1. The Setting

1.1 As the world economy enters into the 1980s, there is considerable concern about its immediate future. Seldom have so many problems arisen at the same time. Economic growth has slowed down further and the industrialised countries appear to be on the threshold of a serious recession. Trade barriers, after a long period of liberalisation, have been raised on a number of critical exports. Meanwhile aid budgets are still very far from the agreed target. Oil prices have again increased sharply. Large debts have been incurred by parts of the Third World and there are doubts about the prospects for another round of massive 'recycling' through the international banks.

1.2 The current world economic crisis has its roots in the serious problems faced by the world economy since the beginning of the 1970s and, in some respects, even earlier. As economic growth slowed down, the world has found it increasingly difficult to deal with the tasks of containing inflation, maintaining full employment, sustaining development and alleviating poverty. It is the purpose of this chapter briefly to review the overall economic performance of the recent past in an attempt to provide a historical perspective for the problems which are undoubtedly interrelated and have led to the crisis described more fully in Chapter 2.

Slow Growth and High Inflation

1.3 Throughout the 1970s rates of growth in the industrialised countries were on average substantially lower than in the 1960s. For the period 1970-1979 as a whole, the annual growth in output of the industrialised countries was about 3.4 per cent as against almost 4.8 per cent in the previous decade. The lower rate of growth resulted from attenuation in the 1970s of some of those factors which had promoted it actively in the 1950s and 1960s.[1]

1.4 Although the precise impact of individual factors is difficult to determine, the events that led to the slowing down of economic growth in industrialised countries are well known, and some of them go back to the 1960s. The breakdown of the Bretton Woods system in 1971 was a direct result of the loss of confidence in the dollar against the background of continuing massive United States external payments deficits. A high rate of monetary expansion in 1972-73 (facilitated by the absence of the usual balance of payments constraints) fed a commodity boom, on which was superimposed a series of agricultural harvest failures. The 1972-73 boom was exacerbated by the fact that supply bottlenecks appeared in response to rapidly rising inflation in many parts of the world. Prices of food, raw materials and industrial products all increased disproportionately compared with earlier upswings.

1.5 Inflation rose sharply in 1972-73. Fifteen years of relative price stability came to an end; Europe moved from inflation rates of under 5 per cent per year to over 10 per cent. The average rate of inflation in OECD countries more than doubled between the 1960s and 1970s. Unemployment rates also increased throughout the OECD area to levels unprecedented since World War II. The OECD has computed a crude 'discomfort index' (the sum of the rate of inflation and the rate of unemployment). This index rose from around 5½ percentage points in the 1960s to 17 percentage points in 1974-75. As Rostow puts it, there was a "convergence of stagnation and inflation unique in modern economic history".[2] Since then, inflation itself and concern to

1. Among the factors that have been noted in the economic literature as having contributed to post-war expansion in the world economy are: the primacy attached to economic growth as an objective of government policy; rapid technological change; growth in trade facilitated by a stable international monetary environment and reduction in tariff barriers; relatively cheap energy; labour migration to economies facing labour shortages; and substantial acceleration in the flow of capital, both governmental and private, from the developed to developing countries. See, for example, W.W. Rostow: *The World Economy: History and Prospect* (MacMillan, 1978); Interfutures: *Facing the Future* (OECD, Paris, 1979); H.W. Arndt: *The Rise and Fall of Economic Growth* (Longman, Cheshire, 1978); C.P. Kindleberger: *Europe's Post-war Growth* (Harvard University Press, 1967); World Bank: *World Development Report* (Washington, 1978); W. Kasper: 'Some Broad Perspectives of World Economic Growth', in W. Kasper and T.G. Parry: *Growth, Trade and Structural Change in an Open Australian Economy* (University of New South Wales, 1978).

2. W.W. Rostow, op. cit.

control inflation, have acted as a major constraint on any attempt to accelerate growth in most of the industrialised countries.

