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SOME OBSERVATIONS ON THE WORLD-WIDE INTENSIFICATION OF INFLATION

by

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Some Observations on the World-Wide Intensification of Inflation[1/] [2/]

by Helen B. Junz

During 1974, the world economy suffered from virulent inflation coupled with a slowdown in economic growth and an actual fall in output in the largest industrial economies. Thus, the question of how to bring their economies back to a stable growth-path with acceptable rates of price increase preoccupied most national authorities during the year and, in almost every case, authorities opted to deal first and foremost with the problem of inflation.

By the end of 1974, rates of inflation among major industrial countries, as measured by the consumer price index, ranged from year-to-year increases of 7 per cent in Germany to 25 per cent in Japan. In the second quarter of 1974, the average year-to-year increase for the OECD area as a whole was 13 per cent (See Table 1). This represents an acceleration in the rate of price increase to about four times the longer-run post-war average. In the less-developed countries, many of which have faced high rates of inflation throughout the post-war period, a similar acceleration in the rate of price increases has occurred. When the most extreme cases are excluded,[3/] recent inflation rates in the less-developed countries ranged from 6 per cent in Venezuela to over 60 per cent in Vietnam. On average, in the second quarter of 1974 consumer prices in all less-developed countries for which data were available

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1/ This paper presents the views of the author and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or its staff. Much of the substantive material in this original paper, sometimes in modified form, was used in a related paper by Ralph C. Bryant and Helen B. Junz presented at the XI Meeting of Technicians of Central Banks of the American Continent, Quito, Ecuador, November 18-23, 1974.

2/ I am grateful for comments by Ralph Bryant and for the help of Doral Cooper in particular, and also of Scott Brown in the preparation of this paper.

3/ Chile at the upper range and Tunisia at the lower end.

were 35 per cent above their year-earlier level. This represents an annual inflation rate almost three times that registered in the 1965-69 period.

This acceleration in the pace of inflation has proceeded at a rate unprecedented in peacetime and in the last two years or so, is in part explained by an unusual set of circumstances. But it reflects also longer-run tendencies towards generally rising rates of price increase, which have been at work at least since the mid-1960's.

Longer-run inflationary tendencies. Inflation has posed a problem to many authorities from time to time throughout the postwar period. But during the 1960's it seemed that each bout of inflationary pressure began with rather higher inflation rates than each preceding one. There are several factors that may have contributed to this upward tendency of underlying inflation trends. These factors relate to the general growth in incomes, structural shifts in the distribution of income and the stance of economic policies in many countries. Rising incomes coupled with a firm expectation of continuous increases in standards of living are tending to pull resources into current consumption, while at the same time stimulating investment demand aimed at providing the longer-run capabilities needed to satisfy the growth in overall demand. And governments have been slow to recognize that economic management problems no longer center mainly on the need to provide sufficient demand to absorb available resources -- as they were a few decades ago and as government policies still focussed primarily on demand management would seem to imply -- but rather on how to assure a sufficiency of supply to meet growing demand or how to restrain the growth of demand so as to correspond to prospective supply. All these factors may have combined to create an underlying pressure of demand that has tended to strain the limits of capacity, at least in certain areas.

Income shifts. Incomes in general have grown considerably over the past decade, although clearly the population in many countries still lives at intolerable poverty levels and whole segments of the population in even relatively rich countries live at the margin of poverty. As shown in Table 2, per capita real output has grown steadily in both developed and developing market economies and the rate of growth has accelerated during the past decade.

The fact that there has been growth in affluence probably would by itself imply some stimulus to consumption. But in many countries a process of income redistribution also has been taking place, with larger shares of income going to wage and salary earners and smaller shares to profits, entrepreneurial and unearned income. This has been partly the result of market forces and partly also a consequence of deliberate government policies. Table 3 shows the shares of national income accounted for by compensation of employees and government transfers to households for a number of industrial countries. Between 1955 and 1972, compensation of employees in all the countries listed has accounted for an increasingly larger share of national income. But the growth in the share of government transfers to households in national income is perhaps even more striking. The relative importance of transfer payments grew by about one-fifth in Japan, the country which experienced the smallest growth, and more than tripled in the Netherlands, the country showing the sharpest growth, between 1955 and 1972. To some extent, the growing importance of government transfer payments reflects rising old-age pensions stemming from the changing age structure of the population in the industrial countries. But other transfer payments also have gained significantly in importance. And there can be little doubt that these income transfers have played an important role in the growth of consumption expenditures.

Table 4 relates government transfers to households to personal consumption expenditures and shows, indeed, how important a factor these transfers have become: in 1955 they equalled 7 per cent of personal consumption expenditures in the United States and Japan and, at the upper range, they equalled 20 per cent in France and Germany. By 1972, these ranges had moved to 9 and 14 per cent in Japan and the United States and to 30 and 40 per cent in France and the Netherlands, respectively. Similar data on compensation of employees and government transfers are not available on a comparable basis for the less-developed countries, but it seems clear that a similar process is beginning to occur there, at least in those countries where real income has grown especially fast, such as Mexico, Brazil, Venezuela, Taiwan, and many others.

The income changes that occurred over the past decade might thus suggest that consumption expenditures are playing a more important role in aggregate expenditure than they did earlier. Indeed, a look at the share of aggregate expenditure that is accounted for by private and government consumption supports this hypothesis. During the 1950's and the early 1960's consumption played a diminishing part -- and in some fast growing countries such as Japan, a rapidly diminishing one -- in total expenditures. But around the middle of the decade, the share of consumption in total GNP appears to have stabilized in many countries, and it has grown since in some, notably in Sweden and Italy (See Table 5). Of course, these comparisons must be interpreted with care because the cyclical situation tends to influence expenditure shares strongly, so that a) a change over time in any one country may reflect merely a change in the prevailing cyclical position and b) differences among countries in any one year may be the result of their being in different stages of the cycle. Nevertheless, data for intervening years not shown in the table support the view that in recent years the trend for consumption to grow more slowly than other expenditure categories has been halted.

