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Minimum Wages and Youth Employment

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Investment and Jobs

Highlights from OECD Economic Outlook, July 1982

Recent Trends and Prospects

The influences now acting upon OECD economies are diverse, and are moving countries into somewhat different cyclical phases. A recovery in activity is thought to be occurring currently in Europe and Japan, and one is expected in North America in the second half of this year.

OECD GNP may grow by ½ per cent this year and 2½ per cent next. The projected recovery derives essentially from a real income induced consumption pick-up and a swing in the stockbuilding cycle. There will likely be important differences between the United States, Japan and Europe. The United States GNP may decline in 1982 (–1½ per cent) and grow by a little over 2 per cent in 1983. In Japan, growth may pick up from 2 per cent in 1982 to a little under 4 per cent in 1983. In Europe, GNP may grow at about 1½ per cent in 1982 and at perhaps 2½ per cent in 1983.

Inflation, as measured by private consumption deflators, is projected to decline in the OECD area as a whole from a rate of 8 per cent in the first half of 1982 to just over 7 per cent in the second half of 1983, in line with expected moderation of wages and continued weakness of oil and non-oil commodity prices. Considerable dispersion between countries will remain. In 1983 five countries (Austria, Germany, Japan, the Netherlands and Switzerland) are likely to have inflation rates below 5 per cent, and another nine countries in the 5 to 10 per cent range. Five countries may have an inflation rate in excess of 15 per cent.

The current account deficit of the OECD area fell to around $30 billion in 1981 owing mainly to the buoyancy of high-absorbing OPEC countries' imports. It could fall by another $10-15 billion in 1982 and show little change in 1983. The picture is varied, with the United States projected to swing into deficit in the first half of 1983, and Japan substantially increasing its surplus through next year.

Unemployment is likely to increase throughout this year and next, even given the pick-up in employment projected from mid-1982. From a rate of 7½ per cent in the latter part of 1981, OECD unemployment could reach 9 per cent of the labour force, approaching 32 million people, in the first half of 1983. In Europe the rate could be 10½ per cent. Unemployment rates of young people in most countries are averaging about twice those for the workforce as a whole. The duration of unemployment has been increasing. In Europe about one third of the unemployed have now been out of a job for six months or more.

Slow Growth and the Problem of Jobs

The immediate outlook suggests the continuation of a number of serious

CHANGES SINCE THE 24TH MAY CUT-OFF DATE FOR INFORMATION

The projections in this Economic Outlook *embody information available at the cut-off date of 24th May. Important basic assumptions underlying the projections include:*

- *no change in actual or announced economic policies*
- *no change in nominal oil prices from April 1982*
- *no change in exchange rates from the average of the four weeks ending 30th April.*

Since the cut-off date the most important changes include a number of movements of exchange rates. These include appreciation of the United States dollar, depreciation of the Canadian dollar, and a realignment of currencies within the European Monetary System (EMS), involving most importantly a devaluation of the French franc and a revaluation of the German mark. At the time of writing of this box – 17th June – effective exchange rates had changed by the following amounts in relation to the assumptions embodied in the projections:

U.S. Dollar	*2.9*	*Japanese yen*	*–1.1*
German mark	*2.1*	*Swiss franc*	*–3.5*
Pound sterling	*1.7*	*Canadian dollar*	*–3.6*
Dutch guilder	*1.4*	*French franc*	*–5.6*
Italian lira	*–0.8*		

It is by no means clear how exchange rates will move over coming months. The depreciations that have occurred since the projections were made would, if exchange rates were to remain at their 17th June levels, have their greatest effects upon the economies of France, Canada and Switzerland. Among the appreciating countries, the United States and Germany would be most affected, although for any given exchange rate change the United States tends to be relatively less affected than other OECD countries because of the smaller share of trade in its GNP.

The effects of such exchange rate changes on GNP, through the effects on exports and imports, would be likely to be fairly modest – half a percentage point or less – but the effects on inflation could well be rather larger. A currency change even as small as 5 per cent may have a direct effect on a typical country's price level of 1 to 2 percentage points. Furthermore, this effect can be amplified to the extent that wages and other domestic cost components then respond to the change in import prices. During the 1960s and much of the 1970s, this recursive process was such that in many OECD countries an initial shock to prices was typically amplified ultimately by a factor of two or even three. The ultimate inflation consequences of the present exchange rate changes will therefore depend importantly upon the extent to which domestic conditions and policies influence the transmission of the initial price shock into the domestic wage/price process.

1. GROWTH OF REAL GNP/GDP IN THE OECD AREA[a]

Percentage changes from previous period, seasonally adjusted at annual rates

	1980 Share in total OECD	Average 1970 to 1980	From previous year			From previous half-year				
						1981	1982		1983	
			1981	1982	1983	II	I	II	I	II
United States	34.6	3.0	2.0	–1½	2¼	–0.8	–3½	2	2	2¾
Japan	13.7	4.8	2.9	2	4	1.8	1¾	3	4	4¾
Germany	10.8	2.8	–0.3	1	3¼	0.9	¼	2	3½	3¾
France	8.6	3.6	0.3	2¼	2½	1.5	2¼	3	2¼	2¼
United Kingdom	6.9	1.9	–2.2	1¼	1¾	1.0	1	2	1½	1¾
Italy	5.2	3.1	–0.2	1½	2½	–1.9	2¾	2½	2¾	2¾
Canada	3.3	4.0	3.0	–1¾	1	–0,8	–2¼	–1½	1¾	2¼
Total of above countries	83.1	3.3	1.2	¼	2½	0.1	–¾	2¼	2½	3
Other OECD countries[b]	16.9	3.1	0.8	1½	2½	1.0	1¼	2	2½	2½
Total OECD	100.0	3.3	1.2	½	2½	0.3	–½	2¼	2½	3
Major four European countries	31.6	2.9	–0.5	1½	2½	0.6	1½	2¼	2½	2¾
Total OECD *less* the United States	65.4	3.4	0.7	1½	2¾	0.9	1¼	2¼	2¾	3
Industrial production:										
Major seven countries	–	3.0	0.8	–1¾	4	–0.6	–4¾	3¾	3¾	5
Total OECD	–	3.0	0.7	–1	4	–0.5	–3¾	3½	3¾	4¾

Other OECD Countries

	1980 Share in total OECD	Average 1970 to 1980	From previous year		
			1981	1982	1983
Austria	1.0	3.7	0.1	1½	3¼
Belgium	1.5	3.2	–0.6	½	2
Denmark	0.9	2.3	–0.2	2½	3½
Finland	0.7	3.5	0.9	1	2½
Greece	0.5	4.7	–0.5	1¼	1¾
Iceland	0	5.0	1.3	–1	1
Ireland	0.2	4.1	1.6	1¾	2¾
Luxembourg	0.1	3.0	–2.0	¼	2
Netherlands	2.2	2.8	–1.3	0	½
Norway	0.8	4.6	0.8	¼	2
Portugal	0.3	4.8	1.8	2½	2½
Spain	2.8	3.8	0.3	2½	3½
Sweden	1.6	1.9	–0.9	¾	2½
Switzerland	1.3	1.2	1.9	–½	2¼
Turkey	0.8	5.1	4.0	4¼	4¼
Total smaller European countries	14.7	3.1	0.2	1¼	2½
Australia	1.8	3.1	5.0	3	2¼
New Zealand	0.3	2.3	3.9	1	1
Total of above countries	16.9	3.1	0.8	1½	2½
OECD Europe	46.3	2.9	–0.3	1½	2½
EEC	37.0	2.9	–0.6	1¼	2½

a) Aggregates were computed on the basis of 1980 GNP/GDP values expressed in 1980 US dollars.
b) Half-yearly data must be interpreted with care since for ten of these countries, amounting to nearly 50 per cent of the total GDP of the smaller countries, half-yearly growth rates were obtained by a purely mechanical interpolation.

features which have characterised recent performance, including still-high inflation in many countries, significant current account imbalances, high public sector deficits, high nominal and real interest rates, and slow real income growth. Particularly important, however, is that OECD economies still seem unlikely to be providing jobs for all who want them. High unemployment is widespread, in line with the general weakness of economic activity. Nevertheless there are important differences in the way in which this problem has arisen. In the United States the present high rate of unemployment seems in substantial part to be a cyclical phenomenon. In many European countries, by contrast, cyclically increased unemployment is superimposed on underlying unemployment that has been rising continuously since the mid-1970s.

Over the decade of the 1970s, the United States civilian labour force grew, from a 1970 level of some 83 million people, by about 20 million. Employment grew by over 17 million; for every ten new entrants to the labour force there were about nine new jobs. Unemployment in 1980 was 7 per cent, lower than it had been, for example, in 1975 and 1976. In Europe, on the other hand, labour force growth was markedly more modest. The labour force of the four major European countries, for example, which in 1970 totalled some 92 million people, grew by only 4 million people over the decade to 1980. Yet employment grew by only one million people, a ratio of less than three new jobs for every ten who sought them. The unemployment rate, which has increased every year since 1974, is now at the highest level since the beginning of the 1950s. The Japanese situation resembled that of the United States, in that out of the four and a half million people entering the labour force over the 1970s, four million found jobs. Unemployment throughout was never more than 2¼ per cent.

The reasons for the protracted deterioration in the employment situation in many countries are complex, and not fully understood. But it would seem that a range of structural factors have been important in various countries, including significant and perhaps growing inflexibility in labour and product markets, the emergence of major imbalances in the share of aggregate income, and a shift in the tax burden to employment and investment.

The Importance of Structural Problems

Over the last two decades or so the socio-economic structures of many, perhaps nearly all, OECD countries developed in a way which contributed to an eventual loss of flexibility. A succession of laws and restrictions combined with a discriminating and complex system of taxes and benefits to limit both the freedom of action of employers and the perceived need for mobility on the part of workers. For instance in Europe particularly, taxes on employment rose sharply, introducing an often substantial and widening wedge between the labour cost paid by employers and the pre-tax wage received by employees. While many such measures were motivated by considerations of security and equity, their cumulative effect may have been to discourage the hiring of labour.

A second important structural factor in a number of countries – notably but not exclusively in Europe – was the development of major imbalances in the share of aggregate income during the 1970s. In these countries, wages and non-wage labour costs rose more rapidly than prices received by producers, leading to a sustained reduction in profit shares. Typically, for these countries, labour cost inflexibility and a squeeze on profits have harmed employment.

During the 1970s many countries also developed concerns over the pattern of government outlays, especially the rapidly growing share accounted for by social security transfers. Financing these transfers led to increased taxation on employment and profits. Many countries had great difficulty in controlling such expenditures, so that more recently modifications of social security and unemployment benefit schemes have been undertaken in some. At the same time growing tax burdens gave rise to adverse private sector consequences in many countries. There has been a tendency for resulting expenditure control to fall disproportionately on public investment.

When growth was brisk and relative prices were changing only slowly, such adaptations as were necessary were able to be made fairly easily, through the allocation at the margin of growing

THE GNP CYCLE: OPEC I AND OPEC II

A consequence of the drawn-out nature of this recession is that, while less deep than that associated with the first oil price shock, it has been, in terms of deviation of GNP from trend, almost as severe in Europe, and only a little less so in North America. It has had considerably less effect on GNP in Japan.

The first oil shock *(OPEC I) of late 1973 accentuated the decline in GNP in North America which started in the first quarter. GNP in North America fell by 2.6 per cent between the first quarter of 1973 and the first quarter of 1975. During this period it is estimated that there was an underlying upward trend of about 3 per cent per annum. As a result, the level of GNP in North America by the first quarter of 1975 was about 8½ per cent lower than it would have been had it grown at the underlying trend rate over these two years; this is labelled as a* shortfall *of 8½ per cent. This provides a crude measure of the severity of the recession which can be used for* purposes of comparison *with other periods of time or other countries. In Japan, although GNP declined only 0.6 per cent during this period, when set against a calculated annual trend rate of GNP growth of almost 5 per cent, the GNP shortfall figure may have been slightly more severe, at about 10 per cent. In Europe, the figure was slightly smaller than in the other regions, some 6 per cent of GDP (see table), the recession starting and finishing two quarters later than in North America and Japan.*

In the more recent episode *(OPEC II) following the oil price increases of early 1979, there have been divergent cyclical movements. It is not yet possible to make a definitive judgement, if only because the data for the most recent period are only estimates. An initial recovery in North America in early 1981 proved very short-lived but recovery is thought to have begun, as in Europe, in the second quarter of 1982.*

In North America *the recovery in the second half of 1980 and in 1981, although marked in many sectors, could probably be regarded as only an interruption in the downswing of the GNP cycle; it could be contended that there was no recovery at all between the first and last quarters of 1981. The addition of OECD estimates to the latest data suggests that near the presumed trough of the recession in the second quarter of 1982 the implicit GNP shortfall at the end of the thirteen-quarter recession amounted to about 6 per cent, approximately two percentage points less than during the recession following OPEC I which lasted only eight quarters. These comparative relative contributions of trend and cyclical components are, of course, dependent upon the method of trend estimation used.*

In the four major European *countries combined, the current recession began in the first quarter of 1980 and is thought to have continued until the second quarter of 1982. It resulted in an implicit GDP shortfall of about 5½ per cent at the supposed trough (actual GDP declining by ¾ per cent, with trend GDP growing by 4¾ per cent) which occurred after nine quarters – a broadly similar development in both length and severity as during the OPEC I recession. In* Japan, *on the other hand, the OPEC II cycle is much more attenuated than that associated with OPEC I if the former in fact proves to have ended in the second quarter of this year, which is not inconsistent with present estimates. The GNP shortfall is forecast to have been 3¾ per cent after ten quarters compared with a shortfall of 10¼ per cent at the OPEC I trough after eight quarters.*

Major cyclical phases in GNP

		North America	*Japan*	*Major four European countries*[a]
OPEC I	Duration	1973 Q1 to 1975 Q1 8 quarters	1973 Q1 to 1975 Q1 8 quarters	1973 Q3 to 1975 Q3 8 quarters
	(1) Actual per cent change	–2.6	–0.6	–0.6
	(2) Trend per cent change	6.0	9.7	5.1
	(annual rate)	(3.0)	(4.7)	(2.5)
	(3) = (1)-(2) GNP short fall	–8.6	–10.3	–5,7
Recovery	Duration	1975 Q1 to 1979 Q1 16 quarters	1975 Q1 to 1980 Q1 20 quarters	1975 Q3 to 1980 Q1 18 quarters[b]
	(1) Actual per cent change	22.1	29.8	18.1
	(2) Trend per cent change	13.8	22.5	10.8
	(annual rate)	(3.3)	(4.1)	(2.3)
	(3) = (1)-(2)	8.2	7.3	7.3
OPEC II[c]	Duration	1979 Q1 to 1982 Q2 13 quarters[d]	1980 Q1 to 1982 Q2 9 quarters	1980 Q1 to 1982 Q2 9 quarters
	(1) Actual per cent change	0	5¾	–¾
	(2) Trend per cent change	6¼	9½	4¾
	(annual rate)	(2)	(3¾)	(2)
	(3) =(1)-(2) GNP short fall	–6¼	–3¾	–5½

a) GDP.
b) Excluding minor recession between the first quarter and the third quarter of 1977.
c) Quarterly forecasts are linear interpolation of half-yearly forecasts except for the United States and the United Kingdom.
d) Excluding minor recovery between the second quarter of 1980 and the third quarter of 1981.

The table summarises the cyclical developments over the last two major recessions and the intervening recovery. In order to study the relationships between cyclical movements in different countries or zones, underlying trends were estimated using the Phase-Average Trend method (PAT) of the United States National Bureau of Economic Research. No method of separating business cycles from underlying trends is entirely satisfactory, but PAT is widely recognised as the most suitable for cyclical analysis. In effect, the period over which the trend is calculated is determined by the duration of the cyclical fluctuations. One characteristic of this method is that when new turning points are encountered, the previously calculated trend is liable to be revised. Another is that when the length of the cycle shortens, as it could be argued has happened in the United States, the weight of the recent period in determining the calculated trend is increased. In practice, the recovery in United States' GNP in 1980-81 is treated here as simply an interruption of the downswing from 1979 to mid-1982. Similarly, in Europe, there was a minor fluctuation in GDP during 1977 which did not occur in the other two regions. For the purposes of comparison between the regions, this fluctuation is ignored and the recovery is treated as being uninterrupted. It is emphasized that the figures for trend GNP are not presented as estimates of what might have happened in the absence of oil price increases. Neither should these trends be interpreted as measures of potential output; indeed it seems likely that, for a number of countries at least, potential output will have grown faster than the trend shown here. Similarly, even if the OECD economy had been "on trend", unemployment would almost certainly have risen over the period. The trends serve merely as a device whereby the amplitude of the recessions can be indicated.

2. PRIVATE CONSUMPTION DEFLATORS IN THE OECD AREA[a]

Percentage changes from previous period, seasonally adjusted at annual rates

	Average 1970 to 1980	*From previous year*			*From previous half-year*				
					1981	*1982*		*1983*	
		1981	*1982*	*1983*	*II*	*I*	*II*	*I*	*II*
United States	6.9	8.3	5¾	5½	8.1	5¼	4¾	5¾	5¾
Japan	8.6	4.5	3¾	4¼	4.1	3½	4	4¼	4½
Germany	5.1	5.9	4½	3	6.6	4	3	3	3
France[b]	9.3	13.3	13½	12	15.2	13¼	12¾	12¼	11¼
United Kingdom	13.2	10.7	9½	7¾	11.3	9	8¾	7½	7½
Italy	14.6	19.0	15½	14½	16.0	16	14½	14½	14
Canada	7.7	11.1	10¼	9½	10.8	10¼	9½	9½	9½
Total of above countries	7.9	9.0	7½	6¾	9.0	7	6½	7	7
Other OECD countries[c]	10.0	12.3	11¾	10½	11.8	12	11½	10½	10
Total OECD	8.3	9.6	8¼	7½	9.5	8	7½	7½	7½
Major four European countries	9.1	11.4	10½	9	11.8	10	9½	9	8¾
Total OECD *less* the United States	9.2	10.3	9½	8½	10.3	9½	9	8½	8½

a) Aggregates were computed on the basis of 1980 values expressed in 1980 US dollars.
b) Consumer price index not seasonally adjusted.
c) Half-yearly data must be interpreted with care since for ten of these countries, amounting to nearly 50 per cent of the total GDP of the smaller countries, half-yearly growth rates were obtained by a purely mechanical interpolation.

output and income. Inflexibility and other structural problems did not appear as particularly serious. There may in a number of countries have been an accumulation of factors resulting in a decreasing responsiveness of domestic supply to increases in demand and a lessening of the trend forces for growth. And the continuing forces of technological change, along with the growing importance of the newly industrialising countries as suppliers of competitive manufactured goods on world markets, necessitated a progressive adaptation of the economic structure of OECD countries. This did not always take place smoothly, particularly in Europe. But rigidities were really laid bare only after 1973, with the quadrupling of the oil price, which was followed less than five years later by a further tripling. Even without the two oil price shocks, economic performance would quite possibly have deteriorated. But coming on top of the underlying situation, they imposed enormous strains on OECD economies, necessitating a degree and pace of adaptation that severely challenged the capability of the OECD economic system.

Adaptation: Successes and Failures

An early recognised problem, and one which the private financial sector adapted to with commercial vigour, was the recycling of the OPEC surpluses to borrowers. While there have been numerous tribulations, including now the degree of indebtedness of a number of non-oil less developed countries, this process has generally proceeded much better than many in early 1974 had expected.

Adaptation was also called for on the real side of the economy. The increase in the price of fuels relative to other inputs warranted significant changes in the proportion in which energy was combined with labour, capital, and other raw material inputs in the productive process. The price of energy-intensive goods having risen relative to other goods, the pattern of demand changed too. Some industries and sectors were much harder hit than others, while most had to revise, often radically, their methods of production. The broad aggregates reveal that considerable success has been achieved in this. Compared with 1973, OECD economies on average now use about 16 per cent less energy per unit of GNP, and about 26 per cent less oil. Given that most OECD economies are highly industrialised, and that the process of industrialisation was made possible in significant part only by the harnessing of energy in its various forms, this achievement is impressive, and important in its own right. Furthermore, it gives considerable cause for optimism about the innate ability of mixed market economies to adapt. The contrast with the centrally planned group of economies is rather sharp. Energy consumption per unit of output is estimated to have declined there by less than 5 per cent in the ten years to 1980.

Despite evident success in financial adaptation and in fuel economy, however, concern exists in most countries about the pace of other structural adjustments. After the first oil price shock in 1974 it was recognised that an important consequence was a once-and-for-all reduction in the economically viable capital stock and possibly a temporary weakening of potential output growth. To replace economically obsolete capital stock with capital equipment more suited to the new structure of relative prices and patterns of demand required substantial investment if employment was to be preserved at prevailing real income levels. When, in addition, account is taken of the faster growth of the labour force since 1974, an accelerated growth of productive investment was needed. Performance here has been less satisfactory.

During the 1960s and early 1970s, shares of non-residential investment in GNP were rising in North America and Japan. But after 1974, when ideally investment growth should have accelerated, investment shares fell somewhat in North America, Europe and Japan. Taken in conjunction with sharply reduced GNP growth rates, this meant that the levels of productive investment hardly rose. Between 1974 and 1978, for example, investment growth fell to about a quarter of its former rate, averaging only about 4 per cent per year in Japan, and about 1 per cent in the United States and Europe. Following the second great oil price shock, investment shares in GNP were broadly maintained in Europe and North America, so that investment performance was somewhat stronger in terms of growth rates than after the first oil price shock, although still far below previous rates. An increasing mismatch opened up between the degree of spare industrial capacity and the rate of unemployment. In Japan, however, the investment share, already high by international standards, was further increased after 1978. That country is generally recognised, by its economic performance, as having made the quickest and most complete adjustment to each of the two oil price shocks.

With the importance of investment having been reaffirmed by events over the last decade or so, a major policy concern in many countries has been to achieve higher rates of capital formation. Stepping up the rate of investment in an essentially market-oriented economy is not, however, straightforward.

