Briefing Book for Secretary Simon

Growth, Inflation, and Trade Problems of Major Developed Countries

7 March 1975

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OVERVIEW

The major developed countries are experiencing their sharpest economic contraction in postwar history. For the seven countries as a group -- Canada, France, Italy, Japan, the United States, the United Kingdom, and West Germany -- real gross national product declined at an annual rate of 2.1% in the first half of 1974 and another 1.7% in the second half. Most economic indicators suggest that the slump, already seven quarters long, will not bottom out before mid-1975. For the year as a whole, we expect that the major foreign economies will register only a slight gain in real GNP – 1% or less.

No signs of recovery have yet emerged. The retrenchment in business investment is continuing in response to a profit squeeze evident in all major industries and a rapid buildup of idle plant capacity. Faced with exceptionally weak demand and huge inventories, firms have accelerated production cutbacks. During the last quarter of 1974, industrial output fell at a 22% annual rate -- a postwar record. The January decline was at least as severe. Because demand has sagged even more than output, inventories have continued to grow, pointing to further production cuts in the months ahead.

Unemployment, after rising slowly through most of 1974, accelerated sharply in the fall. The seasonally adjusted jobless rate has hit 7% in Canada; nearly 4% in West Germany, France, and Britain; and a postwar high of 2% in Japan. In addition, a growing number of workers have been put on short work hours. The recession has also sparked a rash of business failures, particularly in Japan and West Germany. Although the bankruptcy rate probably will remain high in early 1975, governments almost certainly will keep key firms from going under.

Despite poor economic prospects, major foreign countries remain reluctant to initiate stimulative measures. The rise in West Germany's federal deficit this year, to an estimated $13 billion, largely reflects a recession-induced decline in revenues rather than new spending programs. Tokyo has concentrated on programs aimed at cushioning the downturn, postponing any major stimulative action until after this spring's wage settlements. Although pressures for expansionary measures are mounting, serious inflation and payments problems limit the action that the United Kingdom and Italy can take. France and Canada are also reluctant to move quickly.

On the inflation front, weak demand has helped slow the three-year-old price spiral in major developed countries. Except in the United Kingdom, the rise in wholesale prices has nearly halted as firms have been forced to absorb cost increases stemming primarily from record wage settlements. The rise in consumer prices has also eased in recent months, to a still unacceptably high annual rate of 12%. Consumer price inflation in all major economies now reflects mainly rising costs for food and services. Although world food prices have eased considerably in recent weeks, the impact at the retail level will not be felt for several months -- and then only if the decline continues.

The major industrial countries are still feeling the impact of higher oil import costs on their trade positions. For the group as a whole, the oil deficit in 1974 increased by about $50 billion, reaching nearly $76 billion. Major shifts in balances in non-oil trade resulted in an uneven distribution of the payments burden among individual countries. Only the Big Three -- West Germany, Japan, and the United States -- were able to offset most or all of the increase by boosting their non-oil trade surplus. West Germany did particularly well, increasing its total surplus by $8 billion.

Italy and the United Kingdom experienced a serious deterioration in their trade and payments positions. Britain's trade deficit was a massive $12.3 billion last year, reflecting a $6 billion jump in oil payments and a further rise in the large non-oil deficit. Italy racked up a $7.7 billion deficit. Because of its poor credit rating, Rome required bail-out assistance from West Germany and the European Community totaling $4 billion.

This pattern is likely to be repeated in 1975 because demand in the Big Three is expected to remain weak. Japan and West Germany probably will boost their surpluses, perhaps considerably. France should reduce its trade deficit from the $3.4 billion incurred last year and avoid serious payments difficulties. The United Kingdom and Italy, on the other hand, will encounter continuing financing problems. Both countries will require funds from recycling schemes to get by without imposing import controls or harsher austerity measures.

DEVELOPED COUNTRIES: INDUSTRIAL SLUMP ACCELERATES

Industrial production in the major countries has dropped in recent months at the sharpest rate since World War II.

Output in the Big Seven has fallen steadily since May, after marking time for five months at the reduced level brought on by the oil embargo. The annual rate of decline accelerated to 17% in October-November; fragmentary information points to an even steeper descent in December-January. Output almost certainly has fallen below the level of two years ago.

Breakdown, by Country and Sector

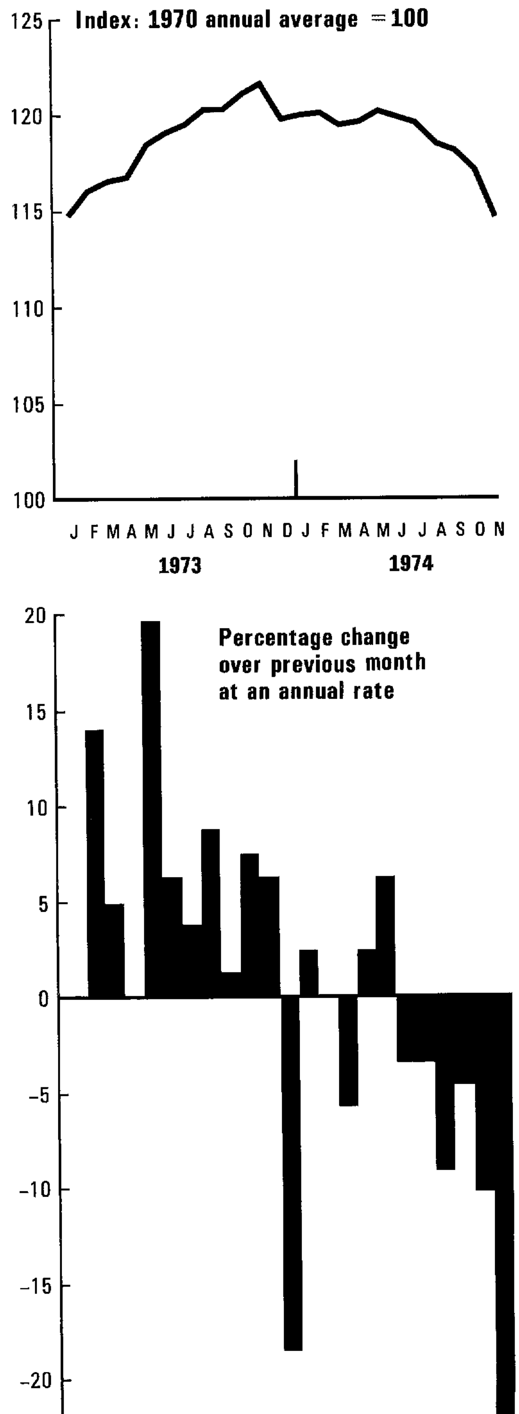
The timing and severity of the industrial decline in the six foreign countries is as follows:

Japan: Production slipped throughout 1974, with the annual rate of decline reaching 18% in June-November and 35% in December.

Italy: After rebounding to an all-time high in June, output fell at an annual rate of 30% in the second half of 1974, to the early-1973 level.

France: Production climbed through August, then declined thereafter at a 25% annual rate.

DEVELOPED COUNTRIES:
Trends in Industrial Production[1]
(seasonally adjusted)



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

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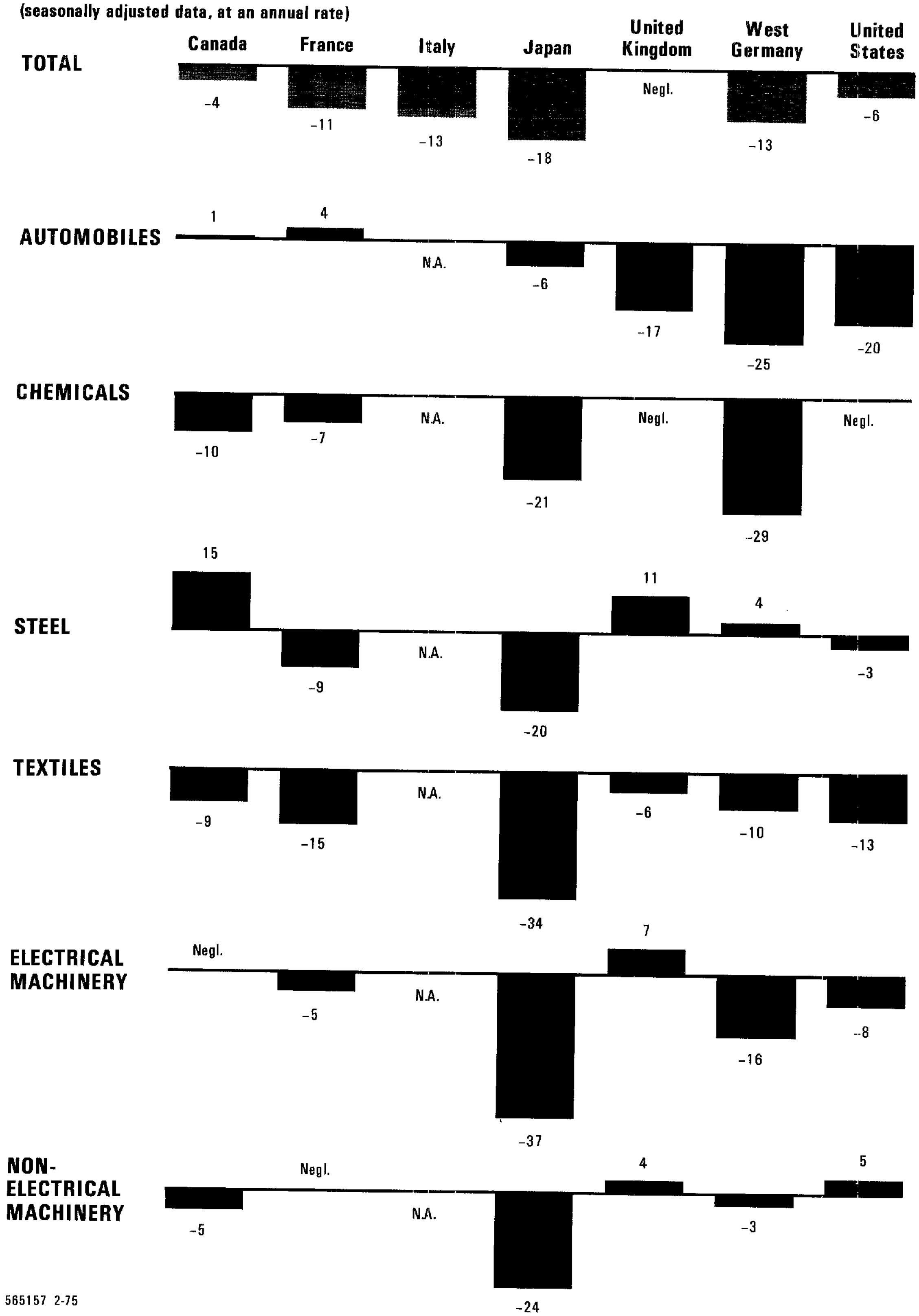
DEVELOPED COUNTRIES:
Percentage Change in Industrial Production, Nov 1974 over May 1974

(seasonally adjusted data, at an annual rate)



West Germany: After stagnating for a year, output declined at an annual rate of 10% in June-September and an estimated 20% in October-November; mass industrial layoffs continued through December-January.

Canada: Since peaking in March, industrial activity has slipped at an annual rate of 7%.

United Kingdom: Output plummeted during last winter's coal strike, rebounded to the prestrike level by August, and then began to sag; output is now roughly 3% below the prestrike rate.

Most major industries have been caught in the downward spiral. In June-November, automobile production dropped precipitously in all countries except France and Canada. West German output showed a 25% rate of decline, the sharpest in the Big Seven. The decline in the Japanese automotive industry amounted to only 6%, because a rapid buildup in inventories offset much of the drop in sales. Chemical production slumped in nearly all countries, with the drop most pronounced in West Germany. Japan led in the falloff in textiles, machinery production, and steel output.

Outlook

The short-term outlook for industrial output is poor. Despite recent cuts in production, inventories remain high and will retard recovery. Moreover, demand—both domestic and foreign—is expected to be weak for several more months. While the decline in industrial activity probably will bottom out by midyear, output almost certainly will be lower in the first half of 1975 than in the second half of 1974.

DEVELOPED COUNTRIES: THE SLUMP IN PERSPECTIVE

The economic contraction in the major developed countries, already seven quarters long, is the sharpest since World War II.

Composite GNP in the Big Six foreign economies fell from a level 2-1/2 percentage points above the long-term trend in early 1973 to 5 percentage points below trend by the end of 1974. This change is two to three times the drop in comparable periods of the two previous postwar contractions.

So far, the contraction has been most severe in Japan and mildest in Italy.