A similar conclusion can be drawn when growth rates of major components of industrial production are compared over time (See Table 6). In the developed countries the growth rate of output in the heavy manufacturing industries has declined in relation to that of total output; and that in the consumer goods sector appears to have stabilized and possibly is trending up again. If the automobile sector, which is included in heavy manufacturing, were added to the consumer industries a stronger downtrend in the ratio of the growth rate of output of the machinery sector to total output would be shown and, conversely, a clear uptrend in that for consumer industries would be apparent. In the developing market economies, there appears to have been a shift in relative growth rates of industrial output away from mining and towards consumer goods. But because of the heterogenous nature of development patterns among these countries, generalizations of this sort tend to be subject to very large numbers of exceptions and variations. This is shown in the regional breakdown given on Table 6.

The movement towards a consumer society in many countries tends to be reflected in the investment patterns. It appears that investment in productive capacity as a share of total investment may be declining over time. However, statistics in this area are not readily available for many countries, so that it is hard to make any generalizations. Nevertheless, some data that are available for particular industries indicate that investment seems to have been channelled increasingly to industries producing finished goods as well as to the service industries. Consequently, capacities in the industrial material and intermediate goods sectors, with the exception of the chemical industry, do not seem to have expanded appreciably in recent years. It seems that the relative profitability at least in the short-run, of investment in finished goods capacity and services may have been greater than that of investment in the basic materials industries. In part, this reflects the lumpiness and longer-lead times associated with investment in heavy industries and in part the fact that productivity advances may have been greater in other industrial sectors. Thus, the supply base for continued fast longer-run expansion may have been eroded slowly, adding to longer-run inflationary pressures.

A further factor, putting pressure on longer-run price trends, is associated with the diminishing proportion of the labor force in industrial countries that is engaged in the production of goods. Labor productivity in the service sector tends to be lower than that in industry. Consequently, unless productivity in industry grows at an accelerating rate, employment shifts towards the service sector imply a slowing in the rate of productivity growth for the economy as a whole. Moreover, in the industrial countries average wages in the service sector appear not to have grown appreciably less fast than those in manufacturing. Thus a tendency towards slower productivity growth was not accompanied by slower growth in labor costs and this may have intensified longer-run price pressures.

Government policy. Government actions in many countries, apart from those designed to redistribute income, may well have been the most important factor adding to the uptrend in underlying inflation rates. The widespread political and social commitment to high levels of employment in the industrialized countries at least implies a reluctance to use restrictive demand management measures before they are clearly needed and a use of reflationary measures at the earliest possible stages of a downturn. Thus, on balance, policies have been rather more expansionary than restrictive or neutral over the past decade, in particular also because there has been a general tendency to underestimate the strength of underlying demand forces. A further factor is the fact that fiscal policies in many countries have been slow to respond to stabilization needs, so that the major burden of anti-inflationary policy has tended to be put on monetary measures in the first instance.

Data on the posture of the government sector are fairly inconclusive for the 1960's and the early 1970's. But it would seem that governments, with the exception of France, certainly have not pursued more stringent fiscal policies in recent years than they did in the 1950's and early 1960's when price pressures, on average, were rather less. This is certainly true for the United States, where taxes were cut in the early 1960's in order to help bring the economy to a better level of capacity utilization than had prevailed in the latter part of the 1950's. When in the mid-1960's relatively high employment levels were reached and the Vietnam War put additional pressure on resources, the government was slow to increase taxation and allowed inflationary pressures to continue to build. Consequently, the government sector, on a national accounts basis, was a massive borrower in every year starting in 1966, except in 1969. A similar trend, towards more frequent or rather larger government deficits, although somewhat less pronounced, can be observed in other industrial countries, notably Italy, Germany and the Netherlands.

With fiscal policy slow to react, swings in monetary policy have tended to be rather large. And this clearly was not helpful in creating an investment climate conducive to satisfying the longer-run needs for expansion of capacities inherent in the emerging demand trends. Thus, a number of interacting factors were putting upward pressure on longer-run inflation rates well before the further world-wide acceleration of price increases occurred in 1972-74. The most important of these factors may have been an inflationary psychology generated by the widespread expectation on the part of the general public that standards of living would rise continually, an expectation partly caused by, and partly itself the cause of, government's commitments to levels of employment that may have been too ambitious.

<u>The 1972-74 inflation</u>. The particular sequence of events culminating in the rapid rates of price increase shown in Table 1 really began in 1970-71. During these two years output growth slowed virtually simultaneously in most industrial countries bringing about in turn a slowdown in production in the less-developed world. During these two years, industrial production grew on average by 1-3/4 per cent in the developed market economies and by 5-3/4 per cent in the

developing market economies. These figures compare with longer-run averages of 5.5 per cent and 7.4 per cent, respectively (See Table 7). Over the same period, the combined GNP of the OECD countries grew by 2.3 per cent in volume as compared with a longer-run average of 5-1/4 per cent. This slowdown in economic activity was in part the result of anti-inflationary measures taken earlier in various countries and partly caused by the shock to business confidence associated with the international monetary crisis of 1971.

Business confidence was relatively quickly restored, however, after the conclusion of the Smithsonian agreement in December 1971. At the same time national authorities took an increasing number of reflationary measures. The record shows that during 1972 and even through early 1973, most national and international forecasters consistently underestimated the strength of demand in particular economies and in the world economy as a whole. Thus, governments continued to take reflationary measures well into 1972, in part because unemployment rates were slow to decline.

Fiscal policy in Japan in 1971 and 1972 provides a good illustration of this as well as of the general point that doubts about the appropriate policy stance have more often than not been resolved in an expansionary direction. The economic slowdown in Japan that began in 1971 was exacerbated by the uncertainties created by the international monetary disturbances culminating in the New Economic Policy, or as the Japanese termed it, the "Nixon shock" of August 1971.

