The Way Back to the Growth of the World Economy

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I. The World Economy in Difficulties

The world economy is at present faced with a number of serious difficulties. Let me first take up the case of industrial countries. While there are growing signs of success in the fight against inflation after a protracted period of high inflation, industrial countries have been suffering from an unexpectedly long period of economic stagnation and rising unemployment.

In retrospect, the price situation in industrial countries generally started to deteriorate almost simultaneously in late 1960's and this led to the demise of the Bretton Woods system and triggered the two oil crises of the 1970's. Over the decade, inflation has been aggravating economic life in all nations. It is only after the outbreak of the second oil crisis that industrial countries unanimously put top priority on the fight against inflation. Fortunately, inflationary pressures started to weaken in 1981 first in Japan and then in Germany. By the spring of last year, signs of progress in inflation control began to emerge in the United States, the United Kingdom and some other European countries as well.

A weakening of inflationary pressures was expected to brighten economic prospects with higher real income and lower interest rates helping the recovery of investment. But, the actual outcome since last summer has not come up to our expectations. In the second half of last year, the economic recovery forecast in the United States did not materialize, while output declined in Europe and stagnated in Japan. Thus, real GNP for OECD economies as a whole declined last year after one per cent growth in each of the preceding two years. Fortunately, since the turn of the year, there have been indications of a pick-up of economic activity in the United States. In Europe, we can now observe a strengthening of aggregate demand in Germany and an upturn of private consumption in the United Kingdom. But, there is no visible evidence that industrial countries as a whole have entered the phase of economic upswing.

In many industrial countries, weak output activity has been associated with rising unemployment. Several of them have been registering unemployment rates in double digit figures. The number of unemployed in the OECD area has risen above the 30 million mark. The increase in unemployment in itself is indicative of economic inefficiency and injustice. At the same time, it increases pressures towards social and political unrest.

The protracted stagnation in the industrial world has also been affecting the economic performance of developing countries. The growth rate of GNP in non-oil developing countries, which had averaged about 5 per cent per annum between the mid-1970's and 1980, has slowed down sharply since 1981. Per capita real income has stopped rising generally in those countries with rapidly growing population, and it has even started to decline in Latin America and Africa. On the other hand, oil-producing developing countries had initially weathered the world recession largely because of gains from oil price hikes in 1979 and 1980. But the weakening of oil prices since the beginning of 1981 aggravated the balance of payments and reserve positions of a number of oil-producing countries, forcing them to abandon or scale down their economic development plans.

Furthermore, international setups surrounding individual countries are also in difficulty. A serious problem on the external financial front is the intensification of strains on the international banking system which was triggered by the deterioration of the debt situation of several countries in Latin America and Eastern Europe since last summer. These more-advanced developing countries, which had continued large-scale external borrowings to finance their domestic economic development plans and current fiscal expenditure in recent years, fell into difficulty in meeting repayment obligations, as high international interest rates increased the cost of debt services and as export earnings declined due to the fall in international commodity prices and the weakening of export volumes, both reflecting world economic stagnation. A sudden withdrawal of a large sum of funds by lending banks from the countries would get not only the borrowers but also the banks themselves inadvertently into trouble. Moreover, it would give rise to the serious malfunction of the international financial system which involves the danger of a further delay in the recovery of the world economy.

Another serious problem on the international front has arisen from growing impediments to the smooth functioning of the free trade system which is indispensable to the development of the world economy as a whole. Over the decade until the outbreak of the first oil crisis, the growth rate of world trade volume averaged 8 1/2 per cent, almost double the growth rate of real GNP in industrial countries as a group. But the volume of world trade started to decelerate in the wake of the first oil crisis. Last year it actually declined – the first fall since 1975. The deterioration of the employment situation and the associated rise in domestic political and social pressures have built up a background to the rising protectionism. It is not easy to figure out precisely the extent to which protectionist moves have contributed to the recent poor performance of world trade in total. It is clear, however, that protectionist moves, in particular those targeted essentially at bilateral trade imbalances in the form of requests for voluntary export restraints by surplus countries and import restrictions by deficit countries, will impede multilateral trade and world economic development in the long run. Trade measures taken by the government to secure jobs in a particular industry may temporarily attenuate the dissatisfaction of people suffering from unemployment, but in the longer run, it will reduce the economic welfare of people in the country which has taken such protectionist measures. Moreover, if trading partners take retaliatory measures against that country, the process of cumulative declines in international trade will be set in motion, and this will exert extremely undesirable impacts on the world economy.

