the government early imposed stringent deflationary measures, and labor has not sabotaged this hardnosed approach despite a painful rise in unemployment. At the other extreme, London has vacillated on anti-inflationary policy in the face of strong labor pressure. Britain's Conservatives were knocked out of office last year on the issue of statutory wage controls, and the unions subsequently kicked over the traces of voluntary restraint.

### Japan

Strong traditions of labor discipline and close government ties with the business community have failed to protect Japan from the inflationary virus.

Inflation took off in early 1973, when an increase in government spending hit an economy already operating near capacity. Accustomed to rapid increases in real incomes, Japanese workers responded to inflation by demanding 25% to 30% annual wage increases in 1973 and 1974 - adding a fillip to the wage-price spiral. In 1973 a 20% gain in labor productivity helped offset wage and other cost increases; in 1974, as output slipped and employers felt dutybound to retain workers, productivity barely rose. Tokyo gradually stepped on the monetary and fiscal brakes through yearend 1974 and made extensive use of moral suasion against wage and price hikes. Consumer prices, nevertheless, jumped 24% last year, double the 1973 rate.

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As international price pressures eased and recession took some of the steam out of union wage demands, inflation slowed starting in first quarter 1975. For the year as a whole, consumer prices probably will be up about 10%. Tokyo is taking advantage of the lull to stimulate the economy without fanfare, with further expansionary measures planned this fall. Slack in the economy precludes major bottlenecks, and inflation probably will be held somewhat under 10% next year.

#### West Germany

Historic fear and hatred of inflation have made firm deflationary policies politically feasible.

The then Economics and Finance Minister Helmut Schmidt put through strong deflationary measures in 1973, months before other governments acted. His program included a 10% surcharge on personal and corporate taxes, an 11% tax on investments, and a sharp rise in the discount rate. In 1974, Bonn relaxed its fiscal stance slightly to offset the drain on purchasing power from the oil price hike; monetary policy remained extremely tight. Weak domestic demand, reinforced by a sudden jump in the savings rate, prevented firms from passing on increased wage costs. Appreciation of the mark, largely a result of success in restraining domestic inflation, dampened the impact of rising prices for raw materials, food, and oil. As a result, the increase in consumer prices at 7% in 1973 and in 1974 was the smallest among the major developed countries.

In first half 1975, consumer prices rose at 6% annual rate, wage increases averaged 7%, and the high savings rate persisted. At the same time, import prices fell and the wholesale price index remained flat, suggesting that the rise in consumer prices could slow further by yearend. The Schmidt government's cautious approach to economic revival, coupled with wage settlements at 6%, suggests little if any worsening on the price front in 1976.

#### France

Gaullist fiscal orthodoxy and technocratic dirigisme have helped offset pressure on prices from domestic demand, rising import costs, and wage push by the left-dominated labor movement.

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Buoyant demand, fed by large increases in the money supply, pulled consumer prices up 7% in 1973 as the economy strained against capacity limits. Rising prices for food and imported raw materials played a growing role over the year, with the oil price hike adding its impact in 1974. Labor responded to the accelerating rise in consumer prices by pushing wage rates up 14% in 1973 and another 19% in 1974, contributing to the inflationary momentum. The consumer price index for 1974 was 14% above 1973.

Paris can claim that efforts to deflate demand through balanced budgeting and restraint of monetary growth, together with tighter regulation of profit margins and prices, have gradually slowed price increases since the early 1974 peak. A decline in the cost of imported raw materials helped, and rising unemployment influenced labor to trim its wage demands. Despite all these factors, prices rose at an annual rate of about 12% in the first half of 1975 and are likely to rise nearly as fast in the coming 12 months. The prices of French raw material imports apparently bottomed in May, and the government has budgeted a small deficit for 1976 to stimulate production and employment. Partly offsetting the inflationary forces are monetary stringency and a large overhang of idle labor and industrial capacity.

#### United Kingdom

Erratic economic policies have combined with the actions of an unruly labor force to give Britain the worst inflation in the developed world.

Fiscal policy has flip-flopped several times since the early 1970s as London's attention has fluctuated between the Scylla of stagnation and unemployment and the Charybdis of inflation and balance-of-payments deficits. In mid-1974 the Wilson government cut value-added taxes, gaining pre-election price relief but worsening inflation later by widening the budget deficit. Fiscal policy again was tightened last April, although the budget was not brought close to balance. Money supply has been permitted to grow at an annual rate in excess of 13% since Wilson regained power in March 1974. After the debacle of former Prime Minister Heath's compulsory wage controls, Wilson adopted a system of voluntary restraint less abhorrent to workers. He maintained price controls, which apparently helped hold inflation to 16% in 1974, although prices accelerated after controls were eased late in the year.

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In first half 1975, the unions pushed wages up more than 30% (annual rate), and inflation accelerated to 27%. Recognizing the failure of his "social contract," Wilson imposed a ceiling on wage increases, backed up by sanctions against employers. Prospects are fairly good that the wage-price spiral will slacken in the next few months. Unemployment has reduced labor's stridency, and weak demand militates against big price hikes. We still expect the momentum of past cost increases to result in consumer price inflation at a 20% annual rate in second half 1975. Prospects are bleak for a return to single-digit inflation in the coming year.

### Italy

A powerful labor movement eager for social improvements and a government torn by party dissensions have made Italy particularly vulnerable to inflation.

In exchange for a truce with labor, Rome adopted sharply expansionary economic policies in 1973 to pull the country out of a lengthy recession. Unions held down their strikes but still managed to wrest 30% wage hikes out of employers fearful of renewed disruptions. Consumer prices jumped 10% in 1973, and inflation accelerated as the upswing in demand continued through mid-1974. Depreciation of the lira and the higher oil costs aggravated inflation early in the year, while a summer increase in value-added taxes contributed to a second-half bulge in consumer prices.

As domestic austerity cut into demand in first half 1975, inflation moderated. Consumer prices will grow 16%-17% for the year as a whole, still an improvement over the 19% of 1974. The salutary effect of reduced demand pressure is being partly offset by (a) declining labor productivity and (b) price-indexed wage adjustments for organized labor. Further progress in reducing inflation appears unlikely. Contracts covering 4 million workers are about to expire, and wages are likely to show substantial increases later in the year. Meanwhile, under strong pressure from the Left, Rome is embarking on a bold program of expansion that will boost the 1976 budget deficit to 9%-10% of GNP.

### Canada

Inflation has followed similar paths in Canada and the United States, with Canada expected to move up a little faster in the next few quarters.

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In Canada, as elsewhere, inflation accelerated early in 1973, and consumer prices were up nearly 8% for the year. Because of Canada's role as a major grain exporter, rising commodity prices were especially important in generating added income and fueling inflationary expectations. By 1974, inflation approached 11%, contributing to the fall of the Trudeau government, which had rebuffed opposition demands for a deflationary budget and an incomes policy. After winning reelection at midyear, Trudeau followed a slightly expansionary policy. While rising import prices and escalating wage settlements were key inflationary elements, Ottawa used fiscal juggling to stave off a surge in domestic oil prices, taxing oil exports and subsidizing oil sold to Canada.

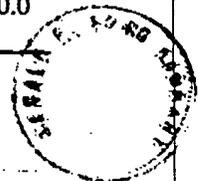
Developed Countries: Price Index Changes

	Percent <sup>1</sup>						
	United States	Japan	West Germany	France	United Kingdom	Italy	Canada
Wholesale industrial prices							
1973 I	7.38	5.65	2.90	5.65	3.64	3.91	14.85
II	6.69	23.14	4.69	9.05	1.39	17.89	14.13
III	6.79	28.44	10.32	31.16	16.19	34.00	19.23
IV	16.99	40.78	10.82	35.61	17.22	39.00	25.66
1974 I	27.69	51.25	21.06	48.55	29.87	82.71	27.16
II	30.08	22.96	14.20	33.93	33.61	43.73	21.71
III	33.27	17.82	12.01	7.34	22.58	32.34	19.56
IV	17.87	5.95	6.97	-4.07	25.06	21.51	3.96
1975 I	6.24	-14.70	-2.48	-20.84	28.04	-8.27	7.06
II	-1.21	7.17	0.40	-16.90	24.70	-7.92	7.20
III <sup>2</sup>	....	5.0	1.0	....	20.0	-2.0	5.0
Consumer prices							
1973 I	6.25	8.75	6.34	4.34	6.41	12.28	8.32
II	7.95	19.75	7.93	7.87	9.40	11.60	8.68
III	10.72	17.57	6.58	10.20	10.95	9.25	10.08
IV	8.65	20.07	8.19	10.91	14.45	11.25	9.04
1974 I	12.31	42.08	6.85	16.53	16.83	23.21	10.88
II	10.62	17.39	6.69	16.76	21.59	21.34	12.96
III	14.42	21.01	6.54	14.14	15.22	31.93	11.09
IV	11.14	19.33	5.78	12.64	19.15	26.68	13.04
1975 I	8.03	3.57	4.75	12.30	25.51	14.67	9.75
II	5.31	13.15	7.80	9.62	39.07	9.14	8.26
III <sup>2</sup>	10.0	10.0	5.5	9.0	25.0	10.0	10.0