Consequently, the Japanese authorities adopted a strongly expansionary supplementary budget in October 1971 designed to impart a fiscal stimulus equal to 2 per cent of GNP. This supplementary budget followed an already expansionary initial budget adopted at the beginning of the fiscal year in April, 1971. Although business confidence began to revive after the Smithsonian agreement of December 1971, the 1972 budget injected a further strong stimulus.

As a consequence of the improved general climate and the expansionary policies pursued by the Japanese authorities, economic recovery continued to gain strength during 1972. However, business investment demand remained relatively weak and no significant inroads were being made into the amount of unutilized resources that had existed at the beginning of the year. Consequently, there also was no noticeable reduction in Japan's large external balance of payments surplus. The authorities, clearly underestimating the stimulus already built into the economic situation, took further expansionary measures in a supplementary budget in October 1972. The total of fiscal measures brought appropriations for fiscal 1972 to almost 30 per cent above their 1971 level. Clearly, this sort of fiscal stimulus superimposed upon an already broadening upswing in economic activity could not but bring about the strong inflationary pressures that indeed, ensued in 1973.

The Japanese experience was fairly typical of that of other industrial countries: investment expenditures were not yet turning up in volume and unemployment was slow to recede. But other indicators, such as order books and foreign trade were showing evidence that the expansion of aggregate demand had indeed become broad-based.

The 1972-73 upturn, thus, was exceptionally sharp and real economic growth in the seven major industrial countries,[1/] for example, rose to an annual rate of over 8 per cent between the second half of 1972 and the first half of 1973. This growth rate was well above the longer-run average of 5-1/4 per cent and clearly was not sustainable for any length of time. Still, supply capabilities proved to be very elastic, partly because of the general slack that had been cumulating during 1970-71, and industrial output in the developed countries grew at almost twice its longer-run average in late 1972 and early 1973. With this very fast growth in output bottlenecks developed at a quite early stage in the economic expansion, despite new additions to capacity. As a result price pressures intensified and growth of output began to slow.

Furthermore, as inflation rates began to increase sharply and delivery periods lengthened, the inflationary climate itself added further impetus to the expansion. Inflationary expectations partly motivated the strong rise in business orders -- for both fixed investment and inventories -- which was a notable feature of the 1972-73 upswing and which lasted well into the slowdown.

1/ United States, Canada, Japan, France, Germany, Italy and the United Kingdom.

The general and very rapid expansion in demand in 1972 and early 1973 in the industrialized countries led to an extremely rapid expansion of world trade. The volume of world trade grew by 13 per cent from 1972 to 1973 as compared with a longer-run average annual increase of 9 per cent. But this expansion of trade could do little to diminish the pressures on capacities because of the simultaneous nature of the expansion of internal demand in the individual countries. In fact, in many cases, foreign demand only added to pressures on capacity and further intensified internal price pressures.

Industrial materials prices. Price rises were particularly rapid in the industrial materials sector, in part because of low starting inventory levels, particularly in relation to the rapid increase in demand. But much more important was the fact that existing capacities were not geared to rapid expansion of output occurring simultaneously in North America, Europe and Japan. In previous years, the underlying shortage of capacity in the basic materials sector had been obscured by the fact that not many economies had been operating at relatively high levels of output at the same time. Thus, foreign supplies could generally be counted on to ease capacity strains for this very trade-intensive sector. However, in 1972-73, when all major economies expanded simultaneously, it became clear that capacities were insufficient to adequately serve worldwide high employment levels.

Spot prices for industrial materials reacted quickly to the pressure of demand. In fact, shortages led to scrambles among users to secure supplies. Consequently, world prices for industrial materials (excluding oil) almost tripled between the end of 1971 and May 1974. (See Chart 1.)

Food prices. In addition to the cyclical pressures on price levels, longer-run pressures on food prices became apparent. The rapid growth of incomes in recent years brought about a rapid rise in demand for protein-rich foods in many countries. But for a considerable period of time, the existence of high inventory levels of foodstuffs in producing countries tended to mask the fact that demand was beginning to outgrow average supply levels. This became increasingly clear in 1972 and 1973 when a number of factors combined to reduce current supplies. Harvests were poor in 1972, particularly in the Soviet Union, and world wheat production, for example, fell by 2 per cent. In addition, demand for feed grains rose as fishmeal became scarce with the disappearance of the anchovies from the Peruvian coastal waters. Further, Argentine beef production had already fallen sharply in 1970 and 1971; this supply shortfall was then exacerbated by low beef production in the EEC, which followed a reduction in herds that had resulted from policies designed to decrease the EEC surpluses of milk and butter.

The combination of rising demand for and shortfalls in output of agricultural products put considerable pressure on food prices. Thus, spot prices for foodstuffs, as reported by the Economist in U.S. dollar terms, rose by more than 150 per cent between late 1971 and early 1974. In 1974, the very low starting levels of inventories of foodstuffs and the indications that harvests in the United States, Canada, Australia and the Soviet Union would be well below expectations put renewed upward pressure on food prices. By the second half of November, spot prices for raw foods (expressed in dollar terms) reached a new peak 43 per cent above their level at the beginning of the year and over three and one half times as high as in late 1971. (See Chart 1.)

1973-74 downturn. As inflation rates began to climb, from an annual average of 4.2 per cent for consumer prices in the OECD-countries during the second half of the 1960's to 7.5 per cent in 1973, authorities in many countries increasingly moved to contain demand within the limits of available capacity. Consequently, the sharp acceleration in output of early 1973 was followed by an equally sharp deceleration -- from an annual rate of real economic growth of over 8 per cent in the seven major industrial countries in the first half of 1973 to less than 3 per cent in the second half and to a negative rate of growth of about -2 per cent in the first half of 1974.

At the early stage of the slowdown, the deceleration in the rate of economic expansion was partly supply-conditioned. Thus, in mid-1973 capacity constraints put limits on further expansion, but by the second half of 1973, policy restraints also began to bite, particularly in Germany, where policy had become restrictive towards the end of 1972.