II. Basic Viewpoints for Appropriate Policy Options

The task of finding out and implementing appropriate policy options to overcome the difficulties of the world economy is formidable. Looking back on the past, we can observe a number of cases where the wisdom of mankind helped the world to solve its difficulties. But there were also many cases where steps to cope with difficulties were inappropriate and they magnified economic, political and social disorders. Whether or not we can succeed in overcoming difficulties largely depends on our capacity to properly assess fundamental causes for the emergence of the difficulties and on our resolve to pursue appropriate policy options to eliminate them. With this historical lesson in mind, I would like to offer my basic viewpoints to find out the way back to the growth of the world economy.

The first point I would like to make is that the present difficult situation of the world economy cannot be overcome by mere reliance on expansionary demand management policy such as the one implemented during the 1960's. This view is supported by our experience with the expansionary demand management policy followed by a number of countries to cope with recession in the wake of the first oil crisis, which contributed to the prolongation of inflationary trends in the world. Indeed, the present economic difficulty stems to a large extent from the delay in the adjustment of national economies to abrupt and large changes in relative prices since the first oil crisis, and it cannot be solved by sole recourse to demand management policy.

The industrial structure, which had been built up over a protracted period of low energy prices, was suddenly forced to adapt to higher energy prices in the wake of the first oil crisis. Large structural adjustment necessitated over quite a short period of time will intensify strains, bringing about unexpected shifts in the future course of various enterprises and industries. The transfer of human and real capital resources from "declining" enterprises and industries to the newly "emerging" fields will require a considerable time and costs. In the meantime, it will be difficult to avoid partial under-utilization of capital and a rise in frictional unemployment which tends to increase social unrest. In a case where economic slack and higher unemployment are caused by a change in the economic structure rather than by cyclical factors, it is inappropriate to cope with them by mere recourse to simple macro-economic policy measures designed to adjust aggregate demand pressure. We have to implement various kinds of steps to promote smooth structural adjustment on the basis of the market mechanism, and persevere in an unavoidable period of adjustment. I endorse the view expressed in the communiqué of the IMF Interim Committee at its meeting in Washington D.C. last February, which states that "the transition to a more stable path of real growth would be facilitated by determined efforts to reduce market rigidities and structural imbalances."

The second reason why I think our policy approach at the present time should differ from the one followed in the 1960's with emphasis on demand management is that there is now little room for the use of fiscal policy to support demand. Large budget deficits accumulated over years are imposing a severe constraint on sustained economic recovery. Over the 1960's and until mid-1970's, public sector expenditure rose sharply in industrial countries, reflecting the policy of improving social welfare and expanding public capital formation, as well as counter-cyclical fiscal action to offset the weakening of private expenditure in the wake of the first oil crisis. In a situation where the dynamism of the private business sector is basically maintained and the economy is on a high medium-term growth path, a temporary increase in the budget deficit in a period of economic slack can be financed later by the rise in tax revenues in the subsequent period of economic upswing. But, since around the middle of the 1970's when the painful period of structural adjustment of the private market economy started, the governments have been suffering from large cumulative budget deficits associated with the persistent deficiency of tax revenues. Despite various steps taken by the governments to reduce public expenditure, there is little hope for a significant improvement of fiscal balance in the immediate future. Prospects of protracted large fiscal deficits have generated the expectation that the phenomenon of crowding-out will be unavoidable in the future, impeding a substantial decline in interest rates from the present high levels, and deterring the recovery of private productive investment and residential construction.

The third point we should bear in mind in working out the strategy to overcome the present economic difficulties is the pressing need for individual countries to design their policies in an international perspective. The unprecedentedly high interdependence of national economies underlines the importance of the constant attention of individual countries to the international aspects of their policy formulation. We are now at a stage where a change in the economic situation or a policy step taken in a country will immediately affect other countries, and the impacts on these countries will quickly feed back to the original country. High interdependence is found not only among industrial countries but also between industrial and developing countries. The recession in industrial countries has adversely affected developing countries, as I explained earlier. But, it is also important to note that markets in developing countries account for one-third of the total exports of industrial countries excluding intra-EEC trade. No country, whether developed or developing, and whether oil-exporting or importing, should and can maintain policies benefiting only its own people at the sacrifice of people in other countries in this interdependent world.

The need for an international perspective in national policy making has not been reduced under the floating exchange rate system. Over a ten-year period since the transition from the fixed to the floating rate system during which the volatility of international capital flows intensified, it has become increasingly clear that the independence of domestic monetary policy and the automatic adjustment of the balance of payments cannot be secured adequately even under the floating rate system, contrary to the general expectation prevailing at the very outset. Exchange rates often stay at levels out of line with relative inflation rates for a protracted period, and this disturbs international trade transactions and also impedes the flexible use of domestic monetary policy in individual countries.