1. Change from preceding period at an annual rate, seasonally adjusted.

2. Estimate.

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Inflation dipped early in 1975, then rose in the summer, averaging 10% (annual rate) for the half year. Fiscal policy continued mildly expansionary; monetary policy wavered erratically. Recently, Ottawa lifted ceilings on oil and natural gas prices, and food prices are moving up again. Wage settlements have approached 20% so far this year. With Ottawa unwilling to clamp down because of 7% unemployment, a double-digit increase in the consumer price index is in prospect for the next 12 months.

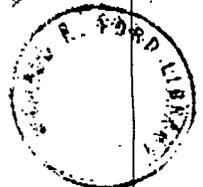
Belgium, Denmark, Ireland, Luxembourg, and Netherlands

The small EC countries are all heavily dependent on trade and extremely sensitive to international price pressures.

The inflationary wave inundated the small EC countries, starting in 1973. Most of these countries are ruled by coalition governments whose survival depends on labor-oriented parties which oppose austerity measures. Government policy thus has tended to reinforce inflationary pressures from abroad. Widespread use of indexing has also prolonged and strengthened the inflation, especially in Belgium. Last year, Ireland experienced the worst inflation at 17%; Denmark was close behind. In the Netherlands, price increases were kept below 10% by the strength of the guilder, which has been enhanced by natural gas exports.

Ireland, strongly influenced by events in the United Kingdom, has experienced an acceleration in inflation to 25% this year. Otherwise, the small countries are posting records that at worst are on a par with last year's. The coming 12 months should see further improvement.

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## DEVELOPED COUNTRIES: SLUMP IN EXPORT VOLUME SLOWS

The decline in the export volume of the major developed countries slowed to an annual rate of only 4% in March and April, compared with 8% in September-November and 18% in December-February.\* The slowing of the trade contraction mirrors the more moderate rate of decline in output in the Big Seven as they approach the bottom of the recession. A sharp pickup in trade volume is unlikely until economic activity begins to expand in several of the larger economies; a decline in sales to non-oil LDCs and smaller industrial countries is expected to more than offset gains in shipments to OPEC states. Consequently, hopes for export-led recovery generally are dim in the large industrial countries.

### Mixed Performance

The export decline for the Big Seven as a group began to moderate late in the first quarter, after the steepest part of the recession had passed. Trends among the individual countries, however, have varied considerably.

- West Germany's foreign shipments declined at a 27% annual rate from August until March, when they began to rise.
- French exports, after falling at an annual rate of 16% from August to February, declined at a 8% rate in March-April.
- Italian shipments dropped sharply in September and trended gradually downward in succeeding months.
- Japanese exports plummeted at a 27% rate from November to February and then stabilized in March.
- In Canada and the United States, both important exporters of food and raw materials, foreign sales fell at rates of 19% and 4%, respectively, from August through February and then dropped more steeply in March and April.

\* Rates of change in trade volume are calculated from three-month moving averages to minimize the effect of anomalies in monthly data.

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- In the United Kingdom, export volume increased until a dock strike in April brought a sharp falloff.

### Geographic Patterns

Depressed demand in the Big Seven has been the major factor in the contraction in exports. Trade among themselves accounts for 45% of their total exports. Their aggregate imports dropped at a 24% annual rate from August to February - nearly twice the rate of the falloff in their exports - and at a 14% rate in March-April. The steepest declines in import demand occurred in Italy, which took the strongest measures to cure oil-related payments problems, and in Japan and the United States, where excessive inventories aggravated the slump in final demand.

With demand slack in the Big Seven, producers in these countries have become more dependent on sales elsewhere. Shipments to OPEC grew rapidly in 1974 and continued to rise in early 1975. Sales to the Communist countries also have continued to rise, though at a lower rate this year. Buoyancy in these markets has had little impact on total export volume, however, because OPEC and Communist countries together account for only 11% of Big Seven exports.

The downward trend in their exports to the smaller developed countries since mid-1974 probably accelerated in the first quarter. Sales to the non-oil LDCs held up well until late last year, when payments problems began to bite. In the fourth quarter, the deficit of these countries with OECD nations as a group reached an annual rate of \$60 billion. The volume of Big Seven exports to the non-oil LDCs declined by 5% in the fourth quarter of 1974 and probably dropped further in early 1975 because of the countries' reduced ability to pay.

### Impact on Trade Balances

The trade balances of most of the major developed countries have improved sharply this year, as the recession induced a steeper drop in imports than in exports. The total trade surplus of the Big Seven swelled to \$7.8 billion in the first quarter of 1975, compared with \$1.9 billion in the preceding quarter. Improvement was most marked in France and Italy, where the balances shifted from large deficits to surpluses..

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Prospects

Although the sharp decline in sales volume of the Big Seven seems to be over, we do not foresee substantial growth in exports through the end of the year. Even if final demand increases moderately in the major countries, the pickup in demand for foreign products probably will be small because of the overhang in inventories.

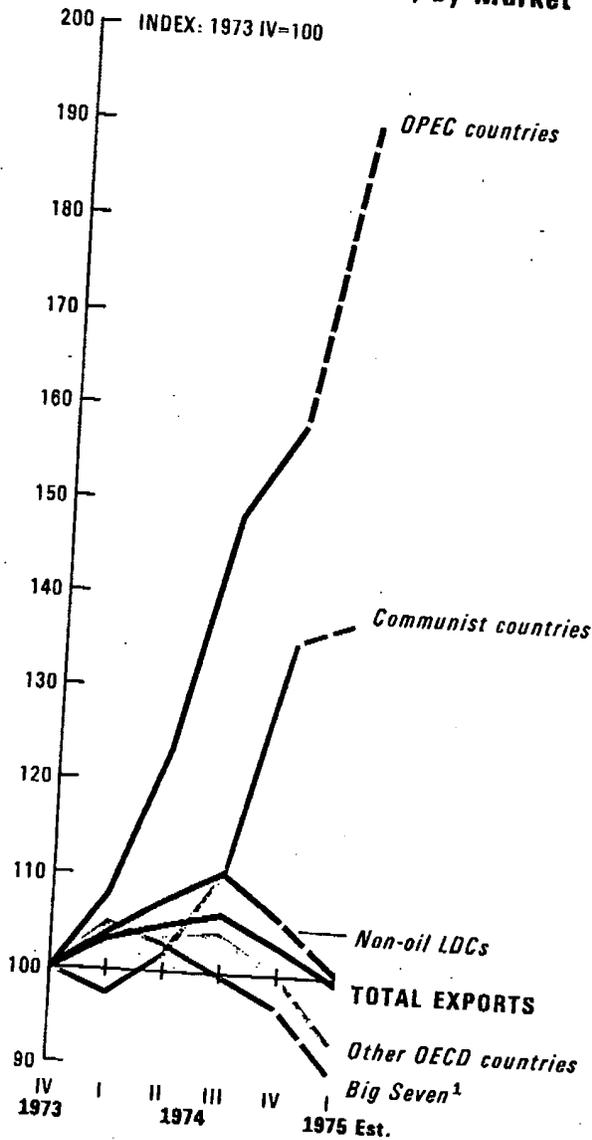
Exports of the major developed countries to the rest of the world probably will continue to slip in spite of increased shipments to OPEC and Communist countries. The recent decline in sales to non-oil LDCs and the smaller developed countries is likely to accelerate. Much of the improvement in the combined current account balance of the Big Seven has come at the expense of these countries, compounding their payments problems. Moreover, the smaller developed countries are generally lagging behind the major industrial countries in the current business cycle and thus can be expected to recover later.