<u>Oil prices and supply</u>. The oil crisis in the fall of 1973 put a further brake on economic growth, first because of supply problems and later through the impact of higher oil prices on the cost of petroleum products and the production costs of other goods and services. The direct impact of the oil price increases, which affects the system in a manner akin to that of an excise tax the revenues of which are not respent, is estimated to amount to about 2 per cent of the industrial countries' GNP. But, at the same time that the oil price increases put a brake on overall demand, they may stimulate new investment demands, for example, for energy saving equipment or for the production of energy from other sources. Thus the net effect on demand of the oil price rise is hard to assess, although it is likely to be significant.

There can, however, be no doubt about the adverse effect the oil price rises have had on the already strong inflationary expectations that economic policy during the past year or so has been aiming to combat. By the fall of 1973, price increases in the OECD countries, as measured by the consumer price index, had already accelerated to an annual rate of over 8 per cent. Then, in just a few months, prices of crude oil in the major producing areas quadrupled. This quantum jump in the price of a commodity as all-pervasively used as petroleum quickly led to substantial increases in the production cost of many goods and services.

Whereas in 1972 and 1973 increases in food prices had been the single most important factor in pushing up inflation rates, petroleum prices played the major role in the doubling of inflation rates between late-1973 and the fall of 1974. According to estimates made by the OECD Secretariat, one-fifth of the overall rise in consumer prices that occurred in the OECD area during the six months from September 1973 to March 1974 was attributable to the oil price increases. As higher costs of petroleum worked their way more fully through the various economies in subsequent months, prices of finished goods were more widely affected, public utility charges rose and prices of domestically produced energy sources moved up. Consequently, the impact of the petroleum price increase in overall inflation rates currently must be significantly larger than the one-fifth share estimated for the initial period.

Foreign trade prices. Foreign trade prices in the past two decades tended to exert a moderating influence on overall inflation rates, with export and import unit values rising only fractionally as much as domestic price levels. But during the 1972-74 period foreign trade prices failed to conform to this pattern (See Table 8). This was in part a consequence of the commodity boom during which unit values of primary commodities (in dollar terms) tripled. Prices rose in all commodity categories at unprecedented rates for peacetime, except in the case of metals, the price of which rose at similar rates during 1954-56. But prices for internationally traded manufactured goods also rose very rapidly. Unit values for exports of manufactured goods rose by 8.1 per cent between 1971 and 1972 and by 16.4 per cent between 1972 and 1973. In the second quarter of 1974, unit values of manufactured goods exports were a further 17 per cent above their 1973 average (See Table 8).

The rise in foreign trade prices was associated with a very large expansion in the volume of trade: 9 per cent from 1971 to 1972 and 13 per cent from 1972 to 1973. The rapid expansion of demand during most of this period combined with the generally inflationary climate blunted the effect of price competition, thus allowing foreign trade prices to rise at rates quite similar to those of domestic price levels. Overall unit values of exports in recent quarters have been showing increases over corresponding periods in 1972 and 1973 of around 25 per cent for developed countries and of close to 40 per cent for developing countries (including oil producers). Of course, export prices for fuel, a category in which petroleum carries a weight of four-fifths, have increased at exponential rates, rising by over 40 per cent between 1968 and 1972 and by a further 283 per cent between 1972 and the second quarter of 1974. This means that export prices for fuel have more than quintupled since the mid-1960's. Consequently, the price terms at which fuels are exchanged for manufactured goods in international trade had swung in favor of fuels by 1971 and the favorable margin established then, of course, has widened continually and enormously since.

But the terms of trade also swung in favor of the non-oil primary producing countries during most the 1972-74 expansion. This allowed developing countries to expand their import volume considerably, first adding to the pressures on capacities in the developed countries during most of 1973 and then providing support to general levels of activity in 1974 as internal demand in the industrial countries weakened.

Some mitigating influence on the upward momentum of price increases can be expected from the recent decline in world prices for metals and fibers (See Chart 1). Prices for these industrial materials began to weaken early in 1974 as economic activity slowed throughout the industrial world. By the end of the year spot prices for agricultural fibers had come down two-fifths from their mid-January high and metal prices, which began to weaken in May, had been reduced by more than one-half. Nevertheless, fiber prices are still almost twice as high as in 1971 and metals are about one-third higher than in 1971. In December 1974 even food prices began to recede a little from their November record levels. If these price declines were to continue, they would contribute to a substantial weakening of inflationary expectations and such a movement of itself would reflect some turnaround in the inflationary psychology.

Wages. A lessening of inflationary expectations would be particularly important at this time because of the effect it could have on wage negotiations. Moderation of wage demands in turn, would have important effects on price pressures and thus help to reenforce tendencies towards a reversal of the upward twist of the price-wage spiral.

But for the moment there is little evidence that wage pressures may be moderating. The sharp rise in consumer prices over the past two years has generated increasingly large wage demands as workers have attempted to protect -- and in some cases to restore -- their real income levels. And in this process the especially sharp increases in prices for items that loom large in family budgets, purchases of which occur on a regular basis so that they are not postponable, have been particularly important. For example, the rise in food prices has been so large that, in the major industrial countries, it has accounted for from about one-fifth to almost one-half of the overall increase in consumer prices from the three months ending August 1973 to the same period in 1974 (See Chart 2). And to these price rises, which cut heavily into family incomes, were added the enromous increases in prices for fuel, lighting and transportation that followed the hike in oil prices.

With the impetus given to wage demands by the high inflation rates, wages themselves were again becoming a major force as a cause for price inflation during 1974. And the movement from cause to effect to cause has been quickened because the use of escalator clauses, which rapidly translate higher prices into higher wages, is spreading fast. Labor militancy has been rising as inflationary expectations became more deeply rooted, and wage-push inflation is likely to give further impetus to the rate of price increases in the near future, despite growing levels of unemployment.