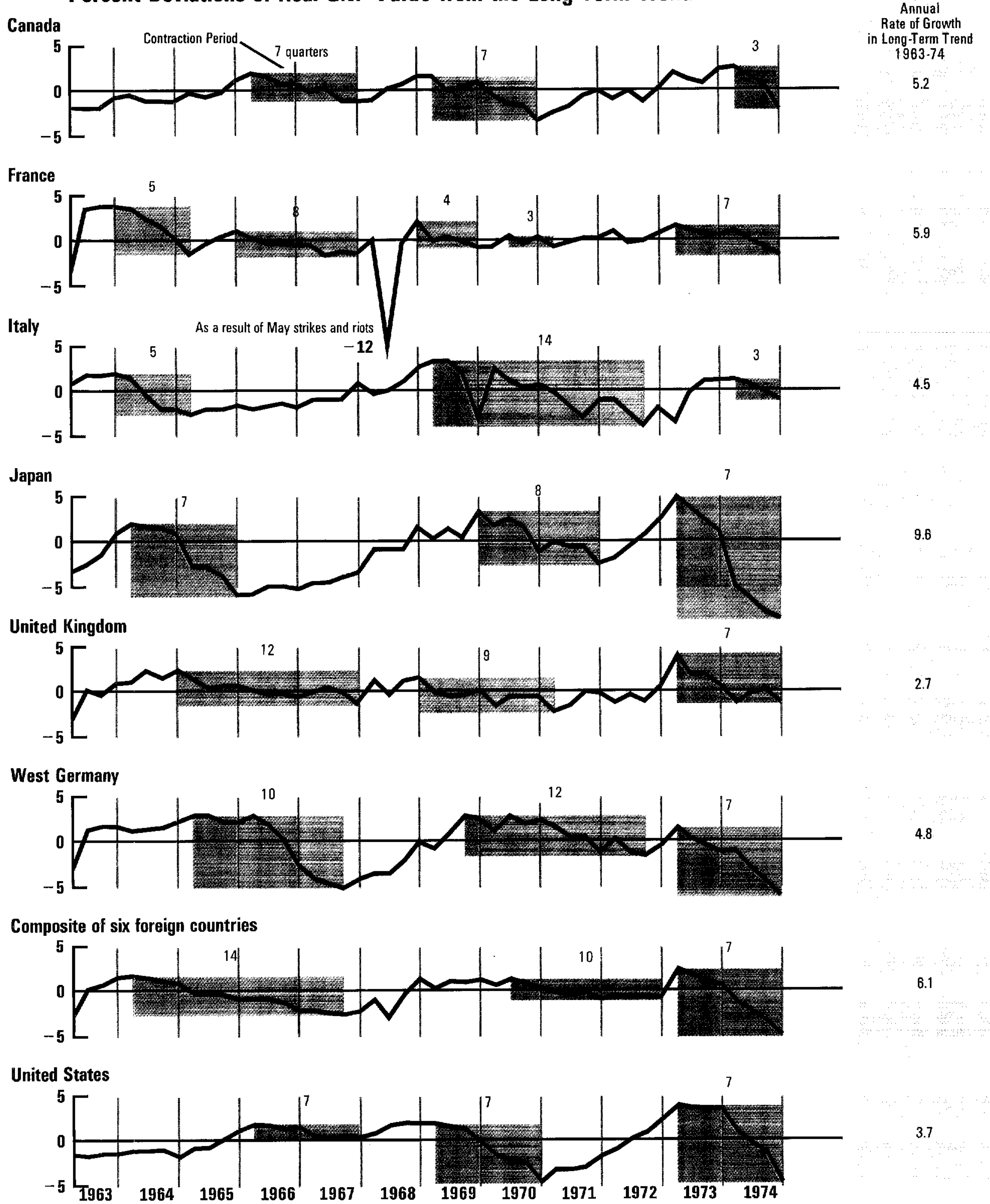
> ***Japan***: The deviation of GNP from the long-term trend has moved from plus 5 percentage points to minus 9 percentage points – an unprecedented post-WWII decline for a major country.
>
> ***United Kingdom***: The contraction already exceeds the declines of the past two slumps.
>
> ***West Germany***: The falloff in growth has now reached the magnitude of the 1966-67 recession.
>
> ***Canada***: In the last three quarters of 1974, the economy sagged as badly as in the seven-quarter recession in 1969-70.
>
> ***France***: In a country noted for steady economic expansion, GNP had slipped 2 percentage points below the trend by late 1974.
>
> ***Italy***: The slump, under way for only three quarters, still is shallow compared with the recession of 1969-72.

The severity of the slump results largely from two factors: (a) the simultaneous beginning of the contraction in several countries, which caused foreign as well as domestic demand to weaken, and (b) oil price hikes and supply squeezes over the past 16 months, which have depressed GNP both directly and indirectly.

The recession has several quarters to go, to judge from the length of the two previous slumps and from the special circumstances of the current slowdown.

DEVELOPED COUNTRIES:

Percent Deviations of Real GNP Value from the Long-Term Trend[1]



[1] The long-term trend is a 25-quarter moving average of seasonally adjusted GNP values at constant prices. Trend values for 1972-74 were obtained by extrapolating the growth rate indicated by the moving averages for 1970-71.

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Oil prices will remain high, lengthening the period of weak demand and placing unprecedented burdens on national and international financial institutions. Governments have been, and will continue to be, slower than usual to react to the slump because of preoccupation with inflation and balance-of-payments problems. Expansion programs, even when adopted, will not be fully felt for a half year or so.

DEVELOPED COUNTRIES: OIL CRISIS AND ECONOMIC GROWTH*

The oil price hike has simultaneously contracted demand and inflated prices in the industrial world. It played a major role in the sharp drop in industrial output and business confidence in 1974. Its effects -- particularly on trade balances and money markets -- darken prospects for an economic rebound in 1975.

An External Shock

The cuts in OPEC oil production in late 1973 and the breathtaking rise in oil prices dealt the major industrial economies an unprecedented external shock. The shock was exceptionally severe because it came roughly six months after the major countries, in near unison, had adopted more restrictive policies to slow their overheated economies. As a result, instead of the planned soft landing, the real annual rate of growth for the six major foreign economies plunged from 9.1% in the first half of 1973 to a negative 0.9% in the first half of 1974. GNP remained in this depressed state through the end of the year, showing practically no growth in the second half over the first. If the United States is included, GNP growth slumped from 8.2% in the first half of 1973 to a negative 2.1% in the first half of 1974 and a negative 1.7% in the second half.

Business and consumer confidence continued to slide; inventories mounted. Real investment in the six major foreign countries fell off at an annual rate of 11.5% in the first half of 1974 and at an estimated 3.6% in the second half. Growth in private consumption was near zero in the first half of 1974 and recovered only slightly thereafter. Final domestic demand for the year as a whole declined at a rate of 0.2%.

Industrial output in the six major foreign countries weakened progressively throughout 1974. Their combined monthly output had fallen below the year-earlier level by August and has since continued to sag. In November, output was down by an estimated 7%. Japan and West Germany -- the two largest foreign economies -- showed declines of 13% and 7%, respectively.

* This article does not attempt to *quantify* the growth impact of higher oil prices as distinct from other factors in the world economic slowdown. Such an assessment would depend heavily on assumptions concerning values and lags of various multipliers -- the reliability of which would be questionable, given recent radical changes in the world economy.

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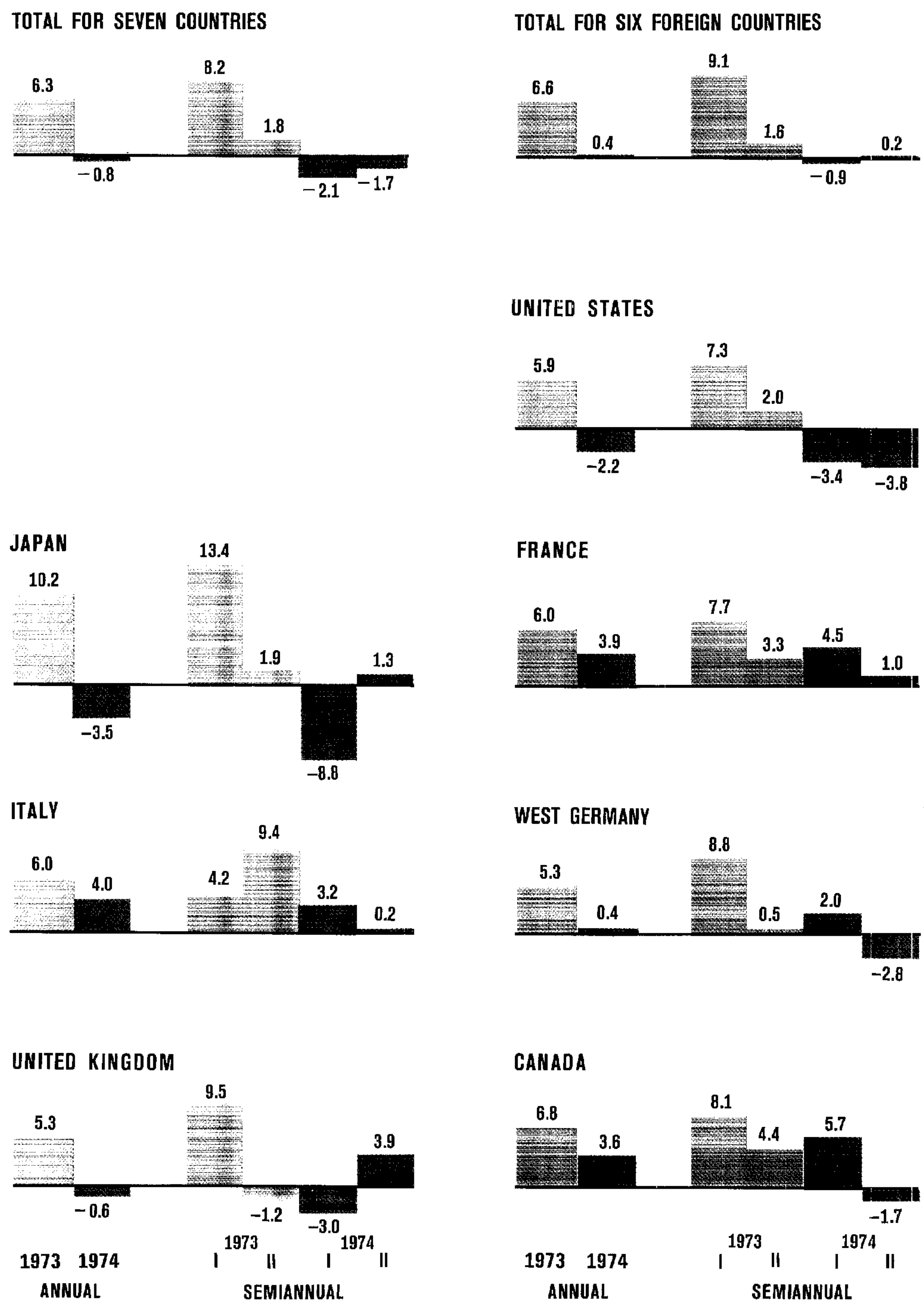
DEVELOPED COUNTRIES: Changes in Real GNP

Percent Change over Previous Period; Semiannual Data at Annual Rates, Seasonally Adjusted



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Unemployment in these countries as a group rose 40% during 1974. The number of unemployed in West Germany about doubled, to nearly 1 million workers. In Japan, the policy of providing lifetime jobs limited the rise in unemployment to 8% until December, when layoffs spurted. The United Kingdom, France, Italy, and Canada experienced rises in unemployment of between 15% and 35%.

Individual Countries

Among the industrialized countries, ***Japan*** suffered the sharpest decline in GNP last year. Total output dropped at an 8.8% annual rate in the first half, improving by a meager 1.3% in the second half. Both consumption and fixed investment fell sharply, pulling down final domestic demand by 5.0% for the year. The GNP slump would have been even worse had inventories not been allowed to mount. With inflation still running at 20%, Tokyo has held to the restrictive policies that are exacerbating the contractionary effects of the oil price hike.

The ***United Kingdom*** suffered a 0.6% drop in GNP for 1974, after the 5.3% gain of 1973. Because of a prolonged coal strike and the oil crisis, growth at an annual rate was a negative 3.0% in the first half of 1974 on top of a decline in the second half of the preceding year. GNP recovered at an estimated 3.9% annual rate during July-December 1974; its value nevertheless remained slightly below that reached in the first half of 1973.