Under these circumstances, each country should formulate its domestic economic policy, paying due attention to the possible impacts of its policy on other countries. Each country should overcome the temptation of taking piecemeal measures in an attempt to solve its own immediate problems without regard to their adverse effects on other countries. Such measures would counter the task of overcoming the present difficulties of the world economy in their entireties and putting it back to the path of a sound recovery.

III. Programme for a Global Approach

It is my considered opinion that the best way to master the present difficulties is for all countries around the world to take a global viewpoint, aiming at the objective of sustained non-inflationary growth.

Convergence of national policies under this "global approach" does not necessarily require adoption of common policy instruments by all countries. Rather, it means the international harmonization of policy instruments with the aim of achieving common policy objectives shared by all countries. Specific policy instruments to be adopted in each country in order to achieve a common objective may differ according to the situation prevailing in the country. What is crucial in the global approach is the efforts by all individual nations over the globe to implement measures which are consistent with the objective of sustained non-inflationary growth of the world economy as a whole, and to avoid and roll back measures which are incompatible with this final goal.

From this viewpoint, I would like to offer my specific remarks, starting with some observations on the appropriate use of macro-economic policy instruments.

Monetary Policy

The first point I would like to stress is the important rôle actually played by monetary policy management with emphasis on the control of monetary aggregates in the fight against inflation in industrial countries since the second oil crisis. In a situation where strong inflationary expectations persist, higher nominal interest rates do not necessarily mean tighter money and credit market conditions. In theory, real interest rates adjusted for expected inflation rate can be used as a more appropriate indicator of monetary tightness in such a situation. But in practice, it is difficult to precisely measure expected inflation rate and thereby real interest rates. This was a basic reason for the greater emphasis placed on the control of monetary aggregates in the implementation of monetary policy by a number of industrial countries since the mid-1970's, and tight monetary control has contributed to the recent considerable weakening of inflationary pressures.

In the process of fighting inflation, however, industrial countries particularly in Europe and North America have suffered from the weakening of output activity and higher unemployment. Against this background, the question has been raised about the desirability of relaxing monetary policy in order to help expand output and reduce unemployment. But, I think it important to bear in mind that what the central bank can influence by monetary control directly and in the short run is only nominal GNP. How nominal GNP will be split between real income and prices depends ultimately on various factors on the supply side, such as the performance of productivity, the attitude of economic agents to price and wage formation, and their underlying inflation psychology.

At the same time, central bankers responsible for monetary policy making must be fully aware of difficulties in the control of monetary aggregates. In recent years, ongoing financial innovations in some industrial countries have destabilized the relationship between the money supply on the one hand and real income and prices on the other, making it difficult to gauge the growth rate of the money supply which is consistent with the policy objective of non-inflationary economic growth. If the central bank sticks to the pre-set target for the growth of the money supply without proper assessment of a large shift in the relationship between the money supply, real income and prices, monetary targeting may bring about tighter or easier financial conditions than intended by the central bank, and this will have undesirable economic impacts both domestically and internationally. The most serious problem of this sort can arise from rigid monetary targeting in a country having huge and externally open domestic money and capital markets whose developments exert dominant influences on Euro-currency and other international financial markets and on foreign exchange rates, with consequences on the real economy of other countries as well. We all know that the task of striking a right balance between the need to secure flexibility in the conduct of monetary policy and the need to gain its credibility is formidable. But, in this context, I must say that greater emphasis on the short-run control of monetary aggregates in the United States since October 1979 unfortunately resulted in the greater volatility of interest rates there and large changes in international interest rate differentials which led to excessive exchange rate fluctuations. We must realize that credibility over monetary policy can ultimately be gained and secured only by the actual realization of inflation control, and the central banks should aim at the stabilization of money supply growth in the longer run, while paying due attention to the need of maintaining orderly financial market conditions in the short run. I regard this as a challenge common to all central banks and we must take it up with all possible means in our arsenal.

Fiscal Policy

The reduction of the size of the public sector and of budget deficits constitutes one of the most pressing tasks in many developed and developing countries. The increase in budget deficits due to built-in-stabilizers in a period of economic slack should not be negated in its entirety. But, continued large budget deficits are taken by the market as indication of the government's loss of controllability over the budget, making it hard to eliminate inflationary expectations. They also increase pressures on the capital market and the resulting high interest rates tend to deter private productive investment.