Summary and concluding remarks. Confronted with unprecedented rates of price inflation in peacetime, policymakers almost everywhere faced the same dilemma in 1974: how to cope simultaneously with a possible excessive weakening of economic activity and with continuing rapid inflation. Most authorities have been pursuing restrictive policies since sometime in 1973. But the timing and the particular types of policies adopted by different countries -- whether general monetary and fiscal policies or direct intervention in the pricing mechanism -- reflect circumstances specific to each country, as well as differing views among governments as to how to deal with these problems. The inflationary pressure emanating from the the strains put upon the international financial system by the large oil price increases clearly are a major factor in the policy determination of the oil-consuming countries.

Whether one believes that the policies currently in place to combat the high inflation rates are likely to be successful depends largely upon the view one takes of the underlying causes for the in inflationary pressures.

First, it is clear that a very large part of the acceler in inflation rates is home-grown. As discussed above, governments neglected to formulate longer-run supply policies in the face of str rising demand trends. In addition, they may have been too ambitious their commitment to high employment levels and in their conviction th they could indeed shape demand management policies so as to minimize fluctuations in employment. Consequently, macro-economic policies in the postwar period have, on average, imparted an inflationary bias to the economies they were attempting to manage.

In the most recent period, there was a consistent tendency to underestimate the rising strength of demand, so that policies in 1971-72 were excessively expansionary. The Gatt estimates that annual increases in the money supply of eleven large industrial countries during 1961-1969 averaged 6.8 per cent per annum; during the next four years the annual rates of increase were 10.6, 17.6, 15.5 and 14.0 per cent respectively.1/ In contrast, the rise in output of goods and services on average did not increase appreciably between the two periods, although growth rates in the first half of 1973 were exceptionally fast. These facts, while only suggestive, indicate that monetary expansion may have been well in excess of the rate appropriate for assuring reasonably stable price levels.

1/ General Agreement on Tariffs and Trade, "Prospects for International Trade" Press Release, September 1974. These figures, as the GATT Secretariat point out, can only be indicative because aggregation of money supply data over countries is frought with statistical and conceptual problems.

Fiscal policy during the 1971-72 period also appears to have added considerably to the pressure of demand, particularly in the capital goods sector, where capacities were also being absorbed quickly by rising private demand. Public investment expenditures rose particularly fast in Japan, Canada and Italy during 1971 and 1972. And, as noted above, policies remained expansionary well into the upturn, partly because of a misreading of the gathering strength of demand.

Second, there is a considerable school of thought that argues that the move to a flexible exchange rate regime in itself has given rise to inflationary pressures by removing the balance of payments discipline that might have put constraints on policies and by letting foreign trade prices flex more substantially. The latter would lead to upward pressures on price levels if it were accepted that prices tend to be sticky in a downward direction, so that an asymmetry would be introduced regarding the effects of revaluations and devaluations upon price levels. Recent studies appear to support the argument that such assymetric behavior of foreign trade prices indeed exists. If it were accepted that the easing of the balance of payments constraint and the way the pricing mechanism operates tend to impart an inflationary impetus to the world economy, it still would be difficult to estimate the net effect of moving from one exchange rate system to another. The possible costs on the inflationary side associated with the flexible system might be partly, fully or even more than offset by the gains coming from elimination of the large speculative capital flows that had been associated with the way the fixed exchange rate system was operated and that had resulted in large increases in the monetary reserves of one country or another from time to time.

A third strand in the inflationary pattern is the so-called commodity inflation. However, it would be hard to argue that, except in the case of the oil price increases, the rise in industrial commodity prices was other than largely demand-induced. For any one country, the large increase in commodity prices may well have appeared to be imposed from the outside and the authorities in individual countries may have felt helpless in the face of this upsurge in inflationary pressures. But, it was government policies that were the basic cause for the very fast worldwide expansion of demand that occurred in 1972-1973, and it was government neglect that failed to perceive that capacities in the materials sector were insufficient to meet high levels of demand occurring simultaneously in many countries.

In the case of food prices, there were severe supply shortfalls and it is likely that supplies over the next few harvest periods -- at least until stocks are rebuilt to more comfortable levels -- will not be so abundant as to cause a very significant reversal of the food price increases of the past two years. Thus, there will be a need for countries to adjust for the time being to substantially higher relative prices for food than existed before 1972-1973. This adjustment comes at the same time as economies also need to adapt to the enormous increases in the relative price of energy.

The responses of consumers and producers to these changes in relative prices involve a shift in current investment patterns as demand for the output of certain sectors declines and that for others rises. This shift, combined with the longer-run need to shift resources into certain investment activities as discussed above, will pose most difficult policy questions. Financial markets will need to be very flexible in order to effect an efficient distribution of capital, both among industries and among countries; policies will need to aim to shift resources according to the perceived longer-run needs and this may well imply a possible reordering of social priorities.

Adjustments of this sort can hardly be expected to be accomplished without friction. But when they need to occur against a background of intense price inflation and anti-inflationary policies, they are likely to give even greater rise to economic inefficiencies and social friction than otherwise.

Economic activity currently is declining in a number of countries and stagnating in others. And the outlook is for continuing weakness in the industrial countries as a whole with further rises in unemployment. At the same time that unemployment in many countries has reached -- or is approaching -- its highest level in a quarter of a century, inflation rates have remained at destructive levels. Although there is some scattered evidence that price pressures have begun to recede, especially in Japan and Germany, two-digit inflation remains the norm on the whole (See Table 9).

Because rates of inflation have remained intolerably high, many authorities have hesitated to take reflationary measures. A major factor in their policy deliberations has been the fact that the strength of inflationary expectations, as it finds its expression in wage demands, is likely to breed further price pressures. Thus, with unemployment cumulating, the dilemma of how to deal simultaneously with a possible excessive weakening of economic activity and with continuing rapid inflation has been sharpened and the risk on the down-side has been increasing.