Developed Countries: Changes in Real GNP and Components, 1974

Percent Change over 1973

	Japan	West Germany	France	Italy	United Kingdom	Canada	United States	Total	Total Excluding the United States
Private consumption	-0.3	-0	4.0	4.0	-0.3	5.5	-2.2	-0.3	1.5
Government purchases of goods and services	-8.6	3.4	3.6	1.6	2.0	6.7	1.0	0.6	0.2
Gross fixed investment	-11.4	-6.5	3.3	4.7	-5.5	8.4	-7.2	-6.0	-4.8
Plant and equipment	-10.5	-8.1	4.7	9.9	0.7	11.1	-0.3	-2.1	-3.8
Construction	-13.5	-5.2	0.6	1.6	-29.9	2.1	-27.1	-16.4	-6.5
Final domestic demand	-5.0	-1.0	3.8	3.6	-0.3	6.3	-2.4	-1.3	-0.2
Exports of goods and services	18.7	14.0	7.0	4.2	5.1	-1.3	7.5	8.6	9.6
Imports of goods and services	10.7	5.2	5.5	0.4	1.1	10.5	1.0	3.3	5.5
Net foreign balance[1]	0.9	2.3	0.4	0.9	0.8	-3.1	0.5	0.7	0.8
Stockbuilding[1]	0.6	-0.9	-0.3	-0.3	-1.1	0.4	-0.3	-0.3	-0.3
GNP	-3.5	0.4	3.9	4.0	-0.6	3.6	-2.2	-0.8	0.4

1. Changes in the net foreign balance and the rate of stockbuilding are expressed as a percent of previous period's GNP, presented at an annual rate.

Thanks solely to moderate increases in government spending and in net foreign demand, ***West Germany*** managed to keep output at the 1973 level. Growth slipped from 5.3% in 1973 -- attributable to a banner first half -- to 0.4% last year. A dramatic falloff in business investment and continued apathy among consumers plagued the economy throughout the year. Because a drop in export demand added to the domestic slump in the second half, GNP fell by 2.8% during July-December.

When the oil crisis hit, the ***Italian*** economy was recuperating from an economic slowdown caused by business malaise and massive strikes. Despite still-strong domestic demand, growth plummeted from an annual rate of 9.4% in the second half of 1973 to 3.2% in the first half of 1974. An austerity program, induced by severe balance-of-payments problems, dropped the growth rate to near zero in the second half of the year.

France's growth rate actually rose in the first half of 1974 because of strong consumer demand and still buoyant investment. Growth slumped from 4.5% to an estimated 1.0% in the second half, however, as investment plunged in reaction to harsh government taxes and restraints on business and as demand for French exports slumped.

As a net exporter of oil, ***Canada*** at first benefited from the sharp hike in oil prices. GNP growth increased to 5.7% in the first half of 1974, compared with 4.4% in the second half of 1973. During July-December, however, housing investment fell precipitously in the wake of a jump in interest rates, and exports were hurt by weak US demand. Growth dropped to an estimated annual rate of negative 1.7%.

Outlook

Prospects for substantial growth in 1975 are dim. Continued weak demand for investment goods, depressed export markets, and a large overhang of inventories will hobble recovery. Private consumption and government spending will be the major strong points. On balance, the six foreign economies should show a growth of less than 1% for the year as a whole. Most of this growth will occur after midyear.

DEVELOPED COUNTRIES: EXCESS CAPACITY BECOMES A PROBLEM

The continued rapid buildup of idle industrial capacity in major developed countries bodes ill for an early revival in capital spending.

Still at low levels in early 1974, surplus capacity developed rapidly after midyear, when industrial output began falling. By yearend, excess capacity* in most of the countries was near or beyond the highest level reached in any recession of the previous 20 years.

- Japanese industry has the largest amount of slack, with output (seasonally adjusted) running 20% below capacity.
- Italian industry is operating nearly 15% below capacity.
- West German production is running an estimated 10%-15% below potential, about as much as in the 1967 slump.
- British output is roughly 10% below capacity – little better than in early 1974, when industry was on a short workweek.
- In France and Canada, where industrial output has held up comparatively well, 5%-10% of capacity is idle.

The auto industries have the most slack, operating 30%-40% below capacity in most countries. Capacity utilization has declined sharply in the textile industries, because of the 10%-15% drop in output over the past year. Basic industries, operating near capacity six months ago, have also begun to develop considerable slack. In the ferrous and nonferrous metals industries, for example, utilization rates had fallen well below normal by late 1974.

With the growth in unused capacity, industrial expansion programs are being pruned. The falloff in new orders for machinery and equipment, evident through the first three quarters of 1974, apparently accelerated in the fourth. Numerous surveys of planned investment point to further cuts in capital spending over the next few quarters. Industrial investment thus promises to remain a drag on economic recovery in 1975.

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* 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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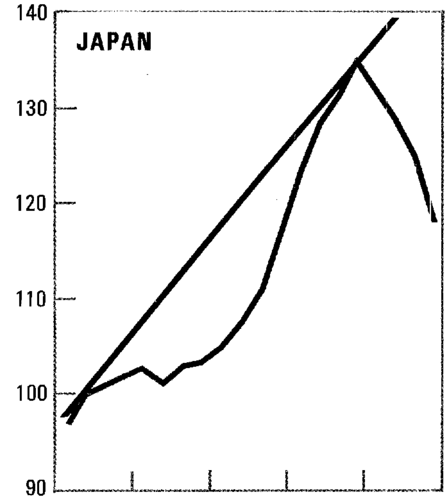
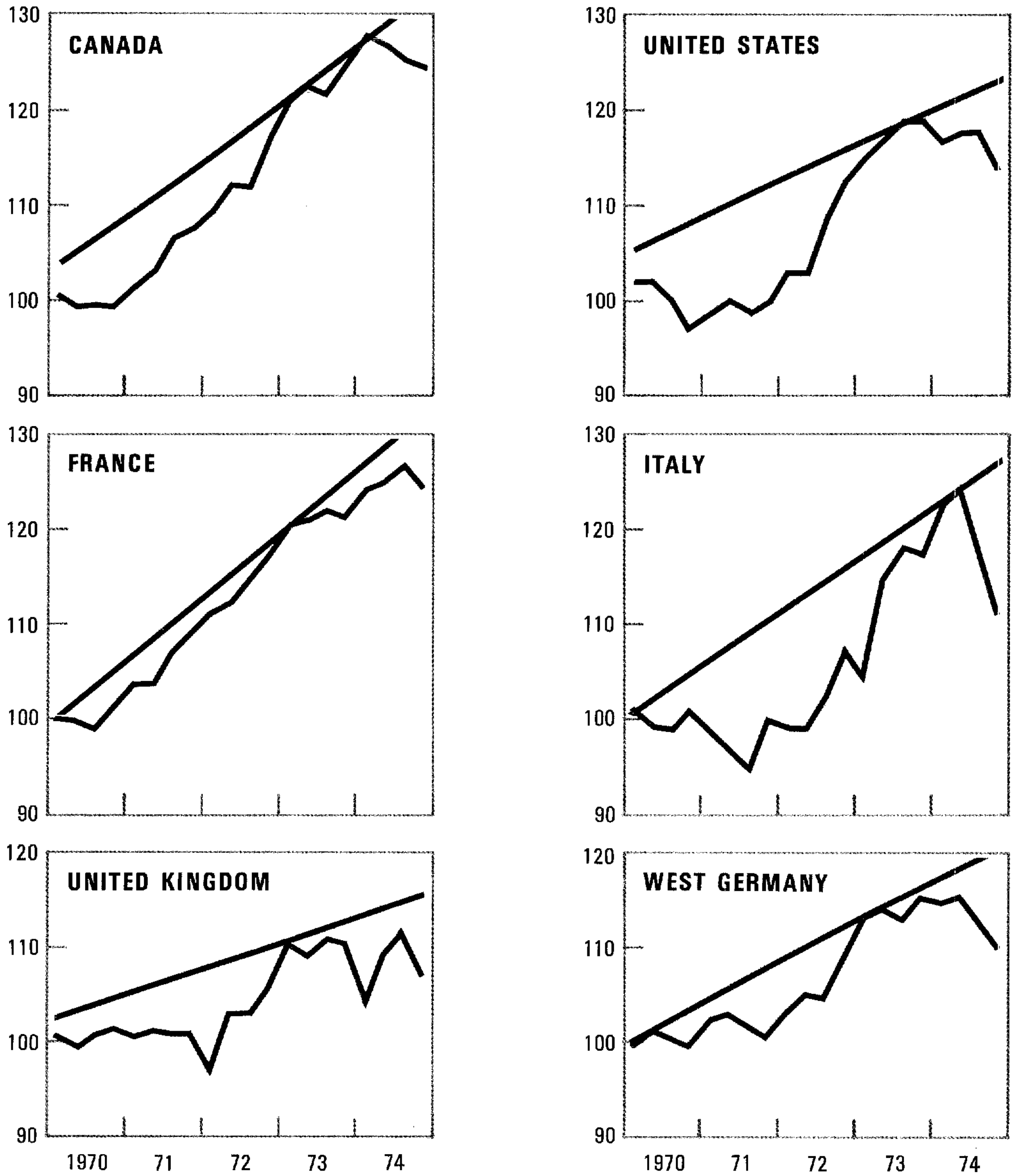
DEVELOPED COUNTRIES: INDUSTRIAL CAPACITY AND OUTPUT TRENDS

INDEX 1970 ANNUAL AVERAGE = 100
SEASONALLY ADJUSTED





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DEVELOPED COUNTRIES: SHAMBLES IN HOUSING CONSTRUCTION

Housing construction in major developed countries is experiencing one of its sharpest downturns in 30 years and faces continuing hard times in 1975.

Housing starts began to fall off in several countries in 1973 because of overbuilding and rising construction costs. The problem deepened in 1974 when costs rose further and tight money kept many consumers and builders out of the market. Japan, West Germany, the United Kingdom, and the United States have been the hardest hit so far.

Country Situations

Housing starts in ***Japan*** were down 36% in the second quarter of 1974 from a year earlier and picked up only slightly in the third quarter. Although dismissals of workers have been limited by the Japanese policy of providing lifetime jobs, unemployment has increased considerably faster in construction than in other sectors.

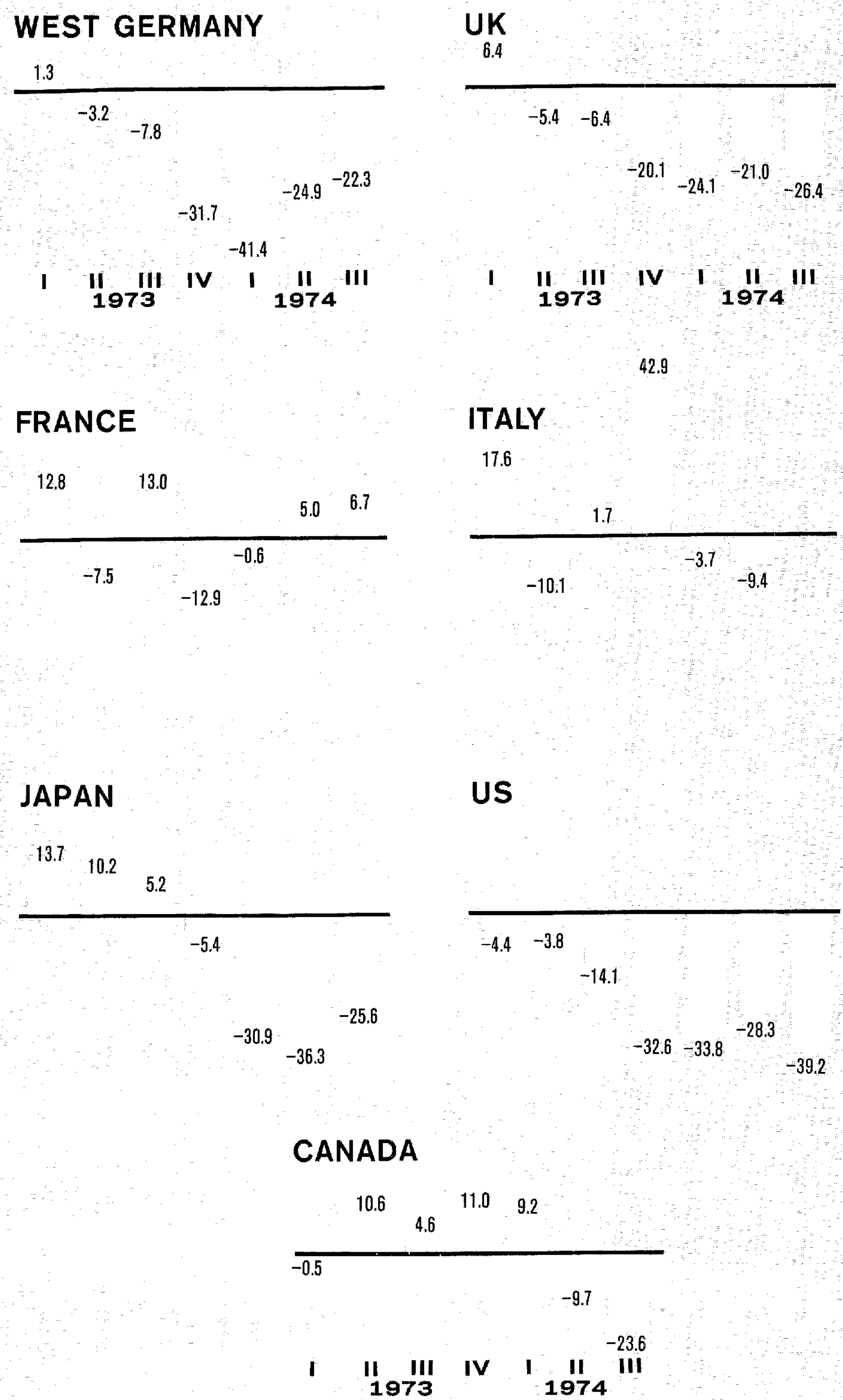
The ***West German*** housing construction industry, long accustomed to boom conditions, has slipped badly since late 1973. Housing starts were off 41% by the first quarter of 1974 and have remained far below 1973 levels. A shift of construction workers to nonresidential projects held unemployment in construction in the third quarter to 6.7%, or five times the year-earlier level.