While the reduction of the size of budget deficits remains the most important concern for the fiscal authorities, it is also imperative to review the pattern of government outlays and tax revenues. Courageous efforts are required to break down resistance to any changes in the established structure of public spending and tax burdens. But, a cut in government current outlays and tax subsidies whose rôles are no longer indispensable is of vital importance.

Micro-economic Policies

During the 1970's, many countries, particularly in Europe, saw a trend decline in corporate profit shares, with wage and non-wage labour costs rising more rapidly than prices received by producers. In some countries, the "hard currency option" in the foreign exchange market geared to the objective of domestic price stability, together with labour cost inflexibility, gave rise to a particularly severe squeeze on exporters' profits. A deterioration of corporate profits by itself is a deterrent to the growth of productive investment, making it difficult to create new employment opportunities. Moreover, if labour costs increase relative to capital costs, a tendency for enterprises to substitute labour with capital will develop. This will reduce employment opportunities, even if there is no change in the level of aggregate demand and output. The rise in classical unemployment due to the increase in labour costs relative to capital costs is an important factor contributing to the deterioration of labour market conditions in countries where labour costs are inflexible, although it may in part also reflect the rise in Keynesian unemployment due to lower aggregate demand.

Expansionary demand management policy is clearly not an appropriate approach to deal with classical unemployment. Several countries have experimented with incomes policy, but without great success. Labour cost inflexibility can be remedied gradually by market forces as the recession deepens and becomes protracted. But costs involved in this process are unbearably high. In order to minimize such costs, it is important for entrepreneurs and wage earners to comport themselves with the social consensus that both of them are in the same boat, sharing the same lot. For the governments, it is necessary to implement various measures, in particular those in the fields of industrial, labour and educational policies, to restore and enhance the flexibility and vigour of the private market economy with due regard to the situation of individual countries.

The energy constraint on economic growth is at present not a serious problem, because of a considerable easing of the oil supply/demand situation since 1982. But there is still the continuing need to step up investment in energy production, fuel switching and conservation in order to improve the energy supply/demand relationship in the medium term and to prevent the recurrence of such oil shocks as we suffered from in 1973-74 and 1979-80.

Capital Flows to Developing Countries

One of the most serious problems on the international front is the huge external debt of developing countries and strains on the international banking system. A number of developing countries in Latin America and Eastern Europe have fallen into difficulty in financing their balance of payments and carrying out their debt service obligations since last summer. Their pressing financial needs are being met by the efforts of the IMF and the ad-hoc cooperation of the BIS and central banks as well as many private financial institutions involved in international credit operations to them. In addition, the size of the credit facility which the IMF can draw on from the Group of 10 and Switzerland under the General Arrangements to Borrow was increased by about SDR 11 billion at the meeting of finance ministers and central bank governors of these countries last January. The loanable funds of the IMF will be raised further by a 47.5 per cent increase in the total size of quotas which was agreed upon at the IMF Interim Committee meeting last February.

It is fortunate that such international financial cooperation is working to cope with the immediate danger of the collapse of the international credit market which would have had serious consequences for the world economy. But it alone cannot solve fundamental problems related to the external debt situation of developing countries. While there is an imperative need for countries with large external debt to accelerate adjustment of the domestic economy and the balance of payments, creditor developed countries should also be fully aware of the need for debtor developing countries to raise the level of per capita income and to improve the economic and social life of their people in the medium term by carrying through development plans to increase economic efficiency. This longer-term consideration underlines the importance of achieving stable flows of funds to developing countries over time.

For several years since around mid-1970's, the "borrowers' market" had constituted the central feature of international bank lending, and there was severe competition among financial institutions of developed countries in their international credit operations. Over these years, interest rates adjusted for inflation rate remained negative in the international credit market, and the negative real cost of borrowing undoubtedly induced a number of developing countries to excessive borrowing from the market. Later, a sharp increase in interest rates in the domestic money and capital markets of developed countries in the process of their fight against inflation since 1979 and the associated rise in the nominal and real costs of borrowing in the international credit market provided a background to a sudden increase in the burden of borrowers' debt services.