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### Trends in Export Volume, by Market



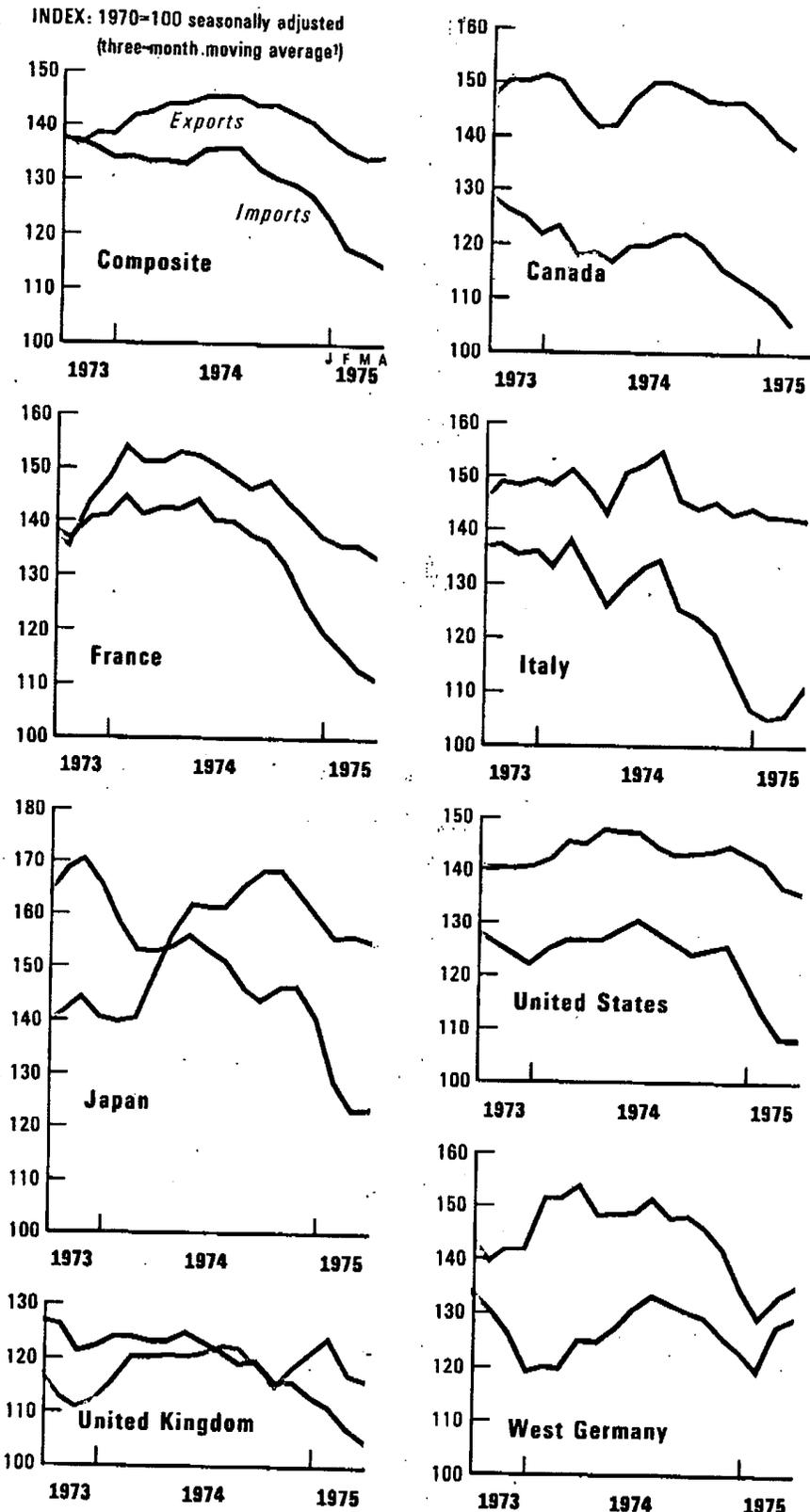
<sup>1</sup>The Big Seven—Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany.

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### DEVELOPED COUNTRIES: Trends in Trade Volume . . .

INDEX: 1970=100 seasonally adjusted  
(three-month moving average)



\* Terminal plot based on two-month average.

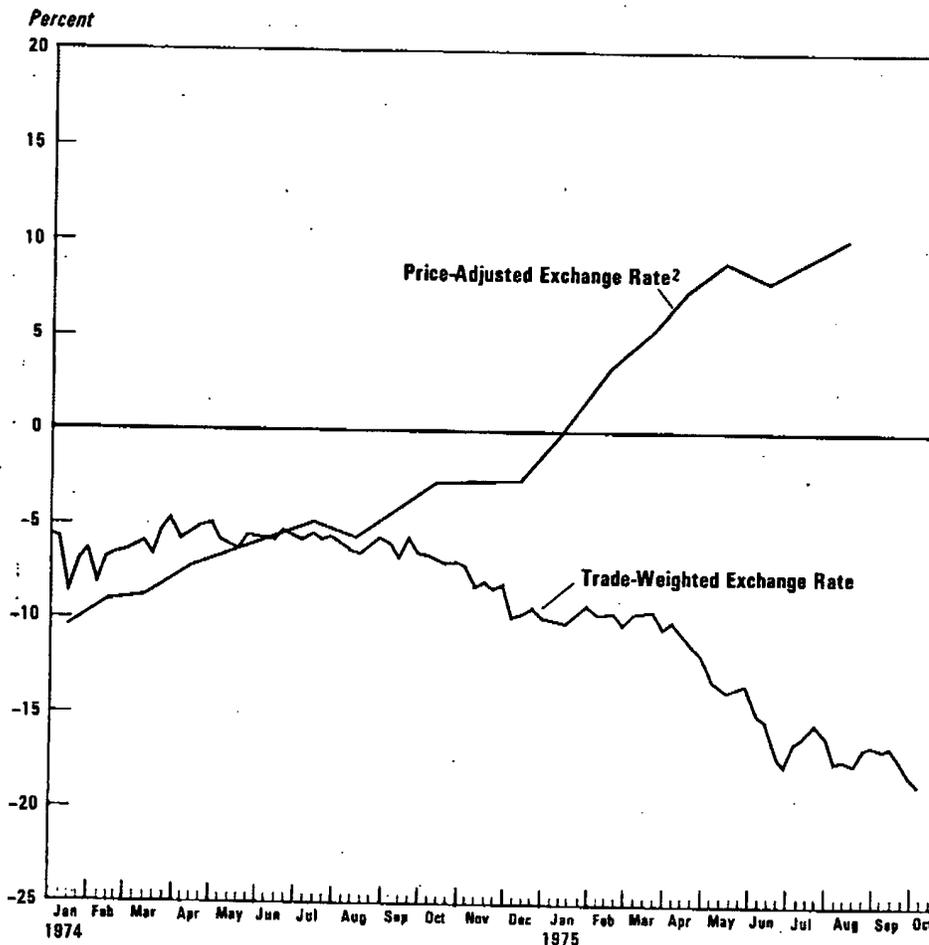
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SLIDE OF STERLING RESUMES

The pound, after three months of relative stability, resumed its rapid depreciation in late September and now stands at \$2.06. The Kuwaiti decision to end sterling payments for oil was the proximate cause of the latest slump. The relatively high rate of British inflation and widespread pessimism about British economic prospects are the underlying cause of the decline. Sterling has tumbled more than 18% on a trade-weighted basis since early 1973.

**UK: Trade-Weighted and Price-Adjusted Exchange Rates<sup>1</sup>**



<sup>1</sup>Compared with 19 March 1973.

<sup>2</sup>Trade-weighted exchange rate adjusted for changes in British wholesale prices relative to those in trading partner countries. An increase in the price-adjusted exchange rate implies a decline in competitiveness.

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Word that the Kuwaiti government had instructed British Petroleum to make future payments for oil in dollars rather than sterling began to circulate in late September. This news, coupled with oil company sales of sterling for dollars to comply with the new payment instructions, has driven the British currency down 1.4% in the past four weeks.

Earlier Declines

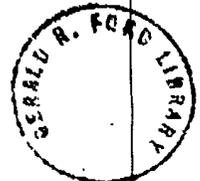
The latest decline follows two other slumps in the last 12 months, slumps also related to financial decisions by oil producers:

- sterling fell about 5% in fourth quarter 1974 following decisions by Saudi Arabia and Kuwait to sharply limit new sterling investment and by Riyadh to stop taking payments in sterling, and
- sterling's trade-weighted exchange rate dropped another 7% in second quarter 1975 as OPEC governments sold off nearly \$500 million of their sterling assets.