In the ***United Kingdom***, housing starts dropped by about one-fourth in 1974. Mortgage rates of 14% - 14-1/2% were a major factor in the decline. Unemployment in the construction industry has been running at 14%, accounting for one-fifth of the national total.

France is the one major country in which residential building has held up well. The industry has benefited from government housing subsidies and, until recently, the economy's strong performance. Employment has been propped up by public works projects.

In ***Italy***, housing construction began to drop in 1974 after a generally strong showing the previous year. Housing starts dropped by 9% in the second quarter, compared with the same quarter of 1973 -- itself a soft period. The decline has prompted the Treasury to reduce the discount rate to 8%.

Developed Countries: Trends in Residential Construction*
(Percent)



* percent change in housing starts compared with same period in previous year.

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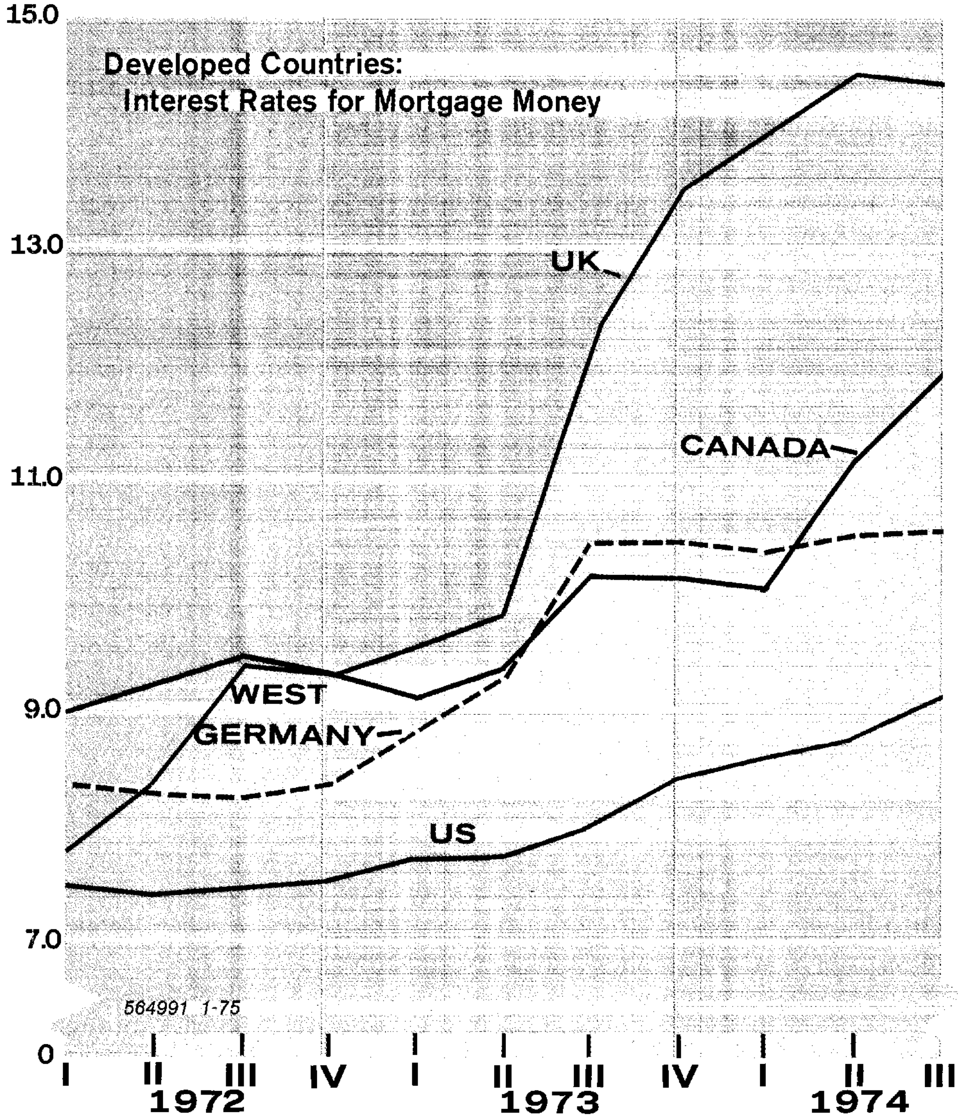


In *Canada*, housing construction remained brisk until the second quarter of 1974. By September, starts had plummeted 24% from the 1973 level, partly because of a 2-percentage point rise in mortgage rates.

Outlook

Even with an easing of credit in 1975, recovery in housing construction will be impeded by the pinch on real incomes, general economic uncertainty, and prices that place homes beyond the reach of many families. Even when the job market improves and the economic climate brightens, a heavy backlog of unsold dwellings will absorb much of the rise in demand.

DEVELOPED COUNTRIES: OVERHANG OF INVENTORIES

The continuing buildup in inventories in major industrial countries, while softening the slump, poses an obstacle to early recovery.

In each of the five countries for which data are available, the real value of additions to stocks from the spring of 1973 to the fall of 1974 exceeded the real increment in GNP – a rare phenomenon. If it had not been for stock-building, GNP would have dropped in most of these countries during the last three quarters of 1973 instead of merely showing a smaller rate of growth. In 1974, the continued accumulation of stocks moderated the leveling off or decline of GNP experienced in these countries. By contrast, inventories plummeted in 1958, the last recession to bring a drop in the aggregrate GNP of the major industrial countries.

In the earlier part of the economic slowdown, firms continued to build stocks because they expected demand to revive quickly. Moreover, material shortages and accelerating inflation made stock-building attractive. In 1974, the drop in final demand was so abrupt that sales slumped even more than output, resulting in an unplannned increase in stocks.

Japan has had the most pronounced buildup in inventories. In the first nine months of 1974, $15 billion worth of stocks (at 1973 prices) were added while GNP was suffering a cumulative loss of $6 billion. Since early 1972, accumulation of inventories in excess of the historic stock/output norm has totaled about $35 billion – a figure equal to 8% of annual GNP.

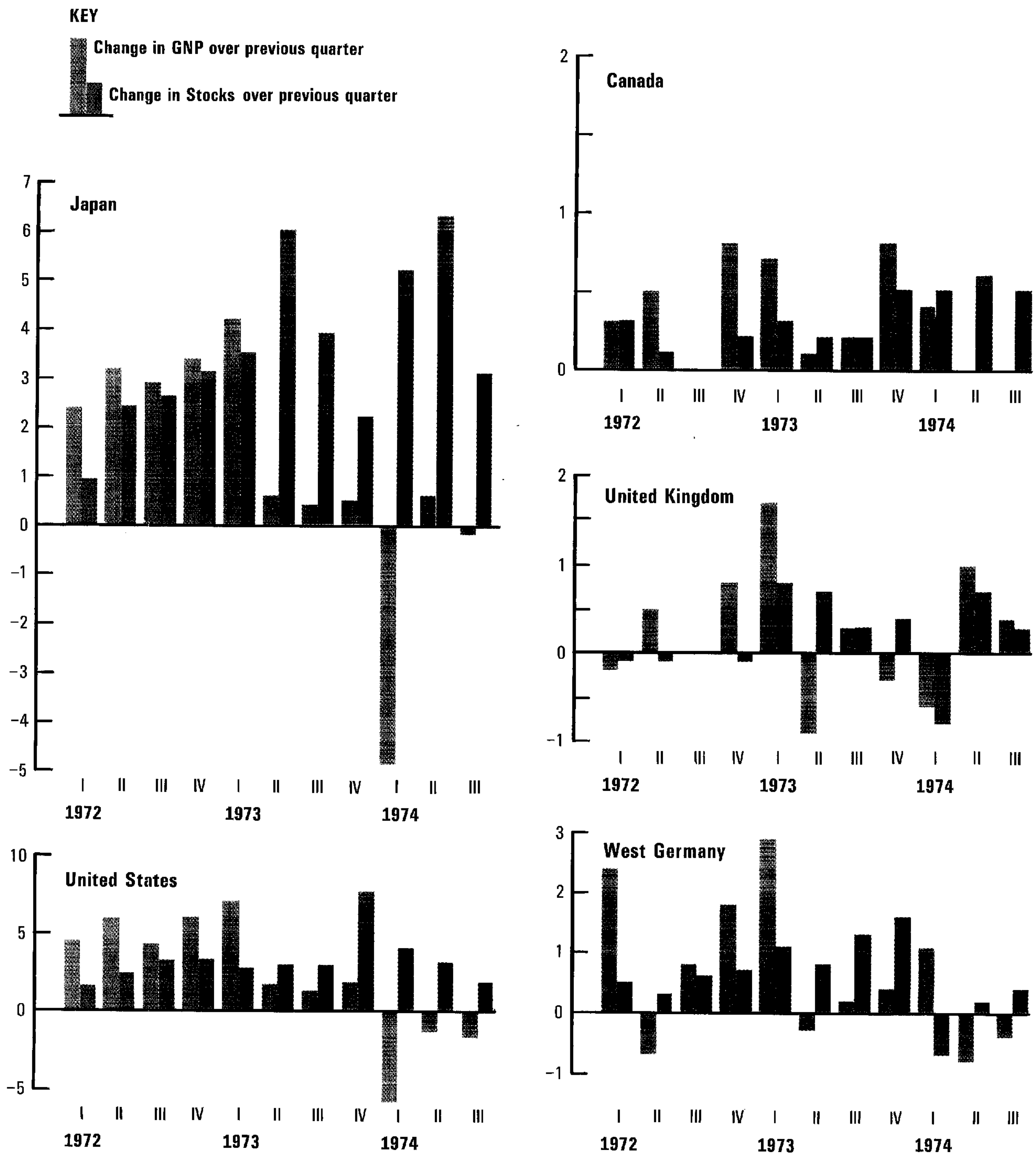
In ***Canada***, inventory accumulation ran at normal levels through 1973. Stock-building subsequently has accelerated even though the GNP growth rate has plunged. By September 1974, abnormal accumulations of goods equaled 2% of annual GNP.

In ***West Germany*** and the ***United Kingdom***, inventory accumulation has been erratic. Stocks were drawn down in the first quarter of 1974 because of increased foreign demand for German products and the three-day work week in the United Kingdom. In the next two quarters, stocks grew rapidly. In September, the excess accumulation was still less than 1% of GNP in both countries.

The timing and pace of economic recovery in these countries will depend heavily on how rapidly industry tries to bring stocks back to desired levels. If business chooses to liquidate stocks before final demand revives, the current recession will be deepened but recovery will be more rapid once begun. If firms hold stocks constant and allow an increase in demand to gradually improve the stock/output ratio, below-normal stock accumulations will act as a drag on recovery.

Changes in Stocks and GNP[1]

Billion 1973 US $ (seasonally adjusted)



[1] Each graph is scaled according to the relative size of the country's GNP.