Fostering the Will to Invest

Business investment decisions require an adequate net return, which in turn

3. CURRENT BALANCES OF OECD COUNTRIES

$ billion: seasonally adjusted, at annual rates

	1979	1980	1981	1982	1983	1981 I	1981 II	1982 I	1982 II	1983 I	1983 II
United States	1.4	3.7	6.5	11½	–5½	10.5	2.6	16½	6½	–5½	–5¼
Canada	–4.2	–1.6	–5.5	–5¾	–9	–5.9	–5.1	–4	–7½	–8½	–9¾
Japan	–8.8	–10.7	4.7	6½	20¾	3.2	6.3	3½	9¼	16	25½
France	1.2	–7.8	–7.5	–8	–7	–5.1	–9.9	–8¾	–7	–6½	–7½
Germany	–6.0	–16.3	–7.6	2¼	4¾	–13.6	–1.7	½	4	5½	4
Italy	5.5	–9.7	–8.0	–6½	–6¾	–11.6	–4.4	–6½	–6½	–6½	–7
United Kingdom	–2.0	7.1	16.2	8¼	5¾	24.2	8.3	9¾	6¾	7	4½
Total of above countries	–12.9	–35.3	–1.1	8½	2¾	1.6	–3.8	11½	5¾	1¼	4½
Other OECD countries	–17.0	–35.2	–27.5	–24	–23	–28.3	–26.8	–22¾	–25	–24¼	–21¾
Total OECD	–29.9	–70.5	–28.7	–15¼	–20¼	–26.7	–30.6	–11¼	–19¼	–23	–17¼
Memorandum item											
EEC	–12.6	–40.5	–15.1	–7¼	–5	–15.3	–14.8	–8	–6½	–3¼	–6½

Other OECD Countries

	1979	1980	1981	1982	1983
Australia	–2.8	–4.0	–8.3	–10¾	–13¼
Austria	–1.0	–1.7	–1.4	–1¼	–1½
Belgium-Luxembourg	–3.0	–5.2	–5.2	–4¼	–3
Denmark	–2.9	–2.5	–1.8	–2¼	–2¼
Finland	–0.2	–1.4	–0.4	¼	0
Greece	–1.9	–2.2	–2.4	–2¼	–2½
Iceland	–0.02	–0.07	–0.15	–0.12	–0.08
Ireland	–1.5	–1.4	–2.0	–1¾	–1¾
Netherlands	–2.0	–2.6	3.2	7	8
New Zealand	–0.6	–0.9	–1.0	–1	–1¼
Norway	–1.0	1.1	2.4	0	–1½
Portugal	0	–1.3	–2.6	–2½	–2½
Spain	0.8	–5.0	–5.0	–4	–3
Sweden	–2.3	–4.5	–3.1	–2½	–2
Switzerland	2.4	–0.5	2.1	3½	5
Turkey	–1.0	–3.2	–2.0	–1¾	–1¼
Total	–17.0	–35.2	–27.5	–24	–23

depends on the expectation of future sales at sufficient profit; such expectations reflect the general state of business confidence as well as the outlook for particular activities. It is not clear how best to foster expectations of an adequate return to investment. With output as depressed as it is at present, traditional aggregate demand management policy would have sought to reduce the immediate underutilisation of labour and equipment, thereby raising expectations about future sales and encouraging the sought for higher levels of investment.

Such an approach is not being pursued, essentially out of conviction that a significant part of any stimulus to demand would fairly soon dissipate itself as an increase in inflation and thereby prove ineffective in lifting demand and investment in a sustainable way. Furthermore, there is concern at the possibility of reigniting inflationary expectations, which became firmly established over a decade or more and are only now being reduced, at significant cost. There is a widespread view that high inflation, and inflation uncertainty, lead to reduced real output by inhibiting investment. There is also concern in a number of countries that investment is being inhibited by low actual and prospective rates of return, and that risk premia may have increased. For all these reasons, there has been a concerted effort on the part of many governments to apply cautious and consistent macroeconomic policies, in an attempt to establish credibility and improve business confidence.

While no summary can fit any one country precisely, the policies of many governments since the second oil price shock have included the following broad policy planks:

- An immediate priority was to see higher energy prices translated straight through into final product prices, so as to encourage needed conservation and production, while protecting profitability.
- Equally, it was judged vital to prevent the rise in fuel prices from becoming embedded in domestically generated inflation, particularly its important wage component. To this end, aggregate demand policy was set in many countries so as not to accommodate the oil price induced acceleration in the rate of growth of nominal GNP. It was considered important not only to reduce inflation in its own right, but also to moderate the growth of labour costs relative to product prices and to restore profit margins to levels sufficient to support a higher rate of investment. Compared with earlier episodes of restriction, monetary policy has played an uncharacteristically important role.
- Some countries felt that the increasing relative size and composition of the public sector or its deficit was in itself fundamentally harming economic incentives; many felt that mounting public sector deficits, especially in a cumulative sense, would present increasing financing problems. There have been widespread attempts to arrest or reduce the sizes of public sectors and the extent of government borrowing.
- Over the medium term, it was judged necessary to overcome the range of structural and supply side problems that had built up slowly but progressively over

4. UNEMPLOYMENT IN THE OECD AREA

National definitions, historical statistics and forecasts

	1981	1982	1983	1981 I	1981 II	1982 I	1982 II	1983 I	1983 II
Unemployment rates									
United States	7.6	9½	10	7.4	7.9	9	10	10¼	10
Japan	2.2	2¼	2¼	2.3	2.2	2¼	2¼	2¼	2¼
Germany	4.8	6½	7	4.3	5.3	6¼	6¾	7	7¼
France	7.4	8¼	8½	7.1	7.7	8¼	8½	8½	8½
United Kingdom	10.6	12	12¼	9.9	11.2	11¾	12¼	12¼	12½
Italy	8.5	9½	10	8.3	8.7	9½	9¾	10	10
Canada	7.6	10	10	7.2	7.9	9¾	10	10	9¾
Total of above countries	6.6	8	8¼	6.3	6.8	7¾	8	8¼	8¼
Other OECD countries	9.8	10¾	11¼	9.4	10.1	10¾	11	11¼	11½
OECD Europe	8.8	10	10½	8.4	9.2	9¾	10¼	10½	10½
Total OECD	7.2	8½	9	7.0	7.5	8¼	8¾	9	9
Unemployment levels (millions)									
North America	9.2	11¾	12½	8.9	9.5	11¼	12¼	12½	12¼
OECD Europe	14.5	16½	17½	13.8	15.1	16¼	17	17¼	17½
Total OECD	25.4	30	31¾	24.4	26.4	29¼	31	31¾	31¾

OIL PRICES: THE MEDIUM-TERM RISKS

The near-term implications of weaker oil prices are benign for OECD countries, but it would be premature to conclude that there has been more than a once-and-for-all step change in the dependence of the OECD economy on oil. While not all analysts agree, there is a risk that current oil market slack could give way later in the decade to another oil-price shock of the sort that has twice staggered the world economy.

OECD real energy prices to final users doubled between 1970 and the early 1980s, reflecting the two oil price pulses and consequent price adjustments for non-oil energy. This upward trend has recently been reversed by sluggish economic growth and continued demand reactions to earlier increases in energy prices. The decline is the first in four years and seems likely to be the sharpest over the last twenty years. Nevertheless, the energy intensity of production and consumption may continue to fall in 1982, although at a lower rate than in the previous two years, due to lagged price effects from earlier price increases, notably in the 1978-81 period, and the related strengthening of energy policies. The accelerating fall in energy use per unit of real GDP since 1973 may be seen from the Chart.

The present level of demand for OPEC oil represents a fall of 14 million barrels per day or 45 per cent from the peak level of 1977. Demand is now at the lowest level since 1969. Three forces contributed to the fall in demand: a reduced energy intensity of production in oil-consuming countries, a shift away from oil use within energy demand, and increases in crude oil production from non-OPEC sources. In addition excess stocks have been liquidated and while OECD GDP has continued to grow, adding to demand, it has been at a much reduced rate compared to previous periods. OPEC production fell in line with declining demand, reflecting, initially, supply conditions but, more recently, action to defend prices.

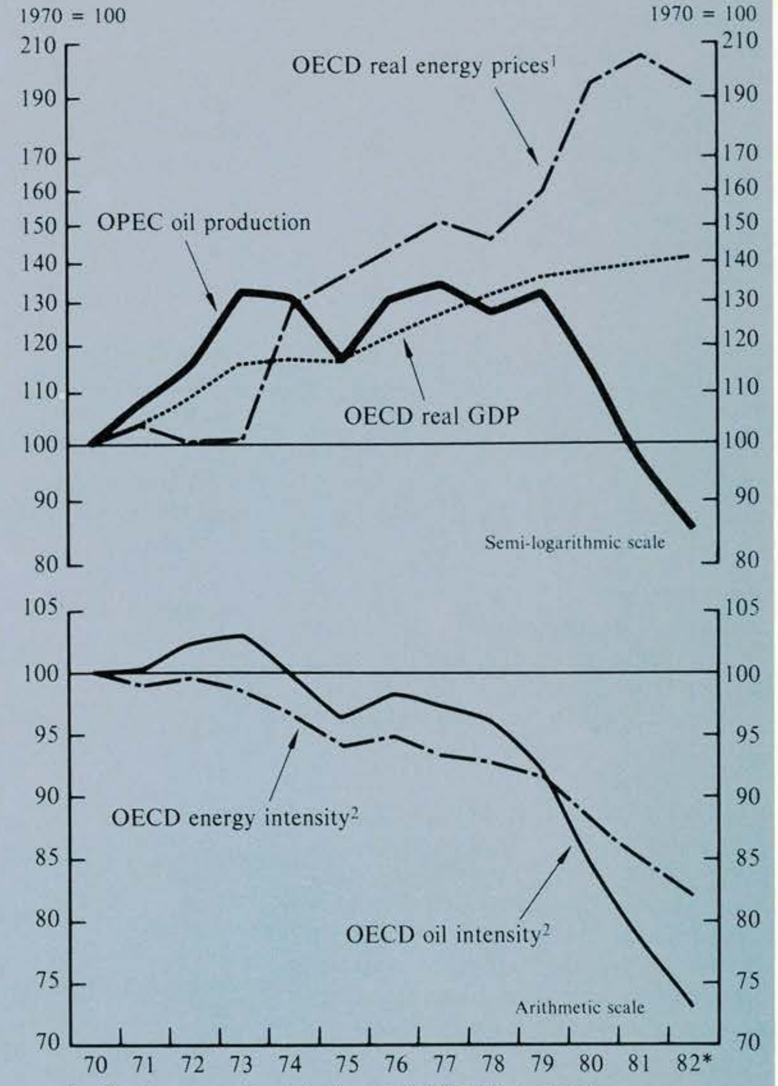
The outlook for oil prices over the medium term clearly depends on the continued interaction of these forces. Interpretation of the past is not straightforward. Assumptions based on historical observation could underestimate the momentum of structural adaptation away from oil use which is under way. On the other hand, some of the recent sharp decline in oil demand, even relative to GDP, could reflect reversible conjunctural developments.

The recent evidence is that cumulative price elasticities of demand are quite large. This suggests that falling oil prices could have correspondingly large effects on oil demand, providing a feedback that would evenutally moderate the price fall. Most of the recent substitution from oil is likely to endure at present prices. Where technologies and production processes have been fundamentally changed to accommodate to expensive energy, the lower prices so far seen would seem unlikely to cause firms to reverse this. The variable costs of oil use are, in many key sectors, substantially higher than those of alternative sources of energy, so that where the capital costs of conversion have been undertaken, there is no incentive to shift back. It is difficult to know, however, whether at current oil prices there remains a sufficient stock of profitable energy-saving projects to offset the effect of any renewed economic growth on demand.

Given the importance of relatively long-lived investment decisions in determining the pattern and intensity of energy demand, the extent to which current weaker oil prices lead to substantially higher demand for oil in some years' time depends critically on the effect of current price developments on longer-term price expectations. If near-term price declines are viewed as clearly temporary, they would have little importance. There are two sorts of risks, however. First, if price expectations about future levels of oil and other energy prices over-adjust, there might be a continuation of the present trend to a deferral of investment decisions in energy supply. Some oil companies have already reported substantial reductions in exploration and investment in developing other energy sources.

Second, changed expectations could weaken the shift towards less energy-intensive modes of production and consumption so that the energy demand-reducing effects of earlier *energy price rises might end sooner, advancing the date at which energy demand once again increases in line with real GDP. In the oil-intensive transportation sector, for example, a sustained fall in real gasoline prices may retard the shift towards more fuel-efficient vehicles and raise the number of miles driven. Even with stable real crude oil prices, real gasoline prices may fall, as inflation erodes the real effect of specific gasoline taxes. Real gasoline prices in the OECD area fell by an estimated 10 per cent between 1974 and 1978, and gasoline use per car rose in 1977 and 1978.*

ENERGY MARKET
Key indicators



1. Real energy prices to final users (13 OECD countries).
2. Index of primary oil (or energy) demand divided by index of real GDP.
* Forecasts.

earlier decades. So far as detailed investment policies themselves are concerned, difficult choices have had to be made so as not to provide inappropriate support either to 'declining' or to 'emerging' industries.

As a result of the policies followed since the second oil price shock, externally induced inflation has been contained in most countries; OECD inflation, as measured by consumption deflators, began to decelerate in the second half of 1981, and so far the general price level has risen by 1½ to 2 percentage points less than was the case at the equivalent stage after the first oil price shock. Furthermore, inflation is now decelerating faster in a number of coun-

Most OECD countries are slowly coming to grips with inflation but unemployment remains a major problem.

tries than it was at the equivalent time after the first oil price shock. Some of this deceleration is attributable to weak oil prices and declining non-oil commodity prices, the result of weak final demand and interest rate induced destocking. Unemployment, starting from a markedly higher level than before the first oil price shock, has so far risen since the second one by just over 2 percentage points, almost exactly as it did over the equivalent two-year period following 1974. On the other hand with aggregate demand policy tight, and in particular with a fiscal/monetary mix that has combined with sticky inflation expectations to give high nominal and real interest rates in many countries, investment so far has shown little sign of the pick-up that is needed for recovery to be self-sustaining. Fostering the conditions for an upturn in investment is proving no easier to achieve than it did after the first oil price shock. It is difficult for demand management policy directly to influence factors bearing on business confidence, and hence on investment decisions. Improving the business outlook now represents perhaps the most important challenge for policy.

Policy makers recognise the challenge; as OECD Ministers recently emphasised[1]: "Sustained non-inflationary growth cannot be achieved unless there is more productive investment, better productivity and technical progress; an increase in investment requires both sufficient profitability and a favourable prospect for an increase in production." Investment tends to pick up shortly after a recovery in economic activity. In earlier periods of cyclical upswing, this investment growth has often contributed a percentage point or more to GNP growth, thereby contributing importantly both to demand and to supply. But with interest rates high, and projected (on the basis of unchanged policies) to remain so, any recovery in business investment seems likely to be muted. It is important that recovery should occur, and that investment should follow not far behind, in order to make the recovery durable; the longer that strong investment recovery is delayed, the more the risks in the situation mount.

Rising unemployment brings its own strains and direct costs. A protracted period of slow growth could seriously damage OECD economies; slow growth tends to engender slow growth. It harms productive potential, through weak investment and a degradation of labour skills. And it risks increasing protectionism, weakening the open trading system upon which much of modern-day prosperity was built. Several major economies are now in a period of disinflation – sharply slowing inflation accompanied, in some cases, by actual price falls. This process, along with high interest rates, has contributed to mounting balance sheet strains and a worrying incidence of corporate failures. It remains the hope, however, that as inflation decelerates, real demand will pick up and that a durable investment recovery will ensue. Indeed, if prices decelerate even more than projected, output may grow a little more strongly. But this is not certain, and, particularly until there is a generalised downward move in interest rates, there will be clear risks in the situation.

On the international front, the delay of exchange rates in adjusting to apparent underlying trends in domestic cost and price performance has been complicating trade issues and increasing protectionist pressures. There is also some concern about the sustainability of private bank lending to deficit countries, and the potential repercussions of any problems they may experience on the international side of their lending activity.

It was against this background that OECD Ministers, meeting in May this year, considered the factors inhibiting a better economic performance in industrial OECD Member countries. The correct identification and rectification of these problems, with an internationally coherent framework, remains the demanding task facing economic policymakers in the OECD world today.

1. *See Ministerial communiqué* OECD Observer *No. 116, May 1982.*

Country Problems and Strategies: Germany, United States

GERMANY
Public Sector Trends

By the late 1970s, the German economy had made considerable progress towards achieving price stability, full employment and utilisation of capacities. Yet in 1980 and 1981, inflation accelerated (although remaining low by international standards), unemployment increased sharply and the current external account moved into deficit. These unsatisfactory developments were due in large part to the difficult adjustment to the second surge in oil prices, as well as to specific factors like the appreciation of the exchange rate over previous years (resulting in a loss of competitiveness) that required restrictive economic policies.

But certain unfavourable long-term trends of a structural nature also began to make themselves felt towards the end of the 1970s and may make it hard for Germany to return to a situation of balanced growth at full employment. For one thing, there has been a significant shift of resources towards the public sector, characterised by an imbalance in the growth of revenue and expenditure. With expenditure outstripping revenue partly as a result of the effects of automatic fiscal stabilisers, the public sector ran up an increasingly heavy deficit. On the other hand, at a time when the world economic environment was deteriorating and the growth of potential output had slowed down, demographic trends increasingly constrained the ability of policy makers to simultaneously achieve their objectives of external balance, moderate inflation and full employment. Given the excess supply of labour at full capacity, unemployment may remain unacceptably high, even if other economic objectives are met.

In the past 20 years, the public sector in Germany has absorbed a substantially greater share of national output and become responsible for redistributing an ever larger proportion of national income. From the beginning of the 1960s to the end of the 1970s, total expenditure by general government rose from 33 per cent of GDP to 46 per cent, while revenues increased from 35½ per cent to 43 per cent of GDP. Hence, the overall public sector balance moved from a position of surplus in the early 1960s to a deficit of around 3 per cent of GDP in the late 1970s. This expansion has affected all areas of the economy: the government has substantially increased its share of current consumption and, to a lesser extent, its share of total capital formation. Government employment and wages have both increased their share of the total by about 7 percentage points. As far as income redistribution is concerned, the rapid growth of social security benefits and grants has been outweighed by increases in direct taxes and social security contributions, so that transfers from households to the government now represent about 18½ per cent of household disposable incomes, compared to 9 per cent in the early 1960s. The corporate sector has also been involved in this trend: employers' social security contributions have doubled as a percentage of their operating surplus over the period, from 15 per cent to 30 per cent.

A large part of the government's increased share of final expenditure on goods and services is attributable to the faster rise in the cost of providing public rather than private goods and services. Growth has been particularly rapid in spending on education and health services, as well as in capital expenditure on transport, communications and energy. The changing composition of the population, in which those aged 65 years and over increased from 10½ per cent of the total in 1960 to 15½ per cent in 1980, has been an important factor in the growth of spending on health care. It is also true to say, though, that there has been a strong and sustained improvement in the quality of the services provided over the past two decades.

The most rapidly expanding component of public expenditure has been social security payments and transfers, which in 1980 comprised 17 per cent of total household incomes and fully one third of total government outlays. There are four main categories of benefit: age benefits, which comprised about a third of government transfers to household in 1980; family benefits, which have declined slightly since 1975, reflecting the fall in the numbers of children under 15, which peaked in 1971; sickness benefits, which in 1980 accounted for only 7 per cent of total government health spending and only 3 per cent of social security payments to households; and unemployment benefits, which in 1980 accounted for just over 8 per cent of total transfers to households (if training assistance and compensation for short-time working are included).

Government revenue in recent years has been comprised in equal parts of direct taxes, indirect taxes and social security contributions (from both employees and employers). Over the years, an increasing proportion of taxpayers has moved into higher tax bands, where the system is relatively progressive, with the result that the average tax rate on wages and salaries rose from about 7 per cent in the early 1960s to 16 per cent in the late 1970s. Taxation of corporate income has shown a relative decline over the period, though, reflecting both falling rates of profitability and improved depreciation allowances.

While employers' social security contributions doubled as a percentage of their operating surplus between 1960 and 1980, employees' contributions increased 38 per cent, from 11 per cent of earnings in 1960 to 16.2 per cent in 1980 (though rates of contribution remained unchanged between 1976 and 1981). The share of

Exports have been increasing rapidly and may remain the primary growth area for the German economy. Above: Bosch computer equipment in Kuwait.

indirect taxes has fallen from 39 per cent of total taxes in 1960-62 to under 30 per cent in 1978-80.

The expansion of the public sector has had a generally positive impact on GDP growth. The expansionary stance of fiscal policy in 1966 and 1967 was insufficient to prevent the economy from sliding into recession, but the stimulus at the beginning of the 1970s was excessive in light of the inflationary pressures that were building up. The subsequent deflationary budget introduced in 1973 produced an appreciable negative impact on the level of activity. A similar turn of events occurred a few years later when, following the positive effect of automatic stabilisers in 1975 (which nevertheless did not entirely prevent GDP from falling), restrictive budgets were adopted in 1976 and 1977 which had a marked contradictory effect during the initial phase of the recovery. Fiscal policy has been positive during the current recession, and remained so even last year, thanks mainly to the effects of automatic stabilisers. Next year, however, expenditure cuts are likely to result in a negative impact.

The growth of the public sector was an evident constraint on the private sector in the period up to 1972 or 1973. Both the economy as a whole and the private sector in particular were expanding at a fairly rapid rate (real GDP was increased at an annual average of 5 per cent) and the only limitations on still more rapid growth were a shortage of capital and labour – as a result of the claims of the government. Although there was a marked transfer of resources and income from the private to the public sector during this period, there was also a trend for the government to meet an increasing proportion of its demands for goods and services from its own production, and the ratio of value added in government production to total government expenditure on goods and services rose from 40 per cent in 1963 to nearly 50 per cent 10 years later. After 1974, when GDP growth declined, unemployment increased and private capital began to flow out instead of in, private sector savings were required to finance the government deficit.

Export Led Recovery

Monetary policy remained tight in 1980 and the early part of 1981, before easing in recent months. Money supply growth was lower last year than the year before and interest rates rose substantially up until October, when US security yields peaked and a realignment of the European Monetary System led to an appreciation of the deutschmark (following a long period of depreciation). This gave some scope for relaxing policy and since then interest rates have fallen by up to 3 percentage points. At the same time, the Federal budget deficit widened to DM 38 billion (2½ per cent of GNP) from DM 27½ billion (2 per cent of GNP). The planned reduction in the deficit was not achieved, as a result of a slower than expected rise in revenue and an overrun in planned expenditure, in particular on unemployment and interest charges.

Despite this fiscal stimulus, though, real GNP declined by 0.3 per cent in 1981, with domestic demand falling for three half years in succession up to the end of 1981. Real private consumption fell for the first time since the war, while government consumption grew by 2 per cent. Fixed capital formation dropped by 3½ per cent, and manufacturing output was generally stagnant. Exports grew rapidly however, reaching an annual rate of 17½ per cent in the second half of the year, and the current external account swung from a deficit of DM 8¾ billion in the first quarter to a surplus of DM 3½ billion in the fourth quarter. Consumer prices rose more rapidly than in 1980, with the year-on-year increase peaking in October at 6¾ per cent. Real wages fell over the year, as the rise in average wage rates was a little under 5 per cent. Unemployment rose sharply to 1.3 million on average in 1981, 4.8 per cent of the labour force. By March this year, it had increased significantly further to 1.7 million (6.2 per cent).