Changes in Foreign Sterling Holdings

	Million Pounds					
	1974				1975	
	I	II	III	IV	I	II
Held by						
Official institu-						
tions						
OPEC	323	596	885	420	348	-210
Other	-55	-388	-319	-53	-117	-60
Private	-56	187	61	-15	19	465
Total	212	395	627	352	250	195
Total holdings, end of period	5,760	6,155	6,782	7,134	7,384	7,579

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Underlying Causes of Sterling Weakness

Decisions by some oil producers to stop accumulating sterling and to begin a slow and quiet selloff are symptoms as well as causes of the pound's weakness. The crux of the problem is Britain's dismal economic performance, particularly the rapid inflation that has eroded the competitiveness of an already weak British industrial sector. In the 30 months ending August 1975, wholesale prices in the United Kingdom increased 27% more than those of its trading partners, considerably exceeding the competitive gain from depreciation.

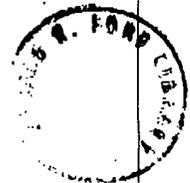
Sterling will continue weak until domestic inflation is brought under control or until North Sea oil trims the trade deficit. In the interim, the inflation gap with other countries requires that sterling drop further if the competitiveness of British industry is to be maintained. One of London's difficulties is that sterling depreciation itself adds to inflation, because nearly one-third of final demand is met with imports.

The UK strategy so far has been to temper sterling's decline, i.e., to keep it from becoming a rout. The government will find controlling the rate of descent progressively more difficult if oil producers abandon sterling at an even faster rate.

Percentage Change  
in Industrial  
Wholesale Prices  
(Annual Rates)

	Three Months Ending August 1975	Year Ending August 1975
United Kingdom	14.4	24.1
United States	4.6	6.6
Japan	2.3	0.7
West Germany	-0.3	2.0
France <sup>1</sup>	-5.8	-9.5
Italy	3.6	2.1
Canada <sup>1</sup>	2.3	7.1

1. Period ending July.



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## ITALY: A RISKY REFLATION PROGRAM

Italy's \$5.5 billion reflation program introduced in August represented a marked shift in policy and ran counter to the advice of the OECD, the EC Commission, and the Bank of Italy. These bodies had been advocating a more conservative posture to avoid aggravating inflation and jeopardizing the sharp but tenuous improvement in the balance of payments.

Political expedience was the key factor motivating the center-left government to veer down this economically risky path. The Communists have found an increasingly sympathetic audience for claims that they alone can solve Italy's problems. By preempting many of their spending plans, the Moro government apparently hopes to undercut Communist efforts to win a larger role in the national political scene.

### The Package

The new spending program attempts to stimulate demand while stilling public clamor for improved governmental services. The measures fall into three major categories:

improvements in public housing, hospitals, ports, airports, and urban transportation (\$2.5 billion);

increased export insurance coverage (\$1.75 billion);  
and

aid for small and medium-size businesses, for agriculture, and for economic development of southern Italy (\$1.25 billion).

### The Impact on Growth

This fiscal stimulus should generate a direct expansion of domestic demand equivalent to 3% of GNP, with the bulk of the impact coming in 1976. Multiplier and psychological effects on consumers and investors will amplify this impact, provided that the government is not forced to abort the program.

After falling sharply in late 1974, industrial output continued to decline through the first eight months of 1975. Following a particularly sharp drop of 14% in May, production

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rebounded in June and July but fell again in August. Unemployment continues to edge up and is expected to average 4% this year, compared with 3% in 1974. Short-time work in the first quarter was double the comparable 1974 level.

Demand has shown no signs of reviving in recent months. Despite rising real incomes, consumers continue to hold back on spending because of job uncertainties. With capacity utilization at record lows, investment has plummeted, even in the face of easier credit. Export volume, usually a strong prop to production, has been stagnant since last quarter 1974.

....On Prices

The new program, along with sharp increases in government pensions and wages, will boost the excess of budget appropriations over revenues for 1976 by 70%-to \$18 billion, the equivalent of 9% of GNP. Although the cash deficit may lag because of bureaucratic delays, government spending will stimulate the inflationary process.

Consumer prices rose at an annual rate of 9% in the latest 90-day period for which data are available, down from about 25% the same time last year. The near-term outlook already has been darkened by a new hike in oil prices, rising prices on other imports, and a weakening lira. Most ominously, wage rates-already 30% above last year's level and not yet digested in the price structure-are sure to rise further this fall when labor unions representing more than 4 million workers negotiate new contracts.

....And on the Balance of Payments

The antirecession program also will worsen the trade balance, which had been expected to deteriorate in any case. By stimulating both consumption and inflation, the increase in government spending will raise demand for imports of raw materials and consumer goods and negatively affect exports. As a result of the new package, the trade balance could worsen to an annual rate of \$1.5 billion.

Even before the reflationary program was announced, imports seemed sure to pick up as companies completed adjustments in their stocks of raw materials, particularly oil.

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At the same time, exports were not expected to grow much because of the slow recovery foreseen in major markets and dwindling sales to the non-oil LDCs. Renewed capital flight, an apparent reaction to Communist success in the recent regional elections, already is hurting the balance of payments.

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FRANCE: STRONG ACTION TO REFLATE

President Giscard d'Estaing in early September announced a wide-ranging package of economic measures aimed at stimulating an upswing. Fiscal steps total \$7.1 billion (2.3% of GNP) - double the amount expected just a few weeks earlier. They are being supplemented by a major easing of credit. Paris has emphasized fast-acting stimuli in hopes of obtaining an immediate impact. The main effect of the program nonetheless will be to amplify the recovery already expected in early 1976.

Rising government concern over unemployment was a major factor determining the size of the proposed program. The number of jobless, which doubled over the past year to 885,000, should go over 1.2 million by December even with the program. Paris has concluded it cannot wait for an upturn in the US and West German economies to pull France out of the recession.

Something for Everybody

The new measures focus on projects that can be initiated quickly. In October, \$1.2 billion will be disbursed to the aged poor and to families with children. About \$1.0 billion will go for construction of highways and other public works. The government has specified that these funds must be spent by the end of March 1976.

Industry is getting a surprisingly large share of the benefits. New aid to business totals \$900 million, mostly in the form of low cost loans. The 10% tax credit has been expanded to cover all purchases of capital goods, at a cost of \$600 million. Paris hopes that the tax credit, still set to expire 31 December, will stimulate a burst of investment spending in the fourth quarter. Finally, \$2.2 billion in corporate taxes due this month have been deferred until April, easing the immediate cash-flow problems of many firms.

A grab bag of other expenditures totals \$1.2 billion and includes 18,000 new public housing units, aid to local governments, and supplementary credits for various government agencies. Giscard also has promised administrative action to improve export incentives, boost housing construction, and encourage firms to hire more workers.

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On the monetary side, Paris has reduced bank reserve requirements, setting the stage for \$4 billion in new loans. The bank rate has been cut sharply, from 9.5% to 8.0%, which should pull down other interest rates. To stimulate demand for consumer credit, the government has substantially eased the conditions for installment loans.

The trade unions are urging universal reduction of the workweek from 42 to 40 hours without loss of pay, a 30% increase in the minimum monthly wage, a lower retirement age, and the creation of 150,000 jobs in the public sector. The Communists have advocated an even more extensive program; they have been criticized in the press for failing to specify how it would be funded.

#### Impact

Financing the government's program will push this year's budget deficit to \$9.2 billion, about 3% of GNP, a huge amount by French standards. This is to be a one-time affair; a return to a balanced budget is planned for 1976.

The new measures will have small impact on production and employment this year. Unemployment will continue to rise rapidly through the fall as new graduates enter the labor force. Industrial production will remain far below the 1974 peak, although some improvement could occur by yearend.

The government's program no doubt will amplify the recovery in private demand expected to begin early next year. The selling off of accumulated inventories, which contributed heavily to the present recession, should end within a few months. Business surveys indicate that private investment in plant and equipment will recover strongly next year from the present depressed level.

#### Political Goals

Giscard is aiming at political as well as economic targets with his program. He will probably propose additional measures to the Assembly later this year. Although aware of the risks of alienating some of his conservative supporters, the president also hopes to win support on the left. He has already received plaudits from leftists of the former Radical Party, now part of the Communist-Socialist alliance.