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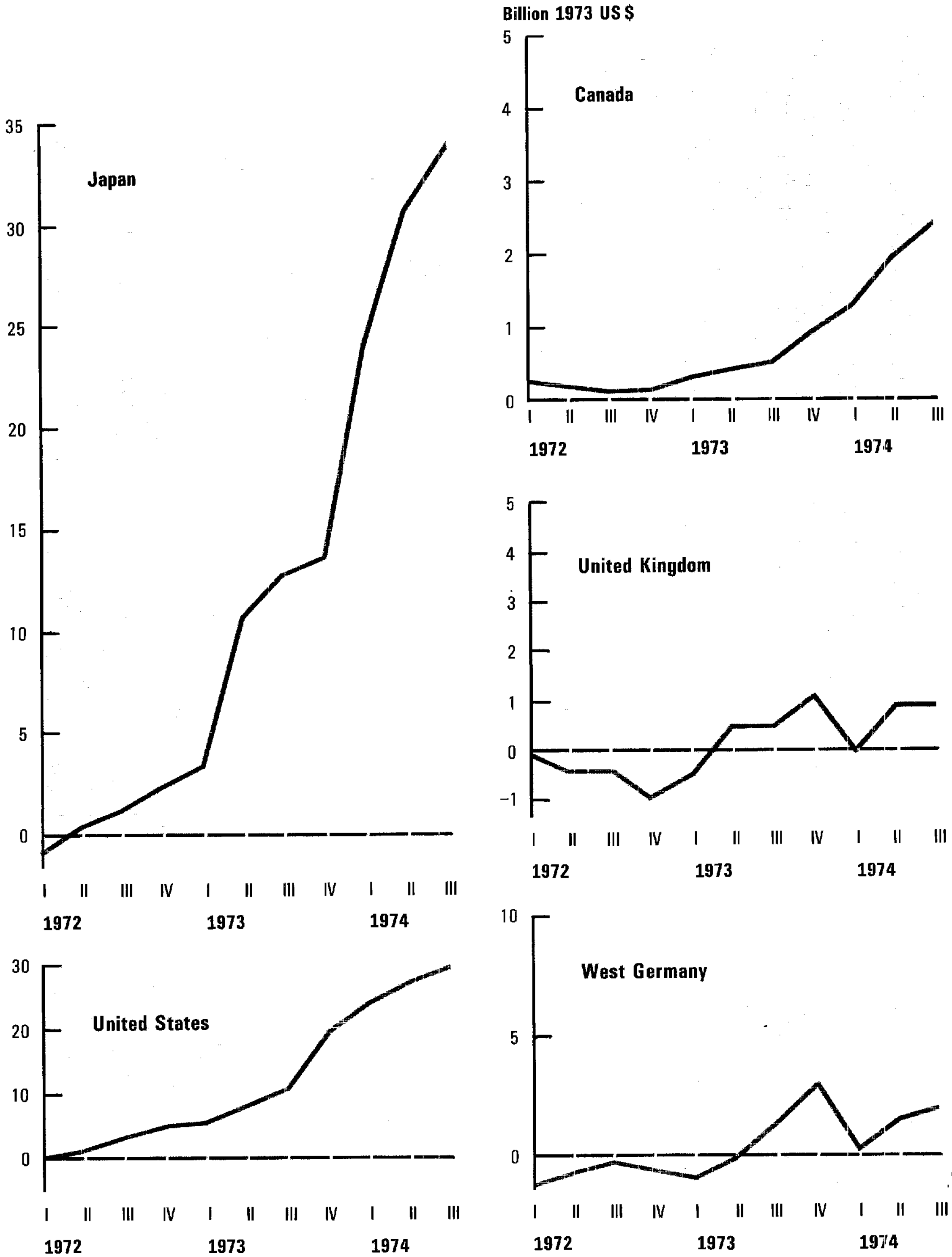
Cumulative Abnormal Additions to Stocks[1]



NOTE: Defined as the difference between total additions to stocks and the product of changes in final demand (GNP minus stock changes) and the long-term marginal stock/out ratio.

[1] Each graph is scaled according to the relative size of the country's GNP.

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DEVELOPED COUNTRIES: NO CHEER IN INVESTMENT INDICATORS

Leading indicators point to a further decline in private investment in major industrial countries over the months ahead. Afflicted with excess capacity and a profit squeeze, business firms are likely to hold back on capital spending even if governments soon adopt expansionary measures. Compared with the recent peaks, real private outlays on plant and equipment are already down 19% in Japan, 12% in West Germany, and 4% in the United Kingdom.

New orders for machinery and equipment, the most important investment indicator, declined in the third quarter in four of the five countries for which data are available.

- Canadian orders fell 10% from the second quarter on a seasonally adjusted basis, to the lowest level in a year.
- British orders slipped by 3%, after a 15% drop in the first quarter and a slight increase in the second.
- West German orders declined 4%, the second consecutive quarterly decline.
- US orders fell about 2%, following a 6% decline in the first quarter and a 2% increase in the second.
- Japanese orders rose 20% from the previous depressed level.

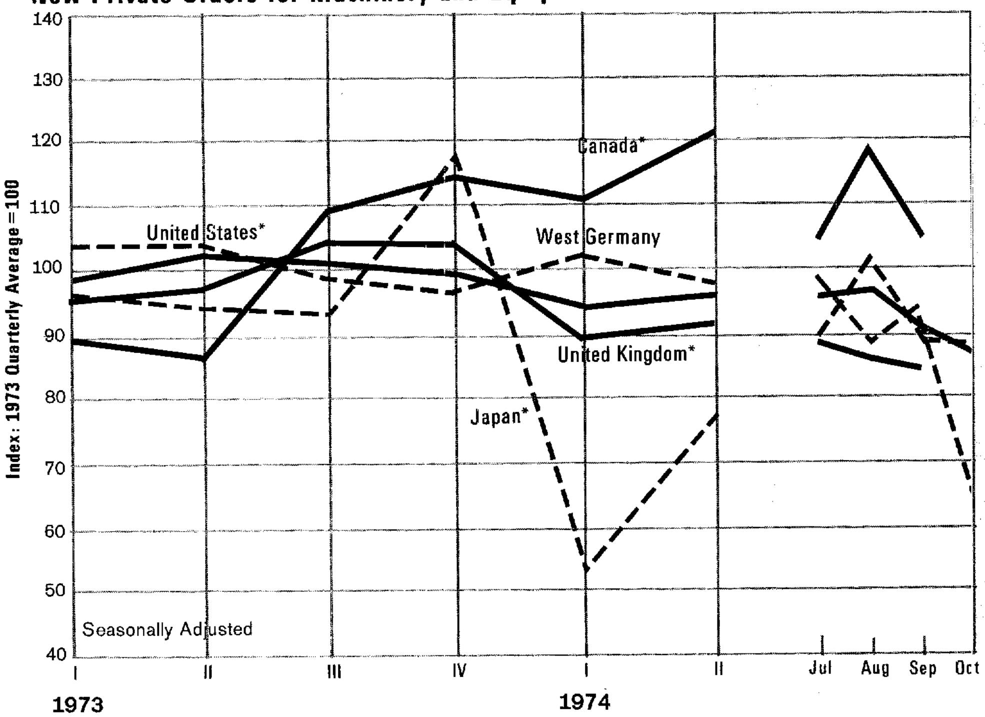
Scattered data for October indicate that new orders plunged in Japan and that the downward trend continued in most countries. Surveys of investment plans suggest that Italian and French orders also have fallen in recent months.

In most countries, orders for non-residential construction stagnated or declined in the third quarter. The 13% drop in Canada was the steepest among foreign countries. Orders fell 3% in the United Kingdom, the fourth consecutive quarterly decline, while Japanese and West German orders remained depressed.

In practically all developed countries, the textile, automobile, and appliance industries already are operating well below capacity. The steel industry is reluctant to increase investment because of an expected fall in demand from the high level of 1974. EC steel producers, for example, plan to cut their outlays by 30% in 1975.

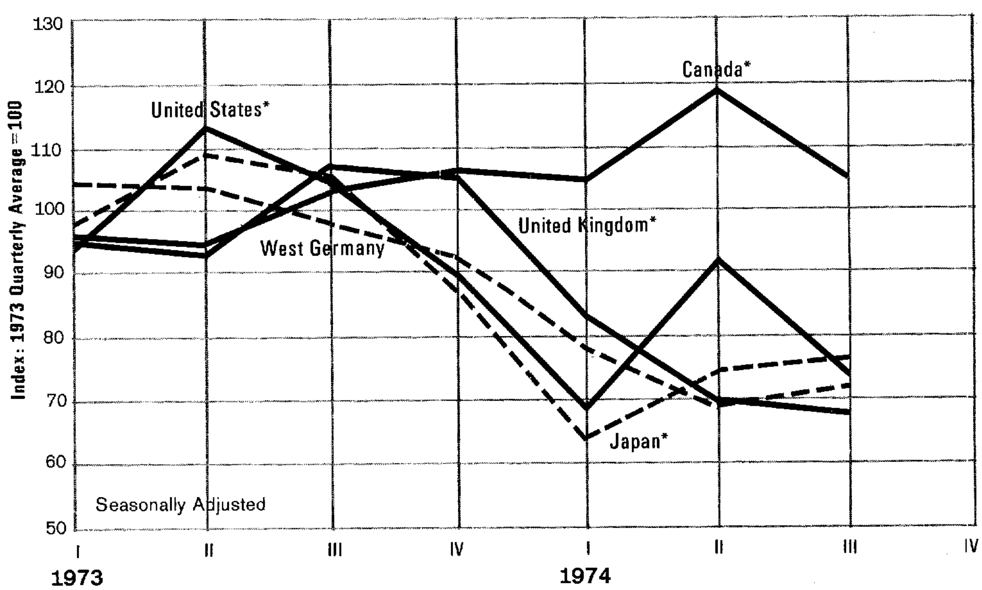
DEVELOPED COUNTRIES: Leading Investment Indicators

New Private Orders for Machinery and Equipment



*Value series deflated by wholesale price index for machinery and equipment.

New Orders for Private Non-Residential Construction



*Value series deflated by wholesale price index for construction materials.

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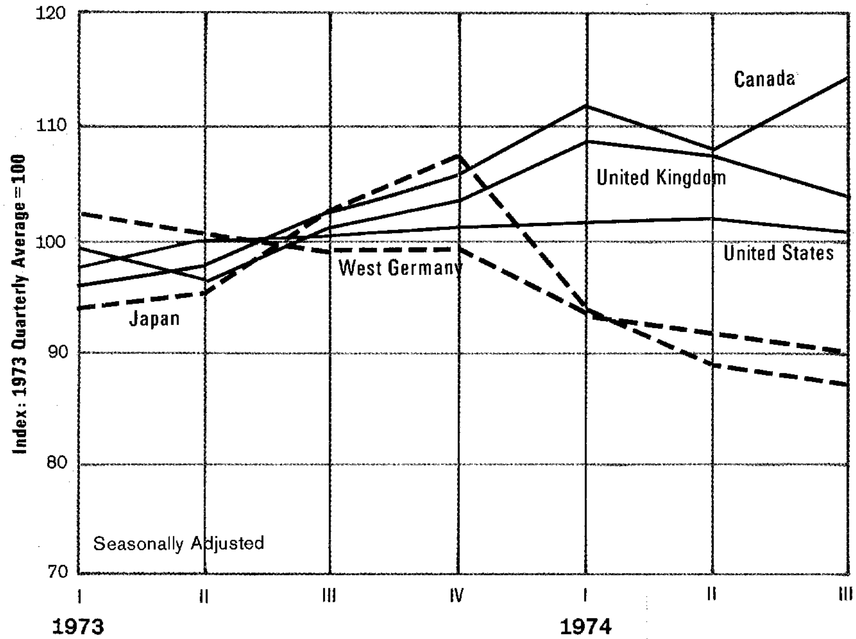
Developed Countries: Real Private Spending on Plant and Equipment



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Relaxation of monetary policy probably would not spark investment, because credit no longer appears to be a major constraint. In Japan and apparently in France as well, commercial bank lending is running below the permitted level. In any case, a minimum of one-half usually passes before business responds to policy changes.

DEVELOPED COUNTRIES: INFLATION BULLETIN

The price spiral in major foreign developed countries, now almost three years old, shows signs of breaking. Increases in wholesale prices (in terms of seasonally adjusted, three-month moving averages) plummeted in the last half of 1974 to nearly zero. The rise in consumer prices eased toward the end of the year -- to a still unacceptably high annual rate of about 12%. Although recent West German wage negotiations have resulted in comparatively moderate increases of 7% per year, generous pay hikes in other major countries continue to be layered [illegible] the industrial cost structure.

Wholesale Prices

Wholesale prices seasonally adjusted have declined by 5% in Japan since October, by 3% in France since September, and by 1% in Canada since November. In West Germany, Italy, and the United States, prices have been rising at a much reduced rate over the past several months. Only in the United Kingdom have wholesale price rises recently accelerated – mainly because price controls were relaxed.

The break in wholesale prices stems primarily from the fall in demand rather than a reduction in cost pressures. While wage rates in such countries as Canada, Italy, and Japan are still increasing at a 20% annual rate, industrial firms are no longer able to fully pass on the added costs.