Clearly, no responsible government would deliberately aim at creating a deep recession even if this in time could achieve the aim of turning inflationary expectations around. But the risk that simultaneous reflation in the industrial countries might regenerate inflationary pressures that had not even appreciably receded from their 1973-74 levels has caused governments to move very cautiously. The chances that the extremes of virulent inflation and deep recession may be avoided might be appreciably improved if the sort of misreading of changes in demand forces that occurred during the 1972-73 period could be avoided. The experience of that period shows that even the largest economies need to take changes in the course of output and demand in the rest of the world into account in the formulation of their demand management policies. Thus, institution of an analytical approach that attempts to assess changes in world demand as distinct from demand changes on national levels only, such as has been suggested for example by Walter Salant, would be helpful in this respect.1/

But the hope of an eventual return of the world economy to a reasonable growth-path accompanied by acceptable rates of price increase does not hinge merely upon improvements in the analytical toolchest of policy advisers. It hinges upon the ability of governments to achieve the necessary shifts in resource allocation without excessive cost in terms of social friction and economic waste. It is clear that in a situation where supply management is becoming an important policy concern international cooperation becomes more than ever a necessary condition for achieving success. Stable growth-paths can be achieved only if and when the business climate is conducive to making longer-range decisions without undue risks. And creating such a climate in isolation is becoming increasingly difficult in a world where the speed with which political and economic events spill across borders is accelerating.

1/ Walter Salant, A Supranational Approach to the Analysis of World Inflation, mimeograph, September 30, 1974.

Table 1

Consumer Prices in OECD Countries and Developing Countries, 1955-1974
(Year-to-year percentage changes and averages, annual rates)

	OECD Countries	Developing Countries of which: Total	Western Hemisphere	Asia[a]	Africa
1955-1960 Average	2.3	n.a.	n.a.	n.a.	n.a.
1960-1965 Average	3.1	14	26	5	4
1965-1969 Average	4.2	14	16	7	4
1970	5.8	11	12	7	4
1971	5.2	10	16	5	4
1972	4.6	12	23	6	5
1973	7.5	24	39	17	9
1974 2nd quarter	13.0	35[b]	56	31	16

a/ Excluding Near East.
b/ First quarter 1974 over first quarter 1973.
n.a. - not available.

Sources: OECD Economic Outlook, No. 15; OECD Main Economic Indicators; IMF Annual Report, 1974; IMF International Financial Statistics; Federal Reserve Board Staff.

Table 2

Growth Rates of Per Capita
Real Domestic Product
(Percentage changes, annual rates)

	Developed Market Economies	Developing Market Economies of which: Total	Latin America	Africa	West Asia	South and South East Asia
1950-1960	2.8	2.4	2.2	2.3	4.1	2.0
1960-1970	3.9	2.6	2.7	1.9	4.5	2.1
1967-1968	4.6	3.3	3.2	3.6	6.9	2.2
1968-1969	3.8	4.2	4.0	1.9	7.4	4.7
1969-1970	2.2	3.3	3.7	3.2	6.4	1.9
1970-1971	2.6	2.6	3.4	1.0	7.4	1.1
1971-1972	4.4	3.1	4.1	2.5	7.2	1.3

Source: United Nations, Handbook of International Trade and Development Statistics, 1973 Supplement.

Table 3

Selected Industrial Countries: Share of Compensation of Employees and Government Transfers to Households in National Income

(Per cent, based on data on current prices and local currencies)

	1955	1960	1965	1970	1972	Per Cent Change in Share 1955-19
A. Compensation of Employees and Government transfers						
Belgium	59	64	68	71	76	29
France	63	63	70	73	74	17
Germany	62	66	71	74	77	24
Italy	54	58 a/	66	69	76	41
Netherlands	56	63	73	84	87	55
Sweden	65	69	76	81	85	31
United Kingdom	69	71	73	76	77	12
Canada	64	70	68	73	74	16
Japan	50	50	57	55	60	20
United States	67	70	69	77	77	15
B. Compensation of Employees						
Belgium	48	51	54	55	58	21
France	49	49	52	54	55	12
Germany	50	52	56	58	60	20
Italy	43	45 a/	50	53	57	33
Netherlands	48	51	57	62	62	29
Sweden	57	59	64	67	69	21
United Kingdom	63	64	65	66	67	6
Canada	57	61	60	64	63	11
Japan	45	46	52	50	54	20
United States	62	64	63	68	67	8
C. Government Transfers						
Belgium	11	13	14	16	18	64
France	14	14	18	19	19	36
Germany	12	14	15	16	17	42
Italy	11	13 a/	16	16	19	73
Netherlands	8	12	16	22	25	212
Sweden	8	10	12	14	16	100
United Kingdom	6	7	8	10	10	67
Canada	7	9	8	9	11	57
Japan	5	4	5	5	6	20
United States	5	6	6	9	10	100

a/ 196

Source: OECD, National Accounts, various issues; U.S. Department of Commerce, Survey of Current Business, various issues.

Table 4

Selected Industrial Countries: Government Transfers to Households as a Percentage of Personal Consumption Expenditures
(Per cent, based on data in current prices and local currencies)

	1955	1960	1965	1970	1972	Per cent Change in Share 1955-7
Belgium	14	17	21	25	27	93
France	20	21	27	29	30	50
Germany	20	24	25	26	28	40
Italy	15	18	22	23	27	80
Netherlands	13	18	25	35	40	208
Sweden	12	15	18	24	28	133
United Kingdom	9	10	12	15	16	78
Canada	10	13	11	15	17	70
Japan	7	7	8	9	9	29
United States	7	9	9	13	14	100

Source: OECD, National Accounts, various issues; U.S. Department of Commerce, Survey of Current Business, various issues.

Table 5

Selected Industrial Countries: Share of Private and Government Consumption in GNP
(Per cent, based on volume data)

	1955	1960	1965	1969	1972
Belgium	82	82	78	77	77
France	80	74	74	72	71
Germany	70	70	71	69	72
Italy	80	77	77	76	79
Netherlands	74	71	74	73	72
Sweden	79	77	75	75	85
United Kingdom	85	83	81	79	82
Canada	78	79	76	76	77
Japan	75	68	64	57	56
United States	82	84	83	85	85

Source: OECD, _National Accounts_, various issues; U.S. Department of Commerce, _Survey of Current Business_, various issues.