An implication of this episode is that somewhat positive real interest rates should be maintained over time in the international credit market as well as in the domestic markets, although there may be cases where negative real interest rates materialize in the short run. International credit market conditions featured by slightly positive real interest rates will induce borrowers to use the proceeds of their borrowing only for the financing of capital investment with positive returns. Promotion of profitable investment in debtor countries will help raise their output potential, and if real economic growth rate in these countries exceeds the level of real interest rate over time, their external financial positions will improve, and accordingly, those of international banks will also be strengthened. This leads to the view that while prudential controls on international banking operations by the supervisory authorities are indispensable, they are by themselves not sufficient to secure the soundness of such operations. It is important at the same time that the authorities of countries with large domestic financial markets and thereby having strong influences on international credit market conditions should follow a stable monetary policy plight and maintain the stance of fiscal policy consistent with the former, with the view to keeping real interest rates at appropriate levels both at home and abroad, hopefully lower than those prevailing presently, and eliminating their excessive fluctuations.

Furthermore, developed countries should continue to strengthen their efforts to increase aid to the low-income developing countries which have no or only limited access to the international credit market. But, in carrying through aid plans, we should not ignore the economic principle of placing emphasis on the need to increase efficiency over the medium term, in addition to the principle of meeting basic human needs of these countries.

Free Trade System

The recrudescence of protectionism and trade frictions is another disturbing feature on the international front, arising from the world recession and the continued deterioration of the employment situation since 1980. There is an accelerated movement towards protectionism in a variety of forms and in both industrial and agricultural sectors. Increased protectionism reduces economic efficiency in developed and developing countries, forcing consumers with little political power to purchase products at higher prices and narrowing the scope for their free choice of goods. When the concepts of "fairness" and "unfairness" are applied to trade policy without any clear-cut specification of the terms and if bilateral trade frictions are solved through negotiations essentially between domestic and foreign industrial or agricultural interest groups concerned in such a way that they alone consider "fair", there is the danger that the multilateral trade system will be distorted and the dynamism of the world economy will be weakened.

The basic principle of a free and open trade system was endorsed at the GATT ministerial meeting of last November. Now is the time for all countries concerned to strengthen efforts to roll back protectionist measures taken over recent years and to open their domestic markets further, although it is admittedly not easy to do so when there is a pressing need to secure job opportunities.

Exchange Rate Stability

There is the argument that the upsurge of protectionist pressures reflects the weakness of economic activity, and they will be reversed when the economy starts to pick up. But it is also undeniable that trade frictions at least in part reflect changes in international price competitiveness, associated with a sustained divergence of floating exchange rates from the levels justifiable by relative inflation rates, and also with insufficient parity adjustment under the regional exchange rate arrangement despite a wide difference in price performance among member countries. Apart from the problem of exchange rates remaining at excessively high or low levels, there are also problems associated with the short-run volatility of exchange rates. Although there has so far been no convincing numerical evidence showing measurable disadvantages of exchange rate volatility in such forms as increased exchange transaction costs, a lower level of international trade and investment, and higher inflation through the "ratchet effect", this does not lead to the conclusion that any central bank responsible for maintaining financial order and price stability can sit back in the face of the large short-run variability of the external value of money.

Central banks should continue to concentrate their efforts to maintain orderly conditions in the foreign exchange market to the extent that they will not lose appropriate control of the money supply. I would urge that at least at a time when the monetary authorities of all countries concerned have come to the common view that the exchange rate of a particular currency is far beyond the zone justifiable by fundamentals, international concerted action should be taken to correct the situation. Furthermore, I think it is time for all of us jointly to strengthen a systematic investigation of ways to achieve exchange rate stability, now that ten years have passed since the demise of the Bretton Woods system and as the performance of the floating rate regime has not come up to our expectations.

IV. Concluding Remarks

In any democratic society, pressures from domestic interest groups are bound to build up in periods of difficulty. And, it is a formidable task for the authorities to override such pressures and carrying through policies which are consistent with the "global approach." But there is no other way out of the present difficult situation to revitalize the world economy than for individual countries to stick to the principle of self-help and international cooperation and take appropriate steps with due regard to the high interdependence of the present world economy.

Let me repeat that simple recourse to expansionary demand management policy cannot be the lasting solution to the present economic difficulty. Its origine dates back to the late 1960's when world-wide inflation started. The subsequent collapse of the Bretton Woods system and the two oil shocks are related to a deeply-imbedded inflationary tendency of the world economy since then, and the present crisis arises essentially from the insufficient adaptation of the economic structure to changing environments. It is of crucial importance from this viewpoint that countries should firmly re-establish price stability on the basis of gains so far made in the fight against inflation and carry through a variety of steps to open a path to economic growth without inflation. If the basic strategy introduced immediately after the outbreak of the second oil shock to achieve sustained non-inflationary growth were abandoned at this time, a new page with a record of enormous sacrifices and disastrous failures would be added to world history.