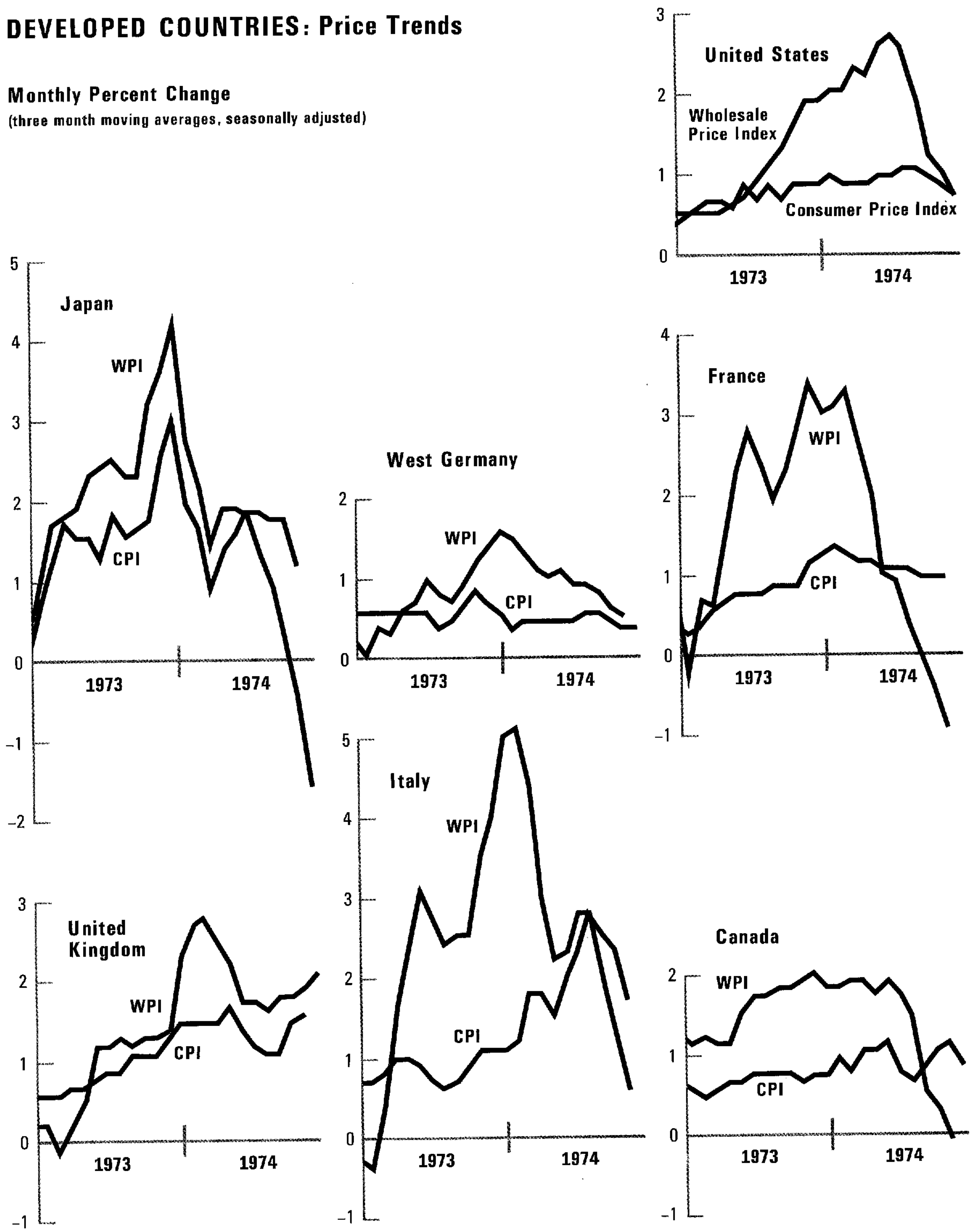
Consumer Prices

The continued rise in consumer prices reflects mainly growing costs for food and services. On the average, increases in food prices have recently accounted for almost one-half of the consumer price rise in major foreign economies. Growth in prices for manufactured goods has slowed to a 4% annual rate in recent months, down from the 15% rate of last fall.

Recent declines in wholesale prices of industrial goods should help slow the pace of consumer price inflation in the near future. The easing of world food prices will not be felt at the retail level for several months – and then only if the decline continues. Because stocks of most foodstuffs remain tight, poor harvests would set off another round of price hikes.

DEVELOPED COUNTRIES: Price Trends

Monthly Percent Change
(three month moving averages, seasonally adjusted)



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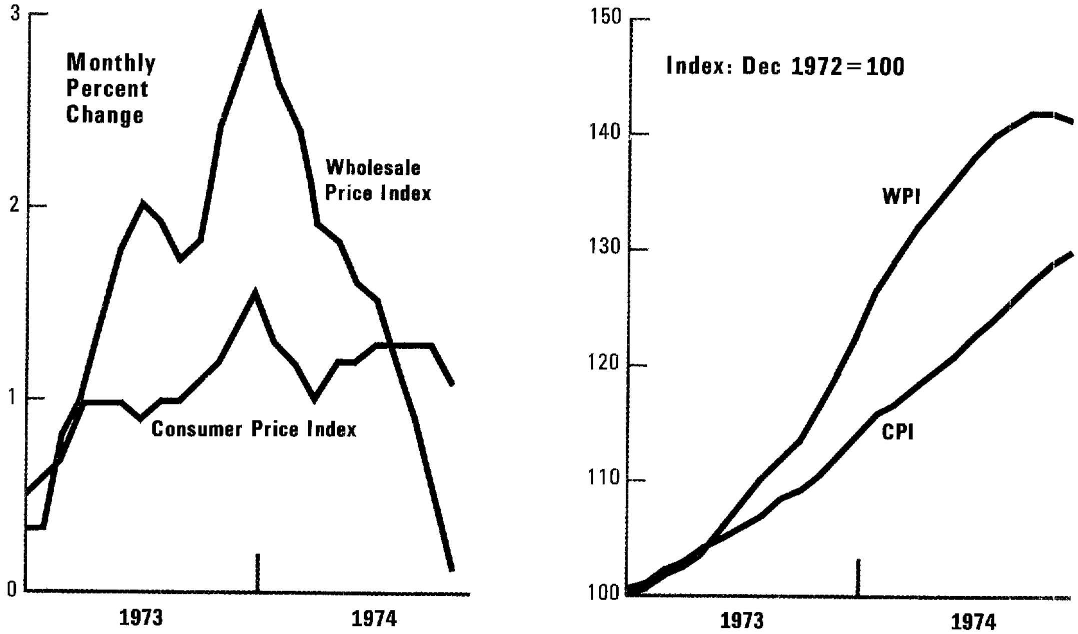
DEVELOPED COUNTRIES: Composite Price Trends (Excluding the United States)

(three-month moving averages, seasonally adjusted)



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Wage Rates

Stiff increases in wage rates -- the extreme example being the recent 31% hike in the pay of British coal miners – continue in spite of depressed demand and rising unemployment. These increases are attributable to the militancy of various labor organizations, demands (or contract provisions) for "catch-up" gains to match soaring consumer prices, and the weakened resistance of several insecure governments to inflationary wage settlements. Some observers believe that reflationary measures will be pushed along before recession takes the starch out of labor's demands.

DEVELOPED COUNTRIES: OIL PRICES AND INFLATION

During 1974 the sharp rise in oil costs gave a strong push to inflation in Japan, West Germany, the United Kingdom, France, and Italy. Since the initial OPEC price hike in October 1973, wholesale prices in these countries have risen 30% on average and consumer prices nearly 20% -- the sharpest increases in post-World War II history.

Overall Impact

Higher oil costs directly accounted for one-third of the overall rise in prices in major foreign economies during the past year or so.* The increase in oil prices has boosted wholesale prices by an average of 9% and consumer prices by perhaps half that amount. Japan and Italy have been particularly hard hit because oil meets three-fourths of their energy requirements. Price levels in the United Kingdom, West Germany, and France were also boosted substantially, as indicated in the tabulation.

	Percent Increase, December 1974 over September 1973		
		Wholesale Prices	
	Delivered Price of Crude Oil	Total	Attributable to Oil Prices
Japan	256	32	11
West Germany	180	16	8
United Kingdom	207	33	7
France	256	30	4
Italy	253	49	12

Most of the oil-induced inflation occurred during the first half of 1974, with higher oil costs accounting for two-fifths of the rise of wholesale prices in Japan, nearly one-half in West Germany, and nearly one-fourth in the United Kingdom. Higher oil costs were also a key factor in Italy's 68% wholesale price inflation in the first half and France's nearly 50% rate. Because one-half of Canada's oil consumption is supplied from domestic output under controlled prices, the rise in Canadian oil prices in the first half was substantially less than in any other major foreign industrial country -- roughly 100%.

* We have used input-output tables to estimate the impact of rising oil prices on the level of wholesale prices. We assumed that two-thirds of the October 1973 price hike was passed through by yearend and that the balance plus three-fourths of the December 1973 price hike was passed through in the first half of 1974.

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The cost of oil remained an important though declining influence on the rate of inflation in the second half of 1974. In Japan and the United Kingdom, certain prices affected by higher oil costs jumped after midyear, when price controls were eased. Japanese utility rates, for example, were raised 70% in July 1974. Oil price hikes continue to reverberate in the West German, French, and Italian price systems at a diminishing rate.

Impact on Industries

Industries hardest hit have included chemicals, rubber, electric power, and textiles. Unit output costs for heavy chemicals in Japan, for instance, have increased nearly 10% as a direct result of higher oil prices. Transport costs in France, to cite a second example, have been boosted by 15%-20%. Data for West Germany indicate that roughly one-third of the rise in machinery prices stemmed directly from higher energy costs.

Percent Increase in Unit Output Prices Directly Attributable to Higher Oil Costs Since October 1973

	United Kingdom	Japan	West Germany
Agriculture, forestry	5.7	3.4	4.9
Raw materials	5.4	8.8	6.1
Refined petroleum	125.1	114.4	71.8
Processed foods	3.6	3.8	4.6
Tobacco	2.7	1.7	1.1
Iron and steel	6.4	5.9	6.5
Nonferrous metals	3.6	6.3	4.2
Fabricated metal products	3.4	4.0	3.5
Chemicals	8.9	10.2	5.1
Rubber	4.0	5.4	3.5
Fibers, yarn, fabrics	3.1	4.9	2.5
Clothing, furs	2.0	3.6	1.6
Leather goods	2.8	3.9	2.7
Wood products	2.7	5.1	3.6
Agricultural and industrial machinery	2.4	3.4	3.4
Electrical machinery	2.4	3.5	2.8
Transport machinery	3.1	3.2	5.1
Precision instruments	2.0	3.0	2.5
Miscellaneous manufactures	4.3	5.9	2.1
Construction	2.5	4.6	2.4
Utilities	16.6	30.7	6.4
Transport	4.1	7.4	10.6

Indirect Impact

Higher fuel prices have added impetus to wage demands. A prime example is the case of Japan where perhaps one-fourth of the rise in hourly wage rates during the past year may be attributed to the added inflation caused by higher oil costs. To judge by past relationships between price changes and wage increases, the 1974 wage hikes of 32% would have averaged approximately 25% in the absence of the oil price rise. Labor productivity also suffered because higher oil costs reduced final demand and output.

The oil price hikes of October and December 1973, combined with the oil embargo, also contributed to the unprecedented round of speculative commodity buying that boosted raw material prices dramatically in the first half of 1974. In this period, commodity prices jumped an average of 30% even though final demand had leveled off or declined.

Outlook for 1975

The latest OPEC price hike announced in December will place additional moderate pressure on prices. If the oil companies are able to fully pass through the price rise, it will add about 4% to crude oil costs. Our analysis indicates that the direct impact on wholesale prices in the major countries could be about 0.5%.

Even if oil prices stabilize, inflation will remain a serious problem for the major industrial countries. Rapidly rising labor costs are a near certainty because of militant labor demands sparked by the spiraling cost of living.

INDEXING FOR INFLATION

Indexing -- the automatic adjustment of wages, loans, and taxes to compensate for inflation -- is an increasingly popular political response to problems stemming from spiraling prices. It has proved most valuable in minimizing the redistribution of income that normally accompanies inflation. While making inflation easier to live with, indexing can speed up the inflationary process.

Use of Indexing

Index adjustments in wages and pensions usually are triggered only after a lag and often do not compensate fully for price changes. For financial instruments such as bonds or savings accounts, both the interest payments and the principal usually are adjusted retroactively to reflect inflation. Tax rates have been adjusted in certain countries by linking the value of personal exemptions and/or the definition of tax brackets to price indexes.