Table 6

Ratio of Growth Rates of Major Components of Industrial Production to Growth Rate of Total Production
(Per cent)

	1955-60	1960-65	1965-70	1970-73
Developed Market Economies				
Consumer industries	90	74	69	77
Heavy manufacturing	110	116	109	106
Mining	28	42	52	21
Developing Market Economies				
Consumer industries	62	70	63	72
Heavy manufacturing	129	123	119	130
Mining	129	116	127	84
of which:				
Caribbean, Central and South America				
Consumer industries	70	70	78	63
Heavy manufacturing	157	128	133	146
Mining	98	68	62	24
Asia, excluding Israel and Japan				
Consumer industries	63	78	42	82
Heavy manufacturing	142	135	115	56
Mining	101	101	144	143

Source: United Nations, Monthly Bulletin of Statistics.

Table 7

Growth of Industrial Production by Region and by Industrial Sector
(Year-to-year percentage changes)

	Average 1959-60 to 1970-71	1971 I	1971 II	1971 III	1971 IV	1972 I	1972 II	1972 III	1972 IV	1973 I	1973 II	1973 III	1973 IV	1974 I	1974 II
Developed Market Economies															
Total industrial production of which:	5.5	0	1.0	1.0	2.9	4.0	5.8	7.1	9.5	10.5	9.2	10.4	7.0	3.5	1.7
Consumer industries	4.0	4.1	2.0	3.0	3.9	3.0	4.9	4.9	7.5	7.7	5.6	5.6	3.5	0.9	1.8
Heavy manufacturing	6.3	-1.0	-1.0	0	3.0	4.0	6.9	8.3	11.7	13.5	12.8	13.3	9.6	4.2	2.4
Mining	2.5	7.1	4.0	-1.0	-6.5	-6.7	-2.9	0	6.0	6.1	2.9	4.0	0.9	1.0	1.0
Developing Market Economies															
Total industrial production of which:	7.4	6.2	6.1	7.0	8.7	4.9	9.5	9.4	9.8	10.2	7.8	11.1	10.6	9.2	n.a.
Consumer industries	5.0	-2.8	2.9	6.2	9.7	0	2.8	10.7	9.7	7.6	7.3	7.0	6.5	7.0	n.a.
Heavy manufacturing	8.7	10.9	6.1	12.9	9.6	6.9	14.4	6.1	10.5	9.2	7.6	9.9	13.5	14.3	n.a.
Mining	9.1	7.3	6.1	5.0	5.9	3.9	8.6	4.8	6.5	14.0	10.0	18.2	10.4	4.9	n.a.
of which:															
Asia, excluding Israel and Japan															
Total industrial production of which:	7.6	4.3	9.4	7.9	7.5	5.8	3.4	7.3	12.9	12.2	12.2	15.3	10.0	7.9	n.a.
Consumer industries	5.0	-7.7	6.7	-0.6	5.1	3.5	1.7	12.7	14.5	10.4	10.8	6.5	6.0	2.2	n.a.
Heavy manufacturing	9.2	10.6	5.7	5.7	3.8	-4.8	-0.5	0	7.3	7.8	4.9	12.5	10.1	12.4	n.a.
Mining	9.0	11.5	16.9	16.5	15.4	14.4	5.8	8.0	11.5	16.2	21.4	26.2	11.2	8.5	n.a.

n.a. - Not available:
Source: United Nations, Monthly Bulletin of Statistics.

Table 8

Export Prices and Terms of Trade
by Commodity Groups
(Index numbers, 1963=100)

	Prices 1/			Terms of Trade	
	Manufactured Goods	Non-Manufactures Total	Non-Manufactures Fuels Only	Non-Manufactures/ Manufactures	Fuels/ Manufactures
1955	93	107	103	115	111
1958	97	105	110	108	113
1961	100	100	99	100	99
1964	101	103	100	102	99
1965	104	102	101	98	97
1966	106	103	101	97	95
1967	107	102	101	95	94
1968	107	100	100	93	93
1969	110	102	100	93	91
1970	117	106	108	91	92
1971	124	113e	127	91e	102
1972	134	128e	143	96e	107
1973	156	185e	188	119e	121
1974 1st Qtr.	166	284e	537	171e	323
2nd Qtr.	183	288e	548 2/	157e	299

1/ Prices are unit values for manufactured goods and total other (non-manufactured) goods, actual export prices for fuels. Export price indexes in general tend to be more volatile than unit value indexes and tend to lead the latter. The index for total non-manufactures is estimated for 1971-74 on the basis of the primary commodity price index for 1971 to 1974, since unit values for that period are not available.
2/ The fuels index in the second quarter of 1974 stood at 561. (Data for other columns of the table are not yet available, or could not be estimated, for the period after the second quarter of 1974.)
e = estimated.
Source: United Nations, Monthly Bulletin of Statistics; United Nations Handbook of International Trade and Development Statistics; FRB.

Table 9

Selected Industrial Countries: Changes in General Wholesale Prices, 1972-IVQ - 1974-IIIQ
(Percentage changes from preceding three months, annual rates)