Forecasts for 1982 and 1983 diverge appreciably as a result of uncertainties about trends in real long-term interest rates. While the government is projecting an increase in GNP of 1 to 1½ per cent this year, four of Germany's five economic research institutes forecast only a ½ per cent increase, while the fifth expects a further fall. The government has tightened its fiscal stance by cutting welfare benefits and raising indirect taxes and social security contributions. At the same time, though, measures were taken to stimulate private investment.

The impact of fiscal policy is likely to be slightly negative in both 1982 and 1983, when a further reduction in the public sector deficit is planned.

Exports may remain the primary growth

area for the German economy. Later this year, domestic demand should also contribute to an acceleration in the GNP growth rate, which could reach 3 to 4 per cent in 1983. Inflation is expected to come out at 3 per cent in the course of 1982 and to remain at that level in 1983. The strong improvement in the current external balance should continue in 1982 and be maintained in 1983. Employment is likely to fall further in 1982, as productivity growth accelerates, and stagnate in 1983, implying a further substantial increase in unemployment, forecast to reach 7¼ per cent of the labour force by the second half of 1983.

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The major problem in the medium term remains unemployment. As in many other OECD countries, there is evidence in Germany that the rate of unemployment has risen more than the rate of unused capacity. Hence, only a part of actual unemployment is a result of the cyclical downturn. And with labour supply continuing to rise markedly over the next few years for demographic reasons, the excess labour supply at full capacity is bound to increase given current trends in potential output. Stronger economic expansion will be necessary to reduce cyclical unemployment. But a fuller absorption of labour market slack would require policies which help to ease the mismatch between unemployment and available capacity, aiming at an increase in employment augmenting investment.

Despite Germany's solid export performance and low inflation, the present and prospective weakness of domestic demand may keep GNP growth below the level needed to bring down the level of unemployment. Growth could be strengthened by further falls in interst rates. Fiscal policy could also play a role. Although the share of the public sector in GNP has stabilised since 1975, the persistently large deficits are viewed by the German authorities as a major constraint on the flexibility of fiscal policy. But while planning for budget consolidation in the medium term, it is important to take account of the conjunctural situation and to give attention to the composition of expenditure between current and investment outlays.

THE UNITED STATES
The New Strategy

The Reagan Administration, which took office in January 1981, has introduced an economic programme which differed from those of preceding governments in its political roots and theoretical foundations. It was presented as a medium-term strategy to break the combination of inflation and sluggish output which characterised the American economy. Apart from a substantial increase in defence spending, the strategy is designed to stimulate the private sector with a combination of tax reductions and cuts in federal expenditure, while at the same time curbing inflation through a policy of firm monetary restraint. The OECD has just published its first economic survey of the United States since the introduction of what has become known as "Reaganomics".

The administration's economic programme comprises three elements: monetary restraint to counter inflation; a shift in fiscal priorities to favour investment relative to consumption; and a reduction in government's claims on resources and its influence on economic affairs. The strategy was not designed so that success on one front could compensate for partial success on another; the three pillars of the programme are conceived not as independent objectives for improving economic performance but as mutually interdependent elements of equal importance to the overall policy structure.

A central feature of the strategy is its medium-term nature; the programme was presented in some detail for a six-year period. The aim of securing a secular decline in inflation while increasing the underlying growth rate of the economy is dependent on successfully engineering a shift in expectations. The fact that the strategy was based on changing historical patterns of behaviour meant that the projections were put forward as scenarios, not forecasts. Nevertheless, the programme was presented as a self-sufficient set of proposals to achieve the desired objectives over the target period, on the assumption that it would require neither major additional elements nor active short-term policy-making to aid the transition to the new pattern of economic behaviour.

The monetary wing of the policy involves a 50 per cent reduction in the growth rate of the monetary aggregates between 1980 and 1986, which, taking the fourth quarter of 1980 as the base, implies a ½ per cent reduction in M1 growth per year, to bring it down from 7 per cent to 3½ per cent. While this is not as sharp a reduction as some "shock therapists" proposed, it represents a tightening of the gradualist approach of recent years.

The fiscal adjustment built into the strategy represents the implementation of supply-side principles. It comprised a plan for three cuts of 10 percentage points in personal income tax rates in successive years. At the same time, the corporate sector was to benefit from the introduction of standardised, simplified and more generous depreciation allowances. These revenue cutting measures were combined with a target for balancing the budget by fiscal 1984 (beginning in October 1983) and required sharp cuts in the prospective levels of public expenditure in all areas except defence. While all other components of government expenditure were to be sharply reduced in real terms, military spending was planned to rise from 5½ per cent of GNP in 1981 to 7 per cent in 1986.

Congress was heavily occupied in 1981 in implementing the fiscal plank of the administration's programme. Despite a remarkable degree of cooperation between the White House and Congress, there was still a gap between what the administration proposed and what the legislators actually enacted. Tax cuts were less generous for the first year with only a 5 per cent cut and with its application delayed for three months. But provisions were added for the annual indexation of personal tax brackets and allowances on the basis of the previous year's rate of price increases, effective from 1st January, 1985. At the same time expenditure cuts fell well short of what would have been necessary to meet administration targets. This coincided with lower than expected growth and inflation in 1981, bringing lower receipts and higher interest payments and social security outlays than forecast. Furthermore, revisions to economic forecasts during the year pointed to an increasing imbalance between prospective revenues and expenditures in the years to come, raising a question mark over the administration's objective of balancing the budget by fiscal 1984.

The fiscal 1983 budget confirmed these fears, showing estimated "current services" deficits of $101 billion in fiscal 1982 rising to $168 billion in 1985. Administration proposals for further reductions in social welfare benefits along with increased user fees for government services and further cutbacks in various government programmes, which would have brought the deficit down to $72 billion in 1985, were not well received in Congress. The search for a compromise which has been going on for several months now seems close to success.

The Present Situation

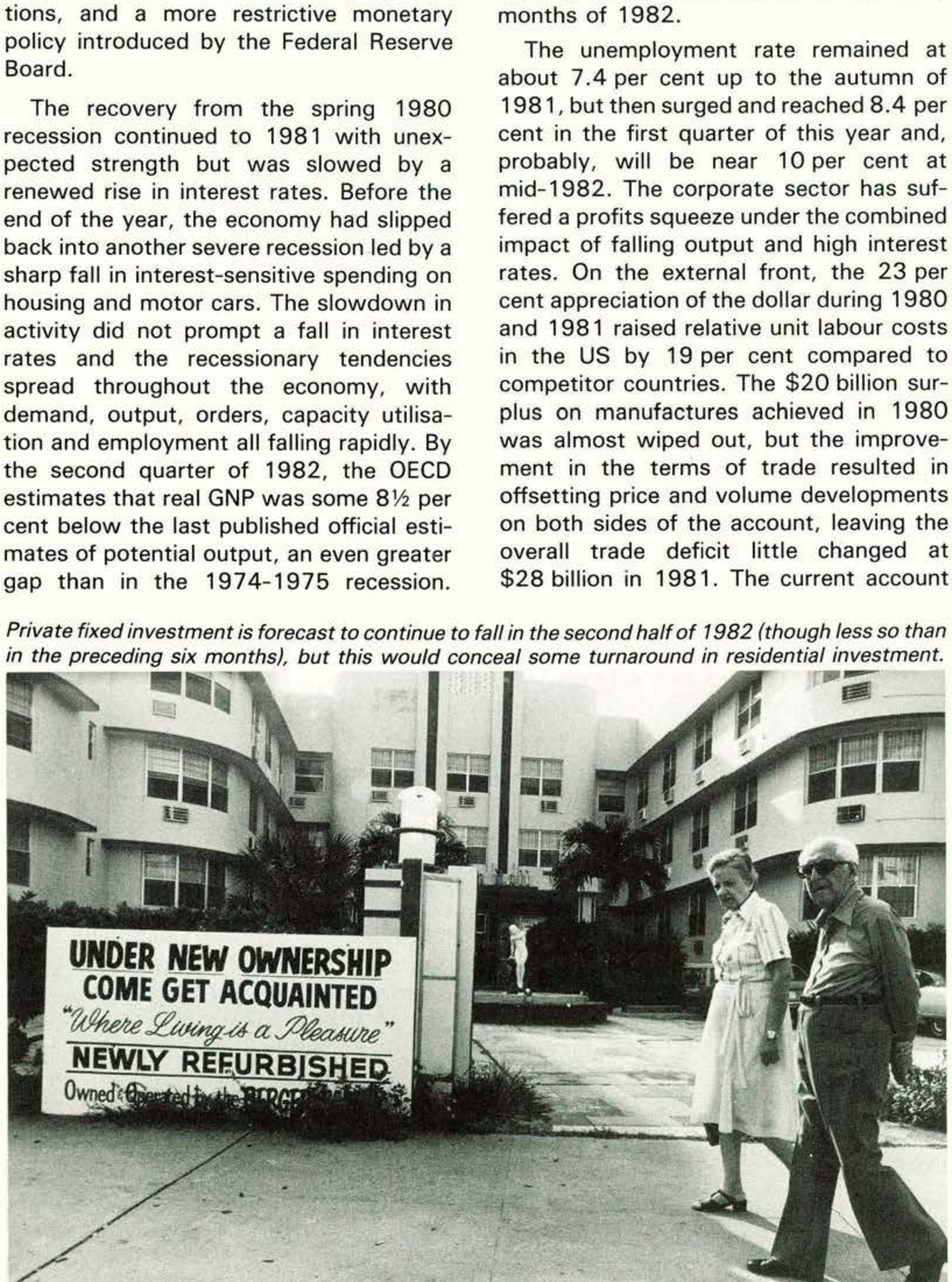
The background to the Reagan plan was a fall in the rate of economic growth from an average of 4 per cent a year in the three previous decades to only 2½ per cent a year in the 1974-1980 period. The average annual growth in productivity in the non-farm business sector had fallen from 2½ per cent to a mere ½ per cent between the two periods, while the average inflation rate had risen from 3 per cent a year to 8 per cent. More immediate influences, apparent at the close of the 1970s, were the impact of world oil price rises and heightening domestic inflationary expectations, and a more restrictive monetary policy introduced by the Federal Reserve Board.

The recovery from the spring 1980 recession continued to 1981 with unexpected strength but was slowed by a renewed rise in interest rates. Before the end of the year, the economy had slipped back into another severe recession led by a sharp fall in interest-sensitive spending on housing and motor cars. The slowdown in activity did not prompt a fall in interest rates and the recessionary tendencies spread throughout the economy, with demand, output, orders, capacity utilisation and employment all falling rapidly. By the second quarter of 1982, the OECD estimates that real GNP was some 8½ per cent below the last published official estimates of potential output, an even greater gap than in the 1974-1975 recession. With the balance of non-monetary influences exerting an expansionary influence in 1981, it became clear that the root of the problem lay in stubbornly high inflationary trends or expectations coming into conflict with counter-inflationary monetary policy.

Pay rises began to slow down early in 1981; the rate for the year was 8.4 per cent compared to 9.6 per cent in 1980, and it fell further to an annual equivalent of 7.2 per cent in the first quarter of 1982. Worsening productivity performance more than offset the reduction in wage increases in 1981, but it is clear that the underlying trend of unit-labour cost has improved significantly. Other influences such as easier world commodity prices and a short-term profit squeeze as business attempted to reduce inventory holdings brought particularly good price results in the early months of 1982.

The unemployment rate remained at about 7.4 per cent up to the autumn of 1981, but then surged and reached 8.4 per cent in the first quarter of this year and, probably, will be near 10 per cent at mid-1982. The corporate sector has suffered a profits squeeze under the combined impact of falling output and high interest rates. On the external front, the 23 per cent appreciation of the dollar during 1980 and 1981 raised relative unit labour costs in the US by 19 per cent compared to competitor countries. The $20 billion surplus on manufactures achieved in 1980 was almost wiped out, but the improvement in the terms of trade resulted in offsetting price and volume developments on both sides of the account, leaving the overall trade deficit little changed at $28 billion in 1981. The current account strengthened slightly, though, recording a surplus of $7 billion, which was the third successive surplus following the record deficits of 1977 and 1978.

Private fixed investment is forecast to continue to fall in the second half of 1982 (though less so than in the preceding six months), but this would conceal some turnaround in residential investment.



Prospects After the First Year

The Secretariat forecasts assume a budget compromise along the lines put forward by the Administration last January, implying an expansionary impetus of around ¾ per cent to the economy in fiscal 1983. The receding trend of inflation is expected to continue, bringing a further two percentage points deceleration of labour costs and accentuating the decline in inflationary expectations which already seems to have occurred. The second half of 1982 will be influenced by the cuts in personal income tax taking effect in July which, together with higher social security benefits and moderating inflation should bring a sharp boost to real disposable income. Continuing tight monetary policy is reflected in the forecasts of monetary conditions, with nominal interest rates falling no further than inflation trends. These tight monetary conditions may rein back the fiscal-based expansion in the latter half of 1982, leading to a deceleration in the first half of 1983. The same pattern may be repeated next year, with the third instalment of personal tax cuts.

Following a 3½ per cent (annual rate) fall in GNP in the first half of 1982, 2 per cent increases are forecast for the second half of 1982 and the first half of 1983, with growth expanding to 3 per cent in the second half of 1983. With productivity showing some cyclical improvement, unemployment is expected to increase throughout 1982, peaking at 10½ per cent. The rate may come down towards the end of 1983, but the outlook is for persisting weakness in labour markets. Private fixed investment is forecast to fall a further 4 per cent in the second half of 1982, following a 7 per cent drop in the first half. This would conceal a turnaround in residential investment – which has suffered badly from high interest rates – but an accelerated fall in non-residential investment which might still be falling in the first half of 1983. A further weakening in the balance of trade in manufactures is forecast, resulting in a deficit of $45 billion next year. But the current surplus is expected to rise to $10 billion this year, before sliding into a small deficit in 1983.

Looking beyond the immediate future, the Administration may be faced with a continued problem of fiscal imbalance. The principal measures taken so far – indexation of the personal tax system at lower margin rates, reduction of corporate taxation, expenditure priorities moving away from social welfare and towards defence –

add up to an important change in fiscal influences on the economy, aimed at achieving a shift in expenditure patterns towards investment. In the medium term, the federal deficit could be reduced by the introduction of new revenue raising measures which would not run counter to the incentive effects sought by the Administration in its personal tax cuts. Among the possibilities for new taxes are excise taxes on petroleum or oil and more rapid decontrol of natural gas prices allied with a wellhead or windfall profits tax. Another possibility would be to reduce tax concessions, such as mortgage and other interest deductions allowed against personal income taxes, which have driven up house prices and may have reduced household savings. But such tax innovations would run counter to what appears to be another element of policy which is to use tax cuts and deficit projections as a means of persuading Congress to cut back on public expenditure programmes and on government activities in general. Considering the adverse impact budget deficits and prospects seem to be having on expectations on financial markets, this is one of the risky aspects of current policy. The administration is now supporting the idea of a balanced budget amendment to the constitution.

There are clear reasons for continuing the non-accommodating stance of monetary policy, though this must be pragmatic and flexible. Given the size of the US economy and the central role of the dollar in international transactions on current and capital account, the achievement of a significant and permanent reduction of inflation in the United States is of crucial importance to the world as a whole. However, the exceptionally high level of nominal and real interest rates is having a major adverse effect on other economies. Some OECD Member countries have been faced with the choice of accepting a depreciation of their currencies against the dollar – which would distort competitive positions in international trade even further and also have unwelcome inflationary consequences – or supporting their exchange rates by raising interest rates beyond what would be appropriate from the point of view of employment and economic activity. As a result of following the second course, the combination of high interest rates and recessionary trends has become a general phenomenon, notably in Europe.

If the United States were able to adapt anti-inflationary policies in such a way that upward pressure on interest rates were reduced, this would be a necessary, though clearly not sufficient, condition for other countries to implement monetary policies more adapted to their own prevailing problems of weak investment and unemployment.

The Impact of Minimum Wages on Youth Employment

What effect does the existence of a minimum wage have on employment? Does it keep people out of jobs? Assuming minimum wages have a negative impact on employment, do they nevertheless have compensating virtues in terms of the social goals that are cited in justification of them – protection of workers with little bargaining power, the suppression of poverty, etc.? Might there be better ways of achieving these goals?

A recent OECD report sheds some light on these questions, with particular reference to measures concerning young people. It looks at the main findings of recent reports on the situation in Canada and the United States, and analyses the effects of changes in the minimum wage provisions in France over the past 20 years.[1] This article concentrates on the general issues and the situation in North America, while the French experience will be discussed in a subsequent issue.

In coming to any judgement on this thorny issue, it is essential to quantify the impact of minimum wages on employment opportunities. Since a minimum wage, if it is to be effective in meeting any of the desired goals, must be set above the market-clearing wage, this is likely to cause some job losses. Thus, the gains from implementing the minimum wage in terms of raising the wages of some groups of workers, have to be offset against the loss of actual or potential jobs for other workers. This issue has assumed much importance in discussions of youth unemployment since young people, with low levels of firm-specific human capital, are typically over-represented among the lower paid and, thus, especially vulnerable to increases in the minimum wage.

There has been no lack of empirical studies on the employment effects of minimum wages. However, virtually the entire literature is confined to analyses of the experience in Canada and the United States. This concentration is regrettable as minimum wages are an important feature of labour markets outside North America: most OECD countries have some form of minimum wage – established by government legislation, collective agreements or convention – even if there is a wide range of variation across Member countries with respect to levels, coverage, the presence or absence of age/regional/industrial differentials etc. Moreover, some countries have systems which are more generous relative to average wages or official poverty lines than the present systems in Canada and the United States.

Theoretical Issues

The basis for the argument that the level of minimum wages and employment are negatively correlated is grounded in conventional microeconomic theory. In the standard competitive model, a minimum wage above the market clearing wage will lead firms to reduce the quantity of labour employed. Obviously, employment of minimum wage earners is also influenced by factors other than the wage rate, e.g. the level of real demand, technological change, the capital stock, etc. Thus, in an expanding economy employment may continue to increase following a rise in the minimum wage. Theory only predicts that

1. Effects of the Minimum Wage on Youth Employment: A Review of the Recent Literature Together with a Study of the French Experience, *to be published shortly as an* Occasional Study.

the increase in employment will not be as large as it would be without the rise in the minimum wage.

In competitive markets a rise in the minimum wage will, *ceteris paribus,* reduce employment but may not necessarily lead to a rise in unemployment. There is a complicating factor in that the minimum wage may also affect the supply of labour. Depending on the direction and magnitude of this labour force effect, it may exacerbate or lessen the impact of the minimum wage induced job losses on unemployment.[2]

This distinction between the employment and unemployment effects is an important one. In order to clarify the behavioural responses involved, the discussion concentrates on the case of an economy with full coverage and a variable labour supply. A hike in the minimum wage raises the expected return to low-wage occupations. This in turn is likely to attract more low-productivity workers to enter the labour force from the non-market sector. Thus, the rise in the minimum wage will lead to an increase in labour supply; this is sometimes called the "added worker" effect. At the same time, the reduction in demand for low-productivity workers consequent on the rise in the minimum wage will tend to lower the probability of finding work for low-skill workers. If job seekers become discouraged by the lack of jobs, they may tend to withdraw from the labour force. If this "discouraged worker" effect is greater than the "added worker" effect, an increase in the minimum wage will lead to a decline in labour supply and *vice versa.*

A Review of the Empirical Research in the United States and Canada

The United States federal jurisdiction first passed minimum wage legislation in 1938 as part of the "Fair Labor Standards Act". Initially this law provided legal coverage for only about one quarter of the private sector. However, it has since been amended six times by Congress in order to extend coverage and to raise the level. Currently over 80 per cent of the labour force is covered by the minimum wage or maximum hour provisions of the Act.

Unlike the United States, minimum wages in Canada are mainly under the jurisdiction of the provinces. Coverage has been gradually extended over the past two decades so that, apart from farm labourers and domestic servants, there is now virtually complete coverage.

Employment effects

Of the 13 post-1970 American and Canadian econometric studies of the employment effects of minimum wages reviewed by E.G. West and M. McKee[3], none reported significant increases in employment. The overwhelming majority (9 out of 13) reported unambiguous and statistically significant reductions in employment; one study found no significant effects while the remaining three showed mixed results for different labour force groups. On the basis of this they conclude that, "there is no convincing evidence to refute the prediction that minimum wages cause reductions of employment (for young workers at least)".

A review for the Minimum Wage Study Commission[4] of teenage employment and unemployment time series studies concluded that on average a 10 per cent increase in the minimum wage reduces teenage employment by between 0.5 and 3 per cent; most studies show a narrower range of 1.0 – 2.5 per cent. These latter estimates translate into a loss of some 80,000 – 200,000 jobs from a teenage workforce of about 8 million. These studies have just been updated to the end of 1979. The new estimates consistently fall in the lower range suggested by the previous literature. It appears that on average a 10 per cent rise in the minimum wage would result in a decline in teenage employment of about 1 per cent.

Unemployment effects

One key implication which follows from a negative labour supply effect is that it may offset the disemployment effects from a change in the minimum wage and, thus, there may be little or no impact on unemployment. Indeed, if the negative effect on labour force participation is very strong, it is conceivable that there could be a decline in measured unemployment.

The authors cited[5] also reviewed the literature on the effects of minimum wages on the teenage unemployment rate. They found a consistent pattern in the more recent studies of a very small effect: on average the results suggested an increase of less than 1 percentage point in response to a 10 per cent rise in the minimum wage. When they updated these studies to 1979, the unemployment effect virtually disappeared. They attributed this latter result to the impact of discouragement on young people following the jobs lost by minimum wage increases.

A special minimum wage for young workers

One outcome of high youth unemployment rates in recent years has been a renewed interest in the issue of youth differentials, i.e. special subminimum wage rates for young workers or students.

A subminimum for youth would have two effects. First, there will be a scale effect as unit costs decline and firms have an incentive to reduce prices and expand sales. This scale effect will tend to raise the demand for all inputs used in the production process. Second, there will be a substitution effect as employers have an incentive to substitute young workers paid at the subminimum rate for other workers, especially minimum wage adults. The net impact of a youth differential on *total* employment depends on the relative magnitude of these two effects.

The system is little used in North America. In Canada, three provinces no longer have minimum wage differentials for youth and the differentials in the other provinces only apply to young workers and students aged less than 18. Moreover, since most of these differentials are fixed in absolute terms rather than as proportions of the basic provincial minimum wage, their effectiveness has probably diminished over time. In the United States, there are no youth differentials as such in the Fair Labor Standards Act, but an exemption to the Act covers full-time students hired at a subminimum wage of 85 per cent of the basic minimum wage under the provisions of the Student Certification Program.