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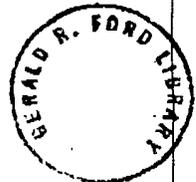


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The divisions within the leftist parties and trade unions will allow Giscard at least to buy time with his program. The almost-one-year-old public debate between the Communist and Socialists not only diminishes the effectiveness of their opposition to the government but also diverts public attention from issues they could exploit.

Continued Communist-Socialist competition can be expected to be a dominant theme on the national political scene this fall, especially among the workers. The leftist unions, meanwhile, are still recovering from setbacks suffered over the last year when they failed to mobilize the rank and file behind their demands. Union leaders realize that rising unemployment and lack of funds to support major strikes will continue to hold back radicalism among the rank and file.

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## WEST GERMANY: SWITCHBACK IN ECONOMIC POLICY

Bonn plans budget tightening measures in 1976 that lessen West German chances for a sustained economic upswing. The new budget calls for only 4% nominal growth in federal expenditures. This translates at best into zero real growth from a sector accounting for nearly one-sixth of GNP. By implication, Bonn is banking on foreign and domestic private demand to promote growth next year.

Release of the budget came on the heels of a newly announced \$2.2 billion program designed to prop up construction this winter. The volte-face in Germany policy comes much earlier than warranted by the stage of the business cycle and is curiously juxtaposed with Chancellor Schmidt's call for coordinated economic expansion by the major industrial countries.

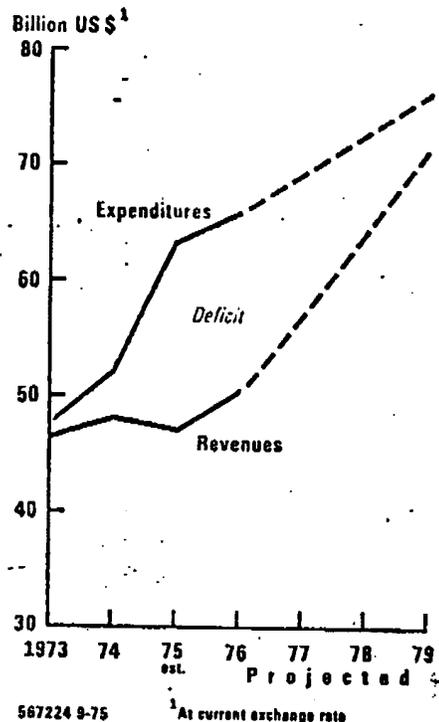
### Leashing the Budget Deficit

The basis [redacted] is a federal budget deficit that will soar to \$16 billion this year, from \$4 billion in 1974. The deficit represents the equivalent of 4% of GNP, compared with 3% in the United States in FY 1975.

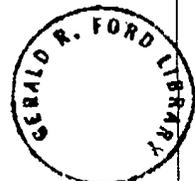
A 21% surge in expenditures coupled with stagnant revenues is responsible for the record red-ink figure. Spending is rising more than the 16% planned earlier, largely because of heavy subsidization of the unemployment insurance fund. Revenues are less than foreseen by budget officials because the economy has performed considerably worse than

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### WEST GERMANY: Federal Budget Trends



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expected. Initial budget projections had assumed a 2.5% increase in real GNP this year; a 3%-4% drop now seems likely.

EO 12958 3.4(b)(6) >25Yrs (C)

The large increase in deficit spending in 1976 has been justified as a necessary foil to weak demand.



Schmidt is also concerned lest heavy government borrowing drive up interest rates and stifle the hoped-for recovery in private investment.

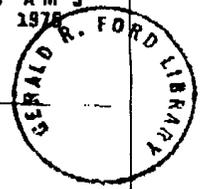
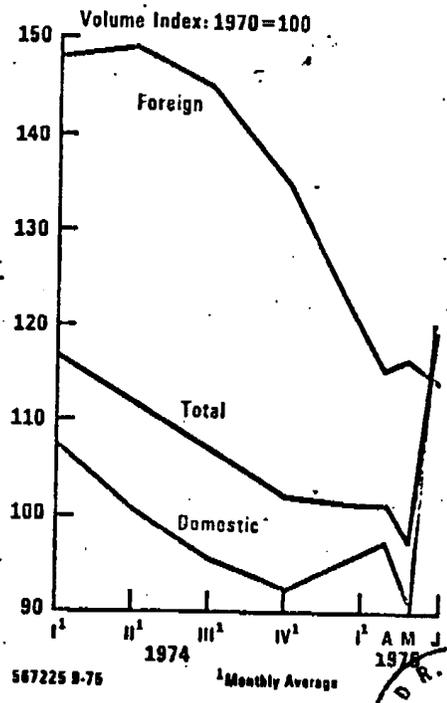
Schmidt hopes to trim \$1 billion from the 1976 deficit by cutbacks on spending for federal government personnel and an increase in employer-employee contributions to the unemployment insurance system. Revenues are expected to rise 7%, outpacing expenditures but lagging the officially forecast rise in nominal GNP by several percentage points. The medium-term budget plan calls for an increase in the value-added tax from 11% to 13% by 1977 to help shear another \$10 billion off the deficit by 1979.

The Razor's Edge

Success for Schmidt's strategy hinges on stronger foreign demand and consumer spending, which in turn would revive long-dormant investment. We believe the budget tightening will dampen the economic recovery-making a 2% to 3% growth rate much more probable for 1976 than the government's sanguine estimates.

A flood of last minute orders for capital goods in June, as businessmen beat the deadline for the investment rebate, will provide only temporary momentum to production. Bonn's August stimulation program-equal to 0.5% of GNP-will concentrate on construction projects that

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can be quickly initiated and completed. Even though exports are regaining some of the ground lost in the first quarter, they are unlikely to become a major impetus until the latter part of 1976, when demand for capital goods should finally strengthen.

The risk of slowed or delayed recovery is accentuated by parsimonious spending plans at the state and local levels. These layers of government account for about a fourth of GNP, and they already have pared their increases in expenditures. State outlays in first half 1975 were up 13% from a year earlier; growth in the similar period of 1974 was 16%.

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DEVELOPED COUNTRIES:  
ECONOMIC PROSPECTS FOR THE SMALL SEVENTEEN

The seventeen small OECD countries\* should eke out real economic growth of 0.5% this year, following a moderate 2.8% increase in 1974. In comparison, the Big Seven OECD countries failed to grow at all in 1974 and face a decline of more than 2% in 1975. The better performance of the smaller economies, surprising in view of their heavy dependence on trade, stems from several causes -- for example, early reflation moves in Belgium and the Netherlands, the resort to import controls rather than cuts in demand in Australia and Finland, and the oil boom in Norway. Next year, the Small Seventeen probably will manage a return to the 1974 growth rate despite worrisome payments balances and persistent inflation.

How 1975 Is Shaping Up

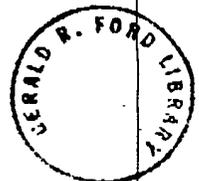
Portugal will turn in the worst performance among the smaller countries. Output is expected to drop approximately 8%. Severe political instability has been accompanied by worker takeovers at industrial plants and other disruptions in production. GNP also will fall in Finland and Switzerland, as these countries feel the effect of sharp declines in export volume. On the brighter side, the North Sea oil bonanza will lift Norwegian GNP nearly 6% this year, while Ankara is engineering 4% growth in the face of 20% inflation and a billion dollar current account deficit.

Lower export volume is an important factor in the economic slowdown. Exports are equivalent to about 40% of combined GNP, running as high as 45% in the Benelux countries, 40% in Norway and Iceland, and 30% or more in Austria, Denmark, Ireland, and Switzerland. With 45% of Small Seventeen exports ordinarily going to the Big Seven, the recession in the major developed nations has been a strong negative factor in the economic balance sheet.

In value terms, imports have slowed even more than exports. Oil imports have leveled off while exports to the OPEC countries have gone up. We expect the overall trade deficit to be

\* Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, New Zealand, Norway, Netherlands, Portugal, Spain, Sweden, Switzerland, and Turkey.

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\$24 billion in 1975, compared with \$29.5 billion in 1974. The current account deficit should decline one-fourth, from \$14 billion to about \$11 billion, despite a considerable drop in tourism.

Australia, Belgium, Denmark, the Netherlands, and Switzerland all are managing substantial improvement in their trade balances. Spain hopes only to hold its own on current account this year, with increased earnings from services balancing a further increase in the trade deficit. Finland, Norway, and Turkey are experiencing substantial slippage in both trade and current account balances.

