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Common Economic Policy Challenges : A European View [1)]

1. Rather than focus on the short-term outlook for the European economy, which is not too bright but not that bad either, I would like to share with you some of my views on the challenges that economic policy makers are faced with on both sides of the Atlantic at the beginning of the 80s. The decade behind us has not exactly been an easy one. The optimism that prevailed in the 60s is long gone, and many people believe that the going may become even rougher in the 80s. Certainly there is no reason for complacency.

2. The challenges are well known. Let me mention the following six:

   (a) we have to tackle the twin problem of inflation and unemployment;
   (b) we must break the link between economic growth and energy consumption , in particular we must reduce our dependence on oil;

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(c) we must make some progress towards solving the most urgent problems of the Third World, i.e. food, energy, and population growth;

(d) we have to strengthen further the open world trading system and firmly resist pressures for protectionist actions;

(e) we must encourage investment and innovation, so as to increase productivity and to adapt our economies to the changes taking place in the world economy;

(f) we must continue to act as custodians of the international monetary system, including the international banking system.

3. None of these challenges is exactly new. We inherited them from the 70s. Moreover, there is no guarantee that economic policy makers will not be faced with different challenges in the decade ahead. Indeed, there is a great likelihood that this will be the case.

In a similar meeting ten years ago, few economists would have predicted the breakdown of the Bretton Woods system within less than 36 months. Likewise, nobody would have

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predicted that the price of a barrel of oil would go up from 2 dollars to over 30 dollars during the 70s.

But the challenges I have listed are those that conventional wisdom can perceive of today. As we know, they are all interrelated. We also know that there are no quick and painless solutions to these problems. And finally we know that we will not be able to solve these problems unless we act in a spirit of international cooperation and coordination.

4. I will not even try to deal in a systematic fashion with all the challenges which I mentioned earlier. I will, instead, deal at some length with those three issues that dominated the discussions of our leaders in Venice -- inflation, energy and our relationship with the South -- and comment on the others in passing or in the discussion which is to follow.

5. It is tempting to put the blame for all of our current economic ills on OPEC, in particular for inflation. Certainly, the quadrupling of oil prices after the Yom Kippur war and the 125 % increase in the wake of the Iranian revolution have had a major inflationary impact. The average OECD inflation rate in 1974/75 was about twice as high as it was in 1973. And in 1980 the stage seems to be set for a repeat performance.

But unfortunately the matter is more complicated; inflation rates had already tended to be significantly higher at the beginning of the 70s -- before the collapse of the Bretton Woods system and before the first oil price explosion. There is a significant homemade element in current rates of inflation as well, most notably so in the U.S., in the U.K. and in Italy. I venture that these are also the countries in which inflationary expectations are most pronounced today, but no country, including my own, is immune against a certain degree of inflation mentality. In my view, breaking these inflationary expectations

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is the first order of business if we want to maintain the open world trading and monetary system on which so much of our prosperity is based.

6. It has been said that inflation is simply the reflection of what has been called the increasing ungovernability of our domestic political economies. While there are also other factors at work it is obvious that there is a strong inclination in our democratic societies to resort to the printing press in order to buy social peace and to satisfy expectations that are not matched by productivity increases. Such policies may buy time and help win elections, but in the long run they are bound to do more harm than good.

7. This institutional bias is aggravated by a professional bias. In the good old 60s professional economists became increasingly confident of their ability to finetune the economy. Accordingly, it became more and more popular to react to every twist and turn in short-run developments rather than to base policy changes on longer-lasting features and necessities. This may have been beneficial in a period when world GNP and trade grew rapidly and when the prices of many commodities,

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including oil, were actually declining.

These conditions no longer exist. Our economies are maturing. The 70s have seen dramatic changes in relative prices, most notably in the price of oil, and the arrival on the international scene of newly industrializing countries. Our economies are still in the process of adjusting to these and other changes in the world economy. This will be a time-consuming process which protectionism can only delay but not prevent. There will therefore be a premium on policies that foster the necessary adjustments. By their very nature these will be structural policies rather than countercyclical policies.

8. To sum up this part of my statement: the differences in domestic inflation rates and, more generally, in overall performance, which we observe today have a lot to do with the firmness with which governments and parliaments have resisted the temptation to please potential voters by printing money that is not matched by real resources and the temptation to react to short-run economic events rather than to long-term trends.

It is the cumulative effect of the unresolved inflation problem in important economies <u>and</u> the inflationary pressures resulting from successive oil price increases that accounts for the persistence and strength of world inflation.

9. Historical experience goes a long way to explain the differences in policy responses. American economic policy makers are haunted by the trauma of the Great Depression. German policy makers are haunted by the trauma of the open inflation which culminated in 1923 and of the repressed inflation which led to the currency reform of 1948.

American economists have tended to take a highly elastic and competitive supply of goods for granted and to search for ways how to create the matching demand, while German economists have tended to focus on the virtues of stability and the need to create conditions conducive to higher productivity and to an expansion of supply rather than demand.

As one American observer, who has spent many years in Bonn, puts it very aptly: "The pattern of German thinking introduces into German policy what Americans regard as a bias toward deflationary policies; American experience and American thinking introduces what the Germans regard as a bias toward inflation."

10. Past experience may also be at the root of different policy reactions to the <u>energy crisis.</u> Americans and Canadians have grown up with the

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presumption that the supply of energy is virtually unlimited and that energy is close to being a "free good". Europeans, on the other hand, were brought up with the firm belief that energy is a scarce and expensive resource.