The existing literature on the issue of a youth differential is very sparse. However, research carried out by Hamermesh (1981)[6] for the Minimum Wage Study Commission suggested that a 25 per cent youth differential would increase teenage employment by about 3 per cent (some 250,000 jobs). He did not calculate the associated adult employment effects. On the basis of additional simulations, the Minimum Wage Study Commission con-

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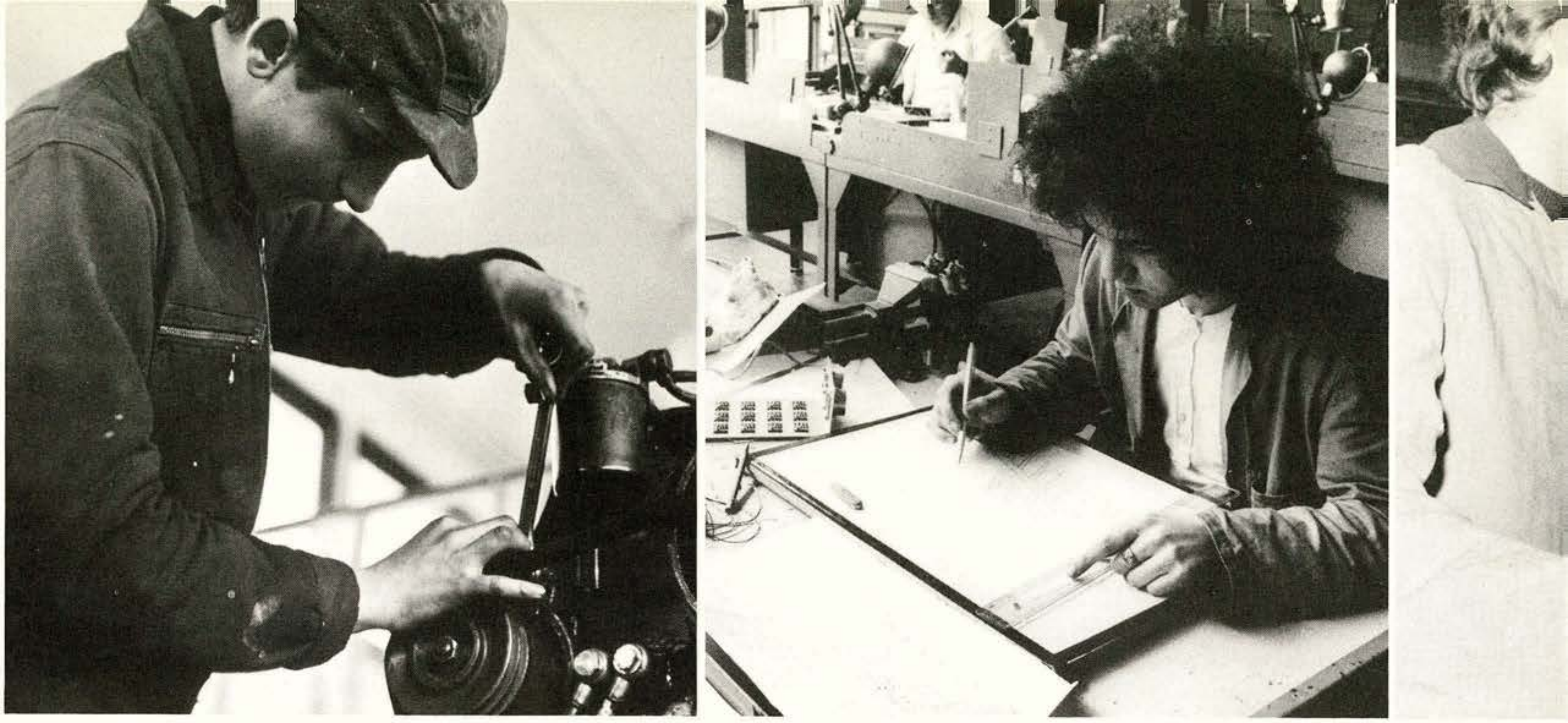
2. Mincer, J., Unemployment Effects of Minimum Wages, Journal of Political Economy, *August 1976 (Part 2), S87-S104.*

3. *West, E.G., and McKee, M.,* Minimum Wages: The New Issues in Theory, Evidence, Policy and Politics. *A study prepared for the Economic Council of Canada and the Institute for Research on Public Policy, Quebec: Canadian Government Printing Centre, 1980.*

4. *The Minimum Wage Study Commission was established in 1977 by the Carter Administration to examine the social, political and economic ramifications of the minimum wage and overtime requirements of the Fair Labour Standards Act of 1938. The Commission was chaired by James G. O'Hara and it submitted its final report in May 1981.*

5. *Brown, C.C., Gilroy, C.L., and Kohen, A.I.,* "Effects of the Minimum Wage on Youth Employment and Unemployment", *in* Report of the Minimum Wage Study Commission, *Vol. V, Washington, D.C.: U.S. Government Printing Office, 1981.*

6. Hamermesh. D.S., *"Employment Demand, the Minimum Wage and Labor Costs", in* Report of the Minimum Wage Study Commission, *Vol. V, Washington D.C.: U.S. Government Printing Office, 1981 (forthcoming).*



There is a reasonable consensus that a subminimum wage for young workers would increase teenage employment... but

cluded that: "A reasonable prediction might be that teenage employment would increase by 1.5 to 3 per cent in response to a 15 per cent differential, and by 2.5 to 5 per cent in response to a 25 per cent differential, but there is substantial uncertainty that the true effect would be within that range. Adult employment would probably be reduced, but it is very unlikely that adult employment reductions would be as large as teenage employment gains".

Effects on income distribution ...

Minimum wages are often advocated as a means of reducing poverty and redistributing income. However, official definitions of poverty are usually expressed in terms of the location, size and nature of households relative to their disposable income, whereas minimum wages apply to individuals with low earnings. Thus, there are many causes of poverty that cannot be eliminated by minimum wages: inadequate levels of income in families where there are no wage earners, and (for individuals) prolonged spells of unemployment and/or large numbers of dependents. The research debate has focused on the issue of whether minimum wages redistribute income to individuals in the greatest need or whether, given that there are some disemployment effects, minimum wages are a useful anti-poverty device.

In the United States, several studies have been carried out in the past five years to assess the income redistribution effects of minimum wage legislation.

The three studies carried out for the Minimum Wage Study Commission[7] came to a conclusion similar to that of other studies: the minimum wage is a relatively ineffective instrument to reduce poverty. All three studies agreed that changes in coverage have had a greater impact in ameliorating poverty among low-wage workers than increases in the level of the minimum wage. However, since over 80 per cent of the labour force is now covered, further extensions are unlikely to make much of a dent in poverty. Other policy measures, such as direct income transfers or a negative income tax, would be more effective at reducing poverty than simply relying on the minimum wage.

... and on prices

If changes in the minimum wage are aimed at securing a permanent redistribution of real income, it is important to analyse the potential impact on wage and price inflation. If prices rise subsequent to a hike in the minimum wage, and if wage structures are not compressed over time, the real income of low-wage workers may not increase and their position in the income distribution may not improve relative to other groups.

Besides giving a direct boost to the earnings of workers on the minimum wage, a higher minimum can also indirectly affect wage inflation through three channels. First, workers whose earnings were at or above the new minimum are likely to demand compensating increases in order to preserve traditional differentials. Second, firms, responding to a new set of relative factor prices, will tend to substitute capital and/or skilled labour for unskilled labour earning the minimum wage. This may tend to raise labour productivity and thus moderate some of the initial impact of the minimum wage change on wage inflation. Finally, the increase in the minimum wage combined with the associated changes in output, income and employment may affect inflationary expectations and thus give a further impetus to wage inflation. However, to the extent that raising the minimum wage creates significant disemployment, this factor should serve to moderate some of the upward pressure on wages.

The Minimum Wage Study Commission used a large quarterly econometric model of the US economy to carry out two simulations. First, they simulated the total (i.e. direct plus indirect) effects of a hypothetical 10 per cent rise in the minimum wage each year from 1973 on through 1979. Second, they attempted to quantify the effect of the actual increases legislated in 1974 and 1977. The results of the first simulation indicated that a sustained 10 per cent annual increase in the minimum wage would have on average raised wages by 0.8 per cent and consumer prices by 0.3 per cent.[8] The second simulation suggested that the actual increases legislated in 1974 and 1977 had raised wage and price inflation by 0.6 and 0.2 per cent, respectively, over the period 1974 through the second quarter of 1979.

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* *

The review of the recent North American literature produced the following conclusions:

- Increases in the level and coverage of the minimum wage have given rise to disemployment effects, especially among the young. These negative employment effects are typically very small (the Minimum Wage Study Commission estimates that a 10 per cent increase in the minimum wage would give rise to a loss of 80,000 – 200,000 teenage jobs out of a workforce of some 8 million).
- The minimum wage also appears to affect labour force participation decisions.

it is difficult to know how much of this would be at the expense of low wage adult workers.

Some North American studies point to a decline in youth labour supply following a rise in the minimum wage but this conclusion is not unanimous.

• Most studies show a small minimum wage effect on youth unemployment: the Minimum Wage Study Commission concluded that on average a 10 per cent rise in the minimum wage led to an increase of less than 1 percentage point in the teenage unemployment rate. When the Commission updated many of these studies, they found that the unemployment effect virtually disappeared.

• The balance of evidence suggests that a youth differential would produce some increase in youth jobs. However, since some of these jobs would clearly come at the expense of adult low-wage workers, it is difficult to predict the impact on total employment with much certainty.

• All the evidence suggests that the minimum wage is a relatively ineffective instrument in reducing poverty.

7. *Behrman, J.R., Taubman, P.J., and Sickles, R.,* "The Short-Run and Long-Run Effects of Minimum Wages on the Distribution of Earnings", *in* Report of the Minimum Wage Study Commission, *Vol. VII, Washington, D.C.: U.S. Government Printing Office, 1981; Datcher, L.P. and Loury, G.C.,* "The Effect of Minimum Wage Legislation on the Distribution of Family Earnings Among Blacks and Whites", *in* Report of the Minimum Wage Study Commission, *Vol. VII, Washington, D.C.: U.S. Government Printing Office, 1981; Johnson, W.E., and Browning, E.K.,* "Minimum Wages and the Distribution of Income", *in* Report of the Minimum Wage Study Commission, *Vol. VII, Washington, D.C.: U.S. Government Printing Office, 1981 (forthcoming).*

8. *In order to put these figures into perspective, the average annual increases in wages and consumer prices over this period were 9 and 9.3 per cent, respectively.*

More Savings: a Key to Non-Inflationary Growth?

Economic development in virtually all OECD Member countries has been characterised by a dramatic slowdown in business fixed investment since the early Seventies, entailing a significant reduction in the growth of the stock of productive capital. At the same time, the labour force in most countries has continued to grow – sometimes at an accelerating pace – due to both the postwar baby-boom generation reaching working age and increasing female participation. The combination of these developments has resulted in a growing mismatch between the size of the economically usuable capital stock and the total labour force and thus in an increasing gap between the demand for, and supply of, labour, with unemployment rates reaching new postwar peaks in many OECD countries. As a consequence, there is a growing consensus that a substantial increase in productive capital formation is required to permit a return to full employment. A key element in the pursuit of this objective appears to be the level of savings, according to a recent OECD study.[1]

Resources for Investment

Additional funds for productive investment could come from various sources. However, given the overriding concern about inflation and the rather uneven distribution of idle plant capacity across countries and sectors, the possibilities for stimulating investment through *aggregate demand management policies* – relying solely on the multiplier-accelerator mechanism to generate increased income and thus savings – is generally considered rather limited.

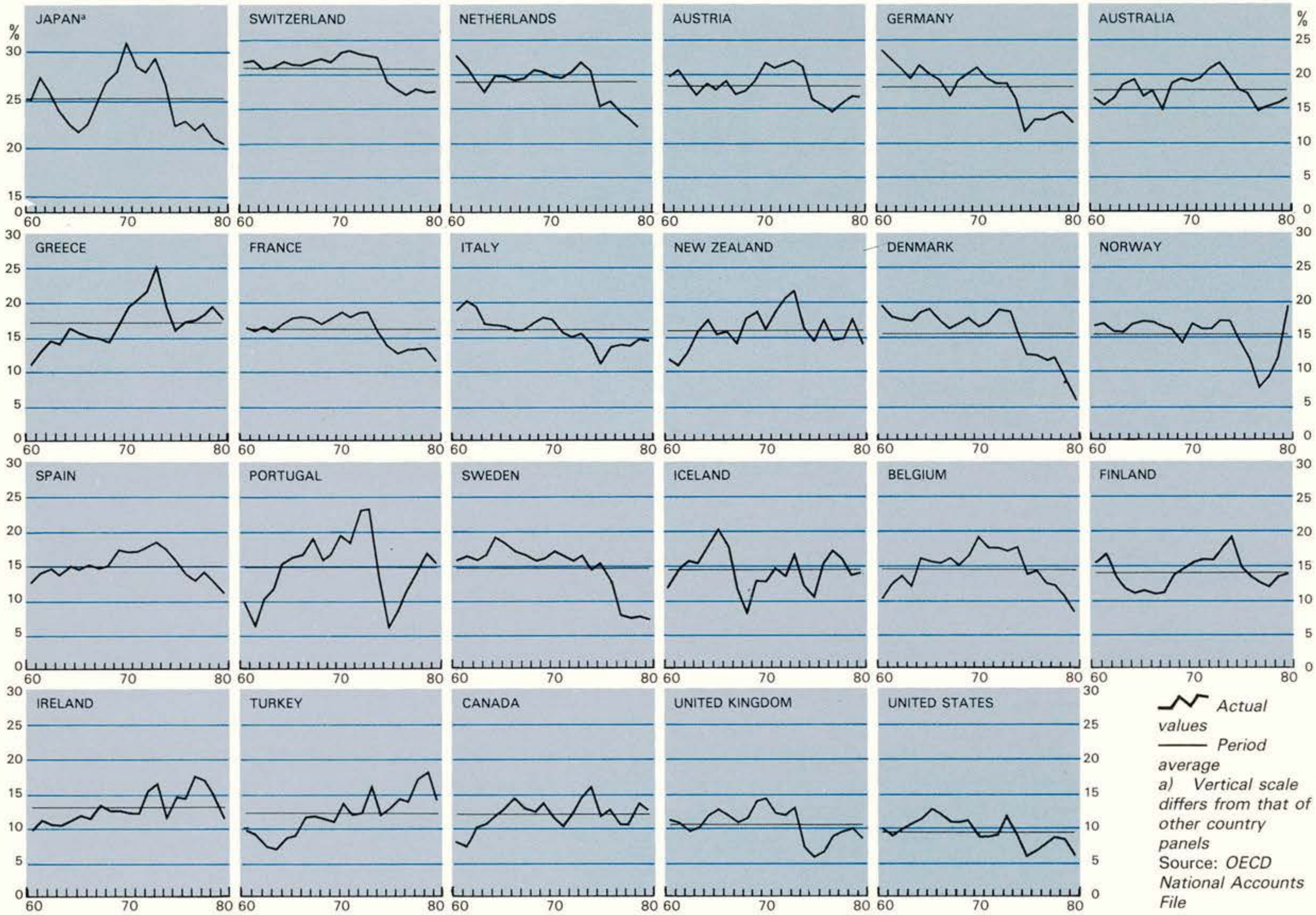
The scope for *attracting additional resources from abroad* also seems to be limited. With OPEC's current account surplus rapidly diminishing, the industrialised world no longer has the possibility of increasing its net foreign borrowing. The demands of the less developed countries for financing current account deficits can be expected to increase, so that, with less international "oil money" available, OECD countries will eventually have to resume their traditional role as net capital exporters.

Alternatively, additional resources for productive investment might be found by *reducing public investment, housebuilding and areas of business investment which do not add to productive capacity.* There seems little scope for this as well however. Public investment has already been trimmed in restrictive budget programmes and further cuts may be undesirable, in light of existing needs for social infrastructure improvements and environmental protection. Demographic and social trends may, on the other hand, permit some moderation in housing investment, in particular if existing tax incentives to housebuilding are removed. Though the situation differs between countries, gross investment in residential construction may nevertheless continue to absorb a high share of national savings given the existing large amounts of housing stock which needs to be replaced or improved.

In light of these considerations, the only remaining promising source of finance is to *shift resources from private and public consumption to productive investment,*

1. International Differences and Trend Changes in Saving Ratios.

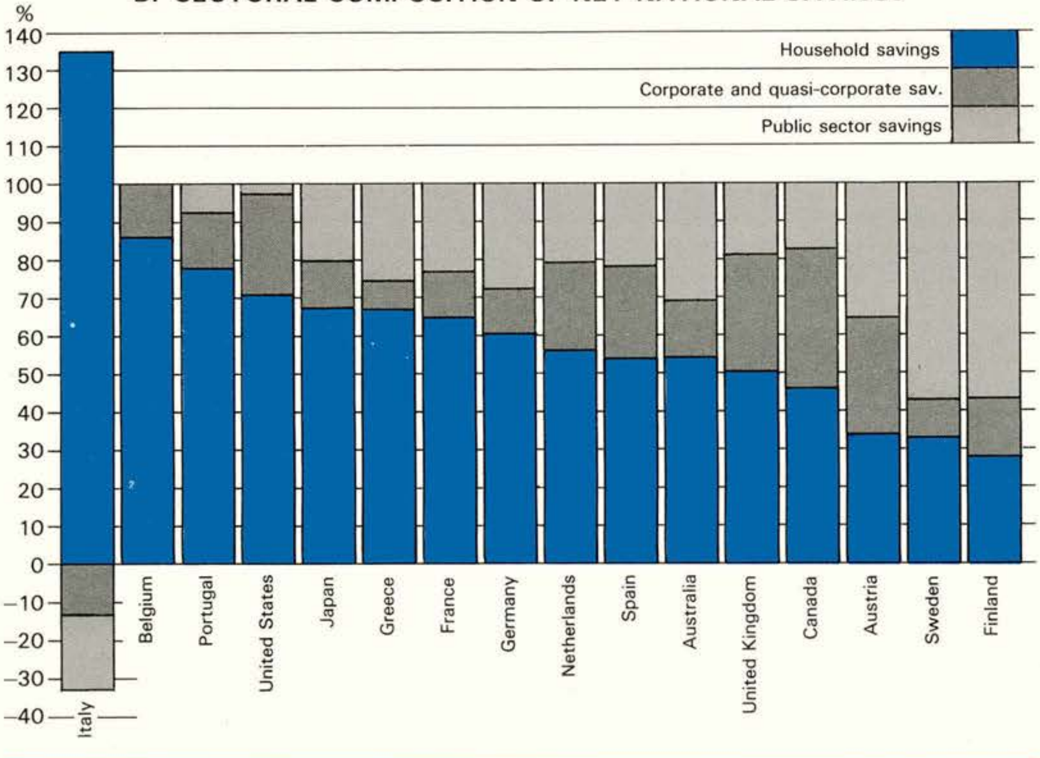
A. NET NATIONAL SAVINGS RATIOS, 1960-80
in order of size



which implies an *increase in the national savings ratio.*[2] This conclusion has caused a renewed interest in the determinants of savings behaviour and the causes underlying the large differences observed in the savings ratios of OECD countries. These are shown in Chart A, which reveals not only marked differences between countries but also significant changes over time. Between 1960 and 1980, the national savings ratio increased by seven percentage points in Greece, compared with a decline of ten percentage points in the Netherlands. Similar differences are evident in long-term average savings ratios, which range from 9 per cent in the United States to 25 per cent in Japan.

Increased savings could in principle be generated by one or another of the three main sectors in the economy: private households, business and government. For each of these groups, total savings plus depreciation equal the amount available for real gross asset formation within the sector or

B. SECTORAL COMPOSITION OF NET NATIONAL SAVINGS



2. *The savings ratio is defined as total savings divided by disposable income.*

for net lending elsewhere (financial asset formation). Chart B depicts the sectoral composition of savings in the majority of OECD countries. For most of them, households are by far the most important source of savings, and this is one of the reasons why analysis has concentrated on household savings behaviour.[3] Average household savings ratios show even greater variations from one country to another than national savings ratios.

Differences in Household Savings Ratios

International variations in household savings ratios can be partly attributed to institutional differences between countries. The effects of such factors on the measured savings ratio are shown in Table 1.[4]

The combined result of these adjustments is that international differences between household savings ratios are substantially reduced. But some striking disparities still remain. The "high savers" (Italy and Japan) still have savings ratios about 50 per cent higher than the "low savers" (United States, Sweden, United Kingdom). Hence a large part of differences in household savings ratios from one country to another can only be explained by factors other than the statistical methods used.

1. ADJUSTMENT OF HOUSEHOLD SAVING RATIOS FOR "SPURIOUS" ACCOUNTING DIFFERENCES

	Average SNA[1] gross saving ratio (1970-1979)	*Effect of adjustment (percentage point change)*						*Adjusted ratio*
		Type of adjustment[2]					*Combined adjustment*	
		(a)	*(b)*	*(c)*	*(d)*	*(e)*		
Canada	13.6	−4.4	+10.1	+1.6	..	+2.2	+9.5	23.1
United States	12.0	−4.9	+7.8	+0.5	−1.4	+0.4	+2.4	14.4
Japan	24.9	−4.2	+3.3	+2.6	−1.1	+1.4	+2.2	27.1
Australia	17.0	−2.8	+7.0*	..	−1.5	+1.9	+4.6	21.6
Finland	11.9	−5.7	+7.3	+0.5	−1.5	+3.3	+3.9	15.8
France	17.1	−3.3	+6.9	+0.7	..	+3.5	+7.8	24.9
Italy	25.3	−3.5	+3.9	−0.2	−2.1	+3.0	+1.1	26.4
Sweden	8.0	−4.4	+7.5	+6.3	−1.3	+2.0	+10.1	18.1
United Kingdom	10.2	−2.9	+7.1	+0.5	−1.2	+1.6	+5.1	15.3
Coefficients of variation	*37.3*	−	−	−	−	−	−	*22.6*

* *estimate*

(1) *SNA = Standardised National Accounts.*

(2) a. *exclusion of unincorporated enterprises from household sector.*
b. *classifiying consumer durables as capital.*
c. *standardising treatment of public and private pensions.*
d. *transfer of final consumption expenditure on health and education from government to households.*
e. *standardising treatment of direct and indirect taxes.*

Why Do Households Save?