### Government Policies

Governments are trying to steer between (a) cuts in output and employment and (b) stepped-up inflation and payments deficits. In recent months, several of the Small Seventeen have loosened policy reins:

- Denmark has slashed value-added taxes and adopted a more expansionary monetary policy.
- Switzerland and Austria have given credit incentives for investment and exports.
- Sweden has cut taxes selectively to encourage investment, while keeping money tight to maintain capital inflows.
- Ireland has reduced value-added taxes and increased subsidies in an optimistic effort to reduce inflation and unemployment simultaneously.

A few governments have followed expansionary policies during most of the recession period. The Netherlands, enjoying a current account surplus and a lower inflation rate than most countries, falls in this category. Despite serious payments deficits, Ankara and Helsinki have tried to prop up domestic demand to compensate for lost export business. Norway has only recently moved to restrain its oil boom by imposing price controls and mild fiscal restrictions.

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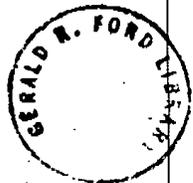
Prospects

We expect real GNP growth in the Small Seventeen to approach 3% next year. This growth rate would not be sufficient to reduce unemployment, given the normal increases in the labor force and in labor productivity.

Denmark will do much better than this year, the Swiss decline will be arrested, and Finland should see lumber and paper exports pick up. Portugal will bounce back from its current low if political order is re-established. Norway and Sweden should maintain their reasonably good growth rates of 1975.

Expansionary fiscal policies are expected to add to disposable incomes and stimulate investment demand in most of the Small Seventeen. Further easing of monetary conditions also is likely, in particular benefiting housing construction and investment in plant and equipment. At the same time, we do not expect a robust recovery in key export markets, notably West Germany, France, and Great Britain.