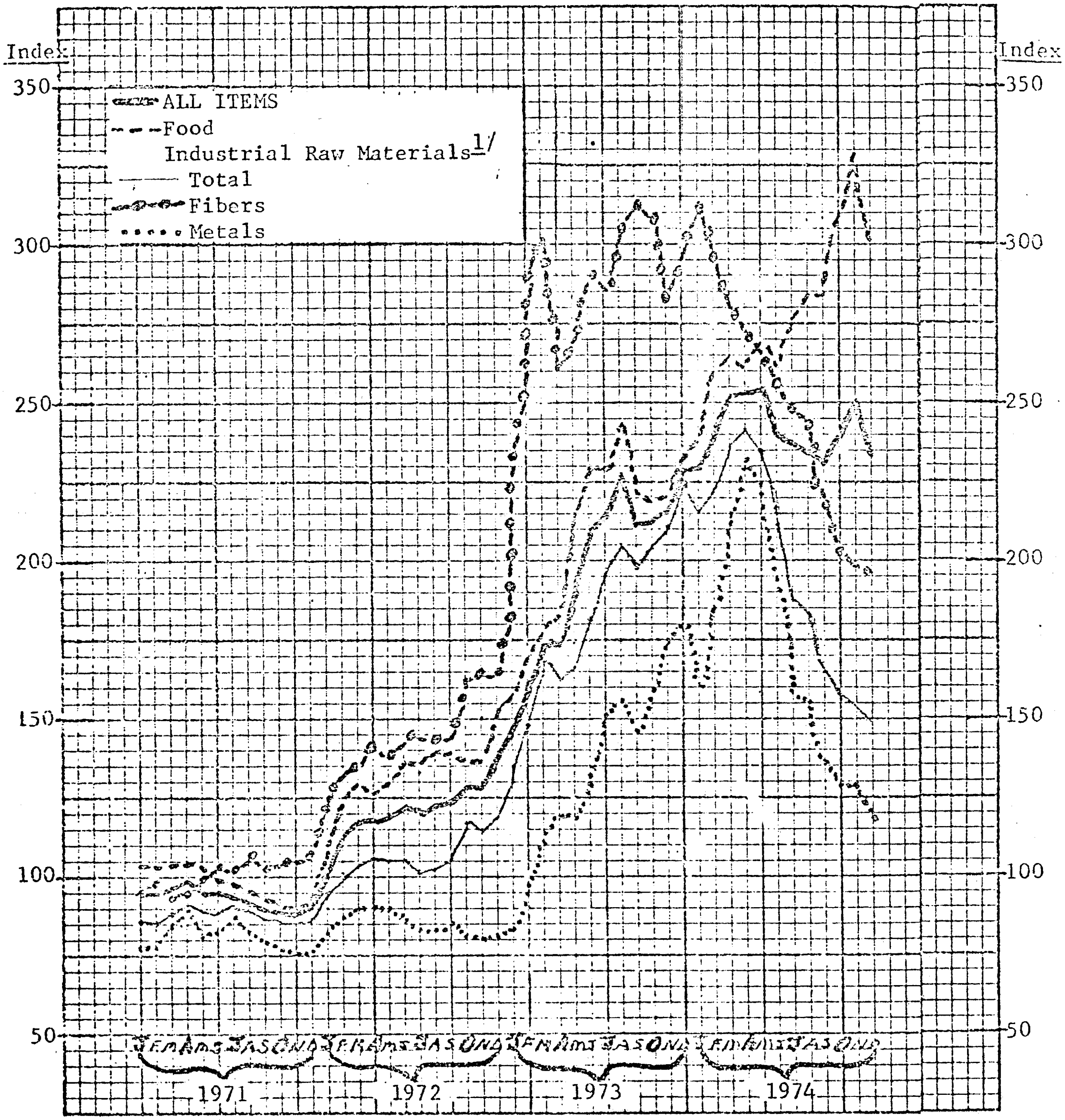
	1972	1973				1974			1974	
	IV	I	II	III	IV	I	II	III	Latest 3-Months	Latest Month
Belgium	13.1	17.2	12.2	12.8	12.2	39.2	14.5	2.2	3.4	Oct.
France	14.6	17.0	13.5	19.1	29.5	64.7	39.3	-3.0	-3.0	Sept.
Germany	6.3	11.9	9.5	4.5	7.8	31.5	21.2	4.0	4.2	Nov.
Italy 1/	11.5	17.8	24.9	26.0	25.7	89.2	39.9	24.2	17.6	Nov.
Netherlands	15.2	15.5	21.0	0.0	15.6	27.1	6.6	9.5	9.5	Sept.
United Kingdom 2/	8.8	5.2	2.0	14.4	16.7	31.8	34.1	20.8	23.5	Nov.
Japan	12.1	20.8	14.2	22.4	39.5	72.7	14.0	12.3	6.5	Nov.
Canada	17.1	28.8	20.8	40.2	17.4	29.8	15.7	13.9	15.4	Oct.
United States	4.3	20.8	20.9	17.4	3.5	29.2	15.0	31.6	21.8	Nov.

1/ VAT was introduced January 1, 1973.
2/ VAT was introduced April 1, 1973.

Note: France: industrial products only, United Kingdom, all manufactured products, home sales.
Sources: National sources.

Chart 1

World Commodity Prices - Monthly Average
1970=100 (dollar index)



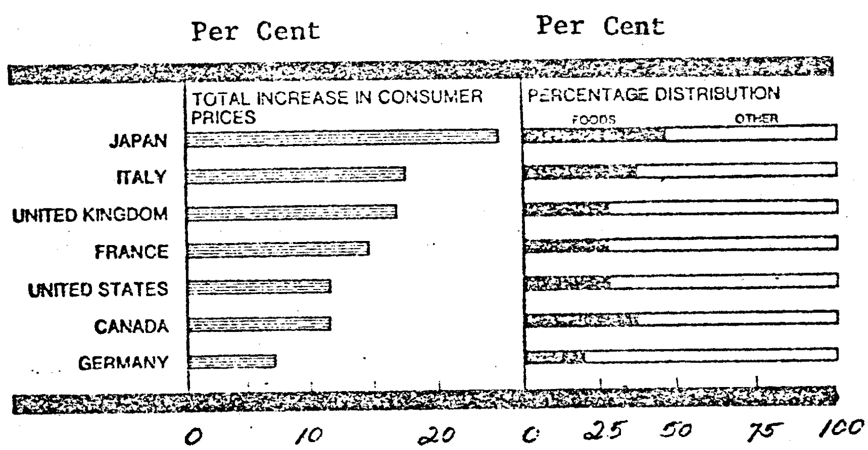
1/ Excludes oil.

Source: The Economist.

CHART 2

The Role of Food in Consumer Price Increases

in Selected Industrial Countries



Source: Federal Reserve Bulletin, October 1974, page 693. Rates of increase are for the three-month period ending in August 1974 over the same period of the preceding year (for the three-month period ending in July 1974 for the United Kingdom and Italy). Data based on national sources.