The most important reasons for long-term savings by individuals are to provide funds for retirement, for bequest and as a hedge against emergencies. In the short to medium run, intermittant savings and dissavings occur due to the irregularity of expenditure on consumer durables. Assuming rational optimising behaviour, the individual household's savings propensity depends on the age structure of the household's members, its expectations of future income, its wealth, interest rates and other less tangible factors, such as time preference and risk aversion. Relating individual household behaviour to aggregate savings ratios, it is interesting to note that whatever the motive, aggregate savings will only be positive in a growing economy; in a stationary economy, positive retirement savings by the young will be offset by the dis-saving of retired people drawing on their wealth to finance current consumption. Similarly, the bequest motive will only lead to passing on a constant stock of wealth from one generation to the other, and precautionary savings will on average be offset by the emergency use of accumulated savings, leaving the overall level of precautionary reserves unchanged. There is thus a remarkable symmetrical relationship between economic growth and the demand for as well as the supply of savings: only a growing economy requires positive net savings to maintain a constant or increasing capital/labour ratio, and likewise individual saving motives will generate aggregate net savings only in a growing economy.

Institutional factors may interact with household behaviour and thus affect household savings ratios. Limited access to consumer credit, for instance, would tend to increase aggregate savings. Other capital market imperfections such as interest rate ceilings would, on the other hand, discourage savings if the interest elasticity of savings is positive. This cannot be taken for granted given the theoretical ambiguity and the inadequate and partly contradictory empirical evidence on this question. The uncertainty about the interest elasticity of savings also makes it difficult to appraise the effect of taxation on profits and interest revenue on the level of savings. There is, however, strong evidence that differential tax rates on different types of assets (or their returns) have important effects on the composition of portfolios and savings allocation, including the choice between real and financial assets.

Although mandatory public pension schemes are at first glance likely to affect savings behaviour significantly, a closer analysis suggests that the impact on the national savings ratio is unpredictable on theoretical grounds. Unfortunately, empirical evidence is unable to resolve this ambiguity: the statistical problems encountered in testing the relevant hypotheses are formidable, rendering the results obtained unreliable.

Inflation may affect savings in several ways but there seem to be two channels through which a permanent and statistically significant influence is felt. Firstly, inflation erodes the real value of financial assets (excluding equity) and this stimulates savings if households aim to maintain a target wealth-income ratio. This is true whether the inflation is anticipated or not, but if it is, nominal interest rates incorporate an inflation premium (treated as income in the national accounts) which compensates for an inflationary loss of real wealth. The second effect of inflation on savings is to increase uncertainty about expected real income, thus inducing increased precautionary savings.

There are no convincing theoretical reasons why the distribution of personal income should affect aggregate savings propensities, unless it is positively correlated with the strength of savings motives (e.g. the bequest motive). Available empirical evidence does not support the hypothesis that this is indeed the case. Concerning the functional distribution of income, it is difficult to establish empirically a significant difference between the marginal propensities to save out of wages and investment income, though this would

3. *Once capital spending has been taken into account, both the business sector and the public sector are usually net borrowers, while households are net lenders, even when residential construction is considered as investment by households.*

4. *In addition to the adjustments listed, Table 1 depicts gross rather than net household savings ratios (i.e. savings plus depreciation) in order to eliminate distortions that originate from country-specific methods of calculating capital depreciation allowances.*

More productive investment is needed for a return to full employment.

seem plausible on *a priori* grounds, given the greater variability of the latter.

The empirical work analysed by the OECD suggests that international differences in savings ratios can be explained quite satisfactorily if the effects of the various factors discussed above are added up. Owing to statistical problems, the causal links between the savings ratio and individual savings determinants are, however, difficult to quantify. Despite these problems, empirical results strongly support the hypothesis that the rate of growth of income and the overall labour force participation ratio (itself strongly dependent on the age distribution of the population) have significant positive effects on savings.

Stimulating Savings

The above analysis permits a tentative evaluation of the possibilities for – and limitations of – trying to influence savings behaviour by economic policy measures.

Tax policies

Reducing the taxation of investment income (or wealth) may affect the supply of private savings through two channels:

• by increasing the after-tax rate of return on savings; this will, however, work only if the supply of savings has a positive interest elasticity; neither theoretical analysis nor available empirical evidence imply that this is indeed the case.

• by changing the after-tax income distribution; here, too, neither theoretical reasoning nor available emprical evidence enable any conclusions to be drawn about the effects of income redistribution on the aggregate savings ratio.

In past years, the combination of high inflation rates and the taxation of nominal rather than real returns on financial capital are likely to have distorted the relative real after-tax rates of return on investment in property (and other tangible assets) as opposed to those on financial assets. The fact that interest payments on mortgage credit are deductible from taxable income, in many countries, has increased this distortion which may have channelled household savings away from productive business investment. A rapid reduction of inflation and/or a change of existing tax provisions to take account of inflation should help to reverse this trend.

Savings Subsidies

Some governments provide grants to savers on the condition that the savings are held for a minimum time period, with a ceiling on both the amount of savings subsidised and the income of the beneficiary. This approach has been used in Germany and Austria, both countries with relatively high household savings ratios. The effectiveness of such a measure in increasing the national savings ratio is, however, open to doubt. If actual household savings are above the ceiling for savings benefitting from the subsidy, there will be no effect on the marginal rate of return and thus no price incentive to save more (only to make sure the subsidy quotas are fully exploited). In fact, if the government's marginal propensity to save is higher than that of the household sector, savings subsidies will actually lower the *national* savings ratio.

Public pension funds

The effect of mandatory public pension schemes on household savings has come to the fore in policy discussions in recent years. Empirical research studied by the OECD is not conclusive as to whether or not private savings are reduced by state pension schemes. If a pension scheme is funded, the expected decline in private savings will be offset by public savings. In an unfunded scheme, people may simply adjust their private transfers and bequests (e.g. children pay less to take care of their parents when forced to contribute to a nationalised pension scheme) so as to leave overall wealth unchanged.

Government regulations

Nominal interest rate ceilings on certain savings instruments have been sluggish in adjusting to inflation so that real rates of return have frequently become negative. This may reduce overall savings or induce shifts into property or other tangible assets. On the other hand, easy access to consumer and mortgage credit will lower the household savings ratio. Limiting credit availability for households and abolishing legal interest rate ceilings would therefore be possible ways of increasing aggregate savings.

Public sector savings

The most straightforward avenue towards increasing the *national* savings ratio would seem for governments to reduce their current expenditures and/or to increase tax revenues (i.e. increase their savings). The problem with this seemingly obvious solution is that it runs counter to government's income stabilisation function. Discretionary deficit cutting in times when productive capacity is not fully utilised may have adverse repercussions on demand, income and savings, and thus may actually turn out to be self-defeating as a result of built-in stabilisers which prevent the deficit from falling. On the other hand, it has been claimed that such a determined effort by governments to reduce public sector deficits would inspire confidence in the private sector and lead to higher business investment propensities, which in turn would generate higher savings via both the multiplier-accelerator process and the normal cyclical recovery of savings ratios. This is the strategy presently being pursued in the majority of OECD economies.

OECD Instruments on Multinational Enterprises and International Investment:
Taking Stock of the Situation

Although the growth of international direct investment has slowed down since the mid-1970s, it has remained fairly buoyant among OECD Member countries. Indeed, many governments, including some outside the OECD area, attach growing importance to direct investment as a prime mover in furthering economic development. Such investment is more diversified now than it was 20 or even 10 years ago and for many countries; for example the United States, there is now a greater balance between their roles as home and host countries. A wider range of companies invests in foreign countries than before, including from the Third World. Service industries have become a major growth sector for international investment.

OECD's Committee for International Investment and Multinational Enterprises (CIME) has just issued a progress report[1] on the three instruments for international cooperation contained in the 1976 Declaration (see box) made by OECD governments: Guidelines for multinationals, national treatment for foreign owned enterprises, and investment incentives and disincentives. Multinationals' experience with the Guidelines and OECD's clarifying work on these instruments are discussed below.

New Features

Several new features have or could become increasingly significant: the introduction of new technologies, particularly in the computer and communications field; the multiplication of integrated networks of production plants at the level of multi-country regions or the world market as a whole; the emergence (alongside the traditional whollyowned branch or subsidiary) of new forms of investment such as, for example, non-equity involvement or cooperation agreements between enterprises[2]. Finally, there has been a shift in many areas away from the creation of new capacity towards restructuring or extension of existing capacity or towards the acquisition of firms. Restructuring frequently involves the closure of certain plants, even if employment losses are compensated by increases elsewhere, while capital deepening or productivity orientated investment, as well as takeovers, extension of capacity and capital widening investment can carry with them implications for the workforce in certain countries. →

1. *Mid-Term report on work relating to the OECD 1976 Declaration on International and Multinational Enterprises. The last full-scale review took place in 1979; the next one is timed for 1984.*

2. *See OECD Observer No. 112, September 1981.*

BACKGROUND

The important contribution of international investment to world economic activity and the major and growing role played in this respect by multinational enterprises led the OECD to set up in 1976 the Committee on International Investment and Multinational Enterprises. The same year, OECD governments issued a Declaration and Decisions on international investment and multinational enterprises. These included the so-called Guidelines for Multinationals – a set of recommendations covering areas like disclosure of information, competition, taxation and employment and industrial relations[1]. The Declaration stated that the "co-operation by Member countries can improve the foreign investment climate, encourage the positive contribution which multinational enterprises can make to economic and social progress, and minimise and resolve difficulties which may arise from their various operations".

In 1979, OECD Ministers reviewed the progress made so far in the application of its decisions and guidelines. They reaffirmed their governments' commitment to the 1976 Declaration and agreed that these instruments provided an effective framework for co-operation. At the same time, they made additions to the guidelines and presented some explanatory comments on the scope and meaning of some of the provisions.[2]

The Ministers decided to hold another review in five years at the latest. The article draws on the mid-term report to the Council which, as well as a résumé of progress made in enlarging acceptance of the Declarations and Decisions in OECD Member countries, contains a list of business federations that have expressed their support for the Guidelines (see below), an updated list of contact points in Member countries, and some clarifications of certain points in the Guidelines – such as reporting by multinational enterprises, the provisions relating to employment and industrial relations and the scope of the "national treatment" instrument.

1. *See OECD Observer No. 82, July 1976.*
2. *See OECD Observer No. 99, July 1976.*

The Guidelines in the Present Economic Situation

These developments raise new questions for the governments of home and host countries as well as for employer and worker organisations, for instance in the area of employment and industrial relations. This is an area where long-established national procedures, sanctioned by law or by practice, exist – and the Guidelines underline the importance of the framework of national law – but it is also an area where the Guidelines, when relevant, can serve as a valuable supplement.

The present economic situation inevitably poses difficult problems when adaptation and restructuring of company activities are envisaged. However, such changes may be justified on the grounds of economic efficiency and can be necessary to promote the long-term security of employment. In instances where such changes involve the closure of an entity or other measures "which would have major effects on the livelihood of employees"[3], management should give reasonable notice of such changes to representatives of their employees and, where appropriate, to the relevant governmental authorities "so as to mitigate to the maximum extent practicable adverse effects"[3]. The notice has to be sufficiently timely for the purpose of mitigating action to be prepared and put into effect, and it would be appropriate, in light of the specific circumstances of each case, if management were able to provide such notice prior to the final decision being taken.

How have multinationals responded?

Experiences since the adoption of the Guidelines lead the Committee to believe that as a general rule the will exists on the part of management to take the Guidelines fully into consideration when faced with a restructuring problem.

The willingness expressed by the representatives of multinational enterprises to live up to the standards set by the Guidelines is viewed by the Committee as evidence of their usefulness and relevance, though it acknowledges that developments in international investment activities will need to be closely monitored if they are to remain both useful and relevant. In an effort to secure wider recognition and acceptance of the Guidelines, the Committee calls on all multinational enterprises to indicate publicly – preferably in their annual reports – their acceptance of them and their experience in applying them. But so far, while a number of multinational companies and national business federations have expressed public support for the Guidelines (see box), the number of individual multinational corporations that have responded to this call has been smaller than the Committee had hoped for. It notes that worker organisations, too, have an important role to play in promoting awareness and acceptance of the Guidelines.

Contact points

Governments have also contributed to the promotion effort. At the request of the Committee, all Member governments have established "contact points" to deal with matters arising in this regard. Their work includes disseminating the text of the Guidelines, gathering information on their application at national level and providing a forum for discussion between interested parties on problems that may arise. Over and above these basic functions, the activities of the contact points vary greatly from country to country, some playing a highly active role, others less so, depending mainly upon national circumstances and practices, especially in labour market matters.

Disclosure of information

One area in particular in which the Committee considers further work and clarification necessary is the Disclosure of Information Guideline. It has set up a Working Group on Accounting Standards to be responsible for drafting some supplementary paragraphs defining and explaining some of the accounting concepts contained in the Guidelines. Given the lack of international harmonisation of basic accounting standards within the OECD area, the Committee has had to define its terms more closely: it has already formu-

3. Paragraph 6 of the Guidelines on Employment and Industrial Relations, International Investment and Multinational Enterprises, Revised Edition, OECD, Paris, 1979.

BUSINESS FEDERATIONS HAVING EXPRESSED SUPPORT FOR THE OECD GUIDELINES

In addition to the Business and Industry Advisory Council to OECD (BIAC), the following business federations have expressed support for the OECD Guidelines:

Belgium
- *La Fédération des Entreprises de Belgique (FEB)*

Canada
- *Canadian Manufacturers' Association*
- *Canadian Chamber of Commerce*
- *Canadian Council of the International Chamber of Commerce*

Denmark
- *Federation of Danish Industries*
- *The Danish Employers' Association*

Finland
- *The Confederation of Finnish Industries*

France
- *Le Conseil National du Patronat Français*

Germany
- *Deutscher Industrie – und Handelstag (DIHT, Association of German Chambers of Industry and Commerce)*
- *Bundesverband der Deutschen Industrie (BDI, Federation of German Industries)*
- *Bundesvereinigung der Deutschen Arbeitgeberverbände (BDA, Federal Union of Employers' Associations)*
- *Bundesverband Deutscher Banken (Federal Association of German Banks)*
- *Deutscher Sparkassen – und Giroverband (German Savings Banks and Giro Association)*
- *Gesamtverband der Deutschen Versicherungswirtschaft (General Association of Insurance Enterprises)*

Italy
- *Confindustria*
- *The International Chamber of Commerce*

Netherlands
- *Verbond van Nederlandse Ondernemingen*
- *Nederlandse Christelijke Werkgeversverbond*

Norway
- *The Federation of Norwegian Industries*
- *The Confederation of Norwegian Employers*

Sweden
- *The Federation of Swedish Industries*
- *The Swedish Employers' Confederation*

Switzerland
- *L'Union Suisse du Commerce et de l'Industrie*
- *Le Groupement de Holdings Industrielles Suisses*

United Kingdom
- *The Confederation of British Industry*

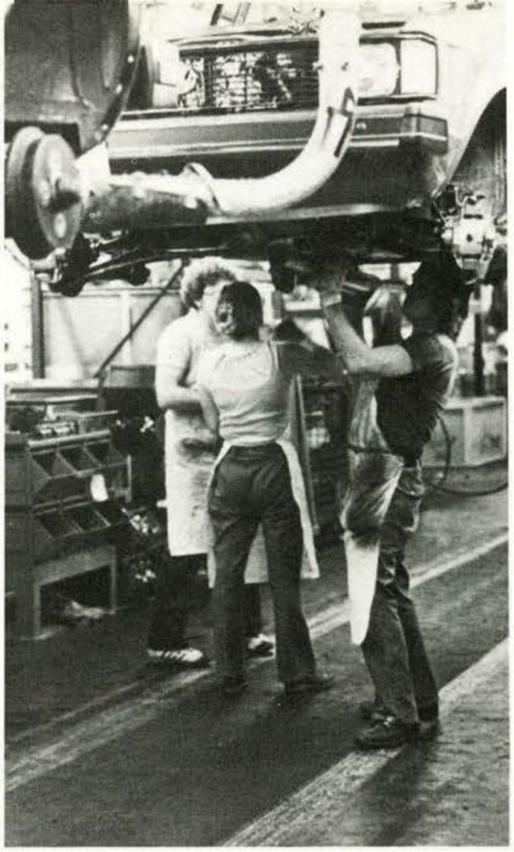
United States
- *The National Association of Manufacturers*
- *The Machinery and Allied Products' Institute*
- *The Chamber of Commerce of the United States*
- *The National Foreign Trade Council*
- *The US Council of the International Chamber of Commerce*

lated more precise meanings for concepts such as sales, new capital investment, sources and uses of funds, average number of employees, research and development expenditure and accounting policies. Definitions of two other, more complex, concepts – operating results and segmentation of accounts – will be completed this year. Work in this field is aimed not only at further clarification of the accounting terms but also at encouraging an exchange of views on the harmonisation of accounting and reporting standards. In general, there has been a positive, though uneven, response on the part of individual enterprises to the information Guideline and the Committee considers that further efforts are clearly required.

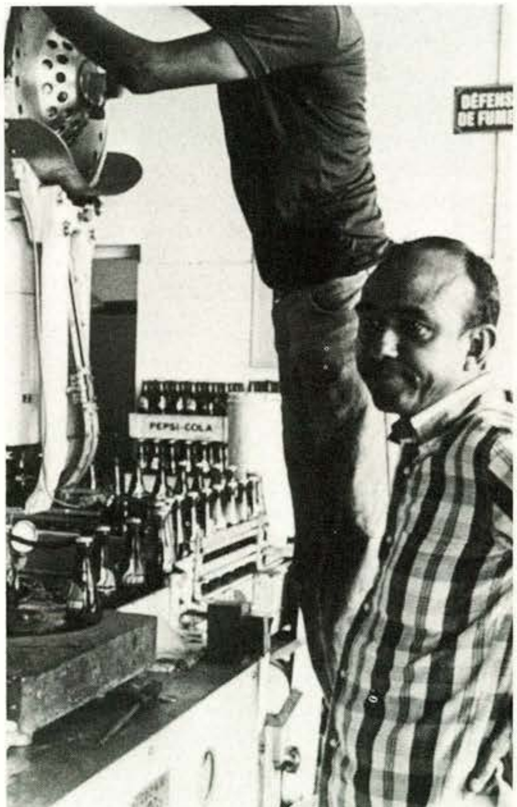
National Treatment

The Committee has pursued its work on clarifying and promoting the National Treatment Instrument, focusing its efforts on increasing the transparency of Member countries' measures in this area. This Instrument states that "Member countries should, consistent with their needs to maintain public order, protect their essential security interests and fulfil commitments relating to international peace and security, accord to enterprises operating in their territories and owned or controlled directly or indirectly by nationals of another Member country treatment under their laws, regulations and administrative practices, consistent with international law and no less favourable than that accorded in like situations to domestic enterprises." In 1979, the Committee noted that, apart from some important exceptions, there was a generally favourable attitude towards foreign investment and equitable treatment of foreign controlled enterprises in the OECD area.

To improve the transparency of government policies, the Committee set out to clarify the scope and application of the National Treatment Instrument – government aids and subsidies, measures related to the maintenance of public order and essential security interests, fiscal measures and government purchasing and public contracts. It is still working on two other issues – investment by established enterprises and access to local financing. The Comittee has also gathered further information on exceptions and restrictions, since its first survey on exceptions to National Treatment, published in 1978, and intends to issue a revised and augmented version of this report and to keep up-to-date records in future of exceptions to National Treatment, which according to the instrument have to be reported to the OECD. The service sector is being given special consideration. This work will pave the way for efforts to extend the application of National Treatment and to make it a more effective instrument for international cooperation.



For many countries, for example the United States, there is now a greater balance between their roles as home and host countries. Above, European and Japanese investment in the US: Volkswagen of America, Westmoreland assembly plant and Sony TV factory at San Diego. Below, US investment in Europe and Africa: Becton-Dickinson pharmaceutical company in Ireland and Pepsi-Cola in Djibouti.



To this effect, a certain number of expressions were thought to need clarification. The Committee decided that "no less favourable" should mean that a situation in which an already established foreign controlled company was treated less favourably in the country in which it operated than the least well treated domestic enterprise, would normally constitute an exception. As far as the term "in like situations" was concerned, the Committee came to the conclusion that a comparison of treatment was only possible within a given sector.

"Government aids and subsidies"

Under this heading, the Committee distinguished between three types: aids and subsidies granted by the state as a shareholder; aids and subsidies designed to offset a particular cost imposed by the state; and aids provided by the state as a supplier of funds. It concluded that the third of these categories was more likely to entail exceptions than the other two.

"Public order" and "essential security interests"

These concepts are included in the legal systems of all Member countries, as well as in the EEC Treaty and GATT. The Committee agreed that in relation to National Treatment, restrictions applied to foreign controlled enterprises on these grounds did not constitute exceptions *per se* but rather inherent limitations of the commitment of Member countries to accord National Treatment to foreign controlled enterprises.

Fiscal policy

Applying the principle of National Treatment to fiscal policy raises complex issues relating to governments' concern to ensure an equitable sharing of the tax base between country of source and country of residence and their determination to prevent tax evasion through the transfer pricing facilities available to international groups of affiliated companies. The key consideration here is not whether a specific tax treatment is compatible with the principle of tax neutrality, but whether it is less favourable to foreign controlled enterprises than to domestic ones in like situations.

Government purchasing and public contracts

This is an area where discriminatory practices can occur, taking the form of preferential treatment for the goods and services produced by domestic enterprises over those produced by locally established foreign controlled firms and/or those of non-resident foreign ones. Unlike the GATT Code on Procurement Practices, which applies to imported products, and the EEC's rules, which govern all products marketed by enterprises established within the Common Market, the OECD's National Treatment instrument applies to domestically produced goods and services marketed by foreign controlled firms. The Committee's work on transparency is especially important in this context, since administrative practices can constitute a barrier and make it impossible for bidding procedures to be truly transparent. Again, a lack of transparency in bidding procedures does not necessarily represent *per se* an exception to National Treatment, but it can impose particular burdens on foreign controlled enterprises to the extent that they are less familiar with local administrative practices than enterprises.

Investment Incentives and Disincentives

Despite the economic problems faced by all Member countries in recent years, there has been no general move on the part of OECD Governments to step up incentives to attract foreign investment. At the same time, real progress has been made towards increased transparency of governmental measures in this area. The Committee reports that one of its main tasks in the coming years will be to see that the present degree of transparency is maintained and that further light is shed on some aspects of governments' incentives and disincentives.

The Committee's investigation shows that only a few Member countries have introduced incentive measures specifically designed to attract foreign investment. On the whole, the major objectives of such incentives are to alleviate regional imbalances in terms of industrial activity and employment or to encourage industrial restructuring, innovation and efficiency. More recently; new incentives have been introduced to promote energy savings and environmental protection. These incentives can sometimes represent a significant proportion of the total cost of an investment project and may thus have an important influence on the choice of location.