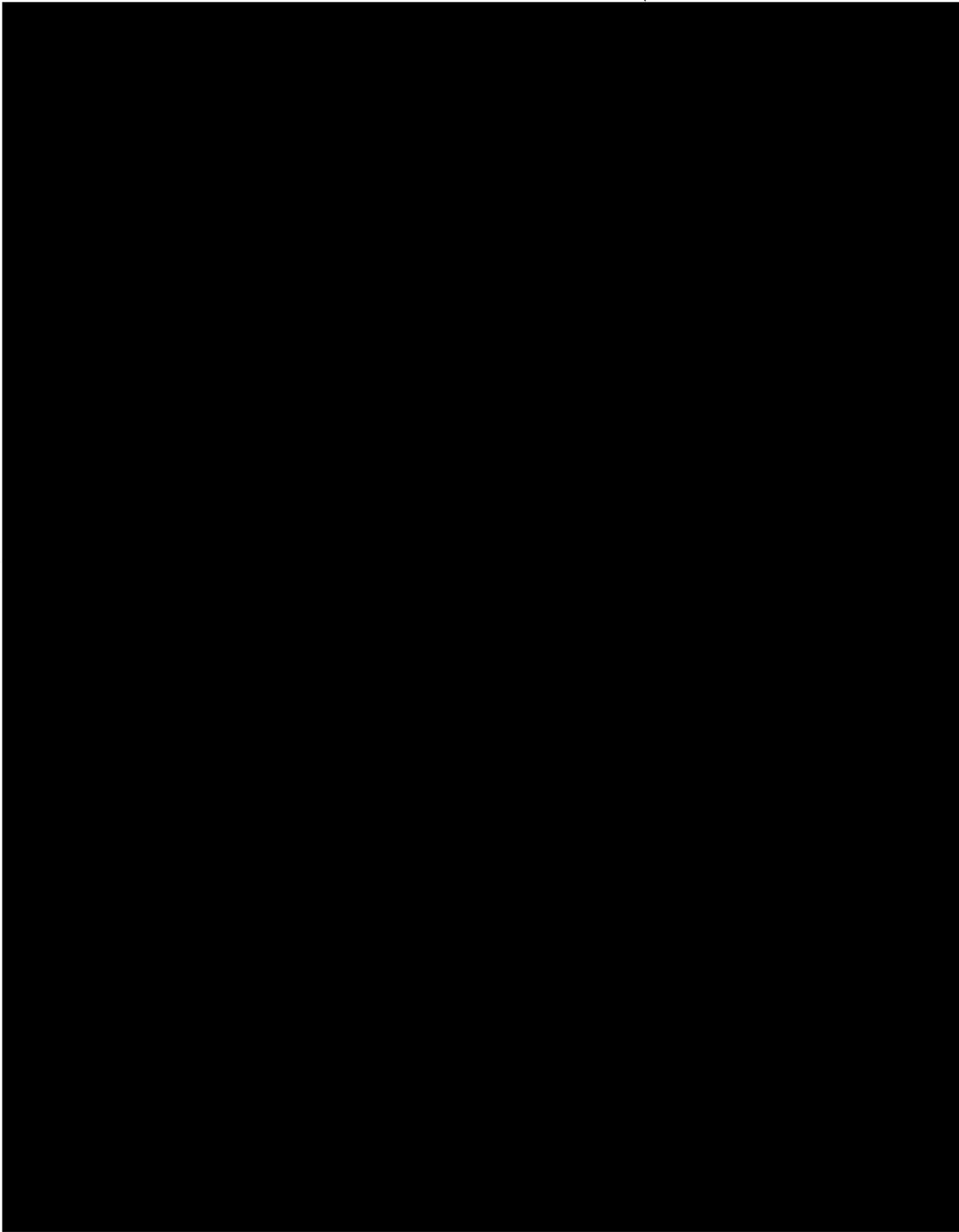
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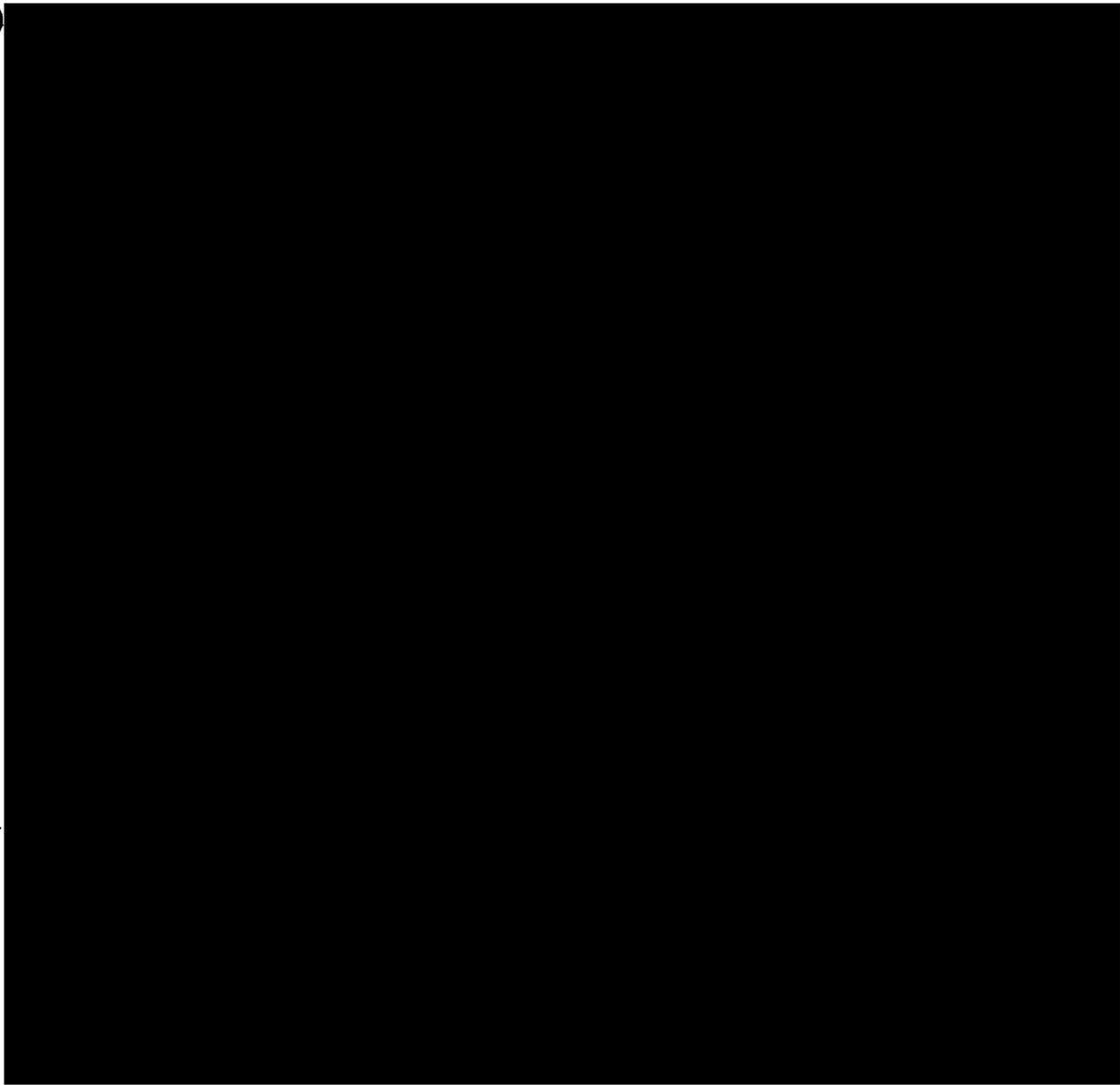
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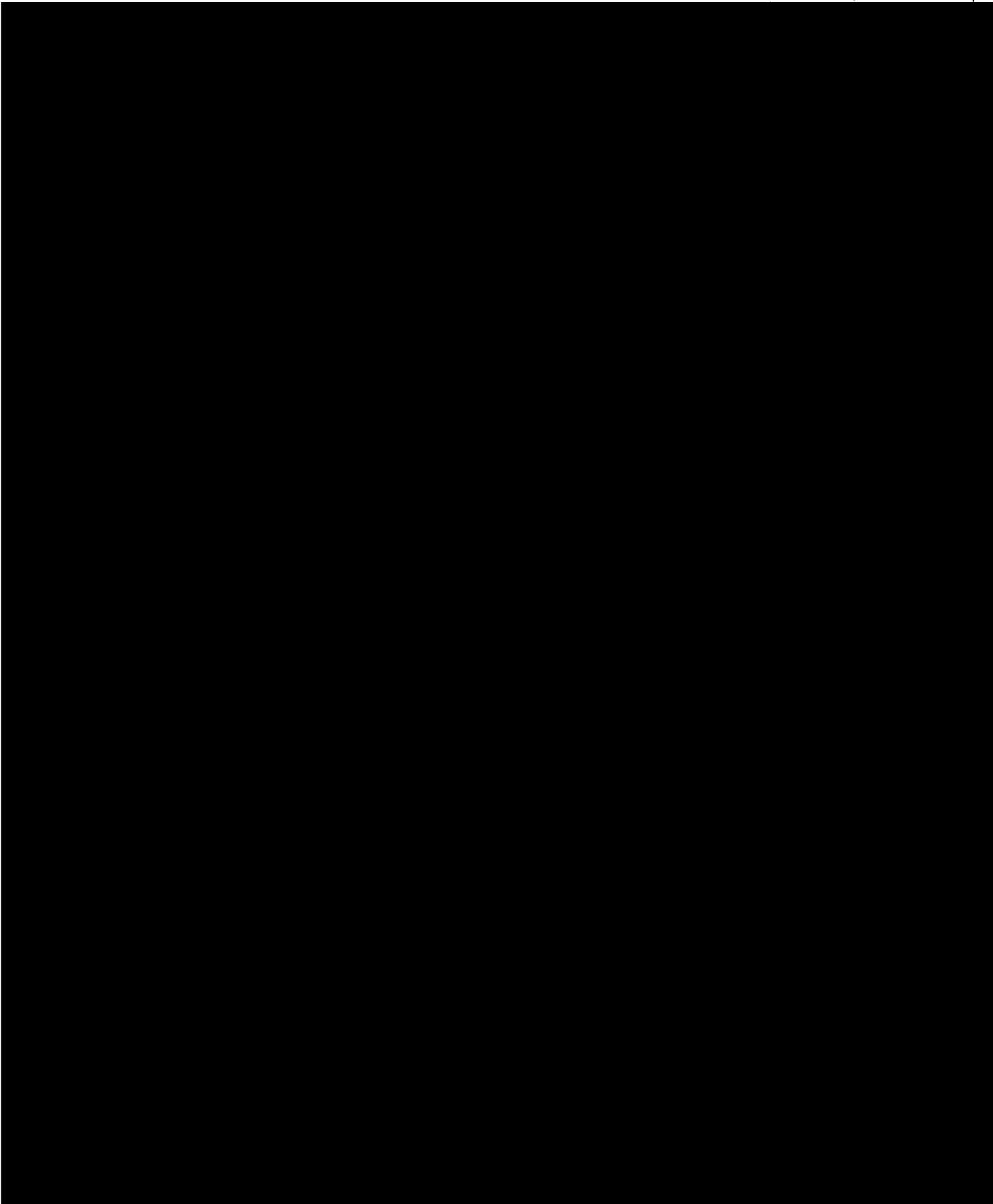
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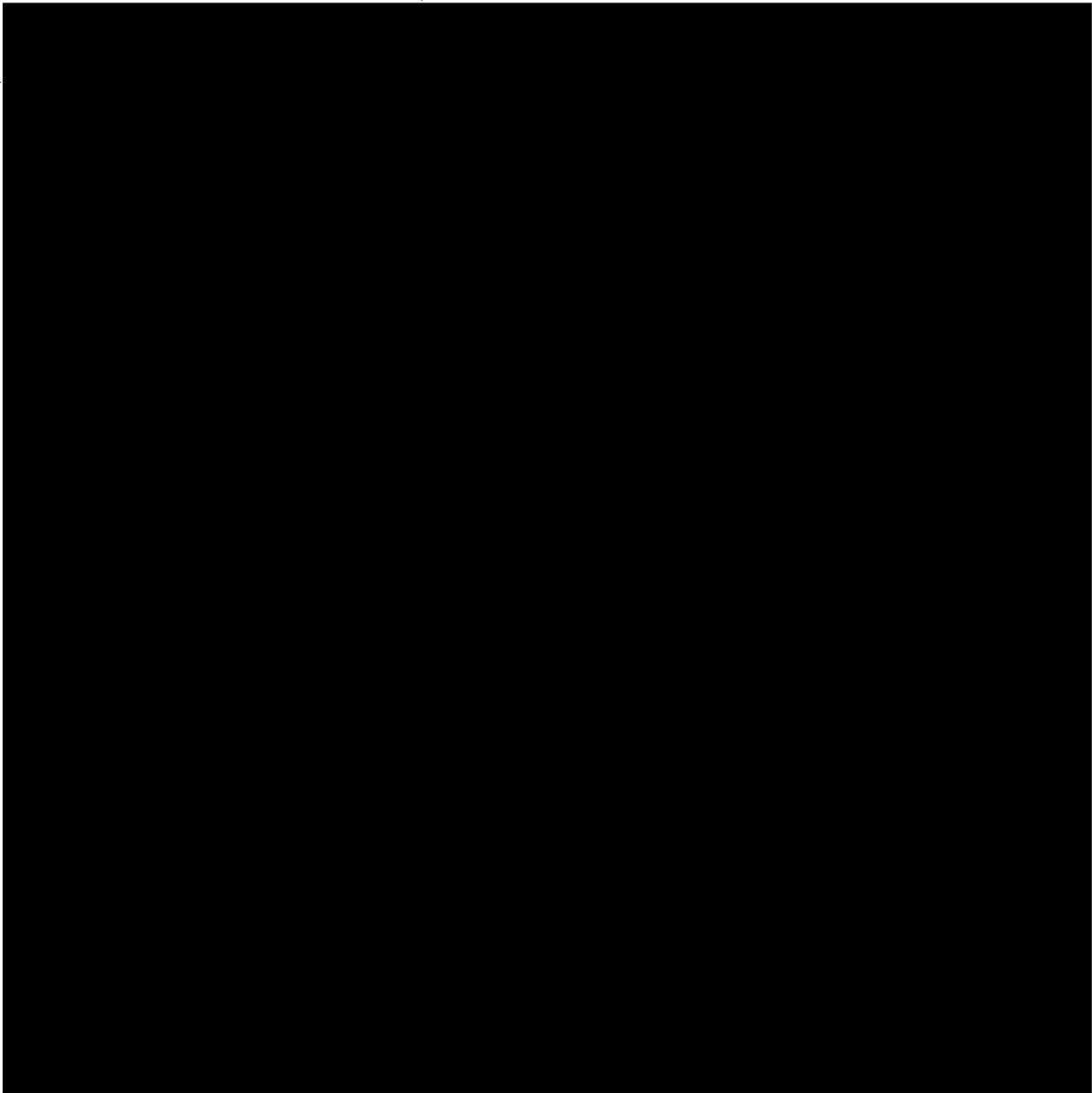