1.6 Inevitably these developments in the industrialised countries have adversely affected the economies of the developing countries. As noted by the World Bank, "with the collapse of a sustained and simultaneous boom in the industrialised countries, the peaking of major commodity prices and the sharp increase in the price of imported oil, 1974 marked a turning point in the economic performance and prospects of developing countries".[1] The effect of the recession in the industrialised countries, coming as it did on top of the energy crisis, was to lower growth rates of imports in the developing countries. The rate of growth of imports in these countries during 1974-1977 declined to 3.8 per cent per annum, which was almost half that in the previous ten years. Similarly, the growth of exports declined to a little over 4 per cent.

1.7 It is remarkable and encouraging that in these adverse circumstances, the growth performance of the Third World as a whole (even excluding the oil-producing countries of the Middle East and North Africa) stood up well. Growth rates of the middle-income countries, particularly those which had relied on trade as the primary engine of growth, declined somewhat but remained on average much higher than those of the OECD area. The low-income Asian countries even experienced a significant acceleration in their growth rates. Part of this improvement was due to better weather but there is some evidence that substantial investments made in the agricultural sector were beginning to yield results by the mid-1970s. The growth rates of the low-income countries as a group, however, have remained below those of the middle-income countries, and many of the least developed have suffered from continuing stagnation or in some cases even decline in per capita income.

1.8 Moreover, the record on redistribution, institutional reform and reduction in poverty levels in developing countries, with a few exceptions, was far from satisfactory. According to World Bank estimates, about 40 per cent of the population of developing countries are still living in 'absolute poverty'. The majority of them are in rural areas in the countries of South Asia, Indonesia, and sub-Saharan Africa. In addition to the absolute poor, large numbers of people have inadequate access to essential public services, such as health-care, safe drinking-water and sanitation. These include substantial proportions of the population in the middle-income countries. In the poorest countries, the incomes and consumption levels of the poorer half of the population have stagnated, and in countries where agriculture has expanded

1. World Bank: *World Development Report* (Washington, 1979).

more slowly than population (parts of South Asia and sub-Saharan Africa) the incomes of some of the rural population have probably declined. Unemployment and under-employment have continued to be acute in much of the developing world. Rapid urbanisation has created a variety of strains and social costs which have been evident in the growth of slums and shanty towns, in the pressing demand for schools and hospitals, and in the overloading of transport facilities. Some progress has been made in respect of education and health, but the deficiencies are many and the gaps in the availability of such basic facilities are still very wide, both among and within countries.

Balance of Payments Deficits

1.9 An important aspect of the post-1973 experience was the dramatic shift in the balance of payments positions of oil-exporting and oil-importing countries. The huge surpluses which resulted from the oil price increases in 1973 had their counterpart in large deficits in the oil-importing countries. The combined current account position of the OECD area, which had been in surplus in the 1960s and early 1970s, swung into a $33 billion deficit in 1974.[1] However, the deficit nearly vanished in the first half of 1975, as exports to OPEC countries rose sharply and recession brought a fall in imports by most oil-importing developed countries. The deficits subsequently widened again as OECD economic activity picked up, but by 1978 they had been, by and large, brought under control. The 1979 oil price increases once again raised the prospect of large deficits for the industrialised countries.

1.10 The experience of non-oil developing countries was more difficult. Their combined deficit increased in 1974 to almost three times the 1973 level of $ 11 billion. These deficits, although somewhat reduced in later years, remained high throughout 1974-1978. While the middle-income countries were generally able to finance even large and persistent deficits, some of them and most of the poorer developing countries suffered reductions, in real terms, in their import capacities and development expenditures. It is clear that many of the latter developing countries now require additional assistance on concessionary or grant terms if their economic development and even their current living standards are not to be depressed further.

1.11 Those countries which managed to maintain or even accelerate their imports and growth rates in the 1970s with the help of borrowings in international capital markets now find themselves with large accumulated debts. Not all of them may be able to continue borrowing on a substantial scale in

1. All figures in dollars in this Report refer to US dollars.

order to cover their newly enlarged deficits and maintain the momentum of their development. There is also doubt in some quarters, as discussed more fully in Chapter 3, about the capacity of international capital markets to recycle further large increases in OPEC surpluses.