The aim of increasing transparency is complicated by the great variety of measures which exist in Member countries. One important group is fiscal in character, ranging from accelerated depreciation to preferential tax rates and tax exemptions or credits. Another major type is financial incentives, in the form of grants, low interest loans and loan guarantees. There are also non-financial aids, such as the provision of land, industrial buildings or a specific infrastructure. All these types of incentive may be granted automatically on the basis of clearly defined and published criteria or allocated on a more case-by-case basis. But the distinction between automatic and discretionary criteria is not always clear-cut; some automatic incentives can also involve an element of evaluation by government agencies while those subject to administrative discretion can be made semi-automatic by the setting of well defined limits.

In some cases, there is a disincentive element in terms of the preconditions and performance requirements attached to the granting of investment incentives. Some constraints are directly related to the aim of a government policy, but others take the form of requirements affecting the performance of enterprises with regard to such matters as exports, imports or use of technology and often containing a discretionary element, giving government departments and agencies the power to put together an investment package in the course of negotiations with investors, whether domestic or foreign. In general, though, domestic and foreign controlled enterprises are not treated differently although some arrangements can clearly be tailored to appeal to foreign companies. Use of incentives, combined or not with performance requirements, can distort investment and trade flows. The Committee has now embarked upon an important programme in the area of trade-related investment measures.

How important are they?

Investment incentives may have only a limited influence on the investment decisions of multinational corporations. Thus the decision to invest abroad rather than at home is determined by an assessment of prospects on the home and foreign markets, by the company's need to maintain or increase market shares in its various markets and by its general growth performance. In service industries such as banking and insurance, there is the additional consideration of the need to service foreign affiliates of home country firms. In primary industries, the desire to secure guaranteed supplies of energy and raw materials will be an important motive. The bulk of available evidence suggests that investment incentives offered by prospective host countries will have little or no influence on major strategic decisions of this kind.

Similarly, investment incentives are unlikely to be a determining factor in the choice of the investment vehicle – whether a locally owned subsidiary, a joint venture or a leasing agreement. More important considerations will be the risks involved and the desire to comply with the host country's general policy stance on direct investment. At the same time, onerous preconditions and performance requirements, even when accompanied by generous incentives, may be counter-productive and increase the foreign investor's perception of risk and uncertainty, though extreme situations of this kind are rare in the OECD area.

Where investment incentives and disincentives are most likely to have an impact is in the foreign investor's choice of the precise location abroad of the investment. While the selection of major geographical regions such as North America, Europe or the Far East is determined by strategic considerations within the enterprise's global production and marketing objectives, the precise choice of country within a region may be determined to a significant extent by local investment incentives and related preconditions and performance requirements.

Aid in 1981

Net disbursements of Official Development Assistance (ODA) by DAC Members combined in 1981 amounted to $25.5 billion, or 0.35 per cent of their GNP (Chart A).

Aggregate volume figures are conventionally calculated by converting national data into United States dollars using current exchange rates. The dollar appreciated markedly against most Members' currencies in 1981, on average by 13 per cent. The statistical effects of this explain most of the apparent decline in ODA between 1980 (when it was $27.3 billion in current prices and exchange rates) and 1981. At constant exchange rates, DAC ODA rose by 6 per cent, slightly below the rate of inflation[1].

Adjusting both for exchange rate effects and price fluctuations, there was a decline of about 4 per cent in aggregate DAC ODA volume. Since aggregate DAC GNP increased by 1 per cent, the ODA/GNP ratio fell slightly from 0.38 per cent in 1980 to 0.35 per cent in 1981.

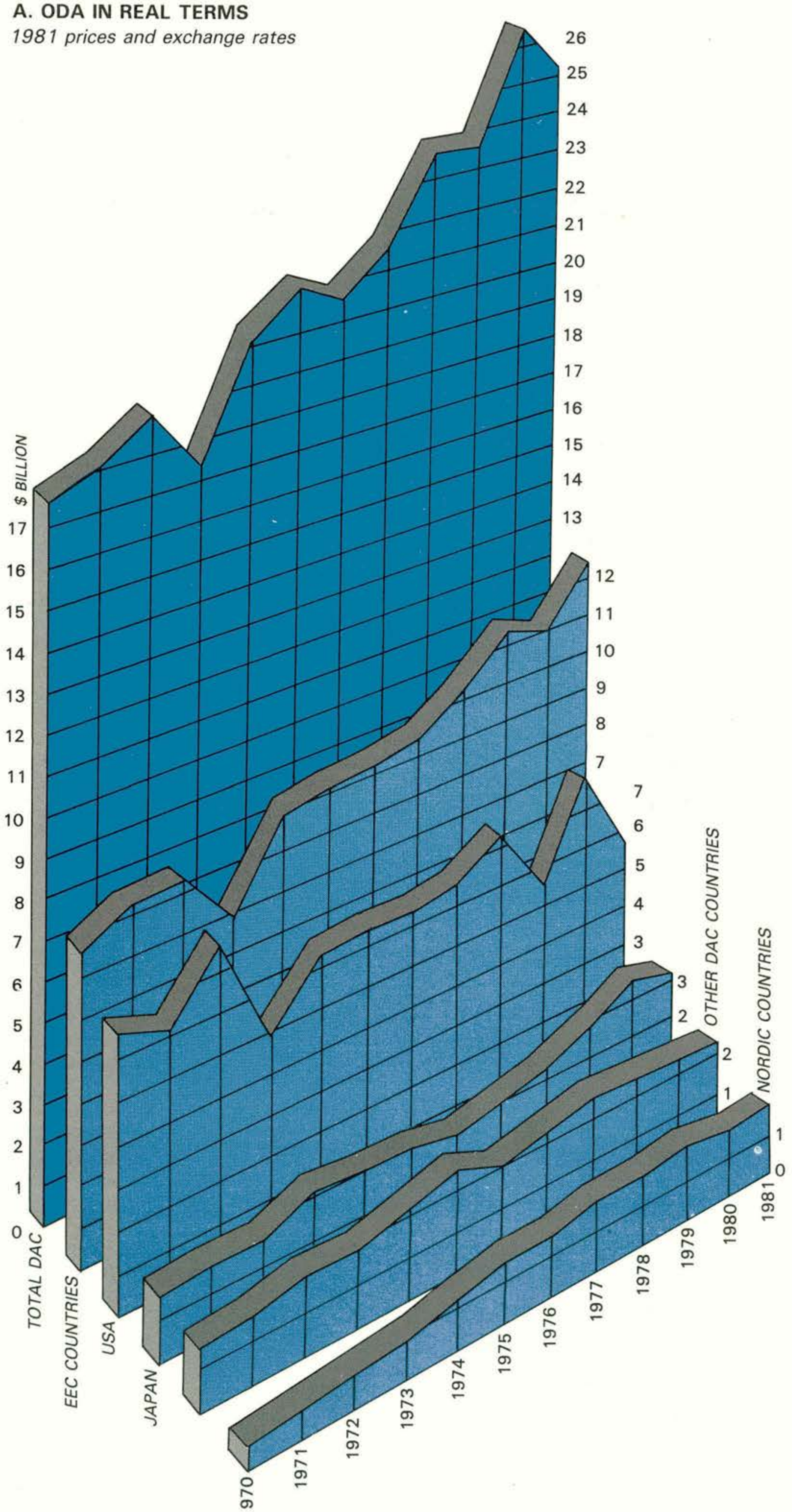
Year-to-year movements are heavily affected by the timing of multilateral contributions. These declined in 1981 by the equivalent of 0.03 per cent of GNP, accounting for the total fall in the aggregate DAC total. This drop in multilateral ODA essentially stems from the timing of letters of credit to IDA and to regional development banks, which in recent years has led to a bunching of contributions.

During the five-year period 1975-80 aid volume rose at an average growth rate in real terms of 4 per cent. The information available on current trends and prospects of a number of DAC countries indicates that further increases may be expected in the next few years in the volume of aggregate

1. As measured by the GNP deflator for DAC Members combined, which when calculated as a weighted average of GNP deflators in national currencies, was 9 per cent higher than in 1980.

A. ODA IN REAL TERMS

1981 prices and exchange rates



DAC aid. But prospects for a number of countries are uncertain and it seems unlikely, on present indications, that the overall rates of growth achieved in recent years can be sustained.

Declines in the ODA/GNP ratio in 1981 were recorded by the United States, Australia and Japan (in all cases resulting from lower issuances of multilateral letters of credit), New Zealand and Norway. All other DAC countries maintained or increased their ODA/GNP ratios, which for these countries together rose from 0.47 to 0.51; aid flows from these countries increased by 10 per cent in real terms.

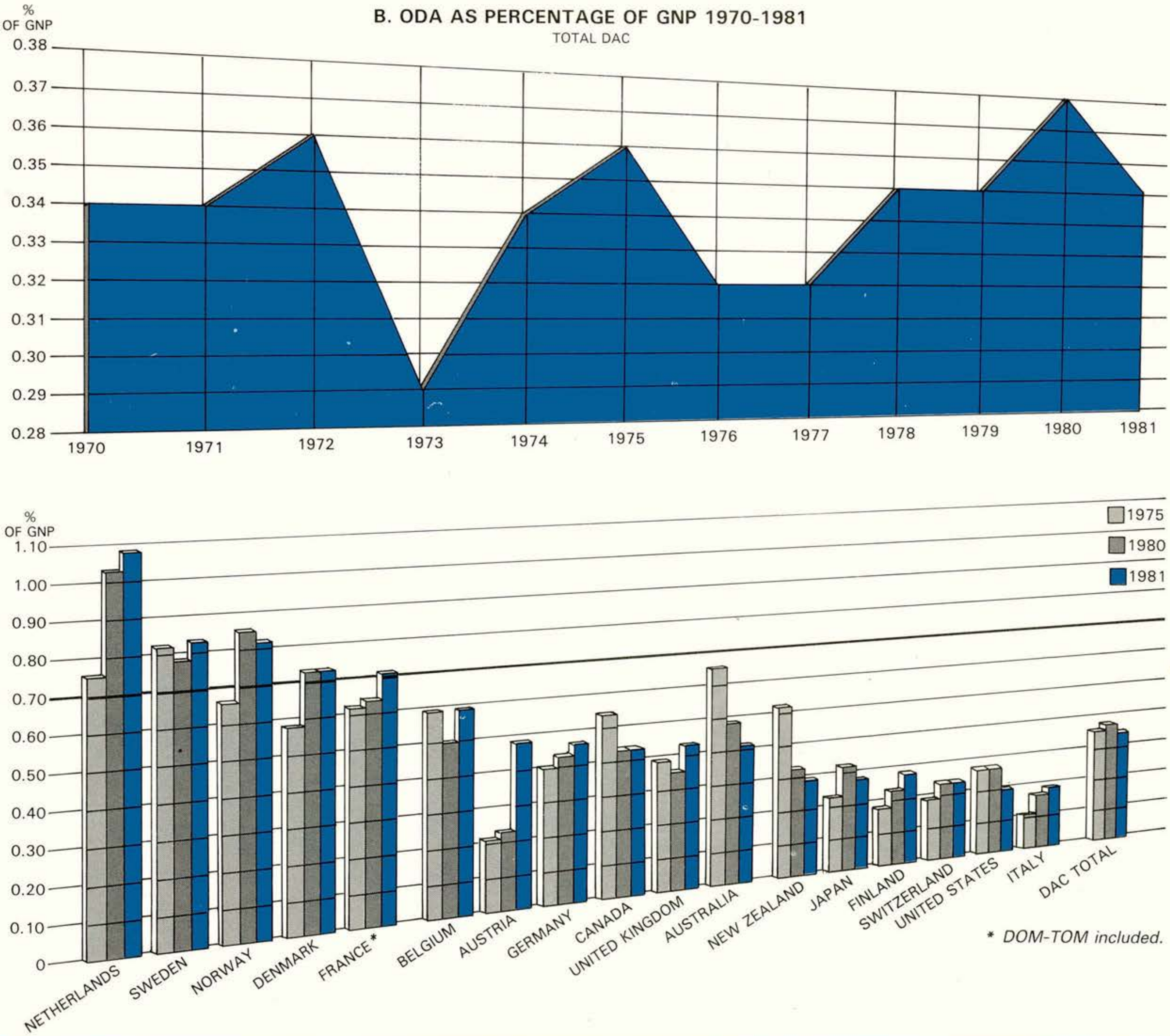
An impressive performance was achieved by the Netherlands. Substantial increases were also achieved by Sweden, France, Belgium, Germany, the United Kingdom and Finland. Austria more than doubled its ODA/GNP ratio.

The figures quoted above include ODA flows to the French overseas departments and territories (DOM/TOM). In 1981 the French government took the decision to reach the 0.7 per cent of GNP target for ODA excluding aid to these recipients. If DAC total ODA were recalculated excluding the DOM/TOM, the ODA/GNP ratio would be reduced to 0.33 per cent, and the comparable 1980 ratio to 0.35 per cent.

Individual Countries' ODA Performance[2]

In spite of serious economic difficulties, the *Netherlands* in 1981 for the seventh consecutive year surpassed the 0.7 per cent of GNP target for ODA, reaching a new record of 1.08 per cent after 1.03 per cent in 1980 (Chart B), the highest ratio recorded by any DAC country since the early 1960s. As the Dutch guilder depreciated vis-à-vis the US dollar by 26 per cent in 1981, an increase of 16 per cent in ODA in national currency is shown as a decline in current dollars, representing, however, a growth in real terms of 10 per cent. In view of the continued high level of budgetary resources devoted to development cooperation (about 1.2 per cent of GNP with approximately 1 per cent consisting of ODA), the Netherlands net dis-

2. *Individual countries are listed in the order of their ranking in 1981 in terms of ODA as a share of GNP.*



bursements may be expected to remain in the vicinity of 1 per cent of GNP.

After a setback in 1980 to 0.79 per cent, *Sweden's* ODA/GNP ratio recovered in 1981 to 0.83 per cent. This mainly reflects the fact that recorded contributions to IDA (nil in 1980) were resumed in 1981. Aid appropriations have been maintained at a level close to 1 per cent of GNP, and the ODA/GNP ratio can be expected to remain in the neighbourhood of 0.9 per cent during the years ahead.

Norway's aid appropriations have been planned to reach a level equivalent to 1 per cent of GNP. However, in 1980 as in 1981, GNP at current prices rose faster than was anticipated when the budget was prepared, and appropriations fell short of the planned ratio. As a consequence, Norway's ODA/GNP ratio in 1981 declined from its very high level of 0.85 to 0.82 per cent with an increase in ODA in national currency of 12 per cent. In spite of budgetary constraints, Norway intends to maintain a level of aid appropriations corresponding to at least 1 per cent of GNP.

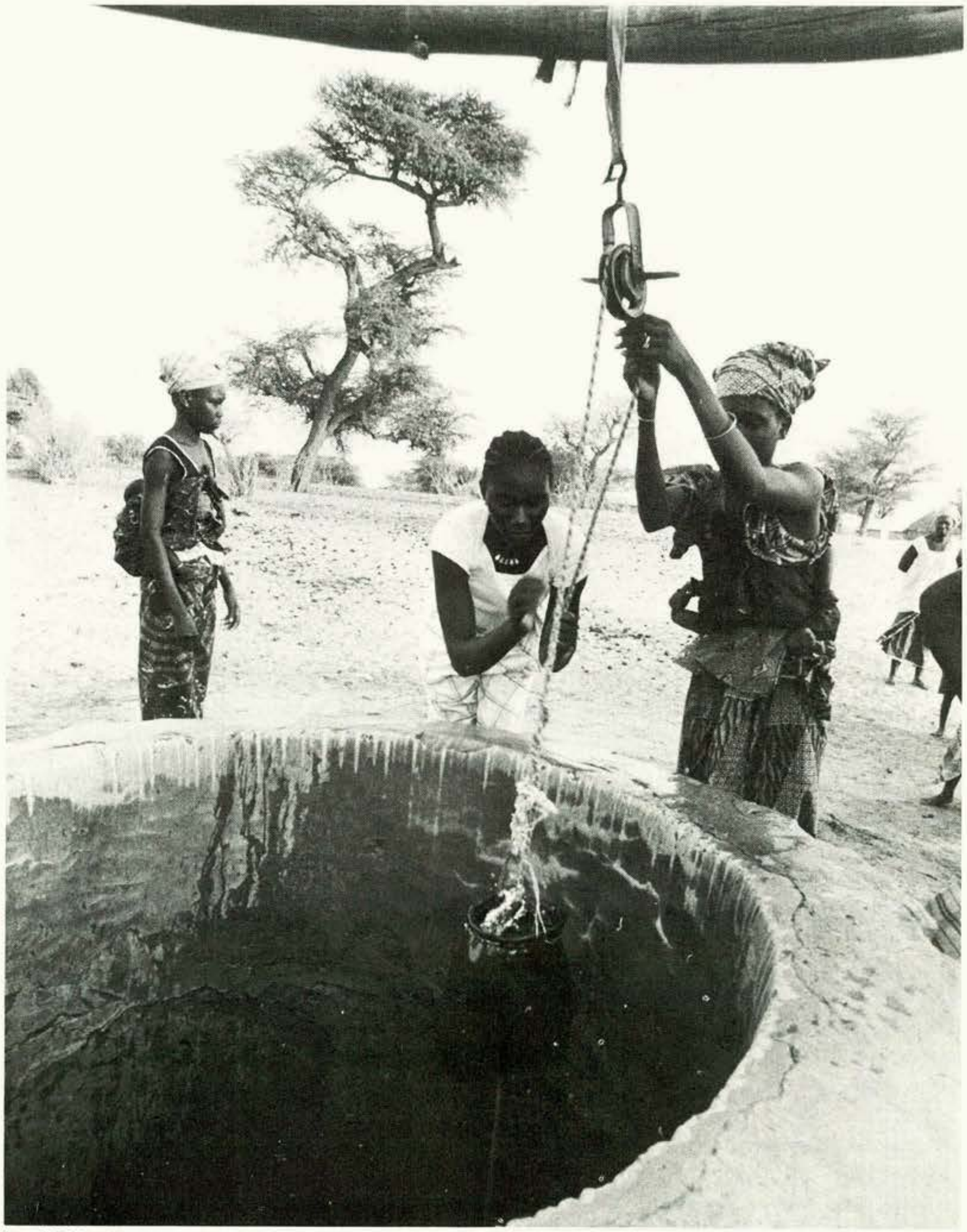
Denmark complied with the 0.7 per cent of GNP target for the fourth successive year with an ODA/GNP ratio of 0.73 per cent, as in 1980. In spite of economic difficulties, the Danish government is aiming to remain at this level in 1982. A further increase in 1983 and subsequent years is envisaged with a view to eventually reaching an ODA/GNP ratio of 1 per cent.

Total ODA from *France,* including contributions to the DOM/TOM, increased by 24 per cent in national currency and by 11 per cent in volume. As a percentge of GNP it rose from 0.64 per cent to 0.71 per cent, the highest ratio since 1967. As mentioned above, the French government in 1981 announced its intention to raise ODA to independent developing countries (i.e. excluding the French DOM/TOM) to 0.7 per cent of GNP by 1988. This represents a commitment to more than double ODA in real terms to independent countries within seven years. In 1981, France's aid to independent developing countries rose by 43 per cent in national currency and by 28 per cent in real terms. As a percentage of GNP, ODA to independent countries increased from 0.38 to 0.46.

Belgium's ODA outflows recovered sharply from 0.5 per cent of GNP in 1980 to 0.59 per cent in 1981. This represents an increase in real terms of 16 per cent, and was mainly due to a doubling (in national currency) of multilateral aid. Although Belgium remains committed to the 0.7 per cent target, short-term prospects are uncertain because of budgetary constraints.

Austria reported an increase in its aid

New record level for Netherland's ODA: 1.08 per cent of GNP. Above: Dutch project to control weed pollution in irrigation canals, Ismailia region, Egypt.



In 1981, the French government made the decision to reach the 0.7 per cent of GNP target, excluding aid to its overseas departments and territories (DOM/TOM). This represents a commitment to more than double ODA in real terms to independent countries within seven years.

Germany's ODA reached 0.46 per cent of GNP – the highest ratio so far. Above: a phosphate mill in Upper Volta which uses local rock and enables the country to limit its imports of fertilizers.

flows of 120 per cent in national currency. Its ODA/GNP ratio increased from 0.23 per cent in 1980 to 0.48 in 1981, reflecting primarily an increase (in national currency) of loans by 150 per cent. Multilateral contributions increased also, with the resumption of issuance of notes to IDA. As regards ODA prospects, Austria has indicated its intention to reach the 0.7 per cent target by the end of the decade, but given present budgetary constraints the short-term outlook remains uncertain.

Germany's ODA outflows in 1981 amounted to 0.46 per cent of GNP, the highest ratio so far achieved (0.43 per cent in 1980). This is in particular the result of an expansion of Germany's bilateral loans which increased by over 20 per cent in national currency. However, ODA prospects are uncertain in light of the budgetary situation. The budget of the Ministry of Economic Co-operation was increased for 1982 by 4.7 per cent.

Canada's aid disbursements in 1981 rose by 13 per cent in national currency, but given the relatively high rate of inflation, there was only a small increase in real terms and as a per cent of GNP, ODA remained at 0.43 per cent as in 1980. Prospects are, however, encouraging and the downward trend in the ODA/GNP ratio observed since 1976 may have been arrested. The Canadian government has accepted a target for aid appropriations of 0.5 per cent of GNP by 1985. Budgetary aid appropriations were increased in fiscal year 1982/83 by 17.6 per cent.

Australia's aid appropriations in the 1981/1982 fiscal year (July-June) increased by 19 per cent. For calendar year 1981, however, reported ODA declined both in nominal and real terms. The drop was predominantly caused by deferral of a major multilateral contribution to the second half of fiscal year 1981/1982. The contribution to IDA fell from $80 million in 1980 to practically nil in 1981: as a share of GNP, ODA fell from 0.48 per cent to 0.41 per cent. A strong recovery may be expected for calendar year 1982[3].

The *United Kingdom's* ODA outflows increased by over 35 per cent in national currency in 1981, reaching an ODA/GNP ratio of 0.43 per cent after 0.35 per cent in 1980. This was due mainly to a resumption of the issue of promissory notes in favour of IDA. However, aid appropriations are planned to increase only moderately in nominal terms until 1984/85.

Japan's ODA declined by 9.4 per cent in national currency (and by 11 per cent in real terms) to $3170 million in 1981. As a percentage of GNP it is provisionally estimated to have fallen from 0.32 in 1980 to 0.28 in 1981[4]. The decline in ODA is entirely attributable to a fall in multilateral contributions which is mainly due to smaller payments to the IDA in 1981 than in the previous year. These contributions were made in 1982 and will be recorded in the data next year. Bilateral ODA continued to increase, as grant contributions rose by 21 per cent, and substantial growth took place also in development and food aid lending. As for future trends, it is expected that the volume of Japan's ODA will show a steady growth since the government of Japan adopted the New Medium Term Target in January, 1981.