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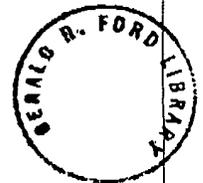


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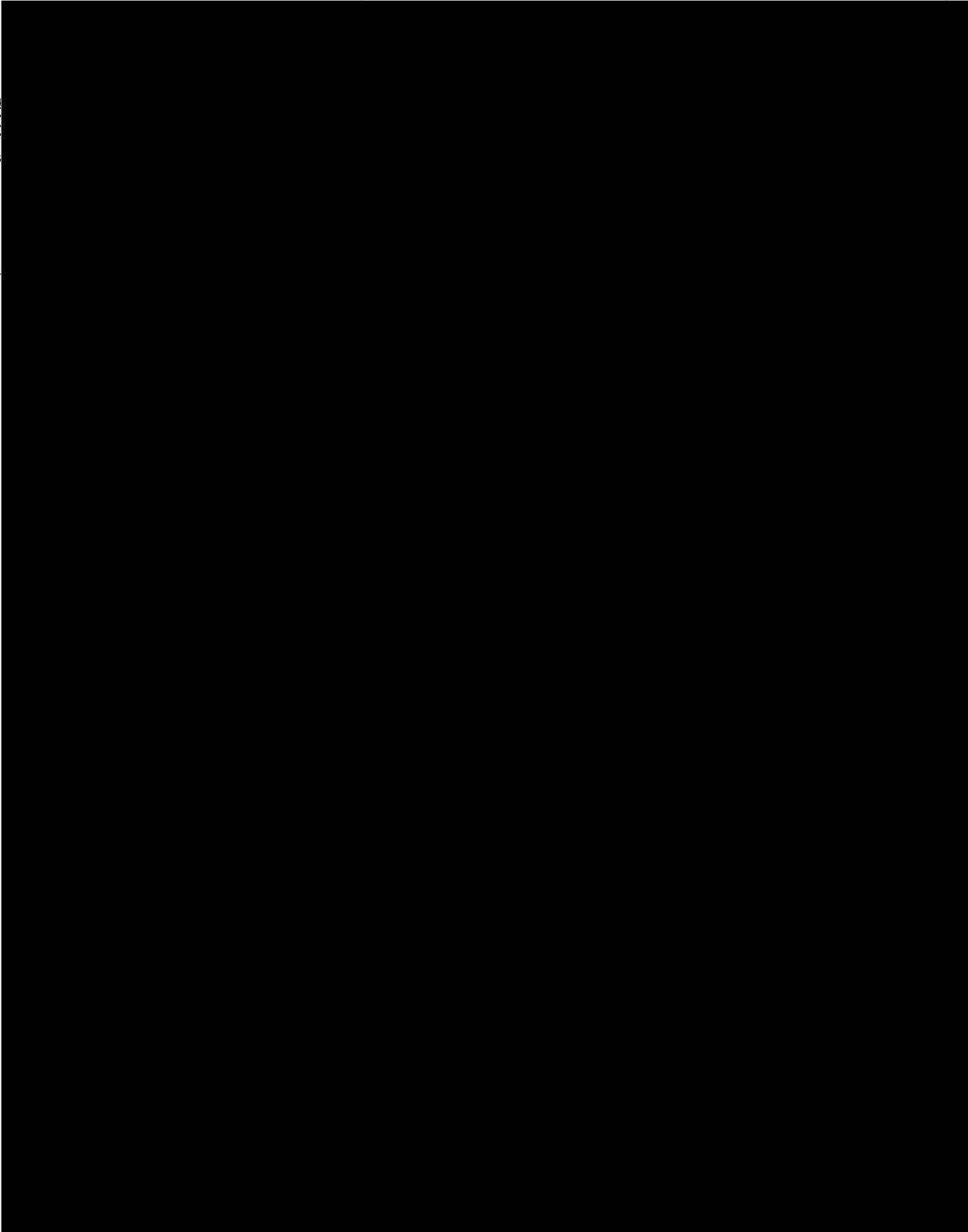


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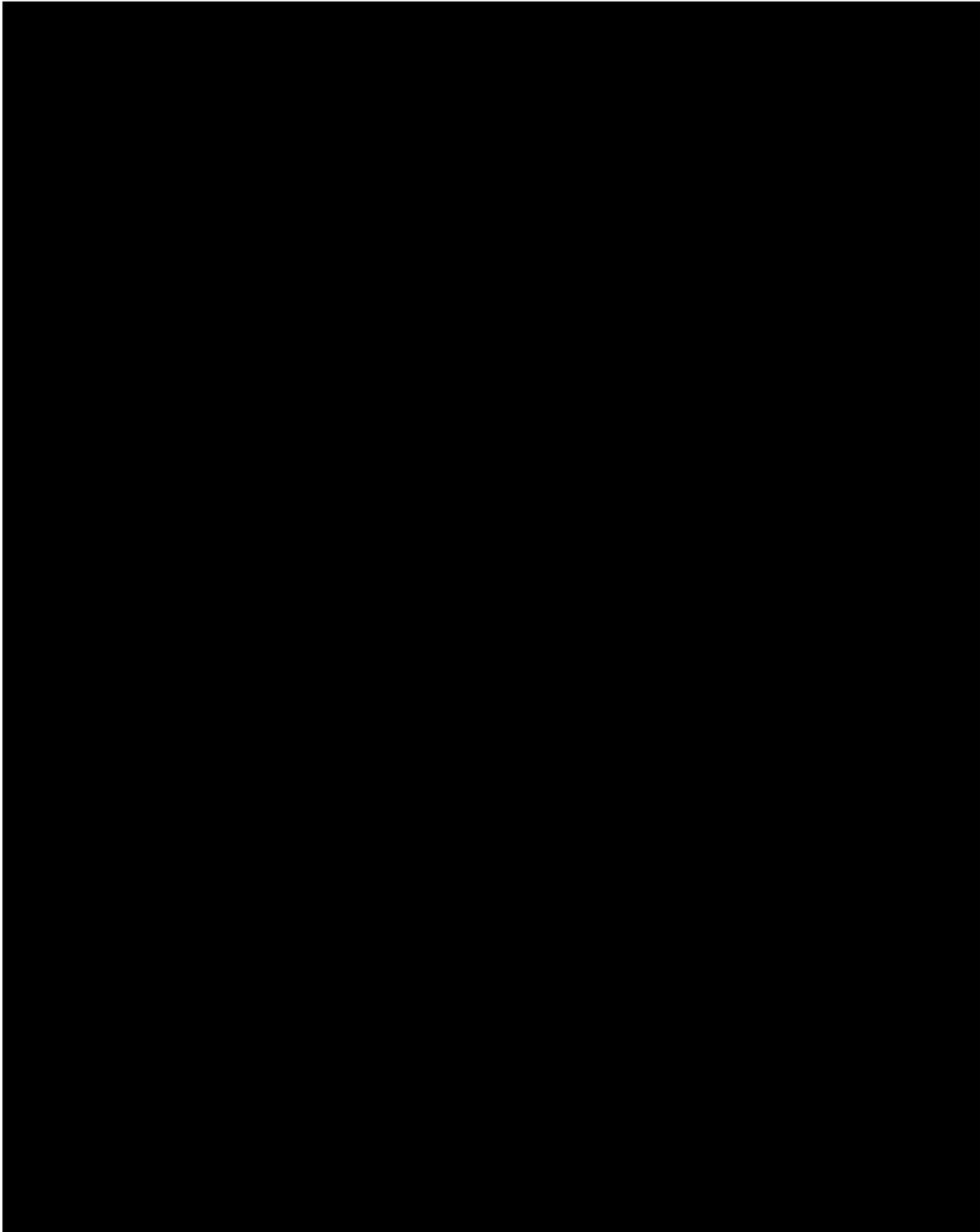


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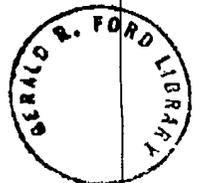


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