Future Prospects

1.12 The problems of the 1970s look like becoming larger and more difficult in the 1980s.[1] As a result of the steep oil price increases of 1979 and inflation, growth in the OECD area as a whole is expected to decline sharply, from over 3 per cent in 1979 to 0.3 per cent in 1980.[2] Although no estimates are available for developing countries, their growth will almost certainly be damaged further by the increases in oil prices and the recession in the industrialised countries.

1.13 Since the Caracas meeting of OPEC in December 1979, estimates of the combined current account deficit of the OECD countries have been revised upwards to more than $75 billion, compared with $30 billion in 1979. Oil price rises, coupled with the effects of recession in the industrialised economies, will continue to aggravate the balance of payments problems of the net oil-importing developing countries. Towards the end of 1980, the combined current account deficit could be running at an annual average rate of $60-$70 billion. The average rate of inflation in the OECD countries is not expected to fall below the present level of 10 per cent while unemployment is likely to rise further.

1.14 The short-term problems could also complicate further the longer-term prospects. An OECD-commissioned report has referred to the danger of a 'low-growth trap', in which future recovery would be increasingly hampered by the lack of past investment because of monetary stringency and higher

1. For instance, the OECD Secretariat estimates that an increase of 10 per cent in oil prices in 1980 would affect the OECD's real output almost twice as much as an equivalent rise in 1979. This is mainly because (a) the net import bill of the OECD area is now larger, both in absolute terms and in relation to GNP; and (b) only about 15 per cent of any further increase in OPEC oil revenue, compared with about half of any such increase early in 1975, is likely to be spent within 12 months, as OPEC import volumes had already grown at a very rapid rate.

2. On the assumption that OPEC oil prices would remain unchanged in real terms after the increases announced up to November 1979, the OECD forecasts were for an overall 1 per cent growth rate in 1980; these were revised downward to virtual stagnation after the increases announced towards the end of 1979.

interest rates.[1] It stresses the need for positive help on the supply side. This involves encouraging structural adjustment and concentrating state aid on industries with fair medium-term prospects. Effective energy policies remain, however, a key element in this structural investment approach. And the fact that demand for energy has been reduced by recession should not lead to complacency about the urgency with which these policies need to be pursued.

1.15 The experience of the 1970s suggests that the continuation of slow growth, the difficulties in bringing down inflation and the balance of payments constraints have been due to deep-seated changes, involving structural causes which limit the use and adequacy of growth policies as they have been pursued in the past. The work of the Interfutures Group[2] has identified at least three types of structural constraints on governments' ability to accelerate growth in industrialised countries: (a) those which relate to the 'crumbling of the social consensus' within the industrialised societies, leading to persistent inflationary expectations and structural unemployment; (b) those which result from the fact that the industrialised world has become, with the relative decline of the USA and an increase in the importance of Japan and Western Europe, a multipolar one, particularly in the monetary, trade and technology spheres; and (c) those which reflect the increased importance of international as opposed to domestic demand. This, together with the increased political awareness of and disparities within the Third World, has brought about extremely important changes in relations between the developed and the developing world.

1.16 One result of these constraints is, perhaps, a lower degree of effectiveness of purely national macro-economic policies. Yet, they have led to more defensive national action as governments have perceived a greater vulnerability of their domestic economies. For example, when governments seek to protect existing industries and jobs, it almost certainly has the effect of putting a further brake on economic growth and thus serving to increase rather than reduce unemployment. An alternative, and undoubtedly more effective response, would have been to adopt a collective approach to overcoming these constraints.

1.17 The 1970s have also demonstrated that the adverse effects of slow growth in industrialised countries on the economies of developing countries must be taken into account in the mutual interest of both groups of countries.

1. Interfutures, op. cit.

2. *Towards full employment and price stability* (a report to the OECD by a group of independent experts headed by Paul McCracken), (OECD, Paris, June 1977).

Moreover, this mutuality of interest has to be realised in the context of longer-term structural problems within the developed and developing countries as well as that of the changing relationships between the two groups. In short, while slow growth makes it difficult to bring about structural changes, higher growth cannot be sustained without them.