The long-term decline observed since 1976 in *New Zealand's* aid performance continued in 1981. Although there was a small increase in national currency, ODA as a percentge of GNP fell from 0.33 to 0.29. The near-term outlook is uncertain.

Finland's aid disbursements in 1981 increased by a substantial 42 per cent in national currency and by 26 per cent in real terms. The ODA/GNP ratio rose to a record level of 0.28 per cent after 0.23 per cent in 1980. The Finnish government intends to reach 0.32 per cent in 1982 and the 0.7 per cent of GNP target by the end of the decade.

The moderate but uninterrupted upward trend of *Switzerland's* ODA observed in recent years came to a halt in 1981. Disbursements increased in national currency (although they declined in US dollars), and rose very slightly in real terms, remaining at 0.24 per cent of GNP. The current policy of budgetary restrictions has affected the aid programme more severely than the Federal budget as a whole and as a result the growth of ODA during the next

3. On a financial year basis Australia's ODA/GNP ratio is expected to rise from 0.48 in 1980/81 to 0.50 per cent or 0.51 per cent in 1981/82.

4. In particular, only partial data are available on the administrative costs of Japan's ODA programme.

two years is expected to be slower than originally planned.

ODA from the *United States* fell by 26 per cent in real terms in 1981 and the ODA/GNP ratio from 0.27 per cent to 0.2 per cent. This decrease was almost entirely due to a halving of multilateral outflows. Contributions to IDA declined by $500 million and those to regional development banks by almost $700 million, reflecting both the bunching of deposits of notes to multilateral organisations in 1980 and the decision of the United States to stretch out contributions to multilateral development banks over a longer period of time, as well as the delays in enacting legislation concerning these contributions. Bilateral ODA disbursements remained stable in nominal terms (declining by 9 per cent in real terms). Although commitments in 1981, at $7.2 billion, were over 10 per cent above 1980, prospects for the longer term future are uncertain.

Italy's ODA outflows increased significantly. In national currency they rose by 30 per cent, representing a rise of 12 per cent in real terms. As a share of GNP they rose from 0.17 per cent in 1980 to 0.19 per cent in 1981. This increase was mainly due to the bilateral grant programme, which more than doubled in national currency. Italy's intention is to raise the ratio of ODA to GNP by 1983 from 0.19 per cent to the current average for DAC countries combined i.e., some 0.35 per cent.

ODA by Geographical Destination[5] ...

The share of DAC ODA channelled to the least-developed countries (LLDCs) rose during the 1970s, and in 1980, it was 22 per cent[6] (Chart C). In comparison, the share of the LLDCs in the total population of developing countries is 12 per cent.

The non-LLDC low income developing countries accounted for one third of the DAC ODA. These countries' share in the total population of developing countries is over 50 per cent. The group includes India which, on its own, accounts for 30 per cent of total developing countries' population, and some 9 per cent of total ODA.

Middle income countries received 43 per cent of total DAC ODA and the newly industrialising countries less than 2 per cent.

... and by Major Purpose

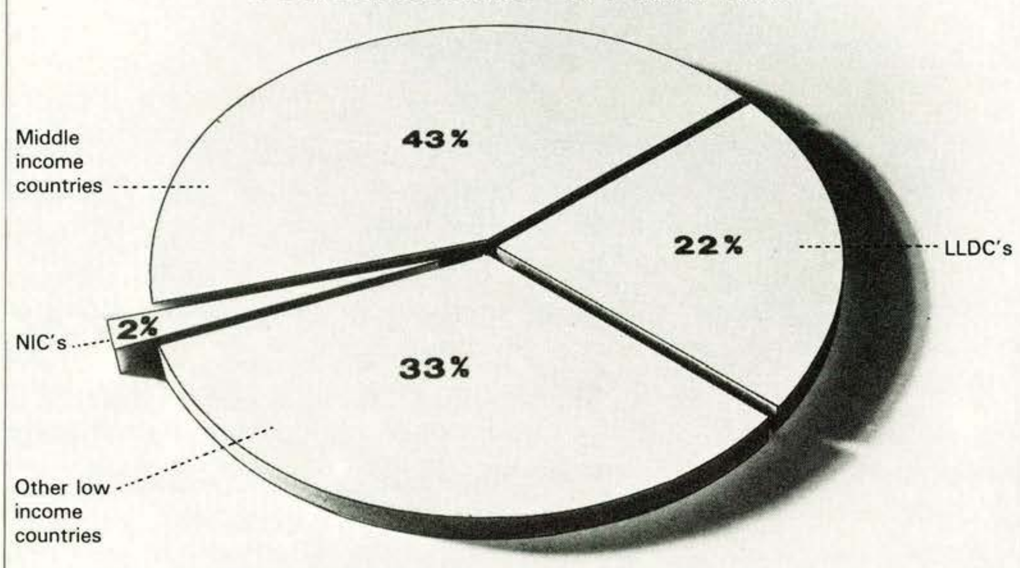
The data used in Chart D relate to commitments for 1980; 1981 figures are not available yet. However, the broad pattern does not change greatly from year to year. Well over two thirds (72 per cent) of bilateral ODA in 1980 was directed to the development of specific sectors in developing countries. The remainder was for general development purposes, consisting in particular of food aid (7 per cent), finance for imports (9 per cent), postponement or cancellation of debt service obligations (5 per cent), and emergency assistance.

As regards sector-oriented aid, 31 per cent of ODA was used for social and community services, consisting mainly of health (5 per cent) and education (14 per cent). A substantial share of the resources devoted to this purpose was provided in the form of technical co-operation. A further 16 per cent went to agriculture (including agricultural based industries) in 1980. Donors have been placing special emphasis on improvement of water resources and the provision of production inputs. Other main sectors receiving support from aid donors include energy (8 per cent), industry and commerce (7 per cent) and transport and communications in developing countries (5 per cent).

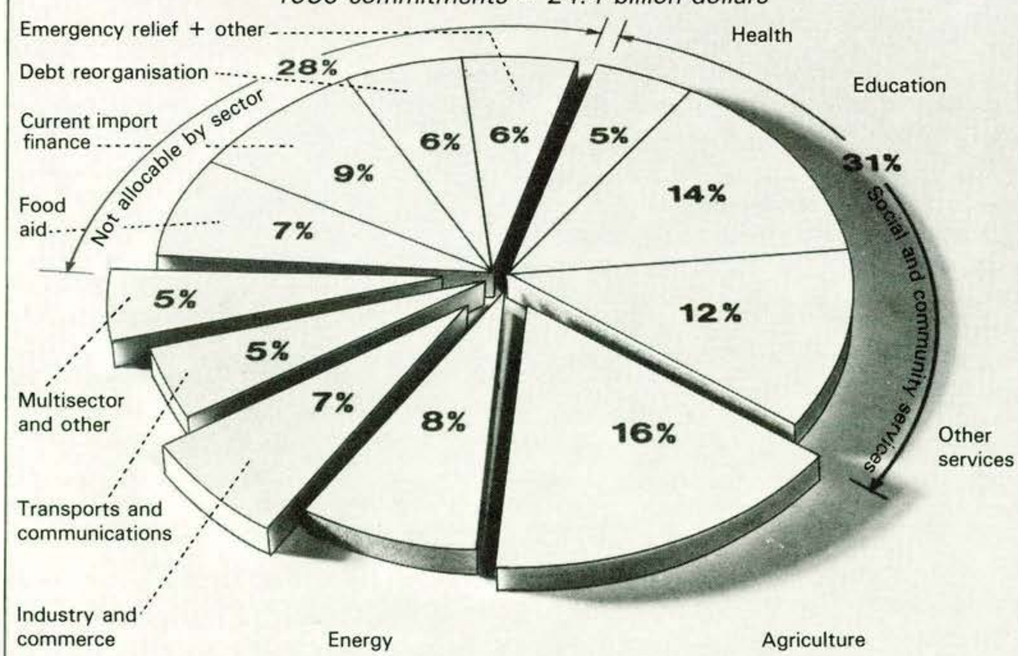
Total Resource Flows from DAC Countries

Preliminary estimates based in some cases on partial data indicate that the total net flow of all categories of financial resources *from DAC countries* (ODA, official and private non-concessional flows, and private sector grants) amounted to

C. ODA BY DESTINATION
1980 net disbursements = 27.2 billion dollars



D. BILATERAL ODA BY PURPOSE
1980 commitments = 24.4 billion dollars



5. *Full data on the geographical distribution of ODA in 1981 will become available only later in the year.*

6. *Including amounts channelled to LLDCs through multilateral development institutions.*

TOTAL DISBURSED DEBT (DD) AND ANNUAL DEBT SERVICE (DS) OF DEVELOPING COUNTRIES, 1971-1981 (Year end)
by source of lending – $ billion

	1971		*1975*		*1978*		*1979*		*1980 (prelim.)*		*1981 (estim.)*	
	DD	*DS*	*DD*	*DS*	*DD*	*DS*	*DD*	*DS*	*DD*	*DS*	*DD*	*DS*
1. DAC countries and capital markets, *of which:*	68	9.2	138	22.5	261	49.7	309	64.6	356	78.9	399	95.6
• *ODA*	*24*	*1.4*	*34*	*1.8*	*49*	*2.3*	*53*	*2.6*	*56*	*2.9*	*56*	*3.0*
• *Total export credits*	*28*	*5.1*	*45*	*11.0*	*85*	*21.0*	*101*	*25.5*	*120*	*30.5*	*131*	*36.6*
• *Capital markets*[1]	*17*	*2.7*	*58*	*9.6*	*128*	*26.4*	*155*	*36.5*	*180*	*45.5*	*212*	*56.0*
2. International organisations	10	0.9	22	1.7	40	3.2	47	3.8	56	4.6	65	5.8
3. CMEA countries (excl. China)	6	0.6	9	0.8	12	1.4	14	1.7	16	2.1	19	2.5
4. OPEC	–	0.1	6	0.2	13	1.0	15	1.3	18	1.8	23	2.2
5. Other LDCs (incl. China)	2	0.1	4	0.4	7	0.7	8	0.9	9	1.1	11	1.2
6. Unspecified and adjustments	1	0.2	2	0.6	4	0.8	4	1.3	4	1.3	8	1.4
TOTAL	**87**	**11.0**	**180**	**26.2**	**338**	**56.7**	**396**	**73.6**	**459**	**89.8**	**525**	**108.7**
of which:												
• *debt of non-OPEC LDCs*	*73*	*8.8*	*149*	*21.0*	*272*	*44.0*	*323*	*55.9*	*381*	*67.6*	*437*	*82.5*
Annual nominal increase (%)	16	16	24	19	28	37	17	30	16	22	14	21
of which: *($ billion)*												
• *interest*		*3.3*		*9.5*		*19.8*		*26.0*		*34.9*		*45.5*
• *amortisation*		*7.7*		*16.7*		*36.9*		*47.6*		*54.9*		*63.2*

1. Bank loans (other than export credits), bonds and other private lending.

some $81 billion in 1981 compared with $76.1 billion in 1980, increasing in real terms by 11 per cent and as a share of DAC Members' GNP from 1.05 per cent to 1.13 per cent.

As regards the components of DAC resource flows for which information is available at this stage, in 1981 ODA was 31 per cent of the total identified flow of $81 billion. This compares with 36 per cent in 1980, 37 per cent in 1979 and 44 per cent in 1970. As ODA has risen quite regularly in real terms from year to year, this movement in its share mainly reflects changes in the flow of resources at market terms in response to changes in the extent and structure of developing countries' overall needs for external resources.

The figures for DAC Members' non-concessional flows are provisional, and may undergo considerable revision. The main movements that can be identified presently are a recovery of *direct investment* from $9.5 billion to $11.3 billion (up by 22 per cent in real terms) due to the recovery in US direct investment by $2 billion. *Bilateral portfolio* lending, consisting mainly of bank lending, reached a new peak at $26.2 billion in 1981 after $17.7 billion in 1980. This likewise was mainly the effect of a sharp rise in US portfolio lending, of over $9 billion. *Multilateral portfolio lending* which has been a very erratic component over the years increased by $1 billion, while *export credits* declined by $3.5 billion to $9.1 billion, reflecting increased amortisation payments.

External Debt of Developing Countries[7]

The total external debt (disbursed) of all developing countries from all sources increased from $180 billion at the end of 1975 to $525 billion at the end of 1981 (from $149 billion to $437 billion for non-OPEC developing countries) (see table). The build-up of nominal debt decelerated somewhat in 1979-1981, largely because the reserve build-up by non-OPEC developing countries virtually ceased in 1980-1981.

Over the decade, the share of debt owed to DAC countries, including international capital markets, has remained at some 75 to 80 per cent, but within this share, private sector claims, all at market terms, rose from one quarter to over one half.

Rather than external debt, what matters most to debtors and creditors alike is the manageability of the debt service. Debt service payments increased sharply in nominal terms after 1975 (more rapidly than debt itself): from $26 billion to $109 billion in 1981 (see table). Following very sharp increases in 1978/1979, the growth rate of debt service payments recorded some decline in 1980/1981. Throughout the 1970s, the bulk of service payments was concentrated on export credit and capital market debt. Together they now represent some 84 per cent of total service payments.

In relation to their total exports of goods and services, the burden of debt service payments of developing countries remained fairly stable during 1978-1980 but, despite a slowdown in the growth rates of nominal service payments, rose significantly in 1981-1982. This overall pattern masks highly differentiated country situations. Countries most affected by an increased debt service burden are, firstly, several newly industrialising countries whose exports suffer from world economic conditions and whose debt is largely on floating interest rates; secondly, lower income countries depending heavily on commodity exports whose price level decreased in 1981-1982; thirdly, several oil exporting countries, in view of decreasing oil export earnings.

In 1981, the two largest debtors, Brazil and Mexico, accounted for 25 per cent of total Third World debt service. The ten largest debtor countries included four OPEC countries (Algeria, Saudi Arabia, Iran and Venezuela) and accounted for some 60 per cent of the total debt service of developing countries. Low-income developing countries accounted for 17 per cent of total LDC debt but for only 7 per cent of total debt service (the ratios for least developed countries are 3 per cent and 1 per cent). The difference in the shares of debt and debt service reflects the soft terms of the loans which the low income and the least developed countries received – in addition to massive grant transfers.

7. A detailed account and analysis will be presented in the OECD study External Debt of Developing Countries, *to be published later in the year.*

The Growing Importance of Co-financing in Funding Development Projects

The co-financing of projects, involving bilateral aid agencies from DAC and OPEC countries and the multilateral development financing institutions, has become an important new form of development cooperation, contributing to an increased and improved flow of funds to Third World countries. By the end of 1981, 349 co-financing projects involving external finance of $22.5 billion had been agreed to or were in an advanced stage of negotiation.

Co-financing is a tool that needs to be used with care, however. While its advantages clearly seem to outnumber its disadvantages, it is nevertheless evident that problems do exist and thus that ways of improving things may be found. That is one of the reasons why the international aid agencies of DAC and OPEC have been meeting regularly for some time.

The following article discusses this form of development aid and presents the figures prepared for the last meeting that has just been held at the OECD.

What is Co-Financing?

Co-financing, in the sense used in this article, is defined as any arrangement whereby funds from a DAC Member country's official aid agency and/or an international financial institution are associated with funds from an OPEC bilateral or multilateral aid agency for the financing of a particular project or programme. In some cases official export credit transactions and equity participation by official investment companies have also been included.[1] Co-financing can take two forms.

Parallel or joint financing

"Joint financing" refers to a co-financing arrangement for which there is a common list of goods and services and where the financing of all or certain items is shared by the co-lenders; "parallel financing" implies that each participant finances a distinct part of the project and decides independently on the procurement of goods and services.

In general, developing countries have a preference for joint financing under a single lead agency, mainly because administrative problems tend to arise in the case of parallel arrangements (although these may often be offset by the longer time taken to put together a joint financing package). In addition, joint financing usually enables the projects to be implemented more rapidly and to benefit from economies of scale.

By contrast, donor countries seem to prefer parallel financing schemes. They appear reluctant to commit a part of the funds required for a project without the assurance that the entire package will be completed. Furthermore, parallel co-financing requires no departure from their own administrative procedures, criteria and preferences; they are able to tie the aid and to impose restrictions on procurement. Parallel financing has the additional advantage for donors of being identified with particular parts of a project.

Joint financing requires untied funds, at least among the participating countries, and a similar, if not identical, approach to project assistance. That is why Arab aid agencies are able to co-finance jointly among themselves but do so mainly on a parallel basis when DAC donors are involved. Arab aid agencies have developed common appraisal and loan withdrawal procedures and their directors of operations meet twice a year to discuss, among other things, joint financing. For each jointly financed project, Arab aid agencies choose a lead agency among themselves which negotiates with the recipient country on behalf of all participants.

Due to the very different backgrounds of their aid programmes, DAC members as a group have never developed such a close relationship, apart from Denmark, Finland, Norway and Sweden, who have carried out joint projects within the Nordic Group. The importance of joint Nordic projects diminished as these countries acquired greater experience in their bilateral activities.

An Assessment

The accumulated experience of the past few years makes it possible to enumerate both the potential advantages and some of the practical disadvantages of co-financing operations.

Advantages

Many of the principal virtues of co-financing are obvious. For one thing, it is one of the possible ways of getting certain types of large-scale projects off the ground – those requiring financial or technical inputs that are either beyond the possibilities of a single donor or represent too high a risk through excessive concentration on a single project. Co-financing is often the only practical method for a small sponsoring agency – or an agency in temporary financial difficulty – to mobilise financial and specialised technical services for a large or complex project. Co-financing also mobilises resources from donors who are not familiar with a given recipient or region. In particular, it permits the more recently established aid agencies to broaden the geographic coverage of their commitments faster than would otherwise have been the case. In particular, DAC donors can benefit from the knowledge that Arab aid agencies have of Arab recipient countries.

Furthermore, co-financing can attract

1. This article does not deal with private sector participation.

1. CO-FINANCING: AMOUNTS COMMITTED 1973/4-1981

		International financial institutions	*Arab/OPEC aid agencies*	*Official DAC donors*	*Private DAC sources*	*Other*	*Total*	*Number of projects*
1973/4	A	663	320	261	0	50	**1,304**	
	B	—	—	—	—	—	—	23
	C	*51*	*25*	*20*	*0*	*4*	***100***	
1975	A	994	870	651	49	65	**2,629**	
	B	*150*	*272*	*249*	—	*130*	***202***	41
	C	*38*	*33*	*25*	*2*	*2*	***100***	
1976	A	828	810	399	19	0	**2,056**	
	B	*83*	*93*	*61*	*39*	*0*	***78***	37
	C	*40*	*39*	*20*	*1*	*0*	***100***	
1977	A	1,283	1,158	503	65	0	**3,009**	
	B	*155*	*143*	*126*	*242*	—	***146***	44
	C	*43*	*38*	*17*	*2*	*0*	***100***	
1978	A	1,263	974	469	88	66	**2,860**	
	B	*98*	*84*	*93*	*135*	—	***95***	57
	C	*44*	*34*	*17*	*3*	*2*	***100***	
1979	A	2,014	1,517	567	182	106	**4,386**	
	B	*159*	*156*	*120*	*207*	*161*	***153***	67
	C	*46*	*35*	*13*	*4*	*2*	***100***	
1980	A	1,656	778	489	7	17	**2,947**	
	B	*82*	*51*	*86*	*4*	*16*	***67***	47
	C	*56*	*26*	*17*	—	*1*	***100***	
1981	A	1,246	1,366	736	5	0	**3,354**	
	B	*75*	*176*	*151*	*61*	*0*	***114***	33
	C	*37*	*41*	*22*	—	*0*	***100***	
Total	**A**	**9,947**	**7,803**	**4,076**	**415**	**304**	**22,545**	
	B	—	—	—	—	—	—	**349**
	C	***44***	***35***	***18***	***2***	***1***	***100***	

A. Commitments in $ million.
B. Per cent of previous year's commitments.
C. Per cent of total annual commitments.

Co-financing arrangements continued to attract considerable amounts of finance from official aid agencies in 1980 and 1981 (about $3 billion a year) but remained below the peak attained in 1979 when several major agreements were concluded.

Participation in co-financed projects has remained largely unchanged over the last two years: international financial institutions, usually the lead agencies in co-financing arrangements, accounted for over two fifths of the funds involved, followed by Arab/OPEC countries and institutions with about one third and DAC Member countries with nearly one fifth. International financial institutions continued to play a major role in organising co-financing arrangements, participating in some 90 per cent of all such projects. As previously, the bulk of funds for co-financing was provided by half a dozen international financial institutions and donor countries: the World Bank, Saudi Arabia, Kuwait, Germany, the Asian Development Bank and the EEC. Together these provided about 60 per cent (or $13.4 billion) of total co-financing flows.

funds relatively rapidly to sectors where additional resources are required; it could, for example, play a useful role in developing the energy, mineral and food sectors of developing countries. Finally, it enables donor agencies to better coordinate their activities in a particular sector or country.

To this extent, co-financing schemes can bring a "qualitative additionality" although they may not result in a quantitative increase in the total amount of development aid. Co-financing also may improve the developmental quality of a project by achieving greater versatility of ideas and inputs. In some cases, co-financing involving a major multilateral agency may make it easier to make allowances for political problems which might otherwise jeopardise the success of the project.

Potential disadvantages

While co-financing undoubtedly has a number of potential advantages, it has become increasingly apparent that there are also some practical disadvantages. Co-financing is a method of development finance and not an end in itself. There is the danger of encouraging or participating in excessively ambitious projects merely because large-scale funds are available through co-financing arrangements. It imposes significant administrative burdens on the recipient country, so much so that in some instances it is preferable to avoid cumbersome co-financing arrangements entirely, through greater division of labour between individual aid agencies and, instead, encourage them to coordinate their activities more closely in the country concerned. Co-financing tends to be administratively difficult compared with single-donor projects. The appraisal and implementation of projects frequently suffer delays due to differences among donors with regard to project appraisal criteria, procurement policies and ratification procedures.

*
* *

Because they are keen to facilitate this method of financing development projects – since it has undoubted advantages, especially at a time when foreign aid is limited – the interested parties are anxious

Infrastructure attracts some 60 per cent of total funds committed. Above: the Aquaba railway project in Jordan, co-financed by Germany and Saudi Arabia.