Indexing is not new. For example, it was used as early as 1742 in the Massachusetts Bay Colony to preserve the real value of government bonds. Most West European countries began using indexing since the late 1940s. Canada has recently expanded its program, and Australia and the United Kingdom are moving to implement or broaden indexing programs. Brazil and Israel now make the most extensive use of indexing.

Among industrial countries, escalator clauses in wage contracts are the most widely used form of indexing. In the United States, nearly 4 million workers in the private sector are covered by wage escalators. In addition, US social security payments were brought under the system last year. At least some wages or pensions are indexed in 13 other countries. A number of LDCs – especially Latin American countries -- have indexed financial instruments with an eye to encourage private investment.

Pros and Cons

Proponents of indexing claim that

- adjustment of salaries, pensions, and taxes is socially desirable because it protects the real incomes of groups with little bargaining power in the market place or the political arena;

- adjustment of the value and earning power of financial instruments promotes economic growth by maintaining incentives to save and invest;

- indexing tends to moderate inflation, since people feel less need to make extreme financial demands in anticipation of continuing price hikes; and

Use of Indexing in Selected Countries[1]

	Wages	Social Security	Bonds/Loans	Mortgages/ Rents	Taxes
North America					
United States	1917 - present	1974 - present	1742, 1925	....	....
Canada	1972 - present	1965 - present	....	....	1974 - present
Latin America					
Argentina	....	....	1972 - present	....	....
Brazil	1964 - present	....	1964 - present	1964	1964 - present
Chile	1960-69	1952 - present	....	....	....
Colombia	....	....	....	1972 - present	....
Uruguay	....	....	....	1971 - present	....
Western Europe					
Belgium	1948 - present	1955 - present	....	....	....
Denmark	1945 - present	1923 - present	....	....	....
Finland	1945-67	1957 - present	1952-67	1952-67	....
France	1948-68	1948 - present	1952-58	....	....
West Germany	....	....	1920s	....	....
Italy	1945 - present	1950 - present	....	....	....
Netherlands	1965 - present	1956 - present	....	....	1972 - present
Norway	1920 - present	1967 - present	....	....	....
United Kingdom	1915-22; 1973-74	....	1973 - present[2]	....	....
Other					
Australia	1921-53[2]	....	....	....	....
Iceland	1971 - present	1960 - present	1955	....	1971 - present
Israel	1949 - present	....	1948 - present	1950 - present	....
China	1949-51	....	1949-51	....	....
New Zealand	....	1974 - present	....	....	....

1. Entries do not necessarily indicate comprehensive indexing in the respective categories. Source: Derived almost entirely from S.A.B. Page and S. Trollope, "An International Survey of Indexing and Effects," *National Institute Economic Review*, November 1974, pp. 46-59, Unclassified.
2. Legislation now pending.

- indexing can contribute to a better allocation of resources – for example, by maintaining the real return on investment.

Critics assert that

- indexing contributes to inflation by raising wage costs and by adding to aggregate monetary demand,

- weakens public support for anti-inflation policies by taking the sting out of inflation, and

- distorts the allocation of resources unless applied throughout an economy in a uniform manner -- a difficult task, at best.

Assessment

Although spreading, indexing remains a minor policy tool in most countries -- mainly because of uncertainties concerning its impact. Many observers are convinced that wage indexing has intensified inflation, not just made it more tolerable. Finland banned wage indexing in 1967 after 22 years of experience, Norway is moving to end the practice, and the Netherlands is reconsidering its program.

Indexing of pensions is strongly supported on the grounds of social equity. No country that has introduced it seems to have any doubts about the need to protect citizens with low, fixed incomes.

Indexing of financial instruments has helped to revive confidence among private investors in at least a few LDCs. Brazil's rapid economic growth over the past decade is partly the result of indexing measures that stimulated saving and investment. The same is true of Israel, where capital was fleeing the country prior to indexing. In Colombia, however, indexing of mortgage obligations has led to overinvestment in housing, depriving competing sectors of capital.

Indexing of income taxes has been of little benefit to consumers. Except for Canada, which introduced the measure in late 1974, these adjustments have been largely offset by increases in indirect taxes to compensate for lost revenues.

OECD COUNTRIES: SHIFTING TRADE BALANCES

A $65 billion increase in the oil deficit last year led to an estimated $31 billion worsening in the overall trade balance of the OECD countries – from an $10 billion surplus to a $21 billion deficit. Major shifts in balances in non-oil trade resulted in an uneven distribution of the payments burden among individual countries.

Twelve Gainers in Non-Oil Trade

Twelve of the OECD countries were able to improve their balances on non-oil trade, thus mitigating the impact of higher oil prices. West Germany, Japan, and the United States were most successful. The $37 billion jump in their combined oil trade deficit was more than offset by a $39 billion improvement in their non-oil trade. The other nine countries of the 12 gainers together racked up only a $4 billion improvement in their non-oil balance.

The largest shift in non-oil balances came in trade between the Big Three and other OECD countries. West Germany, Japan, and the United States together increased their surplus in intra-OECD trade from $15 billion in 1973 to $28 billion in 1974, thus accounting for $13 billion of the $33 billion deterioration in the trade balance of other OECD countries. The Big Three and the other 21 OECD countries each increased their surpluses with non-oil LDCs by $10 billion and $6 billion, respectively. Their small surpluses in trade with the Communist area remained practically unchanged.

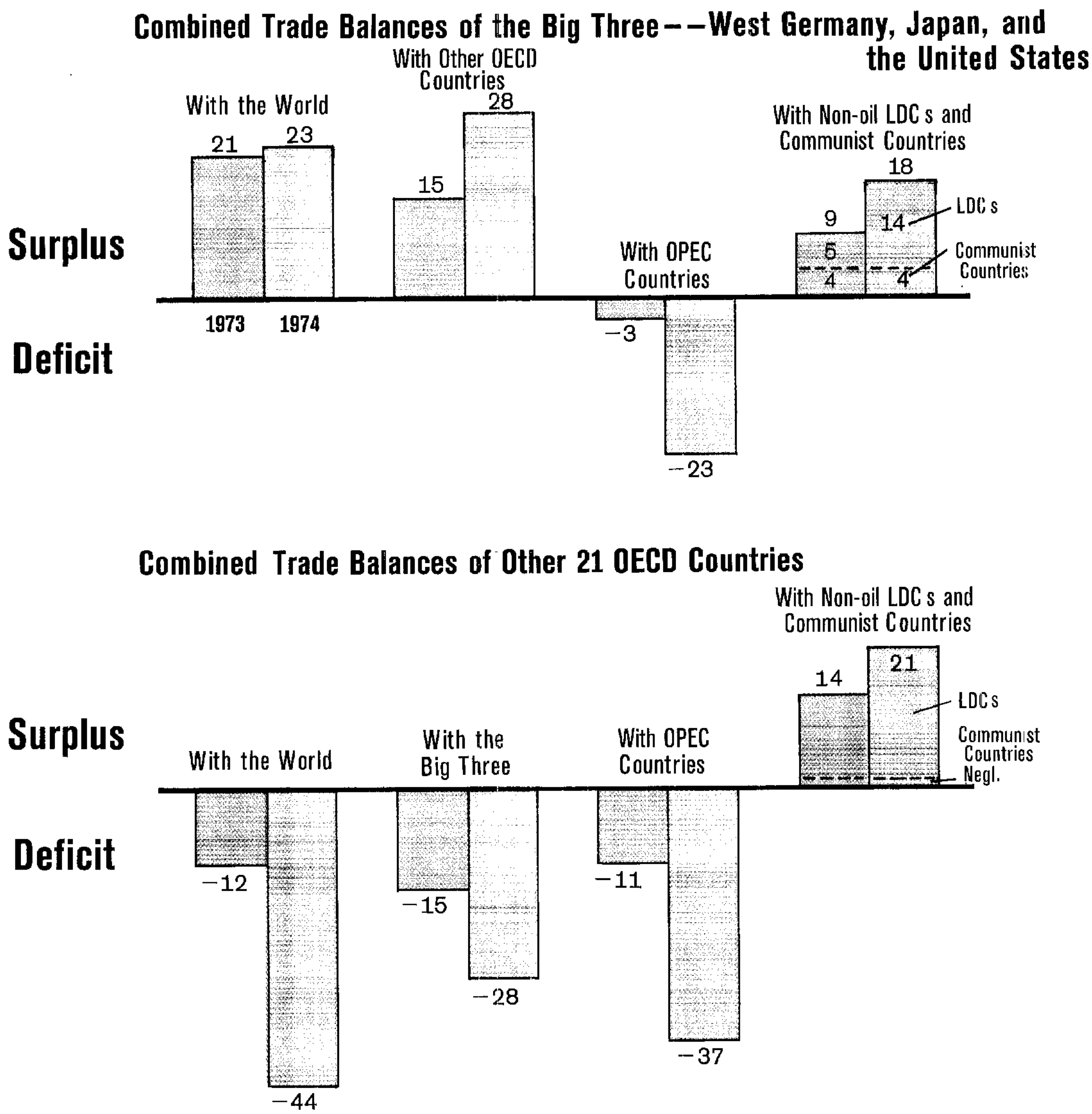
Twelve Losers in Non-Oil Trade

The twelve OECD losers in competition for markets saw their non-oil trade balances worsen by a total of $9 billion, despite an increase in the surplus with non-OECD countries. Larger deficits in trade with the Big Three were the main factor in this deterioration. Australia, Canada, Spain, and the United Kingdom registered the heaviest losses.

Payments Problems of Smaller Countries

Of the smaller OECD countries, Austria, Greece, Iceland, Ireland, Norway, Portugal, Spain, and Turkey ran larger deficits on non-oil trade than on oil trade.

OECD Countries: Shift in Trade Balances [1]
Billion US $



1. *Data for 1974 are partially estimated.*

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Gaining countries -- Improvement in non-oil trade, $43.4 billion
Of which:

West Germany	-	$14.5
Japan	-	$12.2
United States	-	$12.0

Losing Countries -- Deterioration in non-oil trade, $8.7 billion
Of which:

Australia	-	$2.4
Canada	-	$1.5
Spain	-	$1.3
New Zealand	-	$1.1
Turkey	-	$0.6

Spain's overall deficit doubled, to $7.1 billion. Despite a continuing large surplus on services, Madrid was forced to borrow heavily from abroad and to draw down its reserves from $7 billion to $6 billion. Greece and Turkey, which incurred trade deficits last year of $2.6 billion and $1.7 billion, have relatively small reserves to fall back on. All three countries will find it more difficult to finance large trade deficits this year because of an expected decline in workers' remittances and continued softness in the tourist business.

Some of the smaller countries already have moved to curb imports. Australia, whose trade account deteriorated by roughly $3 billion last year because of large tariff cuts and poor wool and beef markets, recently imposed controls on imports of automobile and textile products. Last summer, Denmark sharply hiked taxes on luxury consumer goods, most of which are imported. Its overall trade deficit nevertheless rose to $1.5 billion, posing serious financing difficulties.

Trade Balances of OECD Countries[1]

Billion US $ f.o.b./f.o.b.

	Total Trade		**Oil Trade**		**Non-Oil Trade**	
	1973	**1974**	**1973**	**1974**	**1973**	**1974**
Countries Recording a Marked Improvement in Non-Oil Balances						
West Germany						
Exports	67.7	88.6	0.7	1.2	67.0	87.4
Imports	51.8	64.8	4.3	11.4	47.5	53.4
Balance	15.9	23.8	-3.6	-10.2	19.5	34.0
Japan						
Exports	36.1	54.9	Negl.	0.1	36.1	54.8
Imports	32.6	53.6	5.5	20.0	27.1	33.6
Balance	3.5	1.3	-5.5	-19.9	9.0	21.2

Trade Balances of OECD Countries[1]
(Continued)

Billion US $ f.o.b./f.o.b.