The Europeans would have stuck to that belief had it not been for the decline in the real price of oil which took place in the 50s and 60s. When oil became increasingly cheaper than coal, they, too, switched to oil. Nevertheless, energy consumption per unit of GNP in France, Germany and Japan is still only half of what it is in the U.S. EC oil imports have decreased between 1973 and 1980 while those of the U.S. have gone up (GNP growth has been about the same during that period). Pricing policies have, of course, been different. Americans and Canadians have kept the domestic price of oil below representative world market prices, Europeans have not.

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11. In retrospect, Europeans wonder whether we might not have been collectively better off if the real price of oil had been allowed to rise gradually rather than in a stepwise fashion -- both before and after 1973. If that had been the case the signals to consumers and investors would have been clearer and louder and their reactions to the impending changes in relative prices would have taken place earlier.

While this is water under the bridge, I believe there is a lesson to be drawn for the future, particularly after the disappearance of Iran as a major world oil supplier

12. We must realize that higher oil prices are here to stay, and that the real price of oil is likely to go even higher during the 80s. It is not in our own interest to lament about this and to emphasize only the negative repercussions on our economies. We must make a virtue of the need for structural change that goes along with higher oil prices. The history of mankind is a history of structural change. Now as then it will offer many new opportunities for innovation and investment.

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Structural change is never painless. There will be losers but then there will also be many winners. First of all our domestic energy producers. But also all companies that supply equipment for oil conservation and oil substitution. And finally there are those producers who manage to gain a share of OPEC's increasing purchasing power.

In short, we must seize upon these opportunities -- and not look back in anger.

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13. The oil price explosion has had a devastating impact on the payments balances of non-oil LDCs. In 1980, their oil bill will amount to over 50 billion dollars, i.e. twice as much as the official development assistance provided by OECD countries (25 billion dollars).

On average non-oil LDCs will have to set aside 25 % of their export earnings to pay for their oil imports, some however substantially more (eg. India: 33 %; Brazil 40 %; Turkey 60 %). Clearly, this is an untenable situation.

14. Eighty percent of commercial energy consumption in LDCs is accounted for by oil and gas. Per unit of output LDC energy consumption is roughly the same as in developed countries. On the other hand, per capita energy consumption is only a fraction, in many only a tiny one, of that in our countries. Nevertheless, these countries, too, will have to reduce their dependence on imported oil if they want to fulfill their growth aspirations. In this.

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process full cost pricing of energy will have an important role to play; no country, not even the poorest, can afford the luxury of underpricing scarce resources. This may sound harsh but it is inevitable if the "right" demand and supply reactions are to come forth.

15. Energy has a direct bearing on the food problem. The growth of agricultural production in LDCs has been largely due to higher inputs of water, fertilizer and pesticides. It takes energy to provide these inputs; it takes energy to run the tractors and trucks which are needed to feed an ever growing urban population. In short, the availability of energy is a matter of survival for many LDCs.

16. What can be done about this?

There is uncertainty about the LDC potential for energy savings but whatever potential exists

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should be exploited. In overall terms and in the longer run the development of new conventional and alternative energy sources will have a greater impact, however. Capital, technology and technical assistance will be needed to help non-oil LDCs save and produce more energy.

This will take time. Meanwhile non-oil LDCs are running huger payments deficits than ever before, driving them into ever increasing indebtedness. Official development assistance from OECD countries which used to be a multiple of the LDC oil import bill cannot close this gap. OPEC aid (4.6 billion dollars in 1979) is heavily concentrated on a number of Islamic countries. COMECON provides less than 1 billion dollars a year.(The Federal Republic alone has given eight times as much aid in 1978 as the Soviet Union.) So far the private international banking system has been able to fill most of the gap.

But more and more bankers seem to have doubts about the wisdom of expanding their international business at past rates; perceived or actual country risks have increased and equity/loan ratios have tended to deteriorate - always compared to the situation before the first oil price explosion.

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Most experts expect that non-oil LDCs will be able to muddle through in 1980 and probably also in 1981. But the problem is bound to become more acute as time goes by.

17. The international financial institutions, in particular the IMF and the World Bank, should assume a larger role, both in mitigating the balance-of-payment impact of the second oil price explosion and in financing energy investment in non-oil LDCs. They will only be able to do so, however, if we make available to them, without further delay, the funds we have already pledged; the U.S. Congress has a great responsibility in this respect.

18. But OPEC and COMECON will also have to step up their efforts. As the Venice Summit concluded:

> "The democratic industrialized countries cannot alone carry the responsibility of aid and other different contributions to developing countries: it must be equitably shared by the oil exporting countries and the industrialized Communist countries."

The oil exporting countries which have caused the deterioration of the development prospects in the Third World should participate more than in the past in the direct recycling to

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non-oil-LDCs, preferably by setting up a de facto two-tier price system.

19. The magnitude of these problems is not matched by the qualitiy of the North-South discussions. Therefore, the Brandt Commission has proposed a summit meeting of leaders from both industrialized and developing nations to break the deadlock in North-South relations. My country supports this idea. The purpose of such a meeting would not be to take decisions but to reach a better mutual understanding of the global problems and to provide some guidance for the negotiators in other fora. It is important, however, that such a summit is an informal one and that the number of participants is restricted.

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20. Let me end on a note of confidence. Time and again our democratic societies have demonstrated their ability to feed, clothe and shelter our people better than any other economic system. Indeed they have come a long way to provide the material basis for what the Declaration of Independence calls the pursuit of happiness. I am fully convinced that we will continue to supersede. There is no doubt in my mind that we, collectively, will be able to meet the challenges of the 80s, provided that we bear the lessons of the 70s in mind and approach the 80s in a spirit of cooperation.