Left: Multan Fertilizer Project in Pakistan, co-financed by the World Bank, the OPEC Fund, Abu Dhabi Fund and the City Bank.

to make a better attempt at identifying and eliminating any sources of friction that might inhibit co-financing schemes. When a donor is approached at short notice to "fill a gap" in funds needed to complete a project, he must be allowed to become involved straight away in the conception and execution of it; if not, he may be unwilling to participate in future arrangements. Restrictions on procurement that are imposed by many donors can often be an obstacle to securing agreements on the conception and execution of a project. The best way of overcoming this problem seems to be to introduce waiver clauses into agreements on individual projects. It is generally considered a good idea to exchange lists of prospective projects suitable for co-financing at an early stage so that individual conceptions and preferred criteria can be harmonised from the outset, but talks with a view to eliminating the obstacles to increasing the number of co-financed projects should be held on each particular project between the agencies involved.

2. GEOGRAPHIC DISTRIBUTION OF CO-FINANCED PROJECTS

	Number of projects		*Amounts committed ($ million)*		*Number of projects ($ million)*		*Amounts committed*	
					as % of total			
	End of 1979	*End of 1981*	*End of 1979*	*End of 1981*	*1979*	*1981*	*1979*	*1981*
Europe	3	5	1,004	1,439	1	2	6	6
Africa	140	188	8,091	11,083	52	54	52	49
of which:								
North Africa	*30*	*32*	*2,999*	*3,245*	*11*	*9*	*19*	*14*
Africa South of Sahara	*110*	*156*	*5,092*	*7,838*	*41*	*45*	*31*	*35*
Latin America	44	46	2,012	2,298	16	13	12	11
Asia	76	102	5,123	7,693	29	29	32	34
of which:								
Middle East	*30*	*41*	*1,677*	*2,125*	*11*	*12*	*10*	*9*
South and Far East	*46*	*61*	*3,446*	*5,568*	*18*	*17*	*22*	*25*
Oceania	6	8	14	32	2	2	–	–
Total	**269**	**349**	**16,244**	**22,545**	**100**	**100**	**100**	**100**

Geographic distribution has remained stable in recent years. About one half of the projects undertaken and the funds committed were devoted to Africa, one third to Asia, and around one eighth to Latin America, while the rest was spread over Europe and Oceania. Although Arab countries remained major recipients of co-financed projects, it should be noted that there was a movement in funds away from them to non-Arab countries in both Africa and Asia. This movement was particularly noticeable for Arab aid agencies; in 1979, over 53 per cent of their co-financing funds had gone to Arab states, compared to only 28 per cent in 1980 and 1981.

3. SECTORAL DISTRIBUTION OF CO-FINANCED PROJECTS

Sector	*Number of projects*		*Amounts involved*			
	End of 1979	*End of 1981*	*End of 1979*	*End of 1981*	*End of 1979*	*End of 1981*
			$ million		*% of total*	
Infrastructure, *of which:*	154	197	9,516	13,482	58	60
Roads	*42*	*52*	*1,210*	*1,716*	*8*	*8*
Power Generation (including dams)	*58*	*75*	*5,841*	*8,449*	*36*	*37*
Railways	*7*	*8*	*711*	*1,009*	*4*	*5*
Ports	*13*	*16*	*813*	*967*	*5*	*4*
Airports	*12*	*15*	*215*	*309*	*1*	*1*
Water supply, sewerage	*16*	*22*	*538*	*787*	*3*	*3*
Telecommunications	*5*	*6*	*124*	*132*	*1*	*1*
Other	*1*	*4*	*64*	*113*	–	*1*
Agriculture	34	41	1,085	1,425	7	6
Industries and Mining, *of which:*	43	55	3,869	4,858	24	22
Industries	*39*	*48*	*3,068*	*4,003*	*19*	*18*
Mining	*4*	*7*	*801*	*855*	*5*	*4*
Local Development Banks	9	12	214	352	1	1
Other	29	44	1,650	2,428	10	11
Total	**269**	**349**	**16,244**	**22,545**	**100**	**100**

The sectoral distribution of co-financed projects has remained stable in recent years: infrastructure projects have continued to attract 60 per cent of total funds committed, industry and mining about one quarter and agriculture about 7 per cent. Although the promotion of alternative sources of energy has been designated as a desirable sector for increased cooperation among donor groups, the only project negotiated by the end of 1981, the Biomass Power Scheme in Mali, had to be dropped subsequently, because the relevant technology was not sufficiently developed.

Interactive Videotex Systems and Consumer Information

The increasing computerisation of society becomes more and more a part of the ordinary citizen's daily life. By linking two technical devices already existing in most households, the telephone and the television set, with a central computer, interactive videotex systems offer the consumer an almost unlimited spectrum of information on simple request and at any moment.

A recent OECD study examines the potentials of these systems which are already functioning in several Member countries — in most of them still on an experimental basis. While they no doubt offer great advantages, they also present a number of potential problems of a social, economic and legal character. The study suggests a number of ways to cope with them.[1]

Interactive videotex systems have been developed in different countries under different denominations and trade names. They are based on the linking of three already existing technical devices — the computer, the telephone and the television set — by means of a decoder as an ancillary unit to the standard television set and another device adapted to the telephone network. Information providers, e.g. enterprises and public service institutions, feed the information into the computer; susbscribers to the system (commercial or private users) have access to the data by a dialling device; the desired information is then received on the television screen or on a special video terminal, generally in the form of a multi-coloured text, although some systems can also transmit pictures.

Advantages

The system can convey an almost unlimited spectrum of detailed and precise information. What distinguishes the new technologies from the classical media is that the consumer does not have to go through all the information available in order to find what he wants but can select it directly and only receives the information he requests.

The facility of updating the information is another advantage of the systems which, in this respect, far outdistance other media. Moreover, the information and other facilities are available 24 hours a day, seven days a week.

Another, probably the most important, of the positive features of such systems is the rapidity with which information can be obtained. Since the value of time invested by an information seeker in comparative shopping would have at least to break even with the possible gain he can realise in the market, information provided by the computerised interactive videotex systems represents, from the cost-benefit point of view, substantial progress — at least in theory.

The systems are conceived to provide a number of additional functions, such as enabling the information user to make reservations, transmit purchase orders and pay bills. The obvious convenience of all these facilities — immediate information without paper support, "cashless paying", "shopless shopping" — may in future have spectacular implications for retail trading.

Finally, it has to be noted that while videotex conveys up to now a relatively sober message in the form of a text on a television screen, this may change in the future. New technologies are emerging which provide sound and pictures as well as text and are more attractive both for information providers and for consumers. TELIDON, the Canadian system, for instance, which is conceived as an interactive "graphic" medium capable of conveying more than the printed message, is supposed to profoundly affect education, commerce and information in the long run.

Whether and to what extent such convenience is actually attainable, desirable and accepted by consumers is, however, a question which present short-term experience of the systems cannot evaluate. New technologies are usually accompanied by contradictory views about their desirability, usefulness and economic and socio-cultural impact. In the case of the interactive videotex systems, which could influence almost all sectors of daily life, this discussion is particularly heated. However, it is also true and admitted by consumer leaders that rarely has the birth of a new medium been so carefully handled. The problems that have already appeared are mainly of a practical and legal nature; others concerning the broader economic and social aspects are at present mainly speculative.

Cost

For both commercial and private users, the new technology is valid only if it provides services with a better price/performance relationship than traditional means of information. At the present stage, it seems extremely difficult to evaluate costs for consumers. Purchase cost of the appliances would depend on the possibilities of large scale production (TV set with incorporated videotex facilities or separate devices linking television set and telephone). Charges for using the system might also depend on the number of users.

In the countries at present involved in field trials, a large majority of households is already equipped with a television set and a telephone. However, the adapters linking the two and the keypad are still relatively expensive.[2] It is generally considered by

1. The Impact of Computer Technologies on Consumer Information — Interactive Videotex Systems, *to be published shortly.*

2. *Presently about F 5,000 in France, DM 200-500 in Germany and £ 170-200 in the United Kingdom.*

Currently, interactive videotex systems are operated, mostly on a pilot basis and under various trade names, in 15 Member countries:

Country	Name of the system	No. of terminals
Austria	*BILDSCHIRMTEXT*	*300*
Canada	*TELIDON*	*4,000*
Denmark	*TELEDATA*	*200*
Finland	*TELSET*	*260*
France	*TELETEL*	*2,500*
Germany	*BILDSCHIRMTEXT*	*5,000*
Italy	*VIDEOTEL*	*300*
Japan	*CAPTAIN*	*1,000*
Netherlands	*VIDITEL*	*2,500*
Norway	*TELEDATA*	*60*
Spain	*VIDEOTEX*	*750*
Sweden	*DATA VISION*	*30*
Switzerland	*VIDEOTEX*	*150*
United Kingdom	*PRESTEL*	*12,000*
United States	*Various systems*	. .

manufacturers that, provided the market can be adequately developed, a new generation of TV sets with incorporated decoding and dialling devices would not be much more expensive than today's television sets.

The operating cost for the user seems to be a more complex matter. In the French TELETEL system the billing is made, as for normal telephone calls, according to the duration of the communication, i.e. F 0.50 for five minutes. The French authorities are of the opinion that the system should include an appropriate amount of cost-free information. The present German pilot project, in addition to a base rate similar to that for local telephone communications, charges a maximum price per "page" of information of DM 0.99. It is believed that the majority of information providers will fix the price of the services according to market requirements. The United Kingdom distinguishes four separate costs to the user of the PRESTEL system: the cost of purchasing – £ 600 to 1,000 – or renting – some £ 250 per year – a set; the cost of using the PRESTEL computer (charges are related to the time the user is connected to the computer, based on a unit which, like normal telephone charges is aimed at smoothing out demand peaks); installation and maintenance costs; the cost of the information and services obtained through PRESTEL.

Many information providers, including government departments, public service institutions and advertisers, make no charge; routing pages are generally free of charge.

Access to the System

It has been suggested that if videotex systems follow the growth pattern of the telephone in the early decades of this century, then the present 9 : 1 ratio of business to residential usage could be changed to 1 : 5 by the 1990s. Apart from the cost/performance relationship, this development depends on whether operations for calls and routing are simple enough and page layouts easy to understand.

First evidence in Germany and the United Kingdom suggests that, once the system has been successfully established, it will first gain importance in the commercial sector and in well-to-do households. Consumer information centering for example on comparative tests concerning high value consumer durables and explanations of a legal character coupled with advertising of relatively sophisticated goods and services would cater mainly to a relatively privileged clientele. This clientele looks very much like present well informed consumers: they are middle class, have a good level of education, read consumer magazines, etc. These systems could thus accentuate the information gap between the active and the average consumers. Moreover, many consumer representatives have doubts whether the average consumer frequently needs restaurant guides, airline timetables etc. and whether he would be prepared to pay for this occasional convenience.

In order to make interactive videotex systems more accessible to the general public, consumer or citizen's advice centres in the United Kingdom and Germany have been equipped with terminals which can either be operated by the staff to provide free information to consumers requiring assistance or be operated by the consumer himself for the same purpose. This is also planned in the French pilot project.

Cool Response

In fact, first experience with the pilot projects seems to indicate that they do not necessarily meet with great enthusiasm among prospective users. In Germany, for instance, in each of the two working projects, the 3,000 household quota was subdivided into 2,000 private subscribers and 1,000 subscribers to be nominated by information providers. In February 1981, 96 connections were still available for private subscribers in Berlin and 729 in Düsseldorf. In Berlin, 284 subscribers were still to be nominated by information providers and in Düsseldorf, the figure was 270, although this situation was partly due to difficulties in providing the hardware.

First experience with the PRESTEL system confirms this lack of genuine consumer interest. The Consumers' Association, publisher of WHICH, became strongly involved in the PRESTEL system, and provided some 6,000 information frames, making it one of the largest information providers. The relatively disappointing outcome of the experience up to now is largely attributable to the small number of consumers who are subscribing to the system which in turn is probably caused by high set and usage costs.

By contrast, in Japan, a survey undertaken by a consultative body to the Ministry of Posts and Telecommunications and the Nippon Telegraph and Telephone Public Corporation showed a more positive reaction on the part of the users. They made suggestions concerning certain improvements, but were on the whole satisfied with the system and its future prospects.

Apart from problems concerning certain groups of consumers such as the elderly – children generally seem to have no major difficulties in using the system – there seem to be certain psychological barriers to be overcome by the ordinary consumer. While the rapidity of the information is one of the major characteristics of the system, it may take some time for an average user to acquire the necessary skill to enter into a dialogue with the computer and to retrieve the specific information required according to a "search tree" technique. Some consumer representatives consider the whole experience as a technical game rather than a meaningful supplement to traditional consumer information sources. This attitude probably constitutes not so much a flat refusal of the technology as a recognition of the fact that the sophisticated technologies used are not yet matched by an adequate optimisation of content and presentation of the information.

Consumer representatives and others sometimes raise a broader question of principle: who actually wants the new technologies? Obviously, projects of this order of magnitude have to rely on a massive support by the national telecommunications authorities, and a successful operation would increase their receipts. →

Strong support comes also from manufacturers of the appliances who clearly recognise the marketing potential of the innovation in a rather saturated market for TV sets. This means that two of the parties involved in the functioning of the system are highly interested in the success of the operation. The best way of achieving this aim is probably to convince consumers of the genuine advantages they can derive from the new media.

Legal Problems

It seems *a priori* that the laws and regulations existing with regard to telecommunication, freedom of the press and unfair marketing practices would, subject to some amendments, be sufficiently broad to cover interactive videotex systems.

"Labelling"

The fact that a number of particular problems might arise has, however, led countries to consider the development of specific guidelines. One of the basic problems is the "labelling" of the message. Since the medium as such is neutral in the sense that it does not differentiate, graphically or otherwise the presentation of advertisements, from goods and service providers, and of objective information, from public information institutions, one of the first consumer requests was the provision of a clear distinction between the two categories of messages.

This distinction poses certain problems: to what extent are railway schedules, airplane tariffs and timetables, for example, advertisements? Other problems arise where advertisements are made in the interest of third parties, e.g. when a local tourism board offers a list of hotel addresses. A problem directly related to the dissemination of consumer information is the treatment of the results of comparative tests and comparative price lists with full identification of brands and traders. "BILDSCHIRMTEXT" provides this type of specific information: it can give general advice for a purchase in a particular product group, quality ratings with approximate price indications, and also prices actually charged in identified shops of a given area. Similarly, British and Canadian systems provide price comparisons concerning identified brands and traders. In neither of these countries does this question raise any legal problems: the publication of price information does not conflict with laws against unfair competition if the comparisons are made with the necessary care by an independent person or institution who is not a competitor.

Operational facilities

"Cashless paying" and in particular "shopless shopping" raise a number of complex legal issues, mainly with regard to offers made by catalogue traders: the conclusion of the contract (validity of the offer, etc.); the lack of written evidence; the handling of dialling mistakes or abusive operation (by children for instance); the applicability and presentation of standard contract terms.

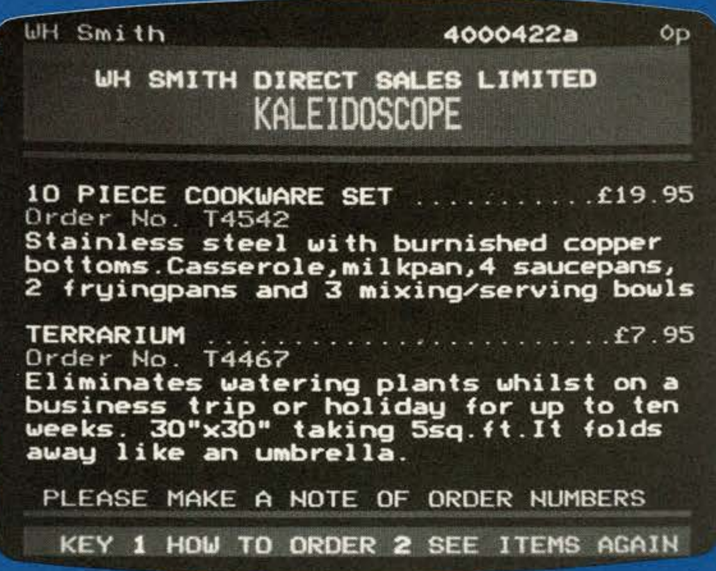
When credit facilities are used by the consumer, the applicability of "cooling-off" periods and other related regulatory provisions (e.g. indication of the cost of credit) has to be taken into account. If the consumer makes a pre-payment and then does not receive the desired merchandise, an even more serious problem of evidence may arise although already now a large number of contracts are concluded by telephone without giving rise to a disproportionate number of complaints. Nevertheless, it may be useful to provide for some legal or voluntary codification of the principles governing such sales.

Another potential problem concerns the retaining of copies of advertisements. The information provider may himself insert and subsequently withdraw material which may misleadingly induce a consumer to make a purchase. There is, however, no proof, unlike the case of a newspaper or magazine advertisement, which the consumer can produce in support of a claim of misrepresentation or misdescription.

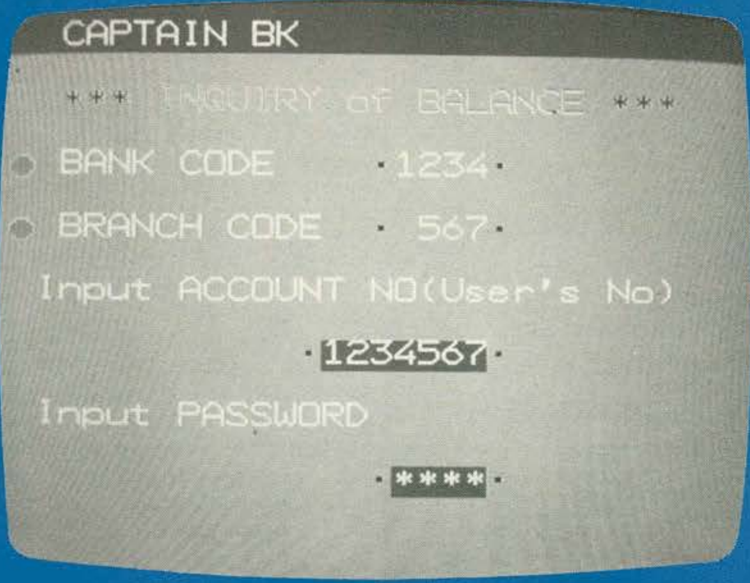
Videotex and the Printed Media

The relationship of videotex systems with the printed media may also entail certain difficulties. Although the former can be used to transmit daily news in short form, it is unlikely that they will replace traditional newspapers and magazines. They might, however, compete successfully with printed media as regards certain types of advertising (job offers, advertisements concerning real estate, cars, antiques, etc.). This is particularly important for the regional press which derives a large part of its income from small advertisements.

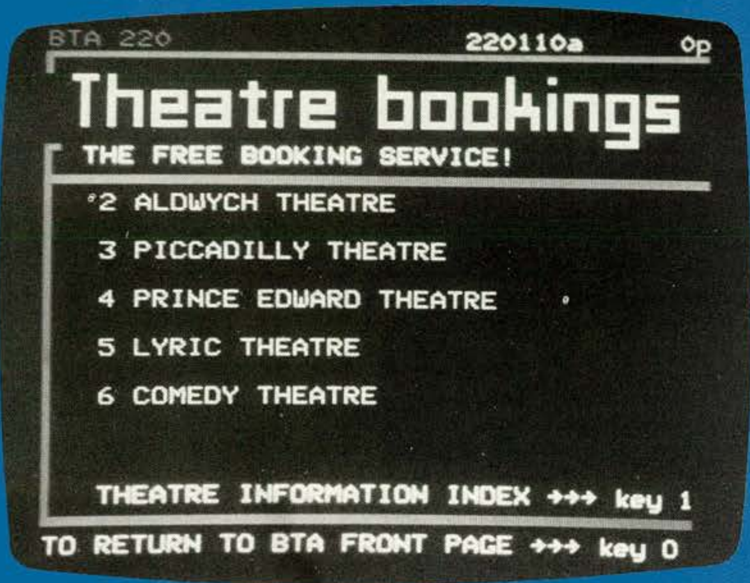
Information for young people – French TELETEL.



"Shopless shopping" and...



Bank statement – Japanese CAPTAIN.



...theatre booking – British PRESTEL.

The Impact on Competition

This is probably one of the most interesting aspects of the new information technologies but the short practical experience only allows some theoretical considerations. Some think that in spite of the free access to the system, the larger firms will dominate as information providers, whereas others hold that the relatively low cost of entry will give a fair chance to small and medium-sized enterprises to extend their market. The actual impact will probably largely depend on the products or services involved. There is however general agreement that the systems should be accessible to all types and sizes of business in order to stimulate competition for the benefit of users.

Suggestions for Action

In view of the new and specific features of interactive videotex systems and their potential impact on consumer information and marketing, the relevant authorities in Member countries should closely follow the development of such systems, in particular with regard to the following issues:

Content and reliability of consumer information

• The information should contain a clear indication as to whether it is a commercial message or not, which may on occasion be achieved by including the name of the information provider. The distinction should be manifest at least in the classification of information and in the search tree; wherever necessary, it should also be shown on each page of information.
• The information disseminated should be clear, true, as complete as possible on the subjects covered and in compliance with national regulations concerning fair advertising, marketing and trading practices. The systems should contain a sufficient amount of non-commercial information directed at consumers.
• The classification of information should be as clear as possible and the search method as simple as possible for users.
• The information carried on the medium should be kept for a reasonable time after it has been withdrawn from use or been modified to the extent required to provide a record for the use of evidence or for control purposes.

Clarification of contractual relations

• Where interactive videotex systems offer booking, ordering or payment facilities, the terms of contract and the relevant consumer protection rules (e.g. consumer credit regulations, cooling-off periods, etc.) should be clearly and concisely set out to the users.
• Complaints facilities should be established and users should be informed about the ways to use them.

Use of the system

• Consumer associations and organisations should be offered possibilities of advising on the setting up and the follow up of the systems together with the common carrier and the information providers.
• The system should contribute to a better transparency of the market, in particular by offering overviews of the market and through the comparative indication of prices of goods and services.
• The technical and financial organisation of the system should enable enterprises of all kinds and sizes, and institutions of various types, to have equal possibilities of participation in the system.
• The system should operate in full compliance with existing regulations on protection of individual privacy.
• Public authorities and public service bodies should consider using such systems to offer information of general interest in an efficient way and installing terminals in information centres open to the public, such as post offices, town halls and public libraries.
• Experiments with interactive videotex in consumer organisations or consumer advice centres or in other places to which the public has access should be made in order to assess its practical value for consumers and to acquaint them with the new technology.
• The practical value of interactive videotex systems for consumers should be closely assessed in the years to come.

Legal framework and codes of conduct

In view of the above, Member countries should examine the need for, and the possibility of, either adopting a specific legal framework or encouraging the development of guidelines or codes of conduct in close cooperation with the interested parties: the operator of the system, the information providers and the users suitably represented.

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