	Total Trade		Oil Trade		Non-Oil Trade	
	1973	**1974**	**1973**	**1974**	**1973**	**1974**
United States						
Exports	71.3	98.5	0.5	0.8	70.8	97.7
Imports	69.5	101.0	7.6	24.2	61.9	76.8
Balance	1.8	-2.5	-7.1	-23.4	8.9	20.9
Countries Recording Some Improvement in Non-Oil Balances						
Austria						
Exports	5.2	7.0	Negl.	Negl.	5.2	7.0
Imports	6.8	8.7	0.3	0.8	6.5	7.9
Balance	-1.6	-1.7	-0.3	-0.8	-1.3	-0.9
Denmark						
Exports	6.1	7.9	0.1	0.3	6.0	7.6
Imports	7.2	9.4	0.7	1.7	6.5	7.7
Balance	-1.1	-1.5	-0.6	-1.4	-0.5	-0.1
Finland						
Exports	3.8	5.7	Negl.	Negl.	3.8	5.7
Imports	4.0	6.7	0.4	1.3	3.6	5.4
Balance	-0.2	-1.0	-0.4	-1.3	0.2	0.3
France						
Exports	36.7	46.6	0.6	1.2	36.1	45.4
Imports	35.3	50.0	2.9	10.2	32.4	39.8
Balance	1.4	-3.4	-2.3	9.0	3.7	5.6
Greece						
Exports	1.2	1.7	Negl.	0.1	1.2	1.6
Imports	3.6	4.3	0.3	0.8	3.3	3.5
Balance	-2.4	-2.6	-0.3	-0.7	-2.1	-1.9
Italy						
Exports	22.2	30.1	1.3	2.2	20.9	27.9
Imports	24.8	37.8	2.7	9.4	22.1	28.4
Balance	-2.6	-7.7	-1.4	-7.2	-1.2	-0.5
Netherlands						
Exports	20.4	28.3	2.1	3.7	18.3	24.6
Imports	19.1	27.0	2.8	5.4	16.3	21.6
Balance	1.3	1.3	-0.7	-1.7	2.0	3.0
Sweden						
Exports	12.1	15.8	0.1	0.1	12.0	15.7
Imports	9.7	14.4	1.0	2.6	8.8	11.8
Balance	2.3	1.4	-0.9	-2.5	3.2	3.9
Switzerland						
Exports	9.4	11.9	Negl.	Negl.	9.4	11.8
Imports	11.2	13.9	0.8	1.3	10.4	12.6
Balance	-1.8	-2.1	-0.8	-1.3	-1.0	-0.8

Trade Balances of OECD Countries[1]
(Continued)

Billion US $ f.o.b./f.o.b.

	Total Trade		Oil Trade		Non-Oil Trade	
	1973	1974	1973	1974	1973	1974
Countries Recording a Deterioration in Non-Oil Balances						
Australia						
Exports	10.0	11.0	0.1	0.2	9.9	10.8
Imports	7.2	11.1	0.3	0.9	6.9	10.2
Balance	2.8	-0.1	-0.2	-0.7	3.0	0.6
Belgium/Luxembourg						
Exports	22.3	27.1	0.6	0.6	21.7	26.5
Imports	21.9	28.3	1.3	2.5	20.6	25.8
Balance	0.3	-1.2	-0.7	-1.9	1.1	0.7
Canada						
Exports	25.5	33.1	1.8	4.1	23.7	29.0
Imports	23.4	32.1	1.1	3.0	22.3	29.1
Balance	2.1	1.0	0.7	1.1	1.4	-0.1
Iceland						
Exports	0.3	0.3	Negl.	Negl.	0.3	0.3
Imports	0.3	0.4	Negl.	Negl.	0.3	0.4
Balance	Negl.	-0.1	Negl.	Negl.	0	-0.1
Ireland						
Exports	2.0	2.4	Negl.	Negl.	2.0	2.4
Imports	2.5	3.3	0.1	0.4	2.4	2.9
Balance	-0.5	-0.9	-0.1	-0.4	-0.4	-0.5
New Zealand						
Exports	2.7	2.5	Negl.	Negl.	2.7	2.5
Imports	2.2	3.3	0.2	0.4	2.0	2.9
Balance	0.5	-0.8	-0.2	-0.4	0.7	-0.4
Norway						
Exports	4.7	6.4	0.1	0.2	4.6	6.2
Imports	5.8	8.0	0.4	0.5	5.4	7.5
Balance	-1.1	-1.6	-0.3	-0.3	-0.8	-1.3
Portugal						
Exports	1.8	2.0	Negl.	Negl.	1.8	2.0
Imports	2.7	3.5	0.1	0.5	2.6	3.0
Balance	-0.9	-1.5	-0.1	-0.5	-0.8	-1.0
Spain						
Exports	5.1	7.2	Negl.	0.1	5.1	7.1
Imports	8.6	14.3	1.0	3.4	7.7	10.9
Balance	-3.5	-7.1	-1.0	-3.3	-2.5	-3.8
Turkey						
Exports	1.3	1.5	Negl.	Negl.	1.3	1.5
Imports	1.9	3.2	0.2	0.7	1.7	2.5
Balance	-0.6	-1.7	-0.2	-0.7	-0.4	-1.0

Trade Balances of OECD Countries[1]
(Continued)

Billion US $ f.o.b./f.o.b.

	Total Trade		Oil Trade		Non-Oil Trade	
	1973	1974	1973	1974	1973	1974
United Kingdom						
Exports	28.0	35.7	0.8	1.7	27.2	34.0
Imports	33.8	48.0	3.0	9.9	30.8	38.1
Balance	-5.8	-12.3	-2.2	-8.2	-3.6	-4.1

1. Data for 1974 are partially estimated.

DEVELOPED COUNTRIES: TRADE IMPACT OF OIL PRICE RISE*

Because of the enormous rise in oil import costs, the six major foreign developed countries last year saw their combined trade surplus drop from $14.5 billion to $2.7 billion. Their current account deficit jumped from $1.6 billion to a massive $19.9 billion.

1974 Trade Balances

We estimate that these countries suffered a net rise in their oil bill of $39.1 billion in 1974. At the same time, their exports to OPEC increased by $6.1 billion, only half of which is attributable to the surge in oil earnings. A sharp rise in their trade surplus with non-OPEC countries was also an important offset to their staggering oil bill.

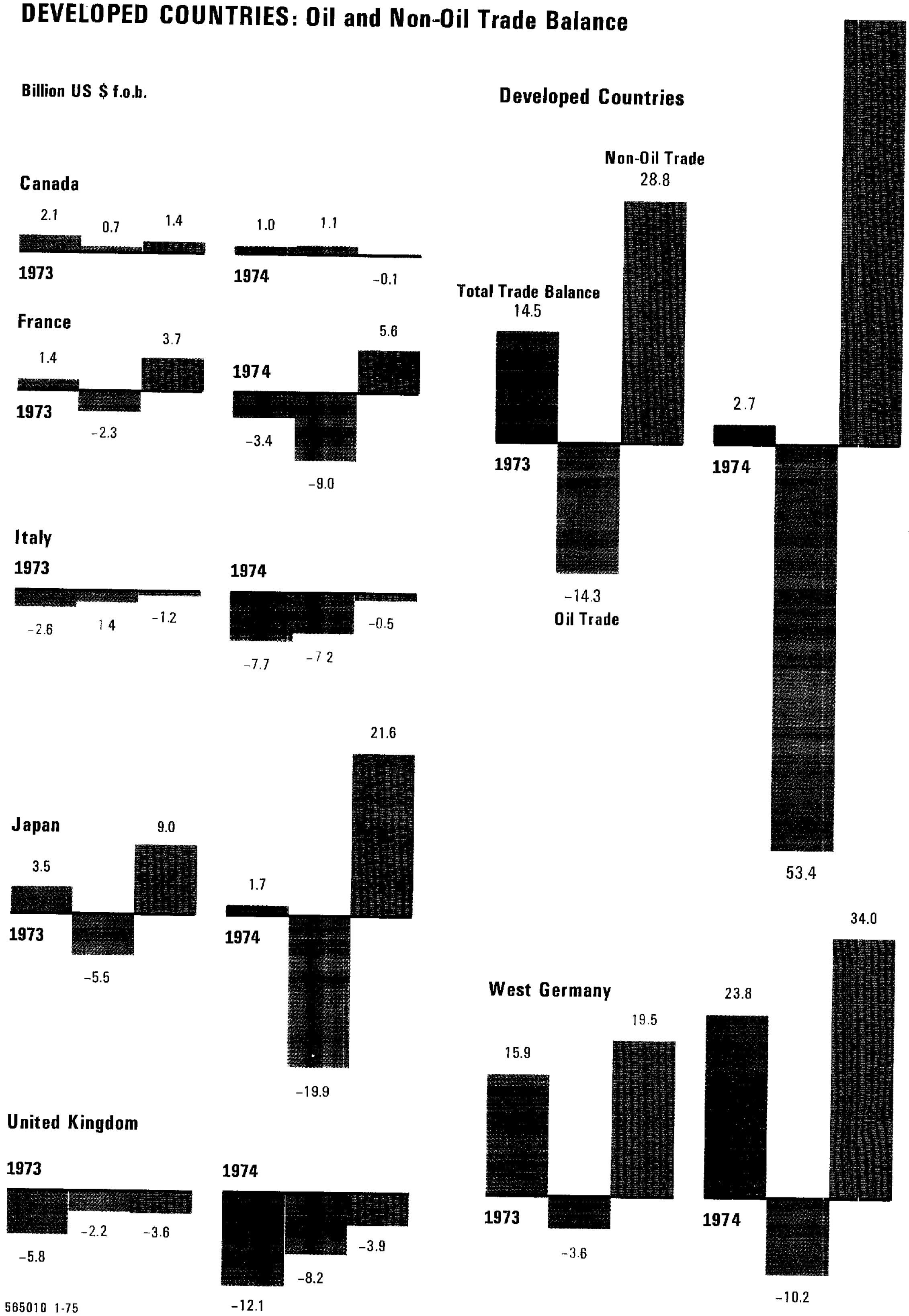
West Germany -- unique among oil importers – actually managed to boost its surpluses on trade and current account by an estimated $7.9 billion and $5.0 billion, respectively. Japan also did well in offsetting the huge jump in its oil bill, ending the year with a small trade surplus and a current account deficit of $5.1 billion. The United Kingdom, Italy, and France proved least capable of coping with the sudden shift in terms of trade; their combined trade deficit increased from $7.0 billion in 1973 to $23.4 billion last year. Canada, itself a major oil producer, gained $1 billion less from an improvement in its oil balance than it lost on net non-oil transactions.

The rise in oil bills reflects an average price increase, c.i.f., of 200% per barrel of crude. The volume of crude oil imports of the six major foreign developed countries fell by 3.3%. The rise in the oil deficit was solely due to dependence on crude oil imports; the balance of trade in petroleum products improved.

The non-oil trade surplus of the six major foreign developed countries rose from $28.8 billion to $56.1 billion, mostly because of the striking improvement in the West German and Japanese balances. Sluggish domestic demand in both countries contributed to a rapid expansion of exports, while holding down the rise in imports. France's surplus in non-oil trade grew moderately; Italy and Britain

* This article does not attempt to measure the indirect impact of high oil prices, for example, the effect on the GNP of oil consuming countries, and hence on net demand for foreign goods, or the effect on the prices of other major internationally traded products. Estimates for 1974 are based on data covering from 9 to 12 months.

DEVELOPED COUNTRIES: Oil and Non-Oil Trade Balance



Developed Countries: Changes in Current Accounts

Billion US $

	Change in 1974 over 1973				Current Account Balances	
	Oil Trade Balance	Exports to OPEC States	Other Trade	Net Services and Transfers	1973	1974
Total	**-39.1**	**6.1**	**21.1**	**-5.9**	**-2.1**	**-19.9**
Canada	0.4	0.2	-1.7	-0.2	-0.5	-1.8
France	-6.7	0.8	1.0	-0.2	-0.7	-5.8
Italy	-5.8	1.0	-0.3	-0.5	-2.4	-8.0
Japan	-14.4	2.4	9.8	-2.6	-0.3	-5.1
United Kingdom	-6.0	0.4	-0.9	0.5	-2.9	-8.9
West Germany	-6.6	1.3	13.2	-2.9	4.7	9.7

saw a worsening in their deficits. Canada's non-oil trade slipped from a $1.4 billion surplus in 1973 to a small deficit, mainly because of weakened US demand.

The increase in sales to OPEC markets, which rose about twice as fast as overall exports, accounted for less than 10% of the $68 billion rise in non-oil exports of the six countries in 1974. By contrast, rising exports to non-oil LDCs contributed 20%-25% of the gain in sales.

Outlook

Oil consumption in the major foreign developed countries probably will decline moderately in 1975 because of the economic slump, consumer resistance to high prices, and conservation efforts. The expected decline in import volume probably will be more than offset by a rise in average oil prices, from about $11.00 per barrel to $11.50 per barrel, c.i.f. As a result, the oil trade deficit of the six countries will rise by an estimated $4.9 billion, largely offsetting an expected one-third increase in the value of exports to OPEC countries. Non-oil LDCs will provide a far less lucrative market for sales than last year because their payments problems are catching up with them. Furthermore, the developed countries, in contrast to 1974, will find that interest payments on loans to pay oil bills will add substantially to their current account deficits.